

Business Session

Intellectual Property and Insolvency Issues

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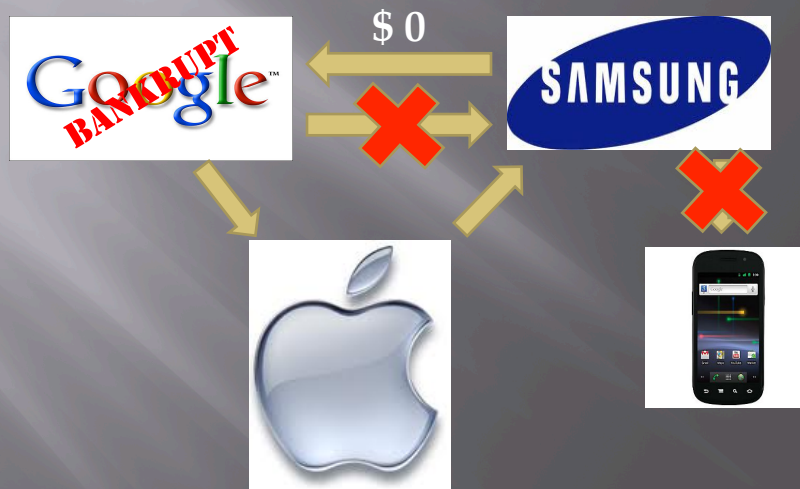
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Consequences to Licensee when Licensor Files Bankruptcy – Pre-365(n) Example



Effect of Section 365(n)



**INTELLECTUAL PROPERTY ISSUES
AND CHALLENGES IN BANKRUPTCY CASES***

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I. INTRODUCTION

Given the central importance of intellectual property to almost every business, it is not surprising that intellectual property issues often play a key role in bankruptcy cases. This article discusses a number of those issues, including the assumption, assignment and rejection of intellectual property licenses, the rights of licensors and licensees in bankruptcy, pending legislation and the treatment of infringement claims.

An important feature of bankruptcy is the ability of a debtor either to assume favorable contracts or reject burdensome ones, under certain circumstances and subject to the requirements of the Bankruptcy Code, including intellectual property license agreements. When a distressed company uses Chapter 11 bankruptcy to sell its assets, the ability to transfer key executory contracts, in particular intellectual property licenses, to the buyer will be a significant issue. As discussed in detail below, the law is very different depending upon whether the debtor is a licensor or licensee, and sometimes depending upon the type of intellectual property involved. Also, the debtor may be *both* a licensor and a licensee under different intellectual property licenses involved in a bankruptcy sale, and may even be both under the same license agreement if the agreement involves cross-licenses.

If the debtor is a licensor of intellectual property, licensees will be especially focused on the impact of the sale on their rights. In addition, potential buyers will want to understand which licensee rights will, and will not, survive a bankruptcy sale. Likewise, if the debtor is the licensee of intellectual property rights, potential buyers will need to understand which license rights can be transferred and which may be stranded if the non-debtor licensor objects to the assignment.

When intellectual property licenses are critical to a debtor's business, these differences can have a major impact on the value of a debtor's assets.

II. EXECUTORY CONTRACTS GENERALLY

An executory contract is a contract between a debtor and another party under which both sides still have important performance obligations outstanding.¹ A debtor in bankruptcy (or its

¹ See, e.g., *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985) (“a contract is executory if performance is due to some extent on both sides”; adopting the Countryman definition) (citation omitted); *In re Aerobox Composite Structures, LLC*, 373 B.R. 135, 139

bankruptcy trustee) has the option of assuming or rejecting agreements, so long as the agreements are considered to be executory contracts.² A debtor's decision to assume or reject an executory contract is governed by the "business judgment" standard.³

Generally, a debtor can assume an executory contract if it meets the requirements of section 365(b) of the Bankruptcy Code, including curing defaults and providing adequate assurance of future performance. Section 365(b)(1) provides:

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of assumption of such contract or lease, the trustee

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any ancillary pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. § 365(b)(1).

(Bankr. D.N.M. 2007) ("Generally, a contract is executory for purposes of § 365(a) when each party to the contract has ongoing duties and obligations such that they contract remains materially unperformed on both sides."); *In re Kmart Corp.*, 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) (noting that Professor Countryman defines an executory contract as "an agreement where the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.") (citation and quotations omitted).

² See 11 U.S.C. § 365(a)(1) ("Except as provided [in the Bankruptcy Code], the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."). A debtor in possession generally has the same rights as a trustee. See 11 U.S.C. § 1107(a) (Subject to certain limitations, "a debtor in possession shall have all the rights ... and powers, and shall perform all the functions and duties ... of a trustee serving in a case under this chapter.").

³ See, e.g., *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d at 1046-7 ("Courts addressing [the question of whether or not rejection of an executory contract is beneficial to the debtor] must start with the proposition that the bankrupt's decision upon it is to be accorded the deference mandated by the sound business judgment rule as generally applied by courts to discretionary actions or decisions of corporate directors....As generally formulated and applied in corporate litigation the rule is that courts should defer to – should not interfere with – decisions of corporate directors upon matters

Typically, the rejection of an executory contract constitutes a breach of such contract and results in the termination thereof.⁴ The nondebtor counterparty is entitled to file a claim for rejection damages, but is not entitled to continue receiving any benefits under the contract.

III. THE BANKRUPTCY OF AN INTELLECTUAL PROPERTY LICENSOR

Many licensees rely on in-bound licenses of intellectual property, especially those involving patents or trade secrets, and spend millions of dollars on research, development, and ultimately commercialization of drugs or products incorporating the licensed intellectual property. With so much at stake, licensees frequently ask a critical question: can their license rights be terminated by a licensor who files for bankruptcy? In a bankruptcy sale context, a potential buyer might ask the flip side of that question: can the debtor's intellectual property be acquired free and clear of existing out-bound licenses?

In many of the cases discussed herein, courts have found license agreements to be executory contracts.⁵ Accordingly, a licensor in bankruptcy (or its bankruptcy trustee) has the option of assuming or rejecting the license. Generally, a debtor licensor can assume a license if it meets the same tests (cures defaults and provides adequate assurance of future performance) required to assume other executory contracts. Most licensees will not object to the assumption of their license as long as the debtor can actually continue to perform. Instead, the real concern for licensees is whether they risk losing their rights to the licensed intellectual property if the license is rejected.

Prior to the enactment of section 365(n) of the Bankruptcy Code, licensees whose executory contracts were rejected lost their rights under the license. This was the holding of the United States Court of Appeals for the Fourth Circuit in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). The Fourth Circuit held that Lubrizol, a

entrusted to their business judgment except upon a finding of bad faith or gross abuse of their "business discretion.") (citations omitted).

⁴ See 11 U.S.C. § 365(g).

⁵ *In re Kmart Corp.*, 290 B.R. at 618 ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy Code.") (citation omitted); *but see In re DAK Indus., Inc.*, 66 F.3d 1091, 1095 (9th Cir. 1995) (finding that the agreement "is best characterized as a lump sum sale of software units to [the debtor], rather than a grant of permission to use intellectual property.") and *In re Exide Techs.*, 607 F.3d 957, 964 (3d Cir. 2010) (finding that agreement was not executory because there were no material ongoing obligations).

nonexclusive patent licensee whose patent license was rejected as an executory contract in the bankruptcy case of Lubrizol's licensor, debtor Richmond Metal Finishers, could not "rely on provisions within its agreement with [the debtor] for continued use of the technology." According to the *Lubrizol* Court, when Congress enacted section 365(g) of the Bankruptcy Code, governing the effect of rejection of an executory contract, "the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party," and no specific performance remedy. The Fourth Circuit held that, as a result, when the debtor rejected the contract, Lubrizol, as the patent licensee, lost its rights under the license.

In reaction to the *Lubrizol* decision and the concerns of the decision's potential impact on patent and other technology licensees, Congress enacted the Intellectual Property Bankruptcy Act of 1988, adding section 365(n) to the Bankruptcy Code to give non-debtor licensees special protections.⁶ If the debtor or trustee rejects an intellectual property license, under section 365(n)

⁶ Section 365(n) provides as follows:

If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect--

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for--

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract--

a licensee can elect to retain its rights to the licensed intellectual property, including a right to enforce an exclusivity provision. In return, the licensee must continue to make any required royalty payments. The licensee also can retain rights under any agreement supplementary to the

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive--

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall--

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall--

(A) to the extent provided in such contract or any agreement supplementary to such contract--

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another

license, which should include source code or other forms of technology escrow agreements. Taken together, these provisions protect a licensee from being stripped of its rights to continue to use the licensed intellectual property.

If the license is rejected, however, the debtor licensor will no longer have to perform under the license. This means the licensor will not have to update or continue to develop the intellectual property, and will not have to make available any updates later developed. In addition, section 365(n) only applies in a U.S. bankruptcy case. It generally will not be of any help in a bankruptcy or insolvency of a non-U.S. licensor under applicable foreign law, although as discussed below, it might be applied in certain instances in a Chapter 15 case filed by a foreign debtor in the U.S.

The enactment of section 365(n) raised the issue of which types of intellectual property does it protect. Many people expect intellectual property to include trademarks. However, when section 365(n) was enacted a special, limited definition of “intellectual property” was also added to the Bankruptcy Code in section 101(35A).⁷ This definition includes trade secrets, U.S. patents and patent applications, copyrights, plant variety, and mask works but does not include trademarks. This distinction means that, on its face, the statute does not provide trademark licensees with section 365(n)’s special protections, and a trademark licensee is at risk of losing its trademark license rights if the licensor files bankruptcy.

The law is unsettled whether section 101(35A)’s definition of intellectual property, and thus section 365(n)’s licensee protections, extends to non-U.S. patents, and there is no U.S. case law on the issue. Section 101(35A)(B) plainly includes U.S. issued patents within its definition because those patents are issued under title 35 of the United States Code. As such, the protections of section 365(n) cover U.S. issued patents. One of the main arguments in favor of protection for foreign patents is that use of the phrase “protected under title 35” in the definition in section 101(35A)(B) is to clarify that to be bankruptcy “intellectual property,” an invention, process, design, or plant must at least be subject to U.S. patent protection. The statute does not

entity.

⁷ See 11 U.S.C. § 101(35A) (“The term ‘intellectual property’ means (A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law.”).

use language limiting the definition “to the extent protected under title 35” or “only under title 35,” implying that it should be read to extend to an invention, process, design, or plant that could be protected under title 35. Also, section 101(35A)(C) includes a “patent application” without reference to title 35. A main argument against protection is that the statute could have included language addressing foreign patents directly but did not, and instead makes reference only to title 35.

Non-debtor licensees often attempt to maximize the benefits of section 365(n) *prior to* a bankruptcy of a licensor. These licensees often consider the following approaches:

- Ensure that there actually is a granted license. Section 365(n) only applies to actual license rights as they existed at the time the bankruptcy case was commenced. Accordingly, an agreement by the licensor to grant a license to intellectual property at some later date, including a springing license grant on a bankruptcy filing, will likely be unenforceable if a bankruptcy is filed.⁸
- Consider a technology escrow. Section 365(n) is not self-executing, meaning it does not require the licensor to deliver the embodiment of the licensed intellectual property to the licensee unless the license or an agreement supplementary to the license expressly provides for such a right. A solution is to include this delivery provision in the license itself, or to establish a technology (often a source code) escrow into which the embodiment and updated versions of the embodiment are in fact deposited, to be released to the licensee on specified conditions.
- Refer to section 365(n) in the license. Section 365(n) applies to licenses of bankruptcy-defined intellectual property whether it is mentioned in the license or not. Stating in the license agreement that such agreement involves intellectual property as defined in section 101(35A) and covered by section 365(n), while not binding on the bankruptcy court, may be helpful in persuading a bankruptcy trustee – or the judge – that the intellectual property involved is indeed subject to section 365(n)’s protections.
- Save the election until later. If a section 365(n) reference is included in the license, it is usually better to state that no section 365(n) election is then being made.
- Get bankruptcy advice before the license is signed. Seek advice from bankruptcy counsel knowledgeable about intellectual property licenses when the license is being drafted, not just after the licensor is already in financial distress.

A. Third Circuit Treats a Covenant Not to Sue as a License

The United States Court of Appeals for the Third Circuit has examined whether a covenant not to sue, rather than an affirmative license grant, amounts to a license agreement,

such that upon rejection, the non-debtor licensee may elect to retain its rights under section 365(n).⁹ Prior to its bankruptcy filing in 2009, Spansion filed a patent infringement action against Apple with the International Trade Commission (ITC). Pursuant to a letter agreement, Spansion agreed to dismiss the action and promised to refrain from future actions related to those patents. In its bankruptcy filing, Spansion sought to reject the agreement. Following the bankruptcy court's approval of the rejection, Apple sought to retain its rights under the agreement pursuant to section 365(n), arguing that the agreement was a license. The bankruptcy court denied Apple's section 365(n) election, but the district court found that the agreement was a license and, accordingly, Apple could retain its rights under section 365(n).

On appeal, the Third Circuit agreed with the district court:

[A] license ... [is] a mere waiver of the right to sue by the patentee." *De Forest Radio Tel. & Tel. Co. v. United States*, 273 U.S. 236, 242 (1927)(quotations omitted). A license need not be a formal grant, but is instead a "consent[] to [the] use of the patent in making or using it, or selling it ... and a defense to an action for a tort." *Id.* at 241. The Court of Appeals for the Federal Circuit explained that the inquiry focuses on what the agreement authorizes, not whether the language is couched in terms of a license or a covenant not to sue; effectively the two are equivalent. *TransCore, LP v. Elec. Transaction Consultants Corp.*, 563 F.3d 1271, 1275-76 (Fed. Cir. 2009).

In the letter agreement, Spansion promised "to dismiss the ITC action against Apple, and [to] not re-file the ITC action or another action related to one or more of the same patents against Apple." This was a promise not to sue Apple for its use of Spansion's patented products. Accordingly, as the District Court found, the letter agreement is a license.¹⁰

Although the decision is marked "not precedential," it will surely influence future courts when faced with similar agreements.

⁸ See *In re Storm Tech., Inc.*, 260 B.R. 152 (Bankr. N.D. Cal. 2001).

⁹ *In re Spansion, Inc.*, 507 Fed. Appx. 125 (3d Cir. 2012).

¹⁰ *Id.* at *3.

B. Bankruptcy Asset Sales: Interplay of Sections 363(f) and 365(n)

Section 363 of the Bankruptcy Code is the key Bankruptcy Code section that governs a debtor's sale of assets in bankruptcy. Regardless of what is being sold, the debtor must seek bankruptcy court approval of the sale and of any effort to assign, under section 365, executory contracts, licenses, and leases to the buyer.

When the debtor files a motion seeking to sell its assets, it usually will ask to do so "free and clear" of liens, encumbrances, and interests under section 363(f). The term "lien" includes everything from security interests filed by banks or other secured lenders under the Uniform Commercial Code taking the debtor's assets as collateral for loans to judgment and other types of liens. In a section 363 sale, a debtor may propose to sell the assets and hold the sale proceeds in a separate account, with the secured creditors' liens being transferred over to those funds. Debtors ask for authority to sell the assets "free and clear" of liens because the buyer wants clear title to the assets, unencumbered with any of the debtor's old debts and liens.

The debtor will typically file another motion (or may combine it with the sale motion) seeking authority to assume and assign to the buyer designated executory contracts and leases under section 365. Assumption and assignment are discussed more fully below.

Although neither addressed section 365(n) directly, two cases from the Seventh Circuit in the section 363 sale context, taken together, appear to limit the protections afforded to intellectual property licensees under section 365(n). These cases highlight for both buyers and licensees how the failure to object to a section 363 sale may preclude a licensee or other contract party's rights after the sale is consummated, frequently to the benefit of the buyer. A recent New Jersey decision that appears to be at odds with those from the Seventh Circuit addresses section 365(n) directly and further adds to the uncertainty regarding the interplay between sections 363(f) and 365(n) of the Bankruptcy Code.

In *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281 (7th Cir. 2002), Judge Posner of the United States Court of Appeals for the Seventh Circuit addressed whether a buyer of certain assets out of a debtor's bankruptcy was obligated to perform under a contract when the buyer did not purchase the rights conferred on the debtor by the contract.

Prior to the bankruptcy filing, the debtor was a party to a contract with FutureSource, pursuant to which, in exchange for royalties, the debtor furnished FutureSource with financial-markets data for resale to FutureSource's customers, along with the software necessary to download the data. Following the debtor's bankruptcy filing, Reuters bought certain assets used in the debtor's financial-markets data service, but did not assume any obligations under the prepetition agreement with FutureSource. Instead, Moneyline Network purchased the rights to receive royalties from FutureSource in exchange for providing the data services. When Moneyline failed to provide the required service, FutureSource sought to compel Reuters to do so. Overruling the district court, the Seventh Circuit found that Reuters, which had no contractual relationship with FutureSource, was not obligated to perform the requested services.

