Intellectual Property Valuation, Monetization, and Disposition in Bankruptcy

Introduction

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May, 2010

INTELLECTUAL PROPERTY VALUATION, MONETIZATION, AND DISPOSITION IN BANKRUPTCY

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TWO MILLION DOLLARS PER WORD

After lengthy and intense negotiations, the bankruptcy auction proceedings drew to a close around 3 am. The representatives of the winning bidder were satisfied that they had acquired a valuable asset for close to four million dollars. Their hard fought purchase consisted of intangible rights to two simple words, supported by trademark registrations, a handful of contracts, and the associated domain name and e-commerce site. These intangible assets embodied enough goodwill to justify what amounts to the two million per word price paid, although the last of 90 us stores bearing the brand had closed months before, after 40 years in business, and the entire inventory had been liquidated.

The "Tower Records" intellectual property was thus the last asset converted into cash to satisfy the claims of a multitude of creditors, but those two words were the foundation upon which an electronic retail business would, in a matter of weeks, continue to generate value for the new, overseas-based, owners.

IP AND THE BANKRUPTCY CONTEXT

The notion that Intangible Assets ("IA"), and particularly Intellectual Property ("IP") are an increasing proportion of total corporate assets is relatively undisputed by now. Industries such as pharmaceuticals, communications, and media are the clearest examples of this phenomenon. Pharmaceutical products depend on patent protection to establish a degree of niche monopoly to raise prices and recoup extraordinary investment costs, and patent offices across many jurisdictions routinely restore to patent owners the term lost to slow approval processes. Compatibility across diverse communication devices produced by otherwise competing manufacturers relies on standards and the pooling of patents embodying them. Media companies increasingly depend on controlling content, i.e. copyrights, rather than specific communication media, such as newspapers, television stations, etc.

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At appropriate stages in the economic cycle, stock analysts justify apparently excessive price-to-earnings ratios by attributing the incremental valuation to the un-reported value of internally generated trademarks, patents, and intangible assets in general.[1] This is a widely shared notion, but it is not the best way to measure the value of a corporation's IP, as evident by the consequence that it leads to an apparent evaporation of IP values in the subsequent and unavoidable bear markets as the book value of tangible assets is assumed to remain constant.[2]

Despite these difficulties, it is clear that most businesses find value in the characteristic adaptability and flexibility of trademarks – which can be extended or licensed, patents – which can also be licensed and traded, and intangibles in general. By contrast, tangible business assets can be quickly be in the wrong location, the wrong scale, using obsolete or uncompetitive production processes, and specialized in making outmoded products with few or very expensive ways to re-locate, re-tool, or sell.

Correspondingly, in corporate bankruptcy processes (restructuring and liquidation), intellectual property assets have been gaining in recognition as some of the most flexible, salvageable, and consequently most value assets the debtor possesses.

From an economic perspective, the bankruptcy process can be thought of as a set of laws providing for the regulated transfer of debtor's assets to creditors in order to settle claims. Consequently, the debtor's assets and liabilities must be valued, in a mutually and legally satisfactory way, to arrive at the appropriate transfer ratio between the parties. This is an eminently administrative process, not a freely negotiated transaction in a competitive market. Intangibles, furthermore, are typically unique and have few, if any organized secondary markets which can provide arm's length prices to establish values as they do for financial assets.[3]

Therefore, the bankruptcy valuation process must be carried out in a context of competing interests, under a necessity or compulsion to sell/buy, while ensuring all available, relevant, and valuable assets are taken into consideration. In the 21st Century, intellectual property has thus emerged as a significant, relevant, viable, and valuable asset class which can settle an increasing proportion of the claims and supporting, in some cases, the possibility of restructuring the original business retaining a substantial proportion of its value.

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[1] Since U.S., and international, generally accepted accounting principles (GAAP) do not allow for the reporting of internally-generated intangible asset values, it is only through acquisitions that the market value of intellectual property is recognized in the balance sheets of publicly-traded companies.

[2] It also assumes that market participants value stocks based on their (assumed) accurate value assessment of the (unobservable) intangible assets used in publicly-traded companies.

