

Intangible Asset Valuations in Health Care Industry Transactions

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Financial advisers routinely assist the various parties to a health care industry corporate transaction. Financial advisers assist clients in all four phases of the corporate transaction: (1) the due diligence pricing and structuring phase, (2) the corporate governance and regulatory compliance “financial opinion” phase, (3) the financial accounting phase, and (4) the post-deal regulatory challenge or shareholder litigation phase. The identification and valuation of the subject health care entities’ intangible assets is an important component of the financial adviser’s procedures in each of these four corporate transaction phases.

INTRODUCTION

Financial advisers are often asked to assist participants in health care industry merger and acquisition (M&A) transactions during four distinct transaction phases. This statement is particularly true if one of the transaction participants is a not-for-profit organization.

First, the financial adviser may be asked to assist with the pricing and structuring phase of the transaction. This phase may involve due diligence procedures, alternative transaction structure valuations, and security design analyses.

Second, the financial adviser may be asked to assist with the corporate governance and regulatory compliance phase of the transaction. This phase may include the adviser preparing a fairness opinion, a solvency opinion, a fair market valuation, a reasonably equivalent value opinion, or some other type of transaction opinion.

Third, the financial adviser may be asked to assist with the financial accounting aspects of the transaction.

And, fourth, the financial adviser may be asked to assist with any contrarian review, a regulatory challenge, or shareholder litigation related to the transaction. This phase may involve forensic analyses and expert witness testimony. Introduction

There are numerous reasons why an independent financial adviser may be asked to conduct a health care industry intangible asset valuation. Virtually all of these health care industry valuation and related analyses involve the identification and valuation of the health care entity intangible assets. This analysis is the topic of this discussion.

First, this discussion considers the types of intangible assets that are commonly found in the health care industry. And, this discussion identifies the types of health care entities that commonly own or operate these intangible assets.

Second, this discussion reviews the various types of intangible asset valuation analysis.

Third, this discussion summarizes the differences between a notational valuation and a transactional valuation, particularly with regard to health care intangible assets.

Fourth, this discussion lists the most common categories of reasons to conduct the valuation.

Fifth, this discussion describes many of the individual reasons to conduct the valuation.

Finally, this discussion summarizes who should perform the health care industry intangible asset valuation; and, this discussion considers whether that determination of the appropriate type of financial adviser is affected by the reason for the analysis.

There are many parties who may ask the financial adviser to value the health care intangible asset. Most commonly, such requests come from the intangible asset own or operator. As described below, the health care industry owner/operator may have various notational or transactional reasons to value the intangible asset.

The financial adviser may also serve the informational needs of other parties who will transact with the owner/operator, such as a potential buyer, licensee, creditor, partner or other investor, joint venturer, or contract counterparty.

In addition, financial advisers are often retained by legal counsel representing various parties in a dispute involving the health care intangible asset.

Often, the financial adviser will serve as an independent adviser to a client with respect to the intangible asset valuation (or other economic) analysis. However, the financial adviser may also be an employee of the health care owner/operator or of some other party interested in the intangible asset analysis.

Typically the qualitative and quantitative analysis will not be affected by whether the financial adviser is an independent adviser to a client or an employee working for an employer.

Of course, the informational needs of the various parties may be different. For example, the buyer or licensee client may be very interested in the development history of the intangible asset.

In contrast, the owner/operator employer does not need a refresher course in the development history of its own intangible asset. The employer may simply need an estimate of the intangible asset value for property taxation, insurance, strategic planning, or some other purpose.

Whether the financial adviser is an independent adviser or an employee, an important first step in the analysis is to learn the reason for the intangible asset valuation. Understanding this reason will help the financial adviser decide whether the client/employer really needs a value estimate—or some other economic metric related to the intangible asset.

TYPES OF HEALTH CARE INTANGIBLE ASSETS

Exhibit 1 presents a nonexhaustive list of the types of intangible assets that are typically identified in health care industry valuations.

TYPES OF INTANGIBLE ASSET VALUATION ANALYSES

Health care owner/operators (and other parties) often ask for an intangible asset valuation when they don't really need a valuation. Therefore, let's review the different types of intangible asset analyses. After considering this list, the financial adviser can provide the type of service that the client really needs.

