

Intellectual Property Valuations within Bankruptcy Controversies - Part 1

INTRODUCTION

There are many reasons why a valuation analyst (analyst) may be asked to value debtor company intellectual property within a bankruptcy environment. While the focus of this discussion is on valuation, there are also many reasons why an analyst may be asked to perform an intellectual property damages analysis or transfer price analysis within a bankruptcy environment. Before the analyst is retained, the party-in-interest (and, typically, the party's counsel) should carefully define the intellectual property valuation assignment. Based on that assignment definition, the analyst, the client, and the counsel should all agree on the objectives and the requirements of the valuation.

This discussion explains—and illustrates—the generally accepted intellectual property valuation approaches and methods that analysts typically consider in a bankruptcy-related controversy. This discussion also describes the intellectual property valuation synthesis and conclusion process. Due to the litigious nature of most bankruptcy proceedings, bankruptcy valuations are often subject to a rigorous contrarian review. Therefore, this discussion concludes with recommended best practices related to (1) the attributes of an effective intellectual property valuation expert report and (2) the types of professionals who should serve as intellectual property valuation testifying experts.

The U.S. Bankruptcy Code does not include trademarks or trade names within its definition of intellectual property. However, for purposes of this discussion, the term *intellectual property* is intended to include all of the following

categories: trademarks and trade names, patents, copyrights, and trade secrets.

This discussion expands on the best practices described in the article “Intellectual Property Market Approach Valuation Methods in Bankruptcy Controversies” that appeared in the June/July 2016 issue of *Financial Valuation and Litigation Expert*.

THE BANKRUPTCY VALUATION ASSIGNMENT

A statement of the purpose and the objective of the analysis is a best practice at the outset of any bankruptcy-related valuation. Such a statement requires the analyst, the client, and counsel to carefully consider all of the so-called elements of the valuation assignment. Such a statement also mitigates the possibility of any misunderstandings about the controversy-related bankruptcy assignment.

Whenever intellectual property is the valuation subject, it is a best practice to consider all of the elements of the assignment. When a party-in-interest needs to know the value of intellectual property that is either owned by or operated by a debtor entity, that party should carefully define the elements of the valuation.

The special legal protections afforded to intellectual property are intended to prohibit the use of—or the sale of—protected works without the authorization of the intellectual property owner. Commercial exchange markets have developed to allow intellectual property owners to license or sell their property to other market participants. Such market participants can develop, adapt, and commercially exploit the subject intellectual property.



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These exchange markets encourage investments in intellectual property. Both United States and international intellectual property law support such license, sale, and other transfer transactions. Among other factors, analysts typically consider the actions of such market participants in the intellectual property valuation process.

Bankruptcy law (both United States and international) seeks to preserve the on-going value of—and to maximize the economic stake of—the creditors to the debtor company. Typically, in the bankruptcy environment, contracts and licenses can be assumed, rejected, or assigned. This fact may complicate the valuation analysis when the debtor in possession (DIP) is either an intellectual property licensor or an intellectual property licensee.

For example, let's assume that the debtor entity is an intellectual property licensee.
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tual property licensor and that the license may be assignable by the bankruptcy estate to the licensor's competitor. In that case, the analyst may have to consider whether the intellectual property valuation should be based on the expectation that the licensor is required to continue to support (e.g., make improvements to) the intellectual property (even if it is in the hands of a competitor).

Defining the assignment is a first best practice in the intellectual property valuation process. This definition may influence many of the analyst's considerations and procedures. The assignment definition may influence many of the decisions to be made in the analysis. The time spent by the analyst, the client, and counsel to define the purpose and the objective of the assignment is time well spent.

There are many possible clients for a bankruptcy controversy-related valuation. This is because there are typically many parties-in-interest to a commercial bankruptcy. These parties may include the debtor company, the company directors, the court-appointed bankruptcy trustee, individual secured creditors, a secured creditors committee, an unsecured creditors committee, individual contract counterparties (e.g., a labor union), and the company equity holders. Each of these parties may have an interest in some valuation (or damages or transfer price) aspect of the bankruptcy proceeding.

