

Venture Capital for Rubbernex

By Tom Beauchamp

On a Saturday morning in April 1987, five good friends met in the basement of John Kleinig's house near Palo Alto, California. They saw each other frequently because they carpoled to work at the Globe Coating Company, one of the world's largest manufacturers of fine paints and varnishes. Globe had consistently surpassed other manufacturers in the development of several new products and had the industry's finest research staff. The five commuters and friends were all members of this exceptionally capable research staff, although only two were research scientists. The other three handled administration and computer records.

Kleinig was Globe's research division manager, a position he had obtained five years ago after 15 years of working with the company. He also was the clear leader of this group. Each of the other four had more than 10 years of experience with the company. They all believed Kleinig was the person most responsible for making their research division the best in the world. These five men knew virtually everything about research, administration, secret formulas, the competition, suppliers, and the general industry. Along with 13 other key people in the division, these five men had helped develop several products vital for Globe's leading position.

During their commutes, the five had ample opportunity to criticize their peers and to discuss the cumbersome and slow operation of Globe. Over a period of several months they gradually became convinced that they could conduct more advanced research on new coatings in upcoming years than their employer.

Therefore, they met on this Saturday morning to put the final touches on a business plan for which they hoped to find funding. Kleinig and another group member, Jimmy Liang, had already drafted and discussed a tentative plan.

Their idea for a new business venture centered on the strategy of constructing a plant to manufacture "thin film" coatings. These coatings are new products pioneered and marketed by Globe, which devoted 10 years of research to the development of three forms of the coating. The film coating is so thin that it is invisible to the eye and allows various forms of electrical and adhesive contact as though no coating existed. Yet it provides all the protection of traditional clear coatings. The technology has a marvelous

potential for application, from oak floors to computer parts, and yet it slashed production costs as compared with standard polyurethane coatings by 32 percent. It is the most innovative new product in the coating industry.

Between July and the end of August 1987, a friend of Kleinig's, Jay Ewing, critiqued the evolving business plan numerous times and helped Kleinig develop contacts with several venture capitalists. He also arranged for a meeting with the Los Angeles specialty law firm of Lion and Lion to provide legal counsel.

In early September Kleinig met with various venture capitalists, and a September 9, 1987, meeting proved to be the decisive one. Kleinig hit it off beautifully with a representative of a large East Coast venture capitalist, HH Ventures of Philadelphia. This representative was already convinced that thin coating promised major technological innovations in the paint and varnish industry and that the five men represented the epitome of coating knowledge. Their discussion of personnel and business plans lasted approximately two and a half hours, and both admired each other's integrity and capability by the end of the meeting. Between September 10 and 18, Kleinig and HH representatives placed 15 evening phone calls to cement the basis for an agreement between HH and what was to be Rubbernex Industries.

On September 19, 1987, Kleinig resigned from Globe. Nearing an agreement with HH Ventures, he felt that he could no longer in good conscience remain a loyal Globe employee. The other four group members did not resign at this point, since they were not holding direct discussions with HH. At his "exit interview" with his supervisor and a Globe lawyer, Kleinig encountered a hostile and intimidating environment. Globe told him in straightforward terms that if he were to put his skills to work with another company by utilizing Globe trade secrets, he would face a massive lawsuit. His supervisor told him that Globe was seriously concerned that its trade secrets and confidential business information would be misappropriated. Kleinig was asked to sign a letter that enumerated 168 broadly worded trade secrets that he could not transmit or use. He refused to sign it but assured Globe that there would be no misappropriation. His supervisors nonetheless continued to focus heavily on moral and legal questions about trade secrets.

By the conclusion of the exit interview, those present had negotiated the following tentative arrangement: In advance of taking a new job or developing any product, Kleinig would consult with his ex-supervisor at Globe to ensure that there would be no trade secret violations. He also would submit a plan to show that any market he wished to explore would not conflict with already established Globe markets. The interview participants discussed neither the nature of trade secrets nor trade secrets specific to thin film technology.

