

# The Identification and Valuation of Intellectual Property for Family Law Purposes

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*Valuation analysts (“analysts”) are often called on to value intellectual property for family law purposes. This is because a marital estate may own, directly or indirectly (through a family-owned or private company or professional practice), intellectual property. In such instances, the value of the intellectual property can be the subject of considerable controversy between the marital parties. For this reason, family law legal counsel—and other parties involved in the marital dissolution process—should (1) understand the procedures and factors commonly used to identify intellectual property assets, (2) recognize the generally accepted approaches to use to value intellectual property assets, and (3) be familiar with the intellectual property economic attributes that analysts consider when valuing intellectual property assets for family law purposes.*

## INTRODUCTION

There are many reasons why a valuation analyst (“analyst”) may be called on to value intellectual property in the context of litigation disputes. These reasons include providing assistance with infringement claims, breach of contract claims, damage claims, and tax controversies. Another common reason why analysts may be asked to value intellectual property is for family law purposes.

The marital estate may include either a direct or an indirect ownership interest in the subject intellectual property. That is, either spouse may directly own or operate the subject intellectual property. Or, either spouse may have an ownership interest in a private company or a professional practice that owns and operates the subject intellectual property.

Directly or indirectly, the value of the subject intellectual property may significantly affect the value of the marital estate. This is often the case when one or both spouses holds a license as a professional practitioner.

The meaning of the term “intellectual property” is widely understood by experienced valuation analysts. However, many business owner/operators, accountants and auditors, family law counsel (“counsel”) and judges, and other parties involved in the marital dissolution process may not have as strong an understanding of the term “intellectual property.”

These interested parties should be aware of what intellectual property is, as well as what is not considered intellectual property. And, these parties should be aware that there are generally accepted approaches and considerations related to the identification and valuation of intellectual property assets.

First, this discussion describes intellectual property and the procedures and factors that analysts commonly use to identify marital estate intellectual property.

Second, this discussion summarizes the generally accepted approaches that analysts use to value intellectual property for family law purposes.

Third, this discussion describes intellectual property economic attributes that analysts typically consider when valuing intellectual property within a family law context.

## INTELLECTUAL PROPERTY

There are four types of intellectual property: trademarks, patents, copyrights, and trade secrets. Each of these four types of intellectual property are legally created by and protected by a specific federal or state statute.

Each type of intellectual property is not an asset category that is separate from intangible assets. Rather, intellectual property is a specially recognized subset of intangible assets. Said another way, all intellectual properties are intangible assets, but not all intangible assets are intellectual property.

Intellectual property is a legal creation designed to reward innovation with market exclusivity. In the United States, intellectual property is typically registered under—and protected by—specific federal and state statutes.

These statutes give the intellectual property owner specific legal rights regarding the commercial development and the economic exploitation of the subject intellectual property. These statutes also give the intellectual property owner the right to prevent other parties from commercializing the subject intellectual property.

The legal recognition and protection of intellectual property that is found in the United States is also common among many other industrialized countries.

According to *The Concept of Intellectual Property*:

Countries have laws to protect intellectual property for two main reasons. One is to give statutory expression to the moral and economic rights of creators in their creations and the rights of the public in access to those creations. The second is to promote, as a deliberate act of Government policy, creativity and the dissemination and application of its results and to encourage fair trading which would contribute to economic and social development.<sup>1</sup>

Intellectual property has all of the identification-related and valuation-related economic attributes of other general commercial intangible assets. That is, like general commercial intangible assets, there is a specific bundle of property rights associated with intellectual property. However, unlike general



commercial intangible assets, intellectual property enjoys special legal recognition and monopolistic protection.

Another important distinction between intellectual property and general commercial intangible assets relates to how the subject asset is created. Intellectual property is intentionally created by specific human intellectual capital activity. And, such creative activity can be attributed to the activity of specifically identified individuals.

