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**Column**

**Assets and Liabilities in an Intellectual  
Property Audit**

**Steven M. Bauer, Esq.\***



\* Mr. Bauer is partner in the law firm of Testa, Hurwitz & Thibeault.

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1. While Congress struggles to slow down or even reverse the pendulum swing of plaintiffs' rights in most civil tort cases, the pendulum continues upward unfettered on matters relating to intellectual property. At the same time that Congress seeks to enact statutes of limitations in product liability cases, it may extend the patent term from seventeen years from the date the patent issues, to twenty years from the filing date of the patent application; and the term for copyright from an author's life plus fifty years, to an author's life plus seventy-five years. At the same time that Congress institutes a "losers pay" legal fee reimbursement policy, the courts encourage litigation by broadening their interpretations of what is copyrightable, what is patentable, and what constitutes a valid trademark. Finally, while Congress debates ways to restrict the size of damage awards in many civil cases, the courts place renewed emphasis on developing theories to calculate larger damage awards in patent cases. These are only some of the more important changes that Congress and the courts are considering. Most of these changes strengthen the hand of the innovator and are best considered "pro-plaintiff."
2. Because these changes both expand the potential reward for the innovator and increase the potential risk of liability for the accused infringer, actual risk is increasingly difficult to predict, and the questions asked need to be reevaluated. Traditionally, the primary question asked when investing in a high-technology enterprise was: What value is there in the company's technology, in its intellectual property. At one time that value was relatively simple to calculate. Now, it is just as important to ask about the risk that the company may infringe someone else's intellectual property, and to determine the resulting potential cost. Entrepreneurs should be as concerned with the company's ownership and protection of its technology, as with whether third-party rights may interfere with the company's use of its technology. They want assurance that the company not only diligently protects its intellectual property rights — and that there is potential value in exploiting those rights — but, conversely, that the company has been equally diligent to avoid infringing the rights of others.
3. In view of these current changes in the law, companies need to step back and review in a formal, systematic manner the value of their intellectual property portfolios, by conducting what is typically known as an intellectual property audit. A well-planned audit creates, in effect, a balance sheet of "assets" — a listing of the company's intellectual property rights in the form of patents or patentable material, copyrights, trademarks, trade secrets, and license agreements, and "liabilities" — ownership risks, third party claims and potential infringement issues.

4. An audit begins by recording the intellectual property already owned by the company in order to place it on the balance sheet. This property includes registered trademarks, copyrights, issued patents, and pending patent applications, both in the United States and abroad. Although listing patent applications may seem like a simple step, because a company should know its intellectual property portfolio, management often allows its property to fall into "disrepair." While some companies are careful about "building" new property by applying for patents and trademarks, once the process begins the company often turns over control to outside patent counsel and pays the bills without monitoring the status of the patent or trademark prosecution work. Engineers lose interest in "old" technology as they turn towards the next generation of products. Foreign patent applications often take so long to wind through foreign patent offices that corporate memory of them can be dead long before the foreign patents issue.
5. When dealing with intellectual property, it must be noted that "ideas are only the raw material from which 'intellectual property' can be manufactured." One can only have legal rights in "intellectual property," which typically includes patents, copyrights, trademarks and trade secrets. If an "idea" cannot be placed into a protectable property form, it falls into the public domain and is free for the world to use. The intellectual property attorney has the uncommon role of "manufacturing" valuable property for a client from the raw "idea" material. Unregistered trademarks and copyrights, unpatented inventions, and trade secret information the company considers valuable proprietary information may all be considered the "crude oil" of ideas, buried in the company's outback, waiting for prospecting. In addition, intellectual property that has never been registered or recorded in a patent or trademark application or copyright registration may hold its own significant value. It is therefore important to review whether the company has properly policed and preserved its ability to obtain and enforce its rights in trademarks, copyrights, and patents. It is also important to take adequate precautions to preserve the confidentiality of trade secrets.
6. For example, the company may have used a product name for so long and in such a way that it has become an important identifier of the company's products and embodies significant good will, yet never has been considered a trademark or registered with the United States Patent and Trademark Office. Companies may lose trade secrets by failing to take proper steps to preserve their confidentiality, leaving them free for former employees to copy and use. It should also be remembered that many engineers consider all inventions "obvious," and many do

not believe that software or other business processes should be patentable as a matter of policy. Nevertheless, the United States Patent and Trademark Office and the courts have granted patent protection to business methods, financial instruments, and computer software, all areas commonly believed to be "unpatentable." Therefore, a company may want to make it a business matter to evaluate technology for patent protection and remove the job function from the engineering department. Most of the steps necessary to preserve intellectual property rights are simple and relatively inexpensive; they only require diligence on the part of the company to show a bona fide intent to protect these rights.

