PART I

Introduction to Intellectual Property Valuation
In writing this book, I have attempted to strike a balance between complexity and simplicity, trying to avoid being too technical and obscure as well as pedantic. This is a tricky balance, and I hope the reader finds I have been able to maintain it.

I owe much to the American Bar Association in the writing of this primer, specifically to its Intellectual Property law section, and to Donna Suchy and her Intellectual Property Valuation Committee. Inspiration and guidance over the years has come from Gordon Smith, Russel Parr, and Greg Battersby, to whom I owe deep appreciation. Early and continuing mentoring has come from Gary Caplan, as well as continuing advice from Daryl Martin and the staff at CONSOR. I thank all of you.
INTRODUCTION

Our business and legal world has changed substantially in the last two generations, from a society and an industrial focus based on hard assets, hard work, and machinery and equipment to one that owes its strength, growth, and future to a much less visible group of attributes—our country’s collective intellectual property. Compounding this change in our industrial and business base is an increasingly complex environment in which we all must live and operate. The Sarbanes–Oxley Act, Section 482 of the IRS Code, FASB 141/142/147—these are just a few of the regulations that increasingly affect corporate life and find their genesis either in, or in connection with, intellectual property. Thus, we start at the base of today’s new wealth and our country’s current prosperity: intellectual property.

But what is intellectual property? In many ways, a piece of intellectual property is an intangible asset, which is classified as part of a company’s goodwill. However, an intangible asset is not necessarily a piece of intellectual property, and the general category of goodwill is certainly not intellectual property; although in most cases intellectual property and intangible assets can be part of the pool of goodwill. With this confusion swirling around, the questions we must answer here are: So what is a piece of intellectual property? What is an intangible asset? When are they the same and when are they different? And, most importantly, what are the different groups of intellectual property and how do we describe and value them?

Another key set of questions revolves around value: Do pieces of intellectual property have value? Do they all have value? If not, why not? Is it true that sometimes a given piece of Intellectual Property can have great value and at other times no value at all, and if so, how can this be? Of greater importance to everyday and practical business decisions is whether a piece of Intellectual Property or an intangible asset always has the same value at the same point in time; if not, why not? We must deal with the questions of what influences value of Intellectual Property and whether those influences are different from those found for tangible assets, such as buildings, equipment, automobiles, inventory, etc. The short answer is that the influences on Intellectual Property are, by their very nature, less tangible and include the two most important influences: context and time. Other influences include environment, the specific strategy driving the valuation, and ownership of the Intellectual Property. Even when all of these criteria or influences remain the same, the value of the Intellectual Property may or may not be the same at all times, so that valuation is a confusing subject at best.

In this book, we attempt to cover some frequently asked questions on Intellectual Property and intangible assets and to engage in brief discussions on the subject of identifying value. We identify many of the main types of Intellectual Property and intangible assets. We also look at the primary, traditional, and not-so-traditional methods of valuing these assets and include case studies and various situations in which the valuation of these assets is required.
Why a Primer?

As the definition at the beginning of Part I implies, a primer is a first step or an initial treatise on a subject or topic. But why do we need a primer on intellectual property valuation when we have so many existing books? The answer is that there are many good in-depth books, most notably those by Gordon Smith and Russell Parr, as well as others by Robert Schweihis and Robert Reilly, Patrick Sullivan, and others. However, all these books tend to be written at a level of detail and with a degree of sophistication greater than the average businessperson or attorney requires. Although the books often deal in great and accurate detail with many aspects of Intellectual Property valuation, no single text seems to provide that simple overview sought by practicing and nonpracticing members of professional groups like the American Bar Association and the International Licensing Executives Society.

Intellectual Property valuation is a very complex subject, and to think that any given book can offer all the answers in simple terms is presumptuous. Nonetheless, that is exactly what we will attempt to do in this book. This book offers simple, straightforward, focused discussions of a complex topic, without too much detailed specialization in any one area or in any one class of intellectual property, and is written in plain English.

Why an Intellectual Property primer? As intellectual property and intangible assets become more and more important to all businesses and in virtually all areas of legal practice, a greater and more general level of knowledge should be held by businesspeople, legal practitioners, and their advisors. More and more questions are arising on intellectual property, and more and more uncertainty is arising as to classification and valuation. Yet, in our increasingly complex world, there are fewer and fewer simple explanations and solutions. In this particular case, sometimes too much detail really is too much.

What Is a Primer?

In the broadest possible terms, a primer is a “first book.” It is a foundation on which to build and should be viewed as a cornerstone for the building of knowledge, not a capstone or a keystone. Another definition of primer, as found in the Oxford unabridged dictionary is “a small introductory book on a subject.” We will attempt to live up to that definition. This intellectual property valuation primer is designed to be a basic document for use as a desk reference. It is hoped that this primer will provide the basic background, simple descriptions, and answers to the core questions and the core concerns that affect virtually everyone in modern industry or legal practice today. A primer is designed to offer its information in the simplest possible terms, with short, brief, but to-the-point explanations, providing a quick reference on a single topic in an easy-to-use format.

