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Intellectual Property Risk Management: IP Valuation and Protection

An Advisen White Paper

Executive Summary

Patents, copyrights, trademarks and other forms of intellectual property (IP) are among the most significant drivers of competitive advantage for many companies today. Thanks largely to digitized information and the Internet, IP is increasingly vulnerable to theft and infringement, requiring companies to implement various safeguards to protect it. Legal protections such as registered copyrights and design and utility patents are essential, but companies should take other precautions so that enforcement actions are less likely to be necessary. An important, but often overlooked, risk management step is assigning monetary value to IP. Valuing IP provides useful information for prioritizing risk management activities and for allocating risk management resources. The valuation process also can help to identify IP vulnerabilities and may suggest ways to help keep IP secure.

Introduction

Protecting IP is not a new concern. Patent protection was recognized by the Greeks at least as early as 500 B.C. The United States Congress enacted legislation protecting copyrights and patents in 1790. In the modern economy protecting intellectual property has taken on heightened importance. IP, not fixed assets, has become the principal sources of shareholder wealth and competitive advantage for many companies.

IP theft is an enormous burden on businesses worldwide. The International Chamber of Commerce (ICC) estimates that IP theft costs legitimate businesses nearly \$900 billion in lost sales annually. Threats to IP come in many forms. Copyrights, patents and trademarks can be infringed – often inadvertently, but sometimes very deliberately by sophisticated networks of pirates and counterfeiters operating outside the reach of the law. Trade secrets can walk out the door in the heads of disgruntled or unethical employees, or can be photographed with a mobile telephone camera and transmitted outside the company with a few keystrokes. The ICC recently called on leaders at the G8 and G20 summits to implement immediate and sustained government measures to bring counterfeiting and piracy under control.

Not only must companies be vigilant about protecting their IP, they also must be careful to not infringe on the IP of others. Companies can be sued for patent or copyright infringement over products or processes they believe to be uniquely their own. If successful, the owner of the IP rights will likely demand compensation for past infringement, and may prohibit further use of the IP. Under any circumstance, IP litigation is expensive and can be a drain on management resources. A battle over digital content delivery patents between Akamai Technologies, a digital media technology company, and Limelight Networks, a content distribution network vendor, has

since February 2008 witnessed a \$45 million jury verdict in favor of Akamai, a set aside of the verdict the following year and a ruling in favor of Limelight, followed shortly thereafter by an appeal by Akamai. "We expect that the litigation will continue to be expensive, time consuming and a distraction to our management in operating our business," wrote Limelight's management in its Q2 2010 10-Q filing with the Securities and Exchange Commission.

All companies should take full advantage of laws that protect IP. These include filing for patents and registering copyrights and trademarks. Companies also should implement rigorous risk management programs to mitigate threats. The objective is to keep IP out of the wrong hands and to avoid costly and uncertain litigation. At the core of managing IP risk is limiting access to IP, whether through internal policies and procedures or through the use of digital and mechanical devices. IP risk management typically touches many parts of a company, and is generally most effective when embedded in a company-wide enterprise risk management program.

An important element of IP risk management is valuation. Assigning monetary value to IP can be an arduous exercise, but it is critical in understanding the damage that can be caused by infringement, providing the basis for prioritizing risk management activities and allocating resources. Additionally, the process of arriving at a monetary value can help to identify how specific pieces of IP are integrated within an organization and may suggest ways that that IP can be better protected.

IP and its legal protections

"Intellectual property" refers to creations of the mind for which property rights are recognized. IP is a subset of "intangible assets," which includes such things as slogans, non-compete clauses, proprietary sales methods, training methods and customer lists. IP protections include copyright, trademark registration, design and utility patents, and industrial design rights.

Copyrights protect literary and artistic works, as well as creations such as software, websites and corporate brochures. They protect not the idea itself, but the way it is expressed. For works created on or after January 1, 1978, copyrights usually run for the author's life plus 70 years. Copyright exists from the moment a work is created, but in most cases a copyright must be registered in order to be enforceable in the courts. Copyright laws to a substantial degree have been standardized throughout the developed world through the *Berne Convention*, which originally was signed in 1886. The Convention also requires signatories to recognize the copyright of works of authors from other signatory countries in the same way as it recognizes the copyright of its own nationals.