Owner/operators, legal counsel, and other parties often refer to all of these types of economic analyses as "valuation":

1. Valuation – the estimate of a defined standard of value for the intangible asset; the valuation date can be retrospective (as of a historical date), contemporaneous (as of a current date), or prospective (as of a future date)
2. Evaluation – an assessment of the potential economic benefits of the intangible based on some (typically hypothetical) future

Exhibit 1 Common Health Care Industry Intangible Assets

- Medical, dental, and other professional licenses
- Certificates of need
- Patient relationships
- Patent files and records (manual and electronic)
- Electronic medical records computer software
- Medical and administrative assembled workforce
- Office systems, procedures, and manuals
- Position or "station" procedures and manuals
- Facility operating licenses and permits
- Physician (and other professional) employment agreements
- Physician (and other professional) noncompetition agreements
- Executive (and other administrator) employment agreements
- Executive (and other administrator) noncompetition agreements
- Administrative services agreements
- Medical (and other professional) services agreements
- Facility or function management agreements
- Equipment and other supplier purchase agreements
- Service marks and service names
- Joint venture agreements
- A professional's personal goodwill
- An entity's institutional goodwill
- Equipment use or license agreements
- Medical (other professional) staff privileges
- Joint development or promotion agreements

conditions; this analysis could project future revenue produced, services provided, royalty income generated, expenses saved, or some other economic benefit.

An intangible asset evaluation often involves a “what if” assessment of possible alternative use scenarios.

3. Economic damages – a measurement of the lost profits, lost value, royalty rate, or other damages measure suffered by the intangible asset owner/operator due to the wrongful actions of another party; the wrongful actions are typically a breach of contract or a tort.

The economic damages are typically measured by a generally accepted damages measurement method, such as one of the “but for” methods, the with and without damages method, or the royalty rate method.

4. License royalty rate – an estimation of the arm’s-length royalty rate that a licensee would pay to a licensor for a license to use the health care intangible asset.

The license fee (typically expressed as a royalty rate) is market-derived in that it assumes independent parties entering into the license agreement; the royalty rate is typically a function of both (a) the economics of the subject intangible asset and (b) the terms and conditions of the subject license agreement.

5. Intercompany transfer price – a determination of the price related to a transfer of an intangible asset between controlled entities under common ownership.

The transfer price is determined as a proxy for an arm’s-length price that would be negotiated for the intangible asset transfer between unrelated parties; the intercompany transfer price is typically used for either (a) financial accounting purposes or (b) federal or state income tax accounting purposes.

6. Remaining useful life – an estimate of the remaining time period (i.e., the remaining useful life) over which the intangible asset will generate economic benefits to the owner/operator.

This analysis often also encompasses the conclusion of a value decay rate or depreciation rate—that is, the expected rate of the decrease in intangible asset value over time; this life estimate is typically used for either (a) financial accounting purposes or (b) income tax accounting purposes.

The financial adviser may be asked to conclude any of these intangible asset economic metrics for either notational purposes or transactional purposes.

TYPES OF HEALTH CARE ENTITIES

Exhibit 2 presents a nonexhaustive list of health care industry participants. These entities are typically the owner/operators of the health care intangible assets listed in Exhibit 1.

Exhibit 2

Types of Health Care Entities That Own/Operate Intangible Assets

- Ambulatory care centers
- Ambulatory surgical centers
- Home health care agencies
- Urgent care centers/clinics
- Dialysis/other specialty clinics
- Primary care and specialty medical practices
- Primary care hospitals
- Specialty (e.g., psychiatric) hospitals
- MRI and other imaging centers
- Primary care and specialty dental practices

NOTATIONAL ANALYSES VERSUS TRANSACTIONAL ANALYSES

The financial adviser can perform the most intangible asset analyses for either notational purposes or transactional purposes. As explained below, the purpose of the analysis may or may not affect (1) the analytical approaches and methods used and (2) the analysis conclusion reached.

Nonetheless, the purpose of the analysis (as notational versus transactional) is typically a function of the reason to conduct the intangible asset valuation (or other analysis). And, the financial adviser should understand:

1. the reason for performing the analysis and
2. whether that reason is satisfied by a notational analysis or a transactional analysis.

It may be easier to describe transactional valuations first. In a transactional valuation (or related analysis), there is an actual intangible asset transfer pending. The transaction can be a sale (a transfer of all rights) or a license (a transfer of some rights). The transaction can be a secured financing (this

transaction also involves a transfer of some legal rights).

In a transactional valuation, there is typically (1) a transfer of cash or some other valuable consideration, (2) a transfer of some or all of the legal rights related to the intangible asset, and (3) a negotiation between two or more parties involved in the transaction. Fairness opinions, solvency opinions, and adequate consideration opinions are examples of transactional valuation opinions related to a health care intangible asset sale, license, or other transfer.

In contrast, a notational valuation (or related analysis), the health care intangible asset does not actually transfer. In a notational valuation, typically there is no (1) transfer of cash or other consideration, (2) transfer of some or all of the intangible asset legal rights, and (3) negotiation between independent parties.

Notational valuations are often performed for financial accounting, taxation planning and compliance, strategic planning, or regulatory compliance purposes. Of course, these purposes are all important. And, the notational valuation may affect the owner/operator financial statements, and it may affect the owner/operator income, gift, or estate, or property tax expense.

Similarly, the notational valuation may affect whether the health care owner/operator has complied with a not-for-profit entity regulation, a debt covenant, or a joint venture agreement. And, the notational valuation may affect the health care owner/operator's future plans for an initial public offering, a commercialization program, or a restructuring of corporate assets.

