

# **THE INTELLECTUAL PROPERTY AUDIT**

**A primer on intellectual property law,  
best practices in intellectual property management and  
due diligence in transactions that include intellectual property**

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## Overview

The importance of intellectual property to businesses has increased dramatically over the last 15 to 20 years. Patents have gained the most attention with damage awards in litigation frequently in the tens of million of dollars, and some in the hundreds of millions of dollars; the largest to date being Polaroid v Kodak involving instant cameras, with a damage award of \$925 million. Patents have been granted and litigated on business methods (such as Amazon’s “one click” Internet ordering method), patents are frequently the major assets of start up companies (particularly in biotechnology), and licensing programs generate hundreds of millions of dollars of royalty income for some major companies (e.g. IBM). The value and use of patents is heavily promoted in the book “Rembrandts in the Attic, Unlocking the Hidden Value of Patents” Rivette and Kline, Harvard Business School Press 2000.

The other forms of intellectual property assets—trademarks, trade dress, copyrights, mask works rights and trade secrets—have also increased in prominence in protecting the businesses of companies and, thus, increasing the value of those businesses that effectively use that protection. One study found that in 1978 80% of corporate assets were tangible assets (buildings, equipment, and the like) and 20% were intangible assets, and that by 1997 the relative value of tangible and intangible assets had essentially reversed so that 73% of corporate assets were intangible assets. Kenneth Crosin, “Management of IP Assets” AIPLA Bulletin (2000 Mid Winter Meeting Issue). While intangible assets include more than intellectual property assets, there is clearly a strong correlation between the growth of intangible assets and the importance of intellectual property.

The increase in the value of intellectual property has also increased the risk that infringing the intellectual property rights of another company (or of an independent inventor)

will result in major costs, including the possibility of closing a business (as Kodak had to do when it lost the patent infringement case to Polaroid). It is, therefore, of ever increasing importance to businesses to know the extent, quality and use of their intellectual property assets and to have processes and procedures in place to generate, perfect and use intellectual property assets and to protect the business against the unauthorized use of the intellectual property rights of others. The importance is present not only in hi-tech industries but also in the more traditional industries where intellectual property is or can be used to gain a competitive advantage. And, different forms of intellectual property have more or less importance to different businesses (e.g. the Coke trademark and the formula for Coca Cola, which is a trade secret, are among the most important intellectual property assets of the Coca Cola Company).

### **What is an Intellectual Property Audit?**

A definition of Intellectual Property Audit will assist in understanding the scope of the remainder of this paper. The common usage of Intellectual Property Audit in its most comprehensive sense means assessing the processes and procedures in place to generate and perfect intellectual property rights and to protect a business from the unauthorized use of the intellectual property rights of others, taking an inventory of the intellectual property rights of the business, judging the quality and usage of those rights, and inventorying and assessing existing and potential intellectual property disputes with others. Depending on the purpose of the audit, as discussed below, it may involve only some of the intellectual property (hereinafter frequently abbreviated “IP”) assets of the business, and it may focus on or not involve at all the assessment of the IP processes and procedures. Frequently, again depending on the purpose, the IP audit is done in conjunction with or followed by a valuation of the IP assets.

## **Why Do an Intellectual Property Audit?**

As noted in the introduction, IP assets have become an increasingly large part of the value of businesses. IP assets have also been licensed and sold to generate substantial income. Thus, for any particular business it is important to know the scope and content of the IP assets of the business in order to make full use of those assets. It is also important to assure that the business has effective processes and procedures in place for generating and protecting its IP assets.

## **When to do an Intellectual Property Audit**

An IP audit is appropriate any time someone in authority wants to know the extent and quality of the intellectual property rights of a company. The breadth and depth with which the audit will be conducted will depend on the purpose. Companies conduct annual audits of their financial status and public companies include the auditor's statement of their financial condition in their annual report to shareholders. In light of the overall importance of intellectual property, an annual intellectual property audit should form a part of the best practices for a company. Additionally, intellectual property audits are typically conducted for the following purposes:

1. Evaluation of a new or existing business (a business unit or the entire company) for its management. This may be done for an existing business because of a change in management, a change in the law, a change in the business direction or as a review of the profitability and potential of the business.
2. Evaluation of a business in support of an IPO or other stock offering.
3. Evaluation of a company for possible acquisition, merger, investment or lending.
4. Evaluation of a business unit or product line of a company for possible acquisition.
5. Evaluation of an intellectual property portfolio for possible acquisition or licensing.

