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IP Strategies

Trends in patent, copyright, trademark and technology development and protection

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DEALING WITH INTELLECTUAL PROPERTY IN BUSINESS COMBINATIONS

Last year, the SEC's Division of Corporate Finance released a review of 2002 filings by Fortune 500 companies. Of particular note was the conclusion that intellectual property and other intangible asset and goodwill impairment tests were among the critical disclosures that either conflicted significantly with SEC rules or were "materially deficient in explanation or clarity." This finding clearly illustrates that two years after the issuance of FAS 141 and 142 by the Financial Accounting Standards Board¹ ("FASB"), a large number of companies still do not understand the proper way to treat goodwill, intellectual property, and other intangible assets acquired in business combinations.

Background

The stated objective of the FASB in taking on a project to account for business combinations was to "improve the transparency of accounting and reporting of business combinations." In doing so, the FASB developed two new accounting standards for the treatment for goodwill and intangible assets, often considered to be intellectual property, including patents, copyrights, trademarks, trade secrets and know-how. Those two new Financial Accounting Standards have become the focus of considerable effort in the form of questions, seminars, articles, books, and discussions concerning the identification and value of intangible assets; FAS 141 Business Combinations² and FAS 142 Goodwill and Other Intangible Assets.³

What is FAS 141?

FAS 141 addresses how corporations account for business combinations because it eliminates the option of recording a combination as a pooling of interests and requires all combinations to be recorded using the purchase accounting method. More specifically, the pooling of interests method simply added the historical book value of the purchasing and acquiring company's assets and liabilities and, as such, did not record any goodwill. In contrast, however, the purchase accounting method requires any premium resulting from a purchase price that is greater than the fair market value of the purchased assets to be booked as goodwill. Although this accounting treatment has been in place for many years, in most cases no attempt was made to identify the portion of the goodwill that is attributable to intellectual property and other intangible assets. FAS 141 changes that because it requires the assessment and valuing of intangible assets with a determinable economic life (patents), and intangible assets with an undeterminable economic life (customer lists), as part of the purchase price allocation effort, thus reducing the amount of goodwill to the remaining "unidentified value." The following table illustrates this change:

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Purchase Accounting Method		
	<u>Old Practice</u>	<u>FAS 141</u>
Tangible Assets	\$100	\$100
Intangible Assets with Determinable Lives	---	50
Intangible Assets with Undeterminable Lives	---	20
Goodwill	<u>80</u>	<u>10</u>
Total Purchase Price	\$180	\$180

In summary, tangible assets and intangible assets with determinable economic lives are amortized over their useful lives consistent with the old FAS 121 standard. Though discussed later under the FAS 142 section, intangible assets with undeterminable economic lives and goodwill are not amortized, but reviewed annually for impairment (lost value) and, if impairment is found the lost value is written off. Because of SEC compliance, Sarbanes-Oxley requirements and other regulatory issues, legal guidance may be necessary to ensure that the proper accounting and valuation methodologies are applied with respect to the identification and valuation of these intangible assets.

What is an identifiable intangible asset?

Although intangible assets can represent many different items within a company or industry, generally, they can be categorized into two major groups: 1) identifiable intangible assets and 2) goodwill. Efforts to identify and categorize intangible assets are oftentimes challenged by the fact that the categories are not mutually exclusive, nor are they well defined. While the standards assist with the identification of many intangible assets, there are weaknesses that make it difficult for an accountant to maintain a conservative representation of the company's assets.

While the old method of utilizing a large "bucket" of goodwill based on the premium paid (illustrated as the

\$80 in the above table) was reasonably easy, the creation and identification of the other types of intangible assets can test one's creativity. The first, and typically the most valuable group, is intellectual property. Intellectual property is usually recognized as patents, copyrights, trademarks, trade secrets and know-how. The value is inherent; such that individuals, groups and companies invest in the creation of intellectual property with the expectation of a beneficial return or competitive advantage within the marketplace.⁴ FAS 141 requires the identification of intangible assets that 1) establish a *contractual or legal right* or 2) can be separated from the goodwill bucket. FAS 141 created five broad categories of intangible assets:

- Marketing-related
- Customer-related
- Artistic-related
- Contract-based
- Technology-based

A review of annual reports recently submitted by publicly traded companies reveals a significant increase in the amount of information related to intangible asset/intellectual property disclosures. Companies are now

reporting non-compete agreements, customer lists, newspaper mastheads, franchise agreements and databases to name a few of the more recent types of now identified value.

