

Valuation Of Contract-Related Intangible Assets



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LEGAL COUNSEL ARE regularly involved in the negotiation, drafting, interpretation, and application of contracts. Counsel may also become involved in the valuation, damages, or other economic analysis of contract-related intangible assets. This is because counsel advise clients with regard to the transaction, financing, taxation, litigation, and other aspects of contracts. In such instances, counsel often retain, rely on, examine, and defend analysts who specialize in such contract-related intangible asset analyses. This discussion summarizes what counsel need to know about these contract-related economic analyses.

This article considers the contents or components of a contract-related intangible asset. It considers what attributes need to be included in the contract in order for it to qualify as an intangible asset. It also considers the different types of contracts that are included in this intangible asset category, and it summarizes the common reasons to analyze contracts or contract rights.

This article also summarizes the common methods related to contract valuation, damages, and transfer price analysis. It describes the factors that are commonly considered in the contract analysis, considers both the internal and external data sources that are commonly considered in the analysis, and presents an illustrative example of a commercial contract valuation.

THE CONTRACT INTANGIBLE ASSET • A contract is typically considered to be an agreement between two or more parties creating obligations that are legally enforceable or otherwise recognizable under the law. The analyst looks at the actual writing that sets forth the agreement of the parties. The analyst understands that a

contract can be oral as well as written. The analyst will typically consult with counsel regarding the legal enforceability of an oral contract.

Alternatively, a contract may be considered a promise or a set of promises either the breach of which the law provides a remedy for or the performance of which the law recognizes as a duty. In this construct, a contract may be viewed as a legal duty or set of duties that is not imposed by the law of tort.

A contract is also an enforceable agreement between two or more parties to either do a thing (or a set of things) or to not do a thing (or a set of things). For purposes of valuation, damages, or transfer price analysis, the analyst considers the terms of the contract. That is, the analyst considers the rights and duties encompassed in the contract. The contract document (or the oral agreement) itself is not the intangible asset. The legal rights and duties of the contract are the intangible asset.

Before any analysis can be performed, there should be an enforceable contract. In order for the contract to be enforceable, it should meet certain legal requirements. The parties to the contract should be competent to enter into such a contract. The subject matter of the contract should be legally appropriate for a contract. There should be consideration given in the contract. There should be a mutuality of agreement and a mutuality of obligation. The analyst should consult with counsel if there is a question as to whether the subject contract meets the requisite legal requirements.

Types Of Contracts

There are at least 10 types or categories of contracts that are commonly subject to valuation, damages, or transfer price analysis. These contract types are summarized in the following list. This categorization excludes certain types of contracts, such as intellectual property licenses and government-issued licenses. The analysis of such contracts deserves a separate discussion.

The common types of contracts include the following:

1. Customer, client, or patient contracts are contracts in which the customer commits to purchase certain goods and services over a specific period. Common examples include publication subscribers, insurance customers, and health maintenance organization (“HMO”) members.

2. Supplier, vendor, or contractor contracts are contracts in which the provider commits to provide certain goods or services over a specified period. Common examples include construction contracts, the contract of a publisher to publish an author’s book, the contract of a music company to produce and distribute a musician’s records, and professional or college sports television broadcast agreements.

3. Employer agreements are agreements that commit an individual to perform a service or to refrain from conducting an activity. Common examples include employment agreements, celebrity performance agreements, personal service contracts, athlete employment contracts, individual noncompete or nonsolicitation agreements, and individual confidentiality agreements.

4. Institutional relationship agreements are agreements that bind two or more corporate or other entities in which cross commitments are made between the entities. Common examples include joint venture agreements, asset or stock purchase agreements, merger agreements, corporate asset or stock purchase agreements, merger agreements, corporate noncompete agreements, corporate confidentiality agreements, and product development or other commercialization agreements.

5. Institutional ownership agreements are documents that evidence ownership of, and documents that evidence the rights and obligations of, equity instruments or debt instruments. Common examples include shareholder agreements, partnership agreements, member agreements, shareholder or other buy and sell agreements, stock option or

warrant agreements, restricted stock agreements, debt indenture agreements, mortgage agreements, bonds, and notes.

6. Operating licenses and permits are: (i) documents usually issued by a governmental or regulatory authority that allow for (and regulate) the operation of a business enterprise, a particular type of facility, or a particular type of equipment; (ii) documents that allow for (and regulate) the practice of a profession or occupation; and (iii) documents that allow (and regulate) a licensee to perform a certain action usually related to either public or private property. Common examples include general business operating licenses, refinery or other specialized facility operating licenses, licenses to operate x-ray or MRI equipment, Environmental Protection Agency environmental discharge permits, sanitary discharge permits, Army Corp of Engineers water diversion or water extraction permits, medical licenses, dental licenses, and other professional licenses.

7. Private franchises are agreements between a franchisor and franchisee to commit the franchisor to provide specified goods or services and allow (or commit) the franchisee to operate a specific type of business. Common examples include professional sports franchise agreements, hospitality industry franchise agreements, food service industry franchise agreements, and television or radio network affiliation agreements.

