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Uncovering and Harvesting Valuable Intangible Assets

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Despite the critical importance of the role of intellectual property and intangible assets as key components of the net worth and overall shareholder value of many established and emerging growth companies, executives often fail to appreciate and take inventory of the assets they have developed and as a result under-leverage these assets. At a time when companies of all sizes and in all industries are under pressure to make more out of what they already have developed and to create incremental revenue streams and new opportunities, it is critical that executives and managers know how to uncover and harvest intangible assets.

The process often begins with a strategic intellectual property audit, which provides the company and its leadership team with a realistic and creative assessment as to what intellectual property assets the company has, the strength of these assets and the opportunities for leveraging these assets into new markets or revenue streams or to strengthen existing distribution channels. Among the questions that are addressed during audit to uncover hidden intangibles include:

- What technologies have non-competing applications that could be licensed to others?
- What brands offer value in a brand-extension licensing or co-branding relationship?
- What distribution channels or partnering opportunities can be strengthened if the company had greater control over these channels or relationships?
- What growth and expansion strategies are being used by the company's competitors? Why? How are their circumstances different, if at all?
- Where are the strategic/financial holes in the company's current licensing and alliance relationships?

BOX A

MANAGEMENT OF INTELLECTUAL PROPERTY INVOLVES THREE BROAD AREAS

| Intellectual Property Creation | Intellectual Property Protection | Intellectual Property Leveraging |
|--|--|---|
| <ul style="list-style-type: none"> • Generating technology (research, development, engineering) | <ul style="list-style-type: none"> • Protecting your intellectual property from someone else | <ul style="list-style-type: none"> • Licensing technology |
| <ul style="list-style-type: none"> • Screening and valuing technology | <ul style="list-style-type: none"> • Protecting the corporation from unintentional infringement of someone else's intellectual property | <ul style="list-style-type: none"> • Selling technology |
| <ul style="list-style-type: none"> • Capturing and documenting technology | | <ul style="list-style-type: none"> • Blocking use of proprietary technology by competitors |
| | | <ul style="list-style-type: none"> • Creating new products/ services/competencies |

Going through a strategic process such as an **intellectual capital audit** is a particularly important management tool given today's economy and capital market conditions because:

- Companies and their leaders must protect what they have and use these intangible assets to penetrate new domestic markets or be the fuel for international expansion. The key challenge is how to keep growing in a slowing economy.
- **Capital-efficient growth** is the mandate of many CEO's and CFO's during these turbulent financial markets. Executives are under pressure to create new opportunities and new revenue streams from existing assets (technologies, systems, brand, relationships, know-how, etc.). The results of the strategic audit



may also identify a need or an opportunity to restructure the company around the IP portfolio or create subsidiaries or spin-out companies based on IP leveraging opportunities, especially in a post-Sarbanes-Oxley environment.

- Senior executives need to periodically re-evaluate whether current distribution channels and market-partners are really working effectively to generate the highest and best shareholder value and income streams/profits (e.g. is this the highest and best strategy available to meet our objectives? What is origin of these relationships? What politics or red tape will we face if these agreements and relationships are re-evaluated? Should there be restructuring around a real or perceived imbalance in the economics of any existing relationships? Wall Street does not reward companies who make their licensees and market partners wealthy at the company's expense.)
- Companies need to repair channels and relationships which are broken, ineffective or where greater controls over the channels would yield better results.
- With high levels of employee turnover and competition for a qualified work force, it is more important than ever that employees are educated on their obligations to protect the company's IP on an in-term and post-term basis.

Understanding Categories of Intangible Audit

Intellectual capital is a difficult concept to grasp because it encompasses intangible items used to measure a company's success and wealth. Most companies are discovering that intellectual capital may be hard to quantify, but essential for survival. Intellectual capital typically falls into the following three categories:

1. **Human Capital.** Everything in this category exists within the skills, experience and ability of your employees. Creativity, innovation and forward thinking drives a company forward and allows it to compete in an environment that is constantly becoming more complex and idea-dependant. Human capital is hard to measure, but is usually viewed in terms such as turnover and employee satisfaction.
2. **Organizational Capital.** This category only includes things owned by the company, such as patents, trademarks, copyrights, formulas and databases. Converting human capital into organizational capital is difficult and means collecting and retaining employee ability so it belongs to the company.



