


Reprinted from

CORPORATE COMPLIANCE INSIGHTS

July 15, 2013

www.CorporateComplianceInsights.com

IP AUDITS: WHAT ARE THEY? WHY ARE THEY IMPORTANT? WHAT DO THEY COST?

By: *Clifton E. McCann* | *Thompson Hine LLP*



About the Author

Clifton E. McCann is a partner in Thompson Hine LLP's Intellectual Property practice group. A patent attorney with more than 30 years of experience and a technical background in chemistry, biotech, and physics, he concentrates on the strategic development and defense of IP rights for clients in the chemical, biological, mechanical, and software/business method sectors. He has conducted hundreds of general purpose and event- and IP-specific intellectual property audits.

Intellectual property is an essential part of a company's bottom line. It encompasses various forms, including patents for useful features that make products more desirable or make manufacturing processes and business methods more efficient and economical; trademarks that protect the names, logos, and symbols used to identify and distinguish a company and its goods and services; trade secrets that protect customer lists, vendor lists, formulations, and the like; copyrights that protect marketing materials, product guides and manuals, audio-visual works, software, information compilations, and artwork; and design patents or trade dress that protect the way products look. Not all forms of intellectual property are important to every company, but some form of intellectual property is important to virtually every company.

Notwithstanding the importance of IP, businesses have overlooked its value until fairly recently. In the 1990s, business strength was focused on tangible assets, with intangible IP being relegated to mention in footnotes. The internet business boom and government regulation changed business thinking. Now companies more typically recognize the importance of IP in business decisions and transactions, and that recognition has increased the demand for IP audits. In a 2011 survey by *CPA Global*¹, 77 percent of in-house IP professionals said their companies had a greater understanding of the importance of IP and IP valuation, but 74 percent highlighted the need for more focused IP management strategies. The following discussion describes IP audits, explains why they are essential for good IP management, and provides information about IP audit costs.

What Is an IP Audit?

An intellectual property audit is a systematic review of a company's IP assets and related risks and opportunities. IP audits can help assess, preserve, and enhance IP; correct defects in IP rights; put unused IP to work; identify risks that a

company's products or services infringe another's IP; and implement best practices for IP asset management. A thorough IP audit involves not only a review of a company's IP assets, but also the company's IP-related agreements, policies and procedures, and competitors' IP.

Because IP rights are created and defined by law, IP audits are typically conducted by a lawyer or law firm. The lawyer is often new to the company being audited and has a broad range of experience with various types of IP and IP valuation matters. The company appoints a point person for the lawyer to deal with—ideally, someone who knows IP concepts and technical aspects of the company's business. When an IP portfolio's monetary value is of chief concern, the team also includes an accountant or economist who has dealt with IP valuation issues.

It can help for the lawyer to begin by providing management and key employees with a general overview of IP and identifying ways in which a company's existing IP rights can be preserved and enhanced. Then the IP audit proceeds with a transfer of IP-related information, which is requested from company management responsible for research, development, sales, and marketing. Any key employees who create or know the company's technology are also asked to contribute. For companies with a sophisticated knowledge of IP, the discussions can begin with a survey of the company's IP portfolio and competitive position in the marketplace, followed by a more focused analysis of IP issues of particular interest. The most comprehensive audits include estimates of the IP's monetary value, and protocols and detailed recommendations for dealing with IP in the future.

IP audits can be general in scope or can be focused on a particular event or type of IP. General purpose audits help start-ups and established companies to not only assess and protect their IP, but also identify IP development needs, opportunities, and risks. Event- and IP-specific audits can be triggered by a company's need to:

- Assess the impact and potential value of obtaining or selling IP, or licensing IP in or out;
- Assess IP rights and risks involving the acquisition or launch of a new product or service;
- Assess IP rights and risks involved in expanding into new markets or channels of trade;
- Determine whether its licensees are complying with the terms of a license;
- Help ensure that an R&D program is designed to best capture future business opportunities;
- Identify risks involved in adopting a new trademark or new product claims and warranties;
- Assess the integrity and strength of trade secret protection procedures and agreements;
- Assess the impact of a key employee's departure on IP rights and value;
- Assess a third party's infringement claims and the possible consequences;
- Assess and deal with the consequences of the expiration of IP rights;

- Assess and deal with the consequences of a change of status in a competitor's IP rights;
- Demonstrate the company's value to obtain or provide financing or investment capital; or

Demonstrate company value in preparation for a merger, joint venture, or sale.

Why Are IP Audits Important?

Although intellectual property occasionally receives bad press, IP is provided for in the U.S. Constitution, used extensively by American businesses of all sizes, and is here to stay. Investment in patent protection is on the upswing, with a record number of new U.S. patents, approximately 300,000, expected for 2013. The historic America Invents Act became fully implemented on March 16, 2013, and it has provisions for streamlining the patenting process and improving the integrity of U.S. patents. An international treaty signed into law in December 2012 makes it easier for U.S. companies to obtain design patents on a global scale. A bill introduced in Congress in June 2013 will provide stronger federal protection against trade secret theft. U.S. law allows companies to leverage intellectual property to significant advantage, and companies that know their IP and how to use it can expect competitive gains over those that don't. IP audits help companies get ahead in the following ways:

They identify what IP is owned. A successful business is well-managed. Intellectual property is part of a business and requires management just as does equipment, inventory, and accounts receivable. If a business does not know what intellectual property it owns, it cannot manage that property and protect it from damage or loss. So lies a first important value of an IP audit ... to inform the company about the intellectually property it owns so that it can make decisions as to the IP's protection, development, and sometimes licensing and exploitation. An audit may also reveal defects in chains of title and outline steps to correct them. Any existing IP-related agreements, such as licensing agreements, assignments, employment and independent contractor agreements, joint venture agreements, tech transfer agreements, and settlement agreements, can be reviewed to help ensure that IP rights have not been encumbered or compromised.

