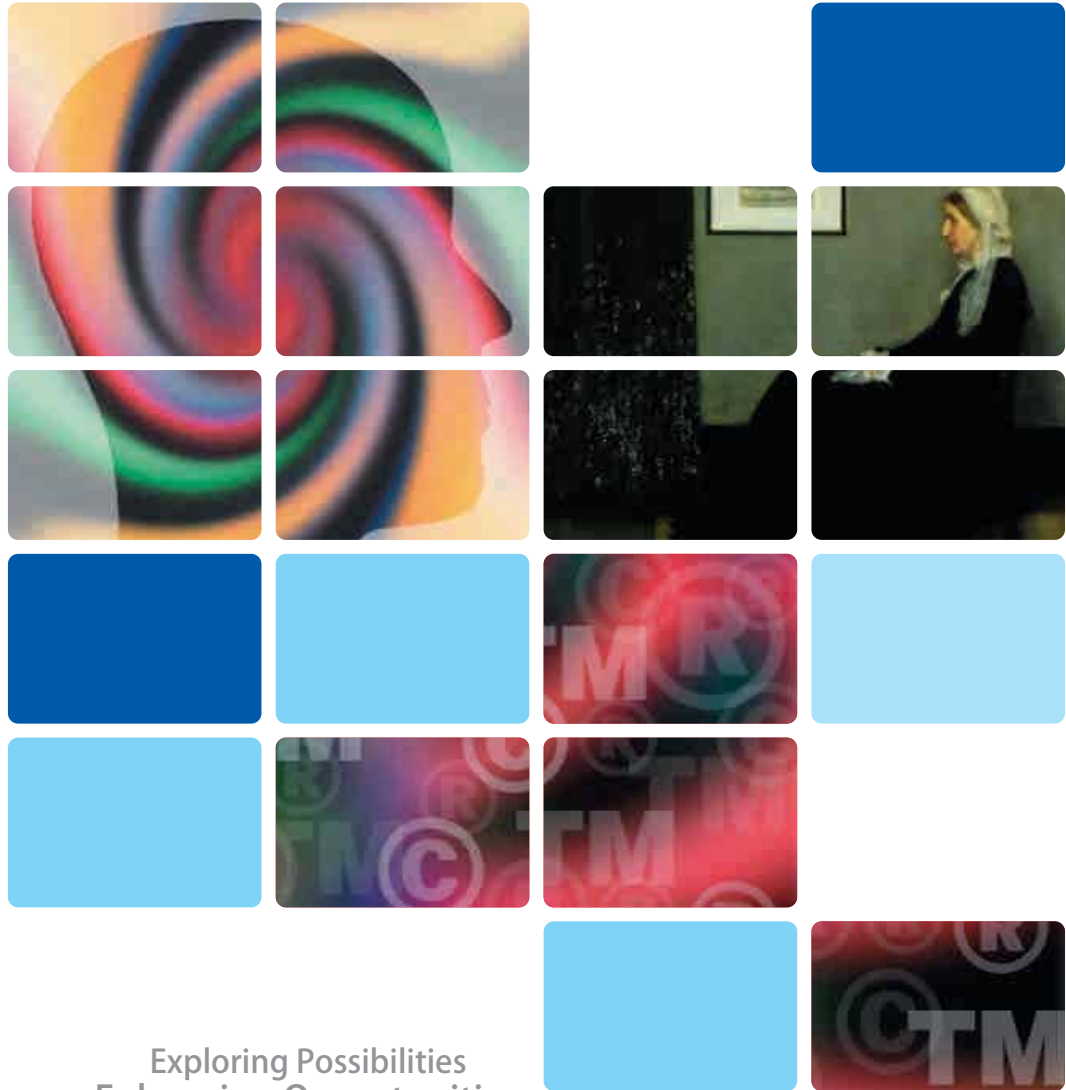




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Intellectual Property (IP) Audit - A Legal Perspective

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Introduction

An enterprise's value is determined based on its assets' quality and not quantity. Further, the value also largely depends as that perceived by its various stakeholders – shareholders, creditors, government, consumers, etc. These assets may be broadly divided into two categories: (i) *tangible or physical* assets - building, machinery, infrastructure, etc; and (ii) *intangible* assets –patents, ideas, trademarks, designs, know-how, etc. Conventionally, physical assets have been responsible for the bulk of the value of an enterprise, and were also considered to be largely responsible for determining the competitiveness of an enterprise in the market place. However, in today's information and knowledge-based economy, this traditional wisdom no longer holds true. A business's intrinsic value is now largely determined by its quality of intangibles. The information technology revolution and the growth of the service sector have furthermore contributed this turnaround.

