

Intellectual Property Market Approach Valuation Methods in Bankruptcy Controversies



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INTRODUCTION

Valuation analysts (analysts) are often asked to value debtor company intellectual property (IP) within the context of a bankruptcy litigation. Common IP controversies within such a bankruptcy litigation include the assessment of the debtor company solvency or insolvency, a secured creditor's collateral and protection, the fairness of Bankruptcy Code Section 363 IP asset sale or license transaction, the debtor's Section 365(n) rejection of its outbound IP licenses (and the implications of that rejection on the IP licensees), and the reasonableness of the IP royalty or operational income component of a proposed reorganization plan, among other reasons.

Many analysts immediately think of applying income approach or cost approach intangible asset valuation methods to value the debtor company's IP. However, if sufficient market-derived pricing data are available, market approach intangible asset valuation methods can also be used in the bankruptcy litigation to provide guidance with regard to the debtor company IP value.

First, this discussion summarizes the various types of debtor company IP that analysts are asked to value within a bankruptcy controversy context. Second, this discussion summarizes the generally accepted IP valuation approaches and methods. Finally, this discussion describes and illustrates a common market approach valuation method to analyze debtor company IP. Analysts (and debtors, creditors, legal counsel, and other parties to the bankruptcy proceeding) should at least consider the application of market approach valuation methods to analyze the debtor company IP.

IP TYPES

According to Section 101(35A) of the Bankruptcy Code, the term "intellectual property" is defined as "(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 non-bankruptcy law." Outside the bankruptcy context, trademarks and trade names are also considered to be common IP types. However, trademarks are not mentioned as part of the Bankruptcy Code definition of "intellectual property." Both within the bankruptcy context and otherwise, these IP types are considered to be a specific subset of the general category of commercial intangible assets.

For bankruptcy valuation purposes, the patent IP category is often expanded to include patent applications, the proprietary technology and product or process designs encompassed by the patent, and the engineering drawings, schematics and diagrams, and other technical documentation that relate to the patent or patent application.

The copyright's IP category is often expanded to include 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.

And, the trade secrets IP category is often expanded to include any information or procedures that the owner/operator keeps secret and provides some economic benefit to the owner/operator. Trade secret IP may

include computer software source code, employee manuals and procedures, computer system user manuals and procedures, station or employee operating manuals and procedures, chemical formula, 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.

IP VALUATION APPROACHES AND METHODS

All of the generally accepted intangible asset valuation approaches are applicable to the bankruptcy analysis of debtor company IP. The following list presents the generally accepted intangible asset cost approach, market approach, and income approach valuation methods that are applicable to the debtor company IP analysis.

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expert TIP

All of the generally accepted intangible asset valuation approaches are applicable to the bankruptcy analysis of debtor company IP.

- *Cost approach valuation methods:* reproduction cost new less depreciation method, replacement cost new less depreciation method, and trended historical cost less depreciation method
- *Market approach valuation methods:* relief from royalty method, comparable uncontrolled transactions method, and comparable profit margin method
- *Income approach valuation methods:* differential income (with/without) method, incremental income method, profit split method (or residual profit split method), and residual (excess) income method

Market approach IP valuation methods are particularly applicable when there are a sufficient quantity of transactional data related to either comparable (almost identical to the subject) IP or guideline (similar from an investment risk and expected return perspective to the subject) IP. These IP transactions may relate to either sale or license transactions. Such arm's-length, third-party transactions involving IP are typically called *comparable uncontrolled transaction (CUT) sales or licenses*. The analyst attempts to extract market-derived valuation pricing metrics (e.g., sale pricing multiples, license royalty rates, or income capitalization rates) from these CUT data in order to apply to the corresponding metrics of the debtor company financial fundamentals. The result of applying the market-derived pricing multiples or rates to the debtor company fundamentals is the market approach indication of the subject IP value.

