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Managing IP in Sarbanes-Oxley's wake

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The Sarbanes-Oxley Act, which became law in July 2002, imposes new obligations on companies with respect to the diligence they exercise in obtaining knowledge about their enterprise. Where the company's profit is dependent on intellectual property, Sarbanes-Oxley has unique implications.

However, the act has raised more questions than it has answered. The legal and business communities can derive some guidance from the law's general concepts, FASB (Financial Accounting Standards Board) accounting rules and previous articles regarding tasks to be performed by companies and their officers to ensure compliance.

The statute says:

- CEOs and CFOs must personally certify the company's financial statements, ensuring the information provided fairly represents the financial condition and results of operations of the company. Section 906.

- Officers must establish and maintain internal controls and must design these controls to ensure officers are made aware of material information. Officers' responsibilities also include evaluating the effectiveness of these internal controls and reporting their conclusions. Section 302(a)(4). These controls must be documented and regularly assessed. Section 404.
- Public companies must report material developments in the financial condition and operations of the company, on a "rapid and current" (real time) basis. Section 409. Moreover, the information for which the company has this real-time disclosure obligation is broadly crafted to include information "in plain English ... as the Commission determines, by rule, in necessary or useful for the protection of investors and in the public interest."

New FASB reporting requirements for IP have complicated matters further. FASB Statements Nos. 141 (intangible asset identification upon acquisition) and 142 (annual intangible asset value measurement) require that intangible assets be divided into various categories related to the financial performance of the company.

Companies also must develop a means of measuring these assets so they can be quantified and included in financial reports. In light of FASB rules, Sarbanes-Oxley's certification and internal controls impose upon public companies an obligation to (1) determine how intangible assets fit into the business from a financial perspective and (2) report this correlation in a manner that can be understood by investors.

WHAT CONTROLS?

Sarbanes-Oxley itself does not identify the types of internal controls required, and few authors have attempted to address the specific measures to implement to be in compliance. Instead, the law and articles written about it provide general principles to guide corporate officers in designing and implementing the required internal controls. There is some sound reasoning supporting this vagueness.

First, each company has a unique way of licensing, using or otherwise exploiting its IP assets. Additionally, because the internal management structure of each company is organized differently and is staffed by people with specific talents at various levels within the organization, the law must be flexible enough to allow each company to develop customized controls that prove effective in that company's unique environment. However, this flexibility can leave officers and managers scratching their heads and wondering: "Exactly who is supposed to do exactly what?"

What becomes clear is there are very few bright-line rules. Although it is impossible to develop a one-size-fits-all manual for Sarbanes-Oxley compliance for IP companies, some more specific guidance can be derived from the general concepts set forth in the act and in previous articles.

IDENTIFYING INTANGIBLES

Companies must first identify their intangible assets to comply with Sarbanes-Oxley and related accounting rules. Identifying IP assets that have been federally registered is generally easy. Identifying unregistered assets can be much more challenging. Conducting periodic IP audits is an effective way of locating and classifying IP assets as well as documenting management's compliance efforts.

Many companies avoid determining whether unregistered assets exist and what category of IP applies because this type of determination is time-consuming, expensive and does not generate revenue. However, this may be shortsighted. For example, a computer program can include both copyrightable works and trade secrets, yet software companies frequently license their software without determining with particularity which portions of the source code are trade secret and which are protected by copyright because such an exercise can be a legal and technical quagmire. Yet, making this determination could be crucial to ensuring Sarbanes-Oxley compliance.

A change in copyright law, for example, would affect only those portions of the source code protected by copyright and may have no impact on those portions protected solely by trade secret. If the company does not thoroughly understand which areas of IP law apply to which portions of the computer program, it may be impossible to properly evaluate the impact arising from a change in a particular area of law.

Once the company has identified the trade secrets and copyrightable works within the source code, it is capable of evaluating the relationship between changes in the law or in the industry that may affect these particular portions of the computer program. Such an evaluation may have implications for the value of the computer program, for the level of competition in the market and ultimately for the company's financial condition.

IP AND FINANCIAL CONDITION

Another essential element of compliance includes an examination of the significance of IP assets to the company from a financial perspective. Companies must determine the relevance of each IP asset to the conduct of their business and its significance to revenue generation. The CEO/CFO certifications cannot be given unless there is a mechanism to ensure this evaluation has occurred and a determination has been made as to which IP assets are material to the financial condition and operations of the company.