[3] In the aftermath of the real estate bubble, however, so called financial "toxic assets" had no easily discernible prices, contrary to the assumptions at their creation and issue.

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In the general area of IP and intangible assets, in the face of the increasing need noted above, the fact that generally accepted accounting principles (GAAP) do not reflect internally-generated assets such as trademarks, patents, and other intellectual property is an obstacle. At the outset, therefore, it is difficult to determine with certainty what IP and intangible assets the debtor actually owns and, moreover, what their book values were on the eve of filing. Nevertheless, Acquired IP and certain types of intangibles have been recognized in GAAP financials as a result of the implementation over the last few years of FASB's statements 141 and 142, as well as the international IFRS-3 standard.[4]

In practice, simple ratios and arbitrary "rules of thumb" have been used to fill this information gap, and closure, liquidation, financing, and restructuring decisions have been made on this incomplete basis. In the current environment, these practices are no longer acceptable, and the prevailing standard tends to include a specific audit of the IP and intangible assets, with appropriately wide variations among industries and the size and length of corporate history of the debtor.

Quality, Hierarchy, and Value

The intangibles a business entity undergoing the bankruptcy process possesses must be closely examined to determine realistic prospects for their monetization. The first consideration in this process is the performance of an IP inventory, whereby the basic questions as to the status of all registrations and applications are answered and licensees, licensors, as well as all other relevant intangible assets are clearly identified.

Business executives and their advisors must then refer to this inventory list and segregate core and peripheral assets. Core intangibles are those that are truly necessary for the continued operation of the line, or lines, of business which make up the core competency of the debtor. Over time and through M&A activities, the intangible inventory of most major companies gathers unused, obsolete, and redundant assets which must be identified as such. All non-core assets have a supporting role to play for the restructuring or liquidation of the bankrupt company and, as peripheral assets, their main characteristic is their separability from the core activities.

A clear example of this classification came up in the bankruptcy of a major innovator which had been developing chemical compounds for many years, prosecuting patents diligently, but only advancing

[4] The new accounting framework for business combinations requires acquiring entities to perform a detailed purchase price allocation that segregates the values attributable to trademarks and other IP from general "Goodwill," which has long been the "catch all" term reflecting the excess of total consideration paid over book value.

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some of these compounds into their core product.5 Some of the patents that did not make it into the company's core product were also bundled with brand names, which had trademark registrations, and extensive scientific documentation which would inform their best uses in other applications. From management's perspective, at the outset the monetization of any IP seemed doomed because their core product and technology had suddenly become obsolete in the context of rapidly advancing technology, and due to a major breakthrough in the company's main line of business. After a comprehensive IP audit, however, the patents, trademarks and trade secrets classified as peripheral assets not only had a higher fair market value than the core IP, but were enough to satisfy the majority of creditors' claims in the case. Years after, the core trademark assets remain a valuable and active asset in the global economy, and several applications in disparate chemical industry segments have benefited from the technology identified and monetized as peripheral assets of the original company.

In general, therefore, there are two dimensions to the IP inventory process: a qualitative audit; and a strategic review. The qualitative audit aspect of the IP inventory deals with the comprehensive examination of the intangibles the company owns, the classification of the assets in the basic core/periphery framework, while the strategic review is concerned with identifying alternative users, industries, processes, and exploitation methods for the assets, particularly those in the periphery.

Significant value can be uncovered by this process, whereby IP specialists work closely with the appropriate members of the management team at the debtor company, and perhaps other analysts from the appropriate advisors in the process.

THE VALUATION PROCESS

Although not every professional involved in the restructuring process needs to perform an IP valuation, they all require an understanding of the process in order to make informed decisions and provide the best advice. The valuation of intangibles is partly an application of the financial and economic valuation techniques used in assessing business valuations, and partly a specialized analysis of the drivers of value and the potential application of these assets. As in any valuation, clarity as to the definition of what is being measured is central to the interpretation of the numerical results. This is the first element of the valuation standards, to which we now turn.