Patents, which are granted by national patent offices, are exclusive rights to make, use and sell inventions for a specified period of time. Patents take two forms: design patents and utility patents. A design patent protects the ornamental appearance of an invention, not its utilitarian features. A utility patent protects the way an article is used and works. In the U.S. the term of a utility patent on an application filed today is 20 years measured from the U.S. filing date, while the term of a design patent is 14 years measured from the date of grant. The *Patent Cooperation Treaty*, an international patent law treaty, provides a unified procedure for filing patent applications to protect inventions in each of its contracting states around the world.

A trademark is a distinctive word, name, symbol or design used to distinguish a company's products or services from those of its competitors. In the U.S., trademarks are registered with the U.S. Patent and Trademark Office, though registration is not always necessary in order to enforce a trademark. While trademark protection lasts as long as the trademark is in use to market goods and services, trademark registration must be renewed initially between the fifth and sixth years following the original registration date, and every 10 years subsequently. The

Madrid System for the International Registration of Marks is the primary international method of facilitating the registration of trademarks in multiple jurisdictions around the world.

An industrial design right protects the visual design of objects. An industrial design renders an object attractive or appealing, thus increasing its marketability. In the U.S. design patents cover the ornamental aspects of utilitarian objects. Copyright and trademark protections also are used to protect industrial designs under some circumstances. The *Hague Agreement Concerning the International Deposit of Industrial Designs* provides a procedure for international registration of industrial designs.

Trade secrets are typically regarded as IP, though they lack a formal protection mechanism such as a copyright or a patent. A trade secret is information, including a formula, pattern, compilation, program, device, method, technique, or process, that is not generally known or reasonably ascertainable, by which a business can obtain an economic advantage over its competitors. While no formal protection mechanism for trade secrets exists in the U.S., state laws concerning the protection of confidential information provide legal recourse for the theft of trade secrets.

IP infringement can occur in any number of ways. At times IP is flagrantly stolen and used by a competitor. At the other end of the spectrum, a company may be unaware it is infringing on protected IP, believing its creations of the mind are wholly original. Intellectual property protections traditionally have been enforced through civil lawsuits, though enforcement through criminal prosecution is increasingly common. In one well publicized case, a 26 year old North Carolina man, Kah Choon Chay, was convicted of criminal copyright infringement for auctioning counterfeit computer games on eBay and other auction sites. Chay was sentenced to eight months of incarceration, three years of supervised release, and \$49,941.02 in restitution to the owners of the copyrighted programs that he had pirated.

The U.S. Department of Commerce provides useful information for small and mid-size business on IP rights registration, border enforcement of IP rights, criminal IP rights enforcement, and protecting and enforcing IP rights overseas at <http://www.stopfakes.gov/>.

IP risk management

The first step in protecting IP rights is to take full advantage of legal protections by registering copyrights and trademarks and applying for patents. However, most companies would prefer to not have to enforce IP rights by keeping IP out of the wrong hands. Safeguarding IP will depend in part on the specific nature of the IP, its value to the organization, and how it is used. In general, companies can reduce IP-related risk through a number of practical loss mitigation steps, including:

- Restrict access to IP to those for who access is essential, both inside the company as well as contractors and supply chain partners.
- Prohibit unauthorized copies of IP on USB devices, network shared drives, etc.
- Lock rooms where IP is stored, whether the server farm or a paper file archive, and carefully control who has access.
- Encrypt all IP that is transmitted electronically.
- Attach confidentiality notices to all documents involving trade secrets and other confidential information.
- Execute nondisclosure agreements with any third parties having access to trade secrets or other IP.

- Require employees and contractors to return all company documents classified as trade secrets if they are terminated or when work is completed.
- If IP is licensed to another company, hold harmless and indemnification agreements should be obtained.
- If a company licenses IP, appropriate steps should be taken to assure its validity, security and continued viability. For example, a company with rights to an essential software product should demand that a copy of the code be held in escrow.
- Regularly audit and value the company's inventory of IP and review products and processes for evidence of new IP requiring protection.

