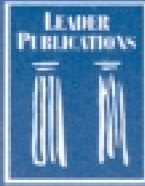

Patent Strategy & Management

Corporate Officers and Directors Can Be Liable for Mismanaging Intellectual Property[1]

By Alexander I. Poltorak and Paul J. Lerner

Licensing of core and non-core intellectual property has become a major revenue source for many companies. Texas Instruments, to cite one example, now earns more from licensing its technology than from manufacturing. Also, companies have begun to enforce rights in non-core technologies (those patents they own but do not exploit directly) as a further means of generating revenue. Honeywell, in one record-setting example, recovered $127.5 million from Minolta as damages for the infringement of a technology that Honeywell itself had never commercialized.

While these changes in the value and role of IP present the business corporation with newfound opportunities, they also expose its officers and directors to newfound risks and potential liabilities. In times past, directors and senior officers could – and almost universally did – ignore intellectual property, leaving it to a clerical staff that filed and forgot it. It was a rare company indeed where the IP portfolio was accorded a fraction of the attention directed to tangible assets. Now, however, the increased importance of the intellectual property portfolio mandates a commensurate increase in the care with which it is managed. It must, in fact, be managed with the same degree of care and attention as are devoted to the company's tangible assets. Failure to meet this new standard may well have serious legal implications for the firm's officers and directors.

NATURE OF INJURIES ARISING FROM MISMANAGEMENT OF INTELLECTUAL PROPERTY

Every officer and director of a corporation, as a fiduciary, has an affirmative "duty of care", which is, broadly stated, a responsibility to diligently manage the affairs and assets of the corporation, and to consider the possible ramifications of its actions (or non-action). Injuries arising from the mismanagement – or non-management – of intellectual property fall, most commonly, into two general categories: waste and mis-valuation. Accordingly, for purposes of this paper, "intellectual property management" shall be considered to encompass both the utilization and valuation of intellectual property.

The duty of care and any liability arising thereunder are governed by the business laws of the state in which the business is incorporated. Aside from any liability arising under state statutes related to the duty of care, the officers and directors of publicly traded companies may also be liable under the applicable state and federal securities laws for failure to adequately value and disclose corporate IP assets and events that affect corporate IP.

Waste occurs when an asset is not utilized, or utilized fully, or is sold for much less than its true value. Avoidance of waste of intellectual property requires, among other things, identification of all of its possible uses and the estimated extent of such uses, determination of the existence and merits of competing technologies, and where a patent is

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involved, assessment of the strength of the patent and the scope of its claims.

Patents protecting unused technology are a prime example of unutilized assets. Failure to license such unused intellectual property and produce an income stream may be waste of corporate assets, which may expose officers and directors to liability.

Novel technology represents a valuable asset. A patent excluding others from practicing this innovation increases significantly the value of the underlying technology. Thus, failure to aggressively patent the results of corporate R&D, like failure to insure valuable plant and equipment, may be deemed mismanagement. Most U.S. companies face a dilemma of whether or not to obtain foreign patents or trademarks, in addition to their U.S. rights, and in which countries to seek such protection. Fear of potential liability should not drive the corporate executive to file in every foreign country, which could be unjustifiably expensive. As long this question is carefully deliberated and a decision is made based on the strategic plans of the company and economic considerations, one may safely rely on "the business judgment rule", which protects directors and officers from liability arising from making bad decisions as long as these decisions were well informed and well considered.

Failure to enforce intellectual property rights is another example of mismanagement of corporate assets. Many technology-related corporations are rushing to file as many patents as possible, which may or may not be a prudent strategy. However, patents afford only exclusionary rights – the right to sue. Failure to enforce these rights by bringing a patent infringement action creates a double waste: loss of a valuable monopoly on the use of the patented technology as well as a waste of the capital spent on obtaining and maintaining the un-enforced patents. Furthermore, any delay in enforcing the infringed patents may result in laches and estoppel, which may ultimately reduce the damage awards, when an action is brought at a later date, or render the patents unenforceable.

