Public Company Intellectual Property Compliance

Intellectual Property

CHEAT SHEET

- ***New territory.*** The dramatic rise in the importance of intellectual property has led to a growing need to disclose financial statements to meet global rules and regulations.
- ***Compliance importance.*** It is vital that in-house counsel act in accordance with the Sarbanes-Oakley Act to ensure that the exact monetary value of a client's intellectual property holds.
- ***Client watching.*** Ensuring that your client is compliant and diligent with intellectual property laws is an essential step to strengthening the value of intellectual property.
- ***Naked licensing.*** It is the responsibility of in-house counsel to police the protection of their client's trademark against looming competitors.

Intellectual property is one of a public company's most valuable, yet potentially most volatile assets. As a material and valuable asset class to your client, it is critical that in-house counsel ensure that it is legally protected, correctly reported, and maintained. This is extremely challenging. It is particularly so in an ever-changing web and social media driven environment where global brands and products can find fortune one day, and be on the defensive the next. For publicly traded companies on a global scale, your role as in-house counsel becomes even more involved. Laws and regulations are blurring, overlapping, and requiring heightened coordination between the accountant and counsel roles when it comes to intellectual property maintenance and reporting. The lack of consistent international norms, and the presence of distinct legal requirements for maintaining and reporting intellectual property in different countries, continues to challenge global counsel. This requires a skilled set of hands in ensuring that country-by-country legal requirements are met, while developing and implementing a highly efficient overall global portfolio strategy.

As the web and related IT developments have accelerated in importance over the last two decades, intellectual property has become a larger and larger percentage of total corporate assets. Current estimates suggest that intellectual property constitutes between 25 to 50 percent of the balance sheet of many companies, totaling trillions of dollars of the asset values of public markets. The value of brands, necessarily linked to the goodwill of a company by law and accounting practice, are one of, if not the most, important element of this growth in intellectual property value.

Considering its tremendous value, it is in the best financial interest of all companies to ensure their brands and other intellectual property assets are well documented, strongly protected, correctly valued, adequately policed, systematically enforced, and statutorily maintained by compliant legal practices. Fiduciary duties of all companies require officers and directors to ensure that corporate assets are adequately maintained, protected, and not allowed to turn to "wastage." As a result, they are also required to comply with federal and state law to maintain and account for such assets. Additionally, best corporate compliance practices dictate that beyond fiduciary duty, your client company have in place systems that ensure such assets are addressed in a manner that allows them to be stable or grow in value.

Since the passage of the Sarbanes-Oxley Act, however, this is even more important for US publicly traded company in-house counsel. This is because their clients are required by law to account for their intellectual property assets in periodic filings with the SEC. These filings are required by law to be true, correct, and backed up by replicable systems that render them compliant. Before those of you that are not public company in-house counsel turn the page, take into consideration that the "exit strategy" of many private companies is acquisition or merger. There is no "safe harbor time" for a private company to be acquired or merged and not be compliant with the law. Accordingly, private company counsel who are advising their clients regarding merging with or being acquired by a public company must be mindful of their client's intellectual property and systems such that they can be readily merged and conformed with those public company requirements. For public companies listed on exchanges outside of the United States, it is similarly critical that intellectual property be properly identified, catalogued, managed, and valued. While specific statutory requirements may differ from country to country and exchange to exchange, the same fundamental practice and consequential reporting considerations for intellectual property assets apply.

Outlined below are sections of Sarbanes-Oxley that affect intellectual property and five steps that a company should follow to ensure it is Sarbanes-Oxley compliant with regard to intellectual property.

Sections of Sarbanes-Oxley that affect intellectual property

Sarbanes-Oxley has five sections particularly relevant to a public company's intellectual property management and accounting practices. They are as follows:

1. **Sarbanes-Oxley Section 302** requires a corporation's signing officers (the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions) to certify the accuracy of financial reports. They must certify that disclosure and internal controls and systems, which have been designed to ensure that relevant material information are in place and have been made known to them. They must also ensure that such systems and controls have been reviewed for efficacy.
2. **Sarbanes-Oxley Section 401** requires that financial statements include all material off balance sheet transactions, arrangements, and obligations. These must also include contingent obligations. Such reported transactions, arrangements and obligations should be those that may have a material effect on the public company's financial condition, changes in financial condition, liquidity, or significant portions of expenses or revenue.
3. **Sarbanes-Oxley Section 404** requires that annual reports contain a declaration of internal control on financial reporting. Such a declaration should state that it is the responsibility of management and the external auditor to establish and maintain internal control structures and procedures for financial reporting. They must provide a review of the effectiveness of said structure and procedure.
4. **Sarbanes-Oxley Section 409** requires that publicly traded companies report material changes in the financial conditions or operations of the company. This reporting needs to be done on a "rapid and current basis." The SEC adopted amendments in 2004. These amendments expand the categories of events that require a Form 8-K filing. They also set out that such reports must be filed no later than four days following the reportable event.
5. **Sarbanes-Oxley Section 906** establishes criminal penalties for the failure of corporate officers to adequately certify the content of such periodic reports. The penalties imposed are not trivial in nature. Corporate officers who certify any statement knowing that the statement does not comply are subject to a fine of up to US$1 million. They may also be imprisoned for up to 10 years, or both penalties may be imposed.