Today we all are living in an information and knowledge society. With the increasing adoption of the Internet and various other web technologies, the flow and dissemination of information and knowledge is just getting augmented. While this seems to be an optimistic sign, it poses a number of challenges in managing the same, especially when such the information and knowledge is in the form of IP.

Intellectual Property (“IP”) refers to creations of the human intellect and is in the form of inventions, literary and artistic works, logos, names, images, designs, etc used in commerce. Intellectual Property Rights (“IPR”) refers to the rights related to IP. For e.g. an idea or an invention is regarded as IP whereas the right associated with such IP (i.e. a patent) is considered as IPR. IPR is the tool to protect such creations and take the form of patents, trademarks, copyrights, trade secrets, designs, etc.

Importance of IP protection and management

All enterprises use some form of IP to successfully conduct their businesses regardless of their size, nature or industry. IP is an important asset not only for business users of IP but also for creators of IP. Various sorts of IP and circumstances surrounding its creation often make it impossible for such businesses and creators to be fully assiduous of its IP. Even if creators and users understand the importance of IP protection, many still do not know how to do so in the most efficient and effective manner. Without an effective IP protection and management system, creators and companies are sure to dispel business opportunities.

One of the best ways that can be adopted to effectively address this issue is by conducting an 'IP audit'.

What is IP audit?

Typically, the term 'audit' refers to a business audit which includes formal examination and verification of a company's accounts with the objective of acquiring and understanding the overall picture of a company's financial position.

Just like a business audit, an IP audit involves the evaluation of a company's IP assets and potential liabilities. There is no clear cut definition of IP audit. However, from businesses' point of view, it can be interpreted to mean a systematic assessment of various processes and procedures adopted in creating or generating IP, including IP assets owned, used and/or acquired by a business and understanding the IP rights/liabilities associated thereto.

An IP audit provides an assessment of the intangible assets of a company. The audit examines and evaluates the strengths and weaknesses in the procedures used to protect each intangible asset and secure appropriate IP rights. Where necessary, the audit provides tools to develop additional processes, make improvements to existing processes, and take corrective measures to help ensure capture of future IP rights.

Briefly the objectives and significance to undertake an IP audit include:

- ascertaining and protecting unutilized or under-utilized IP and IP rights.
- ascertaining pending and registered IP.
- reviewing under-prosecution applications.
- reviewing past IP litigation history.
- ascertaining IP creation and ownership rights.
- ascertaining whether the IP rights pose any challenge or threat by others.
- ascertaining whether the company has an effective IP maintenance and management plan in place.
- developing a comprehensive IP protection program.
- undertake valuation of a company's IP assets.
- effective management of a company's overall IP portfolio.

Absence to conduct an appropriate IP audit has certain disadvantages as well. These include:

- unable to unlock the potential value of IP.
- missed growth opportunities.
- jeopardizing company's viability.
- low market share and profitability, poor leadership, etc.
- unintentional third party infringements.

When to conduct an IP Audit?

An IP audit may be undertaken by a company in a number of instances. These include:

- acquisition of a brand, technology or product;
- sale of a business enterprise;
- for the purposes of IP asset valuation;
- to identify procedures followed by the company with respect to its IP and to frame systematic guidelines for its better protection and management;
- to detect defects;
- to detect whether any third party rights, including IP rights, are being violated;
- to keep updated with changes in the legal environment;
- as part of an ongoing IP management program;
- for enforcing or defending IP rights;

Who should conduct the IP Audit?

The designation of an audit team depends on the nature and scope of the audit. In case of an internal audit, a company's own personnel may have sufficient time, knowledge and understanding of the facts and issues involved to perform the audit. These personnel are often those who are involved in developing, recording and safeguarding the company's IP. In many situations, the scope of the audit may be such that internal personnel may not be sufficient to conduct the audit exercise. In the instances where the company personnel may not have the required time, skills or expertise to perform a full-scale audit, outside counsel and legal practitioners may be brought in to conduct the audit.

When such external people are used, they are sure to bring in considerable knowledge and experience in conducting and managing IP audits efficiently and effectively. Sometimes an audit may be a specific audit which may require a skilled expert to conduct the same, for example, a technology or a software audit. Such external counsels should not only have experience in conducting and managing IP rights uncovered through the audit, but they must also have experience in

obtaining remedies for any defects found in the audit. The skills should include litigation skills, because the types of issues that an audit seeks to reveal and treat will likely be relevant if litigation materializes, for example, a suit for infringement.