8. Government franchises and licenses are rights issued by a federal, state, or local government agency or regulatory authority that allow (and regulate) a licensee's commercial use of government-owned assets. Common examples include Federal Communications Commission ("FCC") broadcast and spectrum licenses, cable television municipal franchises, water and wastewater services private franchises, telecommunications company permits, pipeline company permits, trash collection and hauling services permits, and hospital certificates of needs.

9. Insurance-related contracts are agreements between insurers and insureds that provide the rights and obligations of each. Common examples include life insurance contracts, health insurance contracts, property and casualty insurance contracts, maritime or aviation insurance contracts, and business interruption insurance contracts.

10. Real-estate-related contracts are agreements that allow for the use, occupancy, or operation of real property. The agreements may be issued by the property owner to the property operator or by a government or regulatory agency to the property owner/operator. Common examples include leases, building or construction permits, certificates of occupancy, water rights use permits, air rights use permits, drilling or mineral extraction permits, water extraction or diversion permits, and real estate development permits.

The preceding list is not intended to be comprehensive with regard to all types of contracts. It is only representative of the common types of contracts and contract rights that the analyst may encounter. The list categorizes contracts by the types of contract parties or rights. Some analysts also categorize contracts by the type of applicable valuation approach. That is, these analysts think in terms of which types of contracts are analyzed by reference to cost approach, market approach, or income approach valuation methods. Most contracts can be analyzed by the application of any of the three generally accepted intangible asset valuation approaches. Nonetheless, the following list categorizes contracts with regard to the valuation approach that is more commonly applied to that type of contract:

- Operating licenses and permits, government franchises, and licenses are often valued by application of the cost approach;
- Government franchises and licenses, real-estate-related contracts, and private franchises

are often valued by application of the market approach; and

- Customer contracts, supplier contracts, employee contracts, institutional relationship contracts, institutional ownership contracts, operating licenses and permits, insurance contracts, and real estate contracts are often valued by application of the income approach.

The analyst considers the specific terms of a specific contract. The specific contract terms typically include the contract start date and stop date. Therefore, the contract intangible asset valuation, damages, or transfer price analysis is typically limited to the terms of the contract agreement itself.

There is a related intangible asset to the contract: the expected contract renewals. The expected contract renewals intangible asset generally represents the expectation that an individual contract will be renewed at the end of its stated contract term or expiration. That is, the contract parties may expect that the current, let's say, five year term contract will renew for a second, third, fourth, and so on five-year period after the current contract term expires. If this expectation is reasonable, the analyst may assess the two intangible asset components of the relationship between the contract parties:

- The current contract (with a stated or implied termination date); and
- The expected contract renewals that may occur after the termination of the current contract agreement.

Some analysts consider the current contract and the expected contract renewals to be two separate but related intangible assets. For some purposes, it may be important to analyze these two intangible assets separately. For example, each of these two intangible assets may have a different expected remaining useful life ("RUL"):

- The current five-year term contract may expire in two years;
- The expected renewal of the five-year term contract will expire in seven years.

Alternatively, some analysts consider both intangible asset components to represent a single intangible asset that may be called contracts and expected contract renewals. In some situations, it may be appropriate to analyze both of the value components as a single intangible asset.

In any event, before performing any quantitative analysis, the analyst should decide if the analysis subject is the current contract only or the current contract and the expected contract renewals. The analyst may accept direction from counsel in making this determination. The determination is often influenced by the reason for conducting the contract analysis. The common reasons for performing the contract intangible asset analysis are discussed next.

REASONS TO ANALYZE CONTRACT INTANGIBLE ASSETS

• Of course, all of the general reasons to analyze intangible assets also apply to contracts. The following discussion summarizes the reasons that are particularly applicable to contract intangible assets. There are numerous reasons why counsel may ask the analyst to value contract intangible assets, including the following:

1. Transaction pricing. Arm's-length sales of contracts (or individual contract rights) between third parties are relatively common. The analyst may be asked to price the contract for the buyer, the seller, or both. The analyst may be asked to provide a fairness opinion with respect to a proposed transaction already negotiated by the principal parties; this fairness opinion may be provided to the board of either party or to another specified party (for example, a minority investor or a financing source).

2. Merger and acquisition due diligence. Analysts are often asked to identify and value con-

tract intangible assets as part of an acquirer's due diligence of an acquisition candidate. This due diligence is appropriate whether the deal structure is a purchase of stock, a purchase of assets, or a merger. In fact, this due diligence may help to recommend the potential deal structure.

3. Financial accounting. If the ownership change transaction is completed, the analyst may be asked to conclude the fair value of the contracts (and contract relationships) for acquisition accounting purposes. The analyst may be asked to value the consideration paid for an individual contract purchase for fair value accounting purposes. The analyst may also perform periodic intangible asset impairment studies related to the recorded fair value of the acquired contract intangible asset.

4. Income tax accounting. Depending on the contract purchase deal structure, the contract may have to be valued (at fair market value) as an Internal Revenue Code Section 197 intangible asset.

5. Bankruptcy. If the contract is owned by a debtor in bankruptcy protection, the analyst may opine on the reasonably equivalent value of any contract transfer. The contract value could be considered in a solvency analysis; the contract may be included in a Bankruptcy Code section 363 sale transaction; or the contract could be a component in a proposed plan of reorganization. The analyst may opine on the fairness of a contract transfer between bankruptcy and non-bankruptcy related parties (for example, brother and sister corporations). The contract may be valued as part of the reorganized company's fresh start accounting.

