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# SARBANES-OXLEY: A DARK CLOUD OVER INTELLECTUAL PROPERTY AND BUSINESS

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ABSTRACT

The Sarbanes–Oxley Act seeks to improve corporate financial reporting and eliminate the frauds and improprieties that spurred the numerous accounting scandals. While Sarbanes–Oxley requires an immense amount of time and effort for compliance, the Act's application to intellectual property is woefully lacking. This comment proposes that the proper remedy is increased definition within the language of the Act. Additionally, small businesses, whose activities have little effect on the financial markets, should be subject to fewer regulations within Sarbanes–Oxley. Without paring down ambiguous terms and limiting the scope of the Act, corporate officers are left in the dark about what constitutes sufficient compliance.



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# SARBANES–OXLEY: A DARK CLOUD OVER INTELLECTUAL PROPERTY AND BUSINESS

MATTHEW D. GOODSTEIN*

## INTRODUCTION

"The day will come when [intellectual property] is accounted for like everything else in a business."[1] That day has potentially arrived, thanks to the Sarbanes–Oxley Act ("SOX" or the "Act").[2] As President Bush said, SOX is "the most far–reaching reforms (sic) of American business practices since the time of Franklin Delano Roosevelt."[3]

The idea of conducting business is broad and far-reaching, affected by such forces as government regulations and, perhaps more importantly, relationships with investors. Intellectual property ("IP") also greatly affects business. Business and IP should enjoy a synergistic relationship, where the value of the whole is greater than just the sum of the parts, but, under current practices that is not always possible. SOX, designed primarily to increase the truthfulness of corporate financial reporting, may also be the glue capable of binding these two forces.

This comment aims to advise business executives who face the task of SOX compliance in an information–based economy, as well as the policy makers who have a role shaping the Act's future. The background section of this comment looks generally at IP in business and the SOX legislation, both of which are critical for professionals not versed in IP. The analysis section examines how IP and SOX are interrelated, common objections to the application of SOX, and how the Act affects businesses that rely on their IP rights as a potential source of revenue. The proposal section proffers changes to SOX, in an attempt to satisfy both proponents and critics of the Act. This comment discusses both SOX as an element of business and SOX as it applies to IP within a business context. A better understanding of the influences SOX has on business, especially the IP element of business, can yield greater returns from IP and can reduce the mounting liability on those who choose to ignore the harbingers of change.

## I. BACKGROUND

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1 Russell Barron et al., *Intellectual Property Metrics Today: It Can Be Done*, GLOBAL INTELLECTUAL PROPERTY ASSET MANAGEMENT REPORT, A WORLDTRADE EXECUTIVE PUBLICATION, June 2005, at 2 (discussing the evolution of IP management).

2 Sarbanes–Oxley Act of 2002 (SOX), Pub. L. No. 107-204, 116 Stat. 745 (codified in Titles 15, 18, and 28 of the U.S. Code(Supp. I & II 2002)).

3 Elisabeth Bumiller, *Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1 (quoting a speech made by President Bush at the signing of the Sarbanes–Oxley ("SOX") bill into law, referring to Franklin Delano Roosevelt's New Deal legislation, passed in response to the Great Depression of 1929). *See generally* WILLIAM J. BARBER, DESIGNS WITHIN DISORDER, FRANKLIN D. ROOSEVELT, THE ECONOMISTS, AND THE SHAPING OF AMERICAN ECONOMIC POLICY, 1933–1945 (Cambridge University Press 1996) (discussing Franklin D. Roosevelt's post–depression new deal policies and legislation).

This section discusses two main points. First, part A begins by discussing both IP generally and IP's relationship with business. Second, part B of this section discusses SOX generally, including its background, relevant provisions, and the most prevalent objections to the Act.

### *A. IP as an Element of Business*

IP business assets consist of trademarks, patents, copyrights, and trade secrets.[4] Trademarks protect words, names, symbols, or devices.[5] Patents protect inventions.[6] Copyrights protect "original works of authorship fixed in any tangible medium of expression."[7] A trade secret is proprietary information that derives value by being generally unknown to the public.[8] Trade

[4] BLACK'S LAW DICTIONARY 824 (8th ed. 2004). Intellectual property is a "category of intangible rights protecting commercially valuable products of the human intellect. The category comprises primarily trademark, copyright, and patent rights, but also includes trade–secret rights, publicity rights, moral rights, and rights against unfair competition." *Id.*

[5] 15 U.S.C. § 1127 (2006) ("The term 'trademark' includes any word, name, symbol, or device, or any combination thereof."). A mark may be federally registered. *Id.* § 1051. Trademarks do not have a natural expiration date, though they do expire if they are not used or if they become generic. *See Id.* § 1052. A trademark becomes generic and, therefore, receives no protection when the trademark name becomes a general term referring to a group of products that can be used interchangeable with branded trademark. 87 C.J.S. Trademarks § 43 (2006). Examples of threatened trademarks are Kleenex, for facial tissues, and Xerox, for a duplicate or copy machine. Horizon Mills Corp. v. QVC, Inc., 161 F. Supp. 2d 208, 221 n.17 (S.D.N.Y. 2001).

[6] *See generally* 35 U.S.C. § 100 (describing patents and the patent processes). An invention means an invention or discovery, and a process means a process, art, or method. *Id.* Patentability is a product of the Constitution itself. U.S. CONST. art. I, § 8, cl. 8 ("[Congress shall have the power t]o promote the Progress of . . . useful Arts, by securing for limited Times to . . . Inventors the exclusive Right to their . . . Discoveries."). The codification of patent law is known as the Patent Act. David R. Kuney, *Intellectual Property Law in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 AM. BANKR. INST. L. REV. 593, 596 (2001). Patents are valid for twenty years after the filing date. 35 U.S.C. § 154(a)(2). A patent grants the inventor the sole use of the invention for the period of patent, creating a government–sanctioned monopoly. De La Vergne Refrigerating Mach. Co. v. Featherstone, 147 U.S. 209, 220-21 (1893). *See also In re* Access Beyond Techs., Inc., 237 B.R. 32, 38 (Bankr. D. Del. 1999) ("This monopoly is the essence of the patent and is the basis for the patent holder's exclusive right to make, use, and sell the patented technology.").

[7] 17 U.S.C. § 102(a). Copyright protection, like patent protection, is a product of the Constitution. U.S. CONST. art. I, § 8, cl. 8 ("[Congress shall have the power t]o promote the Progress of Science . . . by securing for limited Times to Authors . . . the exclusive Right to their . . . Writings"). Copyright protection extends to the expression of ideas, not the ideas themselves. 17 U.S.C. § 102(b). Works of authorship, as stated in the copyright statute, include but are not limited to literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic, and sculptural works, motion pictures and other audiovisual works, sound recordings, and architectural works. *Id.* § 102(a). The term or duration of trademark protection depends on both the time of creation and the purpose of creation. *See generally* Rashida Y.V. MacMurray, *Trademarks or Copyrights: Which Intellectual Property Right Affords Its Owner the Greatest Protection of Architectural Ingenuity?*, 3 NW. J. TECH. & INTEL. PROP. 111, 114 (2005) (discussing the varying life span of copyright protection). *See generally* 1 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 1.05 (2004) (discussing the history of copyright law in the United States and the duration of copyrights).

[8] UNIF. TRADE SECRETS ACT § 1 (1985) [hereinafter USTA]. Types of trade secrets traditionally recognized include: chemical formulas; methods of doing business; customer lists; credit ratings; blueprints and architectural plans; data; manufacturing techniques; designs; marketing analysis; and advertising slogans. *See generally id.* Because a trade secret is valuable due to its secrecy, it is only valid while it remains a secret. *See generally id.* Once it is exposed, a trade secret cannot be recaptured. Ari B. Good, *Trade Secrets in the New Realities of the Internet Age*, 2 MARQ. INTELL. PROP. L. REV. 51, 97 (1998). Trade secrets are not subject to limits placed on other forms of IP, such as expiration dates, but this also makes trade secrets more susceptible to loss. Dan L. Burk, *Misappropriation of Trade Secrets in Biotechnology Licensing*, 4 ALB. L.J. SCI. & TECH. 121, 139-41 (1994). Non–disclosure and non–compete clauses in employment contracts are common ways of preventing such a loss.

secrets differ from other forms of IP in that trade secrets receive protection under state and common law, rather than federal law.[9]

There has been a shift from traditional business models, which rely on tangible assets and products, to a knowledge–based economy.[10] This is known as the "new economy," a term coined to reflect the evolution from a traditional economy, based on tangible assets, to a knowledge–based economy, driven by the value of information.[11] IP activities were traditionally separate from conventional business activities.[12] However, in the "new economy," this simply no longer holds true.[13]

Information, specifically that protected by IP, plays an integral role in all major industries. Baruch Lev, an accounting and finance professor, estimates that IP constitutes between two–thirds and three–quarters of all corporate assets.[14] When the analysis is restricted to new economy companies, one industry professional estimates that IP represents eighty percent of corporate assets.[15] It is undeniable that information comprises a significant portion of corporate assets.

