

## THE VALUATION OF INTELLECTUAL PROPERTY FOR FAMILY LAW PURPOSES

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*A marital estate may own an intellectual property directly or indirectly (through a family-owned or closely held business or professional practice). In such instances, the value of the intellectual property can be the subject of considerable controversy between the marital parties. Accordingly, valuation analysts who practice in the family law discipline—and family law legal counsel—should be familiar with the generally accepted valuation approaches, methods, and procedures related to marital estate intellectual property.*

### INTRODUCTION

Valuation analysts are often called on to value intellectual property for family law purposes. Such valuations may be performed (1) when the marital estate owns the intellectual property directly or (2) when the marital estate owns the intellectual property indirectly (through the ownership of a closely held business).

In today's economy, the drivers of business enterprise value have shifted from "bricks and sticks" (i.e., land, buildings, and equipment) to intellectual property and other intangible assets. These intangible assets are usually not recorded on an industrial or commercial company's financial statements. Such intangible assets are often overlooked in the valuation of the family-owned or other closely held corporation. In addition, such intangible assets may also be overlooked in the valuation process if they are owned separately by an individual rather than by an industrial or commercial company.

Intellectual property is a subset of intangible assets. Intellectual property can often have a substantial impact on increasing the revenue and reducing the expenses of the subject marital estate business enterprise. The valuation analyst should be concerned with the following engagement fundamentals when valuing an intellectual property for family law purposes:

- definition
- identification
- standard of value, premise of value, and valuation date
- sources of information
- appropriate methods of valuation

### DEFINITION OF INTANGIBLE ASSETS AND INTELLECTUAL PROPERTY

The main difference between a tangible asset and an intangible asset is that the value of the tangible asset is derived by its physical nature (e.g., its physical existence, its substantial form, and its ability to be touched and seen).

An intangible asset, on the other hand, is not physical in nature. An intangible asset can be broadly defined as something that has value, but can't be touched. However, there should be some physical evidence of the existence of an intangible asset (e.g., a contract, a license, a customer list, etc.).

One reason that an intangible asset has value is because it may enhance the value of other assets. For example, an intangible asset such as computer software may enhance the value of the tangible computer hardware. A company's intangible assets will integrate with its tangible assets in order for the intangible assets to create business entity value.

However, the intangible asset may also have a stand-alone value based on the owner/operator's ability to (1) lease or license the intangible asset to third-party licenses or (2) use the intangible assets in a joint venture with another company. In addition, the intangible asset may be used defensively and be withheld from the market in order to reduce competitive pressures on the intellectual property owner.

Intellectual property is a specialized classification of intangible assets. And, intellectual property possesses the general economic characteristics of intangible assets mentioned above. In addition, an intellectual property:

1. enjoys special legal recognition and protection, which provides motivation and protection for intellectual property innovators and creators;
2. is created by human intellectual effort, which can be attributed and identified to specific individual(s); and
3. is often registered under specific federal and state statutes.

There are five general categories of intellectual property. Each of the five categories is presented below, along with the statutory authority for its legal protection:

1. marketing-related, such as trademarks and service marks (Lanham Act, U.S. Code Title 15)
2. technology-related, such as patents (U.S. Code Section 101)
3. artistic-related, such as literary and musical copyrights (Federal Copyright Act)
4. data-processing-related, such as computer software copyrights and computer chip masks and masters (Federal Copyright Act and the Semiconductor Chip Protection Act)
5. engineering-related, such as industrial designs and trade secrets (Uniform Trade Secret Act)

Intellectual property is typically developed for commercial use. The intellectual property developer will (1) use the subject property in his or her business or (2) license the subject property for a license royalty fee. Sometimes the property is developed for future use.

Alternatively, the intellectual property may be developed to keep competitors from using the intellectual property in a way that may be adverse to the developer. At any rate, all intellectual property is developed for the purpose of either:

1. producing income or
2. protecting current or future income.

The valuation analyst should be concerned with intellectual property valuation not only for equitable distribution purposes, but also for the determination of:

1. maintenance/alimony and child support and
2. subsequent modification motions related to these same issues.

In addition, due to (1) the variation in the remaining useful life (RUL) of the intellectual property and (2) the

sensitivity of intellectual property to economic and technological changes, the valuation analyst should keep abreast of the status of such property.

The following economic attributes of the subject intellectual property can affect its value.

- Specified legal life—many intellectual properties have a specified legal life, which permits future planning with some degree of certainty. On the other hand, as stated above, economic and technological changes may substantially alter the subject intellectual property RUL.<sup>1</sup>

- Legal protection and recognition—because of the special legal recognition and protection afforded to the intellectual property, the owner may have more external commercialization opportunities available than do the owners of other types of intangible assets.