There are also numerous reasons why counsel may ask the analyst to measure the damages due to a wrongful act on the contract intangible asset, including the following:

1. Breach of contract claims. Obviously, a breach of contract allegation is the most common reason to measure economic damages. In conducting such a damages analysis, the analyst should be

mindful that the contract damages measure is rarely equal to the contract value.

2. Tort claims. The analyst may be asked to measure damages related to an actual or proposed contract in an alleged tortious interference with business opportunity.

3. Condemnation and eminent domain. The condemnor (for example, a municipal condemnor of an investor-owned water utility) will often void all of the condemnee's contracts. In addition to the condemnor compensating the condemnee for the "taken" assets (tangible and intangible), the condemnee may suffer stranded costs or other economic damages related to the contract terminations.

There are numerous reasons why counsel may ask the analyst to calculate a contract intercompany transfer price, such as the following:

1. Internal Revenue Code Section 482 compliance. The analyst may opine on the arm's-length price ("ALP") at which a multinational corporation may transfer a contract (or contract rights) between controlled entities in two different taxing jurisdictions.

2. Transfers between wholly owned subsidiaries. Even if there are no direct section 482 implications, the analyst may advise the parent corporation on the transfer of contracts (or contract rights) between wholly owned subsidiaries.

3. Transfers between non-wholly-owned subsidiaries. The analyst may be asked to provide an independent opinion regarding the price of a transfer of contracts (or contract rights) between a wholly owned subsidiary and a less than wholly owned subsidiary.

4. Transfers between company and stockholder. The analyst may opine on the fairness of the contract (or contract rights) transfer price between a closely held company and one or more of the company's individual owners.

5. Transfers between for-profit and not-for-profit entities. The analyst may opine on the fairness of the contract (or contract rights) transfer price between a for-profit entity and a not-for-profit entity. These opinions may be provided for income taxation or regulatory compliance purposes.

The preceding discussion provides a representative listing of the common reasons to analyze contract intangible assets.

CONTRACT VALUATION METHODS • As indicated above, all valuation approaches may be applicable to most contract valuations. This section summarizes the more common contract valuation methods within each of the three generally accepted valuation approaches.

In the cost approach, the analyst often uses the replacement cost new less depreciation (“RCNLD”) method to value contracts. In such an analysis, the direct cost and indirect cost components are generally not the greatest components of the contract value. Direct costs typically include the labor and overhead costs related to the company employees who negotiate and consummate the contract or who apply for and process the license document. Indirect costs typically include the out-of-pocket expenses related to legal counsel, engineers, consultants, and others retained to help negotiate the contract or obtain the license. The developers’ profit cost component typically includes a fair profit margin applied to the sum of the direct and indirect costs.

Entrepreneurial incentive is typically the most important component of the RCNLD method of contract valuation. Entrepreneurial incentive is often considered to be an opportunity cost. This opportunity cost is often measured as the owner/operator’s lost profits during the contract replacement period. If the analyst expects that it would take, for example, six months to replace the subject contract, then the entrepreneurial incentive may include six months of lost profits during the

contract replacement period. This replacement period typically includes the time period between when the owner/operator first decides to enter into a contract or obtain a license and when the new contract or license is in place and fully functioning. In other words, the replacement period includes the time required to negotiate and consummate a new contract or apply for and receive a new license agreement.

The lost income during the replacement period is typically measured as the difference between the income that the owner/operator will actually earn with the actual contract or license during the replacement period and the income that the owner/operator would have earned without the contract or license in place during the replacement period. This lost income, or opportunity cost, component of the entrepreneurial incentive is often the largest portion of the contract valuation RCNLD.

In the market approach, the analyst often uses the comparable uncontrolled transaction (“CUT”) method based on either arm’s-length sales of guideline intangible assets or arm’s-length licenses of guideline intangible assets. That is, for certain types of licenses and permits, there may be an actual marketplace for the arm’s-length sales of such intangible assets between third parties. For example, the analyst may be able to assemble empirical data regarding the arm’s-length sales of FCC broadcast and spectrum licenses and television and radio network affiliation agreements.

In addition, for certain types of government-issued or private franchises, there may be an actual marketplace for the arm’s-length license of such intangible assets between third parties. For example, the analyst may be able to assemble empirical data regarding the arm’s-length license of cable television franchise agreements, hotel and hospitality franchise agreements, and restaurant and food service franchise agreements.

In the income approach, the analyst may use a number of different valuation methods. These methods include the following:

- The present value of the incremental income related to the contract;
- The present value of the differential income related to the contract;
- The present value of the excess (or residual) income related to the contract;
- The present value of the profit split income related to the contract; and
- The present value of the residual profit split income related to the contract.

In the application of any of these income approach methods, the analyst considers the following:

- The income (however measured) that can be directly associated with the contract intangible asset; and
- The income that is expected to be earned over the contract intangible asset's RUL.