However, in the case of the notational valuation, either the intangible asset transaction is already completed or it is not yet contemplated. Usually, no cash changes hands. Or, if cash changes hands (e.g., to pay taxes), it doesn't involve the transfer of the intangible asset.

And, the owner/operator is typically negotiating with itself as to:

1. which foreign or domestic subsidiary should own the intangible asset and
2. what the intercompany royalty rate or other transfer price will be for the use of that intangible asset.

Litigation-related valuations fall into either category of transactional valuation or notational valuation. If the finder of fact's decision results in a transfer of ownership for the intangible asset, then the valuation could be considered transactional. If the finder of fact's decision results in a monetary

damages award, then the valuation may be considered notational.

While a judicial award may result in monetary damages, the intangible asset ownership will not transfer between independently negotiating parties.

CATEGORIES OF REASONS TO VALUE INTANGIBLE ASSETS

Exhibit 3 presents some of the categories of reasons why a financial adviser may be asked to value a health care industry intangible asset. Many of the individual reasons will be described in the next section.

The list in Exhibit 3 is not intended to be comprehensive. Rather, this list is illustrative of the many reasons why a health care owner/operator, legal counsel, or other party may ask the financial adviser to value an intangible asset.

INDIVIDUAL REASONS TO VALUE HEALTH CARE INTANGIBLE ASSETS

The first category of individual reasons relates to the health care intangible asset sale, license, or other transfer.

Depending on the circumstances, most intangible assets can be sold:

1. independently as individual assets,
2. separately from a health care entity but as part of a portfolio of two or more assets, or
3. collectively as part of the assets of a health care entity.

In any of these two circumstances, the financial adviser can be asked to estimate a defined standard of value for the to-be-transferred intangible assets. Alternatively, the financial adviser could be asked to opine on the fairness of the pending or completed sale transaction. That fairness opinion could encompass the price of the proposed transaction, the terms of the proposed transaction, or other transactional factors.

Financial advisers are sometimes asked to opine on the solvency of the old health care owner/operator after the intangible asset sale or other transfer. And, financial advisers are sometimes asked to opine on the solvency of the new health care owner/operator after the intangible asset purchase, particularly if the purchase is financed.

1. Transaction pricing and structuring
 - Pricing the arm's-length sale of an individual intangible asset or a portfolio of two or more intangible assets
 - Pricing the arm's-length license of an individual intangible asset or a portfolio of two or more intangible assets
 - Calculating an exchange ratio between two owners for two respective intangible asset portfolios
 - Measuring the equity allocations in a new health care entity or joint venture when one or more parties contribute intangible assets
 - Measuring the asset distributions in a liquidating health care entity or joint venture when one or more of the parties receive intangible assets
 - Pricing the transfer of an intangible asset between two wholly owned subsidiaries (or between two unequally owned subsidiaries) of a consolidated health care entity
2. Financing collateralization and securitization
 - Using an intangible asset as the collateral in either a cash flow-based or an asset-based debt financing
 - Arranging the sale/licenseback financing of a health care intangible asset
3. Taxation planning and compliance
 - Forming an intangible asset holding company and structuring the intercompany intangible asset license to the taxpayer's operating companies
 - Performing income tax basis purchase price allocations (among the acquired tangible assets and intangible assets) in a taxable health care entity acquisition (e.g., an Internal Revenue Code Section 1060 asset acquisition)
 - Quantifying the amortization deduction for a purchased intangible asset
 - Valuing intangible assets in the taxpayer corporation insolvency exemption (Section 108) related to cancellation of debt (COD) income recognition
 - Valuing corporation intangible assets related to built-in gain (BIG) tax deferral upon the health care entity election to convert from C corporation to S corporation
 - Supporting the charitable contribution deduction for a donated intangible asset
 - Estimating the arm's-length price (ALP) for the cross border transfer and use of a multinational health care corporation's intangible asset (Internal Revenue Code Section 482 compliance)
 - Complying with state and local ad valorem property taxation of either taxable or tax exempt intangible assets
 - Defending against IRS allegations of private inurement, excess benefits, or intermediate sanctions with regard to intangible asset transfers between a for-profit entity and a not-for-profit entity
4. Regulatory compliance and corporate governance
 - Estimating the fair market value estimation of the intangible asset sale, license, or other transfer between a for-profit entity and a not-for-profit entity
 - Performing the fair market value (asset-based approach) valuation of a going concern health care entity to be sold between a for-profit entity and a not-for-profit entity
 - Documenting the custodial inventory and management of owned and licensed intangible assets
 - Assessing the adequate insurance coverage for owned and licensed intangible assets
 - Defending against infringement, misappropriation, diversion, other torts, breach of contract, and other wrongful acts to intangible assets
 - Defending against allegations of dissipation of health care entity assets