IP is more important to a successful business now than it has ever been before.[16] One illustration of this importance is found in the Standard & Poor's 500 Index ("S&P 500").[17] Analyzing the top performing companies in the S&P 500, the twenty–five companies with the highest patent scores[18] outperformed the S&P 500 average by nearly ten times.[19] In other words,

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Hayden R. Brainard, *Study: Survey and Study of Technology Development and Transfer Needs in New York*, 9 ALB. L.J. SCI. & TECH. 423, 464 (1999).

[9] *See generally* ARTHUR H. SEIDEL & DAVID R. CRICHTON, WHAT THE GENERAL PRACTITIONER SHOULD KNOW ABOUT TRADE SECRETS AND EMPLOYMENT AGREEMENTS (American Law Institute ed., 3rd ed. 1995)(1973) (introducing trade secret law). "[M]ore than forty states and the District of Columbia have [] adopted the USTA in one form or another." AMERICAN BAR ASSOCIATION, THE TRADE SECRET HANDBOOK: PROTECTING YOUR FRANCHISE SYSTEM'S COMPETITIVE ADVANTAGE 2 (Michael J. Lockerby ed., American Bar Association 2000). Alabama and Massachusetts have adopted modified versions of the Uniform Trade Secrets Act. Farah Z. Usmani, *Information Privacy and Internet Company Insolvencies: When a Business Fails, Does Divestiture or Bankruptcy Better Protect the Consumer?*, 8 FORDHAM J. CORP. & FIN. L. 273, 290–91 (2003). Seven states rely on common law protection for trade secrets. *Id.* at 290.

[10] Paul Cooperrider, *The Imperatives Around Intellectual Property Asset Management*, ADVOC. (Idaho), July 2006, at 24, 24.

[11] *See* Robert Pitofsky, *Symposium Beyond Microsoft: Antitrust, Technology, and Intellectual Property: Keynote Address Antitrust and Intellectual Property: Unresolved Issues at the Heart of the New Economy*, 16 BERKELEY TECH. L.J. 535, 536 (2001).

[12] *See id.* (discussing the history of intellectual property at it relates to business).

[13] *See id.* There has been a shift from a traditional economy to a knowledge–based economy. *Id.*

[14] Cooperrider, *supra* note 10, at 24. "Baruch Lev, the Philip Bardes Professor of Accounting and Finance for New York University's Stern School of Business, contends that IP now accounts for two–thirds to three–quarters of corporate assets." *Id.*

[15] R. Mark Halligan, *Duty to Identify, Protect Trade Secrets Has Arisen*, NAT'L L.J., Aug. 29, 2005, at 1 (discussing the pervasiveness of intellectual property in the business world).

[16] Barron et al., *supra* note 1, at 1. "In the U.S. alone, from 1991 to 2001 the number of patent infringement lawsuits filed increased every single year, growing from approximately 1,200 to over 2,500." *Id.*

[17] Cooperrider, *supra* note 10, at 24. The Standard & Poor's 500 Index is a composite stock market index. Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 FORDHAM L. REV. 191, 201 (1988).

[18] Cooperrider, *supra* note 10, at 24. The frequency of references to a patent in other patent registration materials yields the patent score. Evan I. Schwartz, *Sparking the Fire of Invention*, TECH. REV., May 2004, at 36–38.

[19] *Id.* at 36–38. The S&P 500 average return of $1,000 invested from 1990 through 2003 was slightly under $5,000. *Id.* at 38 graph. The S&P 500 return of $1,000 invested from 1990 through 2003 for the twenty–five companies with the highest patent scores was nearly $40,000. *Id.*

the twenty–five companies that hold the most frequently cited or referenced patents perform dramatically better than the market average.[20]

While IP is the lifeblood of the new economy, financial assessments largely ignore this entire category of assets.[21] In the past, IP's inferior treatment on financial statements was largely due to the difficulty in identifying, classifying, and valuing such intangibles.[22] Often companies who did not know how to value IP would simply classify it as "good will."[23]

Good will classification is an often–used method of balancing financial statements without taking the time to determine the source of the imbalance.[24] The difference between assets and liabilities, which is largely comprised of intangibles, is marked as good will, rather than calculated to accurately reflect the value of the intangibles.[25] While IP may contribute to a company's good will, the value of IP extends far beyond this role as a default gap-filler.

### *B. The SOX Legislation*

SOX was enacted July 30, 2002.[26] The Act created the Public Company Accounting Oversight Board ("PCAOB") to oversee audits of public companies and to establish national accounting standards.[27] There are approximately 14,000 companies within the United States affected by SOX regulations.[28] The Act was a response to several financial and accounting scandals,[29] which cost employees and investors billions of dollars.[30] In a seven–month period, beginning in December 2001 and ending in July 2002, four major U.S. corporations filed for bankruptcy.[31] First was the Enron Corporation ("Enron"),[32] followed by Global Crossing,[33]

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[20] *Id.* at 36–38.

[21] John P. Hutchins, *The Corporation's Valuable Assets: IP Rights Under SOX*, at 292 (PLI Pats., Copyrights, Trademarks, and Literary Prop., Course Handbook Series No. 8858, 2006) (discussing the historical treatment of intellectual property in business).

[22] *Id.*

[23] *Id.*

[24] *See id.*

[25] *See id.*

[26] H.R. 3763, 107th Cong. (2001) (enacted). The bill was codified in assorted sections of the United State Code. *See generally* SOX, Pub. L. No. 107–204, 116 Stat. 745 (2002).

[27] John Paul Lucci, *Enron – the Bankruptcy Heard Around the World and the International Ricochet of Sarbanes–Oxley*, 67 ALB. L. REV. 211, 222 (2003) (discussing the creation of the Public Company Accounting Oversight Board ("PCAOB")).

[28] Kirstin Downey Grimsley, *Deadline Nears to Certify Accounting; Some D.C. Area Firms Have Already Filed Statement with SEC*, WASH. POST, Aug. 12, 2002, at E01. SOX expanded SEC regulations that previously only affected firms with annual assets of over $1.2 billion. *Id.* SOX expanded the regulations to all public companies. *Id.*

[29] Cooperrider, *supra* note 10, at 25 ("The 2002 enactment of [SOX] in the wake of Enron, WorldCom, and other major corporate scandals was a response to this need for accurate and truthful financial assessments.").

[30] Tom Fowler, *An Era Ends Today as Skilling Learns Fate; Some Counting on a Long Sentence for Ex–Exon CEO*, HOUS. CHRON., Oct. 23, 2006, at A1. Investors in the Enron Corporation alone lost billions of dollars. *Id.*

[31] Daniel P. Wikel & Gavin Toepke, *The New World of Discovery Under Sarbanes–Oxley*, AM. BANKR. INST. J., July–Aug 2003, at 28 tbl. (listing the largest bankruptcies through December 2002).

[32] *Id.* Enron was the first of the four companies to file for bankruptcy. *Id.* Enron created equity partnerships to hide financial losses, creating the illusion that the corporation was successful and profitable. ABI Roundtable Discussion, *Remember When – Recollections of a Time When Aggressive Accounting, Special Purpose Vehicles, Asset Light Companies and Executive Stock Options Were Positive Attributes*, 11 AM. BANKR. INST. L. REV. 1, 36 (2003). At the time, creating partnerships to hide financial losses was not illegal, though it was looked down upon by the accounting industry. Frank Partnoy, Symposium, *Lessons from Enron, How Did Corporate and Securities Law Fail?*, 48 VILL. L. REV. 1245, 1245 (2003). The result was a decline in Enron's stock price from ninety dollars

Adelphia Communications ("Adelphia"),[34] and finally, WorldCom Communications ("WorldCom").[35]

Alleged accounting improprieties that gave investors misleading information about the financial health of the corporations were a prominent factor leading to each bankruptcy.[36] Based on the dollar value of assets of each corporation at the time of bankruptcy, the four filings

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per share to less than one dollar, costing over 4,000 employees their jobs, as well as any investment they, or other investors, had made in the defunct energy company. Jerry Hirsch & Thomas S. Mulligan, *Safeguards Failed to Detect Warnings in Enron Debacle; Energy: Problems Escaped the Scrutiny of Analysts, the Company's Board and Auditors*, L.A. TIMES, Dec. 14, 2001 at A1. Between January 1, 2001 and August 31, 2001, twenty top Enron executives exercised options and sold stock valued at over $115 million. *See generally* http://www.chron.com/news/specials/enron (last visited Feb. 25, 2007) (compiling all Enron related documents from the Houston Chronicle and adding Internet only diagrams). While employees and shareholders were losing their investments, Enron executives engaged in insider trading, allegedly valued at over $1 billion dollars. Nancy Rivera Brooks, *U.S. Probe Targets Enron's 401(k) Plans*, L.A. TIMES, Dec. 6, 2001, at Fin. Desk 2.