For the last three categories, an intellectual property audit is an essential part of the due diligence process for the acquiring company if the intellectual property to be acquired has any importance. Many companies do include the IP audit as part of their due diligence when they are the acquiring company and extensive check lists have been developed, particularly for acquisitions, to assure that the intellectual property is properly audited. However, an IP audit should also be conducted, at least to some extent, by the company granting IP rights so that those rights are not under valued in the transaction.

It is easy to see that depending on the purpose of the audit and the extent and importance of the related intellectual property, the breadth and depth of the audit (and, thus, its cost) will vary widely.

Frequently the desired end result is to put a dollar value on the intellectual property (e.g. the objective of the IPO, acquisition, merger, investment or lending evaluation is to put a dollar value on the assets of the business, including the intellectual property assets). However, valuation of intellectual property is itself a broad topic, often treated separately by specialized financial businesses, and, thus, it is beyond the scope of this paper.

The remainder of this paper will treat the broadest and deepest audit possibilities, which will be appropriate for an IPO where the intellectual property constitutes the major assets of the business. It should be apparent what portions of a full audit will be appropriate for other purposes. The depth of the audit will involve a value judgment by those requesting the audit—the greater the depth, the greater the time required and the greater the cost. The focus on the various forms of intellectual property will also differ by the type of business being audited (e.g. patents and trade secrets will likely be most important to a technology company while

trademarks will be the most important to a marketing company and copyrights to a literary or music company).

## **What to Audit**

A full audit will include all forms of intellectual property—patents, trademarks, trade dress, copyrights, mask work rights and trade secrets. The trick is what to look for in each area of intellectual property as well as overall. Effective protection and utilization of intellectual property and protection of the business from infringing the intellectual property rights of others does not happen by chance. It is the result of planning and dedication of resources. The components of a full audit are addressed below beginning with the processes and procedures for dealing with intellectual property, then the elements that impact all forms of IP and, finally, the unique aspects of each form of IP.

### **Review the Intellectual Property Processes and Procedures of the Business**

We will begin with the processes and procedures that broadly impact all forms of IP. Those that impact only one form of IP will be treated later in the section of this paper treating that form of intellectual property.

First, ask if the business has an intellectual property strategy—a statement of what intellectual property is important to develop and protect for the business (there may be several IP strategies for a company that has diverse businesses). Such a statement will aid in understanding the attention that has been devoted to IP and what you can expect to find in the audit of each IP area.

Second, review the new product and service introduction process. It should have explicit steps for development and protection of IP as well as explicit steps for assuring that there will not be infringement of the valid intellectual property rights of others.

Third, review the employee and consultant agreements to assure that the intellectual property developed for the company will be owned by the company, that trade secrets are protected and that key employees and consultants cannot leave the company and immediately go into direct competition. The law of the state (or country) where the employee or consultant lives and works will usually govern the interpretation and enforceability of these agreements. The enforceability of certain popular provisions (e.g. a non-compete clause in employee agreements) vary from state to state and thus must be reviewed in light of the law of the state where key employees live and work. Also, review the business practices in protecting the company in the process of hiring employees (particularly technical employees) from claims by former employers of breach of their employment agreement—best practices will include a process for assessing and dealing with this risk before the employee is hired. Best practices will also include a process for assuring that employees leaving the company do not take confidential materials and are reminded of their continuing obligations.

### Review Agreements and Disputes Involving Intellectual Property

Review all agreements with third parties affecting the intellectual property rights of the business. What to look for in respect to each form of IP will be treated below under that section. Agreements that deal only with the transfer of ownership or licensing of intellectual property obviously must be included. However, agreements divesting a part of the business, joint venture agreements, government research contracts, financing agreements, settlement agreements, supplier agreements, confidential disclosure agreements and other business arrangements can

significantly impact the overall intellectual property rights of the business. Thus, all such agreements must be reviewed for their affects on the IP rights of the company.

Review all litigation and claims made by and against the business involving intellectual property rights. Intellectual property litigation and claims often involve important aspects of the business and the outcome of such disputes can have a significant impact on the future of the business. For example, in patent litigation a successful patentee will usually obtain an injunction against further infringement, and the infringer may have to shut down an entire business line, as happened in the Polaroid v Kodak lawsuit involving instant cameras.