In a September 21, 1987 meeting, Kleinig, three HH representatives, and lawyers representing both signed a tentative agreement to fund Rubbernex. The contract gave Rubbernex funding for one month to allow for further

development of the business plan. HH had one month to evaluate its position with the choice of dropping its interest at the month's end or trying to reach a final agreement for major funding. The agreement included an offer of further financing after one month conditional on what is called due diligence in the venture capital industry (and elsewhere). In this context, due diligence means, in part, that HH has obligations of due care when money is given to assist in a business startup. It is a standard of proper care that requires an investigator to competently and thoroughly investigate a proposal's business viability as well as to protect against violations of the rights of all affected parties.

The September 21 meeting involved lengthy discussions about Kleinig's exit interview, about Globe's concerns for its trade secrets, and about HH's need for assurances that no trade secrets problem existed. Kleinig reassured them that he could "build thin film coatings using many different alternative chemicals and processes" and that Globe should have no basis for concern by the time Rubbernex developed the new processes. The next day, Jimmy Liang and the group's chief scientist, Jack Kemp, resigned from Globe. One week later the final two group members resigned. Globe officials told all four during their exit interviews that the company was considering a suit against Kleinig to protect its trade secrets and warned all that if they joined him, they faced the same suit. Globe officials told all four that company officials could prove Kleinig had conspired with other individuals to steal Globe's secrets as early as nine months before leaving the company. These officials would not, however, specify the trade secrets when requested by Kemp to do so.

Whether this package called a *tentative agreement* between venture capitalist HH and the five entrepreneurs would be rewritten and result in a new manufacturing company rested in the hands of Henry Hardy, the man whose massive personal fortune constitutes the venture capital that fuels HH. He had at first decided not to fund Rubbernex, based on his lawyer's explicit concern that Globe's threat of a lawsuit was not an idle one. But Mr. Hardy had left open the possibility that Globe could be mollified or that the trade secrets problem could be otherwise dispatched in an honest and forthright manner.

Mr. Hardy had personally taken charge of HH's due diligence review, which he usually leaves to subordinate officers. He first hired the best firm in New York to do reference checks on the entrepreneurs. These consultants were asked to examine both professional credentials and former or existing employment contracts. Mr. Hardy next commissioned a thorough review of the legal questions surrounding trade secrets by a specialist law firm. He also hired 12 outside consultants at American universities to review the feasibility of the entrepreneurs' scientific claims and asked in each case for an evaluation of whether the venture could be successfully launched without using Globe's trade secrets. He then requested a thorough review of the company's financial and legal position by his in-house lawyer and three of his program directors.

Furthermore, Mr. Hardy examined the enterprise's business viability by having two of his trusted consultants check the Rubbernex proposal. He commissioned a review by a Wall Street security analyst of the coating industry and held discussions with two other venture capitalists who had in the past been involved with trade secrets issues. He also asked for an appraisal by Kleinig of whether he would need further direct hires from Globe to fulfill his plan's staffing requirements.

Mr. Hardy then attempted to contact Globe executives to ask them to review the Rubbernex business plan for possible trade secrets problems. Following the course sketched out during Kleinig's exit interview, Mr. Hardy's proposal to Globe invited company engineers and chemists to spend time in any future Rubbernex manufacturing facility for observational purposes to ensure that there were no trade secrets violations. He was prepared to divulge any formulas used for thin film coatings and allow a neutral inspector to examine Rubbernex's formulas by comparison to Globe's to see if there were any violations. In their reply, Globe lawyers issued a warning that the technology of thin film coatings was proprietary to Globe and that if any venture capital was forthcoming from HH, Mr. Hardy would personally be named in a lawsuit.

This response angered Mr. Hardy. He felt that, whereas he had offered numerous concessions to Globe to ensure that there were no moral or legal violations, Globe had taken a hostile position of non-negotiation solely to prevent potential competition. At about this time, Mr. Hardy's internal and external legal advisers submitted reports that stating that with enough chemical and engineering ingenuity and sufficient venture capital to buy expensive new West German machinery, the potential existed to introduce modifications to claim a new product rather than a mere clone of the Globe product. However, his advisers judged it necessary to qualify their reports with roughly the following statement: "I cannot ensure that there will be no violation of trade secrets unless I am able to examine the trade secrets, and law and ethics prohibits me from doing so."