In so holding, the court pointed out that FutureSource did not object to the sale of the debtor's assets. The court rejected FutureSource's argument that an intellectual property license, like a tenancy in real estate, is not extinguished by the sale of the underlying property, stating:

[T]he bankruptcy court's sale order, consistent with 11 U.S.C. § 363(f), extinguished all 'interests' in the assets acquired by Reuters, and this included an interest in the intellectual property that Reuters acquired from [the debtor]....It is true that the Bankruptcy Code limits the conditions under which an interest can be extinguished by a bankruptcy sale, but one of those conditions is the consent of the interest holder, and lack of objection (provided of course there is notice) counts as consent....It could not be otherwise; transaction costs would be prohibitive if everyone who *might* have an interest in the bankrupt's assets had to execute a formal consent before they could be sold.¹¹

In 2003, the United States Court of Appeals for the Seventh Circuit followed *FutureSource* with a decision in the context of a sale regarding the rights of a lessee, which could also have important implications for nondebtor licensees. In *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the debtors were parties to prepetition agreements with Precision Industries, Inc. and Circo Leasing Co., LLC (collectively, "Precision") providing, among other things, that Precision would construct a supply warehouse at the debtors' facility and operate it for a period of 10 years to provide supply services for the debtors. The debtors leased the property to Precision for the same 10-year period, in exchange for nominal rent of \$1

¹¹ 312 F.3d at 285-6 (emphasis in original).

per year. Approximately one year after executing the agreements, the debtors filed for bankruptcy and, shortly after the filing, sold substantially all of their assets pursuant to a bankruptcy court order. Precision did not object to the sale. While the buyer retained the right to assume the lease and supply agreement with Precision, negotiations failed to produce an agreement, and the lease and supply agreement were rejected.

When the buyer changed the locks on the building without Precision’s knowledge or consent, Precision sought relief from the court. The bankruptcy court found that the buyer had obtained title to the debtors’ property free and clear of Precision’s interests, based on the language of the sale order and section 363(f). The district court reversed, noting that “Section 365(h) appears to grant the tenant the right to retain the benefits of the lease, while Section 363(f) appears to allow the [debtor] to divest the tenant of its leasehold.”¹²

The Seventh Circuit framed the issue as “straightforward. We must decide whether a sale order issued under section 363(f), which purports to authorize the transfer of a debtor’s property ‘free and clear of all liens, claims, encumbrances, and interests,’ operates to extinguish a lessee’s possessory interest in the property, or whether the terms of section 365(h) operate to preserve that interest.”¹³ The court found that “the terms of section 365(h) do not supersede those of section 363(f)” for three primary reasons.¹⁴ First, there was nothing in the statute suggesting that one provision superseded or limited the other. Second, the plain language of section 365(h) suggests that it applies only when an executory contract is rejected, and does not explicitly apply in the event of a sale. Third, section 363 provides a remedy for those who feel they have been harmed by bankruptcy sales – adequate protection.

The court concluded:

[T]he two statutory provisions can be construed in a way that does not disable section 363(f) vis a vis leasehold interests. Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee’s possessory interest – provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the

¹² *Id.* at 542 (quoting the district court’s decision).

¹³ *Id.* at 543.

¹⁴ *Id.* at 547.

debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property.¹⁵

However, in a 2014 case (discussed more fully below), the Bankruptcy Court for the District of New Jersey addressed whether an asset sale under sections 363(b) and (f), which included trademarks, was “free and clear” of the licensee’s interests.¹⁶ The buyer argued that the licensees were given notice of the proposed “free and clear” sale but failed to object, thereby impliedly consenting to the extinguishment of their section 365(n) rights. The court examined the notice given in the case, observed that a party had to “traverse a labyrinth of cross-referenced definitions and a complicated network of corresponding paragraphs with annexed schedules” to determine what was being sold, and concluded that the licensees were not provided with adequate notice that the sale put their rights at risk.¹⁷

Both *FutureSource* and *Precision Industries*¹⁸ could pose serious threats to the rights of licensees in sales under section 363 of the Bankruptcy Code, and could benefit buyers of those assets. Although these decisions did not directly address section 365(n), they could be used to argue that section 363 of the Bankruptcy Code allows debtors to sell assets free and clear of licensee rights under section 365(n) when the licensee does not object to the sale. However, *Crumbs*, which directly addressed section 365(n), found that trademark licensees which failed to object did not consent to a sale “free and clear” of trademarks when the reference to the sale being free and clear of the licensee’s rights was buried in a 29-page document. Even if *Crumbs* is limited to the particular circumstances where the impact on the licensees was arguably unclear,

¹⁵ *Id.* at 548.

¹⁶ *See In re Crumbs Bake Shop, Inc.*, No. 14-24287 (MBK), 2014 WL 5508177 (Bankr. D.N.J. Oct. 31, 2014).

¹⁷ *See id.* at * 6.

¹⁸ *See also Dishy & Sons v. Bay Condos LLC, et al.*, 510 B.R. 696 (S.D.N.Y. 2014) (finding that “[a]lthough § 365(h) is applicable to § 363(f) sales, it does not give the lessee absolute rights that take precedence over the trustee’s right to sell free and clear of interests. Rather, it clarifies that the lessee may retain its appurtenant rights notwithstanding the trustee’s rejection of the lease. Section 363(f), in turn, authorizes the trustee to extinguish the lessee’s appurtenant rights – like any other interest in property – but only if one of five conditions is satisfied with respect thereto. The two sections thus work in harmony to establish that the lessee’s appurtenant rights may not be terminated by rejection and must be taken into account in any proposed free and clear sale.... As this case demonstrates, however, § 363(f) will rarely permit such a sale, and consequently, the lessee’s rights will generally be enforceable against the transferee of the property.”

the varying results reached in the Seventh Circuit and in the *Crumbs* case should remind licensees that they may be required to review voluminous documents – and even file protective objections – to preserve their rights.

C. Rejection of Trademark Licenses

Trademark licensees have long faced the serious risk of losing all license rights to a trademark if the licensor files for bankruptcy and rejects the trademark license as an executory contract. With no special protection under section 365(n), the trademark licensee has faced the risk of having its license, often considered to be an executory contract, rejected by the trademark owner in bankruptcy. If the trademark owner decides that the license is now unfavorable and a better deal can be had under a new license agreement with someone else, the trademark owner likely will reject the existing trademark license agreement and seek to terminate the licensee's rights to use the mark. The enforceability of phase-out provisions, which allow a licensee to continue to use a mark for a limited time period after a license is terminated, is unclear. For years, courts have held that a trademark licensee eventually will lose its rights to the trademark following rejection. In some cases the ability to re-license, or sell the trademark and associated goodwill without the encumbrance of existing licenses, can be of great value to a trademark owner in bankruptcy, and thus to its creditors, but it puts the licensee at substantial risk.

However, a significant recent trend has been the efforts by courts to find ways to protect trademark licensees, notwithstanding the limits of section 365(n) and the definition of "intellectual property." They offer trademark licensees rays of hope and caution to buyers of trademarks in section 363 sales. Four decisions warrant discussion in greater detail here.

1. The Third Circuit Treats a Trademark License as Non-Executory

In 2010, the United States Court of Appeals for the Third Circuit examined a series of agreements, determined to constitute one integrated agreement, pursuant to which Exide Technologies sold an industrial battery business, and licensed certain trademark rights, to EnerSys.¹⁹ When Exide filed for bankruptcy in 2002, it sought to reject the agreement as an executory contract. The bankruptcy court granted Exide's motion to reject the agreement, and that decision was affirmed by the district court. On appeal, the Third Circuit held that under

¹⁹ See *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).

New York law, which governed the agreement, once a party has substantially performed, a later breach by that party does not excuse performance.

The Third Circuit held that EnerSys had substantially performed by paying the full purchase price and operating under the agreement for ten years, as well as by assuming certain liabilities related to the business EnerSys purchased when it obtained the trademark license. As such, the agreement was no longer executory. The court also held that EnerSys's obligation not to use the trademark outside of the licensed business was not a material obligation because it was a condition subsequent and, in any event, did not relate to the agreement's purpose – the transfer of the industrial battery business in return for a \$135 million payment. Likewise, the Third Circuit concluded that a quality standards provision was minor because it related only to the standards of the mark for each battery produced and not to the transfer of industrial battery business that was the agreement's purpose. In addition, an indemnity obligation that had subsequently expired, and a further assurances obligation where no remaining required cooperation was identified, were held not to outweigh the factors supporting a finding of substantial performance.

Judge Ambro wrote a concurring opinion to address the bankruptcy court's conclusion that rejection of a trademark license left EnerSys without the right to use the Exide mark. In his concurrence, Judge Ambro analyzed the history of section 365(n), disagreed that the exclusion of trademarks from its reach created a negative inference that rejection of a trademark license should be tantamount to termination, and stated that courts should be able to prevent the extinguishment of all rights upon rejection. As Judge Ambro wrote in his conclusion:

Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not — as occurred in this case — use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve.²⁰

2. The Seventh Circuit Rejects *Lubrizol's* Holding

In another 2012 decision, the United States Court of Appeals for the Seventh Circuit issued a decision hailed as a major victory to trademark licensees whose licenses are rejected in

bankruptcy by trademark owners.²¹ The facts of *Sunbeam* are fairly straightforward. Lakewood Engineering & Manufacturing Co. made various consumer products, including box fans, which were covered by its patents and trademarks. Lakewood contracted with Chicago American Manufacturing (“CAM”) to make its fans for 2009, granting CAM a license to the relevant patents and trademarks. In recognition of both the investment CAM would have to make to manufacture the fans and Lakewood’s own distressed financial condition, the agreement authorized CAM to sell directly any of the 2009 production of box fans that Lakewood did not purchase. A few months after the agreement was signed, Lakewood was forced into an involuntary bankruptcy and a trustee was appointed. The trustee sold Lakewood’s assets, including the patents and trademarks, to Sunbeam Consumer Products, which wanted to sell its own fans and not have to compete with CAM’s sales. The trustee rejected the CAM agreement and, when CAM continued to sell the remaining fans, Sunbeam sued CAM for infringement.

In the decision that ultimately led to the Seventh Circuit’s decision, the bankruptcy court in *In re Lakewood Engineering & Manufacturing Co., Inc.*, 459 B.R. 306 (Bankr. N.D. Ill. 2011), decided to “step into the breach,” follow Judge Ambro’s reasoning in *Exide*, and begin the “development of equitable treatment” of trademark licensees that it concluded Congress had anticipated would occur. In so doing, it held that despite rejection of a manufacturing and supply agreement that included a trademark license, the licensee could continue to sell trademarked goods as it had been licensed to do.

On appeal, the Seventh Circuit disagreed with the bankruptcy court’s analysis but ultimately affirmed its decision. In its opinion, however, the Seventh Circuit took aim directly at the 1985 Fourth Circuit *Lubrizol* decision and reasoning.

The issue on appeal was the effect of the trustee’s rejection of the CAM agreement, and specifically the trademark license, on CAM’s ability to sell the fans. The Seventh Circuit’s focus on the *Lubrizol* decision was apparent:

Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), holds that, when an intellectual-property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. Three years

²⁰ 607 F.3d 957, 967-8 (3d Cir. 2010) (Ambro, J. concurring).

²¹ See *Sunbeam Prods., Inc. v. Chicago Am. Manuf., LLC*, 686 F.3d 372 (7th Cir. 2012).

after *Lubrizol*, Congress added § 365(n) to the Bankruptcy Code. It allows licensees to continue using the intellectual property after rejection, provided they meet certain conditions. The bankruptcy judge held that §365(n) allowed CAM to practice Lakewood's patents when making box fans for the 2009 season. That ruling is no longer contested. But "intellectual property" is a defined term in the Bankruptcy Code: 11 U.S.C. §101(35A) provides that "intellectual property" includes patents, copyrights, and trade secrets. It does not mention trademarks. Some bankruptcy judges have inferred from the omission that Congress codified *Lubrizol* with respect to trademarks, but an omission is just an omission. The limited definition in § 101(35A) means that § 365(n) does not affect trademarks one way or the other. According to the Senate committee report on the bill that included § 365(n), the omission was designed to allow more time for study, not to approve *Lubrizol*. See S. Rep. No. 100–505, 100th Cong., 2d Sess. 5 (1988). See also *In re Exide Technologies*, 607 F.3d 957, 966–67 (3d Cir. 2010) (Ambro, J., concurring) (concluding that § 365(n) neither codifies nor disapproves *Lubrizol* as applied to trademarks). The subject seems to have fallen off the legislative agenda, but this does not change the effect of what Congress did in 1988.²²

Chief Judge Easterbrook's opinion noted that the bankruptcy court had permitted CAM to continue using the trademarks on equitable grounds, but rejected that approach as going beyond what the Bankruptcy Code permits. The Seventh Circuit then directly addressed the *Lubrizol* decision:

Although the bankruptcy judge's ground of decision is untenable, that does not necessarily require reversal. We need to determine whether *Lubrizol* correctly understood § 365(g), which specifies the consequences of a rejection under § 365(a). No other court of appeals has agreed with *Lubrizol*—or for that matter disagreed with it. *Exide*, the only other appellate case in which the subject came up, was resolved on the ground that the contract was not executory and therefore could not be rejected. (*Lubrizol* has been cited in other appellate opinions, none of which concerns the effect of rejection on intellectual-property licenses.) Judge Ambro, who filed a concurring opinion in *Exide*, concluded that, had the contract been eligible for rejection under § 365(a), the licensee

²² *Id.* at 375.

could have continued using the trademarks. 607 F.3d at 964–68. Like Judge Ambro, we too think *Lubrizol* mistaken.²³

After observing that outside of bankruptcy a licensor’s breach does not terminate a licensee’s right to use intellectual property, and section 365(g) provides that rejection is breach, the Seventh Circuit turned to the impact of section 365(g) and rejection in bankruptcy:

What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party’s rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984); *Midway Motor Lodge of Elk Grove v. Innkeepers’ Telemanagement & Equipment Corp.*, 54 F.3d 406, 407 (7th Cir. 1995). The debtor’s unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized. Consider how rejection works for leases. A lessee that enters bankruptcy may reject the lease and pay damages for abandoning the premises, but rejection does not abrogate the lease (which would absolve the debtor of the need to pay damages). Similarly a lessor that enters bankruptcy could not, by rejecting the lease, end the tenant’s right to possession and thus re-acquire premises that might be rented out for a higher price. The bankrupt lessor might substitute damages for an obligation to make repairs, but not rescind the lease altogether.²⁴

The Court then distinguished rejection from avoidance powers, which might lead to rescission or termination of an agreement, observing that “rejection is not ‘the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed.’”²⁵ It ‘merely frees the estate from the obligation to perform’ and ‘has absolutely no effect upon the contract’s continued existence’. *Ibid.* (internal citations omitted).²⁶

²³ *Id.* at 376.

²⁴ *Id.* at 377.

²⁵ *Id.* at 377 (citing *Thompkins v. Lil’ Joe Records, Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007)).

²⁶ *Id.*

The Seventh Circuit referenced scholarly criticism of the *Lubrizol* decision before turning back to the Fourth Circuit's opinion:

Lubrizol itself devoted scant attention to the question whether rejection cancels a contract, worrying instead about the right way to identify executory contracts to which the rejection power applies.

Lubrizol does not persuade us. This opinion, which creates a conflict among the circuits, was circulated to all active judges under Circuit Rule 40(e). No judge favored a hearing en banc. Because the trustee's rejection of Lakewood's contract with CAM did not abrogate CAM's contractual rights, this adversary proceeding properly ended with a judgment in CAM's favor.²⁷

The Seventh Circuit's opinion in the *Sunbeam* case not only creates a circuit split, but more significantly represents the first court of appeals decision in 27 years to challenge *Lubrizol*'s view of how rejection impacts an intellectual property license.

Sunbeam and its potential interplay with section 365(n) raises a number of interesting questions, including:

- Aside from the right to use the licensed trademarks, does the licensee keep other rights under its agreement, such as exclusivity if applicable?
- Would a liquidated damages provision in favor of the licensee, payable on breach, cut against the licensee's right under *Sunbeam* to continue to use the licensed trademarks?
- How long does the right to the trademarks continue, the full term of the license agreement plus any extensions, or some shorter period?
- If royalties are required under a trademark license, must the trademark licensee continue to pay them post-rejection to use the licensed trademarks, as an intellectual property licensee covered by section 365(n) is required to do, or can the trademark licensee argue that rejection is a material breach excusing that performance?
- Since under *Sunbeam* rejection does not terminate trademark license rights, does the same analysis apply to intellectual property other than trademarks, including those covered by section 365(n)?

²⁷ *Id.* at 377-78.

- Are licensees of patents, copyrights, or trade secrets, otherwise protected by section 365(n), required to follow section 365(n)'s statutory scheme to retain their rights, including payment of royalties, or can they rely on the *Sunbeam* decision's analysis of the effect of rejection as an alternative approach?
- How will purchasers of trademarks and other assets react to the potential continued use of the marks by licensees under rejected trademark licenses?

