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This article appeared in the February 2009 issue of *Intellectual Property & Technology Law Journal.* Reprinted with permission.

IP and SOX: Managing Intellectual Property Assets in Accordance with Sarbanes-Oxley

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Publicly traded companies beware: Section 302 of the Sarbanes-Oxley Act (SOX) requires certified disclosures of matters that materially affect, or are likely to have a material impact on, the company value to shareholders. Intellectual property (IP) assets account for much of the total value of most companies, although such assets have traditionally been categorized as "goodwill." While the statutory language of SOX does not specify the need to include explicit IP assets in certified statements, the SEC has yet to decide if IP assets require separate disclosures. Companies typically are behind in identifying, protecting, and reporting their IP assets. A wise solution is to proactively evaluate and organize IP portfolios to prepare for the potentially tougher SEC enforcement of SOX provisions related to certified disclosures of intellectual property assets.

Applicable SOX Provisions

The disclosure requirements of SOX are codified in five sections of the Act. First, section 302 requires CEO/CFO certification of annual (10-K) and quarterly (10-Q) reports. These reports must be a fair representation of the value of the company and must not contain untrue statements or omissions of material facts. The CEO/CFO must certify responsibility for establishing, maintaining, and evaluating internal controls for the disclosure of financial information. 15 U.S.C. § 7241 (2002). Second, section 401 requires that annual and quarterly reports include all material off-balance sheet liabilities, obligations, and transactions. 15 U.S.C. § 78m. Third, section 404 states that annual reports must contain an internal control report providing an assessment of the internal controls for auditing and reporting disclosure information, including commentary on the effectiveness of such controls. 15 U.S.C. § 7262. Fourth, section 409 mandates real-time public disclosures on a "rapid and current basis" for any material changes to the financial condition or business operations of the company. 15 U.S.C. § 78m. Finally, section 906 stipulates criminal penalties for violations of the certification requirements. For knowing certification violations, fines of up to $1 million and a prison sentence of up to 10 years are possible. Willful violations of the certification requirements can result in fines up to $5 million and prison time of up to 20 years. 18 U.S.C. § 1350. SOX takes a no-nonsense approach to prevent fraud against shareholders and may impose severe criminal penalties on non-compliant CEOs and CFOs. How SOX will be applied to IP assets is, for now, a mystery. *See* Matthew Goodstein, Comment, *Sarbanes-Oxley: A Dark Cloud over Intellectual Property and Business*, 6 J. Marshall Rev. Intell. Prop. L. 272 (2007).

SOX Concerns

Although the plain language of SOX does not mention the words "intellectual property," SOX and IP intersect in three ways, each of which will be addressed in further detail. First, failure to properly identify and value IP assets would violate the disclosure requirements of sections 302 and 401 of SOX. Second, failing to establish proper internal controls for monitoring and reporting changes in IP asset values could

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violate section 404 of SOX. Finally, failure to properly value the IP assets of a company could create an unrealistic market value for that company. In this final situation, employees would be empowered to report violations of the SOX disclosure requirements and could be protected by the whistleblower protection provisions of SOX.

Since IP assets represent a very significant portion of the "intangible" value of a company, sections 302 and 404 of SOX likely requires that those assets are reported correctly. When a company fails to maintain a proper inventory of IP assets, however, it becomes impossible to assign a value to those assets. If a CFO or CEO were to neglect conducting a proper analysis of IP assets, the likely result would be a violation of the disclosure requirements. In other words, a CEO or CFO cannot properly certify the company's reports without making full disclosures of all material assets that affect the company value, including IP assets.

SOX also requires that CEOs and CFOs certify that the internal compliance procedures are adequate for reporting company assets. Thus, even if company financial disclosures are accurate, executives can still be liable for failure to implement effective internal controls. Establishing a SOX-IP compliance program requires creating a communication system between the IP and financial reporting areas to facilitate the maintenance of an up-to-date IP asset inventory, which then will allow for proper valuation of assets. In addition, establishing a system of communication between the IP and financial reporting units enables compliance with section 409 of SOX, which requires public disclosures on a "rapid and continuous basis" when material changes to a company's financial condition or business operations become evident. What this means is that certification of annual and quarterly disclosures, in compliance with SOX, requires good communication within a company.