Regardless of who the client is, the assignment is typically provided by the client to the analyst. The assignment should describe the objective of the valuation by considering the following elements of the analysis:

1. Definition of the subject intellectual property
2. Description of the ownership characteristics subject to analysis

3. Decision of the appropriate bundle of legal rights
4. Decision of the appropriate standard of value
5. Decision of the appropriate premise of value
6. Specification of the "as of" valuation date

Before these elements are defined, the purpose of the valuation assignment should be agreed to. That is, the elements of the assignment may also be influenced by the stated purpose of the valuation analysis. The purpose of the assignment should describe (1) why the valuation is being prepared and (2) who may (and may not) rely on the valuation analysis conclusions.

THE BANKRUPTCY VALUATION PURPOSE

Again, there are many reasons why an analyst may be asked to value the debtor company intellectual property. For this purpose, the subject intellectual property can include both (1) the intellectual property owned by the debtor entity and (2) the intellectual property operated by the debtor entity (including inbound and outbound licenses).

The intellectual property could serve as collateral for either the debtor entity's pre-bankruptcy financing or the DIP financing. An intellectual property sale or license could serve to generate needed cash flow for the financially troubled DIP. The analyst may be asked to opine on the fairness of the consideration or terms of an intellectual property sale or license. The analyst may be asked to opine on the impact of an assignment or a rejection of an intellectual property license. The analyst may assess this transactional fairness to the creditors or to other parties-in-interest.

Intellectual property value often affects the debtor company solvency (or insolvency) at various

dates prior to the bankruptcy filing. These debtor company solvency issues become relevant with regard to allegations of fraudulent conveyance or preference payments. Such solvency issues also may be relevant when the pre-filing debtor company is operating within the so-called zone of insolvency.

The intellectual property commercialization potential (or the associated spin-off opportunities) could affect the reasonableness of a proposed plan of reorganization. And, the fair value of the intellectual property may be recognized in the fresh-start accounting when the debtor company emerges from bankruptcy protection. Under U.S. generally accepted accounting principles (GAAP), the fresh-start accounting fair value measurement guidance is provided in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 852.

Counsel is often involved in the bankruptcy-related valuation. This is because counsel is involved in assisting the party-in-interest client in structuring transactions, complying with taxation and accounting requirements, negotiating and arranging financings, litigating claims, and defending and commercializing the intellectual property.

Within a bankruptcy controversy, counsel may become involved in the process of:

1. identifying the debtor company intellectual property,
2. performing the related due diligence procedures,
3. interviewing and selecting the appropriate analyst,
4. defining the analyst's assignment,
5. helping to assemble valuation-related data and documents,
6. providing legal instructions to the analyst,
7. reviewing and challenging the valuation work product,

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8. interpreting and relying on the valuation report, and
9. defending the analyst—and the value conclusions—during any administrative, regulatory, or judicial proceeding.

The analyst may value general (non-intellectual-property) intangible assets in a bankruptcy proceeding without legal advice from, or assistance by, counsel. However, due to the special nature of patents, copyrights, trademarks, and trade secrets, the analyst and counsel often work closely during the intellectual property valuation.

The following list summarizes some of the reasons why an analyst may be asked to value intellectual property in a bankruptcy controversy. Such assignments may come directly from a party-in-interest to the bankruptcy. However, such assignments may also come from counsel to one of the parties.

1. Transaction pricing and structuring
 - Pricing the sale of a DIP's individual intellectual property or of a portfolio of two or more intellectual property assets
 - Pricing the license of the DIP's individual intellectual property or of a portfolio of two or more intellectual property assets
 - Valuing the equity allocations in a DIP joint venture when one or more parties contributes intellectual property
 - Valuing the asset distributions in a debtor company liquidation when one or more parties receives distributed intellectual property assets
 - Transferring an intellectual property between a parent company's subsidiaries (when one subsidiary has filed for bankruptcy protection and another subsidiary