Categories of Reasons to Value Health Care Intangible Assets

5. Bankruptcy and reorganization
 - Valuing an intangible asset that is pledged as collateral for secured creditor financing
 - Using an intangible asset as collateral for debtor in possession (DIP) secured financing
 - Opining on the fairness (to creditors) of the sale or license of an intangible asset as a DIP cash generation spinoff opportunity
 - Valuing an intangible asset in the performance of the debtor corporation solvency or insolvency tests (particularly the balance sheet test) with respect to fraudulent transfer claims and preference actions
 - Measuring the impact of the intangible assets on the plan of reorganization of the bankrupt owner/operator
6. Financial accounting and fair value reporting
 - Preparing the acquisition accounting (i.e., transaction purchase price) allocation among acquired tangible assets and intangible assets
 - Testing for goodwill impairment and for other intangible asset impairment
 - Preparing the post-bankruptcy fresh start accounting for the emerging entity tangible assets and intangible assets of a health care entity emerging from bankruptcy
7. Forensic analysis and dispute resolution
 - Calculating an intangible asset lost profits, reasonable royalty rate, or other economic damages analysis in infringement or other tort claims
 - Measuring intangible asset lost profits or other economic damages in breach of contract, license, or noncompete/nondisclosure agreement damages claims
 - Estimating intangible asset valuation in condemnation, expropriation, eminent domain, or dissipation of corporate assets claims
8. Strategic planning and management information
 - Forming an intangible asset joint venture agreement, joint development agreement, or joint commercialization agreement
 - Negotiating an inbound or outbound intangible asset use, development, commercialization, or exploitation agreement
 - Identifying and negotiating of intangible asset license, spin-off, joint venture, and other commercialization opportunities

Intangible assets may transfer between for-profit entities and not-for-profit entities. Such transfers occur regularly in the health care industry. They also occur in education, charitable institution, museum and cultural institution, and other not-for-profit industries. In such instances, the intangible assets could be transferred individually, or they could be transferred as part of a going-concern business.

To comply with regulatory requirements related to private inurement and excess benefits, the financial adviser may be asked to prepare a fair market value valuation. In order to give assurance to the transaction participants, the fair market value valuation will have to conclude that the not-for-profit buyer did not pay more than fair market value for the intangible asset and the not-for-profit seller did not receive less than fair market value for the intangible asset.

The above-mentioned transactional fairness opinions and fair market value valuations apply to license transactions, as well as to sale transactions. In transactions where there are no taxation compliance considerations, one or more license transaction participants may want the financial adviser's assurance that the license is fair to the licensor, the licensee, or some other specified party.

Sometimes, the health care owner/operator (or the associated board of directors) wants the fairness opinion assurance. Sometimes, a minority stockholder, a partner, a joint venturer, or some other party wants the fairness opinion assurance.

Intangible assets are often transferred in the formation of a new health care entity and in the asset distribution of a dissolving health care entity. In the multi-investor formation of a new business, it is not uncommon for one investor to contribute

cash, another investor to contribute tangible assets, and another investor to contribute intangible assets.

This scenario is particularly common when the new business is structured as a partnership or joint venture. Of course, it is easy to value the one investor's cash investment. It is more challenging to value the next investor's contributed tangible assets. And, a financial adviser may be asked to value the final investor's contributed intangible assets.

The valuation of the health care entity contributed assets is needed for two reasons. First, the investors need to know their income tax basis in their equity interest (whether partnership units, member units, joint venture ownership percentage, etc.). Second, the investors need to know their relative equity ownership. That relative equity ownership is typically based on the asset contributions.

So, let's assume that partner A contributes \$2,000,000 of cash, partner B contributes \$3,000,000 of real estate and equipment, and partner C contributes \$5,000,000 of intangible assets. Absent some contrary contractual agreement, one would expect the equity allocation to be 20 percent, 30 percent, and 50 percent to A, B, and C, respectively.

Likewise, intangible assets are often distributed in the dissolution of the health care entity. Such distributions happen in both voluntary and involuntary dissolutions. And, such distributions may be planned (e.g., a joint venture that reaches its 10-year agreement term) or unplanned (e.g., the winding down of a financially troubled health care entity).

Let's continue with the previous illustration. Let's assume that a 10-year term joint venture between A, B, and C runs its course. At the end of 10 years, let's assume there is no cash left, the tangible assets have depreciated down to \$1,000,000 in value, and the intangible assets are now valued at \$4,000,000. That \$4,000,000 intangible asset value would be provided by the financial adviser.

In this dissolution example, there are \$5,000,000 of total assets to distribute. Based on the above-described equity allocation, the joint venture assets would be distributed based on the following values:

<u>Owner</u>	<u>Distribution</u>
A	\$1,000,000
B	1,500,000
C	<u>2,500,000</u>
Total	<u>\$5,000,000</u>

In order to achieve this asset allocation, all of the remaining assets could be sold for cash. Then, the cash could be distributed to the joint venturers. Or, if the intangible asset portfolio could be subdivided, then some of the patents could be distributed to A,

some of the intangible assets could be distributed to B, and the remaining intangible asset portfolio could be returned to C.

