

What Business Lawyers Should Know About Intangible Asset Valuation

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Discussion Outline

- What economic attributes qualify as intangible assets
- What economic attributes don't qualify as intangible assets
- When and how do business lawyers encounter intangible assets
- Intangible asset standards of value and premises of value
- Various bundles of rights subject to analysis
- Various intangible asset opinions that lawyers may need
- Generally accepted valuation approaches and methods
- Attributes of an effective intangible asset valuation report
- Attributes of a valuation expert who works effectively with counsel
- Summary and conclusion; questions and discussion



What is an Intangible Asset?

- It must be an asset, and it must be intangible
- Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 5 (CON 5) provides guidance on what is an asset:
 - It must provide probable future economic benefits
 - The owner/operator must be able to receive the benefit and restrict others from access to the benefit
 - The event that provides the right to receive the benefit has occurred
- Intangible means something that lacks physical substance
- For an intangible asset, intangible means that the economic benefit of the asset does not come from its physical substance
- Intangible asset value is based on the rights and privileges to which it entitles the owner/operator



Intangible Asset Attributes

- An intangible asset should have the following attributes:
 - It is subject to a specific identification and recognizable description
 - It is subject to legal existence and legal protection
 - It is subject to the rights of private ownership, and that private ownership should be transferable
 - There is some tangible evidence or manifestation of the existence of the intangible asset
 - It is created or it comes into existence at an identifiable time or as the result of an identifiable event
 - It is subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event
 - There should be a specific bundle of legal rights associated with the intangible asset



Intangible Asset Transferability

- An intangible asset should be capable of being sold or transferred either (1) by itself or (2) with other intangible assets or (3) with other tangible assets
- If an intangible asset is transferable as part of a bundle of assets, then it is transferable
- An intangible asset does not need to be transferable separately and independently from any other assets
- Some intangible assets are typically transferred separately from other tangible or intangible assets
- Other intangible assets are typically transferred as part of an assemblage of assets
- Regardless of the structure of the transfer, the intangible asset ownership should be transferable from one owner to another owner



Difference Between Tangible Assets and Intangible Assets

- The tangible elements of an intangible asset (e.g., a list of software source code) do not convert that asset into a tangible asset
- The important economic difference between a tangible asset and an intangible asset is this:
 - The value of a tangible asset is derived from its tangible nature
 - The value of an intangible asset is derived from its intangible nature



Intangible Influences or Attributes

- Intangible influences or intangible attributes are not intangible assets
- Intangible factors or influences that do not qualify as intangible assets include the following:
 - High market share
 - High profitability or high profit margin
 - Lack of regulation
 - A regulated (or protected) position
 - Monopoly position (or barriers to entry)
 - Market potential
 - Breadth of customer appeal
 - Mystique
 - Heritage or longevity
 - Competitive edge
 - Life-cycle status
 - Uniqueness
 - Discount prices (or full prices)
 - Positive image
 - First to market
 - Technological superiority
 - Consumer confidence/trustworthiness
 - Creativity
 - High growth rate
 - High return on investment
- These attributes may increase the value of the actual intangible assets



Accounting Standards Codification 805

Categories of Identifiable Intangible Assets

- ASC 805-20-55 presents five categories of identifiable intangible assets:
 - Marketing-related intangible assets
 - Customer-related intangible assets
 - Artistic intangible assets
 - Contract-related intangible assets
 - Technology-related intangible assets
- According to ASC 805, goodwill is also an intangible asset, although it is not an identifiable intangible asset



ASC 805 Marketing-Related Intangible Assets

- Examples of marketing-related intangible assets:
 - Newspaper mastheads
 - Trademarks, service marks, trade names, collective marks, certification marks
 - Trade dress
 - Internet domain name
 - Noncompetition agreements



ASC 805 Customer-Related Intangible Assets

- Examples of customer-related intangible assets:
 - Customer lists
 - Customer contracts and related customer relationships
 - Noncontractual customer relationships
 - Order or production backlogs



ASC 805 Artistic-Related Intangible Assets

- Examples of artistic-related intangible assets:
 - Plays, operas, ballets
 - Books, magazines, newspaper, and other literary works
 - Musical works such as compositions, song lyrics, and advertising jingles
 - Photographs, drawings, and clip art
 - Audiovisual material including motion pictures, music videos, television programs



