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THE INTERPLAY BETWEEN INTELLECTUAL PROPERTY (IP) AND SARBANES-OXLEY — OUTLINE & BACKGROUND MATERIAL

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I. INTRODUCTION

The disclosure obligations of public companies have been increased by the passage of the Sarbanes-Oxley Act of 2002 (15 U.S.C. ¶7201 et. seq.). Among the various new laws and regulations arising from the Sarbanes-Oxley Act are new requirements for the chief executive officer and the chief financial officer of a public company to make certain certifications with respect to the accuracy of Annual and Quarterly Reports filed with the SEC. In particular, these officers are required to make specific certifications concerning the maintenance of the company's disclosure controls and procedures, and that they have evaluated the effectiveness of such disclosure controls and procedures. Disclosure controls and procedures are the controls and other procedures designed to ensure that information required to be disclosed in periodic reports are recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms.[1]

The new certification requirements have led to invigorated internal diligence regarding disclosure matters. If a company fails to disclose matters that constitute required disclosure, its chief executive officer and chief financial officer may come under intense scrutiny. Penalties for false certifications include, among other things, criminal penalties. Under certain circumstances, CEOs and CFOs can be required to forfeit certain profits and bonuses under Section 304 of the Sarbanes-Oxley Act if, as a result of misconduct, the company restates its financial statements due to the material noncompliance of the company with any financial reporting requirement under the securities laws.

Moreover, Security 404 of the Sarbanes-Oxley Act requires that management of a public company provide a report on the effectiveness of the company's internal control structure and procedures for financial reporting.

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1. See Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), which also provides that "[d]isclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure."

Intellectual property matters such as patent license transactions and their consequences may impact many aspects of the financial statements and related disclosures that public companies must report to the public. Any failure to report transactions in, or other developments in connection with, intellectual property may also cause scrutiny by the SEC of a company's internal controls over financial reporting.

Accordingly, companies have been making extraordinary efforts to establish sophisticated, detailed policies regarding their internal and disclosure controls and procedures. Generally, these efforts have led to intensified responsibilities and scrutiny at many corporate levels as companies and their leading officers seek to gain accurate information upon which to rely for a variety of SEC-reporting purposes. Increasingly, corporate IP professionals are being asked to participate in these internal processes. Given the complexity of the securities laws, IP practitioners should enhance their familiarity with the key issues raised by Sarbanes-Oxley considerations. In fulfilling these additional responsibilities and, IP personnel need not act in a vacuum. One of the positive influences of Sarbanes-Oxley is that most public companies appear to have created working groups and committees to make corporate, securities, financial and audit expertise available to assist IP and other personnel with addressing any specific set of facts or otherwise addressing Sarbanes-Oxley related issues.

The following discussion is intended to highlight some of the typical disclosure obligations that may be related to intellectual property, all of which are heightened by the Sarbanes-Oxley reforms.

II. ANNUAL REPORTS, QUARTERLY REPORT , AND CURRENT REPORTS

For our purposes, it is assumed that the potential disclosing party is an issuer of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 13 of the Exchange Act requires registered companies to file reports with the SEC annually, quarterly , and from time to time upon the occurrence of certain specified events. Upon filing, these periodic reports are available to the general public through a variety of means, including access directly though the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) which is accessible via the World Wide Web.Annual Reports, Quarterly Reports , and Current Reports on Exchange Act Forms 10-K or 10-KSB, 10-Q or 10-QSB, and 8-K, respectively, are the mechanisms by

which public companies disclose information required by either Regulation S-K or S-B[2], depending on the financial situation of the company.

Annual and Quarterly Reports must be filed within a certain amount of time after the end of the company's fiscal year or quarter, respectively. Current Reports disclose certain significant information that arises between the required filing dates for Annual and Quarterly Reports. Non-exclusive examples of events that require Current Reports to be filed are the entry into, or termination or amendment of a material definitive agreement not made in the ordinary course of business of the company, an amendment of such an agreement that is material to the company (or the termination of any material definitive agreement not made in the ordinary course of business), the resignation of a director, the resignation or appointment of a principal officer, the occurrence of a change of control of the issuer, notice of delisting from a securities exchange, and the acquisition or disposition of a significant amount of assets other than in the ordinary course of business. In other circumstances disclosure is voluntary for any other information that the issuer deems to be of importance to investors and which it wishes to report.