3. Eighth Circuit, in *En Banc* Decision, Holds Trademark License Not Executory

Just when the Third Circuit decision was starting to give hope to trademark licensees in asset sales, the Eighth Circuit went the other way and held that a trademark license entered into as part of an asset sale was executory and could be rejected. In *In re Interstate Bakeries Corp.*,²⁸ a case with facts very similar to *Exide*, a three-judge panel of the U.S. Court of Appeals for the Eighth Circuit examined whether an exclusive license to use brands and trademarks belonging to Interstate Brands Corporation ("IBC"), which subsequently filed for bankruptcy, was an executory contract.

Prior to bankruptcy, IBC entered into a \$20 million asset purchase agreement and license agreement with Lewis Brothers Bakeries ("LBB"), and certain baking and business operations in the Chicago area to LBB. Following IBC's bankruptcy, LBB sought a declaratory judgment that the license agreement was not an executory contract. The bankruptcy court and district court both found the agreement executory, with unperformed obligations on both sides. Although the relevant aspects of the license agreement appeared at first blush to be nearly identical to those in *Exide*, the Eighth Circuit panel found the license agreement in *Interstate Bakeries* to be materially different. Specifically, the Eighth Circuit panel found LBB's obligation to maintain quality standards, and IBC's obligations of notice and forbearance with regard to the trademarks, material and unperformed. As such, it held the license agreement was executory and could be

²⁸ 690 F.3d 1069 (8th Cir. 2012)

rejected. The Eighth Circuit panel distinguished *Exide* because there, “the parties had not even contemplated or discussed any quality standards. . . . Here, it cannot be argued the parties did not contemplate any quality standards, as it is an explicit provision of the License Agreement. Moreover, the plain language of the agreement provides a breach of the quality provision would be material.”²⁹

The panel decision was split 2 to 1, and the Eighth Circuit ultimately granted a rehearing *en banc*. On June 6, 2014, the full Eighth Circuit issued an 8-3 decision holding that the license agreement was no longer executory.³⁰ After concluding that intervening events had not rendered the appeal moot, the Eighth Circuit held the proper focus to be on the entire transaction, not just on the license agreement:

The essence of the agreement here was the sale of IBC’s Butternut bread and Sunbeam bread business operations in specific territories, not merely the licensing of IBC’s trademark. The agreement called for LBB to pay \$20 million for IBC’s assets. The parties allocated \$11.88 million for tangible assets, such as real property, machinery and equipment, computers and licensed computer software, vehicles, office equipment, and inventory. They allocated another \$8.12 million toward intangible assets, including the license. IBC has transferred all of the tangible assets and inventory to LBB, executed the License Agreement, and received the full \$20 million purchase price from LBB.

IBC’s remaining obligations concern only one of the assets included in the sale — the license. They involve such matters as obligations of notice and forbearance with regard to the trademarks, obligations relating to maintenance and defense of the marks, and other infringement-related obligations. When considered in the context of the entire agreement, these remaining obligations are relatively minor and do not relate to the central purpose of the agreement to sell the Butternut and Sunbeam bread operations and assets to LBB in certain territories.

Id. at 963-64.

²⁹ *Interstate Bakeries*, 690 F.3d at 1075.

³⁰ *In re Interstate Bakeries Corp.*, 751 F.3d 955, (8th Cir. 2014).

Unlike the three-judge panel, the full Eighth Circuit commented on the similarity of the facts to the *Exide* case and found the Third Circuit's decision persuasive:

We find useful guidance on analogous facts in the Third Circuit's decision in *In re Exide*. At issue there was the \$135 million sale of Exide's industrial battery business to EnerSys, which included a trademark license agreement. 607 F.3d at 960. Along with the license, Exide sold to EnerSys physical manufacturing plants, equipment, inventory, and certain items of intellectual property. *Id.* The Third Circuit held that Exide's remaining obligations, which included duties to maintain quality standards, to refrain from use of the trademark outside the industrial battery business, and to indemnify EnerSys, did not "outweigh the substantial performance rendered and benefits received by EnerSys." *Id.* at 963–64. The court observed that the remaining contractual obligations did not relate to the purpose of the agreement—the sale of Exide's industrial battery business—and that the trademark license agreement was therefore not executory. *Id.* at 964. For similar reasons, we conclude that the License Agreement between IBC and LBB is not executory.

In re Interstate Bakeries Corp., 751 F.3d at 964.

In a footnote, the Eighth Circuit noted the circuit split between the Fourth Circuit's *Lubrizol* decision and the Seventh Circuit's *Sunbeam* decision on whether rejection of a trademark license terminates the licensee's rights to use the trademark. However, given its holding that the license agreement was not executory, the Eighth Circuit did not need to reach the rejection issue.

4. Bankruptcy Court for the District of New Jersey Extends Section 365(n) Protections to Trademark Licensees on Equitable Grounds

Continuing the trend of protecting trademark licensees in bankruptcy cases, the Bankruptcy Court for the District of New Jersey considered, and rejected, a motion by the buyer of the assets of Crumbs Bake Shop ("Crumbs") to clarify, among other things, that it purchased

the Crumbs trademarks free of trademark licenses previously entered into by Crumbs.³¹ Of particular relevance here, the court addressed two issues: (i) whether trademark licensees to rejected intellectual property licenses fall under the protective scope of section 365(n), notwithstanding that “trademarks” are not explicitly included in the Bankruptcy Code’s definition of “intellectual property;” and (ii) to the extent there are continuing obligations under the license agreements, which party is entitled to the collection of royalties generated as a result of third party licensees’ use of licensed intellectual property.

As to the first issue, the court began by examining the impact of rejection on an intellectual property license. Discussing *Lubrizol*, the court stated that it “is not persuaded by the decision.”³² It cited *Sunbeam* and noted that it is “not alone in finding that its reasoning has been discredited.”³³ The *Crumbs* court decided not to follow *Lubrizol* but did not adopt the Seventh Circuit’s approach to the issue.

Instead, it reviewed the language and legislative history of section 365(n) and its companion definition of “intellectual property.” The court stated that to hold that Congress’s omission of trademarks from section 101(35A)’s definition of intellectual property means that section 365(n)’s protections do not extend to trademarks, would be improper. Citing Judge Ambro’s concurrence in *Exide*, the court concluded that “Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case basis, whether trademark licensees may retain the rights listed under § 365(n)” and found “it would be inequitable to strip” the trademark licensees “of their rights in the event of a rejection, as those rights had been

³¹ *In re Crumbs Bake Shop, Inc.*, No. 14-24287 (MBK), 2014 WL 5508177 (Bankr. D.N.J. Oct. 31, 2014).

³² *Id.* at. * 2.

³³ *Id.*

bargained away by Debtors.”³⁴ The *Crumbs* decision appears to be the first holding that section 365(n)’s protections can be extended to trademark licensees, despite section 101(35A)’s intentional omission of trademarks. In *Exide* and *Interstate Bakeries*, the courts found the trademark licenses at issue no longer executory, while in *Sunbeam*, the court held that rejecting a trademark license does not terminate the licensee’s intellectual property rights.

Extending Section 365(n) rights to trademark licenses, even on an equitable basis, appears to conflict with the statute’s language. Section 101(35A), the definition of intellectual property on which Section 365(n) is based, begins with “The term ‘intellectual property’ means” and then lists six specific categories of intellectual property. Trademarks, service marks, and trade names are not among them. Section 101(35A)’s use of the word “means” is significant, notwithstanding the legislative history about the development of equitable treatment, a subject on which the statute itself is silent. Although the *Crumbs* decision did not hold that Sections 101(35A) and 365(n) apply to trademarks in all cases, it extended Section 365(n) rights, expressly by name, to trademark licensees on equitable grounds. Given Congress’s use of the restrictive term “means” in the statutory definition, and its intentional omission of trademarks, service marks, and trade names from Section 101(35A), extending Section 365(n)’s statutory protections to trademark licensees seems to create an unnecessary conflict with the language of the statute. Instead, the *Crumbs* court could have reached a similar result by ruling, as Judge Ambro suggested in his *Exide* concurrence, that on equitable grounds rejection of a trademark license does not deprive the licensee of its rights, or as the Seventh Circuit did in *Sunbeam*, that rejection does not terminate a counterparty’s license rights at all.

As to the second issue, the court addressed whether the buyer, as the new owner of the trademarks, or the debtor, as the party to the trademark licenses that were not assigned to the

³⁴ *Id.* at * 4.

buyer, was entitled to payment of ongoing royalties under those agreements. The court cited the Third Circuit’s decision in *In re CellNet Data Sys., Inc.*,³⁵ and its ruling that section 365(n) links royalties to the license agreement rather than the intellectual property. The *Crumbs* court concluded that because the license agreements had not been assigned, the buyer did not obtain royalty rights under the licenses going forward. However, since the debtors no longer owned the trademarks, the court questioned how anyone other than the buyer could perform under the trademark license agreements and, accordingly, concluded that rejection likely is necessary.

The *Crumbs* decision and the full Eighth Circuit’s decision in *Interstate Bakeries* are yet more rays of hope for trademark licensees. They continue the recent trend of courts finding ways to protect trademark licensees from the harsh result of losing all rights to use a trademark via rejection. Still, unless the *Sunbeam* or perhaps *Crumbs* decisions are adopted broadly or Congress changes the law to include trademarks within section 365(n)’s protections, trademark licensees whose licensors file bankruptcy — and especially those whose licenses were granted outside of an asset sale context — are by no means out of the woods.

D. Rejection of Intellectual Property License Hybrids

Often a license of software or other products that involve copyrights or patents will include a license to use an associated trademark. In that case, even if the license were rejected, the licensee would have section 365(n) rights to retain the “bankruptcy intellectual property” – in this example the rights to the copyrighted or patented intellectual property – but would still lose the trademark license unless the court followed the *Sunbeam* or *Crumbs* decisions. One case so holding is *In re Centura Software Corp.*³⁶ In that case, the debtor rejected a license that granted the counterparty a license to use the debtor’s software and trademarks. The counterparty sought to continue to use the trademarks after electing to retain its rights in the software pursuant to section 365(n). The court found that section 365(n) was clear in that Congress “expressly

³⁵ 327 F.3d 242 (3d Cir. 2003).

³⁶ 281 B.R. 660 (Bankr. N.D. Cal. 2002).

withheld § 365(n) protection from rejected executory trademark licenses.”³⁷ While the court acknowledged that “the result may appear harsh to the counter-party ... once a license has been rejected, the counter-party may not continue to use the trademarks.”³⁸

There are a few, albeit limited, strategies available for trademark licensees to protect themselves in the event a future bankruptcy court refuses to offer any protection regarding trademark rights.

- Unbundle the payments. In negotiating bundled licenses, the licensee should anticipate the prospect of losing rights to the trademark if a bankruptcy is filed. One approach would be to separate out any royalty or license payments for the trademark from those related to the other intellectual property being licensed. This way, the licensee can avoid having to pay amounts allocable to the rejected trademark license in order to retain its other IP license rights under section 365(n).
- Take ownership of the mark. Would-be licensees with enough leverage sometimes demand that the trademark and its goodwill be transferred to them, coupled with a license back to the now-former trademark owner. This is perhaps the most effective method, but also the least likely to be achieved in negotiations.
- Get a security interest. Another strategy involves taking a security interest in the mark or the licensor’s other assets to secure the damage claim that the licensee would have if the trademark owner rejects the license. Licensees pressing for a security interest do so in part hoping that a debtor licensor faced with a secured claim for rejection damages may decide against rejecting the license in the first place.
- Oppose a rejection motion. Once a bankruptcy is filed, a trademark licensee should consider challenging a debtor or trustee’s decision to reject the trademark license or, using *Exide* and/or *Sunbeam*, argue that rejection does not terminate the licensee’s trademark rights. If little good would come of the rejection for the debtor or its creditors, the licensee could oppose the motion arguing that the decision to reject is an inappropriate exercise of the debtor’s business judgment.³⁹

³⁷ *Id.* at 670.

³⁸ *Id.* at 662.

³⁹ See *Centura*, 281 B.R. at 672 n. 19 (“To protect the entire bundle of rights under an intellectual property contract, according to Norton, timing is important. To shield its trademark rights, the licensee must intervene before the court approves of the debtor’s efforts to reject the agreement. ... [T]he licensee should argue that the relatedness of the trade name to the protected property should allow it to bootstrap ongoing trademark rights through an application of the business judgment rule, notwithstanding the Bankruptcy Code’s exclusion of trademarks.”) (citation and quotations omitted).

IV. THE BANKRUPTCY OF AN INTELLECTUAL PROPERTY LICENSEE

An intellectual property licensee in bankruptcy has the option of choosing to assume, reject or assume and assign its license agreements and other executory contracts.

A. Rejection

When a debtor is the licensee of intellectual property and it rejects an intellectual property license, the licensor is entitled to a claim pursuant to section 365(g) for rejection damages as though the license agreement were breached as of the bankruptcy filing. Section 365(n)'s provisions allowing a licensee the option to retain its rights under the contract are not available to a non-debtor licensor; section 365(g) is the sole remedy for licensors whose license agreements have been rejected. However, if the debtor used the intellectual property during the bankruptcy case and before rejection, the licensor may be entitled to an administrative claim for the period following the petition date and prior to rejection. (Likewise, if the debtor assumes a license agreement and then rejects it, the licensor's rejection damages will be afforded administrative claim status.)

B. Assignment

Assumption and assignment, as well as simple assumption, of in-bound intellectual property license agreements are more complicated. As noted above, assumption (or rejection) of a license agreement is only possible if the agreement is an executory contract.

Section 365(b) provides that certain requirements must be met to assume an executory contract (i.e., debtor must cure defaults and provide adequate assurance of future performance). However, section 365(c)(1) contains an exception to the general rule that executory contracts can be assumed and assigned to third parties upon satisfying section 365(b) and that anti-assignment clauses are invalidated under section 365(e). The exception applies when "applicable law" precludes such an assignment absent consent of the nondebtor party.

Specifically, section 365(c)(1) provides that

The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if ... applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in

possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and ... such party does not consent to assumption or assignment[.]

11 U.S.C. § 365(c)(1).

Collectively, and as explained at greater length below, a number of courts have interpreted the phrase “applicable law” in section 365(c)(1) to mean patent, copyright, and trademark law, holding that these federal intellectual property laws excuse a non-debtor party to an intellectual license from accepting performance from or rendering performance to an entity other than the debtor in bankruptcy. This rule applies with greatest force to non-exclusive intellectual property licenses but also likely applies to exclusive licenses too.⁴⁰ As a result, these courts have held that an intellectual property licensor who does not consent can successfully block a debtor from assigning a patent, copyright, or trademark license to a third party during a bankruptcy case. Consent can be given prior to or during the bankruptcy case.

It is important for licensees to know that “consent” to assumption or assignment of an intellectual property license need not be affirmatively given. Instead, consent can come in one of three ways.

- The licensor can affirmatively consent in writing after a bankruptcy case has been filed.
- A licensor that fails to object after a motion has been filed seeking to assume, or to assume and assign, a license agreement will likely be deemed to have consented.
- A number of license agreements expressly permit assignment under certain circumstances and many, but not all, courts will treat such provisions as providing the consent required under section 365(c)(1)(B).⁴¹

⁴⁰ See Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, Berkeley Tech. Law J., Vol. 22, p. 733 (March 1, 2007).

⁴¹ License agreements often include a provision permitting assignment of the license in conjunction with a sale of all or substantially all of the assets of the licensee. See *In re Glycogenesys, Inc.*, 352 B.R. 568, 576-7 (Bankr. D. Mass. 2006)). But see *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 266-67 (4th Cir. 2004) (consent to assignment in license agreement does not constitute consent to assumption).

C. Assumption

Accordingly, licensees have asked if a debtor cannot assign an intellectual property license without the consent of the licensor, can it, at a minimum, assume the license (i.e., keep it for itself)? To answer this question, courts have tediously examined the first seven words of section 365(c)(1): “The trustee may not assume or assign...”, developing three different approaches for interpreting this language.

The assumption issue can arise in bankruptcy sales. Although most sales occur under section 363 and involve an assignment of any intellectual property licenses, sometimes a buyer prefers to acquire the debtor’s assets through a plan of reorganization. In that case, the debtor would likely be seeking to assume, but not assign, its intellectual property licenses.

One of the three approaches taken by courts in answering the assumption question is called the “hypothetical test.” It involves reading section 365(c)(1)’s language as asking whether the debtor *hypothetically could* assign the license even if it is only proposing to assume it.⁴² If the debtor could not assign the license agreement, then it would not be permitted to assume it either, absent consent of the licensor. At least three circuits, the Third, Fourth, and Ninth Circuits, and seemingly the Eleventh Circuit, have adopted this hypothetical test.

A second method, referred to as the “actual test,” interprets the statute’s language as asking only what the debtor is *actually proposing* to do.⁴³ If the debtor cannot assign the license agreement, but is proposing only to assume it and not actually assign it, then the debtor would be

⁴² *In re Catapult Entm’t, Inc.*, 165 F.3d 747, 749-50 (9th Cir. 1999) (citing *City of Jamestown v. James Cable Partners, L.P.* (*In re James Cable Partners*), 27 F.3d 534, 537 (11th Cir. 1994)); *In re West Elec. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988); *Breeden v. Catron* (*In re Catron*), 158 B.R. 629, 633-38 (E.D. Va. 1993); *RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra Corp.*), 361 F.3d 257, 266-67 (4th Cir. 2004).