Such an allocation would require a valuation of the component intangible assets. And, most likely, A and B would enter into use license agreements with C. In those agreements, C would pay A and B royalty payments that would equal (on a present value basis) their asset allocations. And, the ownership of the intangible assets would revert to C at the end of the license term.

Again, the financial adviser would be instrumental in designing such a license agreement, including the selection of the royalty payment and the license term.

For legal, accounting, and operational reasons, the intangible asset owner/operator may transfer intangible assets between controlled entities (e.g., between wholly owned subsidiaries of a parent corporation). Even though (and, arguably, because) there are no independent parties involved, the financial adviser may be asked to value the intercompany intangible asset transfer.

Depending on the structure of the transaction, there may or may not be taxation or accounting implications to the intercompany transfer. Certainly, the parent company would want to keep track of what controlled entity owns what corporate asset (whether it is tangible or intangible).

The above-described intercompany transfer becomes particularly noteworthy when the intangible asset is transferred between a wholly owned subsidiary and a less than wholly owned subsidiary. In such an instance, the minority equity investor wants to ensure that the intangible asset transfers are occurring at a fair, arm's-length price.

In addition, the minority investor wants to ensure that any intercompany intangible asset licenses (and license fees) are set at fair, arm's-length prices.

The second category of individual reasons relate to intangible asset-related financing transactions.

Intangible assets are sometimes used as collateral to allow the health care owner/operator to obtain financing. This collateral pledge occurs when there is a more active secondary market for the subject intangible asset. In such a case, the creditor can feel more comfortable about accepting the intangible asset as debt collateral. An example of such relatively liquid intangible assets are drug formula patents and FDA approvals in the pharmaceuticals industry.

This type of collateral pledge also occurs when the debtor has no other assets to pledge as collateral. Let's consider the case where the debtor entity has already pledged its inventory, receivables, real estate, and equipment as prior loan collateral. The creditor may accept certain intangible assets as

collateral, because there are no other unencumbered collateral assets available.

Health care owner/operators may also enter into intangible asset sale/licenseback transactions as a form of structured financing. Such sale/licenseback transactions are most common with intellectual property.

When the intangible asset serves as debt collateral, the health care owner/operator is repaying principal and interest to the financial institution. The intangible asset title does not change hands, unless the debtor defaults and the creditor has to foreclose on the collateral property.

When the intangible asset is subject to a sale/license agreement, the intangible asset title passes from the owner/operator to the licensor. The prior owner/operator becomes a licensee.

The licensee pays license fees or royalties to the licensor. At the end of the license term, the intangible asset title typically reverts back to the owner/operator.

For both of the above-described financing transactions, the financial adviser may be asked to estimate a defined value for the subject intangible asset as of a current date—that is, the inception of the financing agreement.

The financial adviser may also be asked to predict a defined value for the health care intangible asset as of a future date—that is, the terminus of the financing agreement.

The third category of individual reasons relate to taxation planning and compliance. Within this category, the subcategories of individual reasons include income tax, gift and estate tax, and property tax.

With regard to federal income taxation, there are numerous individual reasons to value intangible assets. Perhaps the most common income tax reasons relate to business acquisition purchase price allocations. In this situation, a target health care entity is purchased by an acquiror business.

A total purchase price is paid for the target health care entity. And, the total purchase price has to be allocated among all of the acquired assets. The most common purchase price allocation situations include the following:

1. A cash for assets type of acquisition, where the acquisitive transaction is accounted for under Section 1060
2. A cash for stock type of acquisition, where the acquisitive transaction is accounted for by the election of a deemed liquidation under Section 338(h)(10)

In both of these instances, the acquired assets typically include Section 197 intangible assets. In

both of these instances, there is a priority of the purchase price allocation among the categories of acquired assets.

And, in both of these instances, the asset categories include the following:

1. Identifiable intangible assets (as the penultimate category)
2. Goodwill and going-concern value (as the last category)

Another common income tax reason relates to the transfer of intangible assets between domestic and foreign subsidiaries of a multinational corporation. The income tax implications of such international transfers are primarily controlled by the Section 482 regulations.

There are two types of intercompany transactions regarding multinational health care entity intangible assets.

First, such transactions may involve the transfer of the fee simple interest ownership between commonly controlled subsidiaries. The transfer can be from a U.S. subsidiary to a foreign subsidiary, or vice versa.

This type of intercompany transaction requires the financial adviser to estimate the fair market value of the transferred intangible asset as of the transfer date. The purpose for the valuation is to determine:

1. the tax basis of the intangible asset to the transferee entity and
2. any gain or loss related to the asset transfer.