None of these sections outline specific rules with regard to intellectual property. It is the overall purpose, however, of Sarbanes-Oxley to require more precise and comprehensive accounting and reporting. This includes all of a company's assets impacting company earnings, and material assets in particular. Intellectual property is frequently such a material asset class.

It is now well accepted that a company's overall value is increasingly related to the value of its intellectual property. Accordingly, your client's officers cannot truthfully certify that the financial reports fairly represent your company's financial condition without knowing the dollar value of its intellectual property. In order to know and correctly assess the value of its intellectual property, a company must first know the intangible assets it holds, as well as its legal status. This is also important due to accounting requirements for public company audits. Financial Accounting Standards Board "FASB" Statement no. 141 relating to intangible asset identification for a corporate acquisition, and FASB Statement no. 142 relating to annual intangible asset fair value measurement, both require companies to measure and report on acquired intangible asset financial performance.

Similarly, your client company officers cannot truthfully certify that your company has adequate internal controls in terms of financial reports unless there is clear and regular communication between those who are involved in creating, using, policing, enforcing, and maintaining the company's intellectual property and those responsible for financial reporting. This requires a new level of communication between in-house counsel and your accounting and financial professionals internally. It also requires a new level of understanding regarding what is required to maintain the legal strength of intellectual property assets, as well as tracking and accounting for their status.

Considering that your client's officers may face criminal penalties if the statements they certify are deemed to be materially false, it is extremely important for companies to take the necessary steps of ensuring their filings are Sarbanes-Oxley compliant. Following the steps outlined below will help ensure your client is compliant with regard to its intellectual property assets.

Steps to follow to ensure your company is Sarbanes-Oxley compliant for IP Asset Valuation

The Sarbanes-Oxley Act clearly affects intangible assets, but the specific requirements with regard to intellectual property assets have not yet been fully defined in detail by the act, the courts, or the SEC. Although the precise requirements under the act may still be open to interpretation, disclosure and controls are still required and the penalties for non-compliance are quite stringent, as noted above. Fiduciary duties, however, are clear. Intellectual property is subject to the same laws in this regard as other material assets. This is particularly true for those associated with avoiding wastage, reduction in value, and proper maintenance.

The Sarbanes-Oxley Compliance Journal recommends the following five intellectual property best practices be implemented by all public companies:

1. Inventory IP assets

A company's intellectual property assets are like other assets. To be effective, an inventory of such assets is required to be undertaken. This is a necessary first step before the company can accurately assess how those assets contribute to the financial performance of a company. At a minimum, the areas to be examined include: (1) patents issued and pending; (2) inventions captured as trade secrets; (3) works of authorship, such as advertising, videos, manuals, websites, marketing material, creative works, and software; (4) business processes and trade secrets that are not inventions (particularly given the new US Federal law on trade secret protection); and (5) logos, trade dress, design marks, word-based trademarks, and service marks. All of these categories reviewed above need to be inventoried domestically and internationally.

2. Determine the value of each IP asset inventoried

Once the intellectual property assets have been inventoried, it must then be determined how important each of these individual IP assets is to the financial performance of your client. Such assets can be categorized in as simple a manner as "essential," "useful," "minimally useful," "to be abandoned," etc. Once it is determined which assets are most and materially important to your client, there can be an assessment undertaken. That assessment should be of how well those assets have been identified, protected, policed, enforced, and maintained from a best practices intellectual property perspective.

3. Establish an IP protection plan

The value of intellectual property is created or lost depending on how well it is protected, policed, enforced, and maintained. Accordingly, it is imperative that public companies establish a systematic plan for protecting their intellectual property. The level of effort and resources directed to such plan should be dependent on the value of the IP asset portfolio to the business of the company. For brands and copyright, adequate protection necessarily includes regular policing, enforcement, maintenance, and active monitoring of any prospective or actual erosion of rights.

At a minimum, a docket, or intellectual property management system, should be established to monitor upcoming deadlines for all intellectual property assets. Adequate clearance checks should be conducted before using a new brand or trademark to avoid infringement, as well as obtaining a written opinion of counsel to avoid potential treble damages claims. National and international registrations should be sought for all key intellectual property assets at use in business units. The same should be true for corresponding domain names.

