

The Intellectual Property Audit

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Intellectual property has an importance today greater than ever before. A generation ago, about 80% of a typical company's assets were tangible (buildings, equipment, and the like) and 20% were intangible, according to a study by the American Intellectual Property Law Association. By the turn of the Millennium, the relative value of tangible and intangible assets had essentially reversed so that approximately three-quarters of a typical company's assets were intangible assets.

It has become increasingly important for companies to keep track of the extent, quality, and use of their intangible assets, as well as to have processes and procedures in place to create, inventory, perfect and use intellectual property rights associated with those assets. Investors and creditors of companies must also have a reliable mechanism to determine ownership, scope and status of the intellectual property rights. Companies should also protect their business against the unauthorized use of third-party intellectual property rights to reduce risks of costly litigation. One mechanism that helps address these issues is an 'intellectual property audit'.

What is an Intellectual Property Audit?

An intellectual property audit provides an assessment of the intangible assets of a company. The audit helps to quantify the value of the intangible assets to the extent that such value depends on the legal right to those assets. The audit examines and evaluates the strengths and weaknesses in the procedures used to protect each intangible asset and secure appropriate intellectual property rights. Where necessary, the audit provides tools to develop additional processes, make improvements to existing processes, and take correcting measures to help ensure capture of future intellectual property rights. The audit also provides tools and processes to help minimize issues involving third party rights.

When an Audit Should Be Undertaken

An intellectual property audit may be appropriate in a number of situations. For example, an audit is appropriate

before a significant acquisition of a technology or product. An audit may be performed in the early stages of a technology company's formation to institute systematic procedures for protecting and perfecting intellectual property rights, particularly for core technologies. An audit may also be used at critical junctures in a company's life cycle to ensure the continuing adequacy of such procedures and to detect defects therein.

An intellectual property audit is also appropriate in conjunction with development of a major new product, particularly if such product carries with it a demonstrable risk of infringement of the intellectual property rights of others. For example, the development of a 'clone' or 'compatible' product often results in additional exposure to infringement claims. An audit may be necessary to institute, or to review the adequacy of, 'clean room' procedures used in the development of such a product to reduce the risk of infringement of third party rights.

An intellectual property audit of limited scope may be necessitated in response to a change or new development in the law. For example, a new legal decision expanding or clarifying the scope of protection afforded by an intellectual property right may necessitate review of existing products for its effect on the company's intellectual property rights as well as potential infringement of rights of others.

Scope of the Audit

The appropriate scope of the audit is often situation specific. For example, if a company is conducting an audit of its company-wide procedures for acquiring, perfecting and enforcing its intellectual property rights, an intellectual property audit of broad scope is appropriate. Audits more narrow in focus may be appropriate when, for example, a company is facing possible trademark litigation and an investigation limited to the trademark at hand may be all that is required. Narrow audits may also be confined to examination of procedures, for example, the 'clean room' procedures used to develop a new software product.

In transactions, an audit of full scope covering all intangible assets of the seller may be appropriate if a buyer is

contemplating an acquisition of a substantial ownership interest in a seller or its assets. For example, the buyer should investigate whether the seller has properly obtained copyright, patent, trademark and trade secret protection for its products, the scope of any third party rights in the seller's assets, whether the products may infringe third party rights, and whether the seller has hired employees away from its competitors under circumstances that could lead to a lawsuit.

Who Should Do the Audit?

The designation of an audit team depends on the nature and scope of the audit. A company's own personnel may have sufficient familiarity with the facts and issues involved to perform an audit. Generally, because of the inherently legal nature of an audit, a company's in-house legal counsel should be involved in the audit. In many situations, the company personnel may not have the time or expertise to perform a full-scale audit and outside counsel should be brought in to conduct the audit.

When outside counsel is used, such counsel should have experience with managing and conducting intellectual property audits to help make the process as efficient and effective as possible with minimal disruption to the company. It is also desirable for counsel to have expertise in the technology involved. Counsel should also have experience in procuring and managing intellectual property rights uncovered through the audit, as well as experience with obtaining remedies for any legal defects found in the audit. The audit team should include litigation skills, because the types of issues that an audit seeks to reveal and treat will likely be relevant if litigation materializes, for example, in an infringement suit.

Once the audit team is assembled, it should work to ensure that the results of the audit do not substantially assist any third party who may later challenge the rights that have been audited. Thus, the audit team should be constantly sensitive to the preservation of the attorney-client and work product privileges.

Audit Plan

For most intellectual property audits of substantial scope, a written audit plan should be prepared in advance. The plan should define the areas of inquiry of the audit, the scope of the inquiry, the schedule, who has responsibility for each area, and the form of expected report. The plan should also

define the documents to be reviewed and the personnel to be interviewed. The documents needed and personnel to be interviewed may not be known in detail in advance of the audit, and the plan may need to be revised after the audit is begun.

Initial Information Gathering

In virtually every case, substantial initial information will need to be gathered and presented before the auditors can efficiently begin their detailed investigation. The types of information that will be needed include:

- **Information concerning the nature of the assets.** It is often helpful for the audit team to be given a thorough demonstration of the technology and products to be audited. An overview of the history of the pertinent technology should be presented. The audit team should be given relevant product brochures, advertisements and release notes. In the case of transaction-related audits, the audit team should also be fully informed of the details of any transaction for which the audit is being performed, and should be given relevant documents such as a letter of intent, terms sheet or draft purchase or license agreement.
- **Background research.** Some initial background research before the audit begins will greatly increase efficiency downstream. For example, there may be issues peculiar to the law of a particular state or country that must be explored. The technology at issue may be so complex that background research by the auditors will be necessary, particularly if patents are at stake or if there are questions of inventorship.
- **Data gathering.** Someone at the company should be designated to coordinate the gathering of documents and information relevant to the particular subject matter of the audit, and as many documents as possible should be reviewed before the audit begins. Depending upon the scope of the audit, relevant documents may include license and maintenance agreements, distribution agreements, government contracts, federal registration and recordation documents, state commercial code filings, employee agreements, consultant agreements, materials referred to during the development process, journal articles, published papers, competitive analysis documents, and marketing files.