7. Once the company compiles and identifies its intellectual property assets, it must trace the ownership of each one, to ensure that it currently owns or holds valid licenses to the property. This review frequently includes consideration of whether the government had any part in the development of the technology.
8. Ownership is the issue most frequently litigated. It has become a significant trouble spot, particularly for companies seeking financing. Federal law may control many "ownership" issues relating to intellectual property rights, even while employment and confidentiality agreements may be controlled by state contract law. For example, absent an express agreement to the contrary, federal patent law gives each coinventor of a patent an equal, undivided interest in the patented invention; neither coinventor is under a duty to account to the other for any profit resulting from the patent. Employees of a company that funds research and development may in fact own the rights to any patentable invention. Similarly, under federal copyright law — again absent any separate agreement to the contrary — non employee authors own the copyrights in their material, regardless of whether they were paid to develop the work. In the recurring example of a company that retains outside consultants for software development work (or for translation of manuals into Japanese), the presumption is that the consultants will retain ownership of their work and control its subsequent use or distribution, absent an agreement to the contrary. Of course, the parties can modify these statutory ownership rights, but unless the consultants or employees have clearly and expressly assigned their rights to the company by written agreement, assuming that the company holds clear title is risky.
9. It is almost always easier to obtain an agreement at the outset of a relationship than during or after its development. Ownership rights should be cleared at this stage of the audit, as it is better than waiting until some significant event for clear

title to close. At this stage of the audit it is also useful to determine whether all employees — be they consultants or visiting graduate students — have signed an agreement transferring to the company any rights they may have in any intellectual property. This leads to the useful result that a system is put in place to ensure that an “invention rights agreement” is signed before new persons are given any opportunity to participate substantively in any research or development activity.

10. Once assets are identified and ownership is assured, the company must then evaluate the strength or value of its technology rights. For example, how vulnerable is a patent to challenge? Are patent claims broad enough to provide true exclusivity in the marketplace? Similarly, the auditor can consider the scope of protection available to particular copyrighted material. In light of the recent copyright case *Lotus Dev. Corp. v. Borland Int'l, Inc.*, \_\_ F.3d \_\_ (1st Cir. 1995), 1995 U.S. App. LEXIS 4618 (Mar. 9, 1995), many companies may want to consider broadening the bases of protection to provide for alternative theories.
11. The liabilities side of the audit identifies the company’s potential liability risk from the use of its own technology. By identifying these risks, the company can determine the extent to which the practice of its technology or use of its trademarks may arguably infringe the rights of others. The company reviews potential claims by former employers or current or former employees, which also focuses attention on the dominant patent positions of key competitors. Finally, the company determines whether there are significant regulatory requirements limiting the company’s ability to exploit its technology, particularly in the case of biotechnology and medical products companies, where government agency approval may be required before a product is marketed.
12. Creating the liabilities portion of the audit is like preventive therapy. To a smaller, technology-based company, the cost of defending an infringement litigation can be simply fatal. According to a survey conducted by the American Intellectual Property Law Association (“AIPLA”), the average company spends up to \$1 million defending a patent litigation. Although a company may spend significantly less defending copyright or trade secret claims, the cost is not only one of dollars and cents. Any litigation involves additional costs in management time devoted to the lawsuit, employee time attending hearings and depositions, administrative time coordinating and supervising document production, and intellectual time creating and performing engineering or scientific tests to prove or disprove claims.