These assets need to match the geographical and jurisdictional areas in which your client is actually doing business. Companies should also engage a watching service. That service should regularly and systematically police and monitor for infringement for all your client's material intellectual property assets, at a minimum, and all of its intellectual property assets as a best practice. These need to be undertaken in all of the jurisdictions where your client does business to avoid or diminish the risk of potential loss of rights. This is particularly important after an acquisition or merger to ensure that value in the continuity and contemplated growth of the acquired business is not lost.

Duty to police and the Lanham Act

In the case of maintaining trademarks for your client, in-house counsel need to be aware of the affirmative obligations to police and defend. The federal trademark law, codified in the Lanham Act, does not explicitly state that trademark owners have a duty to police their marks against infringement. However, the federal courts have interpreted the Lanham Act to carry such an affirmative duty. A common defense to claims of trademark infringement is the trademark owner has engaged in naked licensing or use, and effectively abandoned the mark. This is frequently as a result of a lack of policing, and lack of the subsequent enforcement of rights in its brands.

The courts have derived the naked licensing doctrine from two key provisions in the Lanham Act. 15 U.S.C. § 1125(b)(2) provides that abandonment is a defense to infringement against an incontestable mark. 15 U.S.C. § 1127 defines a mark to be abandoned "when any course of conduct of the owner, including acts of omission as well as commission, causes the mark to become the generic name for the goods or services on or in connection with which it is used or otherwise to lose its significant as a mark." Such loss of rights frequently occurs well before the USPTO cancels a mark, as many marks can be constructively abandoned through lack of policing well before the USPTO may become aware of the issue. This duty to police also extends to an affirmative duty to police licensees (those that use the mark with consent) and to adequately control how licensees use the licensor's mark. Internationally, other countries have similar laws and requirements in many jurisdictions.

There are many degrees between having a "strong" mark and one that is deemed to be generic. A failure to adequately police, and enforce, a mark frequently leads to "dilution," where other parties use the same or similar marks for non-identical goods and services. They may also file applications with the government in other classes of trademark use and therefore restrict the rights of expansion that a mark owner may have otherwise had. Lastly, they may allow infringers to continue to use marks substantially similar to, or identical to, your client's mark. In the first instance this restricts your client's geographic use of the mark, and can eventually lead to the mark becoming generic or further severely limited in its use. All of the above creates a loss of asset value. Such loss in value can, in the final instance, become total in nature for a brand. At this point, the brand fails to function legally to hold goodwill and the asset value of such brand is completely impaired and considered "abandoned."

It is your responsibility as in-house counsel to ensure that trademarks of your client do not inadvertently fall into legal weakness, unenforceability, or become abandoned. It is also your responsibility to ensure that the true and correct legal picture of such assets is correctly detailed to the CFO and their team for accounting and public reporting purposes. If your clients' trademarks become impaired in some fashion, such conversations may not be easy ones. They can be avoided completely by your proactive management of intellectual property for your client.

Copyright abandonment

The Federal Copyright law also contains affirmative obligations for your client to police and defend intellectual property. An affirmative defense to a claim of copyright infringement is that the copyright owner has abandoned their rights in the copyrighted material or work. Copyright abandonment "must be manifested by some overt act indicative of a purpose to surrender the rights and allow the public to copy."[1] While there is no bright line test for copyright abandonment, best practice is to actively enforce your copyright so as to avoid the risk of a finding of abandonment. Inactivity is not a defense.

1 *Hampton v. Paramount Pictures Corp.*, 2797 F.2d 100, 104, cert. denied, 364 U.S. 882, 81 S. Ct. 170, 5 L. Ed. 2d 103 (1960).

Many companies fail to police their copyrights at all, particularly on the web. As a result other companies can "pass off " themselves as being associated with the copyright owner or otherwise misuse the copyright. This not only erodes copyright value, but can put the copyright owner at risk of false or misleading advertising, fraud, and counterfeiting damage. Frequently, third parties misusing a company's brands also misuse their copyrights. Again, your efforts as in-house counsel to set up systems to address these issues in advance will avoid challenging reporting situations under Sarbanes-Oxley and fiduciary obligations arising as an officer of the company.

4. Implement the plan and monitor compliance

Once the Intellectual Property Protection Plan has been established, including assignment of specific responsibilities, it must be executed. This requires education of your client's stakeholders associated with intellectual property protection and management inside and outside your client company. Auditors and outside intellectual property counsel should be included in what you are doing at the appropriate times. After the initial implementation, you will need to monitor compliance and undertake periodic maintenance audits. There needs to be a system in place to capture and assess any change in the value of an intellectual property asset that will affect the financial status of the company. This will necessarily include an acquisition of new intellectual property. It will also include the loss, or material erosion of value of an important intellectual property asset.