Another common income approach method is for the analyst to compare the value of the owner/operator business with the contract in place to the value of the owner/operator business without the contract in place. The difference between the two business value estimates (which should equal the present value of the contract-related income) provides an indication of the contract intangible asset value.

CONTRACT DAMAGES METHODS • Most contract damages claims relate to breach of contract, but some contract damages claims may relate to torts or to condemnation and eminent domain issues. For this reason, the lost profits damages methods are commonly used with regard to breach of contract disputes. If the method is legally permissible, it is also possible for an analyst to perform an unjust enrichment damages analysis. It is also

possible (although somewhat uncommon) for an analyst to perform a cost to cure or lost intangible asset value damages analysis.

The lost profits methods are particularly applicable to many breach of contract analyses. The particular lost profits methods that are often used include the following:

- The projections method;
- The before and after method;
- The yardstick method.

In the application of any of these lost profits methods, the analyst creates a “but for” scenario. The “but for” scenario indicates the amount of income the damaged party would have earned if the contract had not been breached. In other words, the analysis measures the income that the contract party would have earned but for the wrongful action (that is, the breach) by the contract counterparty. As is common for lost profits analyses, the analyst typically measures lost income at the contribution margin level. Contribution margin is typically defined as variable revenue minus variable expense.

A related application of the “but for” scenario is for the analyst to perform the following comparative business value procedures:

- Measure the value of the contract party's business enterprise with the contract in place and in force (scenario 1);
- Measure the value of the contract party's business enterprise with the contract being breached (scenario 2);
- Subtract the scenario 2 value (the with the contract being breached value scenario) from the scenario 1 value (the with the contract being complied with value scenario);
- The difference between these two value indications is the amount of lost profits damages due to the contract breach.

Typically, all damages methods are applied over the remaining legal term of the contract. This is often

the case with regard to the damages analysis of a favorable lease contract breach or a favorable supplier contract breach. There are instances in which the analyst should consider quantifying the damages beyond the legal term of the current contract. This is often the case with regard to the damages analysis of the breach of an employee noncompete or nondisclosure agreement or of an institutional noncompete or confidentiality agreement. In such instances, the contract breach may cause damages to the contract party beyond the legal term of the subject agreement.

When the contract party is damaged beyond the term of the contract in place, the analyst often measures the damages:

- Over the expected RUL of the contract relationship. This time period typically includes the remaining term of the current contract plus the period of any expected contract renewals); or
- Over the time period in which the contract party will recover from the wrongful action. This time period may be considered the amount of time it will take for the damaged party to achieve the level of income (however measured) that it would have if the damages event had not occurred.

For example, let's assume that the damaged party experienced a tortious interference of a business opportunity and that the business opportunity was a customer purchase agreement. In this hypothetical example, the damages period may include the term of the current contract plus the term of any expected contract renewals.

Alternatively, let's assume that a company's key executive resigned and went to work for a direct competitor of the company. This action by the executive violated an employment agreement and a noncompetition agreement. The executive's actions also violated agreements related to the non-solicitation of other company employees and the nondisclosure of confidential information agree-

ments. Let's assume that all of these contracts have two year terms. However, in this example, the executive's actions may cause damages to the company well beyond the two-year contract period.

In such a scenario, the analyst may project damages over a time period until the executive's actions are no longer harmful to the company or the company has been able to recover from the executive's wrongful actions.

If the analyst has questions about the legal basis for projecting postcontract term damages, the analyst should consult with counsel.

CONTRACT TRANSFER PRICE METHODS

• All of the section 482 intangible property transfer price allowable methods may apply to the intercompany transfer of contract rights. These allowable methods include the CUT method, the comparable profits method, and the profit split method. However, because contract rights are often unique, it may be difficult for the analyst to assemble the empirical data necessary to perform a CUT method analysis.

If the analyst is able to identify comparable companies, the analyst may apply the comparable profits method. In such instances, the owner/operator controlled entity is benefitting from the transferred contract or contract rights. Therefore, the analyst typically looks for otherwise comparable companies that do not enjoy similar contract rights. The difference between the profit level indicator earned by the comparable companies and the profit level indicator earned by the taxpayer controlled entity can be used to calculate an intercompany transfer price.

Analysts commonly apply the profit split method to calculate the intercompany transfer price with regard to the transfer of contract rights. The analyst performs a functional analysis of the taxpayer controlled entity that benefits from the transferred contract rights. The analyst may apply a profit split (or a residual profit split) analysis to identify the

portion of the tested party's profits that is due to the benefits of the transferred contract rights.

Of course, the Section 482 regulations allow the analyst to apply an unspecified other method to conclude the intangible property intercompany ALP. However, in selecting an unspecified method, the analyst will have to demonstrate that the selected method is, in fact, the best method to conclude the transfer price for the contract-related intangible property.

FACTORS TO CONSIDER IN THE CONTRACT ANALYSIS

• With regard to a valuation, damages, or transfer price analysis, Exhibit 1 at the end of this article presents some of the factors that the analyst typically considers in the assessment of the contract-related intangible asset. The list in Exhibit 1 is not comprehensive. It is intended to illustrate the types of factors that the analyst typically considers in any contract-related analysis.