As previously discussed, failure to properly inventory, value, and monitor company IP assets can result in the commission of a fraud against shareholders. Under the whistleblower provisions of SOX, an employee is protected from retaliation for providing information concerning any company conduct that the employee reasonably believes is a violation of federal laws relating to fraud against shareholders. 18 U.S.C. § 1514(A)(a)(1). Thus, an employee who feels that IP assets are not being properly managed or reported might consider revealing such a violation. *See Van Asdale v. Int'l Game Tech.*, 498 F. Supp. 2d 1321 (D. Nev. 2007) (protecting the whistleblower rights of in-house IP counsel to report the acquisition of valueless patents where management would profit at the expense of the company). While section 906 of SOX does not give an employee a private right of action to remedy a fraud against shareholders, the employee can act as a whistleblower without fear of reprisal. In the case of an employee-shareholder, his or her stake in a proper valuation of the company could be profound. Whistleblowers, however, must be careful not to act on insider information (e.g., under- or over-valuation of assets) if they are shareholders, because such activity can violate insider trading laws.

Valuation of IP Assets

While the SEC has addressed neither the importance of nor the best methods for valuing intangible assets, the Financial Accounting Standards Board (FASB) statements 141 and 142 identify some requirements for valuing intangible assets such as IP assets during M&A transactions. *See* FASB Statement No. 141, *Business Combinations* (Issued 6/2001, revised 12/2007); FASB Statement No. 142, *Goodwill and Other Intangible Assets* (Issued 6/2001). Although the statements do not directly address SOX compliance, they provide helpful guidance for future compliance with any IP asset-related disclosures under SOX. *See* Karen Balmer, *The Impact of FAS 141, FAS 142 and Sarbanes-Oxley on Financial Reporting for Intellectual Property*, 1439 PLI/Corp 711 (PLI Corp. L. and Prac., Course Handbook Ser. No. 3367, 2004). Specifically, the statements require a company to measure and report the financial performance of acquired intangible assets. Additionally, the statements require that intangible assets, such as IP assets, cannot be accounted for as "goodwill." It is likely that the SEC will

adopt much of this reasoning and will likewise require assets that have been traditionally lumped into the category of “goodwill” to be individually identified and valued in other company financial statements.

Assigning value to IP assets is not a simple task, but is an essential process to SOX compliance. Traditional valuation of IP assets involves considering both litigation and transaction activities. Using these valuation methods, IP assets could be assigned values based on revenue or loss from infringement damages, from the value or price of IP assets that are bought or sold, or from either licensing fees or royalty revenues associated with IP assets. These valuation methods, however, do not capture the value added to a company from developing, exploiting, maintaining, or simply holding IP assets.

Modern valuation methods for IP assets consider other factors, including cost, income, and market values. Costs can include development cost or replacement cost for an IP asset. Income valuation considers the historic, present, and future values expected from cash flows associated with an IP asset. Market valuation can include the price that a third party might pay to acquire a similar IP asset. These factors must be considered in combination when assigning value to an IP asset, and certain factors will be more relevant to certain types of IP assets than others. Jody Bishop, *The Challenge of Valuing Intellectual Property Assets*, 1 Nw. J. Tech & Intell. Prop. 59, 64 (2003). Valuation of IP assets is clearly a speculative process. Therefore, IP asset valuation is likely to receive considerable scrutiny from the SEC, since such valuation judgments can greatly affect the value of a company.

Avoiding SOX-IP Violations: Best Practices for Conducting an IP Asset Audit

SOX compliance likely requires that IP assets be reported accurately in company financial statements, even if the SOX-IP issue has not been resolved by the courts or the SEC. In the face of this uncertainty, the good news is that a company can avoid the potential of future SOX-IP violations by instituting a program now to account for IP assets. Additionally, IP audits can help a company maximize the value associated with IP assets and further identify any weaknesses where the company value might be increased through better IP protection. There are several steps that can be considered best practices for evaluating IP assets. Given the potential time that will be required to implement these steps, it would be best for a company to begin addressing compliance issues before the SEC decides to implement stricter certification disclosure requirements that relate directly to IP assets.

The first step is to establish communication between management and employees. Personnel must become aware of what constitutes an IP asset. All companies have IP assets, including patents, trademarks, copyrights, trade secrets, business know-how, customer lists, and brands. Only after employees become aware of this broad definition will it be possible to begin IP asset evaluation.