On the other hand, general commercial intangible assets are typically created in the normal course of the subject business operations. These general commercial intangible assets may include, for example, supplier contracts and relationships, customer contracts and relationships, employee relations (as represented by a trained and assembled workforce), licenses and permits, business operating systems and procedures, company books, records, and manuals, leasehold interests, and so forth.

Such general commercial intangible assets are typically created over time in successful going-concern business enterprises. That is, a distinction between intellectual property and general commercial intangible assets is the fact that business owner/operators typically do not make a special effort to create general commercial intangible assets.

Rather, as mentioned, such general commercial intangible assets naturally develop during the day-to-day operations of the subject business enterprise.

## THE FOUR CATEGORIES OF INTELLECTUAL PROPERTY

There are four common categories of intellectual property. These categories, or types, of intellectual property are described below.

## Trademarks and Trade Names

A trademark includes any word, name, symbol, or device, or any combination, used, or intended to be used, in commerce to identify and distinguish the goods of one manufacturer or seller from goods manufactured or sold by others, and to indicate the source of the goods.

Generally, a trademark lets a consumer know that a good is produced by a specific producer (such as the “Apple” from Apple or the Nike “Swoosh”). A service mark is the same as a trademark, except that it identifies and distinguishes the source of a service rather than a product. The “Golden Arches” of McDonald’s is an example of a well-known service mark.

The terms “trademark” and “mark” are commonly used to refer to both trademarks and service marks.

Trademark rights may be used to prevent others from using a confusingly similar mark, but not to prevent others from making the same goods or from selling the same goods or services under a clearly different mark. Trademarks may be registered with the United States Patent and Trademark Office. The Lanham Act protects trademarks and defines a trademark as “any word, name, symbol, or device, or any combination thereof.”<sup>2</sup>

This category of intellectual property also includes trade dress.

## Patents

A patent grants the patent holder the right to exclude others from making, using, or selling the patented invention or product for a specific duration of time. For example, a company that develops computer software will register a patent on each new program that it creates.

While the patent is in effect, no other computer software company can develop a software product using the patented program without permission of the patent owner. Once the patent expires, other computer software developers can produce identical software, generally in the form of generic programs.

Patents may be obtained for “any new and useful process, new machine, manufacture or composition of matter, or any new or useful improvement thereof.”<sup>3</sup>

The patents category of intellectual property includes (1) the three kinds of patents—utility, design, and plant patents—and (2) the associated patent applications.

## Copyrights

A copyright is an exclusive right to reproduce, publish, or sell an original work of authorship. Similar

to patents, the legal protection related to a copyright lasts for a limited period of time. An author of any original work owns a copyright on that original work the moment it is completed.

Typically, in order to have assurance of intellectual property legal protection, the author will register the copyright. Copyright law covers many forms of an author’s expression, including books, movies, paintings, and songs.

Specifically, copyrights exist in “original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device.”<sup>4</sup>

The intellectual property category of copyrighted material includes musical and literary compositions, other works of art, and copyrights in computer software and engineering drawings.

## Trade Secrets or Know-How

A trade secret can be any commercial information that has value due to the fact that it is kept confidential and is not publicly known. For intellectual property to qualify as a trade secret, the commercial information (1) is required to be kept secret from the public and (2) should provide a commercial advantage to the owner/operator of the business.

A trade secret is often a secret process, method, recipe, or formula for producing a certain product or service, such as the secret formula for Coca-Cola or the secret recipe for KFC fried chicken.

Specifically, a trade secret is “information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (1) derives independent economic value, actual or potential, from not being generally known . . . and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”<sup>5</sup>

The individual intellectual property in each of these four categories is generally similar in nature, feature, method of creation, and legal protection. Similar valuation approaches, methods, and procedures typically apply to the intellectual property in each of these four categories.

There are also legal distinctions between the various intellectual property categories. For example, there are specific legal rights related to the ownership of patents and copyrights. In the United States, a patent gives the grantee the right to exclude others from practicing the invention for a period of about 20 years.

In the United States, a copyright gives the intellectual property owner the exclusive right (1) to

reproduce, distribute, and perform the copyrighted work and (2) to create derivative works for the life of the author plus 70 years following the author's death.

