# What Business Lawyers Should Know About Intangible Asset Valuation

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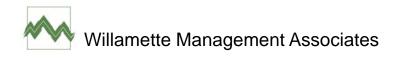
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#### Discussion Outline

- What economic attributes qualify as intangible assets
- What economic attributes don't qualify as intangible assets
- When and how do business lawyers encounter intangible assets
- Intangible asset standards of value and premises of value
- Various bundles of rights subject to analysis
- Various intangible asset opinions that lawyers may need
- Generally accepted valuation approaches and methods
- Attributes of an effective intangible asset valuation report
- Attributes of a valuation expert who works effectively with counsel
- Summary and conclusion; questions and discussion





#### What is an Intangible Asset?

- It must be an asset, and it must be intangible
- Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 5 (CON 5) provides guidance on what is an asset:
  - It must provide probable future economic benefits
  - The owner/operator must be able to receive the benefit and restrict others from access to the benefit
  - The event that provides the right to receive the benefit has occurred
- Intangible means something that lacks physical substance
- For an intangible asset, intangible means that the economic benefit of the asset does not come from its physical substance
- Intangible asset value is based on the rights and privileges to which it entitles the owner/operator





#### Intangible Asset Attributes

- An intangible asset should have the following attributes:
  - It is subject to a specific identification and recognizable description
  - It is subject to legal existence and legal protection
  - It is subject to the rights of private ownership, and that private ownership should be transferable
  - There is some tangible evidence or manifestation of the existence of the intangible asset
  - It is created or it comes into existence at an identifiable time or as the result of an identifiable event
  - It is subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event
  - There should be a specific bundle of legal rights associated with the intangible asset





#### Intangible Asset Transferability

- An intangible asset should be capable of being sold or transferred either (1) by itself or (2) with other intangible assets or (3) with other tangible assets
- If an intangible asset is transferable as part of a bundle of assets, then it is transferable
- An intangible asset does not need to be transferable separately and independently from any other assets
- Some intangible assets are typically transferred separately from other tangible or intangible assets
- Other intangible assets are typically transferred as part of an assemblage of assets
- Regardless of the structure of the transfer, the intangible asset ownership should be transferable from one owner to another owner

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## Difference Between Tangible Assets and Intangible Assets

- The tangible elements of an intangible asset (e.g., a list of software source code) do not convert that asset into a tangible asset
- The important economic difference between a tangible asset and an intangible asset is this:
  - The value of a tangible asset is derived from its tangible nature
  - The value of an intangible asset is derived from its intangible nature





#### Intangible Influences or Attributes

- Intangible influences or intangible attributes are not intangible assets
- Intangible factors or influences that do not qualify as intangible assets include the following:

High market share

Life-cycle status

High profitability or high profit margin

Uniqueness

Lack of regulation

Discount prices (or full prices)

A regulated (or protected) position

Positive image

Managaly position (or barriers to an

Monopoly position (or barriers to entry) – First to market

Market potential

Technological superiority

Breadth of customer appeal

- Consumer confidence/trustworthiness

Mystique

Creativity

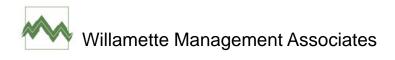
Heritage or longevity

High growth rate

Competitive edge

High return on investment

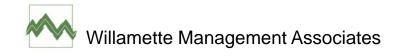
These attributes may increase the value of the actual intangible assets





#### Accounting Standards Codification 805 Categories of Identifiable Intangible Assets

- ASC 805-20-55 presents five categories of identifiable intangible assets:
  - Marketing-related intangible assets
  - Customer-related intangible assets
  - Artistic intangible assets
  - Contract-related intangible assets
  - Technology-related intangible assets
- According to ASC 805, goodwill is also an intangible asset, although it is not an identifiable intangible asset





### ASC 805 Marketing-Related Intangible Assets

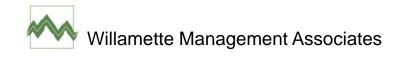
- Examples of marketing-related intangible assets:
  - Newspaper mastheads
  - Trademarks, service marks, trade names, collective marks, certification marks
  - Trade dress
  - Internet domain name
  - Noncompetition agreements