They preserve and enhance the value of existing IP. Intellectual property is protected by a matrix of federal and state laws. These laws provide a level of protection for trademarks, trade secrets, and copyrightable materials without the need to file a formal application for protection with a government agency, but a company can unknowingly make missteps that diminish or destroy this protection. In the case of trademarks and copyrights, a company can strengthen its intellectual property rights by applying for and obtaining trademark and copyright registrations from the federal government. On the other hand, to protect inventions by patent and product designs by design patent, formal patent applications must be filed, and patent rights are irretrievably lost if a company mishandles the invention or application. An audit identifies these and other kinds of actions that can be addressed to avoid IP loss and enhance the value of a company's existing IP.

Audits identify new opportunities to profit from IP. Intellectual property law has many nooks and crannies and is not well understood. A high percentage of non-IP lawyers and business people do not know the difference between patents, trademarks, and copyrights, much less whether their companies own those types of IP. Many do not know the level of inventiveness required to obtain a U.S. patent or the kinds of things that can be patented, the extent of and limitations on rights accorded by a patent, and the good IP value accorded by design patents and copyright registrations and what they protect. They are not aware that new commercial opportunities in domestic and foreign markets can be exploited via IP licenses, and that their competitors' efforts to obtain IP can be monitored and sometimes stopped. An additional value of

an IP audit is that it teaches decision makers, innovators, and marketers about IP and how to proactively protect IP opportunities before they are lost.

They identify roadblocks and prevent costly disputes. Intellectual property litigation is typically complex and expensive, and the sad truth is that small companies must sometime forgo litigation and capitulate, even when they have meritorious and winnable positions. An IP audit can assist companies in anticipating possible disputes and planning successful avoidance and resolution strategies. An audit may identify a need for a freedom-to-operate study, which identifies competitors' conflicting intellectual property rights and options such as designing around, licensing, or anonymously challenging competitors' rights. An audit can identify weaknesses in the audited company's intellectual property rights that can be addressed with timely corrective action, resulting in stronger rights that are less likely to be challenged when those rights are asserted.

They facilitate and optimize business transactions. IP has figured more prominently in business deals ever since the dot-com boom of the 1990s, and this is especially true of patents. The monetary value of IP can be estimated by accounting and economics methods, such as assessing the cost of developing alternative technology, isolating the amount of profits generated by IP-protected features, and determining third party royalties being paid for similar IP assets. Because an IP audit gives a company a current understanding of its IP assets and their estimated value, the company's owners are better prepared to deal with opportunities that might arise, such as a third-party offer to buy the company, or a new sales or expansion opportunity that may require financing.

In conducting IP audits, the following kinds of helpful information are most often identified:

- Valuable product and process features that could be but were not as yet patented;
- Correctable defects in existing patents;
- Missing and deficient employee agreements that risked competitors' access to trade secrets;
- Trademarks central to companies' identities that were not adequately protected from copying;
- Product configurations that could be but were not yet protected by design patents;
- Patent and trademark royalty payment terms that were being ignored;
- Missing notices of patent, trademark, and copyright that were limiting the company's ability to enforce IP rights and claim damages; and

Valuable opportunities for licensing IP in new markets and channels of trade.

IP audits have directly resulted in quantifiable benefits to many companies, including payments of millions of dollars for the use of patented technology that was not originally thought to be patentable.

What Does an IP Audit Cost?

IP audits come in all shapes and sizes, and the time required to perform an audit correspondingly varies. IP audits are typically billed at a lawyer's hourly billing rate or in accordance with alternative fee arrangements. The company should budget for an experienced IP lawyer who is knowledgeable about different forms of IP and has had experience gauging the value of various types of IP in the marketplace, for example, by negotiating IP licenses and other IP-related business transactions and settlements.

In its most basic form, a general IP audit consists of educating company management as to the various kinds of intellectual property that are available, surveying the types of intellectual property presently owned by the company, and answering questions as to how the company's intellectual property position can be preserved and enhanced. If no complex technology issues require attention, the audit may end with confirmation that important intellectual property is protected and correctly titled. Assuming that the lawyer spends four to eight hours preparing for and conducting the audit and the law firm bills by the hour, the costs of the audit can be measured in terms of four to eight hours of an experienced attorney's time, plus expenses if any.

An IP audit for a company that depends on the development or use of new technology or has relatively complex or numerous IP issues will be more involved and more time-consuming. The company may want the audit to include a determination as to whether particular technological improvements are likely to be patentable and worth patenting. The company may be aware of an issue or dispute concerning its intellectual property and want the audit to address likely outcomes and provide recommendations. The cost of this work cannot be determined until the number and complexity of the issues are known, but again the fees will be based on some multiple of an experienced attorney's hourly rate or an alternative fee arrangement. The lawyer can provide estimates after discussing the issues.

Conclusion

Management and enhancement of intellectual property assets may seem a daunting task for companies that have not done it before and for companies whose IP is in major disarray. But effective management of intellectual property is important and often critical to business success. An IP audit is a best first step toward achieving that goal.

Footnotes:

¹ http://www.cpaglobal.com/media_centre/press_releases/5042/ip_taking_on_growing_strategic