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Value & Cents

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12 Reasons to Value IP

This article focuses on the valuation of debtor company intellectual property (IP) within a bankruptcy proceeding. The first part summarizes the various IP types, with the second part focusing on the bankruptcy reasons why valuation analysts may be asked to value IP.

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IP Types

In most contexts, there are four IP types: patents, trademarks, copyrights and trade secrets. Patents, trademarks and copyrights are created under and protected by federal statutes. Trade secrets are created under and protected by state statutes. However, most states have either completely adopted — or adopted the essence of — the Uniform Trade Secret Act within their state statutes.

For this article, we assume that the debtor company may be either the IP owner (and possibly the licensor) or the non-owner operator (*i.e.*, the licensee). For purposes of this article, the above-listed four IP types will be expanded to include associated or contributory intangible assets.

The patents category includes patent applications, the technology and designs encompassed in the patent, and the engineering drawings and other technical documentation that accompanies the patent or patent application. The trademarks category includes trademarks (both registered and unregistered), trade names, service marks, service names, trade dress, product labeling that includes trademarks, institutional advertising (including signage) and promotional materials that include trademarks. The copyrights category includes both registered and unregistered copyrights on publications, manuscripts, white papers, musical compositions, plays, manuals, films, computer source code, blueprints, technical drawings and other forms of documentation.

The trade secrets category includes any information or procedures that (1) the debtor keeps secret and (2) provides some economic benefit to the debtor. Such trade secrets include computer software source code, employee manuals and procedures, computer system user manuals and procedures, station or employee operating manuals and procedures, chemical formulas, food and beverage recipes, product designs, engineering drawings and technical documentation, plant or process schematics, financial statements, employee files and records, customer files and records, vendor files and records, and contracts and agreements.

Reasons to Value IP

This section summarizes common reasons to value IP. The section's citations refer to the U.S. Bankruptcy Code, and the rule citations refer to the U.S. Bankruptcy Rules.

Reason 1: Preference Claims and Debtor Solvency (§ 547)

Creditors may retain an analyst to assess the debtor's solvency prior to the chapter 11 filing date. Creditors may claim that the debtor was solvent prior to the bankruptcy filing, and therefore, that their receipt of either property or cash from the debtor was not an avoidable preference payment.

In chapter 11, the trustee may seek to avoid (*i.e.*, reverse) any transfers of cash or other property out of the estate. This avoidance brings more property and cash back into the estate to allow the trustee to settle more of the debtor's liabilities. Section 547 allows the trustee to avoid certain so-called preference payments under certain circumstances.[1]

The creditor recipients of the debtor's property or cash may not be so willing to return the transaction proceeds to the estate. One way to defend a preference claim is to show that the debtor was solvent at the time of the transfer. Hence, creditors may retain an analyst to assess the debtor's solvency prior to the filing date. The analyst will consider the debtor's IP value as part of the solvency analysis.

1 *See* 11 U.S.C. § 547(b) (2016).

Reason 2: Fraudulent Transfers and Debtor Solvency (§ 548)

In a chapter 11 matter, a trustee may retain an analyst to opine that the debtor company was insolvent on the dates when, among other things, the debtor transferred property to a third party. Here too, creditors may retain an analyst to opine that the debtor was solvent on the prebankruptcy transfer dates.

In chapter 11, the trustee can avoid (or reverse) either transfers made by the debtor or liabilities incurred by the debtor under certain circumstances. An important factor in determining whether the debtor's transfer was fraudulent (and therefore, whether the transfer may be avoided) is whether the debtor was insolvent at the transfer date.

Section 548 lists three separate fraudulent-transfer tests that are performed as of the transfer date. These fraudulent transfer tests determine whether the debtor corporation:[2]

1. was insolvent (*i.e.*, whether the debtor's liabilities exceeded the debtor's assets at fair valuation);
2. was expected to be able to pay its debts (including principal and interest payments) as such debts matured; and
3. had an unreasonably small amount of capital to continue to be able to operate as a going concern.

The trustee may claim that a fraudulent transfer had occurred if the analyst concludes that the debtor failed any of these three tests as of the transfer date. The analyst will also consider the debtor's IP value as part of the solvency analysis.

Reason 3: Asset Sales and Adequate Protection (§ 363)

The trustee may retain an analyst to opine that the price of the proposed § 363 asset sale is fair, thereby providing adequate protection to creditors and other bankruptcy stakeholders. If the proposed asset sale transaction is challenged, then creditors may also retain a valuation analyst to opine that the asset sale price is not fair (*i.e.*, does not provide adequate protection to creditors) — and that the court should not approve the asset sale.[3]

During a prolonged bankruptcy, it is common for the debtor-in-possession (DIP) to sell off some assets included in the estate. Such assets may be a subsidiary, division, other business unit or IP of the debtor company. In particular, the DIP may be able to sell underperforming business assets or nonoperating assets that are not part of its core business. Such "363 asset sales" are typically intended to both eliminate or reduce any DIP operating losses, and to generate cash that would then become available to pay off debtor liabilities.