Second, such transactions may involve the intercompany license of the transferred intangible asset between commonly controlled subsidiaries. The transaction could be a use license between the foreign subsidiary licensor and domestic subsidiary licensee.

In that case, the license royalty payment will be from the U.S. subsidiary to the foreign subsidiary, and the multinational taxpayer's U.S. taxable income would decrease.

Or, the transaction could be a use license between the U.S. subsidiary licensor and the foreign subsidiary licensee. In that case, the license royalty payment will be from the foreign subsidiary to the U.S. subsidiary, and the multinational taxpayer's U.S. taxable income will increase.

This type of intercompany transfer requires the financial adviser to estimate a fair arm's-length price for the intercompany use license. This arm's-length price should be concluded in compliance with the

specific intercompany transfer price measurement methods allowed in the Section 482 regulations.

There are other reasons to value health care intangible assets for federal income tax purposes. A financial adviser may be asked to estimate the fair market value of an intangible asset that is the subject of a charitable contribution. An owner/operator may need a valuation of a health care entity's intangible assets to help support a worthless stock deduction.

The taxpayer may also need a valuation of a health care entity's intangible assets in order to support a conclusion that the entity was insolvent. Such an insolvency finding can be used to offset the recognition of cancellation of indebtedness income.

Another common reason to value intangible assets relates to a health care entity's conversion from C corporation status to S corporation status. At the date of the conversion, the health care entity will need a valuation of all of its tangible assets and intangible assets.

Such a valuation is used to measure the amount of built-in gain (BIG) related to each of the corporation's assets. The conversion corporation can avoid the payment of tax on the BIG if the health care entity owns the assets for ten years after the date of the tax status conversion.

In addition to federal income tax, there are state income tax reasons to value health care intangible assets. Many multistate corporations have created intellectual property holding companies. Using such a structure, the parent corporation transfers its intellectual property to a subsidiary. That subsidiary has the responsibility to hold, protect, develop, and commercialize the parent's intellectual property.

As part of its function, the holding company may license the corporation's intellectual property to third-party licensees. The holding company may also license the corporation's intellectual property to other parent corporation units that operate in other states.

Effectively, the corporation operating units pay an intercompany license royalty payment to the intellectual property holding company subsidiary. That holding company subsidiary is domiciled in a state where such royalty income is exempt from state income tax.

So, the operating business units claim a tax deduction for the license payment expense in the states in which they operate. And, the intellectual property holding company does not pay income tax on the license income. Therefore, the parent corporation may recognize a decrease in its overall state income tax expense.

First, as part of the above-described intercompany intellectual property transfer, the corporate tax-

payer will need a valuation of the intangible assets that are transferred from the parent corporation to the intellectual property holding company.

Second, the holding company will need an analysis of the fair arm's-length price that it should charge to the corporation's operating units for the use of the intangible assets.

In addition to income tax, health care intangible assets may have to be valued for transfer tax reasons, specifically gift tax and estate tax. Decedent-owned intangible assets (including professional licenses) are included in the decedent's taxable estate. The appropriate standard of value is fair market value.

In addition, the decedent may own a closely held health care entity or a professional practice. In that case, the value of intangible assets could be the principal component of the value of the closely held health care business or professional practice.

The fourth category of individual reasons to value a health care intangible asset relates to regulatory compliance and corporate governance. Health care intangible asset sale or license transactions between for-profit entities and not-for-profit entities were discussed above.

When the transaction relates to health care industry entities, industry regulatory issues (in addition to taxation regulatory issues) provide a reason for the intangible asset valuation.

Related to health care industry transactions, the parties must comply with the Anti-kickback statutes, the Stark statutes, and various Office of Inspector General and State Attorney General regulations.

The health care intangible asset valuation can document compliance with the appropriate statutory authority and administrative rulings. Such a valuation may be important whether the health care industry transaction relates solely to transferred intangible assets or to intangible assets as a component of a transferred business enterprise.

Corporate officers and directors sometimes face allegations of breach of fiduciary duty, misappropriation, gross negligence, dissipation of corporate assets, and similar claims.

Depending on the specific claims, an intangible asset valuation may help to prove or disprove such allegations. A valuation that demonstrates corporate investment, development, protection, commercialization, and appreciation of the company intangible assets may help defeat allegations against officers and directors.

On the other hand, a valuation that documents a company's lack of investment and development, inadequate protection, no commercialization efforts, and depreciation of the health care intangible assets

may provide evidence of dissipation of corporate assets or other related allegations.

The fifth category of reasons to value a health care intangible asset relates to bankruptcy and reorganization proceedings. As mentioned above, the debtor company's intangible assets are sometimes pledged as collateral:

1. for secured financing in the normal course of business or
2. for debtor in possession (DIP) financing.

The identification and valuation of intangible assets is often an important component of the solvency (or insolvency) conclusion regarding the debtor company. Such a conclusion is an important consideration in the bankruptcy issues related to:

1. fraudulent conveyance claims and
2. preference payment claims.