HH Venture's due diligence standards had consistently equaled or surpassed those of any business competitor, and Mr. Hardy could not imagine a more thorough review than he had done. But this was his first foray into the territory of a trade secrets problem, and he was perplexed by the fact that there is no way to examine whether a trade secrets violation is likely to occur. He remained uncertain of both how much ingenuity the entrepreneurs have (although in the past they have not lacked for a wealth of new ideas) and what the trade secrets are that cannot be utilized. He now realized that his consultants could not recognize the exploitation of a Globe trade secret by the entrepreneurs. Each consultant said the potential existed for the entrepreneurs to make thin film coatings through, as one recent court opinion put it, "skillful variations of general processes known to the particular trade," but no one could say for sure whether the potential would be actualized.

Mr. Hardy's legal consultants had supplied him with the standard legal definition and analysis of trade secrets, which his consultant report-sheet summarized as follows:

A trade secret consists of any formula, device, pattern, or compilation of information used in business that gives one an opportunity to obtain advantage over competitors who do not know or use it. It is not a secret of any sort, but a process or device for continuous use in the operation of the business. An exact definition of trade secrets is not possible, but there are factors that can be considered in determining whether something is a trade secret: general knowledge, employee knowledge, the adequacy of protective guarding, the value of the information, the amount of money expended in development of the secret, and ease of acquisition or duplication. An employee in possession of confidential information that could damage the economic interests of an employer if disclosed is under an obligation of confidentiality that remains in force when the employee leaves the firm and takes employment elsewhere. However, under common law it is not a breach of any obligation owed to an employer to plan for a new competitive venture while still employed, even though the employee has an opportunity to observe (what will later be) a competitor's secrets, and even though the employee may leave with a wealth of experience in and knowledge about the competitor's processes, products, research, and financial matters.

Mr. Hardy saw that this legal definition makes a sharp distinction between a company that *owns* a formula, device, or process that has been *disclosed* in confidence to one or more employees, and a company whose formula has been developed by those employees while employed at the company. In some of the more innovative industries, employees are typically instrumental in creating or advancing a formula, device, or process through their own ingenuity and skills. The greater the extent of an employee's role in creating or otherwise improving the confidential information or property, the greater the employee's apparent claim to a right to use it elsewhere, and the less an employer's right to claim sole possession. Mr. Hardy believes that the entrepreneurs who came to him for funding were, and still are, in this latter circumstance.

It therefore seemed unfair to the entrepreneurs to keep them from starting Rubbernex simply because their former employer was intimidating them. As Mr. Hardy sees it, these employees have several types of obligations to Globe: contractual obligations based on their employment contracts; a responsibility to avoid conflicts of interest such as remaining employed by the firm that will become a competitor of the firm being planned; and a duty to ensure that the new venture will use independently developed competitive technologies, thus avoiding violations of trade secrets, patents, and proprietary designs.

Although there is some disagreement and ambiguity, Mr. Hardy's reference checks and technical consultants said that these conditions have been at least minimally satisfied in this case. They all emphasized that the

law of trade secrets is amorphous, conceptually muddy, and formed from a number of different areas of law in a patchwork manner. The law attempts to foster innovation and progress without leaving firms the victims of faithless employees or placing employees in a situation of servitude. An employer has a right to his or her intellectual property, but the employee also has a right to seek gainful employment that requires the application of his or her knowledge and abilities. If employees could be prevented by intimidation from moving from one firm to another, technological growth and diffusion could be stifled.

Mr. Hardy agreed with this argument and conclusion. He favored funding the entrepreneurs although he sensed that two lengthy lawsuits were now a virtual certainty, one against the former Globe employees for misappropriation of trade secrets and the second against HH Ventures for a failure of due care. Mr. Hardy denied the latter charge because it implied that he performed an inadequate due diligence review prior to an investment. He considered this charge to be groundless.

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