- has not filed for bankruptcy protection)
2. Financings collateralization and securitization
 - Use of the intellectual property as collateral for cash-flow-based or asset-based pre-bankruptcy debt financings
 - Sale/licenseback financing of the (pre-bankruptcy) debtor company intellectual property
3. Taxation planning and compliance
 - Effect of the intellectual property value on the Internal Revenue Code Section 382 limitation on the debtor company's use of a net operating loss
 - Effect of the intellectual property value on the Section 108 discharge of indebtedness income exclusion related to the debtor company amount of insolvency
4. Adequate consideration for the DIP transactions
 - Use of intellectual property as collateral for a secured creditor's position
 - Use of intellectual property as collateral for a new secured financing for the DIP
 - Fairness of the sale or license of intellectual property as a DIP cash generation spin-off opportunity
 - Use of the intellectual property in the assessment of the debtor company's solvency or insolvency with respect to alleged fraudulent transfers and preference actions
 - Impact of the debtor company intellectual property on the reasonableness of a proposed plan for the reorganization
5. Financial accounting and fair value measurement
 - Goodwill and intellectual property (as an identifiable intangible asset) fair value

- measurement impairment testing
 - Post-bankruptcy fresh-start accounting for the intangible assets of the debtor company emerging from bankruptcy
6. Debtor company strategic planning and management information
 - Formation of a DIP intellectual property joint venture, joint development agreement, or joint commercialization agreement
 - Negotiation of a DIP inbound or outbound intellectual property use, development, commercialization, or exploitation agreement
 - Identification and negotiation of a DIP intellectual property license, spin-off, joint venture, and other commercialization opportunity
 7. Other bankruptcy considerations
 - Prosecution or defense of secured creditor claims that the intellectual property collateral had "inconsequential value"
 - Assessment of the impact on the DIP's decision to reject intellectual property inbound/outbound license agreements
 - Assessment of the impact on a counterparty of the DIP's decision to reject intellectual property inbound/outbound license agreements

Defining the purpose of the assignment may influence the form or the format of the valuation work product. The analyst's valuation report can be oral, written, or a combination of the two. The analyst's valuation report should be prepared for a specified purpose and for a specified audience.

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The valuation analysis should consider all of the valuation approaches and methods that are relevant for the intended audience. And, the valuation report should include all of the information appropriate to the intended audience.

The assignment should describe the purpose of the valuation. That assignment purpose should consider the following elements of the analysis:

1. How will the intellectual property valuation be used?
2. Who will rely on (or receive a copy of) the valuation report?
3. What form and format of valuation report is appropriate?
4. Are there any legal instructions (e.g., specific statutory definitions, judicial precedent, or reporting requirements) that the analyst should consider?

In addition to understanding the reason for conducting the valuation, it is a best practice for the analyst to understand exactly what the analysis objective is. The client or counsel should define which of the following opinions the analyst is being asked to render:

1. Estimate a value (as specifically defined) for the debtor company intellectual property
2. Measure lost profits or some other damages measurement related to a tort or breach of contract related to the intellectual property
3. Conclude an arm's-length price for the intercompany transfer of the intellectual property
4. Estimate a fair license agreement royalty rate between independent arm's-length parties
5. Conclude the fairness of an intellectual property, sale, license, or other transfer transaction from a financial perspective
6. Estimate the intellectual property's useful economic life (UEL)

THE BANKRUPTCY VALUATION OBJECTIVE

The first element of the valuation objective is a definition of the debtor company intellectual property. That definition should specify exactly what patent, copyright, trademark, or trade secret is the subject of the valuation analysis. This definition should include the registration number and country for the patent or the copyright or the trademark (if registered).

This definition may describe any other identifiable intangible assets that should be included with the intellectual property as the subject of the valuation. For example, whether the trademark analysis includes related advertising materials and trade dress. Likewise, the statement of objective may describe whether the patent analysis includes product/process engineering drawings and any non-patented proprietary technology.

There may be uncertainty—or controversy—as to exactly what bundle of intangible assets should be included with (or excluded from) the bundle of the intellectual property that is the objective of the valuation.

For example, combining (1) the right to use certain technology (e.g., a patent) with (2) the right to use a trade name (which imposes some degree of quality control requirements) may result in a controversy. This combination of two intellectual property assets may maximize the combined value of the two assets. However, this combination of two intellectual property assets in one bundle may also impose an unbargained-for duty on the trade name licensor to create a new quality control management system.