Therefore, there may well be an affirmative duty on corporate officers and directors to vigorously enforce corporate IP rights in a timely manner. This equally applies to defensive litigation to protect from competition as well as offensive litigation when non-core patents are enforced.

It may not be enough to simply discuss these matters from time to time at the board meetings. Delay in designing and diligently implementing a sensible IP management program may cause waste because patents are "wasting assets" by their nature.

Although it causes different injuries, mis-valuation is closely related to waste. Where waste can be described as a "realized" loss, mis-valuation is a "book" loss. Both spring from the same errors and omissions. Intangible intellectual property represents the most under-reported asset.[2] Mis-valued IP can adversely affect the total valuation of the transaction in a merger, acquisition, divestiture or equity financing.

> ***"...The intellectual property portfolio ... must be managed with the same degree of care and attention as are devoted to tangible assets."***

Failure to communicate the value of the IP of a publicly traded company to the financial community may result in undervalued stock, thus causing loss of value to shareholders. Such issues, for example, as an important patent issued to a competitor, which may potentially erode the company's market share, may have to be disclosed to shareholders. Similarly, a patent issued to a competitor which may be infringed by the company's product needs to be disclosed to shareholders, regardless of whether or not actual infringement notice has been given. Reasonable apprehension of a threat of a possible patent infringement lawsuit should be disclosed to shareholders. As much as such apprehension is subjective, the same criteria may be used by corporate IP counsel to determine

[2]Nearly 40% of the market valuation of the average company is missing from its balance sheet, according to Professor Baruch Lev, Stern School of Business, New York University.

whether filing an action for Declaratory Judgment is justified.

Expiration dates of important patents, which may adversely affect the company's market share, should be communicated to the shareholders. Such disclosures may need to be made in press releases, in annual and quarterly financial statements and in the Management Discussion and Analysis section of registered financial statements filed with the Securities and Exchange Commission (SEC). Failure to accurately and timely report information relevant to corporate IP to the shareholders, in the initial prospectus as well as in quarterly and annual reports, may result in their ill-advised decision making and subsequent losses, prompting them to seek relief in a class-action suit against the officers and directors.

STANDARD OF RESPONSIBILITY FOR PORTFOLIO MANAGEMENT

Waste through not (or under-) exploiting corporate IP assets need not involve any wrongdoing or evil intent, which may invoke criminal liability. It may be merely negligent; a proverbial sin of omission. Negligent waste may be established by a showing that no person of ordinary sound business judgment would say that a fair benefit had been derived from the challenged transaction. In this regard, it must be borne in mind that intellectual property is almost always a "wasting asset" – patents expire, technology becomes obsolete. Thus, waste may result from any or all of: inadequacy of return for the license or sale of the intellectual property, failure to utilize the intellectual property, undue narrowness of its utilization, or undue utilization delay.

While there is no relevant case law specifically dealing with mismanagement of corporate IP assets, there is no reason to believe that the standards the courts will apply for director's and officer's responsibility for management of IP assets will differ from the well established criteria and standards for duty of care in managing other corporate assets. Until recently, the market for technology stocks has moved spectacularly and consistently upward and everyone was a "winner". With the recent market downturn, however, it seems only a matter of time until some disgruntled shareholders of a publicly traded technology company, seeing their stock price plummeting, will attempt to recoup their losses in a derivative class action suit against officers and directors for mismanaging corporate IP assets. Directors and officers of publicly traded companies are well advised to take prudent steps today to protect themselves from future liability.

When an officer or director fails to meet his duty of care, and waste of IP assets results, an action on behalf of the corporation may be brought by one or more of the shareholders or directors. Typically, officers and directors try to defend against these actions on the basis of the "business judgment rule." The courts, however, have begun requiring that the challenged decision result from "informed business judgment," based on all information "reasonably available." An investigation is generally deemed necessary to satisfy this requirement.