[33] Wikel, *supra* note 31, 28 tbl. (identifying Global Crossing as the second of the four companies to declare bankruptcy). Global Crossing's downfall was its large expenditures in undersea fiber optic cables. Yochi J. Dreazen & Dennis K. Berman, *Global Crossing's Winnick Offers $25 Million to Aid Employees*, WALL ST. J., Oct. 2, 2002, at A1. When revenue from the cables did not match expectations, Global Crossing engaged in questionable accounting practices including failing to disclose transactions and reporting misleading corporate earnings. Dennis K. Berman & Susan Pulliam, *Global Crossing Rebuffed by SEC on Initial Offer*, WALL ST. J., Aug. 28, 2002, at A3. Global crossing executives generated $1.3 billion in stock sales during the three years prior to the company filing for bankruptcy protection. Henny Sender & Rebecca Blumenstein, *Questioning the Books: Global Crossing Creditors Review Sales, Swaps*, WALL ST. J., Feb. 25, 2002, at A6. This amount exceeds the amount of insider trading and stock sales that occurred at Enron, whose executives sold approximately one billion dollars in stock during the three years prior to the company's collapse. *Id.* Global Crossing executives claim there were no insider stock sales in the six–month period preceding the bankruptcy filing, although the CEO made over $734 million in stock sales. Christopher Stern, *Global Crossing Chairman Resigns; Winnick Still Faces Shareholders' Suits*, WASH. POST, Dec. 31, 2002, at E1. The company's CEO pledged twenty–five million dollars to help employees who had lost their substantial investment in the company's 401(k) plan. Dreazen & Berman, *supra* note 33. While the offer was the first of its kind, it fell short of the estimated $250 million that employees lost. *Id.* The amount pledged, if divided evenly, would amount to approximately five thousand dollars per employee. *Id.*

[34] Wikel, *supra* note 32, 28 tbl. Adelphia filed for bankruptcy in June 2002, after indicating in March 2002 that it had failed to report $2.3 billion in debt. Andrew Ross Sorkin, *Adelphia is Next in Parade of Fraud Trails*, N.Y. TIMES, Feb. 23, 2004, at C2. Unlike Enron and Global Crossing, who overstated earnings to bolster corporate value, the fraud in Adelphia was hiding over two billion dollars in credit that the Adelphia founding family drew against for personal expenditures. Jerry Markon & Robert Frank, *Five Adelphia Officials Arrested on Fraud Charges*, WALL ST. J., July 25, 2002, at A3. The criminal complaint filed against the Adelphia founding family alleged that the funds aided in purchasing Adelphia stock, funded construction of a golf course, and paid for extravagant vacations for the family. *Id.* Adelphia's auditor, Deloitte & Touche, approved the family's borrowing on Adelphia's credit, but claimed they did not know the full extent. Sorkin, *supra* note 34, at C2.

[35] Wikel, *supra* note 32, 28. The final company to declare bankruptcy during the seven–month period was WorldCom. *Id.* The WorldCom bankruptcy, based on total assets, was the largest bankruptcy in U.S. history. Patti Bond, *Ex–CEO Given 25–Year Term*, ATLANTA J. CONST., July 14, 2005, at 1A. WorldCom, like Global Crossing, invested heavily on fiber optic cables, and subsequently met the same fate. Simon Romero & Riva D. Atlas, *WorldCom Declares Bankruptcy; $ 107 Billion Filing Largest in U.S. History*, HOUS. CHRON., July 22, 2002, at A1. WorldCom executives allegedly inflated earnings by billions of dollars. Jube Shiver, Jr., *More Charges Expected in Probe of WorldCom*, L.A. TIMES, Sept. 5, 2002, at 3–1. While concealing mounting debts, WorldCom laid off over 20,000 blue–collar employees. Louis Uchitelle, *Turmoil at WorldCom: The Work Force; Job Cuts Take Heavy Toll on Telecom Industry*, N.Y. TIMES, June 29, 2002, at C2. At the same time, WorldCom paid 558 executives over $287 million in retention bonuses, nearly $425,000 per executive. Barnaby J. Feder, *Turmoil at WorldCom: The Executives; Bonuses Meant to Retain Talent Now Risk Outrage*, N.Y. TIMES, June 28, 2002, at C1.

[36] *See supra* notes 32–35 and accompanying text.

constituted four of the six largest bankruptcies in U.S. history.[37] The four corporations had cumulative assets of over $220 billion.[38]

SOX is a method of "cracking down on all the Enron–WorldCom–Global Crossing chicanery."[39] The intended purposes of the Act are to reestablish a sense of integrity in the financial markets and to protect the interests of financial investors.[40] SOX purports to do more than simply require more accurate and substantial financial reporting; the Act gives teeth to the regulations.[41] The Act provides "an important weapon in the fight against corporate fraud."[42] Eleven titles comprise the Act itself.[43] Of the eleven titles, five key sections relate to IP management.[44]

Specifically, Section 302 of the Act requires that a corporation's signing officers certify financial statements.[45] Section 401 requires that financial statements include all material off–balance sheet transactions.[46] Section 404, which has garnered the most criticism,[47] requires

[37] *See* Romero & Atlas, *supra* note 35, at A1. WorldCom was the largest bankruptcy in U.S. history, with over $107 billion in assets. *Id.* Enron was the second largest bankruptcy in U.S. history, with over $63 billion in assets. *Id.* Global Crossing was the fifth largest bankruptcy, with assets of $25.5 billion. *Id.* Adelphia Communications was the sixth largest bankruptcy, with nearly $24.5 billion in assets. *Id.*

[38] *See generally id.* (listing the asset value of each of the four companies that filed for bankruptcy).

[39] Robert Trigaux, *Companies Start to Take a Private Track*, ST. PETERSBURG TIMES, Aug. 28, 2002 at 1E (discussing the growing trend of companies going private to avoid SOX disclosures).

[40] Statement by SEC Chairman Harvey L. Pitt re: Agreement on Comprehensive Reform Legislation, (July 24, 2002), http://www.sec.gov/news/press/2002-111.htm (last visited Feb. 25, 2007) (statement by SEC Chairman Harvey L. Pitt on the enactment of Sarbanes–Oxley).

[41] 18 U.S.C. § 1350(c) (2006) (classifying the failure of corporate officers to certify financial reports pursuant to relevant provisions in the Securities and Exchange Act of 1934 as mail fraud and instituting potential civil and criminal penalties).

> Whoever (1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or (2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.

*Id.*

[42] Press Release, U.S. Sec. & Exch. Comm'n & U.S. Dep't of Justice, Former Ernst & Young Audit Partner Arrested for Obstruction Charges and Criminal Violations of Sarbanes–Oxley Act (Sept. 25, 2003) (on file with author) *available at* http://www.sec.gov/news/press/2003-123.htm (discussing the arrest and guilty plea of a former Ernst & Young auditor under the SOX criminal sanctions).

[43] *See generally* SOX, Pub. L. No. 107–204, 116 Stat. 745 (2002) (the SOX legislation). Title I of SOX is "Public Company Accounting Oversight Board." *Id.* §§ 101–09. Title II is "Auditor Independence." *Id.* §§ 201–09. Tile III is "Corporate Responsibility." *Id.* §§ 301–08. Title IV is "Enhanced Financial Disclosures." *Id.* §§ 401–09. Title V is "Analyst Conflicts of Interest." *Id.* § 501 (amending the Securities and Exchange Act of 1934 by adding section 15D). Tile VI is "Commission Resources and Authority." *Id.* §§ 601–04 (amending various sections of the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Investment Advisors Act of 1940.) Title VII is "Studies and Reports." *Id.* §§ 701–05. Title VIII is "Corporate and Criminal Fraud and Accountability." *Id.* §§ 801–07. Title IX is "White–Collar Crime Penalty Enhancements." *Id.* §§ 901–06. Title X is "Corporate Tax Returns." *Id.* § 1001. Title XI is "Corporate Fraud and Accountability." *Id.* §§ 1101–07.

[44] Hutchins, *supra* note 21, at 293.

[45] *Id.* Corporate responsibility for financial reports requires, among other things, that a public company's signing officers certify that financial reports contain no materially untrue or misleading statements, there are no material omissions, and the reports fairly represent the financial condition of the company. SOX, § 302.

[46] Hutchins, *supra* note 21, at 293. Section 401, Disclosures in periodic reports, requires, among other things, that all financial reports include all material off–balance sheet transactions. SOX, § 401. A balance sheet is one of the traditional documents included in a financial report, along with an income statement and a statement of cash flows. Olufunmilayo B. Arewa, *Measuring and Representing the Knowledge Economy: Accounting for Economic*

financial statements to include a description of the internal control processes used to gather data and formulate the statements.[48] Section 409 requires that companies affected by SOX maintain accurate disclosures of their financial condition.[49] Section 906 imposes criminal and civil liability on executives who violate SOX provisions.[50]

While primarily designed to increase accuracy in financial reporting, perhaps the most important provisions of SOX are those that mandate certification of control procedures by a company's signing officers.[51] Certification attempts to ensure that companies have taken the requisite steps to identify and value all of their assets, including IP.[52] Certification also provides symbolic assurances that financials are of a high quality, thus boosting investor confidence and creating corporate stability.[53] Conversely, diminished investor confidence creates a domino effect, harming all market participants.

The effectiveness of the certification requirement is rooted in the civil and criminal penalties executives face for violations.[54] Without engaging in proper IP management procedures, an executive cannot truthfully certify that the financials fairly and accurately represent the health of the company.[55] This personal liability for inaccurate or misleading financial statements creates an additional incentive for careful and correct IP management.