In the intellectual property valuation, there may also be controversy as to whether to include future access to the assets (e.g., improvements, discoveries, new media) that are not in place as of the valuation date.

The second element of the valuation objective is a description of the ownership characteristics of the intellectual property rights, including any license or contract in effect.

When the debtor company operates within the so-called zone of insolvency, that condition may undermine the incentives for the debtor to (1) license any intellectual property and (2) make investments to exploit any license agreements that have already been entered into.

When a bankruptcy petition is filed and the bankruptcy stay has been entered, the debtor (as intellectual property licensor or licensee) cannot pursue a breach of contract action or an infringement action without authorization from the bankruptcy court.

If there is a license or agreement associated with the debtor's intellectual property, then the analyst should be made aware of all relevant contract terms, such as the following:

1. Licensor/licensee responsibility contract terms
 - Legal protection requirements
 - R&D expenditures
 - Marketing expenditures
 - Licenses, permits, or other regulatory approvals
2. Other contract terms
 - Minimum use, production, or sales
 - Minimum marketing or commercialization expense
 - R&D technology development payments, completion payments
 - Party responsible to obtain the required approvals
 - Milestone license payments

The third element of the valuation objective is a description of the bundle of legal rights. The assignment should specify which of the following (or which other)

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bundles of rights should be included in the valuation analysis:

1. Fee simple interest
2. Term/reversion interest
3. Licensor/licensee interest
4. Territory (domestic/international) interest
5. Product line/industry interest
6. Sublicense rights
7. Development rights
8. Commercialization/exploitation rights

The fourth element of the valuation objective is the standard (or the definition) of value. The standard of value typically relates to the question: Value to whom? Different standards of value often correspond to different reasons to conduct the valuation. The standard of value may be determined by a statutory, judicial, regulatory, or administrative requirement. Therefore, the client (or counsel) should instruct the analyst as to the appropriate standard of value.

Some of the alternative standards of value that may be concluded in an intellectual property valuation include the following:

1. Fair value
2. Fair market value
3. Use value
4. User value
5. Owner value
6. Investment value
7. Acquisition value
8. Collateral value

The fifth element of the valuation objective is the premise of value. The premise of value considers the assumed set of transactional circumstances under which the intellectual property transfer (i.e., sale or license) will take place.

Some of the alternative premises of value that may be applied in an intellectual property valuation include the following:

1. Value in continued use
2. Value in place (but not in use)
3. Value in exchange—orderly disposition basis

4. Value in exchange—voluntary liquidation basis
5. Value in exchange—involuntary liquidation basis

The selected premise of value is typically an assignment instruction from the client (or counsel) to the analyst. If the client (or counsel) does not instruct the analyst as to the appropriate premise of value, then the analyst may select the premise of value that concludes the highest and best use (HABU) for the intellectual property.

The tests for HABU are based on an analysis of what is physically possible, legally permissible, and financially feasible with regard to the subject intellectual property. For example, if the maximum value of the intellectual property is if it is “assembled” in combination with other assets as a group (as installed or configured), then the analyst may consider its value in continued use. If the maximum value of the intellectual property is on a stand-alone basis, then the analyst will consider its value in exchange.

In selecting the appropriate HABU of the debtor’s intellectual property, the analyst may consider the following alternatives:

1. Current owner/operator HABU
2. New owner/operator (marketplace) HABU
3. Licensor/licensee HABU

The sixth element of the valuation objective is the valuation date. The client (or counsel) will instruct the analyst as to the appropriate “as of” date on which to conclude the defined value. The date, or dates, as of which the intellectual property is valued may be important to the value conclusion. This is because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the valuation.

Many internal and external factors can influence intellectual property value. A sudden change in the debtor company earnings, especially if unanticipated, can have a material effect on value. Also, the intellectual property value can vary with the debtor company’s cost of capital, a factor that can vary over time. Major events, such as the signing or the termination of a license agreement, can also impact the intellectual property value.

In order to serve the information needs of the client, the analyst should have a clear understanding of the assignment. In a bankruptcy controversy assignment, counsel is typically responsible for ensuring that the analyst develops that understanding.