A description of the additional specific legal rights of the various intellectual property categories is beyond the scope of this discussion. However, as illustrated above, each category of intellectual property assets has specific attributes that distinguish it from the other categories of intellectual property assets.

This distinction is important to make because it helps to identify intellectual property assets from the broader category of general commercial intangible assets within a marital dissolution context.

One characteristic of intellectual property is that it is transferable. That is, an ownership interest in the intellectual property should be able to be transferred from one party to another party. This statement does not indicate that the intellectual property must be transferred separately from any other asset. Rather, the intellectual property may be transferred with tangible assets or with other intangible assets.

## THE IDENTIFICATION OF INTELLECTUAL PROPERTY

For family law purposes, it is often important to distinguish between intellectual property and the broader category of general commercial intangible assets. This is because the marital estate may include either a direct or an indirect ownership interest in intellectual property that will be a part of the equitable distribution of the marital estate assets, as determined by the court.

Further, intellectual property may be more easily identified when it is owned directly by the marital estate, as opposed to when the intellectual property is combined with other commercial intangible assets in the operation of a family-owned business entity. This is because the existence (or ownership) of intellectual property may not be readily discernible from a company's financial statements.

Generally, only intellectual property that is acquired—as opposed to internally developed intellectual property—is required to be presented on a company's financial statements. And, the value of such an intellectual property may not be reflected in the company's current income or cash flow. This is because, for financial reporting purposes, most companies are not required to separately identify income that is derived from the ownership of specific intellectual property.

Despite the possible difficulties in identifying intellectual property within a marital estate, the analyst should be diligent to ensure that all of the marital-estate-owned intellectual property are identified. This is because the exclusion of a potentially significant marital asset (such as intellectual property) in a family law valuation could result in a material understatement of the equitable distribution of the marital estate.

## INTELLECTUAL PROPERTY VALUATION APPROACHES

Once the marital estate intellectual property has been identified, the typical next step includes estimating the value of the intellectual property to assist in equitable distribution of the marital estate assets.

The generally accepted intellectual property valuation approaches include the market approach, the income approach, and the cost approach.

For counsel (and other parties involved in the marital dissolution process) that are unfamiliar with generally accepted intellectual property valuation approaches, the following brief explanations may be helpful.

- **Market approach**—The market approach to valuing intellectual property is based on the related economic principles of competition and equilibrium.

In the market approach, value is estimated by (1) analyzing similar intellectual property that has been recently sold or licensed, (2) comparing the similar or “guideline” intellectual property to the subject intellectual property, and (3) applying pricing metrics derived from the guideline intellectual property to the subject intellectual property financial/operating fundamentals.

When applying the market approach, the level of comparability between the guideline intellectual property and the subject intellectual property, as well as the appropriate adjustments to account for any differences between the guideline intellectual property and the subject intellectual property, are important valuation variables.

- **Income approach**—The income approach to valuing intellectual property is based on the economic principle of anticipation (also called the principle of expectation).

In the income approach, value is estimated by analyzing the income and/or cash flow generated by the subject intellectual property owner/operator. The analysis

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focuses on the present value of the expected income to be earned from the ownership/operation of the subject intellectual property.

When applying the income approach, both (1) the accuracy and reliability of the projected income and/or cash flow and (2) the estimation of an appropriate discount rate, are important valuation variables.

■ **Cost approach**—The cost approach to valuing intellectual property is based on the economic principle of substitution.

In the cost approach, value is estimated by analyzing the current, market-derived cost to replace or recreate the subject intellectual property with intellectual property of equal functionality and/or equal utility.

When applying the cost approach, the reliability of the current, market-derived cost estimate and the estimation of the appropriate level of depreciation, including an allowance for any obsolescence, are important valuation variables.

The selection of intellectual property valuation approaches is typically based on the type or category of intellectual property, the availability of relevant data and information related to the intellectual property, and other facts and circumstances specific to the subject valuation analysis.

