INTELLECTUAL PROPERTY ASSET AUDITS AND VALUATION

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Why Should a Business Audit Its Intellectual Property Assets or Have them Valuated?

The fastest growing sectors of today's economy are knowledge-based and depend largely on the value of their intellectual property for survival and growth. According to one study, in 1978 twenty percent of corporate assets in this country were intangible assets, of which intellectual property is a subset, but by 1997 seventy-three percent of corporate assets were intangible assets.1 Globally, trade in intellectual property assets makes up "more than 20 percent of world trade, or approximately US $740 billion." 2 As an added perspective, in his April 23, 2002 statement before the Subcommittee on Commerce, House of Representatives, James E. Rogan, the Under Secretary of Commerce for Intellectual Property and Director of the United States Patent and Trademark Office said, IP industries represent the largest single sector of the American economy – almost 5% of GDP- and employ over 4 million Americans. Copyright industries, for example, are creating jobs at three times the rate of the rest of the U.S. economy. In 2006-2007, total copyright industries alone contributed 1.52 trillion dollars, or 11% of GDP of this country, and the growth rates of these industries was more than twice that of the economy as a whole.

Thus, it is crucial for a knowledge-based business to find out what kind of intellectual property assets it has, through an audit, and then to valuate them. A knowledge based business must do so before it can make informed decisions on where and how to invest its resources to maintain, develop and enforce its intellectual property and, thus, its competitiveness. Such decisions include determining which intellectual property assets to develop, whether or not to continue developing an asset, what licensing fee to charge, which assets are suitable for cross-licensing, how much an asset should be sold for and whether or not to sue for infringement. Put differently, if you don't know what the crown jewels in your intellectual property portfolio are worth, how do you know you haven't licensed it away for too little or given away too many rights?

While there is no set formula for conducting an intellectual property audit, it consists primarily of identifying the types of intellectual property assets that the business possesses, those that are important or essential to the business' revenue growth and protection, what technologies are encompassed in the new products or services that the company is planning to introduce, and a review of existing agreements and disputes involving these assets. The audit is also a good way to find out whether you are properly protecting your intellectual property assets.

With respect to valuating intellectual property assets, there is presently no one method that is suitable for all such assets and each method has its inherent limitations. The three accepted and most commonly used valuation methods are: cost, income and market value.

The Cost Method

This method measures the value of the asset by ascertaining either how much it would cost now to create an asset with equal utility to the subject asset using current technology, or how much it would cost now to build an exact copy of the subject asset. 4 The first approach measures the cost of obtaining and using current technology to arrive at an equivalent substitute for the subject asset (replacement cost) whereas the second approach measures the current cost of duplicating the intellectual property asset in the form it was in when it was created (duplication cost).

In essence, the cost method equates the value of the future benefits stemming from an intellectual property asset with one of the above two types of costs.

The Income Method

This method looks at the present value of the net income that can be generated by the asset over its economic life. This income stream can take the form of royalties, proceeds from the sale of the asset, revenue from enforcement of rights in the particular asset or a combination of all three. The economic life of the asset is dependent on a number of factors, which vary depending on the type of intellectual property. In the case of patents, the probability that a competitor will design an equivalent around the patented invention, development of a superior product that would replace the patented invention, market life of a product utilizing the patented technology, and invalidation of the patent are some of the considerations affecting the duration of a patent's economic life. With trademarks, it is assumed that the more you invest in a trademark, the longer its economic life. The economic life of copyrights depends on the timeliness, breadth and versatility of the exploitation of the copyrighted work. Because intellectual property rights are created by law, the legal life of an intellectual property asset is a factor that must be taken into consideration in calculating the income to be derived from the property.

The Market Value Method

This method looks at the fair market value of the intellectual property asset, i.e. what the asset would fetch if it were sold to a willing buyer at arms length. It requires identifying prices for arms length transactions involving comparable assets in an active, public market in order to determine what the market rate should be. As such, it is rarely used because usually information on comparable asset transactions is not publicly available and/or there isn't an active market for such transactions.

For further incentive to conduct an intellectual property audit and valuation, one need only look at the enormous rewards that successful exploitation of intellectual property assets can bring. Texas Instruments now derives more revenue from licensing its intellectual property than from manufacturing.

Enforcing intellectual property rights in non-core technologies can be a good source of additional revenue too. Similarly, market perception of the value of a company's core intellectual property, upon which the company is dependent for its competitive edge, can greatly affect the company's share price. In the case of TiVo, Inc., a company traded on NASDAQ, it experienced a 44% drop in its share price within 10 days of competitor Gemstar's announcement that it was suing TiVo for patent infringement of key technology used in TiVo's digital video recorders and a 127% increase in its share price within two days of its announcement that it had received a patent covering many key inventions in its business. 6 Nor should we forget Polaroid's historic victory against Kodak in 1990 when a trial court awarded it $925 million against Kodak for infringement of its instant photography patents. Polaroid also forced Kodak out of the instant photography business.

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* 1Kenneth Crosin, Management of IP Assets, AIPLA Bulletin (2000 Mid Winter Meeting Issue). 2Lesley Ellen Harris, Digital Property: Currency

of the 21st Century, p. 51 (1998). 3John Eggerton, Copyright Industries Contribute More than 1 Trillion Dollars to Economy: Study, Multichannel News (July 20, 2009) 4Lisa M. Brownlee, Intellectual Property Due Diligence in Corporate Transactions, Sections 12:6-7 (1998). 5Alexander I. Poltorak and Paul J. Lerner, Corporate Officers and Directors Can Be Liable for Mismanaging Intellectual Property, JurisNotes.com. Originally published in two parts in Patent Strategy & Management: Volume 1, Number 1(May 2000); and Volume 1, Number 2 (June 2000). 6 Craig P. Opperman, Do Patents Really Make a Difference to Stock Price? Intellectual Property Today, p. 8 (February 2002).