Now, let's examine what to look for in each of the individual forms of IP. While the order of treatment reflects the author's experience of value to the businesses with which he has worked, clearly the value and thus the emphasis of the audit will be different for different businesses.

### The Patent Audit

Patent rights are obtained by filing patent applications with government institutions throughout the world. Patents issue if the invention described and claimed in the application meets certain criteria. Each country has its own patent law setting forth the criteria and rights obtained, and a patent of a country only provides rights in that country (generally the right to prevent others from practicing the invention claimed in the patent without permission from the patent owner). In the United States, the invention described and claimed in a patent must be new, useful and non-obvious to one skilled in the art to which the invention is directed. There are utility patents for compositions, articles of manufacture, machines and processes, design patents for the appearance of an article and plant patents for asexually reproduced plants. Other countries generally have the equivalent of the U.S. utility and design patents, and some countries

have some other forms of patent protection. Patent rights, unlike the other forms of intellectual property rights discussed below, are protected only by obtaining a government document, the patent. Another distinguishing feature of a patent is its limited life; in the U.S. (and most other countries) the life of a patent is generally twenty years from the filing date of the patent application.

The patent process in a company having good patent practices will follow a document flow from technical notebooks, where all work of those who may make inventions is recorded, to records of invention summarizing work that may qualify for a patent for further evaluation, to patent applications, and finally to patents. The patent audit process should thus include a review of the use of technical notebooks (extent of use, regularity of use, signing, dating and witnessing) and the process for getting inventions from notebooks to records of invention to patent applications. Best practices include a search of the prior art patents and other literature early in a development project to avoid reinventing what others have done and to avoid infringing patents owned by others. Best practices include identifying people responsible for each of these tasks and regular review by technical management to prioritize and assure that patent rights are obtained that support the business strategy and that new products and services do not infringe patents owned by others. This includes obtaining the advice and assistance of patent counsel, especially on any question of infringement of patents owned by others to best assure avoiding infringement and to protect the company against any possible charges of willful infringement. Best practices also include people and processes for deciding in which countries around the world patent rights should be obtained to support the business goals, for interfacing with the patent authorities in those countries to obtain the best patent protection and for making the best use of the patent rights that are obtained. This requires people familiar with the business and

people knowledgeable about the patent systems of the different countries of interest around the world. Best practices include being very selective of the countries in which to file on most inventions because of the significant cost to obtain and maintain patents in most countries and because of the difficulty of enforcing patents in some countries. Best practices also include a periodic portfolio review and abandonment of patent applications and patents that no longer have value to the business. This can eliminate significant unnecessary fees and expenses.

The patent audit will include listing and collecting issued patents and patent applications owned by or licensed to the company. Virtually every country now requires fees to be paid to maintain patents in force and thus maintenance fee records must also be reviewed. A worldwide assignment search will be conducted to determine if the patents have been properly assigned to the company and the assignments recorded and to double check that all patents assigned to the company are listed.

Information should also be collected on any new invention of significance on which a patent application has not yet been filed. The R&D head of the business will know of such inventions and they should be documented in laboratory notebooks and records of invention.

The significance of each invention must be determined both in terms of the quality of the invention and its business impact. The business impact will usually drive how much time is spent assessing a particular invention because a full assessment of every invention would be prohibitive in time and cost. The business impact is usually determined by how much of the sales of the business an invention protects and how broadly it protects the business from competition. However, the business impact may in some cases be measured by licensing revenues collected. Patent rights that have been exclusively licensed to the company will usually

have more value than non-exclusive rights and patent rights that are owned and not licensed to others will generally provide more protection of sales from competition.

Patent license agreements (granting rights to the company or by which the company grants rights to others) should be reviewed for compliance. Where there are ongoing royalty payments to be made, procedures need to be established and followed to assure that the proper payments are made by the licensee (the correct amount, on the correct products, on time). The right to assign each agreement should be noted, and this will be important in the context of an acquisition or divestiture of a business that utilizes the rights under license. Frequently a patent license is not freely assignable by the licensee (it may require the consent of the licensor or it may be assignable only with the entire business of the licensee that relates to the license). And, if both the divesting and acquiring companies will need to use the rights under the license, the licensor's approval will be required unless the agreement grants the licensee the right to sublicense.