## **THE EFFECT OF INTELLECTUAL PROPERTY ATTRIBUTES ON VALUE**

In estimating the value of intellectual property, it is important for the analyst, as well as family law counsel, to thoroughly understand the effect that certain attributes can have on the subject intellectual property value.

This is because the specific economic attributes of intellectual property, which may not affect the value of general commercial intangible assets, can significantly affect the value of marital-estate-owned intellectual property (and, subsequently, the value of the marital estate to be equitably distributed to each spouse).

A subject intellectual property will typically possess all of the economic attributes that are common

to general commercial intangible assets. However, the intellectual property will also possess additional economic attributes that are not common to general commercial intangible assets, such as legal recognition and protection, for example.

This legal recognition and protection attribute is designed to have the dual effect of:

1. motivating and rewarding intellectual property innovators and creators and
2. protecting intellectual property owners and operators.

The legal attributes of intellectual property can affect the value of intellectual property in numerous ways, depending on the purpose and objective of the valuation assignment.

This discussion will focus on six generally accepted intellectual property legal attributes that may significantly affect the value of the marital estate intellectual property.

These generally accepted intellectual property legal attributes are as follows:

1. The legal life of the intellectual property asset
2. The opportunity to commercialize the intellectual property asset
3. The amount and quantity of market data regarding guideline intellectual property asset transactions
4. The generally greater royalty rates earned on intellectual property assets compared to other general commercial intangible assets
5. The quantity of judicial precedent relating to the intellectual property asset
6. The passive value of the intellectual property asset

First, most intellectual property has a specified legal life. This legal life measurement is an integral component of the intellectual property economic analysis. This is because the legal life may influence the analyst's estimation of the remaining useful life (“RUL”) of the intellectual property.

The intellectual property RUL estimation will influence:

1. the valuation methods that the analyst uses to analyze the subject intellectual property and
2. the type and amount of data and information required for the intellectual property valuation analysis.

Second, because of the special legal recognition and protection afforded to intellectual property, intellectual property owners generally have more commercialization opportunities. This is particularly true compared to the owners of general commercial intangible assets.

For example, intellectual property owners often enter into license, joint venture, or other exploitation and development agreements. These agreements allow the intellectual property owners to enjoy the economic benefits of commercializing the subject intellectual property separate and apart from their other business interests.

External commercialization opportunities can include licensing the use of and/or the development rights for the intellectual property:

1. through geographic expansion into new territories,
2. through industry expansion into new industries, and/or
3. through product expansion into new products.

In other words, the owner and the operator of an intellectual property can be (and often are) two different parties. Conversely, these external commercialization opportunities are typically not available to the owners of general commercial intangible assets.

For example, the owners of a favorable supplier contract, an ongoing customer relationship, or a trained and assembled workforce generally may derive the economic benefits from these intangible assets by commercializing them only within their own business operations (i.e., the owner and the operator of a general commercial intangible asset are typically the same party).

These external commercialization opportunities also provide guideline, objective market-based data with regard to the value of various intellectual property assets, which can assist the analyst and counsel in considering the market approach when estimating the value of the family law intellectual property assets.

Therefore, and with regard to the third generally accepted legal intellectual property attribute, there are more transactional data available for valuation or other economic analysis regarding intellectual properties as compared with other general commercial intangible assets.

That is, because there are more reported intellectual property sale/license transactions, there is more data available regarding the sale, license, or other external commercialization of intellectual property.

There are more reported sale or license transactions because intellectual property owners are more confident about entering into external commercialization transactions than are general commercial intangible asset owners. This is because parties to a transaction know that their legal and economic interests are more likely to be protected by the laws associated with their particular intellectual property asset.

Fourth, an intellectual property asset generally enjoys higher royalty rates and higher market value pricing multiples than do general commercial intangible assets. That is, an intellectual property asset will commonly trade (i.e., be licensed or sold) at higher prices than general commercial intangible assets.

This is because intellectual property buyers and licensees are willing to pay more for an intellectual property due to the protection and reduced risk afforded to them by intellectual property laws.