While the legislation may appear clear, its application has proved far more burdensome than expected.[56] These difficulties go beyond the sheer volume of activities covered by the Act and extend to a more fundamental problem. That fundamental problem is the ambiguous terminology within the Act, which leads to over–inclusive audits, skyrocketing SOX implementation costs, and

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*Reality Under the Intangibles Paradigm*, 54 BUFF. L. REV. 1, 17 (2006). A balance sheet is a statement, as of a specific point in time, which lists the assets and liabilities of a company. *Id.* at 18.

[47] Tosha Huffman, Note, *Section 404 of the Sarbanes–Oxley Act: Where the Knee Jerk Bruises Shareholders and Lifts the External Auditor*, 43 BRANDEIS L.J. 239, 253 (2005) (describing the costs and benefits of Section 404 compliance).

[48] Hutchins, *supra* note 21, at 293. Section 404, Management assessment of internal controls, requires, among other things, that financial reports include descriptions of internal controls and procedures used in gathering company data. SOX, § 404.

[49] Hutchins, *supra* note 21, at 293. Section 409, Real Time Issuer Disclosures, requires public companies to disclose material changes in the financial condition of the company to the public on a "rapid and current basis." SOX, § 409.

[50] Hutchins, *supra* note 21, at 294. Section 906, corporate responsibility for financial reports, imposes both civil and criminal liability upon a public company signing officers for failure to follow guidelines set forth in SOX. SOX § 906. Section 906 is a part of Title IX, the White Collar Penalty Enhancement Act of 2002. *Id.* § 901.

[51] *See generally id.* § 906 (creating corporate responsibility for financial reports).

[52] *Id.*

[53] Peter Ferola, *Internal Controls in the Aftermath of Sarbanes–Oxley: One Size Doesn't Fit All*, 48 S. TEX. L. REV. 87, 111 (2006) (describing the increase in investor confidence due to SOX reforms, sometimes to the point of overconfidence).

[54] SOX § 906. An executive who knowingly violates one of the provisions of SOX shall be subject to a fine of not more than $1,000,000 or ten years in jail or both. *Id.* An executive who willingly violates one of the provisions of SOX shall be subject to a fine of not more that $5,000,000 or twenty years in jail or both. *Id.* A knowing or willful violation includes violating the requirement to put in place adequate controls, so ignoring potential SOX problems will not avoid possible liability. *See id.*

[55] Hutchins, *supra* note 21, at 294.

[56] Kevin Drawbaugh, *Interview – Democrat Says Sarbanes–Oxley Already Being Thinned*, REUTERS, Nov. 1, 2006 (LEXIS) (interview with Rep. Barney Frank about potential revisions to SOX).

incorrect IP asset management.[57] These problems create confusion and frustration, which plague companies subject to SOX regulations and lead to inaccurate financial reporting.[58]

Two recently formed industry groups are proposing alterations to SOX.[59] The first group is a part of the U.S. Chamber of Commerce.[60] The second group, the Committee on Capital Market Regulation, is comprised of industry experts and executives.[61] These two committees have created several proposals.[62] First, the groups proposed to limit the liability of accounting firms for work done on behalf of clients.[63] Second, the groups sought to force prosecutors to target individual wrongdoers, rather than companies, when problems arise.[64] Finally, the groups sought to reduce the number of shareholder lawsuits.[65]

## II. ANALYSIS

This section analyzes how IP and SOX are interrelated and how SOX affects businesses that rely on IP as a potential source of revenue. Part A identifies activities associated with IP as they relate to business. Part B uses a hypothetical situation to provide a demonstration of proper IP management. Part C analyzes several problems with the current application of SOX. Finally, part D applies the problems with SOX specifically to IP.

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[57] *See* Tom Fowler, *Following the Rules: The Sarbanes–Oxley Act Has Its Defenders and Detractors as Companies Shell Out to Comply; Taking an Accounting of Reform*, HOUS. CHRON., Jan. 29, 2006, at 1 [hereinafter Fowler, *Following the Rules*] (describing the problems with Section 404).

[58] *See* Drew Desilver, *Probing for Weakness*, SEATTLE TIMES, April 17, 2005, at E1.

[59] Stephen Labaton, *Businesses Seek New Protection on Legal Front*, N.Y. TIMES, Oct. 2, 2006, at 1.

[60] *Id.*

[61] Floyd Norris, *Panel of Executives and Academics to Consider Regulation and Competitiveness*, N.Y. TIMES, Sept. 13, 2006, at 3. This second group is known unofficially as the "Paulson Committee," after Treasury Secretary Paulson, who recently issued an encouraging statement about the group shortly after its formation. Labaton, *supra* note 59.

[62] Labaton, *supra* note 59.

[63] *Id.*

[64] *Id.* Some business and legal experts criticized the decision to bring a criminal action against Arthur Andersen based on actions of individual employees. *Id.* The criminal case, *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005), effectively led to the demise of the accounting firm. Labaton, *supra* note 59. It is usually more difficult for prosecutors to prove violations by individual employees than it is to prove individuals by a firm as a whole, due to the lack of sufficient evidence to show individual action. *Id.*

[65] Labaton, *supra* note 59. A shareholder derivative suit is a suit brought by a shareholder on behalf of the corporation against a third party, usually a corporate officer, when the corporation fails to take action on its own. BLACK'S LAW DICTIONARY, *supra* note 4, at 475. There have been several proposals for limiting shareholder lawsuits. Labaton, *supra* note 59. One such proposal is to end the Justice Department's prohibition on companies under investigation paying legal fees for executives suspected of violating the law. *Id.* Another proposal to reduce shareholder lawsuits is to force arbitration in some cases, which is typically more sympathetic to defendants that traditional lawsuits. *Id.*

### *A. IP Management*

IP management is critical for complying with SOX Section 404, which requires certification of the methods used to derive financial statements.[66] Section 404 mandates accurate financial statements, which is the driving force behind improved IP management strategies.[67] This is the root of the problems encompassing SOX and IP, and is why proper IP management procedures are so critical.

There are many different iterations of effective IP management, but there are key elements common to each iteration.[68] Effective IP management can only occur after executives grasp the full value of IP and the level of integration between IP and essential business practices.[69] Once management accepts the baseline importance of IP, there are three main categories of IP management activity: inventory; valuation; and control.[70]

The first step in proper IP management is identifying and inventorying all potential IP within the company.[71] This identification process is sometimes referred to as an IP audit.[72] Effective IP management involves more than simple identification; it involves a strategic analysis designed to "extract the maximum value and profit from its IP portfolio."[73] The pervasive use of licensing IP increases the importance of IP identification and management because accurate licensing decisions rely on accurate financial analysis.[74]

The next step in proper IP management is valuation.[75] Improved IP valuation techniques, while important for business operations in general, are especially critical for SOX compliance.[76]

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[66] Hutchins, *supra* note 21, at 293–94. Section 404 requires corporate signing executives to certify financial statements as correct and accurate, which is not possible when IP is not correctly valued. *Id.*

[67] *Id.* at 294.

[68] Cooperrider, *supra* note 10, at 25 (noting several salient elements to effective IP management are common among any proper method chosen).

[69] *Id.* The first step to effective IP management is always to "ensure that top management understands the imperatives and importance of IP asset management." *Id.*

[70] Hutchins, *supra* note 21, at 294–95.

[71] Cooperrider, *supra* note 10, at 25. Identification of IP should include the identification of the IP "owner" within the company, which is the person accountable for managing and reporting changes in the IP. *Id.*

[72] Hutchins, *supra* note 21, at 295. "[T]here is no established 'best practice' for conducting the IP audit." *Id.* at 296. While not required, a company may find it useful to create an IP audit team, comprised of in–house and outside council and representatives from major departments within the company, including information technology, research and development, operations, and a representative of the department charged with regulating the company's financial dealings. *Id.*

[73] Cooperrider, *supra* note 10, at 25. While all IP must be identified, it does not all need to be treated the same. *Id.* IP aligned closely with the business model may provide significant value or profit potential compared to extraneous IP, and, therefore, require increased attention and protection. *Id.* This analysis aids in determining the level of expense that is appropriate to protect the IP, as obtaining IP protection can consume significant resources. *Id.* at 25–26. Failure to evaluate IP's value leads some companies to waste resources in an attempt to "blot out the sun" by obtaining expensive protections for IP that do not create enough value to make such protections prudent. Cooperrider, *supra* note 10, at 25.

[74] *See* Cooperrider, *supra* note 10, at 26 (proper IP management is necessary for informed licensing negotiations). Many companies do not own the IP that they rely on for everyday business activities. Michael S. Mireles, *An Examination of Patents, Licensing, Research Tools, and the Tragedy of the Anticommons in Biotechnology Innovation*, 38 U. MICH. J.L. REFORM 141, 164–65 (describing licensing as a cost effective method of obtaining some forms of IP). Some companies find it more cost effective to license IP from another company that either has developed novel IP or can produce the IP at a lower cost than the licensee. *See id.* Many companies that do own their own IP, rather than licensing it from others, do not have unadulterated rights to that IP due to licenses granted to other companies. *Id.* at 165.

[75] Cooperrider, *supra* note 10, at 25.