Finally, the patent audit will include a review of legal opinions provided to the company on possible infringement of patents owned by others (this is in addition to the review of claims and litigation mentioned above). The more important the product or service that is the subject of the opinion, the more detailed this review will need to be.

The detailed assessment of inventions to assess their validity, breadth and products and processes of the business that are protected, and the review of legal opinions provided to the company is the work of an experienced patent attorney. Even though a patent has been granted, it is still subject to review by a court or jury in litigation brought to stop another party from practicing the invention of the patent. There are many possible bases on which a patent can be invalidated in litigation (many of which the patent office could not know about in granting the

patent). Thus, in doing a detailed assessment, a patent attorney will obtain the file histories (the papers filed in the patent office file which includes correspondence to and from the patent office) of the patents and applications, including the prior art publications against which the patentability of the invention is judged. He or she will review these files to determine the quality of the patent office process and the invention and the breadth of the invention claimed in each patent and patent application. Documents of the company will be reviewed and persons will be interviewed relating to the development of the invention, its first disclosure outside the company and the first offer for sale of the invention. Some of the issues the attorney will be looking for evidence of are that the correct inventors are named and that the invention was not offered for sale more than a year before the patent application was filed, which are requirements for obtaining a valid patent in the U.S. In most foreign countries the patent application must be filed before the invention is openly disclosed (i.e. without a confidentiality agreement) outside the company. For an invention that is critical to the business, a prior art search may be conducted, even in respect to an issued patent. This will reduce the possibility that more pertinent prior art that invalidates or reduces the value of the patent might be found after significant resources have been expended based on a belief in a broad scope of protection provided by the patent.

The preceding provides an idea of the time and cost of a detailed review of patents. It is not intended to be an exhaustive list of the elements of the detailed assessment that an experienced patent attorney might conduct. Typically such a detailed review would not be done for all inventions of the company in a full audit. However, where patents are very important and significant money is involved, it will be done for the key patents, and some lesser review will be done for the remainder of the patents. The detailed review may also be conducted where the only assets being purchased are patents or where one or more patents are being exclusively

licensed and significant resources will be expended in the purchase or license and/or in building a business around the patents.

### The Trademark Audit

A trademark is a word, name, symbol or device, or any combination thereof, that indicates the source of goods or services and their quality. They must be properly used, as an adjective, never as a noun, or they can lose their status as trademarks and become generic so that everyone can use them (“aspirin”, “escalator” and “elevator” were once trademarks).

Trademarks, unlike patents and copyrights, can last forever and are low maintenance and relatively low cost. Famous trademarks pull through all kinds of products. For example, Harley Davidson rebuilt the company on license fees, which at one time were 50% of its income, from licensing the Harley Davidson trademark for use on products other than motorcycles.

In the U.S. and other common law countries (the countries that were part of the British empire) trademark rights are acquired by use without registration. In the United States, a U.S. based trademark applicant must use the trademark in commerce in the U.S. before it can be registered (although an “intent to use” application can be filed to preserve a priority date). In the rest of the world registration with a government agency is required and trademark rights are granted to the first to file a trademark application (except that “famous” trademarks generally are granted to the party that made them famous). The individual states of the U.S. also have registration procedures for trademarks.

Best practices include a central authority (a person or committee) responsible for setting the trademark policy for the company. Marketing personnel frequently wish to have a new name for each new product and choose names that describe the product (a “merely descriptive” mark). Often, neither of these practices provides good trademark protection. Trademarks that are

unique (“arbitrary” or “fanciful”) and in which the company builds customer identification are the easiest to protect (e.g. Coca Cola®, Xerox®, Intel®). And, having fewer trademarks is usually better for focusing customer identification. However, suggestive terms need not be “merely descriptive” and some such marks provide great value because they are easily associated with the product from the outset of the product commercialization (e.g. SoftSoap® and Caravan®). And, in some businesses more trademarks are better (e.g. in the private label business a new mark is generally used for each private label customer even though the product is the same). For all of these reasons, the trademark audit differs in many ways from the patent audit.

