Article

Planning For Litigation Over Acquired IP

Michael R. Annis
314.345.6432
mike.annis@huschblackwell.com

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By Mike Annis, Husch Blackwell LLP, and Brad Pursel, Brown Smith Wallace LLC

Intellectual property has become a critical asset. Companies in many industries allocate significant amounts of capital to create intellectual property or acquire it from third parties. As a result, companies must carefully manage their portfolios to maximize value and protect IP rights.

This article discusses U.S. Generally Accepted Accounting Principles (GAAP) requirements related to accounting for acquired IP, and the discoverability and use of accounting work papers if the acquired IP is subject to infringement litigation.

The valuation of allegedly infringed IP and the assumptions used to do the valuation can be central issues in determining damages in IP litigation. Although there is often limited information about a company's internally developed IP, accounting standards under GAAP require the valuation of IP acquired during an acquisition. If the acquired IP is later subject to an infringement claim, the valuation of the acquired IP will likely become a subject of discovery and significant discussion during the litigation.

Corporate executives should plan carefully for the accounting and valuation of acquired IP, not only to comply with accounting standards, but also because the work papers will be discoverable.

Here's a scenario that illustrates what can happen:

Alpha Company acquires Beta Corporation. In performing the accounting for the acquisition, Alpha must record the fair value of any acquired assets, including IP, regardless of whether the asset was previously recorded on the balance sheet of Beta. However, in accounting for the acquisition, Alpha does not record as an asset Beta's patent portfolio. This implies that the fair value of the patent portfolio is $0.

Subsequent to the acquisition, Alpha discovers that Cash Company is infringing on Alpha's patent portfolio in the manufacture and sale of a competing product. The question then becomes: Does Alpha's accounting for the acquired IP patent portfolio negatively impact Alpha's ability to seek damages for patent infringement?

Importance of IP Assets in M&A

Executives should be aware of the potential legal consequences of any IP valuation should the IP later become the subject of infringement litigation. These valuations should not be considered an exercise in accounting compliance unrelated to the protection of rights and maximization of value from such rights.

In a 2008 survey sponsored by CRA International and K&L Gates LLP, the vast majority of respondents (85 percent of corporate executives and 72 percent of private equity executives considered IP assets as important or more important than other assets when evaluating a target. (In addition, 58 percent of respondents said that insufficient time is the biggest challenge they face when conducting due diligence of IP assets.)

A thorough due diligence process supplemented by a post-acquisition IP audit is one way to ensure that all material IP assets are identified and assigned value. If IP identification is not completed during initial due diligence, GAAP compliance offers another opportunity to track and value acquired IP. Although companies may choose to focus on the target's IP that appears to provide the highest value maximization potential, other IP may result in significant value through licensing opportunities.

Since the 2001 issuance of FAS 141 by the Financial Accounting Standards Board, GAAP has required that acquired intangible assets - including intellectual property - be recognized and valued upon acquisition. The basic requirements as applied to acquired IP were generally unchanged by subsequent guidance.

If anything, the prevalence of fair value based measurements under GAAP has increased. For example, FAS 141R expanded the scope of fair value measurements and the requirements related to such IP-intensive items as in-process research and development projects.

Companies that account for acquisitions under FAS 141 may report limited data on acquired IP in their financial statements. However, even if the financial statements do not disclose significant details, other documentation - including third-party or internally prepared valuation reports and analyses - as well as auditor work paper files, typically provide significant detail related to acquired IP. This type of documentation necessarily includes detailed assumptions used in identifying and valuing the IP. Moreover, such valuation reports and work papers also include IP that was not valued, effectively valuing those assets at $0.

The FAS 141 valuation process typically entails selection of a third-party valuation specialist, analysis by the specialist, identification of acquired intangible assets, and review of the work completed by the valuation specialist by an auditor working for an independent firm. The number and types of intangible assets are important factors in assessing fees related to a FAS 141 valuation, as they determine the amount of effort that will be involved.