3. **Relationship Capital.** Putting an emphasis on the customer can be extended to any outside party that creates value for a company. Some organizations have been keeping tabs on this information as it relates to its revenue base. Many are now recognizing the relationship between customer loyalty and increased profits.

Intellectual capital has become one of a company's most important yet misunderstood and it is critical that company leaders understand how the intellectual property laws are used to protect these key assets. Without knowing your inventory levels of intellectual capital, you cannot accurately allocate the proper amount of resources to develop your business in the most profitable direction. Taking the time to study all of the company's assets may uncover attributes or strategies to use your capital in new ways to fully take advantage of your intangibles. Because these assets cannot be touched or felt, today's business leader must rely on the tools and sometimes weapons offered by the various branches of intellectual property law. The key is to match the intangible asset you are trying to protect and/or leverage with the most effective legal and strategic tools available. This requires a basic understanding of the laws that protect intellectual property as well as the strategies that are most effective to leverage intellectual property.

The driving force behind the need for an assessment of hidden intangible assets may be the senior management of the company, the chief patent counsel or even board members/outside shareholders (or venture capitalists in earlier-stage venture-backed companies) who are pressuring the company to produce new revenue streams before another infusion of capital can or will be committed. The strategic objectives of the overall process include:

- To determine the origin of intangible assets and the extent of the company's interest in technology and related intellectual property rights;
- To determine the scope of rights that third parties may have, by license, ownership, or otherwise, in the company's assets;
- To institute systematic procedures for protecting and perfecting the company's intellectual property rights;
- To detect defects in the company's existing intellectual property assets and establish the mechanisms and procedures for protecting and perfecting the same;
- To take steps to prevent the assertion of some of the more common defenses available to misappropriators and infringers (such as estoppel, laches and waiver); and



- To avoid liability for third party claims of infringement resulting from the development of new products.

Preparing for the Intellectual Capital Asset

In preparing for the formal assessment of the intangible assets, the legal and strategic review and analysis team will prepare an **Audit Plan** which sets forth (a) the specific areas of inquiry (e.g., divisions, lines of business, affiliated or non-affiliated agency operations), (b) the scope of inquiry (e.g., only registered assets or a broader scope), (c) the timetable for the analysis, (d) the responsible parties for each part of the process, and (e) the form of the final report to be produced. In terms of initial information gathering, the legal and strategic audit team will identify those intellectual property rights such as patents, copyrights and trademarks which have already been registered or are in the process of being registered. The legal and strategic audit team next will obtain copies of all affiliate agreements (e.g., administrative services, cost allocation), employment, consulting agreements (including web site design agreements), license and maintenance agreements, joint venture agreements, distribution agreements, security documents and UCC filings, confidentiality agreements, litigation files (including outside counsel responses to auditor's letters), source code escrow agreements (in connection with software), any documentation relating to "clean room" development of software, database licenses and relevant corporate policy statements, including document retention policies.

After the relevant documentation has been identified and organized, the legal and strategic intellectual property audit team should then prepare an electronic index of the materials, noting with respect to each intellectual property asset: (a) the nature of the company's ownership interests (e.g., sole or joint ownership, exclusive or non-exclusive license, the royalty or other costs associated with the license and the estimated legal duration and period of technological usefulness of the asset) and whether the nature of the interest is in doubt, (b) any restrictions on the use of the asset (e.g., product or agency-related restrictions, territorial restrictions, assignment or transfer restrictions, time restrictions, non-compete clauses), (c) relevance of the asset to the core business of the company (e.g., whether the asset is a critical asset or an ancillary asset) and connection with other key non-IP assets of the company, (d) whether the asset has been pledged, or in any other way encumbered, and (e) potential for a third party claim of infringement or damages due to the company's use of the asset. In the course of analyzing the assets, the legal and strategic audit team may decide it is necessary to directly interview the company's personnel responsible for the development, acquisition or use of the intellectual property assets.