ASC 805 Contract-Related Intangible Assets

- Examples of contract-based intangible assets:
 - License, royalty, standstill agreements
 - Advertising contracts
 - Lease agreements
 - Construction permits
 - Construction contracts
 - Construction management, service, or supply contracts
 - Broadcast rights
 - Franchise rights
 - Operating rights
 - Use rights
 - Servicing contracts
 - Employment contracts



ASC 805 Technology-Related Intangible Assets

- Examples of technology-based intangible assets:
 - Patented or copyrighted software
 - Mask works
 - Unpatented technology
 - Databases
 - Trade secrets



Section 197 Intangible Assets

- Internal Revenue Code Section 197 also provides a list of amortizable intangible assets
- This Section 197(d)(1) list is used for many income tax purposes:
 - (A) goodwill,
 - (B) going concern value,
 - (C) any of the following intangible items:
 - (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
 - (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers)
 - (iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,
 - (iv) any customer-based intangible,
 - (v) any supplier-based intangible, and
 - (vi) any other similar item,



Section 197 Intangible Assets (cont.)

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.



Intellectual Property

- Intellectual property assets represent a small subset of general intangible assets
- Intellectual property includes the following four categories only:
 - Patents
 - Copyrights
 - Trademarks
 - Trade secrets



How Business Lawyers Encounter Intangible Asset Valuation Questions

- Advising clients on taxation matters
 - Acquisition purchase price allocations
 - Charitable contributions of corporate intangible assets
 - Intercompany transfer prices for multinational transfers of intangible assets
 - Gift and estate tax planning for high net worth individuals
 - State and local property tax for industrial and commercial clients
 - Fairness of transactions between for-profit entities and not-for-profit entities
- Contract and other commercial litigation
 - Breach of contract, causing intangible asset damages
 - Breach of joint venture agreement, where parties contributed intangible assets
 - Breach of intangible asset commercialization or license agreement
 - Shareholder litigation involving fair value of closely held business



How Business Lawyers Encounter Intangible Asset Valuation Questions (cont.)

- Intellectual property law
 - Infringement and other tort claims
 - Structuring of IP license agreements
 - Breach of IP license agreements
- Securities law
 - Fraud against the market based on financial statement misrepresentation
 - Misrepresentation of acquisition target financial statements
 - Equity allocation in a business formation, when one party contributes intangible assets
 - Asset distributions in a business dissolution



How Business Lawyers Get Involved with Intangible Assets (cont.)

- Bankruptcy
 - Effect on solvency of a debtor corporation
 - Effect on fairness of debtor in possession transactions
 - Use as collateral for debtor in possession financing
 - Effect on reasonably equivalent value of debtor transactions
- Commercial financing and other leveraged transactions
 - Effect on corporate solvency during leveraged transactions
 - Effect on fairness of proposed M&A transactions
 - Effect on fairness of related-party transactions
 - Intangible assets as collateral in sale/licenseback transactions



Intangible Asset Standards of Value

- Alternative standards of value
 - Fair market value
 - Market value
 - Fair value
 - Intrinsic value
 - Acquisition value
 - Use value
 - User value
 - Investment value
 - Owner value
 - Collateral value
- The standard of value answers the question: Value to who?
- The appropriate legal standard of value is based on statutory authority and judicial precedent



Intangible Asset Premises of Value

- Highest and best use (HABU) criteria
- Alternative premises of value include:
 - Value in continued use
 - Value in place
 - Value in exchange—orderly disposition
 - Value in exchange—voluntary liquidation
 - Value in exchange—involuntary liquidation
- The premise of value answers the question: How will the intangible asset exchange transaction take place?
- The appropriate legal premise of value may be based on legal authority or on the analyst's HABU conclusion



Types of Intangible Asset Bundles of Legal Rights

- Fee simple
- Term interest
- Life interest
- Residual/reversionary interest
- Licensor or franchisor interest
- Licensee or franchisee interest
- Sub-license or sub-franchisee rights
- Development rights
- Exploitation rights
- Commercialization rights
- Use rights—territorial/geographic
- Use rights—product/industry rights