13. Legal fees and direct litigation costs represent only the day-to-day operating costs of an intellectual property lawsuit. Depending on market conditions, some aggressive holders of intellectual property may act on the belief that simply filing a lawsuit and maintaining its pendency, in and of itself, accomplishes strategic goals, recognizing that customers frequently buy from the patent owner simply to avoid dealing with a bad situation later. For example, if the third-party manufacturers use the accused product as a component in their own products, they may not be willing to risk investing in a research and development cycle to build a product that may eventually be frozen by an injunction against their supplier. Similarly, in those instances where an accused product sells for \$100,000 or \$200,000, if a single customer decides to buy from the patent owner to avoid becoming involved in the lawsuit, that single transferred sale may itself pay the patent owner's litigation costs, making each additional sale pure litigation-related profit. Why should a patent owner settle a lawsuit, when the lawsuit itself generates increased profits both short- and long-term?
14. While the above-described costs must be considered during the course of litigation, the largest costs loom at the end of trial in the form of damages. Throughout the 1970s and into the early 1980s, the developed body of case law on patent damages permitted a court to calculate damages one of two ways: it could award either a "reasonable" royalty, which was typically five to ten percent of the accused infringer's sales, or "lost profits," which typically awarded a higher percentage (often fifty or sixty percent) of the accused infringer's sales but required proof that the patent owner would have made the sale "but for" the infringer's activities. This "but for" test was generally considered difficult, if not impossible, to overcome if more than two competing suppliers were active in the market. How could the patent owner prove that it, and not some other supplier, would have made the sale but for the infringer's sale?
15. Because both methods calculated damage awards based on the accused infringer's volume of sales, small companies — or large companies just entering the market with only small sales — had limited reasons to take a case to trial. Because the legal fees would swallow any potential recovery, little financial incentive existed to litigate rights and then turn over the bulk of any recovery to the attorneys. Although perhaps frustrating to the property rights owner, licenses, and cheap licenses at that, were frequently the resolution to infringing activity. Although the patent statute allows the award of attorneys' fees and/or triple damages in "exceptional" cases, the chance of obtaining such increased damages is low.

16. In the mid-1980s, the courts began to calculate damages based on theories that, when applied, multiplied many times the potential return to the patent owner, well out of proportion to the amount of infringing activity. For this reason, many patent owners have become less willing to settle or to license their patents, preferring instead to gamble on a trial to win a large award.
17. The first of these relatively new damage theories, known as the “price erosion” theory, allows a court to calculate a damage award proportional to the patent owner’s sales instead of the infringer’s sales. The price erosion theory derives from the “lost profits” analysis discussed above, which allows the patent owner to show what it would have earned “but for” the infringement. According to the price erosion theory, if the court believes that an infringer (no matter how small) caused the patent owner (no matter how large) to lower its price or forego a price increase to meet the competitive situation, the infringer can be held liable for the lost profit spread the patent owner would have made if it had sold all its rights at the higher prices. Thus, if the court believes that Company A just entering the market with \$1 million in sales caused Company B with \$100 million in sales to respond competitively by foregoing a five percent price increase, the court can hold Company A liable for \$5 million in damages: the additional amount Company B would have earned but for Company A’s sales. In the face of such an award, one can readily see how bankruptcy could force a smaller company out of business, regardless of whether it could design around the patent to avoid an injunction.
18. A second theory, known as the “accelerated market reentry” theory, extends the claim for damages even to the sale of non infringing products *after* an accused infringer modifies its products to avoid a patent. The accelerated market reentry theory is based on an assumption that the market share of a new product should start low and grow steadily over time. According to this theory, if an accused infringer develops a sizable market share during litigation, it will have a larger market share for the introduction of a new non infringing product than it would have had but for its prior sales of the infringing product, which sales allowed it to establish that market share. The court may award damages based on the infringer’s future sale of non infringing products, at some decreasing rate, to compensate the patent owner for the infringer’s accelerated entry into the market.
19. Finally, the courts have reconsidered the theory of lost profits itself, in particular as it relates to a multi-supplier market. Generally accepted case law now holds that if

a patent owner can prove the percentage of its market share in a multi-supplier market, it should be entitled to a pro rata share of lost sales. The assumption is that but for the infringer, the same percentage of the infringer's customers would have bought from the patent owner as the other customers in the market place. Courts then apply a split calculation, awarding damages for one set of sales at a "lost profits" rate and for the rest at the "reasonable royalty" rate.

20. A judge or jury's view of equity and fairness plays an important role in limiting damages. Whether the court believes that the new competitor has not copied any technology is an important factor. Before an investment in a new company is made, investors should ask the company not only whether threats of infringement claims have been made against it, but whether its scientists and engineers have read, studied, or relied upon any third party's patents or products in their research and development. Investors in a new technology company need to consider carefully the risk that an established company will aggressively try to eliminate its new competition through litigation.
21. As the country debates how to force tort lawyers to slow the pace of expensive litigation, expect to see increases in intellectual property litigation. It will be interesting to watch how the tort reform movement affects the swing of the pendulum of intellectual property law.