### ASC 805 Customer-Related Intangible Assets

- Examples of customer-related intangible assets:
  - Customer lists
  - Customer contracts and related customer relationships
  - Noncontractual customer relationships
  - Order or production backlogs





### ASC 805 Artistic-Related Intangible Assets

- Examples of artistic-related intangible assets:
  - Plays, operas, ballets
  - Books, magazines, newspaper, and other literary works
  - Musical works such as compositions, song lyrics, and advertising jingles
  - Photographs, drawings, and clip art
  - Audiovisual material including motion pictures, music videos, television programs





### ASC 805 Contract-Related Intangible Assets

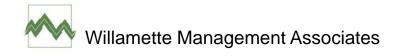
- Examples of contract-based intangible assets:
  - License, royalty, standstill agreements
  - Advertising contracts
  - Lease agreements
  - Construction permits
  - Construction contracts
  - Construction management, service, or supply contracts
  - Broadcast rights
  - Franchise rights
  - Operating rights
  - Use rights
  - Servicing contracts
  - Employment contracts





### ASC 805 Technology-Related Intangible Assets

- Examples of technology-based intangible assets:
  - Patented or copyrighted software
  - Mask works
  - Unpatented technology
  - Databases
  - Trade secrets





#### Section 197 Intangible Assets

- Internal Revenue Code Section 197 also provides a list of amortizable intangible assets
- This Section 197(d)(1) list is used for many income tax purposes:
  - (A) goodwill,
  - (B) going concern value,
  - (C) any of the following intangible items:
    - (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
    - (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers)
    - (iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,
    - (iv) any customer-based intangible,
    - (v) any supplier-based intangible, and
    - (vi) any other similar item,





#### Section 197 Intangible Assets (cont.)

- (D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
- (E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
- (F) any franchise, trademark, or trade name.



#### Intellectual Property

- Intellectual property assets represent a small subset of general intangible assets
- Intellectual property includes the following four categories only:
  - Patents
  - Copyrights
  - Trademarks
  - Trade secrets





### How Business Lawyers Encounter Intangible Asset Valuation Questions

- Advising clients on taxation matters
  - Acquisition purchase price allocations
  - Charitable contributions of corporate intangible assets
  - Intercompany transfer prices for multinational transfers of intangible assets
  - Gift and estate tax planning for high net worth individuals
  - State and local property tax for industrial and commercial clients
  - Fairness of transactions between for-profit entities and not-forprofit entities
- Contract and other commercial litigation
  - Brach of contract, causing intangible asset damages
  - Breach of joint venture agreement, where parties contributed intangible assets
  - Breach of intangible asset commercialization or license agreement
  - Shareholder litigation involving fair value of closely held business



### How Business Lawyers Encounter Intangible Asset Valuation Questions (cont.)

- Intellectual property law
  - Infringement and other tort claims
  - Structuring of IP license agreements
  - Breach of IP license agreements
- Securities law
  - Fraud against the market based on financial statement misrepresentation
  - Misrepresentation of acquisition target financial statements
  - Equity allocation in a business formation, when one party contributes intangible assets
  - Asset distributions in a business dissolution





## How Business Lawyers Get Involved with Intangible Assets (cont.)

- Bankruptcy
  - Effect on solvency of a debtor corporation
  - Effect on fairness of debtor in possession transactions
  - Use as collateral for debtor in possession financing
  - Effect on reasonably equivalent value of debtor transactions
- Commercial financing and other leveraged transactions
  - Effect on corporate solvency during leveraged transactions
  - Effect on fairness of proposed M&A transactions
  - Effect on fairness of related-party transactions
  - Intangible assets as collateral in sale/licenseback transactions



#### Intangible Asset Standards of Value

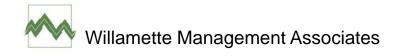
- Alternative standards of value
  - Fair market value
  - Market value
  - Fair value
  - Intrinsic value
  - Acquisition value
  - Use value
  - User value
  - Investment value
  - Owner value
  - Collateral value
- The standard of value answers the question: Value to who?
- The appropriate legal standard of value is based on statutory authority and judicial precedent