⁴³ *Institut Pasteur, et al. v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *Bonneville Power Admin. v. Mirant Corp.* (*In re Mirant Corp.*), 440 F.3d 238, 248 (5th Cir. 2006). In *Mirant*, following the bankruptcy filing, the Bonneville Power Administration (BPA) attempted to terminate its executory contract with Mirant based on an *ipso facto* clause, a provision that makes a bankruptcy filing a breach of contract. While these provisions generally are not enforced, the BPA relied on section 365(e)(2)(A), which closely mirrors the language of section 365(c)(1)(A), and argued that it could terminate the contract because applicable law -- the federal Anti-Assignment Act, 41 U.S.C. Section 15 -- excused it from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession. After a lengthy analysis, the Fifth Circuit joined the First Circuit and expressly adopted the “actual” test. The Fifth Circuit held that the *ipso facto* clause was null and void under section 365(e)(1) because Mirant, the debtor in possession, was not actually planning to assign the contract.

permitted to assume the agreement. Two circuits, the First and Fifth Circuit, have adopted this actual test.

The third approach came in a 2005 decision in *In re Footstar, Inc.*,⁴⁴ where the Bankruptcy Court for the Southern District of New York broke new ground. Although it did not involve intellectual property licenses, the case put section 365(c)(1)'s language front and center and came up with another way of analyzing this critical section. Judge Adlai Hardin adopted a new "literal" reading of section 365(c)(1), one that he found was "entirely harmonious with both the objective sought to be obtained in Section 365(c)(1) and the overall objectives of the Bankruptcy Code, without construing 'or' to mean 'and.'" The Court's approach is that section 365(c)(1)'s use of the word "trustee" does not (as other courts had taken for granted) include the debtor or debtor in possession when assumption is sought because assumption does not require the non-debtor party to accept performance from a new party other than the debtor or debtor in possession. A trustee is a new party and the statute logically provides that a trustee may not "assume or assign" such an executory contract. As such, the right of the non-debtor party to object to assignment does not by itself affect the right of the debtor in possession (as opposed to a trustee) to assume an executory contract.⁴⁵

In January 2007, Judge Robert Gerber, also of the Bankruptcy Court for the Southern District of New York, faced the same issue in the *Adelphia Communications* Chapter 11 case. In his decision, Judge Gerber expressly rejected the cases following the "hypothetical" test as "incorrectly decided," and instead embraced Judge Hardin's *Footstar* decision, describing it as "consistent in outcome with the decisions of" those courts following the "actual" theory.⁴⁶ In a footnote, Judge Gerber stated: "[W]here there is no Second Circuit authority, [the Bankruptcy Court for the Southern District of New York] follows the decisions of other bankruptcy judges in this district in the absence of clear error. But to say that the *Footstar* decisions should be

⁴⁴ 323 B.R. 566 (Bankr. S.D.N.Y. 2005).

⁴⁵ For a detailed discussion of the *Footstar* decision, see Jay R. Indyke, Richard S. Kanowitz and Brent Weisenberg, *Ending the 'Hypothetical' vs. 'Actual' Test Debate: A New Way to Read Section 365(c)(1)*, 16 J. BANKR. L. & PRAC. 2 Art. 2 (2007).

⁴⁶ See *In re Adelphia Commc'ns Corp.*, 359 B.R. 65 (Bankr. S.D.N.Y. 2007).

followed under that standard would be faint praise here. In this Court's view, Judge Hardin's analysis in those decisions was plainly correct."⁴⁷

The Supreme Court has expressed an interest in resolving the issue of the proper analysis of section 365(c)(1). In the *N.C.P. Marketing Group* case, discussed below, the appellant petitioned the United States Supreme Court for a writ of certiorari, seeking review of the decision denying it the ability to assume the trademark license. Although voting to deny review, Justice Kennedy issued a three-page statement on that decision to express his view, joined by Justice Breyer, that the Supreme Court should considering granting certiorari in a future case on

⁴⁷ *Id.* at 72 n.13. Similarly, in *In re Aerobox Composite Structures*, the Bankruptcy Court for the District of New Mexico adopted the *Footstar* approach:

Similarly, the bankruptcy court in *Footstar* reasons that it makes perfect sense for the statute, which uses the term, "trustee," to prohibit the trustee from assuming or assigning a contract, because the trustee *is* an "entity other than the debtor in possession" but it makes no sense to read "trustee" to mean "debtor in possession." *Footstar*, 323 B.R. at 573. Doing so

would render the provision a virtual oxymoron, since mere assumption [by the debtor in possession] (without assignment) would *not* compel the counterparty to accept performance from or render it to "an entity other than" the debtor.

Id.

This Court agrees.

Thus, where the debtor-in-possession seeks to assume, or, as is the situation in the instant case, where the debtor-in-possession has neither sought to assume nor reject the executory contract but simply continues to operate post-petition under its terms, 11 U.S.C. § 365(c)(1) does not prohibit assumption of the contract by the debtor-in-possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract. In reaching this conclusion, the Court finds that the "actual test" articulated in *Cambridge Biotech*, and the reasoning of the court in *Footstar*, is the better approach to § 365(c)(1) when determining whether a debtor-in-possession is precluded from assuming an executory contract.

In re Aerobox Composite Structures, 373 B.R. 135, 141-2 (Bankr. D.N.M. 2007).

the “significant question” of whether the hypothetical test or the actual test should be applied in interpreting section 365(c)(1) of the Bankruptcy Code.⁴⁸

Justice Kennedy’s discussion of the two tests suggests that he (and perhaps Justice Breyer) may be leaning toward the actual test. Although noting that the actual test “may present problems of its own,” including that it aligns section 365 “with sound bankruptcy policy only at the cost of departing from at least one interpretation of the plain text of the law,” Justice Kennedy aimed most of his criticism at the hypothetical test:

The hypothetical test is not, however, without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code’s text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim—and resell at the prevailing, potentially higher market rate—the rights it sold to the debtor.⁴⁹

D. Assignment of Trademark Licenses

Two Courts of Appeals have held that trademark licenses are not assignable in bankruptcy absent the consent of the trademark owner or sublicensor. In hypothetical test courts, the trademark licenses would also not be assumable.

One case comes from the United States Court of Appeals for the Seventh Circuit.⁵⁰ The dispute that led to the Seventh Circuit’s decision arose in the first Chapter 11 bankruptcy case of Hartmarx Corporation (which later changed its name to “XMH”). One of its subsidiaries, Simply Blue (“Blue”), which was also in bankruptcy, sold its assets in a section 363 sale to two purchasers. Among Blue’s assets was an executory contract with Western Glove Works

⁴⁸ Statement of Kennedy, J., *N.C.P. Mktg. Group, Inc. v. BG Star Prods., Inc.*, 129 S.Ct. 1577 (2009), On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, No. 08-463, decided March 23, 2009.

⁴⁹ 129 S.Ct. at 1578.

(“Western”), which Blue sought to assign to the purchasers. Western objected, arguing that the contract could not be assigned because it was a sublicense to Blue of a trademark licensed by Western. The bankruptcy court agreed with Western and XMH appealed. While XMH’s appeal was pending, Blue and the purchasers amended the contract. Under the amendment, title to the contract was left with Blue but the purchasers assumed all of Blue’s contractual duties, together with the right to receive all fees to which Blue was otherwise entitled. The bankruptcy court approved the amendment and Western appealed from that decision. In the meantime, the district court reversed the bankruptcy court’s original decision holding that the contract could not be assigned, effectively allowing the original contract to be assigned. Western appealed the district court’s decision and that brought the case to the Seventh Circuit.

The Court looked to section 365(c)(1) of the Bankruptcy Code, which limits assignment of an executory contract if “applicable law” permits the non-debtor party to the contract to refuse to accept performance from an assignee, regardless of whether the contract prohibits or restricts assignment. In this case, the contract did not prohibit or restrict assignment (but neither did it permit it). Western argued that “applicable law” was trademark law because the contract stated that Western was a licensee of a trademark for “Jag Jeans.” The Court noted that “Jag” is a federally registered trademark, although “Jag Jeans” is not.

The Court held that if the contract included a trademark sublicense when XMH attempted to assign the contract, it was not assignable. This was true regardless of whether federal trademark law applied, any particular state’s trademark law applied, and also, apparently, even if Canadian law applied (Western is a Canadian company):

None of this matters, though, because as far as we’ve been able to determine, the universal rule is that trademark licenses are not assignable in the absence of a clause expressly authorizing assignment. *Miller v. Glenn Miller Productions, Inc.*, 454 F.3d 975, 988 (9th Cir. 2006) (per curiam); *In re N.C.P. Marketing Group, Inc.*, 337 B.R. 230, 235-36 (D. Nev. 2005); 3 *McCarthy on Trademarks* § 18:43, pp. 18-92 to 18-93 (4th ed. 2010).⁵¹

⁵⁰ *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011) (J. Posner).

⁵¹ *Id.* at 695.

After describing how consumers rely on a trademark as an indicator of a good's quality, the Court explained that if a trademark owner (or licensee sublicensing the mark) allows another company to produce the trademarked goods, it

will not want the licensee to be allowed to assign the license (that is, sublicense the trademark) without the owner's consent, because while the owner will have picked his licensee because of confidence that he will not degrade the quality of the trademarked product he can have no similar assurance with respect to some unknown future sublicensee.

Because this is the normal reaction of a trademark owner, it makes sense to make the rule that a trademark license is not assignable without the owner's express permission a rule of contract law--what is called a 'default' rule because it is the rule if the parties do not provide otherwise (as they are allowed to do).⁵²

Ultimately, the Seventh Circuit held that although the contract included a trademark sublicense, the sublicense had expired and the parties had not designated the contract, post-expiration, as a trademark sublicense. Further, the court held that the balance of the contract was only a service agreement and not an implied trademark license. The court also refused to consider whether a contract could be a trademark license for some purposes but not others. As such, with no actual trademark sublicense in existence at the time of assignment, the default rule discussed above did not apply and the executory contract could be assigned. The Seventh Circuit affirmed the lower courts' decisions approving the assignment of the contract as amended.

The other Court of Appeals to hold that trademark licenses are not assignable absent consent of the trademark owner is the Ninth Circuit.⁵³ In this case, the trademark owner, Billy Blanks of the Billy Blanks® Tae Bo® fitness program, successfully moved the court to compel rejection of the trademark license because under the "hypothetical test" analysis of section 365(c)(1) of the Bankruptcy Code, contracts that cannot be assigned by the debtor without the nondebtor party's consent cannot be assumed by the debtor either.

The District Court held that under the Lanham Act, the federal trademark statute, a trademark owner has a right and duty to control the quality of goods sold under the mark:

⁵² *Id.* at 696.

Because the owner of the trademark has an interest in the party to whom the trademark is assigned so that it can maintain the good will, quality, and value of its products and thereby its trademark, trademark rights are personal to the assignee and not freely assignable to a third party.⁵⁴

In an unpublished order dated May 23, 2008, the Ninth Circuit denied the request for oral argument and affirmed the District Court’s judgment “for the reasons provided by that court.”⁵⁵ While the order was designated as “not for publication”, meaning that it is not precedential, it may be cited by other cases. The appellants’ request for a panel rehearing or rehearing *en banc* was subsequently denied, as was their petition to the Supreme Court for certiorari.

In addition to the *N.C.P. Marketing* Nevada District Court decision, a Florida district court has also weighed in on the issue of assignability of trademark licenses. In *In re Wellington Vision, Inc.*,⁵⁶ Pearle Vision sought relief from the automatic stay to terminate a franchise agreement with Wellington Vision, arguing that Wellington could not assume the agreement because it included a non-exclusive license of Pearle Vision trademarks. The United States Bankruptcy Court for the Southern District of Florida granted the motion for stay relief, holding that the inclusion in the franchise agreement of a trademark license made the agreement, under federal trademark law, non-assignable absent consent by Pearle Vision.

Wellington Vision filed an appeal from the Bankruptcy Court’s decision. Wellington argued that (1) Pearle Vision had failed to establish that the franchise agreement included a trademark license, (2) a provision in the franchise agreement allowing for assignments on consent that cannot be unreasonably withheld meant that the parties had opted out of applicable law, and (3) section 365(c)(1) of the Bankruptcy Code only prohibits assumption or assignment by a trustee, not by a debtor in possession, citing *Footstar*. Pearle Vision argued that “applicable law” is the federal Lanham Act, which makes trademark licenses personal and non-assignable, and that section 365(c)(1) creates a hypothetical test and precludes assignment or assumption of the license.

⁵³ See *In re N.C.P. Marketing Group, Inc.*, 337 B.R. 230 (D. Nev. 2005), *aff’d*, 279 Fed. Appx. 561 (9th Cir. 2008).

⁵⁴ 337 B.R. at 236.

⁵⁵ See *In re N.C.P. Marketing Group, Inc.*, 279 Fed. Appx. 561 (9th Cir. 2008).

⁵⁶ 364 B.R. 129 (S.D. Fla. 2007).

The United States District Court for the Southern District of Florida affirmed the bankruptcy court's decision. The district court first held that the franchise agreement expressly included a non-exclusive license to certain Pearle Vision trademarks, making the Lanham Act the "applicable law" to be considered under section 365(c)(1). It then held that the agreement's provisions contemplating assignment under certain conditions did not constitute consent to any specific assignment or an "opt out" of the Lanham Act's general restrictions on assignment, distinguishing *In re Quantegy*,⁵⁷ relied on by Wellington. Finally, the district court held that section 365(c)(1) did apply to debtors in possession and not just to trustees, citing the Eleventh Circuit's decision in *City of Jamestown v. James Cable Partners, L.P.*⁵⁸

E. Assignment of Copyright Licenses

The assignability of copyright licenses may depend, in part, on whether the licensee is granted an exclusive or a nonexclusive license. Courts generally hold that non-exclusive copyright licenses cannot be assigned absent consent.⁵⁹ Again, in hypothetical test courts, this would render copyright licenses non-assumable as well without the copyright owner's consent.

With respect to exclusive copyright licenses, the case law is mixed. On the one hand, in *Gardner v. Nike, Inc.*, the United States Court of Appeals for the Ninth Circuit held that an exclusive copyright license is not assignable absent a copyright holder's consent.⁶⁰ On the other hand, dicta from *In re Patient Educ. Media, Inc.* appears to indicate otherwise.⁶¹ However, the *Gardner* district court rejected this dicta, calling its value into question.⁶²

⁵⁷ 326 B.R. 467 (Bankr. M.D. Ala. 2005).

⁵⁸ 27 F.3d 534 (11th Cir. 1994).

⁵⁹ See, e.g., *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (the nonexclusive license does not transfer any rights of ownership; ownership remains in the licensor....Accordingly, the nonexclusive license is personal to the transferee, and the licensee cannot assign it to a third party without the consent of the copyright owner." Court rejected the argument that bankruptcy changes this result); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 310 (Bankr. D. Del. 2001) (finding agreements to be nonexclusive copyright agreements and noting that because nonexclusive license agreements do not give rise to ownership rights, they cannot be assigned without the license owner's consent).

⁶⁰ See 279 F.3d 774 (9th Cir. 2002).

⁶¹ See 210 B.R. at 240 ("The holder of the exclusive license is entitled to all of the rights and protections of the copyright owner to the extent of the license. Accordingly, the licensee under an exclusive license may freely transfer his rights, and moreover, the licensor cannot transfer the same rights to anyone else.").

⁶² See *Gardner v. Nike, Inc.*, 110 F.Supp.2d 1282, 1287 n.4 (C.D. Cal. 2000).

F. Assignment of Patent Licenses

Courts have generally held that non-exclusive patent licenses are not assignable without the consent of the patent holder because such licenses are personal to the licensee and do not give rise to a property right in the licensee.⁶³ In hypothetical test courts, such patent licenses could also not be assumed by the debtor absent the patent owner's consent.

Although an exclusive license provides the licensee greater rights, including an ability to sue for patent infringement, courts have held that exclusive patent licenses are likewise not assignable without the patent owner's consent. In *In re Hernandez*, the court held that an exclusive licensee's standing to sue for patent infringement does not permit the licensee to assign the license without the licensor's consent.⁶⁴ The court concluded that to allow such free assignability would "create a situation where a patent holder loses control over the identity of its license holders," and would effectively treat an exclusive license as an assignment of the patent, which would be inconsistent with federal patent law, "which carefully distinguishes between the two."⁶⁵ Other courts have adopted the *In re Hernandez* approach as well.⁶⁶ This approach, however, does permit assignment by the exclusive licensee if in the license agreement the licensor consented to assignment, as long as the assignment complies with the scope of that consent.⁶⁷

⁶³ *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986) ("It is well settled that a non-exclusive licensee of a patent has only a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment."); see also, e.g., *Perlman v. Catapult Entm't (In re Catapult Entm't)*, 165 F.3d 747, 750 (9th Cir. 1999) (non-exclusive patent licenses may not be assigned if the licensor objects); *In re Access Beyond Tech.*, 237 B.R. 32, 44 (a non-exclusive patent license is not assignable without the licensor's consent).