Lastly, the audit team should be sensitive and must respect attorney-client communication and the same must not be revealed by the audit team to any other party except after obtaining prior permission from the client.

Scope of the Audit

The relevant considerations in setting the scope of an IP audit include:

- Size of the company.
- Duration and the extent and magnitude of company's business operations.
- The purpose of the audit.
- The strategic or other significance of IP in the company's corporate plan.

The appropriate scope of the audit is often situation specific. Further, depending on its purpose, an IP audit may be narrow or extensive in scope. However, it is always safer and better for the IP audit to be broader rather than narrower in scope.

What is the IP audit process?

The IP Audit process involves certain internal and external activities. These include:

(i) Audit Objective & Scope

First and foremost, identify the objective of the audit. Once the objective is identified, it will be easier to establish whether the audit has to be an internal one or an external one and whether the same has to further be a specific one or a comprehensive one.

The appropriate scope of the audit is often situation specific. For example, if a company is conducting an audit of its company-wide procedures for acquiring, perfecting and enforcing its IP rights, an IP audit of broad scope is appropriate. Audits more narrow in focus may be appropriate when, for example, a company is facing possible trademark litigation and an investigation limited to the trademark at hand may be all that is required. In M&A transactions, an audit of full scope may be appropriate if a buyer is contemplating an acquisition of a substantial ownership interest in a seller or its assets.

(ii) Internal Identification of IP

Before appointing the audit team, the company must first internally identify IP that it has created, owned and/or acquired. Further, the team must internally make a final review of the same and categorize it under its IP portfolio if it's able to do so. For example, a company may have various domain names, brands and logos. It can categorize these under its trademark portfolio.

(iii) Identification & Appointment of the Audit team

Once the audit objective and scope is finalized and the company has identified the IP which requires undergoing the audit exercise, the company must then identify and appoint certain people who will finally conduct the audit exercise. The audit team may be internal or external depending on various factors such as the audit objective & scope of the audit, skills required, etc.

(iv) Information Gathering

Once the audit team has been appointed, substantial information will need to be gathered and presented before the audit team can efficiently commence their detailed audit investigation. Such information may include the following:

- nature of intangible assets.
- relevant material pertaining to the intangible assets such as brochures, advertisements, marketing materials, etc.
- various contracts and agreements such as license agreements, vendor and customer contracts, R&D agreements, government contracts, etc.
- all global intellectual property filings and registrations including related details thereof such as litigation history, assignment, licensing, etc.

Someone at the company should be designated the task to coordinate the gathering of various documents and information relevant to the audit.

To obtain this information, the audit team may also send a questionnaire to the company's employees that use or develop IP, asking them to list all patented, trademarked, copyrighted, and confidential material used or developed by the employee and conduct searches of available databases for information regarding the company's products, services, and advertising, that involve the use of patents, trademarks, copyrights. These searches may reveal assignments, security interests, or other impairments of the company's IP rights, and the company's possible infringement of third party IP rights. A final IP audit report should be prepared that identifies each IP asset owned by the company and specifies the date of acquisition of each IP asset, its developer, any license, assignment, or transfer, and whether it has been registered with any federal or state agency.

A sample questionnaire capturing the above information is annexed at the end of this article.

(v) Internal People Involved

The audit team so appointed will need timely and updated information, documents, etc from the company personnel. Generally, the company identifies certain people which will cooperate with the audit team. These internal personnel would generally include the company's legal team and employees who have been in the company for substantial time and/or have an in depth knowledge of its business.

(vi) Interactions with Company Employees

The IP audit process usually starts with interactions with the company's employees and senior executives / management. The interaction and the responses to the questionnaires developed for this purpose play a significant role in guiding the IP audit team to obtain a clear understanding of (i) the scope and extent of the company's business, (ii) the nature of the products and services offered, (iii) connection of the products and services with IP, (iv) internal procedures followed with respect to generation/creation, protection and management of IP; and (v) reasons and rationale behind certain decisions and actions of the company. Such interactions bring out important facts, which play a crucial role in identifying IP potential and risks within the company.

(vii) Review of Internal Procedures

For the purpose of identifying, documenting, evidencing, registering, protecting and defending IP, it is very important to develop elaborate and strong internal policies and procedures. Lack of these may result in irreparable damage to the companies at a later stage. Mismanagement of IP at the point when it is created, often leads to time-consuming

and unnecessary efforts to prove the ownership of IP and date of creation. Companies may also face infringement proceedings, if diligence is not exercised to avoid incorporation of third party IP. It is, therefore, very crucial to review such policies and procedures as a part of the IP Audit process. This process may eventually help in establishing an IP strategy for the company.

