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INTELLECTUAL PROPERTY

Supreme Court Decisions Affecting IP Valuation

Possible Exposure Under SOX

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The need for companies to assess and monitor the value of their intellectual property is not new. Changes in how intangible assets are to be booked in business combinations under the Financial Accounting Standards Board's Statement 141, and how their values are subsequently tracked under Statement 142, became effective in 2001. But now FASB's newly effective Statement 157 requires companies to assign values by considering the "highest and best use" of the asset. There has been a need for publicly traded companies to certify the accuracy of financial reporting and set up internal mechanisms to ensure their continued accuracy since the passage of the Sarbanes-Oxley Act of 2002.

The increasing importance of intellectual property and other intangible assets suggests that such steps make good business sense.

But if companies needed a further wake-up call, the United States Supreme Court has provided it. The Court's recently renewed interest in patent law, including two recent cases, KSR v. Teleflex and AT&T v. Microsoft, could have significant impact on accounting practices and financial disclosure requirements. Companies that ignore these and other cases risk shareholder lawsuits or other exposure for failing to properly account for the company's intangible assets.

FAIR VALUE REDEFINED

Beginning in 2001, Statement of Financial Accounting Standards 141 was amended to eliminate pooling-of-interest rules. Going forward, all business combinations are subject to "purchase accounting rules." Under purchase accounting rules, companies are required to allocate their intangible assets into one of five categories and then establish the fair value of the intangibles.

At the same time, SFAS 142 regarding "Goodwill and Other Intangibles" was amended. Goodwill and assets with an inherently indefinite useful life are no longer amortized for book purposes, but are subject to a periodic impairment analysis. The analysis applies to all intangible assets, including those with a finite useful life which remain subject to amortization. If the results of the impairment analysis indicate the fair value of the intangibles is less than the current book value, the difference is to be recorded as an expense in the period incurred.

SFAS 157 became effective in

the fiscal years starting after November 15, 2007. It works toward a unified definition by defining fair value, establishing a framework for measuring fair value, and expanding required disclosures about what inputs were used to determine fair value.

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It focuses on the "highest and best use" of an asset as the basis for establishing fair value and, in combination with SFAS 141, requires acquiring companies to assign value to all acquired IP and other intangible assets based on what the acquiring company could expect to receive from prospective purchasers. The acquiring company will then have to amortize those assets over their useful lifetime, i.e. the life of the patent.

This shift could have a significant effect on the fair value measurement because there is often a broad range of potential uses for intangible assets. For example, intangible assets such as patents may be used for defensive purposes, exclusivity purposes or offensive purposes.

Under the new rules, even if a company has an asset that is not being actively used in the business, but rather is being retained for defensive purposes, the company still must assign a value to it. The value must be tested annually for impairment based on its highest and best use in light of what market participants would do with the patent.

The Sarbanes-Oxley Act, passed in 2002, places greater emphasis on the accurate valuation of all company assets by requiring officers to certify the accuracy of their company's financial reports, certify internal controls, and deliver real-time reports of material events affecting the company. Failure to comply exposes individuals and companies to severe civil and criminal liability. A company that fails to comply with SOX also may be subject to stockholder class action suits.

Although SOX does not specifically require reporting the value of intangible assets, most observers agree that a company cannot ignore the role IP plays in the financial health of a company. Therefore under SOX such assets must be accounted.

Thirty years ago, only twenty percent of a company's value came from intangible assets. Today, for a U.S. publicly traded company, that number has increased to as much as 80 percent, and many well-known companies have intangible assets in excess of 90 percent of their stated market value. In 2000, for example, 97.8 percent of Microsoft's value and 98.9 percent of Yahoo's value were intangible assets.

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To comply with these disclosure requirements, commentators have proposed a number of best practices. A company should:

- Designate an IP committee or officer to identify, protect and evaluate IP assets. An IP committee should include personnel from legal, financial, marketing, research and development, and sales.

- Identify the company's IP assets and how they can best enhance shareholder value.

- Determine the value of each asset.

- Create internal procedures for managing the IP assets, including procedures to insure timely reporting of material changes. These internal procedures should involve, at minimum, annual audits of intangible assets to detect and report any material changes in value.

Unlike tangible assets, such as buildings or equipment, intangible assets like intellectual property exist in large part only because the law says they do. Therefore the value of intellectual property is sensitive to changes in IP law, and understanding those changes is critical to a company's valuation of its intellectual property. Involving counsel familiar with jurisprudence in the assessment and valuation process is crucial, both initially and during periodic audits. The Supreme Court's interest in patent law highlights this need.

VALIDITY OF MANY PATENTS IN QUESTION

Since 2005, the Supreme Court has issued decisions in eight patent cases, sending the message that it is re-asserting its role as the final word in patent law – a role that the Court of Appeals for the Federal Circuit had appropriated to itself. With a more active Court, the value of a company's patent portfolio can change overnight. Two recent decisions handed down on the same day serve as cases in point.

In KSR, a patent dispute over the design of automobile gas pedals, the Supreme Court issued a unanimous ruling that an "expansive and flexible approach" should be used in deciding whether a patent claim is obvious.

The Supreme Court thereby rejected the Federal Circuit's "rigid" requirement that a patent claim is not obvious because as prior-art references unless there is an explicit teaching, suggestion, or motivation found in the prior art to combine those references (the so-called "TSM Test"). Furthermore, the Supreme Court declared that the "obvious-to-try" standard, which the Federal Circuit had flatly rejected as a means to show obviousness, may in fact render a patent obvious.

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Commentators have suggested that in light of KSR, the validity of thousands of patents has come into question. Some suggest that certain categories of technology and inventions may be especially susceptible to challenges.

For example, pharmaceutical patents for "improvements" on already existing drugs may be of questionable validity. Pharmaceutical companies will likely have a harder time getting such patents in the future and will have a more difficult time extending the patent life of their drugs.

Likewise, business method patents may now be harder to obtain, and many of those already issued may face challenges to their validity that will be tougher to overcome. A change in the law that may render a company's patent invalid plainly lowers the value of that asset to the company.

In the AT&T case, which was a dispute over a software patent, the Supreme Court held that AT&T could not collect damages based on sales in other countries, thus paving a road for software companies to avoid infringement liability by moving certain aspects of their business overseas.

This effective reduction in monopoly rights could lower the value of many patents, including the attendant licensing fees that the patent holding company may otherwise expect to receive. Depending on the valuation method used to establish the book value of the patents, a reduction in the expected royalties could materially impact the fair value of the patent.

When decisions such as KSR and AT&T are issued, the question becomes, what does a company do if the validity of its patented technology is in doubt? What if the company has effectively lost its ability to enforce its monopoly rights in its technology?

SOX requires the timely reporting of events that materially impact financial reporting. Likewise, SFAS 142 requires periodic impairment analysis of intangible assets. However, most companies are not likely to restate their financials, even if they believe that, in light of a change in the law, one of their patents may be invalidated or that others may now encroach on their monopoly rights. Such a restatement of financials could essentially act as an admission that their patented technology is no longer valid. It would invite others to begin using that technology without paying licensing fees.

On the other hand, doing nothing risks liability for failing to disclose a material change in the value of its assets if patents are later invalidated.

It would be wise for companies to take steps to blunt such exposure by having counsel analyze how such changes may impact the company's portfolio, and assess whether the value of the company's IP has been materially altered.

The difference between just doing nothing and doing nothing because the company's IP committee advised that a change in law does not impact valuation could be vitally important if a suit is brought alleging failure to disclose a material change in assets.

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