⁶⁴ 285 B.R. 435, 440 (Bankr. D. Ariz. 2002).

⁶⁵ *Id.*, at 439-440.

⁶⁶ *ProteoTech, Inc. v. Unicity Intern., Inc.*, 542 F.Supp.2d 1216, 1219 (W.D. Wash. 2008) ("This Court agrees with the Arizona Bankruptcy Court that the rationale for requiring actual or constructive consent of the licensor applies regardless of whether the license is exclusive or non-exclusive.").

⁶⁷ *In re Hernandez*, 285 B.R. at 441.

Intellectual Property and Insolvency Issues:

Valuation of Intellectual Property within a Bankruptcy Context

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INTELLECTUAL PROPERTY AND INSOLVENCY ISSUES:

VALUATION OF INTELLECTUAL PROPERTY WITHIN A BANKRUPTCY CONTEXT

INTRODUCTION

First, this discussion summarizes the various types of intellectual property assets and the general reasons why valuation analysts (“analysts”) are asked to value commercial intellectual property. Second, this discussion focuses on the specific reasons why analysts are asked to value debtor company intellectual property within a bankruptcy context. Third, this discussion describes and illustrates the generally accepted intellectual property valuation approaches and methods. Fourth, this discussion summarizes the common data sources and due diligence procedures related to an intellectual property valuation. And, finally, this discussion presents some analyst caveats and report writing guidelines for intellectual property valuations performed within a bankruptcy context.

Types of Intellectual Property

Whether or not the valuation analysis relates to a bankruptcy proceeding, there are only four categories of intellectual property:

- Patents
- Trademarks
- Copyrights
- Trade secrets

These four types of intellectual property are one subset of the general category of commercial intangible assets.

Intellectual Property and Insolvency Issues: Valuation of Intellectual Property Within a Bankruptcy Context

Patents, trademarks, and copyrights are created by and protected by federal statutes. Trade secrets are created under and protected under state statutes. However, most states have either completely adopted—or adopted the essence of—the Uniform Trade Secret Act within their state statutes.

For purposes of this bankruptcy-related discussion, only the debtor company may be the intellectual property owner (and, particularly, the licensor) or the intellectual property non-owner operator (i.e., the licensee). Therefore, in this discussion, the debtor company is generally referred to as “the owner/operator.”

For purposes of this bankruptcy-related discussion, the above-listed four intellectual property categories may be expanded slightly to include associated or contributory intangible assets.

The patents category includes patent applications, the technology and designs encompassed in the patent, and the engineering drawings and other technical documentation that accompanies the patent or patent application.

The trademarks category includes trademarks (both registered and unregistered), trade names, service marks, service names, trade dress, product labeling that includes trademarks, institutional advertising (including signage), and promotional materials that include trademarks.

The copyrights category includes both registered and unregistered copyrights on publications, manuscripts, white papers, musical compositions, plays, manuals, films, computer source code, blueprints, technical drawings, and other forms of documentation.

For purposes of this discussion, the trade secrets category includes any information or procedures that (1) the owner/operator keeps secret and (2) provides some economic benefit to the owner/operator. Such trade secrets include computer software source code, employee

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manuals and procedures, computer system user manuals and procedures, station or employee operating manuals and procedures, chemical formula, food and beverage recipes, product designs, engineering drawings and technical documentation, plant or process schematics, financial statements, employee files and records, customer files and records, vendor files and records, and contracts and agreements.

It is not uncommon for an owner/operator to have two or more related intellectual properties. For example, the same product can have a utility patent and a design patent. The same product can have a patent and a trademark. The same software can hold a copyright and be a trade secret. The same procedure manuals can hold a copyright and be a trade secret. The same drawings and schematics can be included within a patent, have a copyright, and be a trade secret.

Because the owner/operator can own two or more related intellectual properties, analysts may be asked to assign values for the individual intellectual property for bankruptcy, fair value accounting, income tax accounting, property tax accounting, and many other purposes. In disputes related to infringement or breach of contract, it is often possible for two or more intellectual property assets to be damaged by the wrongful action. The analyst may be asked to assign or allocate the damages amount among the affected intellectual property. Of course, the damages analysis should consider each of the affected intellectual properties, but the damages analysis should not double count the amount of damages by assigning the same damages to two or more intellectual properties.

Within multinational corporations, different business units in different taxing jurisdictions can own different intellectual property. For example, a product design could benefit from a utility or design patent in county alpha, the product could be manufactured with a trade secret in county beta, and a trademark could be assigned to the final product in county gamma.

Such a multinational corporation manufacturer may analyze the intercompany transfer price considerations of each intellectual property application.

Reasons to Analyze Intellectual Property

For purposes of this discussion, analysts may be asked to perform intellectual property valuations for the following general reasons:

1. *Financial accounting*: fair value acquisition accounting and intangible asset impairment testing
2. *Income tax accounting*: value of a contribution from an owner to a company or of a distribution from a company to an owner, a charitable contribution, abandonment deduction, taxpayer solvency or insolvency analysis, or the purchase price allocation in a taxable acquisition
3. *Property tax accounting*: for intangible assets that are either subject to property tax or exempt from property tax
4. *Bankruptcy*: post-bankruptcy fresh start accounting, value of debt collateral, reasonably equivalent value of assets transferred into or out of the bankruptcy estate, fairness of the price of a bankruptcy estate asset sale, and debtor solvency or insolvency analysis
5. *Fairness of transaction price*: between any two arm's-length parties, between a parent corporation and a less-than-wholly-owned subsidiary, and between a for-profit entity and a not-for-profit entity

The preceding list presents many (but not all) of the common transactional and notational reasons to estimate an intellectual property value. The purpose of this listing is to demonstrate that there are numerous commercial reasons (most unrelated to a bankruptcy proceeding) to value an owner/operator's intellectual property.

And, related to all of these reasons, there is a profession of analysts who apply generally accepted intellectual property valuation approaches, methods, and procedures. These analysts comply with promulgated professional standards and rely upon a body of knowledge documented in a set of professional literature. Therefore, intellectual property valuation is not the

invention of one or more parties who are trying to gain some sort of an advantage in a bankruptcy proceeding.

Valuation Approaches and Methods

All of the generally accepted intangible asset valuation approaches are applicable to intellectual property. Cost approach methods are particularly applicable to the contributory (or backroom) types of intellectual property. Market approach methods are particularly applicable to intellectual property that is (or could be) licensed. And income approach methods are particularly applicable to intellectual property that produces a measurable amount of operating income for the owner/operator.

The cost approach is often applicable to the valuation of trade secret proprietary information and of copyrights on internal use software. For example, the cost approach may be used to value procedure manuals, training manuals, technical documentation and drawings, internal use training films, confidential books and records, confidential customer or supplier files, or the source code for internal use computer software. For these types of intellectual property assets, it may be difficult for the analyst to assemble comparable uncontrolled transaction (CUT) sale or license data or to identify asset-specific income measures.

The market approach is often applicable to the valuation of patents, trademarks, and certain copyrights. For such intellectual property, it is common for the asset owner/developer to license the use of the intellectual property to a third-party asset operator. The various forms of royalty payments from the licensee to the licensor (for example, royalty as a percent of revenue, as a percent of income, or on a per unit basis) may be used to estimate the intellectual property value.

The income approach is often applicable to the valuation of patented or unpatented (trade secret) processes or technologies. The income approach is also applicable to the valuation of certain trademarks and copyrights. For example, it may be applicable if the patented product or process (or the trade secret product formulation in process) allows the owner to generate increased revenue or experience decreased costs. This income measure may occur when the owner/operator experiences increased unit sales or increased unit selling prices due to the proprietary feature. Alternatively, it may occur if the owner/operator experiences decreased operating expenses or decreased other expenses due to a property process. The income approach is often used in the valuation of copyrights related to books, plays, musical compositions, or films and film libraries. This is because the analyst can often identify a measurable stream of income associated with the commercialization of the copyrighted work.

BANKRUPTCY-RELATED INTELLECTUAL PROPERTY VALUATIONS

The following discussion summarizes 10 common reasons why analysts are asked to value intellectual property within a bankruptcy context. The section citations refer to the United States Bankruptcy Code. The rule citations refer to the United States Bankruptcy Rules.

Reason 1: Preference Claims and Debtor Solvency (Section 547)

Creditors often retain an analyst to assess the debtor's solvency prior to the date of the bankruptcy filing. The creditors may want to claim that (1) the debtor was in fact solvent prior to the bankruptcy filing and (2) therefore, their receipt of either property or cash from the debtor was not an avoidable preference payment.

In a Chapter 11 bankruptcy matter, the appointed trustee may seek to avoid (i.e., reverse) any transfers of cash or property out of the bankruptcy estate. That avoidance brings more property and more cash back into the bankruptcy estate—to allow the trustee to settle more of the debtor’s liabilities. Section 547 allows the trustee to avoid certain so-called preference payments under certain circumstances. The relevant subsections of Section 547 follow:

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property

1. to or for the benefit of a creditor;
2. for or on account of an antecedent debt owed by the debtor before such transfer was made;
3. made while the debtor was insolvent; . . .

(f) For purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

Of course, the creditor recipients of the debtor’s property or cash may not be so willing to return the transaction proceeds to the bankruptcy estate. Hence, the creditors often retain an analyst to assess the debtor’s solvency prior to the date of the bankruptcy filing.

Reason 2: Fraudulent Transfers and Debtor Solvency (Section 548)

Often, the trustee retains an analyst to opine that the debtor corporation was insolvent on the pre-bankruptcy transfer dates. Alternatively, the affected creditors often retain an analyst to opine that the debtor corporation was solvent on the pre-bankruptcy transfer dates.

In the Chapter 11 bankruptcy filing, the trustee can avoid (or reverse) either transfers made by the debtor corporation or liabilities assumed by the debtor corporation under certain circumstances. An important factor in determining if the debtor’s transfer was fraudulent (and,

therefore, if the transfer may be avoided) is whether the debtor corporation was insolvent at the date of the transfer.

The relevant subsections of Section 548 related to fraudulent transfers and debtor solvency are presented below:

(a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . .

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(b)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

With regard to the above-described conditions related to a fraudulent transfer, Section 548 lists three separate fraudulent transfer tests that are performed as of the transfer date. These three fraudulent transfer tests are typically performed by the analyst. These three fraudulent transfer tests determine:

1. whether the debtor corporation was insolvent—i.e., whether the debtor company liabilities exceeded the debtor company liabilities at fair valuation,
2. whether the debtor corporation was expected to be able to pay its debts (including principal and interest payments) as such debts matured, and

3. whether the debtor corporation had an unreasonably small amount of capital to continue to be able to operate as a going concern.

The trustee may claim that a fraudulent transfer had occurred if the analyst concludes that the debtor corporation fails any of these three tests as of the transfer date. And, each of these tests is based on a financial analysis that is typically conducted by the analyst.

SECTION 101 – DEFINITION OF “INSOLVENT”

The previously mentioned claims of preference payments and fraudulent transfers are made, in part, based on the allegation that the debtor corporation was insolvent as of a particular point in time (i.e., a point in time related to a specific pre-bankruptcy transaction). As presented in the subsection below, Section 101 of the Bankruptcy Code provides the relevant definition for the term “insolvent”:

- (32) The term "insolvent" means—
- (A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—
- (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
 - (ii) property that may be exempted from property of the estate under section 522 of this title;
- (B) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation—
- (i) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and
 - (ii) the sum of the excess of the value of each general partner's nonpartnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's nonpartnership debts; and
- (C) with reference to a municipality, financial condition such that the municipality is—
- (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or
 - (ii) unable to pay its debts as they become due.

The principal provision of this insolvency definition can be summarized as: are the debtor company's debts greater than the value of the debtor company's assets (including intellectual property), at fair valuation? The answer to that question is based on a valuation analysis. If the answer is yes (i.e., liabilities exceed the fair value of assets), then the debtor company is

insolvent. If the answer is no (i.e., the fair value of assets—including intellectual property—exceeds liabilities), then the debtor company is solvent.

REASON 3: ASSET SALES AND ADEQUATE PROTECTION (SECTION 363)

The trustee will often retain an analyst to opine that the price of the proposed Section 363 asset sale is fair, thereby providing adequate protection to the creditors. If the proposed asset sale transaction is controversial, then the creditors may also retain an analyst to opine that the price of the proposed asset sale is not fair (i.e., does not provide adequate protection to the creditors)—and that the court should not approve the proposed asset sale.

During a prolonged bankruptcy proceeding, it is common for a DIP to sell off some of the debtor corporation assets included in the bankruptcy estate. Such DIP assets subject to sale may be a subsidiary, division, or other business unit of the debtor corporation. In particular, the DIP may be able to sell off some underperforming business assets. And, the DIP may be able to sell off any nonoperating assets that are not part of the debtor company's core business. Such asset sales (often referred to as "363 asset sales") are typically intended to both (1) eliminate or reduce any DIP operating losses and (2) generate cash that would become available to pay off some of the debtor company's liabilities.

However, in a bankruptcy proceeding, the trustee has to make sure that such 363 asset sales are fair to the stakeholders of the bankruptcy estate, such stakeholders are primarily the debt holders. The following subsection of Section 363 relates to asset sales from the bankruptcy estate.

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may

use property of the estate in the ordinary course of business without notice or a hearing.

(p) In any hearing under this section—

- (1) the trustee has the burden of proof on the issue of adequate protection; and
- (2) the entity asserting an interest in property has the burden of proof on the issue of the validity, priority, or extent of such interest.

REASON 4: DECREASE IN THE VALUE OF A CREDITOR’S INTEREST (SECTION 361)

After a 363 asset sale, or in other circumstances in which the secured creditor’s interest in the debtor’s property has been reduced, the secured creditor will often retain an analyst to assess (1) the amount by which the secured creditor’s interest was reduced and (2) the value of the additional interest that the creditor should receive in order to obtain the “indubitable equivalent” of the value of the lost security.

The Bankruptcy Code provides protection for a creditor’s interest in the debtor’s property. Sometimes events occur during the bankruptcy proceeding that reduce the creditor’s interest in the debtor’s property (such as a 363 asset sale of that collateral property). In such an instance, Section 361 basically provides that the creditor should be made whole. The creditor could be made whole by receiving (1) cash from the trustee or (2) an additional lien on other debtor corporation property. The relevant subsections of Section 361 are presented below:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

- (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity’s interest in such property;
- (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity’s interest in such property; or
- (3) granting such other relief, other than entitling such entity to compensation allowable under section 503 (b)(1) of this title as an administrative expense, as

will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

In these instances, the important questions often include: (1) by how much was the value of the creditor's interest (in the debtor's collateral property) reduced? and (2) what is the value of the additional interest that the creditor should receive in order to obtain the "indubitable equivalent" of the value of the lost security? These questions are important to the secured creditors, and these questions are typically answered by a valuation analysis.

REASON 5: BANKRUPTCY RULES REGARDING A SECURED CREDITOR'S INTEREST (RULES 3012 & 3018)

The recurring question of the value of the creditor's security interest in the debtor's property is typically answered by a valuation analysis.

In a Chapter 11 bankruptcy proceeding, the value of a secured creditor's security interest is important for a number of reasons. For example, the value of the creditor's security affects the creditor's influence with regard to the approval (or disapproval) of the proposed plan of reorganization. When there is a question about the value of a creditor's security interest, the court may hold a valuation hearing and hear testimony from analysts.

The following are sections of two relevant Bankruptcy Rules regarding the value of a secured creditor's interest:

Rule 3012 Valuation of Security

The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct.

Rule 3018 Acceptance or Rejection of Plan in a Chapter 9 Municipality or a Chapter 11 Reorganization Case

(a) Entities Entitled To Accept or Reject Plan; Time for Acceptance or Rejection.

A plan may be accepted or rejected in accordance with §1126 of the Code within the time fixed by the court pursuant to Rule 3017.

(d) Acceptance or Rejection by Partially Secured Creditor. A creditor whose claim has been allowed in part as a secured claim and in part as an unsecured claim shall be entitled to accept or reject a plan in both capacities.

A creditor typically wants to prove that it is a secured (versus an unsecured) creditor. And, a creditor particularly wants to prove that it is a fully secured (and not a partially secured) creditor. The determination of the value of the creditor's security interest in the debtor collateral property is often the result of a valuation analysis.

SECTION 560: DETERMINATION OF A SECURED CREDITOR'S STATUS (SECTION 1129)

Creditors, of course, are interested in determining whether their security interest in the debtor property is greater (or lesser) than the debtor's liability to them. This relationship (between (1) the value of the creditor's security and (2) the amount of the debtor's liability) affects the secured creditor's status throughout the bankruptcy proceeding.