The trademark audit will include listing, collecting and reviewing the company’s trademark applications and registrations in the United States, the individual states and foreign countries. The applications and registrations will be checked to see that the identification of goods and services is correct and that the correct class, applicant and use date appear. An ownership search will be conducted to assure that the trademarks owned and acquired are properly listed as owned by the company. Trademark rights are lost by non-use for a period of time (abandonment is presumed after three years of non-use in the U.S.) and thus the audit needs to assure continuous usage. In the U.S. trademark registrations are lost unless an affidavit of continued use is filed between the fifth and sixth year of registration and at the time of a renewal application, which is required every ten years after registration. Most countries require the payment of periodic renewal fees. Best practices include people and computer assisted processes for assuring that these requirements are met, and the audit will check for compliance with these requirements.

Trademark registrations and applications will be reviewed to determine if the description of goods and services covers the future plans of the business. New trademarks and extensions of existing marks can be protected in the U.S. by filing an intent-to-use application, the rights in which will relate back to the date of filing even though registration cannot be obtained until the mark has been used in commerce.

Since trademarks need not be registered in the U.S. and other common law countries, the audit must include discovering and listing the unregistered trademarks of the company. This may be accomplished by reviewing the products, product literature, packaging and advertising of the company. Unique elements of packaging, including package shape and graphics, can grow in importance as an identifier of the source of goods over the years and be overlooked for registration. The newer identifiers that have been held to be protectible trademarks—color, scent and sound—may also have been overlooked. Important trademarks should be registered and unimportant trademarks should be phased out. The product, literature, packaging and advertising review will also be used to determine if the trademarks have been used properly (as adjectives, not nouns; in a distinctive script; and with ® if registered or ™ if not). Best practices will include a process for legal review of all new product literature and packaging for compliance with the trademark and advertising laws.

Trademark license agreements (granting rights to the company or by which the company grants rights to others) should be reviewed for compliance. Since trademarks designate the source and quality of goods, trademark license agreements must require some level of assurance of the quality of the goods sold by the licensee or the trademark may be lost. There should be processes in place to assure compliance and records of compliance.

A trademark search should be conducted, at least on the trademarks that are of major significance to the company. Such searches are on-line computer searches checking for similar identifiers used to identify goods, services and businesses. There are commercial services available to do these searches. Trademark registrations (federal and state), business name registrations and other commercial usage (e.g. on the Internet) are checked and reported. Any trademark availability opinions on the important trademarks, trademark registration file histories and documentation relating to enforcement efforts (or lack thereof with respect to known infringers) should be collected. With the company's marks, the searches and the history files, a trademark attorney can advise on the strength and protectability of the company's trademarks, infringement of the company's trademarks by others, and the possible infringement of trademark rights owned by others.

### The Trade Dress Audit

Trade dress protection is often treated with trademarks because trademarks and trade dress protection emanate from the same law. As with trademark protection, trade dress protection protects the consumer from false or misleading representations as to the source of goods or services. Trade dress is the overall visual appearance of products, product packaging, service establishments (e.g. restaurants) and the like. To be protectable, trade dress must be nonfunctional and distinctive.

There is no registration process for trade dress (although creative trademark lawyers have found ways to register what was thought to be trade dress as trademarks, thereby adding to the protection for the client). Rights are developed through use. Consistency of the appearance of products and product packaging over time and across products is the usual form of trade dress

and should be looked for in the audit. However, in recent years the most notable trade dress litigation has been over the interior design of restaurants.

### The Copyright Audit

A copyright protects literary and artistic “expression” and other types of informative media that derive their value from the particular manner in which the information is expressed. Computer programs, books, movies, musical works, paintings and sculptures are among the types of works that are eligible for copyright protection. A copyright arises in a work if at least a portion of it is original. The copyright automatically exists when the work is created. There is no need to sell or use the work (as with trademarks) or to register the work (as with patents) for the copyright to be valid. A copyright in the U.S. generally lasts for the author’s life plus fifty years.

Best practices include affixing a copyright notice to copies of the work. The notice will include the © symbol (or the word “copyright” or “copr.”), the year of first publication and the name of the owner of the copyright. If the work is unpublished, such as with software source code, the notice may include the word “unpublished” and the date of creation (rather than the date of publication). Best practices also include registration of any significant copyright within three months of publication because timely registration provides a presumption of validity and the possibility of collecting statutory damages and attorneys’ fees from any infringer. And, registration is inexpensive. Registration is required before filing a lawsuit for infringement of any copyrighted work in the United States.