Considerations Related to the Intangible Asset Bundles of Legal Rights

- Intellectual property type
- Term(s) of the transfer
- Territory of the transfer
- Products/services covered
- Ability to sublicense
- Ability to modify
- Exclusive/nonexclusive use
- Ability to assign
- Development responsibility
- Commercialization responsibility
- Maintenance responsibility
- Legal responsibility
- Registration responsibility
- Regulatory responsibility
- Minimum sales activity
- Minimum promotion activity



Intangible Asset Analysis Opinions That Lawyers May Need

- The lawyer should instruct the valuation analyst as to the type of intangible asset opinion that is needed in the subject matter:
 - fair market value valuation
 - other defined valuation opinion (e.g., reasonably equivalent value in a bankruptcy matter)
 - intangible asset exchange ratio analysis
 - fairness opinion (for an intangible asset sale or license)
 - opinion on license terms, remaining life, royalty rate, etc.
 - solvency opinion
 - economic damages opinion
 - intercompany transfer price opinion
- The type of intangible asset analyst's opinion is based on the lawyer's legal requirements



Generally accepted Intangible Asset Valuation Approaches and Methods

- Cost approach methods
 - Reproduction cost new less depreciation method
 - Replacement cost new less depreciation method
 - Trended historical cost less depreciation method
- Market approach methods
 - Relief from royalty method
 - Comparable uncontrolled transactions method
 - Comparable profit margin method
- Income approach methods
 - Differential income (with/without) method
 - Incremental income method
 - Profit split method (or residual profit split method)
 - Residual (excess) income method



Intangible Asset Cost Approach Valuation Components

- All cost approach methods include a current cost measurement and a depreciation measurement
- Four cost components
 - Direct costs (direct materials and direct labor)
 - Indirect costs (overhead and administrative expenses)
 - Developer's profit (on the direct and indirect costs)
 - Entrepreneurial incentive (opportunity cost—or lost income—during the replacement period)
- Three depreciation components
 - Physical depreciation (not a significant factor)
 - Functional/technological obsolescence (consider the intangible asset RUL)
 - Economic/external obsolescence (consider the intangible asset ROI)



Intangible Asset Cost Approach Valuation Components (cont.)

- Typical cost approach valuation formula

Replacement cost new
less Functional obsolescence
less Technological obsolescence
less Economic/external obsolescence
equals Fair Value

- Cost approach valuation considerations
 - All cost components (including opportunity cost) included in the measurement
 - Treatment of excess capital (development) costs and excess operating costs
 - Consideration of the intangible asset RUL
 - Consideration of owner/operator economic obsolescence



Intangible Asset Market Approach

Valuation Components

- Valuation pricing metrics are based on either comparable or guideline
 - licenses of intangible assets
 - sales of intangible assets
 - companies that use intangible assets
- Valuation variables and procedures
 - Quantitative/qualitative analysis of the subject intangible asset
 - Guideline license/sale/company selection criteria
 - Guideline license/sale/company selection
 - Verification of the selected transactional data
 - Analysis of the selected transactional data
 - Selection of the appropriate pricing metrics
 - Selection of the pricing multiples specific to the subject intangible asset
 - Application of the selected pricing multiples to the subject intangible asset metrics



Intangible Asset Market Approach Valuation Components (cont.)

- Market approach valuation considerations
 - Seasoned guideline intangible asset/development stage subject intangible asset
 - Development stage guideline intangible asset/seasoned subject intangible asset
 - State of the competition in the owner/operator industry
 - Comparable profit margins—is the subject intangible asset the only reason for the difference in profit margins between the owner/operator company and the selected CPM companies?



Intangible Asset Income Approach Valuation Components

- Common intangible asset income concepts include:
 - incremental (or differential) owner/operator revenue
 - decremental owner/operator expense
 - decremental owner/operator investment
 - decremental risk to the owner/operator
- Common income measures (related to the subject intangible asset) include:
 - EBITDA
 - EBIT
 - NOI (EBITDA less income taxes)
 - Net income
 - Net cash flow



Intangible Asset Income Approach Valuation Components (cont.)

- Income approach valuation formula
 - Yield capitalization methods, based on a non-constant growth income projection
 - over a finite RUL projection period
 - over a finite RUL projection period with a terminal value
 - Direct capitalization methods, based on a constant growth income projection
 - over a finite RUL projection period
 - over a perpetuity projection period



Intangible Asset Income Approach Valuation Components (cont.)