In the relief from royalty (RFR) valuation method, the analyst searches for arm's-length licenses of IP that may provide pricing guidance with regard to the subject IP. Typically, the analyst is looking for a market-derived royalty rate that is expressed as a percentage (or multiple) of a common financial metric. The most common IP royalty rate metric that analysts look for is a royalty rate expressed as a percent of the licensee's revenue. In other words,

the analyst looks for arm's-length license agreements where the use of the comparable IP is licensed from an independent licensor to an independent licensee for a license fee that is expressed as a percentage of the licensee's revenue.

In the CUT valuation method, the analyst searches for arm's-length sales of IP between independent parties. In other words, the analyst is looking for the arm's-length sale of a fee simple interest in the comparable IP from an independent seller to an independent buyer. In particular, the analyst is looking for CUT sales data that can be expressed as a multiple of the number of IP units sold or as a multiple (or ratio) of the IP owner/operator's revenue or income. Such pricing metrics could include dollars per number of patents in an IP portfolio, dollars for line of computer software source code, or dollars per number of engineering drawings or blueprints that have been transferred.

Table 1 at right lists many of the automated data sources that analysts commonly refer to in the search for guideline IP sale or license transactions. These automated databases provide complete copies of the IP sale or license documents. The analyst reviews these potential CUT transactions and selects the most comparable transactions to provide pricing guidance related to the debtor company IP. These databases are searchable by type of IP, owner/operator SIC code, transaction date time period, country of transaction participants, and other search criteria. These online data sources typically obtain their source documents from SEC-registered company (sale or license transaction participants) public filings.

In the comparable profit margin (CPM) valuation method, the analyst searches for publicly traded companies that are sufficiently comparable to the subject debtor company—except that the subject debtor company owns and operates the unique IP and the selected public companies own and operate a generic (or no) IP. This CPM valuation

TABLE 1

Common On-Line Databases for IP Sale or License Transaction Data

RoyaltySource

***www.royaltysource.com*—This AUS Consultants database provides IP license royalty rates and IP sale data. Source documents are available for download.**

RoyaltyStat, LLC

***www.royaltystat.com*—RoyaltyStat is a subscription-based database of IP license royalty rates, IP license agreements, and IP sale data compiled from Securities and Exchange Commission documents.**

Royalty Connection

***www.royaltyconnection.com*—Royalty Connection™ provides online access to license royalty rate and other license information related to all types of technology, patents, trade secrets, and know-how IP.**

ktMINE

***www.bvmarketdata.com*—ktMINE is an interactive database that provides direct access to IP license royalty rates, IP license agreements, and IP sale agreements. Source documents may be printed.**

method is based on the premise that the subject IP provides a profit margin advantage for the subject debtor company compared to the selected guideline companies. This profit margin advantage is typically measured at the earnings before interest and taxes (EBIT) profit margin level. For example, let's assume that the subject IP owner/operator earns a 20 percent EBIT margin and the median EBIT margin of the selected guideline companies is a 15 percent EBIT margin. According to the CPM method, the IP

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owner/operator's 5 percent profit margin advantage could be assigned as a reasonable royalty rate for the subject IP.

That royalty rate (based on the incremental profit margin) is multiplied by the debtor company revenue in order to estimate a royalty income stream. The present value of the royalty income stream over the IP remaining useful life (RUL) is the CPM method value indication for the debtor company IP.

There are common online data sources that analysts use to identify either industry average or comparable company profit margins. These comparable profit margins are then compared to owner/operator's profit margin in order to identify any IP-related excess profit margin. These sources may include FactSet Research Systems Inc. (FactSet), Hoover's Inc. (Hoover's Company Records), Mergent Inc. (MergentOnline), Morningstar Inc. (Morningstar Equity Research), Standard & Poor's (Capital IQ), and Thomson Reuters (Thompson ONE Analytics).

**MARKET APPROACH
IP VALUATION
ILLUSTRATIVE EXAMPLE**

In this example, let's assume that Debtor Company is seeking debtor in possession (DIP) financing. All of the debtor company's tangible assets are already pledged as a secured financing collateral. However, the lender will accept the debtor's trademarks and trade names as collateral for the DIP financing. Before extending the DIP financing, the lender requires an independent valuation of the subject trademarks and trade names.