5. Establish internal procedures to ensure changes to IP assets are reported

Companies must ensure not only that any material change in the value of intellectual property assets is measured, obtained, assessed, and such conclusions audited, but also that there is a procedure to ensure that this information is communicated to the company's management. Such management must include the reporting officers under Sarbanes-Oxley, such as the CEO and the CFO. Ultimately they are charged with overseeing compliance with the act and SEC reporting requirements, but as in-house counsel they will be looking to you for advice, guidance, and to ensure compliance in the legal realm.

Conclusion

Your clients face real challenges in properly accounting for and reporting intellectual property assets correctly and accurately. Your job as in-house counsel in setting up and actively monitoring intellectual property management systems is a critical aspect of your clients meeting their obligations under law. While the business judgment rule may provide corporate officers with a wide discretion over what intellectual property assets to maintain and those to abandon, it does not provide legal cover for failure to act, mistakes, or express omission. Given the strict requirements and harsh penalties established by the Sarbanes-Oxley Act, it is extremely important that public companies and their officers are compliant with the act. For those private companies that wish to have the option of a public company exit strategy, the time to become proactive regarding compliance is now.

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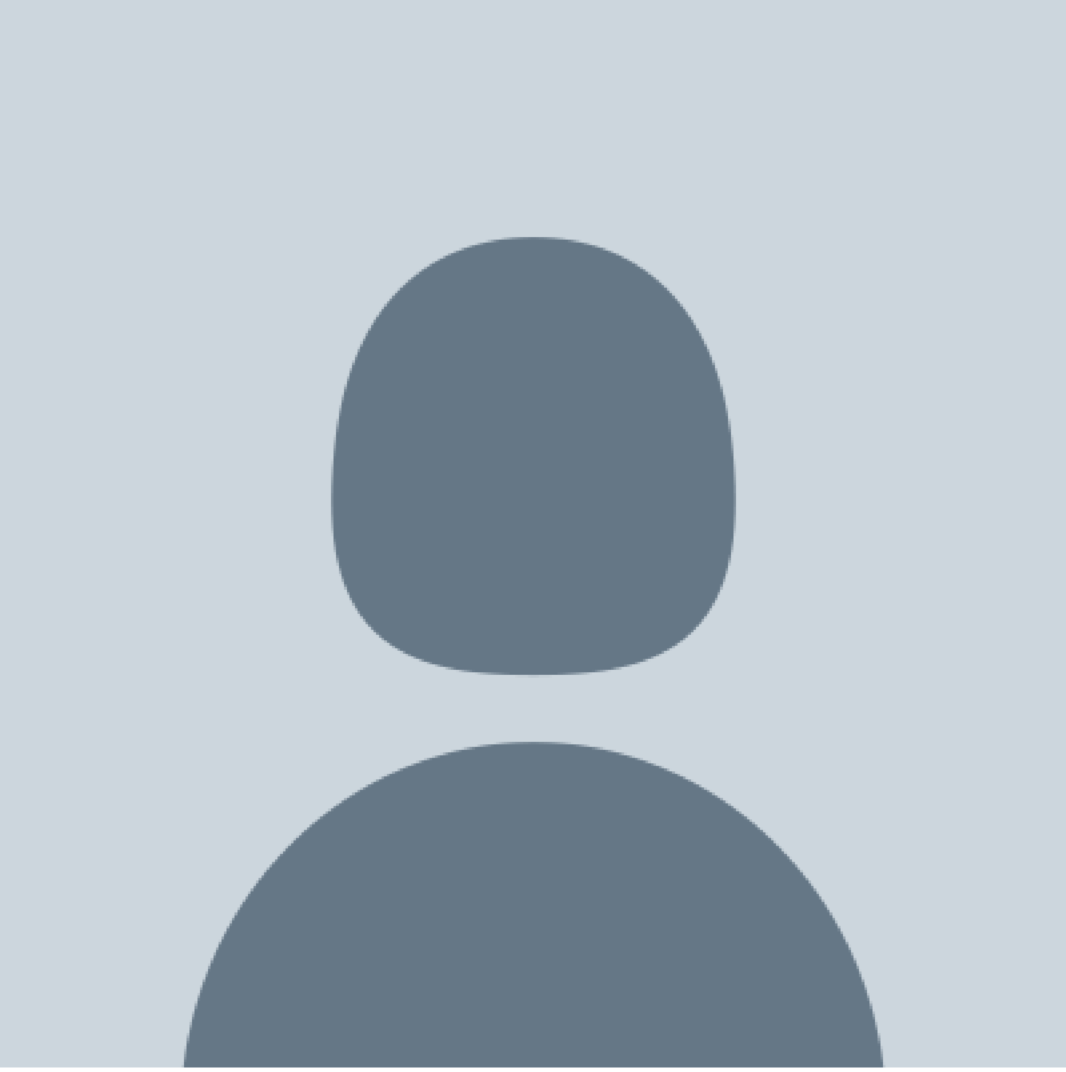

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