Periodic reports require a number of disclosure items relating to intellectual property which may implicate matters involving patent license agreements. Generally speaking, an issuer's Annual Report will require the most disclosure of any periodic report.

Specific Disclosure Items

—Item 101(c)(1)(iv) of Regulation S-K requires that a public company disclose in its Annual Report the importance to the industry segment of the company, and the duration and effect of, all patents, trademarks, licenses, franchises and concessions held by the company to the extent the foregoing is "material."[3] Accordingly, any material information regarding patents and the licensing of such patents is required to be disclosed in an Annual Report. Some of the important issues for IP lawyers raised by this Item is not only what is "material", but what is meant by the phrases "importance to the segment" of the company being reported on, and the "effect of" the intellectual property? Interestingly, it may be that a "con-

2. Regulation S-B is applicable only to certain small business issuers. Regulations S-K and S-B have been promulgated by the SEC and generally require similar disclosure although the disclosures required under Regulation S-B are more limited than those of Regulation S-K.
3. See also Item 101(b) (7) of Regulation S-B. Guidance relating to the concept of materiality is provided throughout, but particularly in Section V below.

cession" would include a covenant not to sue, and thus such covenant may be reportable in appropriate circumstances.

—Item 103 of Regulation S-K requires that a company disclose matters relating to legal proceedings, which often may involve matters relating to intellectual property.

—Lastly, Item 601 of Regulation S-K requires that every contract not made in the ordinary course of business which is material to a company and is to be performed in whole or in part at or after the filing of the Annual Report or was entered into not more than two years before such filing must be filed as an exhibit to such Annual Report (or incorporated by reference if filed as an exhibit to a previously filed periodic report).[4] Accordingly, material license agreements not only must be disclosed in the relevant report, the agreement itself may be required to be filed publicly as an exhibit to an Annual Report.

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4. See Item 601(b)(10)(i) of Regulation S-K. In Item 601(b)(10)(ii) of Regulation S-K, the SEC provides additional guidance regarding what types of contracts may be deemed to be "ordinary course." Specifically, Item 601(b)(10)(ii) of Regulation S-K states as follows:

   > If the contract is such as ordinarily accompanies the kind of business conducted by the registrant and its subsidiaries, it will be deemed to have been made in the ordinary course of business and need not be filed unless it falls within one or more of the following categories, in which case it shall be filed except where immaterial in amount or significance:
   >
   > A. Any contract to which directors, officers, promoters, voting trustees, security holders named in the registration statement or report, or underwriters are parties other than contracts involving only the purchase or sale of current assets having a determinable market price, at such market price;
   >
   > B. Any contract upon which the registrant's business is substantially dependent, as in the case of continuing contracts to sell the major part of registrant's products or services or to purchase the major part of registrant's requirements of goods, services or raw materials *or any franchise or license or other agreement to use a patent, formula, trade secret, process or trade name upon which registrant's business depends to a material extent*;
   >
   > C. Any contract calling for the acquisition or sale of any property, plant or equipment for a consideration exceeding 15 percent of such fixed assets of the registrant on a consolidated basis; or
   >
   > D. Any material lease under which a part of the property described in the registration statement or report is held by the registrant (emphasis added).

—Item 303 of Regulation S-K and S-B requires that each Annual Report include a section entitled Management's Discussion and Analysis of Financial Condition, and Results of Operations, or, as it is commonly known, the "MD&A."

—Generally, the MD&A must discuss matters related to the liquidity, capital resources, results of operations and other matters relating to the company so as to enhance the public's understanding of the company's financial condition, changes in financial condition and results of operations.