An analyst is retained to perform the IP collateral value valuation as of January 1, 2016. Based on the availability of market-derived transaction data, the analyst selects the market approach and the RFR valuation method. After analyzing several guideline IP license agreements, the analyst selects 2 percent of revenue as the appropriate market-derived IP license royalty rate.



Debtor Company management provided the analyst with a five-year revenue projection for the debtor company. Working with Debtor Company management, the analyst selected (1) a 12 percent present value discount rate (based on the debtor's weighted average cost of capital), (2) a 15-year trademark total RUL, and (3) a 0 percent expected long-term growth rate beyond the discrete projection period.

The analyst's market approach RFR method IP valuation analysis is summarized in **Exhibit 1** on page 23.

Based on the illustrative fact set, the analyst concluded that the fair market value of the hypothetical Debtor Company trademarks and trade names is \$590 million as of January 1, 2016.

SUMMARY

Analysts are often asked to value a debtor company's IP for a variety of bankruptcy litigation reasons. This dis-

ussion summarized the generally accepted IP valuation approaches and methods.

Analysts (and other parties to the bankruptcy litigation) often initially think of applying income approach or cost approach valuation methods to value the debtor company IP. However, if there are sufficient market-derived sale or license transactional data available, market approach methods can also provide meaningful pricing guidance with regard to the debtor company IP. This discussion summarized the generally accepted market approach IP valuation methods. And, this discussion provided a simplified illustration of one common market approach IP valuation method—the RFR valuation method. Analysts and other parties to the bankruptcy litigation should consider market approach valuation methods in the bankruptcy-related IP controversy. *☞*

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**Debtor Company
Trademarks and Trade Names
Fair Market Value Valuation
Market Approach—Relief from Royalty Method**

	Projected Calendar Years				
	2016	2017	2018	2019	2020
Discrete Projection Period Trademark Income:	\$000	\$000	\$000	\$000	\$000
Management-Provided Revenue Projection [a]	8,634,139	8,358,945	8,042,393	7,720,369	7,377,326
Arm's-Length Trademark License Royalty Rate [b]	2%	2%	2%	2%	2%
Projected Pretax Trademark License Income	172,683	167,179	160,848	154,407	147,547
Less: Projected Income Tax Rate [c]	37%	37%	37%	37%	37%
Projected After-Tax Trademark License Income	108,790	105,323	101,334	97,277	92,954
Discounting Periods [d]	1	2	3	4	5
Present Value Factor @ 12% [e]	.8929	.7972	.7118	.6355	.5674
Present Value of Trademark License Income	<u>97,138</u>	<u>83,964</u>	<u>72,130</u>	<u>61,820</u>	<u>52,742</u>
Sum of Present Value of Trademark License Income	<u>397,018</u>				
Terminal Period Trademark Income:					
Fiscal 2021 Normalized Trademark Income [f]	\$92,954				
Direct Capitalization Multiple [g]	<u>5.6502</u>				
Terminal Value of Trademark License Income	525,209				
Present Value Factor @ 12%	<u>.5674</u>				
Present Value of Terminal Period Trademark Income	<u>\$298,003</u>				
Trademark Value Summary:					
Present Value of Discrete Period Trademark Income	\$287,794				
Present Value of Terminal Period Trademark Income	<u>298,003</u>				
Fair Market Value of the Debtor Company Trademarks (rounded)	<u>\$590,000</u>				

Footnotes:

[a] Revenue projection provided by Debtor Company management, consistent with the company's plan of reorganization.

[b] Based on the analyst's selection and review of arm's-length guideline IP license agreements.

[c] Based on the Debtor Company expected income tax rate.

[d] Assumes year-end discounting for simplification purposes only.

[e] Based on the Debtor Company 12% weighted average cost of capital.

[f] Based on the 2020 projected after-tax trademark income and a 0% expected long-term growth rate.

[g] Based on a present value of an annuity factor for a 12% discount rate and a 10-year expected RUL (after the 5-year discrete projection period).