For example, intellectual property owners often enter into license, joint venture, or other exploitation and development agreements. These agreements allow the owners to enjoy the economic benefits of commercializing their intellectual property outside of the marital estate business interest.

- External commercialization can be accomplished through:
  - geographic expansion—new territory
  - industry expansion—new industry
  - product expansion—new product

- A wealth of transactional data are available related to the sale, license, or other commercial use of intellectual property as a result of the legal protection available to the intellectual property owner/creator. An intellectual property generally enjoys higher royalty rates and higher market value pricing multiples than do other intangible assets.

However, it may be difficult to locate transaction pricing data that are comparable to the subject intellectual property. The search for comparable transaction pricing data can sometimes be analogous to looking for a “needle in a haystack.”

Sources of intellectual property license royalty rate data include the following:

- Intellectual Property Research Associates
- Financial Valuation Group intellectual property transaction database
- *Licensing Royalty Rates*, Gregory J. Battersby and Charles W. Grimes, Aspen Publishers, Inc.
- RoyaltySource intellectual property database
- RoyaltyStat, LLC

- There is a substantial body of legal precedent related to:

- intellectual property valuation methodology,
- reasonable ranges of intellectual property license royalties and other valuation fundamentals, and
- economic damages analysis.

## IDENTIFICATION OF INTELLECTUAL PROPERTY

Intellectual property is more easily identified when it is owned directly by the marital estate, as opposed to when the intellectual property is combined with other assets in the operation of a marital estate business entity. It is important to note that the value of a marital estate business enterprise consists of the value of all of its tangible assets and intangible assets, including intellectual property.

In many cases, the assets of a business enterprise can consist almost entirely of intellectual property. The existence of intellectual property may not be readily discernible from 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.

In such an instance, the intellectual property has to be valued separately from the value generated from the current operations of the subject business. Although intellectual property assets can be easily overlooked, the valuation analyst should ensure that these valuable assets do not "fly under the radar."

## Information Gathering

The family law legal counsel and the valuation analyst should use the entire battery of discovery techniques, including deposition, interrogatories, and document production to determine the existence and type of the universe of intellectual property included in the marital estate. They can perform simple procedures to ensure the identification of the intellectual property included in the marital estate.

Such procedures for the valuation analyst's identification of the intellectual property that is part of the marital estate generally include:

1. asking management whether or not such intellectual property exists and
2. analyzing financial statements and other company documents for references to such intellectual property.

Application and registration documents of such intellectual property may be on file at the appropriate government agencies. Confirmation of the existence of the intellectual property, as well as pertinent details, can be requested from those agencies.

The valuation analyst should consider the following sources of information:

1. financial statements, including footnotes
2. the accountant's supporting audit work papers, including the permanent file and the legal file, which may include evidence of intellectual property
3. communications and confirmation from outside legal counsel
4. governmental filings, such as those with the U.S. Patent and Trademark Office
5. board of directors minutes
6. financial budgets and projections, including any associated narrative descriptions
7. interviews of owners with the subject company, management, and key employees
8. business articles—news relating to the subject company may indicate evidence of intellectual property
9. purchase price asset allocation studies required under current accounting principles;<sup>2</sup> these studies identify and allocate value to the various components of an acquirer's tangible assets and intangible assets, including intellectual property
10. SEC filings (e.g., forms 8-K and 10-K), which may identify any intellectual property that is still in the development stage
11. private placement memorandums or other transaction-related documents
12. internal transfer pricing studies, in which intercompany and intracompany prices charged for the use of intellectual property are established for existing tangible assets and intangible assets
13. income tax returns and revenue agents' adjustments dealing with intercompany transfer pricing disallowances

The sources of intellectual property information presented above are a starting point. This list of information sources is not intended to be all inclusive.

## STANDARD OF VALUE, PREMISE OF VALUE, AND VALUATION DATE

In analyzing any business asset, including intangible assets and intellectual property, the valuation analyst and the family law attorney should determine the appropriate standard of value, premise of value, and valuation date.

The term "standard of value" is considered to be synonymous with the term "definition of value." In the family law

arena, different jurisdictions require different standards of value. However, most jurisdictions rely on either of the following two standards of value.

1. Fair market value—hypothetical willing buyer and hypothetical willing seller, neither under any compulsion to buy or sell, with each party knowing all relevant factors that may affect value.
2. Investment value—value to a specific owner. Investment value for the current owner considers the current use and the current opportunities, capabilities and resources for commercially exploiting the subject company's assets, including its intellectual property.