Internal And External Data Sources

Most of the documents and data sources that the analyst may rely on in the contract analysis are internal to the intangible asset owner/operator. Generally, those internal data sources include the following:

1. A copy of the subject contract, permit, or license;
2. Information about the direct and indirect costs to negotiate the contract or apply for the license;
3. The amount and duration of time required to negotiate the contract or apply for the license;
4. Historical financial statements for a reasonable time period before the agreement was in place;
5. Historical financial statements for the time period since the agreement has been in place;
6. Prospective financial statements for the RUL of the contract or agreement;

7. Pro forma financial statements that would represent the expected results of the owner/operator without the contract or agreement;
8. Pro forma financial statements that would represent the expected results of the owner/operator with a damaged contract or agreement.
9. Data regarding any owner/operator revenue, expense, or investment metrics that can be directly associated with the contract or agreement, including the following —
 - Fixed revenue, expense, or investment metrics;
 - Variable revenue, expense, or investment metrics;
 - Total revenue, expense, or investment metrics;
 - Information about the owner/operator's historical (and planned, if available) renewals of the contract, license, or permit.

Some of the documents and data that the analyst may rely on in the contract analysis may come from external sources; that is, these data may relate to selected guideline companies, selected contract license or transfer transactions, or selected owner/operator industry sources.

The general categories of these external data sources include the following:

1. Guideline publicly traded company financial statements (typically SEC filings) for the time period —
 - Before the valuation date,
 - During the damages period, or
 - Before the transfer price calculation date.
2. Sales of guideline licenses, permits, or franchises —
 - Between the private issuer and private parties (new agreements),
 - Between a government agency and private parties (new agreement), or
 - Between private parties (seasoned agreements).
3. Licenses of guideline licenses, permits, or franchises —

- Between the private issuer and private parties (new agreements),
 - Between a government agency and private parties (new agreement), or
 - Between private parties (seasoned agreements).
4. Information from government agencies or regulatory authorities about —
- The expected (or actual) costs of a license/permit application and
 - The expected (or actual) time period of a license/permit application.
5. Owner/operator industry data regarding —
- Revenue or profit growth rates,
 - Cost and expense ratios,
 - Profit margins,
 - Returns on investment,
 - Required levels of investment, and
 - Average costs of capital.

If such data are available, the analyst may rely on the following data from the contract counterparty:

1. Revenue or profit growth rates;
2. Cost and expense ratios;
3. Profit margins;
4. Returns on investment;
5. Required levels of investment;
6. Costs of capital.

These data would be particularly helpful if the analyst is applying an unjust enrichment measure of contract damages.

CONTRACT VALUATION ILLUSTRATIVE EXAMPLE • This discussion presents the facts of the illustrative contract valuation example, the contract valuation analysis, and the contract value conclusion.

The Illustrative Fact Set

This example illustrates the fair market value valuation of an employee noncompete agreement.

In this example, Alpha Corporation (Alpha), counsel's client, plans to purchase Beta Corporation (Beta) as of May 2, 2013. Like Alpha, Beta is a C corporation. Alpha will buy the stock of Beta from Fred Founder (Fred). Fred is the founder and sole shareholder of Beta. Beta designs and manufactures customized furniture. Alpha will continue to operate Beta as a wholly owned subsidiary.

Fred is a key executive for the Beta business enterprise. In the opinion of Alpha's management, Fred has important relationships with Beta customers, suppliers, and employees. Accordingly, as a condition of the transaction, Alpha wants Fred to sign a long-term noncompete agreement. Fred agrees to sign that noncompete agreement. According to the agreement, Fred may not compete against Beta in the furniture design and manufacture industry for the time period ending the later of (i) ten years beginning on the closing date or (ii) five years after Fred's last date of employment with Beta. (For purposes of this illustration, let's assume that this long-term agreement is legally binding in the relevant jurisdiction.)

The client asks counsel how to structure the transaction so as to maximize any future tax deductions for Alpha and to minimize any taxable income to Fred. Counsel notes that the purchase of the Beta stock will result in a carryover (and low) tax basis of the acquired Beta assets. Therefore, Alpha will not be able to obtain a tax deduction associated with any purchase price premium (over the tax basis) paid for the Beta assets. However, the purchase of a personal noncompete agreement from Fred should be an amortizable intangible asset. Counsel also notes that Fred will be subject to double taxation on the sale proceeds related to his C corporation stock. That is, Beta will be taxed once at the corporate level related to any gain in the sale of the company assets, and Fred will be taxed once again at the individual level related to the distribution of the sale proceeds from Beta to Fred. In contrast,

Fred will only be taxed once on the receipt of personal noncompete agreement payments.

Counsel retains an analyst to value the non-compete agreement. The objectives of the valuation are to estimate the fair market value of: (i) the noncompete agreement contract-related intangible asset; and (ii) the stock of Beta without the non-compete agreement in place. The purposes of this valuation are to assist counsel to structure the transaction in a tax-efficient manner and to allocate the total transaction proceeds between the Beta stock and Fred's noncompete agreement.