There are three main methods of valuing IP: the cost approach; the income approach; and the market approach.[77] The goal of each valuation technique is to determine the accurate value of IP, which helps to ensure financial reports are SOX compliant.[78] Determining the best method of IP valuation is highly individual to each company.[79]

Within the cost-approach method of valuing IP, there are different variations. One type of cost approach considers the initial costs associated with developing the IP.[80] Another form of cost–based valuation evaluates the cost of replacing lost, stolen, or otherwise unusable IP.[81] There are two types of cost valuation: reproduction costs and replacements costs.[82] The cost approach is sometimes the easiest and cheapest to implement because it relies on historical data rather than speculation and complex computations.[83] This approach to IP valuation is especially useful when there is little or no comparable economic activity with which to compare the IP.[84]

Valuation under the income approach is determined by calculating the net present value of future cash flow generated by the IP.[85] The advantage to using the income approach is that the value of some IP diminishes over time.[86] However, the income approach's flexibility based on market forces is also a disadvantage because market fluctuations and future competitive innovations cannot always be predicted and may drastically alter the expected income from IP.[87]

The final available method for IP valuation is the market approach. Under the market approach, valuation is based on what others in the market would be willing to pay to use the IP.[88] The advantage to using the market approach is that when enough data is available, it provides a

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[76] Hutchins, *supra* note 21, at 292. The primary purposes for IP valuation are: litigation, where it is used to determine damages that result from use by a third party, transactions, where is it used in negotiations determine the value of the item being transferred, and financial reporting, where it is used to inform investors of corporate health. *Id.*

[77] *Id.* at 302. These three forms of valuation are the same as valuation for traditional assets. *Id.* In addition to the three primary methods of IP valuation, there are derivations of the valuation strategies that utilize slight variations or combinations of the traditional models. Barron et al., *supra* note 1, at 6. Additional methods of IP valuation include option pricing, which is based on Black–Shoales financial modeling, and leverage valuation, which is based on the value that use of the IP will generate, through increased functionally, performance, or time to market, for a third party that is able to use the IP. *Id.*

[78] Hutchins, *supra* note 21, at 292. Financial reporting is one of the three main reasons for IP valuation, along with IP litigation and IP transactions. *Id.*

[79] *Id.* at 302. The type of IP being valued, the availability of historical data, and a cost/benefit analysis of the methods all affect the valuation strategy chosen. *Id.* The ability to conduct more expensive valuation procedures may not lead to significantly more accurate results, making the added expense unjustified. *Id.*

[80] *See id.*

[81] *Id.* Cost valuation includes the costs of research and development as well as lost profits. *Id.*

[82] David C. Drews, *Intellectual Property Valuation Techniques*, IPMETRICS, at 4, Oct. 2004, http://www.ipmetrics.cc/IPVT.pdf (describing the two categories of cost based IP valuation). Reproduction costs are the costs associated with reproducing the exact same asset. *Id.* Replacement costs are the costs associated with developing an asset with similar utility. *Id.* Changes to the cost of production affect both evaluations. *Id.* Examples of such changes are increased knowledge or technological experience, which may make development easier and less costly. *Id.*

[83] *See* Hutchins, *supra* note 21, at 302.

[84] Drews, *supra* note 82, at 5.

[85] Hutchins, *supra* note 21, at 302. Net present value is calculated by using historical data to measure cash flows from the IP that are projected into the future, which are then discounted back to the present value. *Id.* It is possible to extend net present value forecasts through the life of the IP protection. *Id.* The income approach is generally valid when applied most situations involving intangible assets. Drews, *supra* note 82, at 6.

[86] Hutchins, *supra* note 21, at 303. The value of IP is not stagnant, due to outside forces, so the value may change over time. *Id.*

[87] *See id.*

[88] *Id.* at 302.

generally sound estimate of present value.[89] However, like the income approach, the market approach is highly speculative due to the unique nature of IP and the limited availability of information.[90]

After identification and valuation of IP, the final steps in effective IP management are protection and control.[91] Internal controls within the context of SOX do not refer to direct controls over IP, such as obtaining patent protection or restrictive covenants.[92] Rather, internal controls within SOX, as explicitly required in Section 404 of the Act, refer to control over the process of financial management, including IP management.[93]

The internal control requirement of Section 404 is the source of most complaints about SOX.[94] While certification of control processes may appear simple, many companies have found that Section 404 compliance is excessively expensive, redundant, and vague.[95]

Controls, through certification from the company's signing officers, seek to ensure that the reports are accurate and contain no false or misleading information.[96] There are no identified requisite control processes; however, the processes chosen must provide a reasonable basis for certification by the signing officer.[97] This ambiguity is a source of objection to SOX.[98] Regardless of how a company chooses to establish internal control, the company must identify all of its IP, as well as the data used to value it.[99]

Protection of IP, on the other hand, relates directly to control over the IP.[100] Protection decisions are based on the risk of loss of the IP, which must be reflected in valuation.[101] Lack of adequate IP protection has cost companies over one trillion dollars.[102]

Protection for IP in the form of patents, trademarks, and copyrights comes primarily from registration. Regardless of the minimal protection that that automatically accompanies some

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[89] Drews, *supra* note 82, at 5–6.

[90] *See generally* Robert F. Reilly, *Intellectual Property Considerations in Pharmaceutical Industry Valuations*, AM. BANKR. INST. J., June 2006, 46, 46. Data on IP transactions is rarely released, making accurate data for calculations difficult to obtain. *Id.*

[91] Cooperrider, *supra* note 10, at 24.

[92] Hutchins, *supra* note 21, at 304. "The entire subject of internal controls has been confused by the growing belief by some that 'internal controls' mean something directly related to the controls on IP (i.e., restrictive covenants and passcodes, or patents) or something directly related to network security." *Id.*

[93] *See generally* Sarah Hewitt, *Sarbanes–Oxley Reporting Requirements and Its Implications for Outsourcers* (PLI Pats., Copyrights, Trademarks, and Literary Prop., Course Handbook Series No. 8858, 2006) (discussing the implications SOX has on outsourcers). *See also* Hutchins, *supra* note 21, at 304 ("SOX deals with internal controls over the financial reporting process, so that the reporting officer can be assured that what he or she is reporting has not been the subject of fraud or manipulation.").

[94] *See generally* Huffman, *supra* note 47, at 253–56 (describing the costs and benefits of Section 404 compliance).

[95] Desilver, *supra* note 58.

[96] Hutchins, *supra* note 21, at 304.

[97] Hewitt, *supra* note 93, at 280. The control process must provide sufficient "evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting." *Id.*

[98] Fowler, *Following the Rules*, *supra* note 57 (lack of definitions within SOX is a significant objection by those bound by the Act).

[99] *See* Hewitt, *supra* note 93, at 280 (discussing common elements of control methods).

[100] Hutchins, *supra* note 21, at 304–05.

[101] *Id.*

[102] Breana C. Smith, *Intellectual Property Crimes*, 43 AM. CRIM. L. REV. 663, 665 ("By 2000, American companies lost over $ 1 trillion from intellectual property theft and that number is expected to continue growing.").

forms of IP, registration is critical for complete protection,[103] and is especially important when the IP has significant value.[104] Trade secret protection comes from internal security policies since there are no formal methods of protection.[105]

### *B. Hypothetical Application of SOX*

The best way to analyze how SOX applies to IP is to use a hypothetical, and a good example to illustrate the vast influence IP has on business is through a pharmaceutical company. For the purposes of this comment, Joe–Schmo Pharmaceuticals ("Joe") is a drug company that holds many valuable patents, trademarks, and trade secrets.

Joe's primary source of income comes from its wonder drug, Cureitall. Cureitall represents a breakthrough in modern medicine, with its ability to cure everything from cancer to the common cold. Joe has patent protection on the ingredients in Cureitall. The process by which Joe creates the drug is a trade secret. In addition, Joe licenses the rights to use Cureitall's signature packaging, to which the company attributes a large portion of Cureitall's success, from another company.

Before SOX, good will calculations comprised the difference between assets and liabilities in Joe's financial statements. The picture painted for investors by these financial statements was very different from the actual corporate health.

Evaluating Joe's financial health under SOX, investors receive a much more accurate depiction of the company. Once Joe has identified all of its IP, including the licensing of the packaging material, the patented ingredients in Cureitall, and the trade secret production method for Cureitall, Joe must value and protect the IP, and those processes must be certified as sufficient.

Due to Joe's size and the importance of IP to the company, Joe is not limited in its choice of valuation strategies like a smaller company with fewer resources might be. The first IP to be valued is the patent. It may be easy to value Cureitall using the cost method; however, it is highly likely that the value of Cureitall will be much higher than the cost of development, due to the drug's success. Thus, the cost method is likely not the best method to value the patent.

Joe could use the market approach, but the value of Cureitall is so great, and the drug is so unique, that it may be beyond comparability in the open market. Joe's best valuation strategy for the patent is the income approach. The present value of the estimated revenue Cureitall will generate during the patent's lifespan will be the most accurate indication of Cureitall's value to Joe.

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[103] *See generally* 15 U.S.C. § 1051 (2006) (discussing the registration of trademarks). Trademarks are valid regionally without national registration, but national registration increases the level of protection, and is the prudent decision for any company currently using or that will potentially use trademarks. *Id.*

[104] *See* Cooperrider, *supra* note 10, at 25. Federal or international protections may cost more than the value generated by the IP, making the increased protections inefficient. *Id.* Whatever the level of protection deemed necessary, complete information about the protections must be available to the auditors who certify the internal controls. *See generally*, SOX, Pub. L. No. 107–204, § 404, 116 Stat. 745 (2002) (requiring auditor certification of financial controls).