An informed acceptance or rejection of a settlement offer in a patent infringement suit, for example, is a decision that may be justified under the business judgment rule. If, however, an offer is rejected and an unfavorable judgment results, management and the board could be exposed to personal liability if they failed to perform litigation risk analysis. Note that the acceptance of a directorship implies a competent knowledge of the duties assumed. A director cannot be excused on the grounds of ignorance or inexperience. Nor does serving without compensation or merely as an "accommodation" negate a director's responsibilities.

Note also that the duty of care owed with respect to IP depends in part on the nature of the company's business. The duty may be greater where the type of business affects the general public, especially where there is an established regulatory scheme for that type of business, such as in investment banking. While valuation of an IP portfolio is always prudent in the day-to-day management of corporate assets, valuation of an IP portfolio involved in an IPO, M&A, divestiture or corporate reorganization may be obligatory. Decline in the price of stock resulting from the dissemination of false information about the value of corporate IP constitutes an actionable injury to individual shareholders. Although the standards applied by courts to publicly traded companies may be the same as those applied to privately held non-banking concerns, the SEC itself is a powerful potential plaintiff. Misrepresentation or omission of material information pertaining to the IP assets of the

securities issuer is a violation of §10(b) of the Securities Exchange Act of 1934. So is presentation of values for IP assets that are based on invalid data or techniques.

Other caveats:

- The courts often hold that failure to determine actual value, as opposed to book value, of a corporation engaged in a merger is a breach of care. IP assets are a major factor contributing to the discrepancy between actual and book value.
- Officers and directors may also be liable to corporate creditors for losses suffered as a result of mismanagement. If the corporation is in reorganization or liquidation, such an action may be brought by the corporation's trustees or receivers.
- A director of a holding company may be liable to that company for the diminished value of its shares resulting from his waste of a subsidiary's IP assets, even though he might also be liable to the subsidiary for the same acts.

DELEGATION OF RESPONSIBILITY

While management of the IP portfolio may be delegated, such delegation must comply with certain requirements to satisfy the duty of care. A director may not delegate to non-directors the responsibility for activities that are outside the ordinary course of business. Furthermore, the director should, despite any delegation, remain informed about the general goings-on of the delegated functions and use of resources. He is chargeable with knowledge that he would have possessed had he diligently discharged his functions.

Where a board of directors appoints a committee of its members to assume responsibility for a task, a non-member director is still expected to satisfy himself that the committee merits his confidence. Neither the designation of the committee nor the delegation of authority to it constitutes full compliance, by any non-member director, with his duties as a director.

Directors must often seek the advice of experts. Where directors seek expert advice and honestly follow it, they are protected from personal liability, even if the advice proves erroneous. (To be entitled to rely on it, they must either read it, be present at a meeting at which it is orally presented, or take other steps to become generally familiar with it.) Indeed, precedent suggests that failure to seek advice from outside experts may itself constitute a breach of duty.

A number of IP management firms provide businesses with such advice. As an initial matter, our firm generally advises that IP management no longer be relegated to middle management or even to in-house patent counsel overburdened with filing and prosecuting patent applications. It must be addressed by corporate directors and officers. Despite the obvious complexities involved, they should devise and establish a reasonable IP management program.

The first step is to conduct an IP portfolio audit to identify core, non-core and obsolete IP. Prudence dictates that an IP management firm or other specialist conduct the audit and otherwise manage a corporation's IP portfolio. Such management may include development of a corporate technology transfer program or a joint venture to leverage dormant IP assets. Obviously, the individual(s) involved must have appropriate education and experience. There should be a documented history of success in the management of intellectual property. Further, the manager(s) should be required to provide regular and complete reports of their activities, including reasonably detailed descriptions of methodologies employed.

Alexander I. Poltorak is the Chairman and Chief Executive of General Patent Corporation, an IP management firm based in Suffern, New York. Paul J. Lerner is the Senior Vice President and General Counsel of the firm. They may be reached at apoltorak@gpci.com.

General Patent Corporation International
Montebello Park
75 Montebello Road, Suffern, New York 10901-3740 USA

www.patentclaim.com
tel: 845.368.4000 fax: 845.368.8770
e-mail: info@gpci.com