The analyst decided to use the income approach and the comparative business enterprise value method to estimate the value of the noncompete agreement. The analyst decided to use the discounted cash flow ("DCF") method to value the Beta business enterprise. To simplify this example, let's assume that Beta has no long-term debt. That is, the Beta business enterprise value equals the Beta stock value. Using this business valuation method, the analyst compared the following two scenarios:

- Scenario 1— the value of the Beta business with the subject contract in place and without competition from Fred. This value should agree to the total purchase price that Alpha should pay for both the Beta stock and for Fred's non-compete agreement;
- Scenario 2 — the value of the Beta business without the subject contract in place and with the expected amount of competition from a noncontractually obligated Fred. This value indicates the amount that Alpha should pay for the Beta stock.

The difference between these two scenario value indications is the amount that Alpha should pay to Fred related to the value of his personal noncompete agreement.

Valuation Analysis

The analyst discussed with Alpha management the expected impact on the Beta revenue if Fred were to compete against the company. The analyst concluded that it would take minimal time (two weeks) for Fred to: (i) develop competing products; (ii) acquire the necessary tooling to manufacture the products (or to have the product manufactured); (iii) ramp-up production of the competing products; (iv) re-establish customer relationships; and (v) begin selling the products into the market. As a result, the analyst estimated that, absent the noncompete agreement, Fred could effectively start to compete with Beta almost immediately.

The analyst considered Fred's age, health, financial resources, and geographic reach. The analyst estimated that if Fred were to compete, his competition could reduce the projected Beta revenue by approximately 50 percent. In addition, based on discussions with Alpha management, the analyst estimated that there was a material probability that Fred would compete against Beta if he was not contractually prohibited from doing so. In consultation with Alpha management, the analyst estimated this probability at 75 percent. The analyst also estimated that if Fred competed, Beta would experience employee turnover. That employee turnover would result in an increase in operating expenses in year one due to an increase in employee recruiting and training expense. This expense would increase because current Beta employees would be expected to leave the company and work for Fred.

These two sets of projection variables (that is, a 75 percent probability that Beta would experience a 50 percent reduction in revenue) result in a reduction in the revenue in year one of the projection period of approximately 30 percent (compared to the revenue reported for the pre-acquisition year).

Exhibit 2 presents management's projected income statements and cash flow for the fiscal years ended December 31, 2013, through December 31,

2022. These projections are based on the premise that Fred's noncompete agreement is in place. The projected operating income, depreciation expense, capital expenditures, and net working capital requirements were provided by Alpha management.

Of course, Beta will continue to generate cash flow beyond fiscal 2022. In order to capture the value represented by the cash flow generated beyond 2022, the analyst's DCF valuation incorporates a terminal value. The analyst estimated the terminal value using the Gordon growth model. That terminal value model is based on the premise that, after the discrete projection period, the Beta net cash flow will increase at a constant rate of 2 percent per year into perpetuity.

The analyst concluded that the appropriate discount rate to apply in this valuation is the weighted average cost of capital ("WACC"). The WACC represents the weighted average of the cost of each component in the Beta capital structure.

Total Transaction Consideration

As presented in Exhibit 2, the value of the Beta business enterprise under the scenario 1 analysis is approximately \$28.6 million. This value conclusion corresponds to the total consideration that Alpha should pay for both the Beta stock and for Fred's noncompete agreement.

Beta Stock Value Conclusions

Exhibit 3 presents the analyst's adjustments to the management projected income statements and net cash flow under the premise that the noncompete agreement is not in place. In the scenario 2 analysis, the projected Beta revenue was based on: (i) the revenue that Fred would divert from Beta; (ii) the probability of Fred competing against Beta (75 percent); and (iii) the fact that if Fred were to compete, he could likely reduce the projected Beta revenue by approximately 50 percent.

As presented in Exhibit 3, the value of the Beta business enterprise under the scenario 2 analysis is approximately \$17.7 million. This value conclusion corresponds to the amount of consideration that Alpha should pay for the Beta stock only (i.e., without Fred's noncompete agreement).

Noncompete Agreement Value Conclusion

Based on the difference in the business enterprise value indications calculated under each scenario, the fair market value of the noncompete agreement is approximately \$10.9 million. That is, Alpha should pay Fred approximately \$10.9 million as compensation for his personal noncompete agreement.

Therefore, based on the analyst's valuations, the counsel will recommend a transaction structure and a total transaction consideration as follows:

Purchase price for the Beta stock —
\$17.7 million

Payment for Fred's noncompete agreement —
10.9 million

Total transaction consideration —
\$28.6 million

CONCLUSION • Counsel are often involved with drafting, defending, and interpreting contracts. When various transaction, financing, taxation, litigation, and accounting issues arise, counsel are also involved in the economic analysis of contract intangible assets. Counsel often retain, direct, and rely on specialists for such contract valuation, damages, or transfer price analyses. Therefore, counsel should have a basic understanding of the factors these specialists consider in these contract-related analyses.

This article has summarized what counsel needs to know about the generally accepted procedures related to the valuation, damages, and transfer price analysis of contract-related in-

tangible assets. This category of intangible assets includes contracts, agreements, license, permits, and leases. This discussion explained some of the attributes that are typically present in a contract intangible asset, and it summarized the common reasons for conducting a contract valuation, damages, or transfer price analysis.

This discussion also presented: the most common contract valuation methods, damages methods, and transfer price methods; the factors that analysts typically consider in the contract analysis; and an illustrative example of a contract valuation (that is, the valuation of an executive noncompete agreement).