Even if a third party is hired to perform the IP valuation, the appropriate recognition and valuation of intangible assets is ultimately the responsibility of management. This includes the accounting, reporting, and presentation of any financial statements in accordance with GAAP. For instance, the Sarbanes-Oxley Act specifically requires corporations to manage internal processes - such as IP due diligence - for identification and reporting of assets. Additionally, it requires that executives be personally responsible for corporate financial reports and other internal processes which control accounting disclosures. It is, therefore, important that corporate executives stay knowledgeable about their company's assets, including acquired IP.

Calculating IP Value and Infringement Damages

There are similarities between the methodologies frequently used to value IP assets under FAS 141 and those used to calculate damages in IP infringement cases. For instance, reasonable royalty awards are the most common form of damages awarded in patent infringement litigation. From 1990 to 2004 over 75 percent of all damage awards in patent cases were based solely or in part on a reasonable royalty.

Application of the relief from the royalty method typically involves estimating the fair market value of an intangible asset by quantifying the present value of the stream of market-derived royalty payments that an asset owner is "relieved" from paying. Whether valuing a patent under FAS 141 or calculating a reasonable royalty for a patent infringement claim, the primary inputs are the same: royalty base and royalty rate.

The purpose of patent protection is to provide the patentee proper economic return. Therefore, a jury should consider the valuation of the infringed asset at the time of its acquisition when assessing alleged damages caused by infringement. FAS 141 valuations may be particularly useful to a defendant if the plaintiff previously allocated only nominal value to the infringed IP.

Moreover, a difficult fact pattern would likely develop if the plaintiff failed entirely to list or value the acquired IP. Conversely, a plaintiff who properly valued - or even overvalued - an infringed asset when it was acquired may reap a benefit in litigation.

The amount paid by a plaintiff in acquiring a company with desired patents is unquestionably relevant in the calculation of damages should those patents later be asserted in litigation. Litigants have long stressed the importance of balancing the consideration paid for declared assets against damages claimed for their subsequent infringement. Courts have also recognized the relevance of a company's allocated value to patents in the context of reviewing a damage award for those assets.

Discoverability of Valuations

Valuations prepared pursuant to FAS 141 should be discoverable in cases involving the alleged infringement of acquired IP under the standards set forth in Rule 26 (b) of the Federal Rules of Civil Procedure. The rule sets broad standards, allowing parties to obtain discovery for any non-privileged matter that is relevant to a claim or defense of any party. A plaintiff's financial records are relevant for purposes of calculating damages in an action for patent infringement. Accordingly, valuations prepared pursuant to FAS 141 should be discoverable in cases involving the alleged infringement of acquired IP.

Although courts have not specifically referenced FAS 141 when ruling on the discoverability of financial statements in the context of infringed IP, at least one court has compelled discovery of a company's financial statements and other documentation related to acquisition of a company that previously owned the patent subject to litigation.

A likely scenario in which prior FAS 141 valuations of IP would be admitted comes about when the valuations are used in support of or in opposition to expert witness testimony on damage calculations because of the valuation's impact on opinions regarding reasonable royalty determinations. The FAS 141 valuations are undoubtedly relevant to the royalty rate itself and the base to which it is applied.

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Judicial decisions addressing the discoverability of financial statements reflecting the sale of patents both before and after infringement strongly support the concept that FAS 141 valuations are germane and relevant to damage calculations in IP infringement suits. Although there may be concerns that FAS 141 valuations that assign minimal or no value to a patent are overly prejudicial, such evidence should nonetheless be admissible.

Compliance with accounting standards related to acquisitions does not necessarily receive the attention of executives outside of the finance or accounting departments of large corporations. However, due to the importance of IP assets, executives should understand the impact of such accounting if the IP is later subject to infringement litigation.

Similarly, executives who may be motivated by assumptions that maximize earnings per share by assigning either no value or a small value to acquired IP should be cautioned: Such short-term decisions could have significant negative consequences if the acquired IP is the subject of infringement litigation.

Although not believed to prevent an injured party from seeking legal remedy, the allocation of $0 to acquired IP could become a difficult fact pattern for the plaintiff to explain to a judge or jury. We recommend that executives carefully consider the assumptions used in the valuation of acquired IP. In situations where either no value or low value is assigned to acquired IP, executives should carefully document the process used to derive the underlying assumptions behind such an assessment. ■