[105] *See* SEIDEL & CRICHTON, *supra* note 9, at 2–6. This is a great advantage for companies that take the requisite steps to protect their trade secrets, but creates potentially devastating liability for companies that are unable to protect them. *See generally* note 9 and accompanying text. "Trade secrets are the most powerful, but also among the most risky, form of protection for a company product or formula." Chico Harlan, *Trade Secret Plot Pulls Coke, Pepsi Together*, PITTSBURGH POST–GAZETTE, July 7, 2006, at A–1 (describing Coke's use of trade secret protection for parts of its IP portfolio).

The next piece of IP subject to the rigors of SOX compliance is the trade secret production method used to produce Cureitall. Since the trade secret is for a method of production, it does not generate revenue alone, thus ruling out the income approach. Even though disclosure would reduce the trade secret's value, Joe would still be able to use the method without the cost of developing a new one, ruling out the cost approach. The market approach is best suited for this IP because it evaluates what competing firms would pay for access to the technology. The trade secret should be protected by limiting access to the trade secret information and through mandatory non–disclosure agreements.

The final piece of IP is the license. The best valuation strategy for the licensed packaging is the cost approach because the packaging's value to the company is directly related to how much it would cost the company to replace it, rather than the income that the packaging generates or the price for which the license could be sold.

Control processes for licensed IP are different from owned IP because Joe does not have complete control over the license due to the third–party owner. Joe's sole forum for protecting the company's interest in the packaging lies within the licensing negotiations and agreement.

Full compliance with SOX also requires Joe to exercise appropriate IP controls. Joe's signing executive must review the control procedures used to identify and value the different forms of IP before verifying the financial statements. Because Joe utilized the proper methods for identifying and valuing each of the three types of IP in this hypothetical, as long as there have not been any material changes since the valuation, the IP controls can be certified for the statements. Once Joe has completed each step in the IP management process, Joe's financials can be certified as SOX compliant.

### *C. Objections to SOX*

Aside from the substantial benefits derived from SOX, there are those who object to the implementation procedures for some provisions of the Act. The difficulties with SOX compliance include the increased expense of asset valuation and the costs associated with maintaining auditor independence. Objections to SOX generally stem from two requirements within Section 404, the cost of compliance and the breadth of the auditor independence requirements.[106]

The first major objection to SOX is with the cost and difficulty of compliance with Section 404. The Securities and Exchange Commission ("SEC") previously estimated that the total cost of SOX implementation would be \$1.24 billion, or an average of \$91,000 per company that is required to comply with the Act.[107] Industry groups have found these estimates to be grossly inadequate. Financial Executives International, a finance industry trade organization, conducted a survey of 217 companies subject to SOX regulations.[108] The survey revealed that, on average,

[106] *See generally* Huffman, *supra* note 47, at 253–56 (describing the costs and benefits of Section 404 compliance).

[107] Final Rule: Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release Nos. 33–8238; 34–47986, 68 Fed. Reg. 36,636 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm (last visited Mar. 1, 2007) [hereinafter SEC Final Rule].

[108] Letter from Financial Executives International to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 1, 2005), *available at* http://www.fei.org (last visited Mar. 1, 2007). The cost of Section 404 compliance calculated by the group includes time spent by employees to achieve compliance, which was, on average, 26,758 hours per company. *Id.*

each of the 217 companies surveyed spent $4.3 million in compliance activities.[109] Other studies by trade organizations[110] and business schools echo similar findings.[111]

The second major objection to the application of SOX is with the many provisions relating to audits, including Accounting Standard 2 ("AS2").[112] AS2 establishes the standards called for in Section 404 of the Act.[113] Section 404 not only states that management must establish internal controls, but also that public accounting firms must certify these internal controls.[114]

The effect of this regulation is two–fold. First, the independence requirement means that the same firm cannot provide audit services and accounting or consulting services. Non-auditing services provide a large source of revenue for accounting firms. This substantial revenue stream may create a conflict of interest, since auditors may be tempted to sign off on internal control processes rather than risk losing lucrative consulting business by upsetting clients.[115]

This independence requirement forces companies to duplicate work, which in turn duplicates expenses. Companies must pay for advice from consultants, while subsequently paying auditors

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[109] *Id.* Companies with over $25 billion in revenue spent, on average, over $14.7 million on Section 404 compliance. *Id.*

[110] Letter from the Chamber of Commerce to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 12, 2005), at 1, http://www.uschamber.com [hereinafter Chamber Letter]. A survey conducted by the Independent Community Bankers of America ("ICBA") found that member community banks that responded to the survey spent, on average, over two hundred thousand dollars for Section 404 compliance. ICBA Community Bank Survey: The Costs of Complying with Section 404 of the Sarbanes–Oxley Act, INDEPENDENT COMMUNITY BANKERS OF AMERICA, 2005, at 2–3, www.icba.org/files/PDFs/SarboxSurveyResults.pdf. According to the same survey, over two thousand work hours were needed per bank, on average, to conduct the necessary tasks for compliance. *Id.* The American Electronics Association ("AEA") conducted a similar study as the ICBA, with similar findings. Chamber Letter, *supra* note 110, at 4 n.2. The AEA report indicated that the chief concern with the costs associated with the current iteration of Section 404 does not take into account firm size. SARBANES–OXLEY SECTION 404: THE 'SECTION' OF UNINTENDED CONSEQUENCES AND ITS IMPACT ON SMALL BUSINESS 1–2 (American Electronics Association 2005), http://www.aeanet.org/GovernmentAffairs/ aeasoxpaperfinal021005.asp [hereinafter AEA Paper]. While equal applicability may appear desirable, the AEA contends that while larger companies are not subject to additional burdens due to their size, smaller companies receive no relief from the sometimes exorbitant costs associated with compliance. *Id.* The cost of compliance for companies with multi–billion dollar revenues is as low as approximately 0.05% of revenues, while the cost of compliance with revenues below twenty million dollars is as much as approximately three percent. *Id.* at 5. This is in direct opposition to SEC projections. *See* SEC Final Rule, *supra* note 107. The AEA estimates that the actual cost of compliance with Section 404 is thirty–five billion dollars, twenty times greater than the initial SEC projection. AEA Paper, *supra* note 110, at 2.

[111] *A Price Worth Paying? – Auditing Sarbanes–Oxley*, ECONOMIST, May 21, 2005, at 71 (the total market loss due to SOX compliance is estimated to be $1.4 trillion, when comparing the benefits of the Act to the market costs).

[112] Public Company Accounting Oversight Board; Order Approving Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("Auditing Standard No. 2" or "AS2"), Exchange Act Release No. 34–49884, 69 Fed. Reg. 35,803 (June 17, 2004), *available at* http://www.sec.gov/rules/pcaob/34-49884.htm (last visited Mar. 1, 2007). AS2 was created by the PCAOB. *Id.* AS2 gives the standards for auditor independence in Section 404 audits on management controls over financial reporting. *Id.*

[113] *Id.*

[114] SOX, Pub. L. No. 107–204, §§ 201-09, 116 Stat. 745 (2002) (establishing requirements for auditor independence).

[115] Sean M. O'Connor, *Strengthening Auditor Independence: Reestablishing Audit as Control and Premium Signaling Mechanisms*, 81 WASH. L. REV. 525, 572 (2006) (auditors have a quasi–fiduciary relationship with the public). Auditors may be tempted to provide favorable audit results in exchange for lucrative audit contracts, rather than using the proper level of scrutiny in examining financial statements. Final Rule: Revision of the Commission's Auditor Independence Requirements, Exchange Act Release Nos. 33–7919; 34–43602; 35–27279, 65 Fed. Reg. 76,008 (Dec. 5, 2000), *available at* http://www.sec.gov/rules/final/33-7919.htm (last visited Mar. 1, 2007). Potential conflicts of interest also exist when one firm engages in both accounting and auditing services since auditors are tempted to certify accounting, regardless of quality, rather than risk upsetting the client. *Id.*

to evaluate that advice. Previously, companies could retain a single firm for both roles. Smaller companies may not have the resources available to make such operations feasible.[116] Additionally, due to the limited number of large public accounting firms, achieving independence between auditors and other financial services is difficult.[117]

Second, the independence requirement means that auditors may only give limited advice to the firms they are auditing. Auditors previously provided an important source of valuable business information.[118] Now that auditor independence is required, many smaller companies that cannot afford auditors and advisors go without this valuable advice.

Auditor independence is necessary, but the application of Section 404 is problematic. These common objections have gained the attention of both Republican and Democratic legislators. Vice President Dick Cheney said during a television interview that it was possible SOX regulations "went too far."[119] Representative Barney Frank (D–Ma), chairman of the House Financial Services Committee,[120] has said that the Act, as it has been administered, "has become too burdensome."[121] These general problems apply directly to IP. The PCAOB recently voted to propose a new accounting standard for audits, which would supersede AS2, however, that new standard must be approved by the SEC before it takes effect.[122]

### *D. Problems with the Current Application of SOX to IP.*

The general problems with SOX can be directly applied to IP. The overarching problem with the current application of SOX to IP is the lack of accurate reporting on financial statements. Because many companies do not recognize the importance of IP, and many of the companies that do recognize the importance of IP do not correctly value it, it is very difficult to draft accurate

[116] *See* Ferola, *supra* note 53, at 88 (discussing the disproportionate affect SOX has on small business). The Act unintentionally increases audit fees both for annual audits as well as for evaluations of internal control processes. *Id.* at 108.