—MD&A may also include a discussion of future events such as known trends regarding the company's liquidity or capital resources or any known demands, commitments, events , or uncertainties that will result in or that are reasonably likely to result in the company's liquidity increasing or decreasing in any material way.

There is no formulaic approach to the required elements of the MD&A. Rather, each company must structure its own disclosure based upon its own facts and circumstances, and that of the industry or industries in which it does business. There are a number of ways that intellectual property matters and patent license agreements may warrant disclosure in the MD&A. Any transactions or other developments by a public company in connection with intellectual property matters may impact the financial condition and/or results of operations of the public company. If any development with respect to intellectual property matters is considered an "impairment" of the company's intellectual property assets under applicable accounting standards, such impairment may require disclosure in the MD&A.[5]

Other disclosure items provide specific guidance regarding intellectual property matters. For example:

—Items 303(b)(1)(v) and (vi) of Regulation S-B require disclosure of significant elements of income or loss that do not arise from a company's continuing operations and the causes of all material changes from period to period in one or more line items of the company's financial statements. The economic consequences of intellectual property licenses can trigger either of these disclosure items.

5. See Financial Accounting Standards Board (FASB) Statement 142, *Goodwill and Other Intangible Assets.* This Statement includes the accounting framework for valuation and periodic impairment testing for intangible assets.

—Disclosure with respect to intellectual property licenses, and any developments with respect to such licenses, also may be appropriate pursuant to Item 303(a)(1)(ii) of Regulation S-B, which requires disclosure regarding a company's product research and development. Some guidance from the SEC's Division of Corporation Finance with respect to specific issues relating to MD&A, including Research and Development Activities, and the appropriate accounting and disclosure of licensing activities and R&D Expenses is included in Part II-R of Exhibit D hereto.

Quarterly Reports are similar to Annual Reports in that they require many of the same types of disclosure as an Annual Report. The Item 101 discussion of patents referred to above is not, however, required in a Quarterly Report. Also, rather than disclose a complete Item 303 MD&A, the MD&A in a Quarterly Report need only include disclosure regarding material changes to the MD&A. According to Item 601 of Regulation S-K or S-B, as applicable, the material contracts that need to be attached to a Quarterly Report are such contracts that were executed or became effective during the most recent period reflected in the Quarterly Report as opposed to the historical list of exhibits that are required to be disclosed in the Annual Report.

A Current Report is different in nature from an Annual or Quarterly Report in that its mandatory disclosure requirements are much narrower. Enumerated events must be reported within specific time periods. Other events may be reported voluntarily in a Current Report. Under recently adopted changes, the execution or material amendment of a material contract is an enumerated event requiring the filing of a Current Report within short time of their execution. It is also a relatively common practice to file a material contract as an exhibit to the Current Report, although an issuer generally may choose to do so at the time of filing its next scheduled periodic report.

It should be noted that the disclosure items set forth in Regulations S-K and S-B are also required in various different registration statements filed with the SEC under the Securities Act. Accordingly, if a public company or its shareholder(s) register shares of the company's securities for sale or resale, material information about the company will be required to be disclosed ahead of the schedule otherwise required by the periodic reports.

Required Processes

As mentioned at the outset, Sarbanes Oxley and the securities laws generally require that processes be in place to ensure that financial statements and reporting are reliable under GAAP standards. The SEC has indicated that this must include appropriate maintenance of records and recording of transactions, as well as procedures, to provide "reasonable assurance regarding the prevention or *timely detection of unauthorized acquisition, use or disposition of the registrant's assets* that could have a material effect on financial statements."

With the foregoing in mind, IP attorneys are sure to be called upon to assist their clients and corporate colleagues in evaluating the relevant intellectual property portfolio in order to determine whether anyone is using or disposing of the intellectual property in a reportable fashion.