The premise of value explains the current economic conditions surrounding the subject intellectual property. Normally, the premise of value represents the highest and best use (HABU) of the subject intellectual property. The intellectual property HABU is based on the following four criteria:

1. legally permissible
2. physically possible
3. financially feasible
4. maximizes profitability

Alternative premises of value may be appropriate depending on the economic condition of the subject marital estate business at the time of the intellectual property valuation:

- value in exchange, as part of an orderly disposition
- value in exchange, as part of a forced liquidation

The valuation date is the date as of which the intellectual property valuation takes place. The selection of a valuation date can have a substantial impact on intellectual property value during a period of economic fluctuation or technological development. Usually, the valuation date is an issue that is determined by either statute or judicial precedent in the subject jurisdiction.

The valuation analyst should be concerned with the selection of a valuation date. This is because the existence of intellectual property under development may not be readily apparent. As of the valuation date, the intellectual property may be in a stage of substantial development, but not yet ready for commercialization. Nonetheless, such an in-process intellectual property may still have a measurable value. The most frequently observed valuation dates in the family law context are:

1. the date of commencement of the action or
2. the date of the trial.

## THE VALUATION PROCESS

At the outset of the intellectual property valuation assignment, the valuation analyst should gather relevant information necessary to support the valuation report and conclusion. This information includes the following:

1. characteristics of the subject intellectual property and factors affecting ownership and operational control
2. the nature, history, and outlook of the business and the industry in which the subject intellectual property is used
3. economic factors affecting the subject intellectual property
4. historical financial information relating to the subject intellectual property
5. prior sale/license transactions involving the subject intellectual property

## Valuation Approaches and Methods

The selection of valuation approaches used to value intellectual property will differ based on the types of intellectual property and other factors. Generally accepted intellectual property valuation approaches include the cost approach, income approach, and the market approach. To family law attorneys who may be unfamiliar with these generally accepted valuation approaches, the following brief explanations may help.

- Market approach—In the market approach, value is estimated by (1) analyzing similar intellectual property that has been recently sold or licensed, (2) comparing the similar intellectual property to the subject intellectual property, and (3) apply pricing metrics derived from the guideline intellectual property transactions to the subject intellectual property financial/operation fundamentals.

When using this valuation approach, the level of comparability between the similar “guideline transactions” and the subject intellectual property, as well as the appropriate adjustments to account for any differences, are important factors.

- Income approach—The income approach estimates value by analyzing the income and/or cash flow generated by the intellectual property owner/operator. The analysis focuses on the present value of the expected income to be earned from the ownership/operation of the subject intellectual property.

When using this valuation approach, both (1) the accuracy and reliability of the projected income stream and (2) the determination of an appropriate discount rate are important.

- **Cost approach**—The cost approach estimates value by analyzing the cost to obtain a replacement intellectual property of equal functionality and/or equal utility less an allowance for any obsolescence.

### Issues Related to Intellectual Property Valuation

Family law legal counsel should be familiar with certain common issues related to the valuation of intellectual property. A brief description of these common intellectual property valuation issues follows.

#### Remaining Useful Life (RUL) Analysis

Regardless of the approach used to value the subject intellectual property, the expected RUL of the intellectual property should be computed. Although some intellectual property effectively has an unlimited legal life, such intellectual property often has a shorter economic life. This limited life is a fundamental factor that distinguishes intellectual property analyses from business enterprise analyses.

The valuation analyst may consider a number of life determinants, or measures of life, in estimating the intellectual property RUL. This RUL estimation process may involve:

1. observation of the lifespan and/or decay patterns of a group of intellectual properties over time,
2. quantification of life-related factors, and
3. the application of any statistical results to the subject intellectual property.

A variety of life measures—or life determinants—are used in estimating both the intellectual property total life and RUL. Statutory, contractual, judicial, economic, technological, and analytical factors all affect intellectual property RUL.

The valuation analyst will, depending on the type of intellectual property, use a variety of data in determining the RUL. Such documents may include registration documents, contracts, judicial decisions/orders, financial statements, usage data, operational documents, technology data, and age/life data.

#### Income Projections

A valuation analyst will often use the income approach in valuing intellectual property. The income approach provides a systematic framework to estimate intellectual

property value, economic damages, or transfer price. This systematic framework is based on either:

1. the direct capitalization method or
2. the yield capitalization method.

Either income approach valuation method involves the present value of the expected future economic income from the use, forbearance, license, or other exploitation of the intellectual property.

