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The Crocs Cautionary Tale And Instant Competition

Law360, New York (September 12, 2008) -- For startup companies, barriers to entry used to be physical — factories, distribution, mass-marketing campaigns, even skilled employees.

In the modern world of business, all of these resources can now be subcontracted and a startup no longer needs to pull together large amounts of capital for physical assets. Prototyping and manufacturing can by outsourced to any number of factories overseas.

In many cases, FedEx, UPS, DHL and the like can take the place of traditional shipping departments. The Internet can be used as the primary marketing medium and even as the main distribution channel. Consider online retailer sites like Amazon, eBay and thousands of smaller, lesser-known companies.

Thus, the cost of starting a company has never been lower.

However, in the past the same physical barriers to entry also acted as barriers to competition. Now, any new and successful product on the market should expect nearly instant competition from idea-bankrupt, me-too manufacturing companies, former employees, ex-suppliers and coattail riders.

Today intellectual property, not physical assets, is the arbiter of whether a successful startup will become a lasting company or succeed only in creating a market for low-margin copycats and pirates. Modern startups need to leverage the cost-efficiencies of the modern outsourcing climate while simultaneously using intellectual property to create a barrier to entry to competitors.

There is no better example of the perils of failing to understand these new rules than in the case of Crocs Inc., the Niwot, Colo.-based shoe manufacturer.

The New Life Cycle Of A startup

Over the course of only six years, Crocs illustrated the modern life cycle of a startup.

First, there was the big idea and a person or persons with the drive to take that idea to the next level. In the case of Crocs, it was the now-ubiquitous, brightly colored resin shoe. A round of angel funding or initial venture capital gets the startup off the ground and the personalities take it from there.

If the startup is successful, next comes the private growth phase in which the product becomes popular and sales increase dramatically. This is usually when the first knockoffs begin to appear.

In the next phase, most successful startups then take one of several paths: IPO, buyout or mature private operation.

Regardless of the path taken, the mature phase typically includes a two-pronged approach of trying to protect market share for the original product while simultaneously trying to develop new or next-generation products to replicate the success of the original.

Crocs followed this life cycle exactly, going from initial startup in 2003, through an IPO in 2006, to a mature company today buying startups with promising new products in an effort to bolster revenues due to flagging sales of its original product. This is the life cycle of a startup in a microcosm of six years.

The Modern World Of Instant Competition

As soon as a startup has a successful product, it can expect instant competition.

This can be particularly frustrating to the original entrepreneurs, as the competitors typically are doing nothing more than capitalizing on the startup's success in creating a market for a new product.

The competitors may range from me-too companies that design and market a similar product for less, to pure knockoff companies that are selling exact copies of the original under a different trademark, to pirates that are selling counterfeits. Sadly, it is not uncommon for these competitors' products to be made by the same oversees facilities that are making the original.

In Crocs' case, the instant competition was built in. Crocs was not the original manufacturer of the shoe, but rather one of many footwear companies that bought the shoe from a manufacturer that Crocs later purchased outright in 2004.

When Crocs purchased the manufacturer, it cut off sales to the other footwear companies. However, those companies immediately found suppliers willing to re-create the shoe and continued competing. The level of competition was exacerbated by Crocs' success, which led to problems meeting demand for its shoes — a situation that its competitors happily capitalized on by supplying nearly identical products to erstwhile Crocs' distributors.

Protecting Market By Creating IP As Barriers To Entry For Competitors

In this climate of instant competition, it is imperative that modern startups plan for that competition from the very beginning. There are many simple things a startup can do in each phase of the life cycle of the company to strategically create intellectual property to prevent or inhibit competitors. But the most important thing is to develop a comprehensive IP strategy early on in the life cycle of a product.

Each startup is unique and should approach its intellectual property counsel with the question, "What is the best mix of intellectual property protection for my product?"

This is a question that is larger than "Should I get a patent?" or "Should I register my trademark?" Instead, it is a question about developing the best strategy and tools for dealing with the inevitable competition that comes with success.

Such a strategy should take into account the startup's current financial realities as well as the anticipated future trajectory of the startup and its IP, as well as develop efficient ways to counter the expected competition.

A good comprehensive strategy will include a mutually supporting mix of different kinds of IP protection in order to prevent the most egregious competition.

For example, copyright registration (as opposed to common law copyrights) can be very valuable in preventing counterfeiters. Copyright registration is available to protect distinctive products, even when the product itself has been on the market for some time. The threat of a lawsuit in federal court in which statutory damages and attorneys' fees are available is a powerful tool against infringers.

Couple copyright registration, which provides protection for a very long time, with a design patent on the same product and a startup has a simple and cheap one-two punch that will slow down any counterfeiters and knockoff manufacturers.

Of course, the holy grail of IP protection is protection through utility patents. However, utility patents are expensive and hard to obtain on "big ideas." They also require significant forethought on the part of the startup — at a time when money is tight and the value of the product is unclear.

However, as the startup progresses into phase two, the early successful growth phase, many opportunities arise to obtain blocking patents that can hamstring the competition. These patents, which I call "Tier 2" patents, grow out of the experience obtained by "first movers" in an industry or market.

They are not patents on the big idea but rather patents on the subsequent little ideas that every later-coming competitor will have to deal with. These are patents on how to use the product, the best way to manufacture, package and ship the product, and next-generation improvements to the product that the consumers refuse to live without after their introduction.

Wrapping all of these pieces together is trademark protection.

Trademarks for a successful company can act as a "force multiplier" that increases the value of the company and provides for greater visibility and sales. By deliberately incorporating trademarks and trade dress into a product's design or distribution at an early stage, it may be possible for a startup to distinguish its products from any competition other than counterfeits.

In Crocs' case, they were behind the eight ball from the beginning.

By their own admission, the original Crocs shoe design was a slight modification of a pre-existing and unprotected clog design. While Crocs was able to get utility patent protection for the slight modification, the scope of that protection is apparently so narrow that Crocs has been as yet unsuccessful in preventing knockoffs via patent infringement actions.

Furthermore, as Crocs was not the original manufacturer of the shoe, Crocs was limited to using what little intellectual property there was that came with that purchase of the original shoe manufacturer — i.e., common law copyright and trade dress claims.

Regardless, it is unclear whether Crocs would have been able to register copyrights or obtain more comprehensive utility patent, design patent or trademark protection on the original shoes, their shapes and their colors if Crocs had been involved with the manufacture from the beginning.

It does seem that Crocs has learned from its early mistakes.

The company has instituted a comprehensive IP plan going forward. It has filed extensively to protect its newer designs with design patents, although it does not appear to be utilizing copyright protection for the shoe designs. Crocs is also applying its IP strategy to its new acquisitions, as evidenced by its recent $28.9 million and $27.2 million infringement awards against two Chinese knockoff manufacturers by its Jibbitz division.

An IP Strategy That's Not a Croc

The hyper-competition in today's business climate requires a special attention to intellectual property — one that designs the best mix of utility patent, design patent, trademark, copyright and trade secret protection for that product. The strategy should be implemented in the same way as any other major project — with clear goals and constant management to make sure those goals are ultimately met.

For a startup, that goal should be to stymie the competition quickly and effectively.

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