Additionally, patent searches should be conducted for all critical products and processes to assure the company is not infringing protected IP. Similarly, searches should be conducted to verify that trademarks and service marks have not been claimed by other companies or individuals.

IP risk management typically spans a number of different departments within an organization, making it challenging to develop, implement and monitor an effective risk management program. Companies should consider embedding IP risk management within an enterprise risk management (ERM) program that addresses the full range of risks to which a company is exposed. ERM provides a platform for managing IP risk across the organization, as well as a feedback mechanism for identifying emerging risks.

Valuing IP

Assigning value to IP is important for a number of purposes.

- If a company sells or licenses its IP, a value should be determined.
- If a company or a division of a company is to be sold, identifying all IP and its value likely will be necessary.
- If a company accuses a competitor of violating its IP, assigning value may be an important part of justifying how the company was damaged by the infringement.
- Valuation information can be important for strategic planning purposes.
- Financing and bankruptcy situations may require third parties to know the value of IP.

Assigning value to IP also is useful in risk management. Attaching specific monetary value to each piece of IP provides a clear picture of the significance of the asset to the organization and aids in allocating resources: higher value assets justify greater resource allocation for their protection. The valuation process itself also can provide useful information for other risk management purposes. Understanding the significance of a piece of IP, how it is used in the organization and its products, and the potential financial impact of damaged IP on the financial performance of the company can suggest ways of protecting it.

The most widely recognized valuation methodologies are the Cost Approach, the Market Approach and the Income Approach.

The Cost Approach establishes the value of IP by aggregating the costs associated with its development. The Cost Approach assumes that a company would pay no more to license or purchase IP than it would to develop it from scratch.

The Market Approach establishes the fair value of IP based on the cost of similar assets bought and sold under similar circumstances.

The Income Approach, which is the most widely used method of valuing IP, defines the value of a piece of IP based on the discounted income or cash flows that will be produced by the business unit employing the IP over the IP's useful life. Future income or cash flows are estimated, and then discounted to present value. The portion of the discounted revenue or income attributable to the IP is then determined.

The forward-looking nature of the Income Approach combined with its focus on economic impact makes it the most useful IP valuation method for risk management purposes. Certain risk factors such as technology risk, market risk and regulatory risk often are factored into the Income Approach calculation, usually in the choice of a discount rate. Other risk factors, such as piracy and obsolescence, also can be incorporated.

By forecasting future revenues under a variety of threat scenarios, IP can be ranked according to its vulnerability and potential impact on earnings, creating a prioritized roadmap for assigning risk management resources. Additionally, alternative risk management strategies can be evaluated based on their impact on future income. For example, discounted future income can be calculated under a scenario where IP pirates introduce competing products and compared to a scenario where piracy is thwarted by digital protection devices, but sales suffer because customer satisfaction is reduced as a result of onerous protection mechanisms.

Conclusions

Intellectual property can be one of the most valuable assets of a company, but IP is highly vulnerable. Unlike physical property, IP can be stolen with a few computer keystrokes or can walk out the door in an employee's head. Copyright and patent protection can provide legal remedies for IP infringement, but companies typically prefer to protect their IP from infringement rather than relying on lengthy, expensive and uncertain legal proceedings.

IP risk management activities can help protect IP. The most effective risk management program for a company will depend on the nature of the IP, how it is used, and the size and organizational features of the company. Under almost all scenarios, incorporating IP risk management within ERM provides a platform for managing IP risk across an organization. IP valuation processes, especially the Income Approach, can help prioritize risk management activities and assess the costs and benefits of various methods of safeguarding IP.

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This report is the first in a series sponsored by OneBeacon Professional Insurance. Coming up:

- 9/29/2010 Advisen White Paper on Intellectual Property in the Global Marketplace
- 10/13/2010 Advisen White Paper on Monetizing Information
- 10/25/2010 SAVE THE DATE...OBPI Webcast at 11:00 am (Eastern). Dial in information to follow.

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