Intangible assets often provide a source of cash flow generation for the DIP. Even if they were not actively involved in intangible asset commercialization activities previously, DIP companies can enter into intangible asset sale or license transactions.

The DIP can sell (and possibly license back) an intangible asset that has a greater value to the market than it does to the DIP. In addition, the DIP can license certain intangible assets (particularly intellectual property) to noncompetitor licensees, generating license income in the process.

In addition, intangible asset ownership, protection, and commercialization are often important components of the DIP company's proposed plan of reorganization. An intangible asset valuation can be used by the DIP, creditors, and other parties to the bankruptcy to support and/or challenge the proposed plan of reorganization.

The sixth category of reasons to value a health care intangible asset relates to financial accounting and fair value reporting. The Financial Accounting Standards Board (FASB) promulgates U.S. generally accepted accounting principles (GAAP).

GAAP is codified in the FASB Accounting Standards Codification (ASC). Several of the ASC topics relate to the fair value valuation of intangible assets.

ASC 820 relates to fair value measurements and disclosures. ASC 820 provides the fair value definition, the fair value measurement hierarchy, and other measurement and disclosure guidance related to both tangible assets and intangible assets (and to liabilities, as well).

ASC 805 relates to the acquisition accounting with respect to business combinations. The ASC

805 guidance relates to the fair value valuation of both acquired assets (including identifiable intangible assets) and liabilities.

ASC 350 relates to the tests for goodwill impairment. ASC 350 provides guidance for:

1. the test for determining whether recorded goodwill should be impaired and
2. how the goodwill impairment (if required) should be measured.

ASC 360 relates to the test for impairment related to other long-lived assets (including long-lived intangible assets). ASC 360 provides guidance related to:

1. the test for determining whether a recorded long-lived asset should be impaired and
2. how the long-lived asset impairment (if required) should be measured.

ASC 852 relates to accounting for corporate reorganizations. This ASC topic addresses the accounting and financial statement disclosure of a debtor company that emerges from chapter 11 bankruptcy protection.

In certain specified circumstances, such reorganized entities will adopt fresh-start reporting upon their emergence from chapter 11. Such fresh-start reporting includes the fair value valuation of the reorganized entity's assets (including intangible assets) and liabilities.

The seventh category of reasons to value a health care intangible asset relates to forensic analysis, litigation claims, and dispute resolution. Litigation claims involving intangible assets generally fall into two categories: (1) breach of contract and (2) torts.

Of course, a breach of contract claim requires that there be some type of contractual relationship between the parties. In a tort claim, there is no contract between the parties. Rather, one party owes a duty to the other party. And, the allegation is that the first party violated that duty.

Common examples of breach of contract claims include alleged violations of an intangible asset purchase or other transfer agreement, use license agreement, development agreement, commercialization agreement, or joint venture agreement.

Common examples of tort claims include breach of fiduciary responsibility, infringement, eminent domain and expropriation actions, interference with business opportunity, fraud and misrepresentation, slander, and libel.

For each of these types of litigation claims, there are generally accepted methods and procedures

“Different professionals have different skills and different credentials that may make them more or less suitable. . . .”

for measuring the economic damages suffered by the aggrieved party. These economic damages methods and procedures fall into three measurement categories:

1. Measurement of owner/operator lost profits related to the wrongful acts
2. Measurement of a fair royalty rate to compensate the intangible asset owner/operator for the wrongful acts
3. Measurement of a decrease in the intangible asset value due to the wrongful acts

The eighth category of reasons to value a health care intangible asset relates to strategic planning and management information. These reasons generally relate to the question: How can the owner/operator benefit in the future from the intangible asset use (or forbearance of use)?

The first reason in this category relates to the control of the owner/operator’s intangible asset. The owner/operator can use the valuation to inventory and to centralize internal control procedures related to the entity’s intangible assets.

The second reason relates to the protection of the owner/operator’s intangible asset. The owner/operator can use the valuation:

1. to assess the adequacy of the entity’s insurance on its intangible assets and
2. to document ownership and value of intangible assets in order to prosecute infringement and other damages claims.

The other reasons in this category generally relate to intangible asset commercialization opportunities. Based on the intangible asset valuation, the owner/operator could investigate and enter into license agreements, technology-sharing agreements, joint development agreements, joint commercialization agreements, and joint venture agreements.

The owner/operator could develop and implement nondisclosure and noncompetition agreements. And, the owner/operator could explore cash-generating intangible assets and other opportunities.

WHO IS THE APPROPRIATE INTANGIBLE ASSET VALUATION ANALYST?

There are many categories of professionals who perform health care intangible asset valuation (and

related) analyses. Each of these categories of professional has certain pros and cons related to who is best qualified to perform the valuation analysis.