The fundamental components of an intellectual property economic income projection include the following:

1. the absolute amount of the future income stream
2. the growth (or decline) rate of the future income stream
3. the timing of the future income stream

The methods used in an intellectual property income projection range from simple to complex. Some common procedures for developing an income projection include the following:

1. extrapolation
2. life cycle analyses
3. sensitivity/scenario analyses
4. simulation analyses—Monte Carlo
5. other (judgmental) methods

As with any analysis, the quality of the resources will influence the quality of the intellectual property income projection.

The typical intellectual property income projection should consider both (1) operating income to the property operator and (2) licensing income to the property owner.

#### Discount Rates and Capitalization Rates

In the income approach, the valuation analyst will use a discount rate or capitalization rate to convert projected economic income to an estimate of value.

A discount rate and a capitalization rate represent a risk-adjusted rate of return that an investor would expect on a given investment. Both rates of return take into account the risks and uncertainties associated with the expected economic income stream of the intellectual property.

The main distinction between a discount rate and a capitalization rate is that a discount rate is used to present value (1) income and/or cash flow over a discrete projection period and (2) a terminal value at the end of the discrete period. The terminal value reflects the value of the income and/or cash flows from the end of the discrete period in perpetuity.

In contrast, the capitalization rate is used to estimate the present value of a single level of economic income with a projected constant rate of growth. Both rates are derived by the valuation analyst from available market data.

### Relief from Royalty Method

The relief from royalty method is a common market approach valuation method. Using this method, intellectual property is valued by reference to the amount of royalty income the intellectual property would generate if it was licensed in an arm's-length transaction.

In applying this intellectual property valuation method, the valuation analyst first identifies a set of arm's-length license agreements involving properties that are comparable to the subject intellectual property.

Second, the valuation analyst projects the annual net revenue related to the expected revenue from the subject intellectual property. The expected revenue projection is typically made over the expected RUL of the subject intellectual property.

Third, the valuation analyst selects the appropriate market-derived royalty rate for the subject intellectual property. This selection is based on both a qualitative and quantitative assessment of the terms of the selected arm's-length license agreements related to the guideline transactions.

Fourth, the valuation analyst multiplies (1) the selected royalty rate times (2) the projected subject company revenue. The product of these two valuation variables is the projection of the hypothetical royalty income stream.

Fifth, the projected hypothetical royalty income stream is capitalized using an appropriate present value discount rate. The appropriate discount rate (or yield capitalization rate) is a function of:

1. the level of economic income projected,
2. the risk of the royalty income projection, and
3. the selected premise of value.

### The Goodwill/Intellectual Property Trade-Off

It is common in the valuation of closely held businesses for the calculation of business enterprise value in excess of net tangible asset value to be labeled as "goodwill," a catchall term for all intangible assets. When the intangible assets of a business enterprise are simply defined as goodwill, a distinction can often be made between the "institutional goodwill" of the business and "personal goodwill" that relates to any owner or key employee of a business.

This distinction is important in the family law context, where much of the value of a business or practice may be personal goodwill, rather than business goodwill.<sup>3</sup>

This haphazard classification of total intangible asset value as goodwill can have negative consequences depending on the jurisdiction where the family law case is heard. Throughout the country, family law courts treat goodwill in one of three ways:

1. all goodwill is disallowed.<sup>4</sup>
2. only business goodwill and not personal goodwill, is permitted.<sup>5</sup>
3. goodwill is included if reasonable.<sup>6</sup>

If there is a possibility that goodwill may not be included in the marital estate, then it is important to separate the components of the catchall categorization of goodwill into more specifically defined intangible assets, including intellectual property. The subject company intellectual property and the other identified intangible assets:

1. may have substantial value and
2. will not automatically be subtracted from the component assets of the marital estate.

## SUMMARY AND CONCLUSION

The proper identification and valuation of intellectual property in a family law matter will require due diligence on the part of the legal counsel and the valuation analyst. Nevertheless, intellectual property is often far too valuable to overlook in the formulation of equitable distribution.

### Notes:

1. For example, the life of certain types of patents are currently 20 years from the date of application. The protection for copyrights is currently the life of the author plus 70 years.
2. These statements include the following statements of the Financial Accounting Standards Board: Statement No. 141, *Business Combinations (Revised)*, and Statement No. 142, *Goodwill and Other Intangible Assets*.
3. *Marriage of Nichols*, 060 P.2d 1423 (Colo. Ct. App. 1979).
4. *Powell v. Powell*, 648 P.2d 218 (Kan. 1982).
5. *Taylor v. Taylor*, 386 N.W.2d 871 (Neb. 1986).
6. *Dugan v. Dugan*, 457 A.2d 1 (N.J. 1983).

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This article was adapted from an article entitled "Intellectual Property in Matrimonial Cases." That article was published in the summer 2006 issue of the American Journal of Family Law, published by Walters Kluwer Law & Business.

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