#### Intangible Asset Premises of Value

- Highest and best use (HABU) criteria
- Alternative premises of value include:
  - Value in continued use
  - Value in place
  - Value in exchange—orderly disposition
  - Value in exchange—voluntary liquidation
  - Value in exchange—involuntary liquidation
- The premise of value answers the question: How will the intangible asset exchange transaction take place?
- The appropriate legal premise of value may be based on legal authority or on the analyst's HABU conclusion





## Types of Intangible Asset Bundles of Legal Rights

- Fee simple
- Term interest
- Life interest
- Residual/reversionary interest
- Licensor or franchisor interest
- Licensee or franchisee interest

- Sub-license or subfranchisee rights
- Development rights
- Exploitation rights
- Commercialization rights
- Use rights territorial/geographic
- Use rights product/industry rights





## Considerations Related to the Intangible Asset Bundles of Legal Rights

- Intellectual property type
- Term(s) of the transfer
- Territory of the transfer
- Products/services covered
- Ability to sublicense
- Ability to modify
- Exclusive/nonexclusive use
- Ability to assign
- Development responsibility

- Commercialization responsibility
- Maintenance responsibility
- Legal responsibility
- Registration responsibility
- Regulatory responsibility
- Minimum sales activity
- Minimum promotion activity





#### Intangible Asset Analysis Opinions That Lawyers May Need

- The lawyer should instruct the valuation analyst as to the type of intangible asset opinion that is needed in the subject matter:
  - fair market value valuation
  - other defined valuation opinion (e.g., reasonably equivalent value in a bankruptcy matter)
  - intangible asset exchange ratio analysis
  - fairness opinion (for an intangible asset sale or license)
  - opinion on license terms, remaining life, royalty rate, etc.
  - solvency opinion
  - economic damages opinion
  - intercompany transfer price opinion
- The type of intangible asset analyst's opinion is based on the lawyer's legal requirements





### Generally accepted Intangible Asset Valuation Approaches and Methods

- Cost approach methods
  - Reproduction cost new less depreciation method
  - Replacement cost new less depreciation method
  - Trended historical cost less depreciation method
- Market approach methods
  - Relief from royalty method
  - Comparable uncontrolled transactions method
  - Comparable profit margin method
- Income approach methods
  - Differential income (with/without) method
  - Incremental income method
  - Profit split method (or residual profit split method)
  - Residual (excess) income method





### Intangible Asset Cost Approach Valuation Components

- All cost approach methods include a current cost measurement and a depreciation measurement
- Four cost components
  - Direct costs (direct materials and direct labor)
  - Indirect costs (overhead and administrative expenses)
  - Developer's profit (on the direct and indirect costs)
  - Entrepreneurial incentive (opportunity cost—or lost income during the replacement period)
- Three depreciation components
  - Physical depreciation (not a significant factor)
  - Functional/technological obsolescence (consider the intangible asset RUL)
  - Economic/external obsolescence (consider the intangible asset ROI)





### Intangible Asset Cost Approach Valuation Components (cont.)

Typical cost approach valuation formula

Replacement cost new

less Functional obsolescence

less Technological obsolescence

<u>less</u> <u>Economic/external obsolescence</u>

equals Fair Value

- Cost approach valuation considerations
  - All cost components (including opportunity cost ) included in the measurement
  - Treatment of excess capital (development) costs and excess operating costs
  - Consideration of the intangible asset RUL
  - Consideration of owner/operator economic obsolescence

### Intangible Asset Market Approach Valuation Components

- Valuation pricing metrics are based on either comparable or guideline
  - licenses of intangible assets
  - sales of intangible assets
  - companies that use intangible assets
- Valuation variables and procedures
  - Quantitative/qualitative analysis of the subject intangible asset
  - Guideline license/sale/company selection criteria
  - Guideline license/sale/company selection
  - Verification of the selected transactional data
  - Analysis of the selected transactional data
  - Selection of the appropriate pricing metrics
  - Selection of the pricing multiples specific to the subject intangible asset
  - Application of the selected pricing multiples to the subject intangible asset metrics

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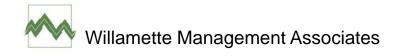
#### Intangible Asset Market Approach Valuation Components (cont.)