Exhibit 1

Factors Commonly Considered in the Analysis of Contract Intangible Assets

1. The degree of legal enforceability of the contract or agreement.
2. The state law under which the contract is binding.
3. The specific terms of the agreement, including the rights, duties, and obligations of each of the parties.
4. The expected amount of time required to negotiate a new contract (or to obtain a new license or permit).
5. The degree to which the contract is transferable.
6. The degree to which the contract is assignable.
7. The party's ability to create or support subcontractors or sublicenses.
8. The legal term of the agreement (the contract start date and termination date).
9. The provisions (if any) for a renewal or extension of the agreement.
10. The schedule of any payments associated with the contract.
11. Whether the determination of contract payments is fixed or variable.
12. Does the contract specify that it contains all of the agreements between the parties?
13. Does the contract refer to (and does it depend on) any other contract or agreement between the parties?
14. Is this type of contract between the parties common or unique? (Do all company customers, suppliers, or employees have similar contracts?)
15. Has the contract or agreement ever been tested in court?
16. Does the contract mention (or quantify) liquidation damages?
17. Does the contract describe what happens in the case of a contract dispute (mediation, arbitration, and litigation)?
18. What is the degree of standardization (for example, a standard real estate lease) or uniqueness (a celebrity performance agreement) of the contract?
19. How comparable is the contract to other contracts (of the parties or in the industry)?
20. What did the parties do before the contract? What would the parties do without the contract?

Exhibit 2
Beta Corporation
Income Approach
Scenario I: Total Transaction Consideration With Fred's Noncompete Agreement in Place
As of May 2, 2013

	Projected Fiscal Year Ended December 31,									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000
Discrete Projection Period Net Cash Flow:										
Net Revenue	33,841	38,071	41,878	46,066	50,673	54,220	58,015	62,076	6,422	71,071
<i>Growth Rate</i>	12.5%	12.5%	10.0%	10.0%	10.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Cost of Sales	23,350	26,524	29,453	32,707	36,317	39,038	41,771	44,695	47,824	51,171
Gross Profit	10,491	11,547	12,425	13,359	14,356	15,182	16,244	17,381	18,598	19,900
Operating Expenses	6,364	6,990	7,621	8,311	9,068	9,664	10,299	10,978	11,702	12,476
Operating Income	4,127	4,557	4,804	5,048	5,288	5,518	5,945	6,403	6,896	7,424
Other Expenses:										
Corporate Administration	(508)	(571)	(628)	(691)	(760)	(813)	(870)	(931)	(996)	(1,066)
Interest (Expense)	(1,336)	(1,222)	(1,099)	(935)	(758)	(564)	(351)	(120)	-	-
Interest Income	-	12	12	12	12	12	12	12	12	12
Other Income/(Deductions)	(72)	(86)	(104)	(124)	(150)	(108)	(116)	(124)	(133)	(142)
Goodwill Amortization	(1,077)	(2,154)	(2,154)	(2,154)	(2,154)	(2,154)	(2,154)	(2,154)	(2,154)	(2,154)
Total Other Expenses	(2,994)	(4,021)	(3,937)	(3,892)	(3,810)	(3,627)	(3,479)	(3,317)	(3,271)	(3,350)
Pretax Income	1,134	536	831	1,156	1,478	1,891	2,466	3,086	3,625	4,074
Income Taxes	452	214	332	461	590	754	984	1,231	1,446	1,625
Net Income	682	322	499	695	888	1,137	1,482	1,855	2,179	2,449
Net Operating Income	1,485	1,056	1,159	1,257	1,343	1,476	1,693	1,927	2,179	2,449
Calculation of Net Cash Flow:										
Less: Capital Expenditures	(254)	(286)	(314)	(345)	(380)	(271)	(290)	(310)	(332)	(355)
Plus: Depreciation and Amortization Expense	1,167	2,280	2,315	2,349	2,382	2,402	2,410	2,424	2,441	2,461
Less: (Increase) Decrease in Net Working Capital	1,034	(847)	133	151	168	124	116	124	132	142
Net Cash Flow (NCF)	3,433	2,203	3,293	3,412	3,513	3,731	3,929	4,165	4,420	4,697
Adjustment Factor [a]	1	1	1	1	1	1	1	1	1	1
Adjusted NCF	2,300	2,203	3,293	3,412	3,513	3,731	3,929	4,165	4,420	4,697
Present Value Factor @ 15% [b]	0.9543	0.8491	0.7384	0.6421	0.5583	0.4855	0.4222	0.3671	0.3192	0.2776
Present Value of NCF	2,195	1,871	2,431	2,191	1,962	1,811	1,659	1,529	1,411	1,304
Present Value of Discrete Projection Period NCF	<u>18,364</u>									

Present Value of Terminal Period NCF:

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2023 NCF [c]	\$ 4,791
Direct Capitalization Rate [d]	13%
Terminal Value	36,853
Present Value Factor	0.2776
Present Value of Terminal Period NCF	\$ 10,230

Conclusion of the Total Transaction Consideration:

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Present Value of Discrete Period NCF	\$ 18,364
Present Value of Terminal Period NCF	10,230
Total Transaction Value with Fred's Noncompete Agreement in Place	\$ 28,594
Total Transaction Value with Fred's Noncompete Agreement in Place (rounded)	\$ 28,600

Footnotes:

[a] Reflects a valuation date of May 2, 2013.