The trustee has to make sure that § 363 asset sales are fair to the bankruptcy stakeholders, primarily the debtholders. The valuation analyst might be retained to assess whether a proposed § 363 asset sale (including an IP sale) is fair — or not fair — to the stakeholders.

Reason 4: DIP Entering into Inbound or Outbound IP License Agreements (§ 363)

Section 363 covers the "use, sale, or lease of property" within a bankruptcy estate. In addition to sales of assets, § 363 also covers both inbound and outbound IP licenses entered into by the DIP.

The trustee (or the DIP) may wish to enter into IP license agreements for operating purposes or cash-flow generation purposes. In a chapter 11 case, the estate may enter into IP licenses only if they are a reasonable execise of the debtor's business judgment. The trustee is responsible for ensuring that the estate (1) receives no less than a fair price for outbound licenses and (2) pays no more than a fair price for inbound licenses. In addition, the trustee is responsible for ensuring that such an IP license does not decrease the security of the secured creditors. Lastly, the analyst might also be asked to assess the fairness of the proposed IP license agreement.[4]

Reason 5: Decrease in the Value of a Creditor's Interest (§ 361)

After a § 363 asset sale, or in other circumstances in which the secured creditor's interest in debtor property has been reduced, the secured creditor may retain an analyst to assess the amount by which the secured creditor's interest was reduced and the value of the additional interest that the creditor should receive in order to obtain the "indubitable equivalent" of the value of the lost security. The Bankruptcy Code provides protection for a creditor's interest in the debtor's property.[5]

Events sometimes occur during the bankruptcy proceeding that reduce the creditor's interest in the debtor's property (such as a § 363 sale of that collateral property). In such an instance, § 361 basically provides that the creditor should be made whole by receiving cash from the trustee or an additional lien on other debtor property. The valuation analyst might be asked to answer these two questions: (1) By how much was the value of the creditor's interest (in the debtor's property) reduced, and (2) what is the value of the additional interest that the creditor should receive in order to obtain the "indubitable equivalent" of the value of the lost security?

Reason 6: Bankruptcy Rules Regarding a Secured Creditor's Interest (Rules 3012 and 3018)

A claim in bankruptcy is secured to the extent of the value of the collateral in which the creditor has an interest. The value of the creditor's security interest in the debtor's property is typically determined by a valuation. In chapter 11, the value of a secured creditor's security interest is important for a number of reasons. The value of the creditor's security affects the creditor's influence with regard to the approval (or disapproval) of the proposed reorganization plan. When there is a question about the value of the collateral in which a creditor has a security interest, the court may hold a valuation hearing. The following Bankruptcy Rules relate to the value of a secured creditor's interest:

Rule 3012: Valuation of Security

The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct.[6]

2 *See* 11 U.S.C. § 548(a)(B).
3 *See* 11 U.S.C. § 363(b)(1).
4 *See* 11 U.S.C. § 363(d).
5 *See* 11 U.S.C. § 361(3).
6 *See* Fed. R. Bankr. P. 3012.

Rule 3018: Acceptance or Rejection of Plan in a Chapter 9 Municipality or a Chapter 11 Reorganization Case

(a) *Entities Entitled to Accept or Reject Plan; Time for Acceptance or Rejection*. A plan may be accepted or rejected in accordance with § 1126 of the [Bankruptcy] Code within the time fixed by the court pursuant to Rule 3017....[7]

(d) *Acceptance or Rejection by a Partially Secured Creditor*. A creditor whose claim has been allowed in part as a secured claim and in part as an unsecured claim shall be entitled to accept or reject a plan in both capacities.[8]

A creditor typically wants to prove that it is a secured (versus unsecured) creditor. A creditor wants to prove that it is a fully secured (and not partially secured) creditor. The value of the creditor's security interest in the debtor's property is often determined by a valuation.

Reason 7: Reorganization Plan Confirmation (§ 1129)

A valuation analyst may be asked to review the proposed reorganization plan for § 1129 confirmation purposes. The analyst may also be asked to assess whether the proposed reorganization plan is "reasonable" and "fair and equitable" to the various classes of creditors and to other stakeholders.[9]

The analyst may opine on the proposed reorganization plan. This assessment considers all financial aspects of the plan in addition to any IP-related considerations. The analyst can perform this reorganization plan analysis on behalf of the DIP or creditors.

Reason 8: Cramdown of the Reorganization Plan (§ 1129)

When the court seeks to confirm a proposed reorganization plan over the objection of creditors (a "cramdown"), the analyst may be asked to assess the reorganization plan to determine if it is fair and equitable. Ideally, all parties will accept the proposed reorganization plan, but plan acceptance by all parties does not always happen. Often, one or more of the creditor groups is not satisfied, but the court can still confirm the plan over the holdout creditors' objections. Even if the reorganization plan impairs the interests of one or more of the creditor groups, the court may confirm the proposed plan if it is deemed to be "fair and equitable" with regard to all groups of creditors that are impaired.