- Market approach valuation considerations
  - Seasoned guideline intangible asset/development stage subject intangible asset
  - Development stage guideline intangible asset/seasoned subject intangible asset
  - State of the competition in the owner/operator industry
  - Comparable profit margins—is the subject intangible asset the only reason for the difference in profit margins between the owner/operator company and the selected CPM companies?



### Intangible Asset Income Approach Valuation Components

- Common intangible asset income concepts include:
  - incremental (or differential) owner/operator revenue
  - decremental owner/operator expense
  - decremental owner/operator investment
  - decremental risk to the owner/operator
- Common income measures (related to the subject intangible asset) include:
  - EBITDA
  - FBIT
  - NOI (EBITDA less income taxes)
  - Net income
  - Net cash flow





### Intangible Asset Income Approach Valuation Components (cont.)

- Income approach valuation formula
  - Yield capitalization methods, based on a non-constant growth income projection
    - · over a finite RUL projection period
    - over a finite RUL projection period with a terminal value
  - Direct capitalization methods, based on a constant growth income projection
    - over a finite RUL projection period
    - over a perpetuity projection period





### Intangible Asset Income Approach Valuation Components (cont.)

- Income approach valuation considerations
  - Match the selected discount/capitalization rate with the selected income measure
  - Match the selected discount/capitalization rate with the subject intangible asset risk
  - Consider the state of the competition in the owner/operator industry
  - Consider all subsequent (to the valuation date) capx, R&D expenses, marketing expenditures, etc.
  - Analyze only the income that is directly related to the subject intangible asset
  - Present value the projected income over either:
    - the intangible asset average RUL
    - down the intangible asset RUL decay curve





## Intangible Asset Valuation Synthesis and Conclusion

- The synthesis and conclusion is the last procedure in the valuation process
- The analyst typically performs a valuation reconciliation procedure related to the alternative value indications
- The analyst answers the following questions:
  - Did I value the right thing? That is, did I analyze the correct intangible asset?
  - Did I value the right thing the right way? That is, did I apply the appropriate valuation approaches, methods, and procedures?
  - Did I reach the right value conclusion? That is, did I correctly apply the valuation procedures that I performed in order to reach a reasonable and supportable value estimate?
  - Did I do what I intended to do? That is, did I perform the assignment that I set out to perform? Did I achieve the purpose and objective of the assignment?
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## Attributes of an Effective Intangible Asset Valuation Report

- In order to encourage the reader's acceptance, the effective intangible asset valuation report should be:
  - clear, convincing, and cogent
  - well-organized, well-written, and well-presented
  - free of grammar, punctuation, spelling, and mathematical errors
  - procedurally and mathematically replicable, without the use of any unexplained or unsourced valuation variables
- The persuasive intangible asset valuation report will tell a narrative story that:
  - defines the valuation analyst's assignment,
  - describes the analyst's data gathering and due diligence procedures,
  - justifies the analyst's selection of (and rejection of) the generally accepted valuation approaches, methods, and procedures,
  - explains how the analyst performed the valuation synthesis and reached the final value conclusion,
  - defends the analyst's intangible asset value conclusion, and
  - describes all of the data sources that the analyst relied on (and includes copies of non-public source documents)



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### Intangible Asset Valuation Report Errors to Avoid

- An effective intangible asset valuation report will avoid these common errors:
  - Failure to apply the defined standard of value
  - Failure to apply the defined premise of value
  - Analytical internal inconsistencies
  - Arithmetic errors in the valuation analysis
  - Insufficient support for the selected valuation variables
  - Reliance on industry or other rules of thumb
  - Insufficient data and inadequate market research
  - Inadequate due diligence procedures