The relevant subsections of Bankruptcy Code Section 560 related to a secured creditor's status are presented below:

(a) (1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to set off is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

As mentioned above, to the extent that the value of the creditor's security interest exceeds the amount of the debtor's liability, then the secured creditor can claim interest on that difference

during the bankruptcy proceeding. The recurring question of the value of the creditor's security interest in the debtor's property is typically answered by a valuation analysis.

REASON 6: REORGANIZATION PLAN CONFIRMATION (SECTION 1129)

An analyst may be asked to review the proposed reorganization plan. The analyst is asked to assess (and opine on) whether the proposed reorganization plan is “reasonable.” Also, the analyst is asked to opine as to whether the proposed reorganization plan is “fair and equitable” to the various classes of creditors and to other stakeholders in the bankruptcy estate.

Analysts (and other financial advisors) are often called on to analyze and opine on the proposed plan of reorganization in a bankruptcy. The analyst can perform this reorganization plan analysis on behalf of the DIP or on behalf of any group of secured or unsecured creditors.

The relevant subsections of Section 1129 are presented below:

- (a) The court shall confirm a plan only if all of the following requirements are met:
 - (7) With respect to each impaired class of claims or interests—
 - (A) each holder of a claim or interest of such class—
 - (i) has accepted the plan; or
 - (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; . . .
 - (11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan. . .
 - (16) All transfers of property of the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.
- (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

REASON 7: CRAM DOWN OF THE REORGANIZATION PLAN (SECTION 1129)

When the court seeks to confirm a proposed reorganization plan over the objection of creditors (a “cram down”), analysts may be asked to testify regarding their analysis of the reorganization plan and whether the reorganization plan is fair and equitable.

Ideally, all parties to the bankruptcy will accept the proposed reorganization plan. However, this general acceptance by all parties does not always happen. Often, one or more of the creditor groups is not satisfied with the reorganization plan. However, the court can still confirm the reorganization plan over the creditors’ objections. Even if the reorganization plan impairs the interests of one or more of the creditor groups, the court may confirm the proposed plan if the plan is “fair and equitable” with regard to all groups of creditors that are impaired. Analysts often testify in such bankruptcy hearings regarding their analyses of the reorganization plan and, particularly, regarding their opinions of whether the proposed plan is “fair and equitable” to all impaired creditor groups.

This judicial confirmation of such a reorganization plan is called a “cram down,” and such a cram down is allowed in Section 1129. The following discussion summarizes the provision of Section 1129:

Another requirement for reorganization plan confirmation is that, with respect to each class of claims, (1) such class has accepted the plan, or (2) such class is not impaired under the plan. If all the requirements for plan confirmation are met except for this one, the plan can still be confirmed *if* the plan does not discriminate unfairly, and is *fair and equitable* with respect to each class of claims or interests that is impaired under, and has not accepted the plan. This is known as a *cram down*.

REASON 8: SECURED CREDITOR RELIEF FROM THE AUTOMATIC STAY (SECTION 362)

The analyst may be asked to testify when a secured creditor seeks relief under Section 362 from the automatic stay against collection efforts.

After a bankruptcy filing, there is an automatic stay with regard to the creditors' ability to collect the debtor's prepetition debts. This automatic stay can be lifted by the court in certain instances. Section 362 allows for a secured creditor to receive relief from this automatic stay of collection efforts if two certain conditions are met. First, related to the secured property, the debtor corporation must have no equity in the property (i.e., the amount of the specific liability exceeds the value of the specific collateral asset). Second, the secured property must not be a necessary part of the debtor company's core business.

The analyst may be called on to provide expert testimony related to both of these questions with regard to a Section 362 motion. Here are the relevant subsections of Section 362:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the [automatic] stay . . . , such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property . . . , if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization. . .

REASON 9: COLLATERAL VALUATION FOR DIP FINANCING

An analyst may be asked to value the debtor company's proposed collateral property for DIP financing purposes. Frequently, that proposed collateral property is intellectual property.

A debtor company's ability to borrow is limited during a Chapter 11 proceeding. Without the court's authorization, the debtor company can only incur ordinary course of business trade debt, that will be allowed as an administrative expense in the bankruptcy case.

However, the court can authorize the debtor's obtaining of credit secured by a senior or equal lien on encumbered property of the bankruptcy estate. The court can authorize such debt only if (1) the debtor company is unable to obtain credit otherwise and (2) there is adequate protection of the interest of the holder of the lien on the property on which such senior or equal lien is proposed to be granted. This type of new debt is usually referred to as DIP financing.

So, in order to obtain DIP financing, the debtor company has to prove that the collateral property's value is greater than the amount of the new DIP liability. An analyst may be asked to value the proposed collateral property and to opine that the property's value is greater than the amount of the proposed financing.

The financially distressed DIP usually doesn't have a lot of property left to pledge for DIP financing collateral. Often the debtor company has already pledged all of its receivables, inventory, real estate, tangible personal property and equity in subsidiaries and joint ventures. However, the debtor company may not have previously pledged its intellectual property as secured debt collateral. Therefore, the DIP financing may involve the pledge of the debtor company's intellectual property assets as the DIP financing collateral.

Hence, the analyst may be asked to value the debtor company's intellectual property for DIP financing collateral purposes.

SECTION 101 – DEFINITION OF “INTELLECTUAL PROPERTY”

Bankruptcy Code Section 101, subsection 35A, provides the following definition of intellectual property:

(35A) The term "intellectual property" means—

- (A) trade secret;
 - (B) invention, process, design, or plant protected under title 35;
 - (C) patent application;
 - (D) plant variety;
 - (E) work of authorship protected under title 17; or
 - (F) mask work protected under chapter 9 of title 17;
- to the extent protected by applicable nonbankruptcy law.
-

REASON 10: THE ZONE OF INSOLVENCY AND THE DEBTOR CORPORATION DIRECTOR DUTIES

Before a bankruptcy filing, analysts are often asked to assess the financial condition of a financially distressed company. Before approving any major dividend, financing, capital expenditure, or other corporate decision, the corporation directors may want the analyst to opine as to whether the debtor corporation is operating near (or in) the zone of insolvency.

The directors of a debtor corporation typically owe a duty of loyalty, care, and good faith to the corporation and to its shareholders. But when a debtor corporation approaches the zone of insolvency, under the laws of most states, the directors owe those duties to creditors, too. In such a case, creditors (and not just shareholders) have standing to assert breach of fiduciary duty claims on the company's behalf.

BANKRUPTCY REASONS TO VALUE INTELLECTUAL PROPERTY SUMMARY

Intellectual property valuation issues frequently arise in commercial bankruptcy proceedings. Therefore, analysts are often called on to assist the many parties to the commercial bankruptcy, including: the debtor in possession and/or the trustee, the management or directors of the pre-filing debtor corporation, the secured creditors committee, the unsecured creditors committee,

Intellectual Property and Insolvency Issues: Valuation of Intellectual Property Within a Bankruptcy Context

and other parties in interest to the proceeding (e.g., contract counterparties, unions, joint ventures, etc.).

This section summarized many (but not all) of the reasons why intellectual property valuations may be performed within a bankruptcy context. And, this section summarized many (but not all) of the issues that analysts commonly encounter when preparing bankruptcy valuations.

INTELLECTUAL PROPERTY VALUATION APPROACHES AND METHODS

This section describes and illustrates the three generally accepted intellectual property valuation approaches, specifically, the cost approach, the market approach, and the income approach. In addition, this section summarizes the intellectual property valuation synthesis and conclusion process.

Intellectual Property Valuation Approaches

Within a bankruptcy valuation, analysts typically attempt to use all three valuation approaches to value the owner/operator intellectual property. When that is possible, the analyst can develop mutually supportive evidence and a multi-faceted perspective regarding the intellectual property value. However, due to data constraints, it is common for an analyst to rely on only one or two valuation approaches in the intellectual property valuation process.

The following section summarizes the cost approach, market approach, and income approach valuation methods. And, this section summarizes the analyst's process of reconciling multiple value indications into a final intellectual property value conclusion.

Cost Approach Valuation Methods

There are several intellectual property valuation methods within the cost approach. Each valuation method uses a specific definition of cost. Two common cost definitions are:

1. reproduction cost new and
2. replacement cost new.

Reproduction cost new is the total cost, at current prices, to develop an exact duplicate of the subject intellectual property. Replacement cost new is the total cost, at current prices, to develop an asset having the same functionality or utility as the actual intellectual property. Functionality is an engineering concept that means the ability of the intellectual property to perform the task for which it was originally designed. Utility is an economics concept that means the ability of the intellectual property to provide an equivalent amount of satisfaction.

There are also other cost definitions that may be applicable to a cost approach valuation. Some analysts consider cost avoidance as a cost approach measure. This cost measure quantifies either historical or prospective costs that are avoided because the owner/operator owns the intellectual property.

Some analysts consider trended historical costs as a cost approach measure. In this cost measure, historical intellectual property development costs are identified and trended to the valuation date by an inflation-based index factor. Regardless of the specific cost measure used, all cost approach methods include a comprehensive definition of cost.

The cost measurement (whether replacement cost new, reproduction cost new, or some other cost measure) typically includes four cost components: (1) direct costs (e.g., materials), (2) indirect costs (e.g., engineering and design labor), (3) the intellectual property developer's profit

(on the direct cost and indirect cost investment), and (4) an opportunity cost/entrepreneurial incentive (to motivate the development process).

Typically, the intellectual property development material, labor, and overhead costs are easy to identify and quantify. The developer's profit can be estimated using several procedures. It is often estimated as a percentage rate of return on the total investment in the material, labor, and overhead costs. The entrepreneurial incentive is often measured as the lost profits during the replacement intellectual property development period. For example, let's assume it will take two years to develop a replacement patent. If the buyer buys the seller's actual patent, then the buyer can start earning income (either operating income or license income) immediately. If the buyer "builds" its own hypothetical replacement patent, then the buyer will not earn any income (operating income or license income) during the two-year development period. The two years of lost profits during the hypothetical patent development period represents the opportunity cost of developing a new replacement patent—compared to buying the actual seasoned patent.

All four cost components—i.e., direct costs, indirect costs, developer's profit, and opportunity cost—should be considered in the intellectual property cost approach valuation. So, while the cost approach is different from the income approach, there are economic analyses included in the cost approach. These economic analyses provide indications of both: (1) the appropriate levels of opportunity cost (if any) and (2) the appropriate amount of economic obsolescence (if any).

The intellectual property cost new (however measured) should be adjusted for losses in value due to:

1. physical deterioration,
2. functional obsolescence, and
3. economic obsolescence.

Physical deterioration is the reduction in value due to physical wear and tear. It is unlikely that an intellectual property will experience physical deterioration.

Functional obsolescence is the reduction in value due to the intellectual property's inability to perform the function (or yield the periodic utility) for which it was originally designed. The technological component of functional obsolescence is a decrease in value due to improvements in technology that make the intellectual property less than the ideal replacement for itself.

Economic obsolescence is a reduction in value due to the effects, events, or conditions that are external to—and not controlled by—the intellectual property current use or condition. The impact of economic obsolescence is typically beyond the control of the owner/operator.

In any cost approach analysis, the analyst will estimate the amounts (if any) of intellectual property physical deterioration, functional obsolescence, and economic obsolescence. In this estimation, the analyst will consider the intellectual property actual age—and its expected remaining useful life (RUL).

A common cost approach formula for quantifying intellectual property replacement cost new is: reproduction cost new—curable functional obsolescence = replacement cost new. To estimate the intellectual property value, the following cost approach formula is commonly used: replacement cost new – physical deterioration – economic obsolescence – incurable functional obsolescence = intellectual property value.

Cost Approach Illustrative Example

Exhibits 1 and 2 present a simplified illustrative example of a cost approach intellectual property valuation. In this example, the analyst is asked to estimate the fair market value of the copyrights and trade secrets related to the hypothetical Kappa Company computer software. All of the Kappa Company computer software is subject to copyright protection. And, the software source code and the systems documentation and user manuals are treated as company trade secrets. The analyst is instructed that the appropriate valuation date is January 1, 2015.

The analyst decided to use the cost approach and the replacement cost new less depreciation method. Exhibit 1 includes the analysis of all four cost components of the cost approach. Exhibit 1 also illustrates the analyst's functional obsolescence considerations. Exhibit 2 presents the detailed calculation of one cost component of the cost approach: the developer's profit analysis.

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Exhibit 1
Kappa Company
Computer Software Copyrights and Trade Secrets
Cost Approach—Replacement Cost New Less Depreciation (RCNLD) Method
Valuation Summary
As of January 1, 2015

Software System	Estimated Software Replacement Development Effort in Person Months [a]	Time to Develop Replacement Software (in Calendar Months) [b]	Indicated RCNLD Component [c] \$000
AS/400	4,531	29	66,100
Point of Sale	575	25	8,400
Tandem	3,304	16	48,200
Unisys	1,229	5	17,900
Pioneer	1,807	41	26,400
Voyager	325	12	4,700
Host to Host	85	9	1,200
Total Direct and Indirect Costs	11,856	24	172,900
Plus Developer's Profit [d]			10,500
Plus Entrepreneurial Incentive [e]			31,200
Total Replacement Cost New			214,600
Less Depreciation and Obsolescence [f]			13,300.0
Replacement Cost New Less Depreciation			201,300
Indicated Fair Market Value of the Kappa Copyrights and Trade Secrets (rounded)			200,000

Footnotes:

[a] The estimated development effort for each software category is equal to the average of the replacement development effort indication using (1) the COCOMO software cost engineering model and (2) the KnowledgePLAN software cost engineering model, rounded.

[b] The estimated time to develop replacement software in calendar months for each software category is equal to the average of the time to develop the replacement software in calendar months using (1) the COCOMO software engineering model and (2) the KnowledgePLAN software engineering model, rounded. The final figure in this column represents a weighted average time to develop the replacement software in calendar months (weighted by effort in person months), which is used to calculate the entrepreneurial incentive.

[c] Equal to the estimated development effort in person months multiplied by the \$14,585 cost per person month, rounded. The \$14,585 cost per person month was calculated by multiplying the blended hourly rate of \$82.87 provided by the Kappa Company vice president of data processing, by 176 (8 hours per day times 22 days per month).

[d] Calculated as (1) total direct replacement cost new times (2) a computer software developer's profit margin of 11 percent times 55 percent. This adjustment is made because 45 percent of software development workforce represents outside contractors, the cost of which already includes a market-based developer's profit.

[e] Calculated as (1) the Kappa Company present value discount rate of 17 percent times (2) the sum of the total direct and indirect replacement cost new and the developer's profit, divided by 2 times (3) the weighted average total development time of 2 years (based on the weighted average time to develop in person months of 24 months as described in footnote [b]).

[f] According to Kappa Company data processing management, the Point of Sale system is scheduled to be replaced and upgraded in approximately five years. The Pioneer system is also scheduled to be replaced and upgraded in approximately five years. And, the Voyager system is scheduled to be substantially upgraded next year. Therefore, the analyst estimated functional obsolescence as follows:

System Scheduled for Replacement	Replacement Cost New*	Percent Obsolete	Obsolescence Allowance
Point of Sale	\$10,400,000	20%	\$2,100,000
Pioneer	\$32,700,000	20%	\$6,500,000
Voyager	\$5,800,000	80%	\$4,700,000
Total			<u>\$13,300,000</u>

*includes the developer's profit and entrepreneurial incentive cost components.

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Exhibit 2
Kappa Company
Computer Software Copyrights and Trade Secrets
Cost Approach—Replacement Cost New Less Depreciation (RCNLD) Method
Estimate of Computer Software Developer's Profit

<u>Profit Margin Comparison</u>		<u>Operating Profit Margins</u>				
		4/1/13- 3/31/14	4/1/12- 3/31/13	4/1/11- 3/31/12		
<u>Selected Industry Sectors</u>						
SIC Code 7371 - Custom Computer Programming Services - All Companies	[a]	4.2%	4.2%	4.8%		
SIC Code 7371 - Custom Computer Programming Services - Sales of \$25 Million and Over	[a]	7.4%	3.8%	2.2%		
SIC Code 7373 - Computer Systems Design Services - All Companies	[b]	4.3%	3.1%	2.1%		
SIC Code 7373 - Computer Systems Design Services - Sales of \$25 Million and Over	[b]	4.7%	4.3%	1.1%		
<u>Adjusted Operating Profit Margins</u>						
<u>Selected Guideline Public Companies</u>	<u>Ticker</u>	for 2014/2013	for 2013/2012	for 2012/2011	Three-year Average	
Accenture plc	ACN	[c]	11.6%	11.4%	11.6%	11.5%
Analysts International Corp.	ANLY	[c]	-0.5%	0.5%	0.8%	0.3%
Bearing Point Ind.	BGPT	[c]	4.8%	6.7%	8.7%	6.7%
Cap Gemini Ernst & Young Group	CGEY	[c]	-0.1%	4.7%	9.8%	4.8%
Cognizant Technology Solutions Corp.	CTSH	[c]	19.7%	20.0%	19.1%	19.6%
Computer Sciences Corporation	CSC	[c]	6.6%	5.6%	6.2%	6.1%
Electronic Data Systems Corp.	EDS	[c]	8.7%	10.3%	9.5%	9.5%
Infosys Technologies Ltd.	INFY	[c]	29.0%	32.7%	33.2%	31.7%
Perot Systems Corp.	PER	[c]	10.2%	6.1%	6.7%	7.6%
Unisys Corporation	UIS	[c]	7.5%	4.5%	6.2%	6.1%
Wipro Ltd.	WIT	[c]	21.1%	23.8%	22.8%	22.6%
<u>Selected Guideline Public Companies</u>						
High Profit Margins		29.0%	32.7%	33.2%		
Low Profit Margins		-0.5%	0.5%	0.8%		
Median Profit Margins		8.7%	6.7%	9.5%		
Average Profit Margins		10.8%	11.5%	12.2%		
Selected Computer Software Developer's Profit		11%				

Footnotes:

[a] The Risk Management Association (RMA) 2014-2013, 2013-2012, and 2012-2011 *Annual Statement Studies* - Custom Computer Programming Services.