One must keep in mind, however, that these requirements of identification and valuing only apply to intangible assets that are *acquired*. Intangible assets that are developed and pursued internally are still not recorded on a company's balance sheet as an asset. In an effort to maintain conservatism in the reporting of a company's assets, the costs related to internally generated intangible assets are expensed rather than capitalized.

The rationale for this conservative treatment lies within the uncertainty of the yet undeveloped asset and the hazards of trying to account for such an unknown asset. Consider the following scenario related to the development of a new piece of intellectual property:

If a company were allowed to capitalize its expenses related to the development of a piece of intellectual property, the immediate effect would be that net income would be overstated as a result of booking the development costs as an asset rather than charging the costs to an expense on the income statement. Secondly, how long should the intellectual property be considered under development? Over time, the expenses related to the development of the intellectual property could be substantial. Finally, if, after a period of years, the development of the intellectual property is abandoned due to any number of reasons – unfeasibility, obsolescence, change of ownership, shift in company focus, etc. The balance sheet has an overstated asset that now must be written off and expensed to the income statement. This situation allows for a judgment call that is ripe for litigation by shareholders claiming pursuit of an “obviously” frivolous asset recorded only to manipulate the stock price.

The conservative treatment of internally generated intangible assets, such as intellectual property, explains why the market capitalization of many firms far exceeds their book value. Intellectual property, market leadership,

brand recognition, cutting edge technology, customer relationships, distribution channels, etc. are recognized by the market, even though they are not identified on the balance sheet.

In the traditional sense, an asset existed when it could be identified through physical inspection, along with a corresponding invoice that would establish the historical cost for recording the asset. The converse does not mean that an asset does not exist. However, the existence of an intangible asset does not rest upon faith alone. Thus, FAS 141 has thrust the identification and verification of intangible assets into the forefront for every business combination and professional guidance is required to properly comply with it.

How is an intangible asset valued?

While FAS 141 has established reporting requirements for business combinations and the related intellectual property and intangible assets, it was silent on the valuation methodologies that should be applied to reach a determination of value. The AICPA recently issued an Exposure Draft, *Proposed Statement on Standards for Valuation Services No. 1 (“SSVS 1”), Valuation of a Business, an Interest in a Business, or an Intangible Asset* to help assist on this issue. SSVS 1 represents the codification of rules and procedures already followed by members of the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and the Institute of Business Appraisers. Although typical valuation approaches of cost, income, and market are identified, new approaches are also allowed if the valuator can clearly and explicitly justify the method used.

What is FAS 142?

While FAS 141 established the responsibility of identifying an entity's intangible assets, FAS 142 requires the monitoring of the value of both the goodwill component and the intangible assets with undeterminable lives (collectively referred to as “goodwill” for the remaining discussion) that were specifically identified at the time of the business combination. The goodwill remaining after specific identification under FAS 141 is considered to

have an indefinite life. However, the term indefinite does not mean infinite. FAS 142 requires that the entity make a rigorous assessment of the goodwill and consider external factors that could affect its value on at least an annual basis.

The first step in the process requires the identification of the reporting units to which the acquired assets, assumed liabilities and resulting goodwill will be assigned. A reporting unit represents a business unit for which discrete financial information is available and management regularly reviews the operating results. Similar reporting units that have the same economic characteristics can be grouped into one reporting unit.⁵ Obviously, a detailed organizational chart for the business would assist in identifying reporting units and those that could be combined for reporting purposes.

As of the date of a business combination, all acquired goodwill should be allocated to the reporting units to which it applies. In essence, the fair value for each reporting unit representing a “purchase price” should be determined, and that purchase price should be allocated to the assets and liabilities of that unit. If the purchase price exceeds the amount assigned to those net assets, the excess represents the goodwill assigned to that reporting unit.⁶

The initial valuation and assignment of goodwill should then be tested for impairment on at least an annual basis. In that regard, a valuation may be carried forward from a prior year to relieve companies of the expense of a full valuation each year if the following criteria are met:

1. *The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination.*
2. *The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.⁷*
3. *Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current*

fair value determination would be less than the current carrying amount of the reporting unit is remote.⁸

In order to prevent companies from reshuffling reporting units to shield goodwill from impairment, the FASB has stated that any restructuring will automatically trigger an impairment test. Also, the following events or circumstances can trigger an impairment test:

- *A significant adverse change in legal factors or in the business climate*
- *An adverse action or assessment by a regulator*
- *Unanticipated competition*
- *A loss of key personnel*
- *A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of*
- *Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit*

The goodwill impairment test is a two-step process. First, the fair value of the *reporting unit* as a whole is compared to its book value (carrying amount) as a whole. There is impairment if the fair value of the reporting unit is less than its carrying amount. If impaired, the company must then allocate the total fair value of the reporting unit down to each of its assets, including recognized and unrecognized intangible assets, to determine the implied fair value of *goodwill*. Finally, if the resulting implied fair value of goodwill is less than the carrying amount of goodwill, the company should report an impairment loss.

