Compliance Can be Catalyst for a Smart IP Strategy

You Have to Pay for It, So Get Your Money's Worth

By Scott Locke and David Kalow

Intellectual property now represents the greater share of the value of most companies. Accordingly, the investment community has grown to appreciate the fact that evaluating a company requires a thorough understanding of its intellectual property.

This is often a complex, expensive and uncertain undertaking. It can be very difficult to obtain information about the true value of IP assets. Some information remains shrouded behind the attorney-client privilege, while some is simply not publicly accessible. Compounding the problem, the IP landscape of new technologies—from universities, competitors, suppliers, customers and individuals—is in constant flux.

These hurdles can leave potential investors or acquirers with no choice but to rely, at least in part, on a company's own description of its IP assets. This lack of independent verification can create difficulties when shareholders or other investors challenge company decisions or company-provided information. The risks for an investor who relies on company information have long been understood, but the stakes are raised when the information involves intellectual property.

In view of these developments, we believe both the company and investors will benefit if disclosure requirement are regarded not as obligations to be dispensed with, but as instructions meant to clarify and increase the reliability of information on which both depend.

To take one example, Sarbanes Oxley ("SOX") mandates that IP information must be disclosed to the SEC. SOX also addresses the company's process for reviewing IP-related issues. Officers must certify that they have satisfactory procedures for analyzing IP issues, and that their SEC submissions do not contain material misstatements or omissions.

It's clear that under SOX, IP-related information as well as the process for generating it needs to be disclosed. The details, however, are still the subject of debate.

We suggest that companies that are tempted to do only the minimum to avoid SOX liability should instead seize the day and consider the law's requirements as an opportunity. With only an incremental amount of additional effort, these requirements can become a vehicle to develop IP strategies that will increase business value and enhance employee creativity.

Those motivated more by stick than carrot should note the recent painful lessons of NVE Corporation

with regard to IP-related decisions that were second-guessed. Earlier this year, at least five class action lawsuits were brought against NVE for alleged IP misrepresentations in press releases.

These cases are at an early stage and their results unknown, but the fact they were brought at all is a reminder that touting one's intellectual property is not mere harmless puffery. It can subject the company to close examination, attack, and potential liability.

At the same time, silence regarding a company's IP position, at least for those regulated under SOX, is not an option. Material information related to intellectual property must be disclosed.

The NVE cases underscore the importance of both IP-disclosure obligations and the need for appropriate internal procedures for managing the issue.

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LIABILITY FOR POOR DECISIONS

Shareholders may challenge companies with respect to intellectual property issues in at least two-and-a-half significant ways: (1) by looking at decisions made (what is done and not done), (2) by looking at disclosure of decisions or events (what is said and not said), and (2.5) looking at the adequacy of policies and procedures for decision-making and proper disclosure.

Shareholders may question a corporation's decision with respect to obtaining, enforcing or licensing its own rights, or with respect to ignoring, challenging or obtaining a license to the rights of a third party. As with any corporate decision, the threshold issue will be whether the action or inaction satisfies the business-judgment rule.

But SOX goes further than that. It suggests that judgments may be challenged with respect not only to substantive decisions, but also with respect to decisions to adopt and/or follow the processes that led to those substantive decisions.

The business-judgment rule offers substantial protection, but is applicable only if a degree of judgment is actually exercised.

Thus, if a company fails to apply for patent protection on an important invention, it may be protected from a derivative suit if it can be demonstrated that the company considered making the application, but then concluded the technology would not become commercially valuable during the life of a patent.

But if the company had no process for evaluating inventions to determine whether patent protection should be sought (or if it failed to employ a reasonable process in a particular case) then it failed to exercise proper judgment and might not be protected by the business-judgment rule.

For example, in a case known as "In re RSA, Security, Inc. Derivative Litigation," it was alleged that failure to file European patent applications for the company's core technology brought down the company's stock price and constituted breach of fiduciary duty.

The case was settled, reportedly for seven figures, so ultimate liability was not determined. Nevertheless, this case tells us that attorneys who represent shareholders in derivative lawsuits are keeping their eyes open for potential mismanagement of intellectual property.

One can imagine many other situations that would precipitate charges of intellectual property mismanagement, but whether a court actually will find violations of SOX or failure to exercise business-judgment will depend on more than just a finding of a bad strategy or a decision that turned out badly.

For example, bet-the-company litigation may result in an extended period of uncertainty, effectively giving competitors an opportunity to grow. So even if the litigation is eventually won or settled, shareholders may seek to attack a company (such as BlackBerry) for not settling years earlier, or (as in the SONY case) for implementing the ill-received "root kit" copy protection.

LIABILITY FOR FALSE OR MISLEADING STATEMENTS

Shareholders may choose to question a company's representations or omissions, which could be in a press release or other marketing materials, and/or (for publicly-traded companies) in required 10K, 10Q, 8K or other required SEC filings.