Box B

| Protectable Intellectual Property | | Possible Revenue Sources |
|--|---|-------------------------------------|
| • Patents | → | • Spin-off new companies |
| • Trademarks (including brands and slogans) | → | • Joint Ventures and Alliances |
| • Copyrights | | • Technology and software licensing |
| • Trade Dress | | • Outright sale of new technology |
| • Trade Secrets | | • Co-branding |
| • Distribution channels | | • Franchising |
| • Show-how and know-how | → | • Enter new markets |
| • Databases and customer information | | • Develop new products |
| • Software and proprietary algorithms | | • Brand-extension licensing |
| • Customer and strategic partner relationships | → | • Technology transfer |
| • Proprietary processes and systems | | • Cooperatives, consortiums |
| • Knowledge and technical workers | → | • Outsourcing |
| | | • International expansion |
| | | • Government contracts |

As legal and strategic advisor to companies who have grown through the leveraging of their intellectual property, the lawyer's role in this critical process is to:

- Work with clients to find their intellectual property and hidden intangible assets (intellectual property protection and leveraging audits, etc.);
- Protect the intellectual property (through registration strategies, confidential agreements, etc.);



- Develop strategies to leverage the intellectual property (through joint ventures, alliances, licensing, etc.); and
- Look at these strategies in comparison to other growth strategies as alternatives.

Our strategic analysis may include questions such as:

- What protectable competitive advantages has the company developed?
- What intellectual property law strategies can be used to protect ownership/use?
- How can this intellectual property be leveraged into revenue/profit streams?
- How can we use intellectual property to create substantial competitive advantages with durable revenue streams?

A leader's ability to grow a business or division and achieve success depends on his or her ability to invent and exploit new products and services; open up new distribution channels; foster new production and training techniques; implement new promotional and marketing campaigns; establish new pricing methods; and adapt to changes in competition, consumer preferences or demographic trends. The manager's ability to identify, develop and protect intellectual property rights is critical. Doing so can help the company:

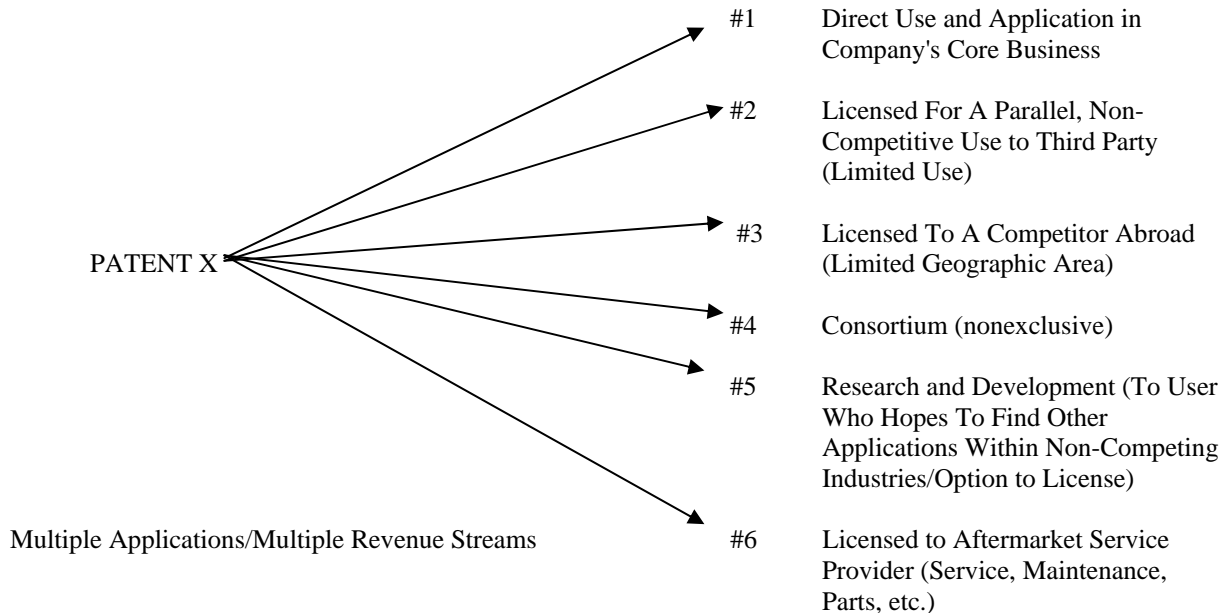
- Improve the overall value and rate of growth by increasing intangible assets;
- Create competitive advantages and barriers for competitors to enter the marketplace;
- Understand the intellectual property rights of other firms;
- Create licensing opportunities and additional revenue sources;
- Build consumer goodwill and brand loyalty; and
- Provide maximum control over the development and ownership of the ideas and invention of employees.