Impairment testing can result in sizable losses, as shown by Boeing in the first quarter of 2002 when it adopted FAS 142 and recorded a charge of \$2.4 billion. Likewise, AT&T recorded close to \$900 million in

impairment losses in 2002. The sheer magnitude of these charges reveals the importance of properly complying with this new standard.

Conclusion

As discussed above, the implications of these accounting standards are significant. Not only have purchase price allocation efforts at the time of acquisition become critical, one can easily predict increased volatility in earnings from the more rigorous impairment testing requirements that are now in place. In fact, a recent survey of financial executives revealed that about one-third expected to record an impairment loss and an astounding one-fourth did not know what to expect! Given the potential magnitude of these issues and the increased scrutiny being directed toward them, it is extremely important for these standards to be approached with adequate professional guidance.

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RECENT CAFC PATENT DECISIONS

Patent applicants will require even more care in preparing claims and amending them during the prosecution of a patent application under the most-recent holding of the Federal Circuit in *Festo Corporation v. Shoketsu Kinzoku Kogyo Kabushiki Co., Ltd.*, (en banc), (September 26, 2003). On remand from the Supreme Court, the CAFC states that, under *Festo*, when an applicant narrows a patent claim, a presumption will arise that the applicant surrendered the territory between the original claim limitation and the amended claim limitation. The patentee can overcome the presumption if the patentee can demonstrate either: (1) that the equivalent would have been unforeseeable at the time of the amendment; or (2) that the rationale underlying the amendment bore no more than a tangential relationship to the equivalence in question; or (3) that there was some other reason suggesting that the patentee could not reasonably be expected to have described the insubstantial substitute in question. If the presumption

cannot be rebutted, prosecution history estoppel will preclude a patentee from stretching the scope of a limitation added to obtain a claim's allowance. Therefore, narrowing amendments made during prosecution should be carefully considered in view of the prior art of record.

Upholding grant of summary judgment of no literal infringement and vacating the district court's grant of summary judgment of no infringement under the doctrine of equivalents, the CAFC finds that submitting a new claim as a combination of a rejected independent claim with an objected to dependent claim raises the presumption of prosecution history estoppel. *Deering Precision Inst., L.L.C. v. Vector Distribution Systems, Inc.*, (October 17, 2003). Following *Festo*, the court found that the Appellant had disclaimed the subject matter between the original independent claim and later-submitted combination claim. Moreover, the court found that the presumption of prosecution history estoppel applies to all claims containing the disclosed limitation(s). Regarding raising the presumption of prosecution history estoppel, the court stated that holding "otherwise would be to exalt form over substance and distort the logic of this jurisprudence." Therefore, if a narrowing amendment is required, care should be taken to assert, on the record, support against the application of prosecution history estoppel.

Affirming the dismissal of a counterclaim of infringement, the CAFC determined that under 35 U.S.C. § 271(g), information is not a product and that the production of information is not within the scope of the process of manufacture. *Bayer AG v. Housey Pharmaceuticals, Inc.*, (August 22, 2003). Section 271(g) provides liability if a party imports into the U.S. a product made by a patented process. Therefore, a party may import information generated by a patented process and readily use that information without violating 35 U.S.C. § 271(g).

Reversing a denial of a motion for judgment as a matter of law (JMOL) and a grant of summary judgment of noninvalidity, the CAFC held that software was improperly construed as an additional structure for a particular 35 U.S.C. § 112, ¶ 6 claim limitation. *Medical Instruments and Diagnostics Corp. v. Eleckta AB*, (September 22, 2003). The court held that the lower court properly construed two other means plus function

claims as having adequate structure defined by software. The court failed to find support clearly linking or associating the software with the function of the means plus function limitation on appeal. Therefore, during patent drafting, if software-based limitations are claimed as means plus function, the associated software should be clearly linked with the claimed function.