ANALYST DATA GATHERING AND DUE DILIGENCE PROCEDURES

Before selecting and applying any of the generally accepted valuation approaches, methods, and procedures, the analyst performs due diligence with respect to the debtor company intellectual property. Counsel may participate in this due diligence process. In particular, counsel may participate in the process if the valuation relates to an intellectual property transaction, financing, or litigation.

These due diligence procedures relate to identifying and obtaining information for the intellectual property valuation. The analyst’s due diligence process is a supplement to—and not a substitute for—counsel’s legal due diligence process.

First, the analyst typically gathers and analyzes information related to the current intellectual property owner/operator (i.e., the debtor company). The information typically relates to the intellectual property’s historical development and current use.

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Such information may include the following:

1. Owner/operator historical and prospective financial statements
2. Owner/operator historical and prospective development/maintenance costs
3. Current and expected owner/operator resource/capacity constraints
4. Description and estimate of the intellectual property economic benefits to the current owner/operator
 - Associated revenue increase (e.g., related product unit price/volume, market size/position)
 - Associated expense decrease (e.g., expense related to product returns, COGS, SGA, R&D)
 - Associated investment decrease (e.g., inventory, capital expenditures)
 - Associated risk decrease (e.g., the existence of an intellectual property license contract, decrease in the cost of capital components)

The analyst may consider the intellectual property's market potential outside of the debtor company. For example, the analyst may consider the following factors from the perspective of an alternative (e.g., hypothetical willing buyer/willing licensee) owner/operator:

1. Change in the market definition or in the market size for an alternative owner/user
2. Change in alternative/competitive uses for an alternative owner/user
3. The intellectual property's ability to create inbound/outbound license opportunities to an alternative owner/user
4. Whether the debtor company can operate the intellectual property and also outbound license the intellectual property (in different products, different

markets, different territories, etc.)

The analyst may also review and challenge any debtor-prepared financial projections and any debtor-prepared measurements of intellectual property economic benefits. The analyst may test such financial projections and economic benefit measurements against industry, guideline company, and other benchmark comparisons.

For example, the analyst may perform the following comparative benchmark analyses:

1. Compare prior debtor projections to prior debtor actual results of operations
2. Compare current debtor management projections to the debtor's current capacity constraints
3. Compare current debtor management projections to the current total market size
4. Consider published industry average comparable profit margin (CPM) data
5. Consider selected guideline publicly traded company CPM data
6. Consider the quality and the quantity of available guideline or comparable intellectual property license data
7. Perform an intellectual property UEL analysis, with consideration to the following:
 - legal/statutory life,
 - contract/license life,
 - technology obsolescence life,
 - economic obsolescence life,
 - lives (i.e., ages) of any prior generations of the subject intellectual property, and
 - the position of the subject intellectual property in its life cycle.

In addition to comparing the debtor company historical and projected results of operations to those of selected guideline public companies (described below), the analyst

TABLE 1

**Comparative Benchmark Analysis
Published Industry Data Sources**

- Financial Research Associates—Financial Studies of the Small Business
- The Risk Management Association – Annual Statement Studies: Financial Ratio Benchmarks
- BizMiner (The Brandow Company) – Industry Financial Profiles
- CCH, Inc. – Almanac of Business and Industrial Ratios
- Fintel, LLC – Fintel Industry Metrics Reports
- MicroBilt Corporation (formerly IntegralInfo) – Integra Financial Benchmarking Data
- ValueSource – IRS Corporate Ratios
- Schonfeld & Associates, Inc. – IRS Corporate Financial Ratios

may compare the debtor company results of operations to published industry data sources.

Table 1 above lists some of the published industry data sources that analysts may consider for these comparative benchmark analyses. The Table 1 data sources may allow the analyst to compare the debtor company financial results to benchmark industry expense ratios, profit margins, returns on investments, and other financial fundamentals. ↻

Future installments of this article will include:

- Valuation Approaches and Methods in Bankruptcy Controversies
- Valuation Synthesis and Conclusion
- Attributes of an Effective Report