(viii) **Review of Documents**

Review of agreements

The audit team has to review various contracts and agreements to which the company is, or has been, party to. This will assist in establishing whether any IP has been created under any agreement, and if yes, who owns the rights to the same, how is the IP exploited, etc. Documents to be reviewed should include contracts/agreements with consultants, contractors, freelancers, employees, joint development agreements, research & development agreements, IP licensing and IP assignment agreements, transfer of technology agreements, distribution agreements, marketing or co-marketing agreements, franchise agreements and other business arrangements.

The aforesaid review and analysis of documents helps to ensure that the agreements contain clauses assigning the IP developed by the employees to the company and obligations relating to confidentiality and non-compete.

Reviewing litigation related documents is also immensely vital. This will help in ascertaining and examining IP disputes pending with courts in India or abroad or before any international authority such as the WIPO. IP litigation and claims often involve important aspects of the business and the outcome of such disputes can have a significant impact on the company's viability.

Description of all claims and pending or threatened litigation, arbitration, administrative and regulatory proceedings by or affecting the Company, its current or former directors, officers or employees should also be examined. All correspondence relating to IP disputes, cease and desist notices, affidavits, letters alleging infringement, letters threatening lawsuits, complaints for IP infringement, criminal complaints for copyright infringement, details of opposition proceedings initiated with regards to registration of IP should also be examined carefully.

Review of documents recording registration of IP

These documents are examined to ascertain the correctness of the information recorded on various IP registers. For example, in case of a trademark (the correctness of the name of the owner, correctness of description of goods / services and classes), in case of copyright (correctness of the name of the author and the holder of various rights in the copyrighted work), etc.

This is most important in case of group companies. It is often found in group companies that no conscious decision is taken regarding the ownership of IP while registering it. This leads to conflicting or concurrent rights being recorded, creating legal complexities and also problems at the time of hiving off of one of the group companies or in cases of mergers and acquisitions.

Once the documents examination and ascertainment has been done, the audit team must ideally conduct a formal database search to validate their finding as well as to understand the actual factual position. IP database search can be conducted with various registries such as the Trade Marks Registry, the Designs Office, the Patents Office, etc.

(ix) **Conducting Interviews**

The audit team can also conduct interviews with various stakeholders of the IP development and management

team. Quite many times, when there are many persons to be interviewed, the audit team prefers to send a questionnaire to such persons for the purposes of obtaining the requested responses. Such persons may be present and/or former employees, contractors, etc.

(x) Issue of IP Audit Report

Just like a due diligence report is issued post due diligence exercise, in case of an IP audit, an IP Audit Report is issued once the audit is completed. The report states the objective of the audit, the audit plan and how it was executed and the results of the analysis. It describes and evaluates defects uncovered in the audit, proposes and describes specific remedial action that needs to be taken or that has been taken and responds to any other specific need for information the parties commissioning the audit may have. For example, there may be certain changes to be undertaken in the way IP is identified or protected internally.

If 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 should provide a basis for valuing the rights to be acquired. Necessary remedial action can be implemented either before the transaction is consummated or after the acquisition (with appropriate adjustments in the purchase price to reflect the risks or cost of the cure) by way of condition precedent or condition subsequent.

The audit report will definitely be highly confidential and is generally given only to the management or the concerned department head/s. Privileged attorney-client communications is generally embodied or summarized in the report and care must also be taken in its distribution to assure that the privilege is not inadvertently waived.

(xi) Filings

Prior to conducting the audit exercise or even post recommendation stage, if any recommendation pertains to some filing to be undertaken then the same must be immediately taken care of so as to avoid any disaster at a later date. For example:

- If prior to undertaking an audit, there is an existing litigation on trademark front then the necessary filings must be made by the company before it undertakes the audit exercise.
- The audit may uncover areas or IP which require it to file copyright and trademark registration applications and affidavits of continued use of trademarks.