### Attributes of an Effective Intangible Asset Valuation Expert

- Lawyers look for the following attributes in a valuation expert witness:
  - Experience in valuations of the subject intangible asset type
  - Experience in valuations in the subject industry
  - Experience in valuations for the subject legal issues
  - Relevant professional credentials
  - Familiarity with relevant professional literature
  - Familiarity with relevant professional standards
  - Ability to communicate effectively, both orally and in writing
  - Ability to work cohesively, as part of the litigation team
  - Experience as expert (may or may not be important)
  - References
  - Lack of contradictory reports or testimony in prior cases
  - Professional writings on subject consistent with testimony





#### Working Effectively With Counsel

- Clarify nature of assignment
- Ask for guidelines as to what communications, drafts are discoverable
  - Federal rules have changed in last few years and different states have different rules
- Understand scheduling milestones
- Understand budget
- Reveal potentially inconsistent testimony or work product up-front
- Don't let lawyer expand role beyond expertise





### Attributes of an Effective Intangible Asset Valuation Expert (cont.)

- Lawyers should be aware that there are intangible asset valuation professional standards that may be relevant to the subject matter. The following organizations have issued such professional standards:
  - American Institute of Certified Public Accountants
  - National Association of Certified Valuators and Analysts
  - Institute of Business Appraisers
  - American Society of Appraisers
  - The Appraisal Foundation





#### Intangible Asset Valuation Summary and Conclusion

- This discussion considered:
  - What economic attributes are—and are not—intangible assets
  - When business lawyers may need intangible asset valuations
  - The various types of intangible asset analysis opinions
  - The generally accepted intangible asset approaches and methods
  - Attributes of the effective intangible asset valuation report
  - Attributes of the effective intangible asset valuation expert
- Questions and discussion





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Robert Reilly has been a managing director of Willamette Management Associates for over 23 years. Willamette Management Associates provides business valuation, forensic analysis, and financial opinion services for transaction, financing, taxation, bankruptcy, litigation, and planning purposes. Robert frequently provides valuation, economic damages, and intercompany transfer price analyses related to intellectual property and other intangible assets. Robert has testified in both federal and state courts on numerous occasions on intellectual property valuation, damages, and transfer price matters.

Robert holds a BA in economics and an MBA in finance, both from Columbia University. He is a certified public accountant, accredited in business valuation, and certified in financial forensics. He is also a chartered financial analyst, chartered global management accountant, certified management accountant, certified business appraiser, and certified valuation analyst.

Robert has served as a member of the AICPA forensic and valuation services executive committee (FVSEC), business valuation committee (BVC), and consulting services executive committee (CSEC). He is an inductee into the AICPA business valuation hall of fame.

Robert is the co-author of 12 valuation books including *Guide to Intangible Asset Valuation* (published in 2013 by the AICPA) and *Practical Guide to Bankruptcy Valuation* (published in 2013 by the American Bankruptcy Institute).

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Fady holds a BA in accounting from New York University, and an MBA in finance from Booth Graduate School of Business at the University of Chicago.

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Elena Norman regularly counsels boards of directors, board committees, executives, stockholders, and in-house and outside counsel on Delaware corporate and commercial matters, and frequently represents parties to litigation, most often in the Delaware Court of Chancery. Her practice focuses primarily on counseling and litigation in connection with merger and acquisition transactions, going-private transactions, corporate stock appraisal, corporate governance, limited liability companies and limited partnerships, and cases involving fraud and breach of contract. Ms. Norman also litigates commercial matters in the US District and Bankruptcy Courts.

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Before attending law school, Elena studied English Constitutional Law and Jurisprudence as a visiting student at Somerville College, Oxford University, and received a M.A. in Legal and Political Theory from University College London. She also worked on law reform issues as an attorney for an NGO in Moscow, Russia.

Elena is admitted to the bar in both Delaware and New York. She is a member of the American Bar Association where she serves as the vice-chair in the International M&A Joint Venture Committee and the Women's Interest Network. She is also a member of the International Bar Association.

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