The harvesting of intellectual capital is a *strategic process* that most begin with the taking an inventory by the company's management team and qualified outside advisors in order to get a comprehensive handle on the scope, breadth and depth of the company's intangible

assets. In these times of distrust and disappointment by shareholders in the management teams and boards of publicly held companies, corporate leaders owe an obligation towards these shareholders to uncover hidden value and make the most of the assets which have been developed with corporate resources. See Box B above for leveraging strategies that create new revenue opportunities. The leadership of the company will never know if it has a "Picasso in the Basement" unless if both: (a) takes the time to take inventory of what's hiding in the basement and (b) has a qualified intellectual capital inventory team that is capable of distinguishing between a Picasso and your children's art project. Once these assets are properly identified, and Intellectual Asset Management (IAM) system should be developed to ensure open communication and strategic management of these assets. At that point, the company is ready to engage in the strategic planning process to determine how to convert these assets into profitable revenue streams and new opportunities which will enhance and protect shareholder value.

For example, see Box C below to understand how one underleveraged portfolio of patents for a given technology can be leveraged into multiple licensing reverse streams, typically at high profit margins.

Box C





Conclusion

Companies of all sizes and in all industries in today's turbulent and competitive economy should be focusing on the protection and leveraging of their intangible assets in order to continue their development and succeed in the marketplace. This means that the leadership team must devote greater amounts of time, attention and resources to building and protecting brands, customer relationships, goodwill, proprietary formulae, strategic alliances, cross-licensing and co-branding alliances, and other intangible assets. The company's ability to develop, recognize, protect and exploit these intangible assets is critical to its survival in the marketplace and to building shareholding value.



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ABOUT THE AUTHOR

Andrew J. Sherman, Esq. is an internationally-recognized authority on the legal and strategic aspects of business growth. Mr. Sherman is a senior partner with McDermott Will & Emery LLP (McDermott), an international law firm with nearly 1,000 lawyers worldwide, where he manages a corporate and transactional practice representing Fortune 500 corporations as well as technology-driven, and rapidly growing businesses and government contractors. He is the co-developer and practice leader for the McDermott Intellectual Property Protection and Leveraging Analysis (IPPLA) practice group and has written and lectured extensively on intellectual property protection and leveraging. He is the author of twelve (12) books on business growth, capital formation and the leveraging of intellectual property, including the best-selling and critically-acclaimed *Raising Capital* (Kiplingers, 2000), *Mergers and Acquisitions from A to Z* (AMACOM Books, 1998), *The Complete Guide to Running and Growing Your Business*, (Random House, 1997) and *Franchising and Licensing: Two Ways to Build Your Business*, (2nd edition) (AMACOM Books, 1999) and the third edition was published by (AMACOM Books, December 2003) and *Fast Track Growth Strategies* (Kiplinger) which was published in January of 2002. He has appeared as a guest and a commentator on all of the major television networks as well as CNBC's "Power Lunch," CNN's "Day Watch," CNNfn's "For Entrepreneurs Only," USA Network's "First Business," and Bloomberg's "Small Business Weekly" and various other regional and local television broadcasts as well as national and local radio interviews for National Public Radio (NPR), Business News Network (BNN), Bloomberg Radio, AP Radio Network, Voice of America, Talk America Radio Network and the USA Radio Network. He has served as a top-rated Adjunct Professor in the Masters of Business Administration (MBA) programs at the University of Maryland for fourteen (14) years and at Georgetown University for nine (9) years where he teaches courses on Entrepreneurship and Business Planning, Growth Strategies and New Venture Financing. Mr. Sherman can be reached at 202.756.8610 or e-mail ajsherman@growfastgrowright.com.