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Conducting An Intellectual Property Audit

Such audits are a must given the significance of intellectual property assets in business transactions

BY LOUIS R. DIENES

Intellectual property rights are increasingly the most valuable assets in business transactions, including capital raising, secured finance and mergers and acquisitions. As the value of intellectual property rights in such transactions continues to grow, effective audits of intellectual property rights is becoming increasingly important.

Unfortunately, many businesses fail to conduct intellectual property audits or conduct ineffective or inadequate audits. This article discusses how to plan an effective and thorough intellectual property audit.

Outside auditors' access to the audited business is often controlled by in-house personnel. Because the information made available to an outside auditor is generally limited and has been filtered through an intermediary, it is important that the accuracy of the information that is provided be verified to the greatest extent practical.

The outside auditor's first step is to review the proposed transaction documents for the audited business, such as the audited business' draft prospectus, purchase agreement or security agreement and related disclosure schedules. It may also make sense for the auditor to initiate independent searches (for example, title and lien searches) to verify the accuracy of the transaction documents.

The next step in an audit conducted by outside counsel will depend upon the transaction. For example, if the audited business is a borrower that will be securing a loan with an interest in one or more trademarks, the lender may engage legal counsel to confirm that the borrower has complied with the statutory formalities for trademark registration, that no superior rights have been perfected, and that the transaction documents create an enforceable security interest.

Alternatively, when patents are involved, legal counsel may be engaged to confirm that all of the formalities of patent prosecution have been met, that critical filing dates have been complied with, and to ensure that all necessary ownership and assignment agreements have been executed and filed.

In some instances legal counsel may be engaged to examine the audited business' key patents and applications in order to assess the validity and enforceability of its patent portfolio. An investigation of this type may entail examining the patent portfolio of the audited business' competitors and determining the likelihood of infringement claims. In other instances it may be equally important to examine the scope of any government or university rights (which may result from sponsored research) in the audited business' intellectual property.

Copyrights may raise equally complicated issues. For example, it can be very difficult to determine the owner, or owners, of copyrights in audio-visual works, such as motion pictures. Separate ownership of copyrights in scripts, recorded music and film is common. In these instances, determining the source of the copyrights (for example, by license or assignment) and the scope of these rights is critical.

In-house audit

In contrast to an audit conducted by outside counsel, an intellectual property audit conducted by in-house counsel can be comprehensive as well as expensive. However, regardless of expense, given the increasing significance of intellectual property assets in business transactions, an intellectual property audit, regularly updated, has become a cost of doing business.

Typically, an in-house intellectual property audit is begun in the context of one of the following three events: (1) a major business transaction, (2) a threat or filing of an intellectual property law suit, or (3) the regular review of a business' intellectual property assets. Each of these events requires the planning of a different type of audit.

An intellectual property audit conducted in connection with a business transaction will generally focus on ensuring that the subject intellectual property rights are fully and accurately disclosed in the transaction documents and identifying problems that may need to be addressed in order for the transaction to be consummated.

An intellectual property audit conducted in connection with litigation will generally focus on different issues, such an assessment of any allegations, probable defenses and the magnitude of damages if a suit is successful.

Finally, an intellectual property audit conducted to inventory intellectual property assets and review procedures is generally the most comprehensive and is an important tool in determining the business' intellectual property position and strategic direction.

The process of conducting an intellectual property audit can be divided into several discrete stages: planning, inventory, analysis, conclusions and a report.

Five stages

During the first audit stage, the auditors should fully familiarize themselves with the business to be audited and plan the scope of the audit to be performed. The auditors should meet with the in-house counsel who handle the business' intellectual property, employment, antitrust and transactional matters and the department heads responsible for sales, marketing and research and development. The auditors should also review the business' publicly available securities filings and marketing materials.

Planning an audit begins with understanding the audit's purpose. If the audit is being conducted in connection with a transaction, the focus will likely be on discrete assets and sufficiently thorough as to avoid a risk of non-disclosure under the transaction agreements and applicable laws. In contrast, the focus of a general audit will be broader and frequently will focus on risk management and revenue generating opportunities.

The second stage of the audit is taking an inventory of the business' intellectual property assets. The auditors will require access to all of the business' materials relating to its patents, trademarks, copyrights and trade secrets. The auditors should also have access to, and interview, managers involved in the creation, protection and exploitation of the business' intellectual property.

With regard to the business' patents, inventors' notebooks and records and the Patent and Trademark Office's official file histories should be reviewed. With regard to the business' trademarks, in addition foreign and domestic registrations, the auditors should review copies of applications as well as information on any unregistered trademarks used by the business. The auditors should also review copies of all agreements affecting the business' intellectual property rights.

The audit's third stage is to determine the extent of the business' intellectual property rights and how such rights may be most effectively exploited. The auditors need to review liens, security interests and pledges that affect the business' intellectual property and all assignments of intellectual property rights by employees, consultants and third parties in order to determine who owns the business' intellectual property rights.

Title searches should also be conducted, including the United States Patent and Trademark Office, the United States Copyright Office and applicable Secretary of States' offices to both confirm ownership and the business' compliance with statutory formalities applicable to its intellectual property assets.

When dealing with businesses that have close ties to universities and other research institutions auditors also need to review research funding agreements to determine if any university or government ownership or march-in rights may affect ownership or exploitation of the business' intellectual property.

All intellectual property license agreements should be reviewed. The audit team should also review development agreements and manufacturer and supplier agreements to ensure that the business in fact owns its intellectual property assets, that parts and materials are properly licensed and covered by an indemnity against possible infringement. In this way, the auditors can determine if the business is adequately protected, identify potential infringement which could create liability for the business as well as any of the business' intellectual property rights that are being infringed by third parties.