Affirming a summary judgment finding of invalidity, the CAFC held that a printed publication or other prior art reference should not be limited to its literal contents. *Schering Corp. v. Novartis Corp.*, (August 1, 2003). Rather, a prior art reference discloses whatever is necessarily present or inherent in it. The CAFC noted that information that must necessarily be present in a publication places the inherent subject matter into the public domain. Inherency, like anticipation, requires a determination of the meaning of the prior art, which a court may determine from one of ordinary skill in the art. Therefore, individual limitations, as well as entire claims, can be rendered invalid if they can be found inherent in a prior art publication.

UPCOMING CAFC EVENTS

In an order dated September 26, 2003, the CAFC *sua sponte* took *Knorr-Bremse v. Dana Corporation and Haldex* in an *en banc* review. The CAFC is reconsidering precedent regarding drawing adverse inferences with regard to willful patent infringement, based on the party charged with infringement obtaining legal advice and then withholding that advice from discovery. According to the CAFC, 25 amicus briefs have been filed and the oral arguments have been set for February 5, 2004.

RECENT TRADEMARK MATTER

In a recent trademark decision, the U.S. District Court for the Southern District of New York denied a motion for a preliminary injunction to enjoin the use of the phrase “**Fair and Balanced**” on the cover of a newly released book. The suit, brought by Fox News Network, LLC, originally sought to prevent the use of the phrase “Fair and Balanced” on a book cover by comedian Al Franken

and publishers Penguin Group USA, Inc. The Court found that there does not exist any likelihood of confusion between the book cover and Fox News Network. Subsequently, Fox News Network dropped the lawsuit.

RECENT BUSINESS-RELATED IP MATTER

Illustrating the influence of businesses in the European Union, on November 26, 2003, European Ministers postponed a vote on legislation regarding the allowance of software patents. Leading telecommunication companies threatened to move their investments in research and development out of Europe. The European Parliament approved a directive for the European Ministers, but, during the voting process, the directive was drastically amended to restrict the availability of software patents. No date for a vote by the European Ministers has been set.

CTM REGISTRATION

As of May 1, 2004, 10 new countries will become Member States of the European Union (“EU”), namely (by size of population), Poland, Czech Republic, Hungary, Slovakia, Cyprus, Lithuania, Latvia, Slovenia, Estonia and Malta. All existing Community Trade Marks (“CTMs”), applications and registrations will normally be extended automatically and without any official fees to all those new countries.

The EU will then cover 25 countries and 450 million consumers.

There will be no opportunity for the owner of a national trademark right in a new EU country to object to the automatic extension of a CTM registration. However, the owners of prior national trademark rights may file an opposition against any new CTM application applied for between November 1, 2003 and April 30, 2004. The owner of a CTM registration will not be able to object to a junior right that pre-dates expansion.

As is still the case, ownership of a CTM registration will be no defense to an action for infringement of a national registration/right.

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- ¹ The private sector organization empowered by the SEC to establish financial accounting and reporting standards.
- ² Effective for combinations after June 30, 2001.
- ³ Effective for fiscal years beginning after December 15, 2001.
- ⁴ Even the altruistic inventor who does not seek fame and fortune hopes for the betterment of mankind through his or her inventiveness.
- ⁵ Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 142, Goodwill and Other Intangible Assets (June 2001), ¶ 31.
- ⁶ However, if goodwill is to be assigned to a reporting unit that has not been assigned any of the assets acquired or liabilities assumed, the amount of goodwill to be assigned can be the difference between the fair value of the reporting unit before the acquisition and its fair value after the acquisition, to reflect the synergies of the combination. See Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 142, Goodwill and Other Intangible Assets (June 2001), ¶ 34-35.
- ⁷ “Substantial margin” is not defined, nor given a numerical value.
- ⁸ Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 142, Goodwill and Other Intangible Assets (June 2001), ¶ 27.

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We welcome your suggestions for future articles. Please call **Angelo J. Bufalino**, the Intellectual Property and Technology Practice Chair at (312) 609-7850 with suggested topics, as well as other suggestions or comments concerning materials in this newsletter.

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Technology and Intellectual Property Group

Vedder, Price, Kaufman & Kammholz, P.C. offers its clients the benefits of a full-service patent, trademark and copyright law practice that is active in both domestic and foreign markets. Vedder Price's practice is directed not only at obtaining protection of intellectual property rights for its clients, but also at successfully enforcing such rights and defending its clients in the court and before federal agencies, such as the Patent and Trademark Office and the International Trade Commission when necessary.

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