To do this, management must understand not only the legal developments surrounding a particular IP asset, but also the related technical and economic implications. No doubt, this requires a multi-disciplinary approach. Depending on the particular asset, a team including lawyers, engineers, accountants, and sales and marketing professionals very well may be necessary to fully assess the impact of a particular development.

MONITORING

Public companies must establish and maintain internal mechanisms to ensure that material information regarding the company's IP assets are reported "up-the-ladder." Many corporations already may have instituted these internal mechanisms because they're beneficial to business operation. Sarbanes-Oxley contemplates that companies assigning specific tasks related to material assets identify who is responsible for performing each task and provide for periodic reporting of material developments.

Companies should devise internal systems to ensure that material information known to non-management personnel is evaluated and reported to management so it can be taken into account in preparing financial statements and other SEC reports. Such systems may include mechanisms for tracking the progress of the prosecution of trademark and patent applications — ensuring maintenance and renewal filing dates are carefully monitored — and reporting the status of either third-party infringement claims against the company or pending company infringement claims against a third party.

All these mechanisms can be viewed as passive since they are designed to track information about affirmative events the company would be aware of without any external investigation. In light of Sarbanes-Oxley, at least with respect to IP assets, these passive and exclusively internal-looking mechanisms may not be sufficient.

IP developments outside the company's operations can be just as important, or in some cases more so, than the day-to-day occurrences within the scope of the company's operations. If potential infringers remain undiscovered, over time they could erode the value of the company's IP. Similarly, changes in the scope of IP protection arising from statutory or regulatory changes, or even case law, can significantly impact the valuation of IP assets.

EXTERNAL CONTROLS

Because of this, implementation of external-looking controls can be critical to the company's financial condition. The degree to which the company is required to institute controls is not clarified under the act. For example, a variety of companies offer watch services that monitor potentially conflicting trademarks. The service can be narrowly designed to report only potentially conflicting trademark applications that are published by the U.S. Patent and Trademark Office.

They also can be more broadly structured to provide reports on marks that are applied for or even marks that are found to be in use but for which no application has yet been filed. Many companies elect not to subscribe to such watch services due to the cost of evaluating the reports generated by the service. However, without some degree of external monitoring, a company's trademark rights can be substantially impaired.

If a company with substantial trademark assets fails to subscribe to watch services and therefore fails to become aware of an erosion of its trademark value, can it still be in compliance with the requirements of Sarbanes-Oxley? Probably not. Existing SEC requirements mandate that the management discussion and analysis sections of quarterly (10-Q) and annual (10-K) reports address "known trends and developments" that may affect the company. This supports construing Sarbanes-Oxley to require external-looking controls for IP assets.

Additionally, Section 409 requires companies report in real time information that is necessary or useful to protect investors. This further suggests that merely reporting those items that passively come to the company's attention is probably insufficient and that Sarbanes-Oxley compliance must reasonably include some degree of external monitoring of relevant developments. The level of such monitoring — and related expense — is not specifically delineated.

CEOs and CFOs are left to their own judgment as to the degree of monitoring. Since they face potential civil and criminal liability — including up to $5 million in fines and as much as 20 years in prison for a violation — prudent officers should understand how their company's IP assets may be impaired, subscribe to monitoring services and obtain regular professional advice so as to reasonably monitor external developments.

Moreover, it is critical that monitoring programs are cost-efficient so the programs will be actualized. Evaluating which IP assets are material to the company's operations and financial condition is fundamental to the creation of an efficient program.

CONCLUSION

Seeing both the forest and the trees is important if IP is to be properly managed in the context of Sarbanes-Oxley. In this regard, any program should provide management sufficient information to understand the relationship between a company's IP and its financial condition and operations. The internal controls must be designed to more closely monitor those assets having the greatest effect on the company's financial condition.

Determining how and where to allocate resources for Sarbanes-Oxley monitoring and reporting can be done efficiently only after the company has evaluated thoroughly the relationship between its IP assets and its financial performance. It may be unnecessary, for example, to subscribe to trademark watching services for every mark in the company's portfolio. For the goods or services generating material portions of the company's revenue, such additional monitoring is warranted.

Until there is further development in the law, the best advice for managers is to structure internal controls to ensure different degrees of monitoring and reporting for different assets based on the relationship between the particular assets and the company's operations and financial performance. Management should be informed of significant events related to its most important assets.

Effective up-the-ladder internal controls, however, are not enough. It is equally important that management have a command of the legal, technical, accounting and market implications of the information of which it is made aware. Only then can management properly evaluate developments and their impact on the company to ensure those developments are adequately described and disclosed in compliance with Sarbanes-Oxley requirements.

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