One function of the audit is to evaluate litigation which may have been filed or threatened against the business. Potential litigation risks which management is aware of should also be evaluated. In the instances of actual or pending litigation, or in cases where significant new products or services are being introduced into the market, the audit team is also sometimes asked to review non-infringement and validity opinions of counsel.

One fertile area for review that is often overlooked in the audit is competitive information. This material can take the form of competitors' issued patents, registered trademarks and copyrights and perfected security interests as well as trade and general press clippings and even rumors and gossip, and can be collected and analyzed in some instances in order to assess fully the business' competitive position.

The auditors should also review the business' policies and procedures for dealing with departing and incoming employees, each of which presents different types of risk. The business should have exit procedures in place to remind departing employees of their confidentiality, non-competition and non-solicitation obligations. Also, as departing employees frequently wind up with competitors or form their own competing businesses, an audit can be used to ensure that confidential information is not misappropriated.

New employees raise different concerns. The auditors should review the business' employee intake procedures to ensure that policies and procedures are observed, that appropriate agreements are used and that employees are educated on intellectual property issues. In some instances, an employee screening process or questionnaire (signed by the employee) should be used to confirm that new employees are not violating confidentiality or non-compete agreements by accepting employment with the business.

The audit's fourth stage is an analysis of how the business may best use its intellectual property rights. In order to do this, the auditors must understand the industry in which the business competes. For example, in a competitive, high growth industry with mobile employees, the business may need to be very careful in the amount of access to highly valuable trade secrets it permits its employees. This sometimes means that policies and procedures may need to be created to restrict access to certain areas of the business or its computer network.

Policy review

The next step in the auditor's analysis is a review of the business' various policies. Auditors often begin with the an evaluation of the business' patent protection procedures. In some businesses, in order to motivate employees to conceive inventions, the business' policy will include an incentive program, awarding cash or stock option bonuses. A patent policy will also generally detail guidelines for keeping laboratory records and notebooks and for evaluating ownership, determining the effect of university or government research funding on ownership.

Related to a business' patent policy, it is also important for auditors to review the business' trademark policy. The key elements of a trademark policy review include: registration and maintenance procedures, quality control and monitoring of foreign counterfeiters. Tax counsel may also have a significant role to play in reviewing the business' trademark portfolio in determining whether the trademark portfolio should be owned by an offshore holding company and licensed back to the operating business, resulting in a deduction for the business and license revenue for the offshore holding company.

The audit team should also review the business' copyright policy. A key issue for review is the criteria for deciding which works to register and which to register and rely on common law protection. The auditors should also review the business' policies and procedures for monitoring photocopying and software installation which might violate third party rights.

Other, perhaps peripheral policies and procedures should also be reviewed by the audit team in order to determine their impact on the business' intellectual property portfolio. Examples include the business' document retention policy (which should be reviewed for the retention of litigation sensitive materials), internal and external email policies (which may be used to distribute infringing materials, misappropriate trade secrets or merely create a record which could be damaging in litigation) and unsolicited invention submission policies (which should always be reviewed by the legal department and only accepted with a signed waiver of ownership rights).

The fifth audit stage is the preparation and delivery of a report or opinion. In some instances, such as where the report may be subject to discovery in litigation, it may be desirable to deliver the report orally. Regardless of the medium of delivery, the report should be made with an eye to its utility to the business. Several matters should be addressed by the report: (1) an inventory of the assets, (2) a discussion of deficiencies requiring action, and (3) long term recommendations.

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Test
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1. Because the information made available to an auditor is frequently filtered through an intermediary, an auditor can only be rely on if its accuracy if it is verified by an independent third-party.

2. An enforceable security interest can be created in a borrower's trademarks even if the borrower has not complied with any of the statutory formalities for trademark registration.

3. An assessment of the validity and enforceability of a business' patent portfolio may entail examining the patent portfolio of the business' competitors to determine the likelihood of infringement claims.

4. The likelihood of infringement claims cannot be determined solely from an examination of the patent portfolio of the audited business' competitors.

5. Separate ownership of copyrights in scripts, recorded music and film is uncommon.

6. An intellectual property audit conducted in connection with a business transaction will focus solely on ensuring that the intellectual property rights are fully and accurately disclosed.

7. An intellectual property audit conducted in connection with litigation may focus on an assessment of allegations, probable defenses and the magnitude of damages if a suit is successful.

8. An audit conducted to inventory intellectual property assets may also be used to confirm whether the business is following the appropriate procedures to protect its intellectual property.

9. Auditors should review copies of document retention policies because they might affect the business' intellectual property rights.

10. The results of title searches in the United States Patent and Trademark Office and the United States Copyright Office provide definitive evidence of ownership.

11. Auditors should review research funding agreements to determine if the federal government has any rights that may affect ownership or exploitation of the business' intellectual property.

12. Rumors and gossip may be useful in analyzing a business' competitive position.

13. New employees and departing employees raise virtually identical intellectual property concerns.

14. An emerging growth business looking to raise capital should avoid disclosing in its offering documents that it has developed or acquired a unique intellectual property portfolio.

15. Ownership of a business' trademark portfolio by an offshore holding company may result in a deduction for the business and license revenue for the offshore holding company.

16. E-mail policies may be used to prevent infringing materials from being distributed by email.

17. Unsolicited invention submissions should only be reviewed by business managers unless the inventions will be patented.

18. The creation of a final report may be a valuable legacy of an intellectual property audit.

19. In some instances, such as where the report may be subject to discovery in litigation, it may be desirable to deliver the report orally.

20. An audit may result in additional revenue generating opportunities for exploiting a business' core intellectual property assets.

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