[117] O'Connor, *supra* note 115, at 558. There are four large public accounting firms, KPMG, PricewaterhouseCoopers, Deloitte & Touche, and Ernst & Young, which are known as the "Big Four." Gregory L. Paul, Comment, *Not Biting the Hand That Feeds You: Public Accounting Firms and Conflicts of Interest*, 44 GOLDEN GATE U. L. REV. 325, 333 n.68 (2004) (discussing the audit process and the availability of audit companies). Before the dissolution of Arthur Andersen, which occurred in large part due to the firm's involvement in the Enron scandal, there were five large public accounting firms, known as the "Big Five." *Id.* Arthur Andersen was convicted of obstruction of justice in connection with the destruction of Enron related documents that the firm knew would be sought by investigators. Bill Deener, *Are Big Four Too Few for Accounting Task?; Federal Report Urges Monitoring; Industry Touts Competition*, DALLAS MORNING NEWS, Aug. 21, 2003, at 1D. The Supreme Court reversed Arthur Andersen's conviction. *See* Arthur Andersen LLP v. United States, 544 U.S. 696 (2005). The Big Four accounting firms audit seventy-eight percent of public companies. Deener, *supra* note 117. The seventy-eight percent of public companies audited by the Big Four account for ninety-nine percent of all public company revenue. *Id.*

[118] *See* Ferola, *supra* note 53, at 107–08 (noting SOX regulations have the effect of chilling communication between management and auditors).

[119] *Cheney Expresses Doubts About Sarbanes–Oxley but the Bush Administration's SEC's Chief Praised the 2002 Law for Helping Uncover Irregularities over Backdating Stock Options*, COMMWEBNEWS.COM, Oct. 31, 2006, 2006 WLNR 18914343 (Westlaw) (quoting a transcript of an interview with Vice President Dick Cheney, speaking about SOX).

[120] Marcy Gordon & Ellen Simon, *New rules promise More Details of CEO Pay; More Disclosure May Not Slow Increase*, Buffalo News, Jan. 21, 2007.

[121] Drawbaugh, *supra* note 56 (interview with Rep. Barney Frank about potential revisions to SOX).

[122] Statement of SEC Chairman Christopher Cox and Chief Accountant Conrad Hewitt Regarding PCAOB's Proposed Section 404 Auditing Standard, No. 2006–213 (Dec. 19, 2006), www.sec.gov/news/press/2006/2006-213.htm (last visited Mar. 1, 2007).

financial statements. Although SOX does not explicitly require changes to the management of IP, compliance with provisions of SOX requires significant alteration in current IP management strategies.[123]

Investors rely on the accuracy of financial statements when making key decisions,[124] and IP is becoming a larger portion of those statements than ever before. Evidence of IP's growth as a corporate asset is the modern increase in corporate market-to-book ratios.[125] The market-to-book ratio is the ratio between the market value of a company and the book value of the company's assets.[126] An increase in the market-to-book ratio signifies a growth in intangible assets compared to physical assets; however, it can also signify inaccurate financial statements due to inaccurate intangibles. This creates the SOX IP problem.

Inaccuracies in financial reporting and inadequate IP management procedures are not always malicious or insidious in nature. Many companies that incorrectly value IP do so because it is easier than the costly and time–consuming process of performing the correct IP management functions.[127] IP is often lumped into the amorphous good will category, which is often the source of raised market-to-book ratios.[128] SOX directly counters the growing problem of inaccurate financial statements by requiring proof of accurate IP valuation.

On its face, SOX does not reference IP; however, failure to apply SOX to IP could yield significant negative ramifications.[129] Ignoring the increasingly important role that IP plays in business will create gaping holes in financial statements, which are intended to paint a complete picture of the company's health. The way to fill these holes is through better application of SOX.

## III. PROPOSAL

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[123] Hutchins, *supra* note 21, at 293. Instead of direct references to IP, SOX creates requirements that can only be satisfied by sufficient IP management process. *Id.*

[124] Daniel V. Dooley, Financial Fraud: Accounting Theory and Practice, 8 FORDHAM J. CORP. & FIN. L. 53, 54 (2002).

> Investors use financial information to assess operating results, make judgments about probable future performance, and evaluate non–accounting factors within the framework of a microeconomic and financial model of the enterprise in which an investment might be made. Thus one of the greatest risks to investors is the risk that the financial information upon which they rely is materially misstated. Financial information may be misstated erroneously or intentionally. When such financial information is misstated by any scheme, artifice, or device with the intent to mislead investors, this is a form of financial fraud.

*Id.* at 54.

[125] *See* Arewa, *supra* note 46, at 41–42. The average S&P 500 market-to-book ratio has grown from 0.81 in 1973 to 1.69 in 1992 and finally to 6.25 in 1999. *Id.*

[126] *Id.* at 40.

[127] Hutchins, *supra* note 21, at 292. "Good will" is frequently the difference between the value of "hard" assets and the total market capitalization value. *Id.* There is a trend of shrinking "hard" assets and increasing market capitalization, leading to a growth in "good will" on balance sheets. *Id.*

[128] *See* Arewa, *supra* note 46, at 41–42. Good will is, by definition, an intangible asset. 1 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 2:19 (4th ed. 2004). An increase in intangible assets greater than an increase in the market capitalization will lead to an increased market-to-book ratio. *See* Arewa, *supra* note 46, at 41–42. Good will began with a positive image associated with a brand, which would convey quality and reliability. Thomas D. Drescher, *The Transformation and Evolution of Trademarks – From Signals to Symbols to Myth*, 82 TRADEMARK REP. 301, 310 (1992) (discussing the history of good will as it relates to trade marks).

[129] Hutchins, *supra* note 21, at 293–94; *see also supra* note 54 and accompanying text.

Former Federal Reserve Chairman Alan Greenspan said, during a discussion about SOX, "anything that goes through Congress with that level of unanimity can't be good."[130] Greenspan, like many others, agrees with the goals of SOX, but recognizes that there are significant problems with how SOX purports to achieve its lofty goals.[131] The proposal section of this comment evaluates solutions put forward to fix the SOX problems and proposes alternative methods of improving SOX, while maintaining its necessary and desirable effects.

One of the most critical changes needed concerns the stance that SOX takes on IP management.[132] General changes to Section 404, one of the most controversial, costly, and burdensome sections of the Act, are necessary to realize the broad goals of SOX.[133] Other changes to SOX should come through the implementation of the Act.[134] There is general agreement that SOX demonstrates a valuable evolution in business.[135] Without the ability to build investor confidence and eradicate corporate fraud, the markets will collapse and everyone will lose. SOX is necessary to bolster the foundation of financial markets in the United States.

### *A. Changing IP in SOX*

While there are several serious problems with the application of SOX, perhaps the most critical is the way in which the Act applies to IP. Specifically, there must be increased direction in IP management. Without increased guidance, many companies will continue to inadvertently violate SOX. There are two solutions to this problem.

The first solution is through clarification of the rules by the PCAOB and the SEC. SOX does not specifically mention IP.[136] An air of ambivalence towards such a critical business component creates a negative image about the importance of IP to SOX compliance. Such a major exclusion is the likely result of the speed in which SOX was drafted and passed, rather than as a conscious oversight. Regardless of the reason for the omission, the PCAOB and the SEC must now take action to rectify the problem.

There are several appropriate SEC and PCAOB responses. The first action is to identify "best practices" for IP management. Also, within the Act, there should be more precise definitions for vague terms, such as "material."[137] Without an articulation of proper methods of IP

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[130] *Greenspan Predicts Productivity Pickups, Dems Will Change Sarbanes–Oxley*, COMMWEBNEWS.COM, Nov. 9, 2006, 2006 WLNR 19516351 (Westlaw) (discussing Alan Greenspan's remarks to an AMR research conference).

[131] *Id.* Greenspan said SOX, and especially Section 404, is "a nightmare," but that Congress should retain SOX provisions requiring certification of financial statements. *Id.*

[132] Hutchins, *supra* note 21, at 291 (describing SOX's impact on IP as "[o]ne of the most vague").

[133] *Sarbanes–Oxley Deserves Scrutiny – Business Experts*, REUTERS, Oct. 30, 2006, *available at* www.reuters.com (discussing the common belief among business leaders that SOX is to burdensome and expensive to comply with, especially Section 404).

[134] Drawbaugh, *supra* note 56. Rep. Frank said, "[i]t's possible to reduce the burden without undercutting the principle." *Id.*

[135] Kara Scannell & Deborah Solomon, *Business Wins Its Battle to Ease a Costly Sarbanes–Oxley Rule*, WALL ST. J., Nov. 10, 2006, at A1 ("Much of the business community continues to support Sarbanes–Oxley's overall goal of improving corporate governance.").

[136] Hutchins, *supra* note 21 at 291.