An analyst may testify regarding the reorganization plan and, particularly, regarding whether the plan is "fair and equitable" to all impaired creditor groups. This judicial confirmation of such a reorganization plan is called a § 1129 "cramdown."[10]

Reason 9: Secured Creditor Relief from Automatic Stay (§ 362)

After a bankruptcy filing, there is an automatic stay with regard to a creditor's ability to collect the debtor's prepetition debts, which can be lifted by the court in certain instances. The analyst may be asked to testify when a secured creditor seeks relief under § 362 from the automatic stay against collection efforts.

Section 362 allows for a secured creditor to receive relief from this automatic stay of collection efforts if two conditions are met: (1) related to the secured property, the debtor must have no equity in the property (*i.e.*, the amount of the specific liability exceeds the value of the collateral asset); and (2) the secured property must not be a necessary part of the debtor's core business. The analyst may opine related to both of these two questions with regard to a § 362 motion.[11]

Both bankruptcy practitioners and valuation analysts should be aware of the many reasons why IP may need to be valued in a bankruptcy proceeding.

Reason 10: Collateral Valuation for DIP Financing

An analyst may be asked to value the debtor's proposed collateral property for DIP financing purposes. Frequently, that proposed collateral property is the debtor's IP.

A debtor company's ability to borrow is limited during a chapter 11 proceeding. Without the court's authorization, the debtor can only incur trade debt in the ordinary course of business, which will be allowed as an administrative expense.

The court can authorize the debtor's obtaining credit secured by a senior or equal lien on encumbered property of the estate. The court can authorize that debt only if the debtor company is unable to obtain credit otherwise and there is adequate protection of the interest of the lienholder on the property on which a senior or equal lien is proposed to be granted. This new debt is usually referred to as priming DIP financing.

In order to obtain DIP financing, the debtor has to prove that the collateral property's value is greater than the amount of the new DIP liability. An analyst may be asked to value the proposed collateral property and to opine that the property's value is greater than the amount of the proposed financing.

The DIP usually doesn't have a lot of property left to pledge for DIP financing collateral. Often, the debtor has already pledged all of its receivables, inventory, real estate, tangible personal property and equity in subsidiaries and joint ventures. However, the debtor may not have previously pledged its IP as secured debt collateral, so the DIP financing may involve the pledge of IP as the DIP financing collateral. The analyst may be asked to value the debtor's IP for DIP financing collateral purposes.

Reason 11: The Zone of Insolvency and the Debtor Company Director Duties

Before a bankruptcy filing, the valuation analyst might be asked to assess the financial condition of a financially distressed company. Before approving any major dividend, financing, capital expenditure or other corporate decision, the company directors may want the analyst to opine as to whether the debtor is operating near (or in) the zone of insolvency.

7 *See* Fed. R. Bankr. P. 3018(a).
8 *See* Fed. R. Bankr. P. 3018(d).
9 *See* 11 U.S.C. § 1129(a)(11).
10 *See* 11 U.S.C. §1129(b)(1) and (2).
11 *See* 11 U.S.C. § 362(d)(2).

The company directors owe fiduciary duties to a corporation and to its shareholders. However, when a debtor company approaches the zone of insolvency, under the laws of most states the directors owe those duties to creditors, too. In such a case, the creditors (and not just the debtor's shareholders) have standing to assert breach of fiduciary duty claims on the company's behalf. The board of directors of a financially troubled company may retain an analyst to advise the board as to whether the company is in the zone of insolvency.

Reason 12: Rejection of Debtor's IP Licenses (§ 365)

Section 365(n) allows the trustee to reject an executory contract in which the debtor is the licensor to a right in IP. If the trustee makes such a contract rejection, the IP licensee has certain rights specified in § 365(n). The analyst might be asked to assist the trustee in making the decision as to whether to reject the debtor's IP licenses, as well as whether to assist the licensee(s) in the assessment of the licensee rights in the case of the trustee's rejection of this IP license.[12]

Particularly with regard to the § 365(n) rejection of debtor IP licenses, it is noteworthy that under § 101(35A), IP is defined as patents, copyrights and trade secrets — but not trademarks.[13] Generally, the courts have ruled that debtor trademark license agreements are not subject to the provisions of § 365(n). For § 365(n) and other bankruptcy purposes, the IP categories include patents, copyrights and trade secrets. For most other purposes, IP also includes the category of trademarks.

Conclusion

There are many reasons to value debtor company IP within a bankruptcy context. This article summarized the IP types and described 12 common reasons to value debtor IP. Counsel and other parties to the bankruptcy proceeding often retain and rely on valuation analysts to estimate the value of the debtor company's IP. There are generally accepted IP valuation approaches and methods, but a discussion of those approaches and methods is beyond the scope of this article.

Both bankruptcy practitioners and valuation analysts should be aware of the many reasons why IP may need to be valued in a bankruptcy proceeding. In addition, both bankruptcy practitioners and analysts should ensure that such valuations are performed in accordance with the generally accepted IP valuation approaches and methods. abi

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12 *See* 11 U.S.C. § 365(n).

13 Section 101(35A) of the Bankruptcy Code provides the following definition:

(35A) The term "intellectual property" means —

(A) trade secret;

(B) invention, process, design, or plant protected under title 35;

(C) patent application;

(D) plant variety;

(E) work of authorship protected under title 17; or

(F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law.