[b] The Risk Management Association (RMA) 2014-2013, 2013-2012, and 2012-2011 *Annual Statement Studies* - Computer Systems Design Services.

[c] Capital IQ Database.

Based on the cost approach analysis summarized in Exhibit 1, the analyst concludes that the fair market value of the hypothetical Kappa Company computer software copyrights and trade secrets, as of January 1, 2015, is \$200 million.

Market Approach Valuation Methods

Analysts typically attempt to apply market approach methods first in the intellectual property valuation. This is because the market—that is, the economic environment where arm’s-length transactions between unrelated arm’s-length parties occur—is often considered to provide the best indicator of value. However, the market approach will only provide meaningful valuation evidence when the owner/operator intellectual property is sufficiently similar to the intellectual property that are transacting (by sale or license) in the marketplace. In that case, the guideline intellectual property transaction (sale or license) prices may indicate the expected price for the owner/operator intellectual property.

There are two principal market approach intellectual property valuation methods: (1) the comparable uncontrolled transaction (CUT) method and (2) the comparable profit margin (CPM) method. In the CUT method, the analyst searches for arm’s-length sales or licenses of benchmark intellectual property. In the CPM method, the analyst searches for companies that provide benchmarks to the owner/operator company.

In the CUT method, the analyst will more likely rely on CUT license transactions than on sale transactions. This is because third party licenses of intellectual property are more common than third party sales of intellectual property. Nonetheless, for both sale and license transactions, the analyst will follow a systematic process in the CUT method valuation.

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First, the analyst will research the appropriate exchange markets to obtain information about sale or license transactions, involving guideline (i.e., similar from an investment risk and expected return perspective) or comparable (i.e., almost identical) intellectual property that may be compared to the owner/operator intellectual property. Some of the comparison attributes include the intellectual property type, intellectual property use, industry in which the intellectual property operates, date of sale or license, etc.

Second, the analyst will verify the transactional information by confirming (1) that the transactional data are factually accurate and (2) that the sale or license exchange transactions reflect arm's-length market considerations. If the guideline sale or license transaction was not conducted at arm's-length market conditions, then adjustments to the transactional data may be necessary. This verification procedure may also elicit additional information about the current market conditions for the sale or license of the intellectual property.

Third, the analyst will select relevant units of comparison (e.g., income pricing multiples or dollars per unit—such as “per drawing” or “per line of code”). And, the analyst will develop a comparative analysis for each selected unit of comparison.

Fourth, the analyst will compare the selected guideline or comparable intellectual property sale or license transactions with the subject intellectual property, using the selected elements of comparison. Then, the analyst will adjust the sale or license price of each guideline transaction for any differences between the guideline intellectual property and the owner/operator intellectual property. If such comparative adjustments cannot be measured, then the analyst may eliminate the sale or license transaction as a guideline for future valuation consideration.

Fifth, the analyst will select pricing metrics for the subject intellectual property from the range of pricing metrics indicated from the guideline or comparable transactions. The analyst may select pricing multiples in the low end, midpoint, or high end of the range of pricing metrics indicated by the transactional sale or license data. The analyst will select the subject-specific pricing metrics based on the analyst's comparison of the owner/operator intellectual property to the guideline intellectual property.

Sixth, the analyst will apply the selected subject-specific pricing metrics to the subject intellectual property financial or operational fundamentals (e.g., revenue, income, number of drawings, number of lines of code, etc.). This procedure will typically result in several market-derived value indications for the owner/operator intellectual property.

Seventh, the analyst will reconcile the various value indications provided by the analysis of the guideline sale and/or license transactions into a single market approach value indication. In this final reconciliation procedure, the analyst will summarize and review (1) the transactional data and (2) the quantitative analyses (i.e., the various pricing metrics) that resulted in each value indication. Finally, the analyst will resolve these value indications into a single value indication.

Table 1 describes several of the databases that the analyst may search in order to select intellectual property sale or license CUTs. Table 2 describes several of the print sources that the analyst may search in order to select intellectual property sale or license CUTs. Of course, the analyst may confer with the owner/operator management to explore whether the owner/operator has entered into any intellectual property license agreements (either inbound or outbound). These owner/operator license agreements could relate to either the subject intellectual property or to comparable intellectual property.

Table 1
Market Approach
Comparable Uncontrolled Transaction (CUT) Method
Common Intellectual Property License Transaction Databases

RoyaltySource

www.royaltysource.com—AUS Consultants produces a database that provides intellectual property license transaction royalty rates. The database can be searched by industry, technology, and/or keyword. The information provided includes the license royalty rates, name of the licensee and the licensor, a description of the intellectual property licensed (or sold, if applicable), the transaction terms, and the original sources of the information provided. Preliminary CUT results are available online and a final report is sent to the subscriber via e-mail.

RoyaltyStat, LLC

www.royaltystat.com—RoyaltyStat is a subscription-based database of intellectual property license royalty rates and license agreements, compiled from Securities and Exchange Commission documents. It is searchable by SIC code or by full text. The CUT results can be viewed online or archived. The intellectual property transaction database is updated daily. The full text of each intellectual property license agreement in the database is available.

Royalty Connection

www.royaltyconnection.com—Royalty Connection™ provides online access to intellectual property license royalty rate and other license information on all types of technology, patents, trade secrets, and know-how. The data are aggregated from information on all types of technology, patents, trade secrets, and know-how. The data are aggregated from arm's-length sale/license transactions, litigation settlements, and court-awarded royalty order from 1990 to the present. The intellectual property license database is frequently updated. Users can search by industry, product category, or keyword. The information provided includes the consideration paid for the intellectual property license and any restrictions (such as geographic or exclusivity).

ktMINE

www.bvmarketdata.com—ktMINE is an interactive intellectual property database that provides direct access to license royalty rates, actual license agreements, and detailed agreement summaries. The database contains over 7,800 intellectual property license agreements. The intellectual property license database is updated frequently. License agreements are searchable by industry, keyword, and various other parameters. The full text of each intellectual property license agreement is available.

Table 2
Market Approach
Comparable Uncontrolled Transaction (CUT) Method
Common Intellectual Property License Transaction Print Sources

AUS Consultants publishes a monthly newsletter, *Licensing Economics Review*, which contains license royalty rates on selected recent intellectual property transactions. The December issue each year also contains an annual summary of intellectual property license royalty rates by industry.

Gregory J. Battersby and Charles W. Grimes annually author a book called *License Royalty Rates*, which is published by Aspen Publishers. This reference tool provides intellectual property license royalty rates for 1,500 products and services in 10 different licensed product categories: art, celebrity, character/entertainment, collegiate, corporate, designer event, music, nonprofit, and sports.

Intellectual Property Research Associates produces three books that contain information on license royalty rates for patents, trademarks, and copyrights. The books are *Royalty Rates for Trademarks & Copyrights*, *Royalty Rates for Technology*, and *Royalty Rates for Pharmaceuticals & Biotechnology*.

The CPM method is also based on a comparative analysis. However, in this valuation method, the analyst is not relying on the sales and licenses of comparable or guideline intellectual property. Rather, the analyst is searching for comparable or guideline companies. The objective of the CPM method is to identify guideline companies that are comparative to the owner/operator company in all ways except one. The owner/operator company, of course, owns the subject intellectual property. Ideally, the selected guideline companies should provide a meaningful benchmark to the owner/operator—except that they do not own comparable intellectual property.

Ideally, the CPM method guideline companies operate in the same industry as the owner/operator company. Ideally, the guideline companies have the same types of raw materials and the same types of sources of supply. Ideally, the guideline companies have the same type of

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customers. Ideally, the guideline companies produce the same type of products or services. And, ideally, the only difference should be that the owner/operator has an established trademark and the guideline companies have generic trademarks. Or, the owner/operator owns the subject patent and the guideline companies produce unpatented (and presumably inferior) products.

Because of the economic benefit that the intellectual property provides, the owner/operator should earn a higher profit margin than the selected guideline companies. This profit margin comparison is usually made at the earnings before interest and taxes (or EBIT) level of income. This EBIT margin typically reflects the pretax operating income of the comparative companies—a measure of income that the intellectual property can influence. The incremental (or superior) profit margin earned by the owner/operator can then be converted into an intellectual property implied royalty rate. Typically, all of the excess profit margin is assigned to the intellectual property (if the intellectual property is the only reason for the owner/operator's superior profit margin).

This implied royalty rate (derived from the excess profit margin) is then multiplied by the owner/operator revenue in order to estimate the amount of implied royalty income generated from the intellectual property. This hypothetical royalty income is capitalized over the intellectual property expected RUL. The result of this capitalization procedure is an estimate of the intellectual property value, according to the CPM method.

Table 3 presents a nonexhaustive list of publicly traded company data sources that the analyst may use to (1) select guideline companies for the CPM method analysis and (2) obtain guideline company profit margin information to use in the CPM method analysis.

Table 3
Market Approach
Comparable Profit Margin (CPM) Method
Common Data Sources for Guideline Company Profit Margins

FactSet Research Systems, Inc.—FactSet
Hoover’s, Inc.—Hoover’s Company Records
Mergent, Inc.—MergentOnline
Morningstar, Inc.—Morningstar Equity Research
Standard & Poor’s—Capital IQ
Thomson Reuters—Thomson ONE Analytics

Accordingly, there are several market approach intellectual property valuation methods. However, each method is based on comparative analyses of either comparable intellectual property sales, comparable intellectual property license royalty rates, or comparable companies (that own generic intellectual property).

Market Approach Illustrative Example

Finally, Exhibit 3 presents an illustrative example of a market approach intellectual property valuation. In this example, the analyst is asked to estimate the fair market value of the hypothetical Tau Company (a telecommunications company) trademarks and trade names. The analyst is instructed that the appropriate valuation date is as of January 1, 2015.

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Exhibit 3
Tau Company
Trademarks and Trade Names
Market Approach—Relief from Royalty Method
Valuation Summary
As of January 1, 2015

<u>Present Value of Discrete Trademark Income:</u>	Projected Calendar Years				
	2015	2016	2017	2018	2019
	\$000	\$000	\$000	\$000	\$000
Management-provided Revenue Projection [a]	8,634,139	8,358,945	8,042,393	7,720,369	7,377,326
Arm's-length Trademark License Royalty Rate [b]	2%	2%	2%	2%	2%
Projected Pretax Trademark Income	172,683	167,179	160,848	154,407	147,547
Less Projected Income Tax Rate [c]	<u>37%</u>	<u>37%</u>	<u>37%</u>	<u>37%</u>	<u>37%</u>
Projected After-tax Trademark Income	108,790	105,323	101,334	97,277	92,954
Discounting Periods [d]	0.5000	1.5000	2.5000	3.5000	4.5000
Present Value Factor @ 11% [c]	<u>0.9492</u>	<u>0.8551</u>	<u>0.7704</u>	<u>0.6940</u>	<u>0.6252</u>
Present Value of Trademark Income	<u>103,264</u>	<u>90,061</u>	<u>78,068</u>	<u>67,510</u>	<u>58,115</u>
Sum of Present Values of Trademark Income	<u>397,018</u>				
<u>Present Value of Terminal Period Trademark Income:</u>					
Fiscal 2020 Normalized Trademark Income [f]	\$ 92,954				
Direct Capitalization Multiple [g]	<u>7.579</u>				
Terminal Value of Trademark Income	704,498				
Present Value Factor @ 11%	<u>0.6252</u>				
Present Value of Terminal Value	<u>\$ 440,452</u>				
<u>Trademark Valuation Summary:</u>					
Present Value of Discrete Trademark Income	\$ 397,018				
Present Value of Trademark Terminal Value	<u>440,452</u>				
Indicated Fair Market Value of the Tau Trademarks (rounded)	<u>\$ 840,000</u>				

Footnotes:

[a] Revenue projection provided by Tau management, consistent with the company's long-range financial plan.

[b] Based on an analysis of arm's-length license agreements between parties for similar property, as presented in Exhibit 4.

[c] Based on the Tau Company expected effective income tax rate.

[d] Calculated as if cash flow is received at mid-year.

[e] Based on the Tau Company weighted average cost of capital, presented in Exhibit 5.

[f] Based on the 2019 projected after-tax trademark income and an expected long-term growth rate of zero percent.

[g] Based on a present value of an annuity factor for an 11 percent discount rate and a 15-year expected RUL.

The analyst decided to use the market approach and the relief from royalty (RFR) method in this trademark valuation. Exhibit 4 summarizes the analyst's search for, selection of, and analysis of comparable uncontrolled transaction (CUT) trademark license agreements. Like Tau Company, the CUT trademark license data are all related to the telecommunications industry.

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Exhibit 4 Tau Company Trademarks and Trade Names Market Approach—Relief from Royalty Method CUT Trademark License Transactions

Trademark Licensors	Trademark Licensee	Comparable Uncontrolled Transaction (CUT) Trademark License Description	License Start Year	License Royalty Rate Range		License Upfront/Flat Fee
				Low	High	
Southwestern Bell Telephone	Affiliate Group	The affiliate group imputed an affiliate compensation fee or “royalty” for the affiliates’ right to the name, reputation, and public image of the parent telephone company. The affiliates recognize the franchise-like benefits realized as a result of their relationship with the licensor.	2012	5.0%	5.0%	NA
Cable and Wireless PLC	Hong Kong Telecommunications Ltd.	In a related party transaction, the Company entered into an agreement with a subsidiary, a Hong Kong telephone company, for the use of its trade marks (in particular, use of the telecommunication name and logo in connection with international business) on relevant products and services.	2012	8.0%	8.0%	NA
AT&T Corp.	KIRI Inc.	The licensor grants to the licensee a nonexclusive, non-transferable, non-sub licensable license to use the licensed marks (AT&T and globe design logo) solely in connection with the marketing, advertising, promotion and provision of the licensed services (such as telecommunication and internet services) in the licensed territory.	2013	2.50%	4.00%	\$2.5 million minimum guarantee
Nextel	Nextel Partners	A partnership or alliance between a U.S. parent company and a publicly owned spin off company includes a licensing agreement for rights to use the Nextel brand name. The licensee owns its own spectrum and provides services as Nextel.	2012	0.50%	1.00%	0
France Telecom (Orange Brand Services Limited, UK)	PTK Centertel	PTK Centertel is rebranding its name from Idea to Orange. Idea, which now holds 32.2% of the market, will change its name and logo (trademark). PTK Centertel will pay the France Telecom a royalty for use of the Orange name.	2013	1.6%	1.6%	NA

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Trademark Licensor	Trademark Licensee	Comparable Uncontrolled Transaction (CUT) Trademark License Description	License Start Year	License Royalty Rate Range		License Upfront/ Flat Fee
				Low	High	
Qwest Communications International, Inc. [a]	Unical Enterprises, Inc.	An exclusive, limited nontransferable, revocable right to use the following trademarks: Techline, Easytouch, Favorite, Classic Favorite, Classic Favorite Plus, Phototouch, Choice, Competitor, Competitor Plus, Roommate, Plaza, Favorite Plus, Easyreach, Big Button, EZ Button, Cleartech, Favorite Messenger II, Digimate, Mountain Bell. Nonexclusive, limited, nontransferable revocable right to use the following trademarks: B Office, Bell Symbol, Bell mark, Northwestern Bell. All of the above in connection with corded telephones, cordless telephones, answering machines, integrated telephone/answering devices, and computers and monitors.	2013	2.1%	2.2%	NA
Virgin Enterprises Limited	NTL Inc.	The licensee entered into a trademark license agreement under which they are entitled to use certain Virgin trademarks within the United Kingdom and Ireland. The agreement was entered into on the same date and is an exclusive license covering a number of aspects of our consumer business, including the provision of communications services (such as internet, television, fixed line telephony, and upon the acquisition of Virgin Mobile, mobile telephony), the acquisition of branding sports, movie and other premium television content, and the branding and sale of certain communications equipment related to the licensee consumer businesses, such as set top boxes and cable modems.	2013	0.25%	0.25%	£8.5 million minimum annual royalty
NA = Not applicable			Indicated CUT License Agreement Royalty Rate Range			
			Low		High	
			<u>Indications</u>		<u>Indications</u>	
			High Rate	8.0%	8.0%	
			Low Rate	0.3%	0.3%	
			Mean Rate	2.9%	3.2%	
			Median Rate	2.1%	2.2%	

Exhibit 5 summarizes the analyst's calculation of the Tau Company present value discount rate. This discount rate is used to present value the royalty income projection over the trademark expected RUL.