The second step is to assemble an IP audit team, including both in-house and outside IP counsel. To the extent that results of an IP audit should be protected from discovery, it might be advisable to have outside counsel heavily involved in the process. Management representatives, who have the power to implement company policies; technology personnel or department heads, who are likely the most familiar with the company IP assets; and an outside auditor, who is familiar with IP asset audits and SOX compliance, will give an extra layer of protection to the company.

Next, IP assets are inventoried. For patent assets, collect both patents and patent applications along with all related licensing agreements. For copyrights, compile copyright registrations along with licensing agreements. Additionally, other works of authorship must be collected and evaluated for both authorship and potential registration. Trademark, trade name, trade dress, and brand names should be collected along with their corresponding registrations. The marks should be identified by a corresponding product or service, the date of first use, and potential for continued use in commerce. Additionally, trademark licensing agreements should be collected along with associated quality control provisions. Trade secrets

and corporate know-how must be compiled into lists. Corporate secrets must be further labeled with an estimate of useful life, the products and services associated with the secret, protective efforts in use to maintain secrecy, a list of employees that know the secret, and potential competitive advantages obtained from the secret.

The fourth step is valuation of IP assets. Each individual asset must be assigned a value. *See* Kenneth Hautman, *Intellectual Property and the Sarbanes-Oxley Act: Steps for Implementing IP Best Practices*, 106 Intell. Prop. Couns. Art. II (2005); John Hutchins, *The Corporation's Valuable Assets: IP Rights Under SOX*, 859 PLI/Pat 289 (PLI Pat., Copyrights, Trademarks, and Lit. Prop., Course Handbook Ser. No. 8858, 2006); Russ Banham, *Valuing IP Post-Sarbanes-Oxley: It's No Longer a Matter of Making a Best Estimate*, J. Acct. (Nov. 2005), *available at* http://www.aicpa.org/pubs/jofa/nov2005/banham.htm. Since the method of valuation will vary considerably based on the type of IP asset involved, it is not practical to give a list of best valuation methods. Instead, here are two valuation examples.

Example one involves a patented drug that is FDA-approved and has been selling on the market for several years. Valuation would be the sum value obtained from the following steps: (1) establishing the development cost of the drug; (2) identifying the historic revenue derived from sales; (3) projecting future revenue for continued sales based on the duration of the patent; (4) detailing financial aspects of any licensing agreements.

Example two is for a secret formulation used to make a commercially viable soft drink. Valuation would be the sum value of the: (1) historical cost for formulation development; (2) costs of keeping the secret; (3) historical revenue; (4) projected revenue; and (5) licensing expenses or revenues. As can been seen from these examples, other IP assets would be individually valued using similar methods.

The fifth step is to establish an internal system for monitoring changes in IP asset holdings and values. Additionally, a method to report this information would be designed. Essential to this process are quarterly internal updates and yearly external audits. Routine internal controls also should include establishing an IP liaison for each department to track changes to intangible asset holdings. The liaisons would report directly to the financial unit where the IP assets could next be valued. The CEO/CFO is then updated with the asset inventory and valuation report to facilitate the required SOX disclosures. Additionally, by creating routine internal reporting, a company can readily comply with the reporting requirements for sudden changes in company valuation.

Practical Considerations for Companies

While SOX does not directly address the issue of reporting IP assets, it is likely that SOX was designed to cover the full disclosure of IP assets in certified company statements. Indeed, the legislative history of SOX suggests the protection of and respect for IP assets are key elements to reduce white-collar crime. *Penalties for White Collar Crime: Hearings on Sarbanes-Oxley Act of 2002 Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 107th Cong. 59, 174-76 (2002) (statement of Sen. Grassley & remarks of Prof. Thomas Donaldson, The Wharton School, Univ. of Penn.).

For now, the legal issues relating to the convergence of SOX and IP have not been addressed by the courts. Similarly, the SEC has yet to address the reporting requirements for IP assets. Nonetheless, companies should take every effort to be in compliance with both the present and potential future certified disclosure requirements of SOX. Given the level of complexity involved in properly reporting IP assets in company financial statements, it is wise to begin conducting IP audits and designing IP asset management systems now, since these practices will likely become mandatory under SOX.