- **Logistics of access.** Because the audit team may need to investigate the history of a product, both active and archived files may have to be examined. Relevant documents may be located in regional or international offices of the company. Special means may be required to gain access to documentation stored on computer media. If the audit is to be conducted in secret, examination of documents may have to take place after hours or at special designated sites.

Written Report of Results of the Audit

If the circumstances are such that a written report will be privileged and not discoverable, the results of an intellectual property audit should normally be memorialized in a report. The report should discuss the development history of the technology at issue, describe and evaluate intellectual property defects uncovered in the audit, propose and describe specific remedial action that needs to be taken or that has been taken, and respond to any other specific need for information the parties commissioning the audit may have.

If the audit was conducted in the context of an acquisition transaction, the report should provide the information necessary to decide whether the rights available are the rights required by the acquiring party, and should provide a basis for valuing the rights to be acquired. Necessary remedial action can be implemented either before the transaction is consummated or after the acquisition (with appropriate adjustments in the purchase price to reflect the risks or cost of the cure).

Federal and State Filings

The audit may uncover areas of intellectual property that have not been protected by appropriate federal filings. For example, patent protection may be available for certain aspects of the technology at issue, and the costs and benefits of filing for such protection should be assessed. The company may need to file copyright and trademark registration applications, and affidavits of continued use of trademarks; the company may need to pay maintenance fees to keep issued patents in force.

The audit may reveal the need to institute systematic procedures that ensure the appropriate federal filings are made as a matter of course in a timely manner as future products are created in which intellectual property rights may vest. A patent evaluation committee may need to be

created to assess new technology for patentability and to decide in each instance whether patent applications should be filed based upon a cost/benefit analysis.

Ownership Issues

The company may need to cure defects in title to intellectual property that are discovered in the audit. Assignments of ownership from consultants may need to be secured and recorded with the appropriate federal agencies. Alternatively, quitclaim deeds may be obtained from an alleged author or inventor. An employee may have developed an invention incorporated into a company product on his or her own time, and rights to the invention may need to be secured.

The audit may reveal deficiencies in license rights from third parties to make derivative works that incorporate elements of works owned by such third parties. Without sufficient license rights, there will be a cloud on the title of the derivative work the company has created. A cloud may also be created by incorporation of publicly available works, such as Open Source code, into a software product such that the software product may have been dedicated to the public domain.

The audit may reveal third parties who may be able to claim joint ownership with the company of a patent and who, by virtue of such joint ownership, will be free to exploit the patent themselves without the permission of the company. The company may need to buy out a joint owner's rights. If the joint ownership concerns a copyright, the law will imply a duty of accounting of profits to the other joint owner from the exploitation of the joint work by the company. If the company does not wish to buy out the rights of the joint owner, a written agreement may be needed in which the joint owners agree that neither shall have a duty of accounting of profits to the other as a result of exploitation of the copyrighted work.

Potential defects discovered in patents may need to be remedied by additional disclosures to the U.S. Patent and Trademark Office, requests for reexamination or reissue of a patent, amendments to applications, or certificates of correction. Errors in copyright and trademark applications may need to be similarly corrected.

Infringement Issues

If the audit reveals potential infringement of third party rights, licenses may be sought or the product at issue may be redesigned 'around' a patent that covers the product, or technology that may be the trade secret, or copyrighted work of another may be removed or redeveloped. In transaction-

related audits, if it appears that consummation of a proposed acquisition will precipitate a lawsuit, it may be possible to obtain a partial or complete indemnification from the present owner or a third party. Purchaser control of any potential lawsuit might also be sought during the negotiations.

The audit may reveal areas of particular risk in which a ‘clean room’ development should be used to develop a new product or portion thereof. Alternatively, if clean room procedures were used and the audit reveals defects in such procedures, portions of the product may need to be redeveloped, or a detailed examination of the resulting product may need to be made to determine whether there is substantial similarity to the product of another. Missing or inadequate affidavits from the clean room participants may need to be remedied.

Other Issues

If the future value of a product depends heavily on retaining certain key personnel, some potential problems can be avoided by developing contractual or other incentives for such personnel to stay on. If the principals or key employees will not remain with the company after an acquisition, then consulting agreements, nondisclosure agreements or covenants not to compete (where enforceable) may lessen the severity of their departure. If there are important contracts preventing the assignment of key rights, it may be possible to secure the consent of all involved.

Prospective legal, marketing and research and development strategies can be designed to minimize the exposure from defects discovered in the audit. For example, if an early version of a software product is in the public domain and cannot be copyrighted, future exposure may be reduced by immediately registering later versions. Similarly, if no patent protection was sought for key areas of technology, potential protection may be available for improvements to such technology.

Conclusion

Today, an important factor for a company’s success is understanding its intangible assets. An audit provides information on the nature and strength of the intangible assets by studying the intellectual property rights associated with those assets. To help distill this information, a report produced as a result of the audit describes the development history of the intellectual property, details the areas in which protection has been compromised, evaluates the risk that must be allocated among the parties to the contemplated transaction and proposes remedial actions that can be taken to correct the defects.

As intangible rights continue to grow in importance, the intellectual property audit provides front-end information that will protect against catastrophic surprises in the future.

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