To some extent, the selection of the type of valuation professional is a function of the owner/operator’s reason to conduct the intangible asset valuation. The various categories of intangible asset valuation analysts include (1) academics, (2) economists, (3) industry consultants, (4) licensing executives, (5) accountants, and (6) appraisers.

Each of these professionals brings certain experience and expertise to the valuation assignment. Each of these professionals can conclude a quantitative value (or damages, transfer price, etc.) conclusion. An important consideration for the owner/operator is: What other advice or service is desired in addition to the quantitative conclusion?

The health care owner/operator may want to answer that question in consultation with other professional advisers who may be involved with the intangible asset valuation reason (e.g., legal counsel, tax adviser, auditor, banker, etc.).

In addition to reporting the intangible asset value conclusion, the health care owner/operator may want the selected analyst to assist with the following tasks:

1. Preparing an offering document or other sales memorandum to begin the process of selling the intangible asset
2. Negotiating the terms of a license or other commercialization agreement
3. Identifying licensor or licensee candidates for a potential agreement
4. Advising with regard to the financial accounting for an intangible asset transaction
5. Advising with regard to the tax aspects for an intangible asset transaction
6. Advising the owner/operator on how to optimize the use of its intangible assets
7. preparing the intangible asset components of a bankruptcy plan of reorganization
8. Finding an interested financing source
9. Appearing before a government regulatory authority
10. Providing an expert witness report and courtroom expert testimony

Different professionals have different skills and different credentials that may make them more or less suitable for each of the above-mentioned tasks. In such instances, the owner/operator should decide what skills or credentials are needed—in addition to the ability to conclude an intangible asset value.

That is, for the specific assignment, the owner/operator may need a financial adviser who is also a PhD, a CPA, a tax expert, a health care industry expert, an experienced license negotiator, a licensed appraiser, and so forth.

In selecting the type of professional who is best suited for a particular assignment, the health care owner/operator (perhaps in consultation with legal counsel) should think through the intended purpose of—and the intended audience for—the intangible asset valuation.

Based on these considerations, the owner/operator can decide if the appropriate professional needs sale/license negotiation expertise, banking connections, health care industry experience, accounting and auditing credentials, expert testimony experience, and so forth.

In this selection process, the health care owner/operator should realize that some categories of analyst subscribe to codified professional standards and other categories of analyst may subscribe to more informal (or no) professional standards.

Some categories of analyst have achieved professional credentials; these credentials are typically earned through education, examination, compliance with codes of ethics, and adherence to published professional standards.

Other categories of analyst do not have professional organization credentials. This fact does not make these individuals any less “professional.” Such individuals may have perfectly adequate experience and expertise.

The owner/operator has to decide if a certain set of professional credentials is important to the subject valuation assignment.

SUMMARY

Financial advisers are often asked to assist participants in health care industry merger and acquisition (M&A) transactions during four distinct transaction phases. This statement is particularly true if one of the transaction participants is a not-for-profit organization.

First, the financial adviser may be asked to assist with the pricing and structuring phase of the transaction. This phase may involve due diligence procedures, alternative transaction structure valuations, and security design analyses.

Second, the financial adviser may be asked to assist with the corporate governance and regulatory compliance phase of the transaction. This phase may include the adviser preparing a fairness opinion, a solvency opinion, a fair market valuation, a

reasonably equivalent value opinion, or some other type of transaction opinion.

Third, the financial adviser may be asked to assist with the financial accounting aspects of the transaction.

And, fourth, the financial adviser may be asked to assist with any contrarian review, a regulatory challenge, or shareholder litigation related to the transaction. This phase may involve forensic analyses and expert witness testimony.

There are numerous individual reasons for a financial adviser to conduct a health care intangible asset valuation. This discussion summarized many of these reasons and considered the common categories of these individual reasons.

Understanding the reason for the intangible asset analysis is an important prerequisite to conducting the valuation, both for the financial adviser and the health care owner/operator. This is because an intangible asset valuation may not be the type of analysis that the owner/operator really needs.

Rather, the owner/operator may really need an economic damages measurement, a license royalty rate analysis, an intercompany transfer price study, a commercialization potential evaluation, or some other type of intangible asset analysis.

In addition, a clear definition of the reason for the valuation or analysis will allow the financial adviser to understand if (1) any specific analytical guidelines, procedures, or regulations apply and (2) any specific reporting requirement applies.

For example, intangible asset valuations prepared for fair value accounting purposes should meet specific ASC topic 820 fair value accounting guidance.

Intangible asset valuations performed for intercompany transfer price tax purposes should comply with the guidance provided in the Section 482 regulations.

Likewise, intangible asset valuations prepared for Section 170 charitable contribution purposes should comply with specific reporting requirements.

The individual reasons for the health care intangible asset valuation may influence the standard of value applied, the valuation date selected, the valuation approaches and methods applied, the form and format of valuation report prepared, and even the type of professional employed to perform the health care valuation.

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