Relevant issues relating to the value of the intellectual property portfolio would include:

a. What intellectual property does the compan have (patents, trademarks, trade secrets, etc.) What is the economic value of the intellectual property? What is the size and profitability of the relevant market? Companies need reliable, testable procedures to ensure that they can properly identify and monitor changes in intellectual property assets or values. What policies and procedures will be necessary to alert management of meaningful changes?

b. To which products/services/segments of the company does the intellectual property portfolio relate?

c. Are there any intellectual property infringers, and if so, how does that effect the financial position or prospects of the company?

d. What is the likely validity of the intellectual property? How is that to be assessed, and on what basis should any positions be revisited?

e. What is the potential for infringement damages and/or licensing income?

f. What, if any, new issues might impair the value of the intellectual property? What if the market place has changed and the public interest in products or services covered by the intellectual property changes?

g. What if an opposition to a patent (non-U.S.), a cancellation proceeding (non-U.S.) or reexamination (U.S.) of a patent has been filed. What type of evaluations are necessary to determine if this has materially impaired the value of your intellectual property?

h. Recall that Item 103 of Regulation S-K (discussed in Section II above) requires disclosure of "material legal proceedings, such as legal challenges to a company's patent rights, or governmental investigations." What if no formal action has been filed, but you have become aware of prior art or other factors which place your intellectual property in jeopardy? What if someone has found a new way to design around the intellectual property?

It also should be mentioned that under Section 303 of the Sarbanes-Oxley Act, fraudulently influencing, coercing, manipulating, or misleading the auditor of an public company's financial statements for the purpose of rendering such financial statements materially misleading may lead to criminal penalties. To the extent that IP attorneys are involved in the process of reporting up information that they have reason to believe may be the subject of an audit, including assessments of claims and contingencies that may be the subject of analysis for possible inclusion in financial statements disclosures (including accounting reserves), it is important that IP attorneys be mindful of the law's reach.

III. ATTORNEY CONDUCT RULES

All IP lawyers should be aware that pursuant to Section 307 of the Sarbanes-Oxley Act, the SEC has prescribed minimum standards of professional conduct for all attorneys who "appear and practice before the SEC in any way in the representation of" public companies. Rule 205 adopted by the SEC (17 C.F.R. Part 205, "Implementation of Standards of Professional Conduct for Attorneys")(see Exhibit C hereto), requires attorneys to report "up-the ladder" within the public company if they discover evidence of the company's material violation of the securities or certain other laws. The SEC has indicated that it expects companies and law firms to put in place procedures to help their lawyers comply with the rule.

Reporting-Up Rule

Rule 205 applies to attorneys "appearing and practicing before the SEC", which generally means any attorney: (i) transacting any business, or communicating in any form, with the SEC; (ii) representing a public company in an SEC administrative proceeding or in connection with any

SEC investigation, inquiry, information request, or subpoena; (iii) providing securities law advice regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; or (iv) advising a public company as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the SEC's rules or regulations to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC.

Rule 205 provides, among other things, that if a lawyer, appearing and practicing before the SEC in the representation of an issuer that is a public company, becomes aware of credible evidence of a "material violation" by the issuer or by any officer, director, employee or agent of the issuer, the lawyer must report such evidence to the issuer's chief legal officer or to both the issuer's chief legal officer and its chief executive officer. Unless the reporting lawyer reasonably believes that the chief legal officer or the chief executive officer has provided an appropriate response within a reasonable time, the lawyer must then report such evidence to the audit committee of the issuer's board of directors or, if there is no audit committee, to another committee of the board consisting solely of directors who are not employed by the issuer or, if there is no such committee, to the issuer's board of directors. "Material violation" means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law by the issuer or its agent, or a similar material violation of any United States federal or state law. If the issuer's board has established a "Qualified Legal Compliance Committee" (as defined in the Rule), a lawyer may comply with the Rule by reporting evidence of a material violation directly to that committee.