We hope this primer performs that function. It is most of all intended to be instructional, informative, and functional. With this primer, we provide a broad-brush approach to the topics of intellectual property, its valuation, and the contexts
in which those valuations are done—readers will need more detailed information as they go on to explore these topics, and we encourage them to use the bibliography at the end of this primer and the other resources that we provide. Above all, this primer should serve as a resource document.

**How to Use this Primer**

First, use this book as a resource, second as a reference source, third as a guide to other sources, and fourth as a referral vehicle to other publications. The primer focuses on the basics: the how, what, and when.

- First, we deal with how to value intellectual property. In this section, we look at the traditional methodologies of valuation, including cost, market, and income, as well as permutations such as replacement value, substitution value, relief from royalty, etc. We also look at nontraditional and proprietary methodologies, ranging from technology factor analysis to the VALMATRIX® approach used by CONSOR.
- Second, the primer deals with what we are valuing. We specifically look at groups of Intellectual Property, including corporate identity, trademarks and brands, trade secrets and technology, patents, Internet assets, copyrights, software, Information Technology, and other intangible assets. However, we have not attempted, in the space allotted, to deal with every permutation and type of intellectual property and every class of intangible assets.
- Third, we deal with the critical part of the valuation equation: When do we value and under what circumstances? We look at valuation in a licensing scenario, in a sale or merger, in a bankruptcy or reorganization, and under various tax requirements, SEC requirements, and litigation. Each of these contexts is examined briefly for its effect on value.
- Fourth, we combine this how, what, and when of Intellectual Property valuation into a series of short case studies. These case studies are scattered throughout the primer and work to illustrate both the various types of intellectual property and various methodologies to value them.
- Fifth, and finally, the primer provides checklists, due diligence suggestions, and how-to guidelines, to help the reader proceed from the information contained in this primer to an active Intellectual Property valuation project.

Part II of the primer introduces the concept of bundling similar assets together. This section also contains a brief discussion of some basic financial conditions, constraints, and terms that one needs to be aware of in the valuation process: terms like discount rate, net present value, remaining useful life, WACC, and orderly disposal.

Part III reviews basic and traditional valuation methods. This section of the book also deals with what value is and how value is defined. Do we define value as fair market value? In-place value? Tax value? Liquidation value? Part III covers
the current accepted valuation methodologies described, as well as new and proprietary methodologies.

Part IV examines the value and valuation of different and discrete types of intellectual property, from trademarks to patents, from domain names to databases. In the valuation process in Part IV, we make the basic assumption that in all cases (in that part of the primer), valuation of the assets takes place under the same basic conditions of an arm’s length transaction, seeking a fair market value, with neither party compelled to buy or negotiate, and in a nonlitigation, nontax environment. As we move to the final two parts of the primer, we begin to deal with more subjective concepts.

In Part V the very important concept of context of value is discussed and illustrated. This is perhaps the single most important concept to take away from this primer. Why? Because unlike any other asset class, intellectual property and intangible assets can change in value very quickly and very substantially, depending on the context in which they are being valued. For example, a well maintained factory building has essentially the same value whether it is being sold because of a bankruptcy, being sold in an acquisition by another company, or being disposed of for litigation or for tax reasons—in all these cases, the building essentially holds its value within a range of plus or minus 8 to 10%. This is not so with intellectual property. Therefore, the context is critical in our valuation world, and so are the time and place of valuation.

The only absolute in intellectual property valuation is relativity! This primer addresses valuing Intellectual Property assets in different contexts, as mentioned previously, ranging from tax and transfer pricing to litigation and SEC reporting. For each of these, we offer a valuation case study. Because by necessity these case studies must be brief and in summary form, no single case study can hope to cover all circumstances that could be found in a specific context, such as litigation. Therefore, the reader must reach out beyond this book for his or her own research and expert advice in any particular case.

Part V also briefly deals with the single most important influence on the increase and maximization of Intellectual Property value—the licensing, leveraging, and commercialization of intellectual property. We include a short section on licensing and licensing valuation because of the continually increasing role and importance of licensing in virtually every corporation’s management of its intellectual property portfolio. Two decades ago, fewer than a dozen major American corporations concentrated on licensing any of their intellectual property. Today, we estimate that more than half of the Fortune 500 have active and proactive, aggressive and strategic plans to license, leverage, or commercialize their intellectual property. As a consequence, these activities are the greatest drivers of increased value of intellectual property today.

Part VI offers conclusions and an overview process of due diligence. These chapters provide the reader with some guidelines about where intellectual property
valuation is heading and also some sense of the general trends that affect intellectual property in general. Importantly, we also address the due diligence process, from the concept of engaging in the valuation of one of these important assets through the actual process itself. In the Appendices, we also include research resources and professional organizations that can be used as additional references and knowledge generators.