[137] Drawbaugh, *supra* note 56.

management and more substantive definitions, SOX is overly broad and may have the undesirable effect of dissuading companies from entering public markets.[138]

Such alterations to SOX may be in the form of administrative rules, rather than amendments to the SOX legislation itself.[139] The ability to create revisions through the rule-making process means that the needed changes can be made regardless of congressional politics.[140]

The second solution involves applying IP management practices described in the analysis section of this article.[141] Implementation of enhanced IP management procedures is critical. This solution to the SOX IP problem is imperative, regardless of the steps taken by the PCAOB and SEC. The outlined steps[142] to proper IP management may appear excessive, but without further guidance from the PCAOB and the SEC, they are essential to avoiding liability for SOX infractions. When the consequences for breach are so high, it is better to proceed cautiously than to risk the criminal and civil penalties imposed by the Act, even if this leads to a high cost for SOX implementation.

### *B. Section 404*

Within the general SOX problems, IP management is the slumbering giant, but the considerably more visible problem with SOX is the cost of Section 404 compliance. Representative Frank has indicated that Section 404 may be pared down dramatically in the coming years.[143] Frank has two ideas for SOX improvements. First, his diluted version of Section 404 would require audits on fewer items.[144] Second, he suggests clearer direction on what sufficient compliance entails.[145]

Industry groups have espoused several suggestions. The groups want to "limit the liability of accounting firms for the work they do on behalf of clients, to force prosecutors to target individual wrongdoers rather than entire companies, and to scale back shareholder lawsuits."[146]

The best solution combines elements of the proffered suggestions, while maintaining the same spirit and core attitude towards compliance. Some propose revisions to make compliance easier.[147] Ease is not the correct motive for change, rather the proper motive for change is to eliminate unnecessary or confusing elements of the Act.[148] Alterations to Section 404 compliance

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[138] Trigaux, *supra* note 39. Some companies are opting to remain private in order to avoid confusing or costly SOX compliance. *Id.* Some public companies are opting to go private again due to complications with SOX compliance. *Id.*

[139] Labaton, *supra* note 59.

[140] *Id.* The current political environment is not conducive to legislation altering SOX. *Id.*

[141] Cooperrider, *supra* note 10, at 25 (outlining the steps to effective IP management).

[142] *See supra* notes 71–91 and accompanying text.

[143] Drawbaugh, *supra* note 56.

[144] *Id.* Relaxing SOX provisions will reduce the burden of compliance. *See id.* Classifying fewer activities as "material" means that fewer business activities need evaluation, further reducing the burden of an audit. *See* Fowler, *Following the Rules*, *supra* note 57.

[145] *See* Drawbaugh, *supra* note 56. Specifically, Representative Frank would like a more clear definition of "material" within SOX. *Id.* Audit firms are auditing all business activities out of fear that an item excluded from the audit may in fact be material, making the audit firm liable. Fowler, *Following the Rules*, *supra* note 57.

[146] Labaton, *supra* note 59.

[147] *See generally* Chamber Letter, *supra* note 110 (calling for revisions to SOX). The Chamber of Commerce is concerned with potential damage to market competitiveness caused by provisions within SOX rather than the effective promotion of the ideas SOX embodies. *Id.*

[148] Alison Vekshin, *Frank Suggests Relaxing Sarbanes–Oxley*, WASH. POST, Nov. 18, 2006, at D2 (quoting Rep. Frank from an interview on "Political Capital with Al Hunt," which aired November 19, 2006 on Bloomberg

should serve that limited purpose. Regardless of the reasons for the change, the outcome remains substantially the same, a more focused and effective SOX.

The three changes proposed by the industry groups reduce the burden on companies, but do so by changing the spirit of SOX. The first change, reduction in accountant liability, completely negates a significant purpose of the legislation, to counter corruption found within accounting firms.[149] The second change, elimination of corporate liability for individual acts, runs counter to the goal of altering corporate culture and encouraging ethical behavior.[150] The final proposed change, reduction in the number of shareholder lawsuits, serves to make it more difficult for investors to ensure compliance.[151] Even if the reduction of shareholder suits were a legitimate goal, shareholder suits that lack merit are rare.[152] Each of the three proposed changes seeks to eliminate corporate liability and return the business world to its prior, largely unregulated, state.[153] For that reason, none of the three recommended changes are acceptable.

Representative Frank's proposed reduction in audited materials may satisfy critics of SOX, but may also go too far in degrading the Act's effectiveness. The purpose of completely auditing a firm is to ensure validity in the financial statements.[154] Creating loopholes in auditing requirements may encourage unethical business practices as companies creatively structure operations to fit within those loopholes.

Moreover, reducing the breadth of audits for smaller companies may be an appropriate compromise because "smaller public companies represent a proportionately smaller risk to the capital markets and their investors than large public companies."[155]

Additionally, while identification and valuation of IP remain important, it is possible to scale down the audit process for IP assts that do not hold significant value.

Representative Frank's call for increased definition within SOX is both a practical and an efficient solution.[156] Increased instruction for Section 404 compliance, like IP compliance, serves

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Television). Representative Frank believes that SOX can be relaxed without detracting from the integrity and purpose of the Act. *Id.* Revisions to SOX, which will make compliance easier, are possible, but should not interfere with the integrity of the Act. *Id.*

[149] Rafael Gerena–Morales et al., *Placing Responsibility; After a Year, Here's How the New Law's Working*, SUN–SENTINEL, Aug. 3, 2003, at 1G (discussing conflicts of interest between accounting firms and their clients). The relationship between accounting companies and clients is not healthy when the firms offer consulting and accounting tasks along with audit services. *Id.* Close ties between accounting firms and their clients weaken the rigor of audits and undermine financial statements. *See id.*

[150] Craig S. Lerner, *Spies, Secrets, and Security: The New Law of Intelligence: Intelligence Reform: Calling a Truce in the Culture Wars: From Enron to the CIA*, 17 STAN. L. & POL'Y REV 277, 279, 282–83 (2006) (discussing the corporate culture that led to the Enron scandal and the corporate culture SOX tries to create in response). One of the seven functional areas PCAOB inspections focus on is "tone at the top," which is interpreted to mean the corporate culture being created by top management. Katherine S. Pell, Comment, *The New Enforcement Paradigm for Big Four Accounting Firms*, 78 TEMP. L. REV. 775, 790–91 (2005).

[151] Labaton, *supra* note 59. Former Commissioner of the SEC Harvey J. Goldschmid called a possible reduction in the number of shareholder lawsuits a "shocking turning back." *Id.* Goldschmid continued by saying that private enforcement of SEC regulations is a "necessary supplement to the work that the [SEC] does," and that it provides a "safety valve against the potential capture of the [SEC] by industry." *Id.*

[152] *Id.* According to James D. Cox, a securities and corporate law professor at Duke Law School who studied 600 class action lawsuits over the past ten years, there are few instances of "abusive or malicious" class actions suits, the kind the prohibition on shareholder suits seeks to prevent. *Id.*

[153] *See id.* Cox described the potential adoption of these three policies as a "dark day for investors." *Id.*

[154] Paul, *supra* note 117, at 329 (discussing the purpose of audits). Audits prevent companies from manipulating financial statements and give investors a sound basis for making investing decisions. *Id.*

[155] Ferola, *supra* note 53, at 117. Smaller companies comprise eighty percent of the U.S. capital markets, but only represent six percent of the total U.S. market capitalization. *Id.* "[T]he failure of a smaller public company poses a significantly lower risk to the U.S. capital markets than [the] failure of a large public company." *Id.* (alteration in original).

to inform companies of their obligations, and permits them to tailor compliance activities to those necessary for satisfaction of Section 404 requirements.

There is a risk that drafting more precise definitions will serve to inform potential violators of exactly how malleable the rules are and what they can get away with. However, there is a need for reform resolving the ambiguities that currently exist. An adequate resolution must strike a balance between the lesser of these two evils.

## IV. CONCLUSION

Accurate financial reporting is more than just a prudent business practice. With the advent of SOX, it is now the law. Compliance with SOX, while potentially difficult, provides required information to investors and reduces corporate fraud. Sufficient compliance requires a fundamental understanding of asset management compliance activities. While this applies to all business assets, it is especially true for IP assets, due to their historically inferior treatment.

SOX has undeniably been a significant force on everyday business operations in the early part of the twenty–first century, but its application has been marred with confusion and inefficiency. In order to achieve the Act's noble ideals, there must be a clear explanation of concise definitions and best practices. Until both of these changes occur, the exorbitant costs and unpredictable risks will continue.

There is a better way to realize the goals of SOX. Both the drafters of the Act and those affected by it are learning from the experiences of those subjected to the first applications of the law. Based on those lessons, important changes are in order.

[156] *See* Drawbaugh, *supra* note 56. The "simplicity" of Section 404 is the direct cause of the high costs associated with compliance. Fowler, *Following the Rules*, *supra* note 57. The lack of definition within Section 404 leads to the presumption that every business function is "material" and is therefore subject audit. *See* Drawbaugh, *supra* note 56. Due to the risks involved with failing to audit a "material" fact, many audit firms simply choose to audit everything and pass the expense onto the client. *See* Fowler, *Following the Rules*, *supra* note 57. Defining materiality within business actions will cut down on the quantity of audited materials and reduce the cost and burden of compliance. Drawbaugh, *supra* note 56. *See* Fowler, *Following the Rules*, *supra* note 57.