Because some of the Rule' s key terms such as "appearing and practicing" and "in the representation of an issuer" are very broad, they present difficult interpretive questions. For example, an IP attorney that comments on the patent disclosure of an issuer's periodic reports, is likely to be considered to be "appearing and practicing" within the meaning of the rule. Similarly, if one is involved in the preparation of a license agreement that one has reason to know is material to a company or otherwise likely to be filed as an exhibit to a company's public filings, then one is well-advised to consider oneself to be "appearing and practicing" in connection with that license agreement. In fact, it would be prudent to take the view that, unless otherwise advised by their internal securities lawyer counterparts, all IP attorneys representing public companies should

understand and comply with the applicable rules and internal compliance policies, regardless of whether they believe they are appearing and practicing before the SEC, and regardless of whether they regularly and directly participate in securities law matters.

SEC issuers and outside counsel generally have been fairly quick to develop and implement policies and procedures for attorney compliance with these professional conduct rules. IP lawyers should become familiar with the relevant provisions of Rule 205, and feel free to seek advice and guidance from securities law attorneys by discussing with them their obligations under Rule 205. For further reference, the SEC's attorney conduct rule is included in the Exhibits hereto.

IV. CONFIDENTIAL TREATMENT

It should be noted that even where disclosure of a patent license or other sensitive disclosure might otherwise be required, the SEC allows for the redaction of certain information set forth in an exhibit attached to a periodic report pursuant to Item 601 of either Regulation S-K or S-B, or as otherwise attached as an exhibit to any other report or other document filed with the SEC. Confidential treatment may be obtained for certain information otherwise subject to disclosure.[6]

Rule 24b-2 promulgated under the Exchange Act sets forth the general requirements for obtaining confidential treatment of information contained in documents filed as exhibits attached to filings pursuant to the Exchange Act.[7] The information for which confidentiality is requested must not have been publicly disclosed. Redacted information must be limited to matters that are trade secrets and commercial or financial information obtained from a company and must be "privileged and confidential." Privileged and confidential information is defined as information that is of the type that: (i) is regularly kept confidential in the company's industry and is not available from any other source; and (ii) the release thereof will be likely to cause substantial competitive harm to the company.[8] The company must omit the information from all sections of the exhibit to be

6. The SEC has set forth substantive and procedural guidelines for Rule 24b-2 confidential treatment requests in the Division of Corporation Finance Staff Legal Bulletin No. 1 (with Addendum), "Confidential Treatment Requests" (February 28, 1997, addendum July 11, 2001).
7. Rule 12b-4 promulgated under the Exchange Act deals with specific types of supplemental information requested by the SEC's staff in processing filings made by companies with the SEC.

filed. The company should also ensure that other parties to the agreement do not disclose the information publicly.[9]

V. REGULATION FD

Under certain circumstances, Regulation FD promulgated under the Exchange Act, may impose additional disclosure obligations on a public company. A company generally may not selectively disclose material information to certain parties, such as analysts or shareholders that may be reasonably expected to trade in the securities based upon such disclosure, in advance of its disclosure of such information to the general public. An offending disclosure would need to promptly be brought to the attention of the general public, typically through the filing of a Current Report. The foregoing would also apply to information that had been redacted from publicly filed exhibits. Material information relating to patent license agreements and other intellectual property matters are clearly within the scope of those matters requiring care under Regulation FD, and noncompliance with such rules falls within the ambit of the type of matters that are regulated by the attorney conduct rules and other provisions of interest under Sarbanes-Oxley.

VI. MATERIALITY DEFINED

A recurring securities law concept is materiality. The definition of materiality is the subject of countless articles, law suits, books, and other legal periodicals. In the adopting release issued by the SEC in connection with Regulation FD (the "Regulation FD Release")[10] the SEC stated that it would rely on the definition for materiality "established in the case law."[11] In TSC Industries, Inc. v. Northway, Inc.,[12] the Supreme Court, in a decision relating to materiality, stated that a fact is material if "there is a sub-