With respect to press releases, it's common for public companies to announce what seems to be genuinely good news, like the issuance of a patent, signing of a license, formation of an alliance or joint venture, or successful completion of litigation.

But marketing departments, consistent with their job mandates, often try to put a positive spin on bad news. When an adverse financial event (such as depression of a stock price) later occurs, shareholders begin to question both the accuracy of the positive statements and

the intent of the company in making them.

Alleged false and misleading statements in press releases form the basis for the class action suits brought against NVE. Among the allegations are that the corporation made false and material misrepresentations with respect to the economic feasibility of developing and selling technology outside of a niche market, and with respect to the willingness of companies to license IP for technology that was not economically feasible.

Other allegations include that the company concealed the fact that a licensee did not use NVE's technology, and thus would not need to pay licensing fees; that NVE's patents were immaterial and unenforceable; that announcing receipt of a relatively inconsequential patent was timed to affect share price; that NVE did not invent a certain technology; and that a certain license lacked commercial significance.

Revisit procedures and communication channels between the legal department and the marketing department, to ensure that accurate information is being transmitted.

LESSONS IN POLICY AND PROCEDURE

There are lessons from NVE's predicament, regardless of who ultimately prevails in the lawsuit. Among them is that companies need to revisit procedures and communication channels between the legal and marketing departments, to ensure that accurate information is being transmitted, and they need to bring into the process personnel who are senior enough to keep it on track.

While SOX does not dictate any particular decision-making procedure, it does make clear that there must be some system, first for analyzing and controlling intellectual property issues, and then reporting to management personnel who will make the requisite certifications.

But within a wide range – so long as a company adopts some procedures and acts rationally within them – the company likely will receive business-judgment protection, even if more extensive or expensive steps are possible. (After all, it was always possible to do more or decide differently.)

In any case, in light of the potential liability either for breach of fiduciary duty or for making a fraudulent statement to the press or SEC, intellectual property issues simply must be systematically addressed. It's clear that a proper system can serve as a shield from certain forms of SOX liability, but equally important, it can help create opportunities for using intellectual property as a sword, for business growth.

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Because publicly-held corporations are so diverse, it's not possible to formulate a one-size-fits-all intellectual property plan. It must be tailored to the company. That task may seem overwhelming, and if so a company might be tempted to skip it altogether. That definitely is not advisable.

For starters, there are a few basic steps that would go a long way toward defending against charges of improper management, and in the meantime will increase company value.

- **Form an intellectual property committee.** It should be comprised of representatives from legal, R&D, sales and marketing departments. Inventory the company's intellectual property, including patents, copyrights, trade secrets, and trademarks. Include licenses (in and out), litigations as well as inventions, and authored works that have been started but not completed. Include works not yet begun if they will be commenced in the near future. Also include a summary of processes for soliciting creative work from employees. This should provide ample time to perfect associated rights and specify employee obligations with respect to ownership of intellectual property they create.

- **Set an initial budget.** Take into consideration current costs for maintaining rights presently held, and future expenses for one year. Include government fees, attorney time and the cost incurred by this task's causing distraction from other activities.

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• **Look outside your walls to prepare a "landscape analysis."** Include what you license in and what you license out. Audit to determine whether you are receiving all royalties due, whether you have made appropriate payments of royalties owed, and whether you are needlessly paying royalties for technologies or other rights that you do not use or need.

Survey the competitive landscape, including what your customers, suppliers and academics are doing. This will help you to determine what is "white space" (technology areas in which no one else is working), whether someone is using your rights without your authorization, and whether you should consider affirmative action to prevent others from obtaining rights (for example, through patent reexaminations or trademark oppositions).

This analysis will also help to determine what you need to license in and what you can license out.

• **Formulate a plan.** Once you know your needs, priorities and budget, you can form a defensible plan that will add value. Summarize in a memo for management. (Remember, however, the memo itself may be subject to discovery during litigation.) Then act on your plan.

For example, file patent applications, license technologies, litigate, and conduct freedom-to-operate analyses. Finally, schedule your next review, replan and re-budget intellectual property issues. Reviews generally should occur two to four times per year.

Increasingly, public companies will be scrutinized over their management of intellectual property issues, as well as how they describe them to the public and the SEC. Companies that don't have procedures for addressing these issues may find themselves subjected to liability or attack for failing to act, for missing opportunities, for misrepresenting information to the public, or simply for not having the procedures to make appropriate determinations in these areas.

The best defense is to be able to demonstrate active acquisition and use of intellectual property assets and active awareness of competitors' positions. Having garnered the proper information, the company will have a strong defense to charges of impropriety, at the same time it will be well positioned to maximize the potential of its intellectual property.

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