[b] Calculated as if cash flow received at mid-year.

[c] Assumes a net cash flow expected long-term growth rate of 2%.

[d] Equals the 15% discount rate minus the 2% expected long-term growth rate.

Exhibit 3 (continued)

Beta Corporation

Income Approach

Scenario II: Beta Stock Value Without Fred's Noncompete Agreement in Place

As of May 2, 2013

	Projected Fiscal Years Ended December 31,									
	2018		2019		2020		2021		2022	
Present Value of Discrete Projection Period Net Cash Flow	\$000	% [h]	\$000	% [h]	\$000	% [h]	\$000	% [h]	\$000	% [h]
Total Revenue [b]	54,220		58,015		62,076		66,422		71,071	
<i>Growth Rate</i>	7.0%		7.0%		7.0%		7.0%		7.0%	
Revenue Adjustment if Competition [c]	50%		50%		50%		50%		50%	
Probability of Effectively Competing	75%		75%		75%		75%		75%	
Adjusted Revenue [d]	33,888		36,259		38,798		41,514		44,419	
<i>Growth Rate</i>	7.0%		7.0%		7.0%		7.0%		7.0%	
Cost of Sales	24,399	72.0	26,107	72.0	27,934	72.0	29,890	72.0	31,982	72.0
Gross Profit	9,489	28.0	10,153	28.0	10,863	28.0	11,624	28.0	12,438	28.0
Operating Expenses [e]	6,040	17.8	6,437	17.8	6,861	17.7	7,314	17.6	7,798	17.6
Operating Income	3,449	10.2	3,716	10.2	4,002	10.3	4,310	10.4	4,640	10.4
Other Expenses:										
Corporate Administration	(508)	(1.5)	(544)	(1.5)	(582)	(1.5)	(623)	(1.5)	(666)	(1.5)
Interest (Expense)	(564)	(1.7)	(351)	(1.0)	(120)	(0.3)	-	-	-	-
Interest Income	12	0.0	12	0.0	12	0.0	12	0.0	12	0.0
Other Income/(Deductions)	(68)	(0.2)	(73)	(0.2)	(78)	(0.2)	(73)	(0.2)	(89)	(0.2)
Goodwill Amortization	(1,346)	(4.0)	(1,346)	(3.7)	(1,346)	(3.5)	(1,346)	(3.2)	(1,346)	(3.0)
Total Other Expenses	(2,474)	(7.3)	(2,302)	(6.3)	(2,114)	(5.4)	(2,040)	(4.9)	(2,089)	(4.7)
Pretax Income	975	2.9	1,414	3.9	1,888	4.9	2,270	5.5	2,551	5.7
Income Taxes	389	1.1	564	1.6	753	1.9	905	2.2	1,017	2.3
Net Income	586	1.7	850	2.3	1,136	2.9	1,365	3.3	1,534	3.5
Debt-Free Net Income	925	2.7	1,062	2.9	1,208	3.1	1,365	3.3	1,534	3.5
Calculation of Net Cash Flow:										
Less: Capital Expenditures	(169)	(0.5)	(181)	(0.5)	(194)	(0.5)	(208)	(0.5)	(222)	(0.5)
Plus: Depreciation and Amortization Expense	1,501	4.4	1,506	4.2	1,515	3.9	1,526	3.7	1,538	3.5
Less: (Increase) Decrease in Net Working Capital	78	0.2	73	0.2	78	0.2	83	0.2	89	0.2
Net Cash Flow (NCF)	2,335	6.9	2,459	6.8	2,607	6.7	2,766	6.7	2,939	6.6
Adjustment Factor [f]	1.00		1.00		1.00		1.00		1.00	
Adjusted NCF	2,335		2,459		2,607		2,766		2,939	
Present Value Factor @ 15% [g]	0.4855		0.4222		0.3671		0.3192		0.2776	
Present Value of NCF	1,134		1,038		957		883		816	

Footnotes:

[a] Reflects a valuation date of May 2, 2013.

[b] Based on Alpha management projections.

[c] Assumes that if Fred were to compete against Beta, he would be able to capture 50 percent of the Beta business.

[d] Calculated as: total revenue minus (total revenue * revenue adjustment if compete * probability of effectively competing).

[e] Operating expenses in fiscal year 2013 are estimated to increase by \$500,000 due to an increase in recruiting and training workforce costs; this increase assumes that some current Beta employees may leave to work with Fred.

[f] Reflects a valuation date of May 2, 2013.

[g] Calculated as if cash flow received at mid-year.

[h] Assumes the same margin as in Exhibit 2, except for interest expense margin, interest income margin, and income tax margin. Interest expense and interest income is the same as the projections in Exhibit 2. Income tax is calculated as pretax income * 40 percent income tax rate.

[i] Assumes a net cash flow expected long-term growth rate of 2%.

[j] Equals the 15% discount rate minus the 2% expected long-term growth rate.