- Income approach valuation considerations
 - Match the selected discount/capitalization rate with the selected income measure
 - Match the selected discount/capitalization rate with the subject intangible asset risk
 - Consider the state of the competition in the owner/operator industry
 - Consider all subsequent (to the valuation date) capx, R&D expenses, marketing expenditures, etc.
 - Analyze only the income that is directly related to the subject intangible asset
 - Present value the projected income over either:
 - the intangible asset average RUL
 - down the intangible asset RUL decay curve



Intangible Asset Valuation Synthesis and Conclusion

- The synthesis and conclusion is the last procedure in the valuation process
- The analyst typically performs a valuation reconciliation procedure related to the alternative value indications
- The analyst answers the following questions:
 - Did I value the right thing? That is, did I analyze the correct intangible asset?
 - Did I value the right thing the right way? That is, did I apply the appropriate valuation approaches, methods, and procedures?
 - Did I reach the right value conclusion? That is, did I correctly apply the valuation procedures that I performed in order to reach a reasonable and supportable value estimate?
 - Did I do what I intended to do? That is, did I perform the assignment that I set out to perform? Did I achieve the purpose and objective of the assignment?



Attributes of an Effective Intangible Asset Valuation Report

- In order to encourage the reader's acceptance, the effective intangible asset valuation report should be:
 - clear, convincing, and cogent
 - well-organized, well-written, and well-presented
 - free of grammar, punctuation, spelling, and mathematical errors
 - procedurally and mathematically replicable, without the use of any unexplained or unsourced valuation variables
- The persuasive intangible asset valuation report will tell a narrative story that:
 - defines the valuation analyst's assignment,
 - describes the analyst's data gathering and due diligence procedures,
 - justifies the analyst's selection of (and rejection of) the generally accepted valuation approaches, methods, and procedures,
 - explains how the analyst performed the valuation synthesis and reached the final value conclusion,
 - defends the analyst's intangible asset value conclusion, and
 - describes all of the data sources that the analyst relied on (and includes copies of non-public source documents)



Intangible Asset Valuation Report Errors to Avoid

- An effective intangible asset valuation report will avoid these common errors:
 - Failure to apply the defined standard of value
 - Failure to apply the defined premise of value
 - Analytical internal inconsistencies
 - Arithmetic errors in the valuation analysis
 - Insufficient support for the selected valuation variables
 - Reliance on industry or other rules of thumb
 - Insufficient data and inadequate market research
 - Inadequate due diligence procedures



Attributes of an Effective Intangible Asset Valuation Expert

- Lawyers look for the following attributes in a valuation expert witness:
 - Experience in valuations of the subject intangible asset type
 - Experience in valuations in the subject industry
 - Experience in valuations for the subject legal issues
 - Relevant professional credentials
 - Familiarity with relevant professional literature
 - Familiarity with relevant professional standards
 - Ability to communicate effectively, both orally and in writing
 - Ability to work cohesively, as part of the litigation team
 - Experience as expert (may or may not be important)
 - References
 - Lack of contradictory reports or testimony in prior cases
 - Professional writings on subject consistent with testimony



Working Effectively With Counsel

- Clarify nature of assignment
- Ask for guidelines as to what communications, drafts are discoverable
 - Federal rules have changed in last few years and different states have different rules
- Understand scheduling milestones
- Understand budget
- Reveal potentially inconsistent testimony or work product up-front
- Don't let lawyer expand role beyond expertise



Attributes of an Effective Intangible Asset Valuation Expert (cont.)

- Lawyers should be aware that there are intangible asset valuation professional standards that may be relevant to the subject matter. The following organizations have issued such professional standards:
 - American Institute of Certified Public Accountants
 - National Association of Certified Valuators and Analysts
 - Institute of Business Appraisers
 - American Society of Appraisers
 - The Appraisal Foundation



Intangible Asset Valuation Summary and Conclusion

- This discussion considered:
 - What economic attributes are—and are not—intangible assets
 - When business lawyers may need intangible asset valuations
 - The various types of intangible asset analysis opinions
 - The generally accepted intangible asset approaches and methods
 - Attributes of the effective intangible asset valuation report
 - Attributes of the effective intangible asset valuation expert
- Questions and discussion



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