The audit will include a listing of registered copyrights and a review of the registrations for accuracy (e.g. correct authors and correct statements of whether original or derivative work). Other significant copyrightable works developed by or for the company should also be listed.

Significant copyrightable works the company has purchased (e.g. major computer programs) should be reviewed to assure that appropriate licenses have been obtained and that the company is in compliance with the terms of those licenses. The company should also have an explicit policy against employees copying copyrightable works of others without written permission from the copyright owner.

Agreements with consultants who produce copyrightable works for the company must be reviewed. The general rule is that copyright ownership vests in the individual who makes the work. The exception is in the case of a “work made for hire”. These include copyrights in works created by employees within the scope of their employment (however, best practices provide for company ownership in the employee agreement referred to above). It also includes copyrights in certain classes of works created by consultants where there is an agreement before the work is created that it will be deemed to be a “work made for hire” and the agreement is reduced to writing. Best practices include having written agreements with consultants that may produce copyrightable works, before they begin work. Such agreements should provide that the work will be a “work made for hire” if the work is within the classes of works covered thereby or that otherwise they will assign their rights to the company. If the work is not a “work made for hire” the author or their successor can reclaim ownership after thirty-five years.

Where the company is in the business of making and selling copyrightable works, such as books or computer programs, the development process should be audited. With respect to each work in question, the auditors should interview the authors and determine whether any preexisting material was incorporated into the work and, if so, whether permission to use that material to create a derivative work was needed and obtained. The auditors should carefully examine all outside sources and persons that contributed to or were consulted in the creation of

the work. A determination must be made in each case whether source material that was consulted or contributed to the work was in the public domain or was owned by a third party. If owned by a third party, the terms pursuant to which such contributions were made must be analyzed to identify any parties who may have rights to the work or portions of it. Particular inquiry should be made to determine whether any copyrightable material contributed by employees in fact belongs to a former employer. Where other works were consulted without permission, or in the event there is a high risk of claims of infringement from a particular third party, an analysis of substantial similarity between the company product and the product of the third party should be conducted with the assistance of a copyright attorney.

### The Mask Works Rights Audit

Mask work rights are rights created by the Semiconductor Chip Protection Act enacted in the United States in 1985 to protect the masks developed at great expense and used by computer chip manufacturers in production from being copied by others. A mask work is, in essence, the design of an electrical circuit, the pattern of which is transferred and fixed in a semiconductor chip during the manufacturing process. Mask works may be registered with the U.S. Copyright Office for a non-renewable term of 10 years. Mention of mask work rights is included here for completeness but it will not be treated in detail because it applies to few companies, it has resulted in few reported disputes and there is little discussion in the literature.

### The Trade Secret Audit

A trade secret is generally defined as information, including a formula, pattern, compilation, program, device, method, technique, or process that: (1) derives independent economic value, actual or potential, from not being generally known to the public or to other

persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy (Uniform Trade Secrets Act). Trade secret protection in the U.S. is governed exclusively by state law, but for all practical purposes, every state makes theft or unauthorized dissemination of a trade secret an unlawful act. Theft of trade secrets can also result in criminal penalties under the federal Economic Espionage Act. One of the benefits of trade secret protection is that there is no limitation on the length of time that the trade secret can be protected (e.g. the formula for Coca-Cola® soft drink).

Trade secrets are typically found in new product plans, manufacturing processes, advertising plans, customer lists, cost and pricing data, financial statements and projections, and computer software. There is no formula for what constitutes reasonable efforts to maintain the secrecy of the information. Some of the factors that courts have identified are controlled access to facilities, central control of blueprints and drawings, security guards, employee identification badges, locked storage of laboratory notebooks, confidential notices on all purchase orders and requests for quotes, employee confidentiality agreements and restriction of visitor access. Best practices include more restrictive access to the more important trade secrets of the company, including limiting access to only those employees who need to have access and increasing the security against unauthorized access. All of this is counter to the increasing need to share information with suppliers and customers but courts have understood this practicality and have provided allowance for it so long as the suppliers and customers are under obligations to retain information in confidence and the access provided is reasonably necessary to conduct business.

Best practices should also include a well-controlled process for accepting confidential information of other parties. Such information should not be accepted if it will conflict with or

limit the future business of the company. Idea submissions by individuals from outside the company can create significant problems. Not infrequently such submitted ideas will already be known to the company and may relate to a product already under development but kept secret within the company. If there is no response by the company, or the individual is sent a rejection letter, and the company later markets the product, the individual is likely to be upset and demand compensation. This has led some companies to refuse outside idea submissions and others to only accept them after the individual has signed an agreement stating that the idea is being submitted on a non-confidential basis.