Fifth, there is substantially more judicial precedent regarding intellectual property than there is regarding general commercial intangible assets. This judicial precedent attribute itself has three implications:

1. There is greater judicially determined definitions of certain intellectual property than of general commercial intangible assets. For example, due to infringement and other litigation, courts have defined to some extent what a trade name is and what a trade secret is. Analysts can generally rely on these definitions in the identification and valuation of intellectual property.

There is much less published precedent regarding general commercial intangible assets such as supplier relationships, customer relationships, business operating systems and procedures, or intangible value in the nature of goodwill. Therefore, there is somewhat less definition (at least, judicial definition) as to what constitutes these general commercial intangible assets.

2. With respect to certain intellectual property, there have been more judicial decisions regarding (a) appropriate (and inappropriate) valuation methodologies, (b) reasonable ranges of royalty rates, and (c) reasonable profit margins than of general commercial intangible assets.

Again, judicial precedent may provide valuable guidance to the analyst and counsel when analyzing the family-owned intellectual property. This is not to suggest that analysts should naively apply valuation

pricing multiples or royalty rates in a specific intellectual property analysis just because they are published in a judicial decision.

Obviously, such pricing multiples and royalty rates are only appropriate given the unique facts and circumstances of the specific court case. Nonetheless, a review of published precedent may provide the analyst (and counsel) with an indication of a reasonable range of pricing multiples, royalty rates, profit margins, and so forth.

3. Commercial participants (that is, buyers, sellers, licensors, licensees) in the intellectual property secondary market will be generally aware of the amount of judicial precedent. This judicial precedent will inform market participants that (a) federal and state intellectual property laws exist and (b) the courts recognize and protect various types of intellectual property.

This level of judicial awareness and protection may motivate market participants to enter into more intellectual property market transactions. This is because market participants may consider the intellectual property market to be relatively safe and protected based on the amount of intellectual property judicial precedent.

Sixth, it is noteworthy that these intellectual property economic attributes can have a positive effect on both the active value and the passive value of the intellectual property.

Active value is generated when an intellectual property asset is used proactively (that is, to increase the intellectual property owner/operator price levels, market share, or profits).

Passive value is generated when an intellectual property asset is used defensively (that is, to protect the intellectual property owner/operator price levels, market share, or profits).

In other words, both active value and passive value may be positively influenced by the legal attributes and the economic attributes of the intellectual property asset as compared to general commercial intangible assets.

For the analyst, and for counsel, the value of the marital estate intellectual property may be observed by examining how the marketplace treats the specific economic attributes of the intellectual property asset.

The six intellectual property attributes discussed above encompass some of the market-specific and

asset-specific attributes that the analyst (and counsel) should consider when valuing intellectual property within a family law context.

## SUMMARY AND CONCLUSION

When a marital estate owns intellectual property, either directly or indirectly (through a family-owned or private company or professional practice), the value of that intellectual property can be the subject of considerable controversy during the marital dissolution process. This is because the intellectual property owner/operators, accountants and auditors, counsel and judges, and other parties involved in the family law process often have differing opinions of the value of the marital-estate-owned intellectual property.

These parties should be aware that there are generally accepted approaches, methods, and procedures related to:

1. the identification of intellectual property and
2. the valuation of intellectual property.

This discussion described intellectual property, and described the procedures and factors that the analyst typically applies to identify intellectual property. This discussion also summarized the four categories of intellectual property: trademarks, patents, copyrights, and trade secrets.

This discussion summarized the generally accepted approaches that an analyst may apply to value intellectual property for family law purposes.

Finally, this discussion described the intellectual property legal and economic attributes that the analyst, as well as counsel, should consider when valuing marital estate intellectual property.

### Notes:

1. *The Concept of Intellectual Property*, World Intellectual Property Organization at [www.wipo.int](http://www.wipo.int).
2. 15 U.S.C. §1127.
3. Melvin Simensky and Lanning Bryer, *The New Role of Intellectual Property in Commercial Transactions* (New York: John Wiley & Sons, 1994).
4. Ibid.
5. Ibid.

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