Valuation Standards

Typically, the concept of value applied in bankruptcy analyses is either the seemingly familiar notion established by the IRS with reference the more general concepts of fairness and arm's length negotiations, i.e., the concept of "Fair Market Value," or the financial notion of "Fair Value" as utilized

[5] The debtor in this case is a well-known brand which has undergone several restructuring processes and is now a pure trademark licensing organization, no longer manufacturing products.

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under the guidance of the FASB. These confusingly similar notions can differ significantly in their quantification and, consequently, awareness of their distinctions is very important.

Fair Market Value is defined as "the price that (the subject intellectual) property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts."6 The key concept in this definition is the hypothetical nature of the market participants that would be selling/buying the subject asset. No specific information or advantages about the parties is part of this definition.

By contrast, for financial reporting purposes, the notion of Fair Value is "The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.7 In this case, as the rest of the FASB indicates, the specifics of the parties are important. In capitalizing the cost of acquiring a patent, for example, it does matter for its value that the buyer can bolster its competitive position by adding otherwise partial coverage of a key technology to an existing portfolio. The same patent in the hands of a new entrant to the industry will not be as valuable if this new owner cannot enforce a licensing strategy due to insufficient cost effectiveness or must accept lower royalties due to a weak negotiating position with respect to existing competitors. Thus, the Fair Market Value of the intellectual property will be the same in either case, but the Fair Value will be higher if the property is acquired by the established licensor.

Therefore, early in the valuation process, it will be critical for all professionals involved in using the information to be clear as to the applicable standard of value.

Methods

Given the standard, the next decision point is how the valuation is actually performed. Among the various financial valuation approaches, the Cost, Market and Income approaches are the most commonly applied. Their differences are important, because they attempt to measure economic value from diverse perspectives.

The Cost approach adopts the notion that an asset is worth today what it actually cost to develop in the past, or what in the current environment it would cost to reproduce the existing asset with a new one of equivalent utility. This notion is relevant for specific items of Intellectual Property that are relatively straight forward to reproduce, such as software with specified functionality, but the actual cost to develop a creative or breakthrough idea, or to create and maintain a trademark registration are logically unrelated to the economic value these assets can capture for a business enterprise. Generally, this

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[6] The typical source reference for this definition is IRS publication Num. 561 in the context of valuing donations.

[7] FASB SFAS 157 Issued in September, 2006.

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approach should only be used when the underlying assumptions are reasonably valid because, for the most part, Intellectual Property seldom can be attributed with intrinsic value, unlike tangible commodities such as gold.

The Market approach, on the other hand, strives to measure value by the range of prices actually observed in a relevant market, assuming informed market participants exist in sufficient numbers and execute a sufficient number of publicly-disclosed transactions. This, of course, has been a persistent problem for intangible assets in general, and Intellectual Property in particular; IP tends to be unique and secondary markets for IP are developing only gradually. As an indication of a range of reasonable values, however, it has been applied often enough so that suitable databases of IP licensing and sale transactions are being accumulated and can be used, in the most active industries like electronics, pharmaceuticals, and telecommunications, as reference points for ranges of value. Its application, nevertheless, is far from being generally accepted as it is in real estate transactions and the familiar price-to-earnings ratios of Wall Street finance.

Finally, the Income approach takes a more specific look at the realities that can be expected to determine the economic value creation made possible by the use of the intellectual property at issue. In this approach, value is measured by estimating the potential net revenue (or gross profit) streams of income that can be generated through licensing a property, the incremental price premium of a unique patented technology, or the exclusive exploitation of a copyright, and adjusting these forecasts to reflect the applicable degree of risk implicit in the projections and the time-value of money.8 If the entity under consideration does not earn royalties on the IP because it makes internal use of its own assets, then the relief from having to pay an opportunity cost of the royalties that a typical competitor would have to pay in the market for an equivalent property is considered the measure of value, in what is appropriately known as the “Relief form Royalty” method.

This is an excerpt of a chapter in the upcoming book Corporate Intellectual Property Management in the 21st Century, Wiley 2010

[8] The specific financial technique is the “Discounted Cash Flow” method based on the concept of the “Net Present Value.”

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