8. While FOIA (as defined above) does not define "privileged" or "confidential," the District of Columbia stated that "[information] is privileged or confidential if it is not of the type usually released to the public and is of the type that, if released to the public, would cause substantial harm to the competitive position of the person from whom the information was obtained." See Gulf & Western Industries, Inc. v. United States, 615 F.2d 527, 530 (D.C. Cir. 1979).
9. A further discussion of confidential treatment applications is beyond the scope of this outline.
10. Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154 (http://www.sec.gov/rules/final/33-7881.htm).
11. Id.
12. 426 U.S. 438 (1976).

stantial likelihood that a reasonable shareholder would consider it important" and further explained that "there must be a substantial likelihood that the disclosure of the. . .fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." This notion was reiterated by the Court in Basic v. Levinson,[13] a case involving preliminary merger and acquisition negotiations. In Basic, the Court adopted what is referred to as the "probability/magnitude approach."[14] That is, the assessment of materiality with respect to contingent or speculative information or events "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[15]

The SEC has provided some guidance on questions of materiality in the Regulation FD Release. In its discussion, the SEC referred to Staff Accounting Bulletin No. 99 ("SAB 99").[16] Although arguably only relevant to financial statements, many commentators consider the SAB 99 citation to be significant. SAB 99 provides that materiality should be tested based upon quantifiable and qualitative factors, a test similar to Basic's "probability/magnitude approach." Accordingly, under SAB 99 one may not test materiality of events based upon a fixed threshold. Rather, additional factors must be considered. This is generally thought by commentators to expand the potential scope of matters that may be deemed material to a company and a rejection by the SEC of the notion that there may be a formulaic or "rule of thumb" test of materiality, such as a 10% threshold for revenues or earnings. SAB 99 also states that the potential reaction of the financial markets to the information should be considered in determining materiality.

In addition, the SEC presented in the Regulation FD Release a nonexclusive list of events that it believed would be likely to be material in most cases:

a. earnings information;

b. mergers, acquisitions, tender offers, joint ventures, or changes in assets;

c. new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);

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13. 485 U.S. 224 (1988).
14. Id. at 238.
15. Id. (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2nd Cir. 1968)).
16. See Selective Disclosure and Insider Trading.

d. changes in control or in management;

e. change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report;

f. events regarding the issuer's securities - e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, and public or private sales of additional securities; and

g. bankruptcies or receiverships.

It should be noted that the SEC has called for disparate treatment of materiality specifically within the context of the MD&A. According to the SEC, the MD&A disclosure must be objectively reasonable. In other words, if the company believes that an event is unlikely to occur, it is not required to be disclosed in the MD&A no matter how substantial the event may be.[17] However, it should be noted that it is nonetheless often likely that the same event still may be required to be disclosed elsewhere in a periodic report based upon the probability/magnitude line of analysis discussed above, and accordingly, this distinction is in practice relevant solely to the MD&A.

VII. CONCLUSION AND PRACTICAL IMPLICATIONS

Under SEC regulations, adopted in the wake of Sarbanes-Oxley, there are numerous issues that require careful analysis and difficult judgments for IP practitioners. Ultimately, each company needs to determine what policies and procedures it needs to have in place to properly evaluate the foregoing issues, and ultimately what procedures it requires to ensure that material information is reported upstream so that the company and its managers can fulfill their responsibilities under the federal securities laws, including Sarbanes-Oxley. The proper role of IP counsel in connection with the various SEC reporting obligations will need to be determined in close consultation with such counsel's business, legal and accounting colleagues. If nothing else, clear and effective lines of communication are more imperative than ever in light of the numerous complexities left in the wake of the Sarbanes-Oxley Act. Although IP lawyers

17. This is a departure from the "probability/magnitude approach" laid out by the Supreme Court in the context of preliminary merger and acquisition negotiations in the Basic case.

may have much to learn in order to effectively fulfill their portion of these responsibilities, it is also the case that they have much to offer to their colleagues regarding the nuances and complexities of the intellectual property arena. Taken together, a collaborative effort to meet the demands of Sarbanes-Oxley should result in more effective reporting and disclosure.

In addition to the foregoing discussions, the accompanying material contained in the Exhibits sets forth in pertinent part some of the relevant regulations.