The audit should identify areas of significant trade secrets and assess the reasonableness of the procedures for protecting them. The identification should be done in a manner so as not to detail the trade secrets because it is unnecessary and to do so risks dissemination. As with other forms of intellectual property, the business impact of trade secrets is usually determined by the competitive advantage in cost, quality, sales, etc. they provide over the competition. However, trade secrets can also be licensed to others and generate income or other value to the company.

### **The Audit Process**

In establishing an audit process it is important to determine in advance what is to be accomplished so no more nor less than needed is done. It is also important to create a record of what is done for use in valuation and/or future planning.

### **Make an Audit Plan**

The amount of intellectual property to be audited and the number of people who will be involved will dictate how detailed and formal the audit plan should be. However, it is always critical to have agreement in advance with the audit requester and the company being audited, if

different, as to what is to be done. As should be evident from the discussion above, a full audit would rarely if ever be done if the intellectual property of the company is of a significant amount. The purpose of the audit will focus the potential scope of the audit. Then the most important risks and opportunities must be identified and those should be the focus of the audit. Identifying those most important risks and opportunities must be the first step in the process. As with any good plan, the audit plan should identify the tasks, the people, the timeline and the estimated cost. When the plan is approved, the audit can begin.

### Collect the Relevant Information

Collection of some of the information is straightforward. Patents, registered trademarks and registered copyrights and mask work rights are matters of public record. The company's internal processes, agreements, inventions not yet patented, unregistered trademarks, copyrights and mask work rights, and trade secrets must be determined by talking to the right people in the company.

People responsible for research and development, sales and marketing and manufacturing for the company and the company's intellectual property counsel (in-house and/or outside) will be a starting point. With a checklist of the information sought, those persons can provide information or direct the auditors to the people in the company responsible for the information being sought. If good systems are in place, the processes will be documented and the audit can focus on whether the processes are appropriate and are followed. Agreements having intellectual property implications will be listed in a database and one or a few people will have the relevant agreements. Significant inventions not yet patented and any unregistered mask work rights will be known to the responsible research and development person(s). Unregistered trademarks of significance will be known to sales and marketing and significant unregistered copyrights and

copyrightable material will be known to different persons depending on the company (e.g. a software company will have that aspect focused for the software itself and perhaps for any training materials, but in a hard goods company there may be software developed in separate business units). Trade secrets are potentially the area that requires the broadest sweep since significant trade secrets may exist in sales and marketing (customers, pricing, market information, strategic plan, etc.); research and development and manufacturing (products and processes in development, manufacturing processes, formulas, material suppliers, etc.), and computer programming (wherever it resides in the company, or outside the company and done by consultants or separate entities under contract).

### Analyze the Information

The intellectual property processes and systems audited can be compared against best practices which are in part noted above, are today extensively covered in the literature, and are known to experienced intellectual property counsel who have conducted audits. The quality of patent, trademark and copyright protection and the risks to the company in possibly infringing intellectual property rights owned by others should be analyzed by intellectual property counsel who specialize in those areas of the law. Intellectual property counsel should also review the agreements collected to assess the risks and benefits in them.

### Write the Audit Report

The results of an intellectual property audit should normally be memorialized in a report. The report should include the objective of the audit, the audit plan and how it was executed and the results of the analysis. It should describe and evaluate intellectual property defects uncovered in the audit, propose and describe specific remedial action that needs to be taken or

that has been taken, and respond to any other specific need for information the parties commissioning the audit may have.

If, for example, the audit was conducted in the context of an acquisition transaction, the report should provide the information necessary to decide whether the rights available are the rights required by the acquiring party and what the related risks are, and it should provide a basis for valuing the rights to be acquired as well as the risks or costs of cure. Necessary remedial action can be implemented either before the transaction is consummated or after the acquisition (with appropriate adjustment in the purchase price to reflect the risks or costs of the cure).

The audit report will, of course, be highly confidential and its distribution should, therefore, be limited. Privileged attorney-client communications will be embodied or summarized in the report and care must also be taken in its distribution to assure that the privilege is not inadvertently waived.