(xii) IP Chart

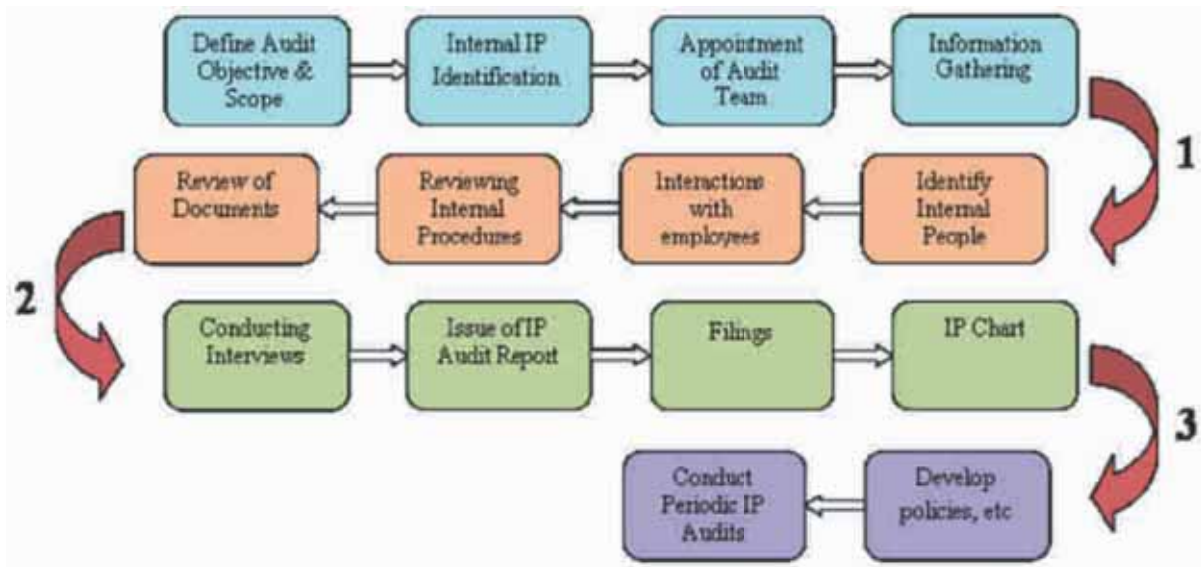
If the company does not have an existing chart which can facilitate in capturing its IP portfolio, then it is advisable to draw up an IP chart which can capture various types of IP under one document. A sample chart is annexed to this paper.

(xiii) Develop policies, guidelines and procedures

If the company does not have any existing policies, guidelines and procedures with respect to identification, development and protection of IP, then it is advisable to develop the same for its overall better management.

(xiv) Conduct Periodic IP Audits

A company must revisit the Audit Report and ensure that the company and all its employees are adhering to the recommendations outlined in the Audit Report as well complying policies, guidelines and procedures so drafted above. Further conducting periodic IP audits will also help a company to keep its IP portfolio up-to-date.



Conclusion

An IP audit provides information on the nature and strength of the intangible assets by studying the IPR associated with those assets.

An IP audit can be a relatively simple exercise that can have a meaningful role in avoiding various circumstances - violation of others' rights, protecting one's IP/IPR, minimizing the risk of thirty party IP violation, clarifying IP ownership issues, etc. It also serves as a guiding tool for maintenance, management and safeguarding of IP rights.

As companies understand the value of their intangibles and rights associated thereto, the importance of IP is bound to grow. As a result the role of IP audit and valuation has a long way to go. Professionals will surely hone their skills in order to conduct meaningful and an effective audit and valuation which will further help companies in safeguarding against appalling future surprises.

SAMPLE CHECKLIST

	INTELLECTUAL PROPERTY (IP)				
	Patents	Trademarks	Copyrights	Designs	Confidential information
Nature /Type of IP	?	?	?	?	?
IP created by	?	?	?	?	?
IP creation date	?	?	?	?	?
IP expiry date	?	?	?	?	?
Is the IP registerable?	Y/N	Y/N	Y/N	Y/N	Y/N
If YES (Y), is it registered?	Y/N	Y/N	Y/N	Y/N	Y/N
Is the IP in use?	Y/N	Y/N	Y/N	Y/N	Y/N
Where is IP used?	?	?	?	?	?
Can it be further exploited? eg. through royalty, licensing, etc.	Y/N	Y/N	Y/N	Y/N	Y/N
Is the IP being commercially exploited?	Y/N	Y/N	Y/N	Y/N	Y/N
Do contracts exist? a) with employees b) with contractors	Y/N Y/N	Y/N Y/N	Y/N Y/N	Y/N Y/N	Y/N Y/N
Who / Which department is responsible for its protection?	?	?	?	?	?
Who / Which department is responsible for its management & enforcement?	?	?	?	?	?
What is the current approx. value of IP?	?	?	?	?	?