Exhibit 5
Tau Company
Weighted Average Cost of Capital
As of January 1, 2015

Cost of Equity Capital:

Method #1: Modified Capital Asset Pricing Model (Ex Post Equity Risk Premium)		Source
Risk-free Rate of Return	4.5%	20-year U.S. Treasury bond, <i>The Federal Reserve Statistical Release</i> , as of December 31, 2014.
General Equity Risk Premium	7.10%	<i>Stocks Bonds Bills & Inflation</i> , Morningstar, Inc., 2014.
Multiplied by: Industry Beta	<u>1.05</u>	
Industry-adjusted General Equity Risk Premium	7.4%	
Size Equity Risk Premium	0.7%	2nd decile, <i>Stocks Bonds Bills & Inflation</i> , Morningstar, Inc., 2014.
Company-Specific Equity Risk Premium	<u>2.0%</u>	Valuation analyst estimate.
Indicated Cost of Equity Capital	<u>14.6%</u>	
Method #2: Modified Capital Asset Pricing Model (Supply Side Equity Risk Premium)		Source
Risk-free Rate of Return	4.5%	20-year U.S. Treasury bond, <i>The Federal Reserve Statistical Release</i> , as of December 31, 2014.
General Equity Risk Premium	6.20%	<i>Stocks Bonds Bills & Inflation</i> , Morningstar, Inc., 2014.
Multiplied by: Industry Beta	<u>1.05</u>	
Industry-adjusted General Equity Risk Premium	6.5%	
Size Equity Risk Premium	0.7%	2nd decile, <i>Stocks Bonds Bills & Inflation</i> , Morningstar, Inc., 2014.
Company-Specific Equity Risk Premium	<u>2.0%</u>	Valuation analyst estimate.
Indicated Cost of Equity Capital	<u>13.7%</u>	

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Method #3: Duff & Phelps, LLC Risk Premium Report Model					Source
Risk-free Rate of Return		4.5%	20-year U.S. Treasury bond, <i>The Federal Reserve Statistical Release</i> , as of December 31, 2014.		
Equity Risk Premium Over Risk-free Rate:					
	Qwest Corporat	Regression Equation		Risk	
	Fundamental	Variables		Premium Over	
	SMM	Constant	Coefficient	Risk-free Rate [a]	
Book Value of Equity	977	17.397%	-2.949%	8.6%	
5-Year Average Net Income	1,169	14.216%	-2.715%	5.9%	
Total Assets	15,397	18.036%	-2.725%	6.6%	
5-Year Average EBITDA	4,957	15.583%	-2.709%	5.6%	
Total Revenue	9,877	16.420%	-2.192%	7.7%	
Number of Employees (not in Mil)	24,000	17.675%	-2.210%	8.0%	
Median Equity Risk Premium Over Risk-free Rate				7.1%	
Company-Specific Risk Premium				2.0%	
Indicated Cost of Equity Capital				13.6%	
Method #4: Build-Up Model					Source
Risk-free Rate of Return		4.5%	20-year U.S. Treasury bond, <i>The Federal Reserve Statistical Release</i> , as of December 31, 2014.		
General Equity Risk Premium		7.1%	<i>Stocks Bonds Bills & Inflation</i> , Morningstar, Inc., 2014.		
Industry Equity Risk Premium		0.0%	Morningstar, SIC 4813, average 2011 - 2014.		
Size Equity Risk Premium		0.7%	2nd decile, <i>Stocks Bonds Bills & Inflation</i> , Morningstar, Inc., 2014.		
Company-Specific Equity Risk Premium		2.0%	Valuation analyst estimate.		
Indicated Cost of Equity Capital		14.3%			
Selected Cost of Equity Capital		14.0%	Median of Methods #1 - #4 Indicated Cost of Equity Capital		
Cost of Debt Capital:					
Before Tax Cost of Debt Capital		7.6%	Beta Company cost of debt.		
Income Tax Rate		37%	Beta Company effective income tax rate.		
Selected Cost of Debt Capital		4.8%			
Weighted Average Cost of Capital Calculation:					
Selected Cost of Equity Capital		14.0%			
Multiplied by Equity / Invested Capital		70%	Based on median of selected guideline companies.		
Equals Weighted Cost of Equity Capital		9.8%	10%	(Rounded)	
Selected Cost of Debt Capital		4.8%			
Multiplied by Debt / Invested Capital		30%	Based on median of selected guideline companies.		
Equals Weighted Cost of Debt Capital		1.4%	1%	(Rounded)	
Weighted Average Cost of Capital (rounded)		11%			

[a] Estimated as the constant plus the coefficient multiplied by the log of the financial fundamental.

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Based on discussions with Tau Company management and on research regarding comparable telecommunications industry trademark life cycles, the analyst determined that the average RUL of the subject trademarks was 20 years. Therefore, the trademark valuation is based on a 20-year trademark royalty income projection period.

Based on the market approach valuation analysis summarized in Exhibit 3, the analyst concluded a fair market value of \$840 million for the Tau Company trademarks and trade names, as of January 1, 2015.

Income Approach Valuation Methods

In this valuation approach, value is estimated as the present value of the future income from the ownership/operation of the intellectual property. The present value calculation has three principal components:

1. An estimate of the duration of the intellectual property income projection period, typically measured as the analyst's estimate of the intellectual property RUL
2. An estimate of the intellectual property-related income for each period in the projection, typically measured as either owner income (e.g., license royalty income), operator income (e.g., some portion of the operator's business enterprise income), or both
3. An estimate of the appropriate capitalization rate, typically measured as the required rate of return on an investment in the intellectual property

For purposes of the income approach, the RUL relates to the time period over which the owner/operator expects to receive any income related to the intellectual property (1) license, (2) use, or (3) forbearance of use. In addition to the term of the RUL, the analyst is also interested in the shape of the RUL curve. That is, the analyst is interested in the annual rate of decay of the future intellectual property income.

For purposes of the income approach, different intellectual property income measures may be relevant. If properly applied, these different income measures can be used in the income approach to derive a value indication. Some of the different income measures include:

1. gross or net revenues,
2. gross income (or gross profit),
3. net operating income,
4. net income before tax,
5. net income after tax,
6. operating cash flow,
7. net cash flow,
8. incremental income,
9. differential income,
10. royalty income,
11. excess earnings income, and
12. several others (such as incremental income).

Because there are different income measures that may be used in the income approach, it is important for the capitalization rate (either the discount rate or the direct capitalization rate) to be derived on a basis consistent with the income measure used.

Regardless of the measure of income considered in the income approach, there are several categories of valuation methods that are typically used to value intellectual property:

1. Valuation methods that quantify an incremental level of intellectual property income—That is, the owner/operator will expect a greater level of revenue (however measured) by owning/operating the intellectual property as compared to not owning/operating the intellectual property. Alternatively, the owner/operator may expect a lower level of costs—such as capital costs, investment costs, or operating costs—by owning/operating the intellectual property as compared to not owning/operating the intellectual property.
2. Valuation methods that estimate a relief from a hypothetical license royalty payment—That is, these relief from royalty (RFR) methods estimate the amount of hypothetical royalty payment that the owner/operator (as licensee) does not have to pay to a third party licensor for the use of the intellectual property. The owner/operator is “relieved” from

having to pay this hypothetical license royalty payment for the use of the intellectual property. This is because the owner/operator, in fact, owns the intellectual property.

3. Valuation methods that estimate a residual measure of intellectual property income—That is, these methods typically start with the owner/operator overall business enterprise income. Next, the analyst identifies all of the tangible assets and routine intangible assets (other than the intellectual property) that are used in the owner/operator overall business. These assets are typically called contributory assets. The analyst then multiplies a fair rate of return times the value of each of the contributory assets. The product of this multiplication is the fair return on all of the contributory assets. The analyst then subtracts the fair return on the contributory assets from the owner/operator business enterprise total income. This residual (or excess) income is the income that is associated with the intellectual property.
4. Valuation methods that rely on a profit split—That is, these methods typically also start with the owner/operator overall business enterprise income. The analyst then allocates or “splits” this total income between (1) the owner/operator tangible assets and routine intangible assets and (2) the intellectual property. The profit split percent (e.g., 20%, 25%, etc.) to the intellectual property is typically based on the analyst’s functional analysis of the owner/operator business operations. This functional analysis identifies the relative importance of (1) the intellectual property and (2) the contributory assets to the production of the owner/operator total business income.
5. Valuation methods that quantify comparative income. That is, these methods compare the owner/operator income to a benchmark measure of income (that, presumably, does not benefit from the use of the intellectual property). Common benchmark income measures include: (1) the owner/operator income before the intellectual property development, (2) industry average income levels, or (3) selected guideline publicly traded company income levels. A common measure of income for these comparative analyses is the earnings before interest and taxes (or EBIT) margin. This EBIT income is considered to be a pretax measure of operating income. When publicly traded companies are used as the comparative income benchmark, the method is often called the comparable profit margin (or CPM) method.

All of these income approach valuation methods can be applied using either the direct capitalization procedure or the yield capitalization procedure.

In the direct capitalization procedure, the analyst (1) estimates a normalized income measure for one future period (typically, one year) and (2) divides that measure by an appropriate investment rate of return. The appropriate investment rate of return is called the direct capitalization rate. The direct capitalization rate may be derived for (1) a perpetuity time

period or (2) a specified finite time period. This decision will depend on the analyst's estimate of the intellectual property RUL.

Typically, the analyst will conclude that the intellectual property has a finite RUL. In that case, the analyst may use the yield capitalization procedure. Or, the analyst may use the direct capitalization procedure with a limited life direct capitalization rate. Mathematically, the limited life capitalization rate is typically based on a present value of annuity factor (PVAF) for the intellectual property RUL.

In the yield capitalization procedure, the analyst projects the appropriate income measure for several future time periods. The discrete time period is typically based on the intellectual property RUL. This income projection is converted into a present value by the use of a present value discount rate. The present value discount rate is the investor's required rate of return—or yield capitalization rate—over the expected term of the income projection.

The result of either the direct capitalization procedure or the yield capitalization procedure is the income approach value indication for the intellectual property.

Income Approach Illustrative Example

Exhibit 6 presents a simplified illustrative example of an income approach intellectual property valuation. In this example, the analyst is asked to estimate the fair market value of the hypothetical Pi Company pharmaceutical product patent. As described below, the Pi patent is used to manufacture the Delta pharmaceutical product line. The analyst is instructed that the appropriate valuation date is January 1, 2015.

Exhibit 6
Pi Company
Valuation of Delta Pharmaceutical Product Patent
Income Approach—Yield Capitalization Procedure
As of January 1, 2015

Valuation of the Delta Product Patent	Notes	Pro Forma Years									
		12/31/15	12/30/16	12/30/17	12/30/18	12/31/19	12/30/20	12/30/21	12/30/22	12/31/23	12/30/24
		\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000
Pi Company Delta Product Line Revenue		4,643,232	4,450,217	4,184,750	3,880,112	3,548,858	3,548,858	3,548,858	3,548,858	3,548,858	3,548,858
Annual Growth Rate Percent		-1.2%	-4.2%	-6.0%	-7.3%	-8.5%	0.0%	0.0%	0.0%	0.0%	0.0%
Estimated Delta Product Attrition Rate	23% [a]										
Revenue Attributable to the Delta Product Patent		3,575,289	2,604,350	1,849,994	1,289,821	883,047	679,946	523,559	403,140	310,418	239,022
Annual Growth Rate Percent	[b]	NA	-27.2%	-29.0%	-30.3%	-31.5%	-23.0%	-23.0%	-23.0%	-23.0%	-23.0%
EBITDA		1,573,127	1,145,914	813,997	567,521	388,541	299,176	230,366	177,382	136,584	105,170
EBITDA Margin	[c]	44%	44%	44%	44%	44%	44%	44%	44%	44%	44%
Less: Depreciation/Amortization Expense		793,018	552,967	375,423	248,354	160,263	123,402	95,020	73,165	56,337	43,380
% of Revenue	[d]	22.2%	21.2%	20.3%	19.3%	18.1%	18.1%	18.1%	18.1%	18.1%	18.1%
EBIT		780,109	592,947	438,575	319,167	228,278	175,774	135,346	104,216	80,247	61,790
EBIT Margin		21.8%	22.8%	23.7%	24.7%	25.9%	25.9%	25.9%	25.9%	25.9%	25.9%
Less: Income Taxes @ 37 percent		288,640	219,390	162,273	118,092	84,463	65,036	50,078	38,560	29,691	22,862
Net Income		491,469	373,557	276,302	201,075	143,815	110,738	85,268	65,656	50,556	38,928
Net Margin		13.7%	14.3%	14.9%	15.6%	16.3%	16.3%	16.3%	16.3%	16.3%	16.3%
Plus: Depreciation/Amortization Expense		793,018	552,967	375,423	248,354	160,263	123,402	95,020	73,165	56,337	43,380
Less: Charges for the Use of Contributory Assets:											
Working Capital Capital Charge	[e]	27,530	20,053	14,245	9,932	6,799	5,236	4,031	3,104	2,390	1,840
Tangible Assets Capital Charge	[f]	(823,022)	(599,454)	(425,589)	(296,467)	(202,736)	(156,107)	(120,202)	(92,556)	(71,268)	(54,876)
Routine Intangible Assets Capital Charge	[g]	(164,756)	(123,965)	(91,524)	(66,472)	(47,625)	(36,671)	(28,237)	(21,742)	(16,742)	(12,891)
Equals: Patent Economic Income		324,239	223,159	148,856	96,422	60,516	46,598	35,880	27,627	21,273	16,381
Discounting Periods	[h]	0.5000	1.5000	2.5000	3.5000	4.5000	5.5000	6.5000	7.5000	8.5000	9.5000
Present Value Factor @ 11%		0.9492	0.8551	0.7704	0.6940	0.6252	0.5633	0.5075	0.4572	0.4119	0.3710
Present Value of Patent Economic Income		307,767	190,823	114,679	66,917	37,834	26,249	18,209	12,631	8,762	6,077
Present Value of Patent Economic Income (2015-2024)		789,949									
Indicated Fair Market Value of the Delta Product Patent		790,000									

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[a] Considers the historical weighted decay rates for the Delta patented product line revenue.	Three-Year			
	<u>Delta product line</u>	2012	2013	2014
	Weighted Annual Revenue Decay Rate	23.4%	23.6%	23.3%

Average

[b] Represents 77 percent of the Delta product line revenue in 2015 based on the estimated attrition rate. Thereafter, the Delta product line revenue is decreased annually based on (1) the estimated attrition rate and (2) the negative annual growth rate.

[c] The projected 2019 EBITDA margin is maintained after 2019.

[d] The projected 2019 depreciation expense as a percent of revenue is maintained after 2019.

[e] Based on (1) working capital requirement for the Delta product line and (2) the return on working capital estimated based on the Pi Company weighted average cost of capital (WACC).										
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Working Capital - % of Consolidated Pi Company Revenue	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%
Working Capital Requirement (times Delta product line revenue)	(250,270)	(182,305)	(129,500)	(90,287)	(61,813)	(47,596)	(36,649)	(28,220)	(21,729)	(16,732)
Return on Working Capital	11%	(27,530)	(20,053)	(14,245)	(9,932)	(6,799)	(5,236)	(4,031)	(3,104)	(2,390)

[f] Equals the sum of projected capital expenditure allocated to the Pi product line based on (1) % of revenue and (2) the return on tangible assets requirement estimated (based on the WACC).										
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Net Tangible Assets as % of Pi Consolidated Revenue (see Exhibit 7)	113%	113%	113%	113%	113%	113%	113%	113%	113%	113%
Tangible Assets Requirement (times Delta product line revenue)	4,038,767	2,941,962	2,089,816	1,457,025	997,520	768,090	591,430	455,401	350,659	270,007
Return on Tangible Assets	11%	444,264	323,616	229,880	160,273	109,727	84,490	65,057	50,094	38,572

[g] Routine intangible assets contributory asset charge as percent of consolidated revenue multiplied by the revenue attributable to the Delta patented product line.

[h] Calculated as if all cash flow received at midyear.

The analyst decided to use the income approach and the excess earnings method. Because the patent product revenue is expected to change at a non-constant rate over time, the analyst decided to use the yield capitalization procedure. Using this procedure, this valuation method is often called the multiperiod excess earnings method (or MEEM).

The Pi Company patent is used to manufacture the Delta pharmaceutical product line. Based on the remaining legal life of the Pi patent and the Delta product line revenue decay rate (considering the effect of a competitive drug product), the analyst estimates a 10-year RUL for the Delta patent.

Pi Company management provided the analyst with a financial projection for the overall Pi Company and for the Delta product line. The analyst performed a revenue decay rate analysis related to the Delta product line in order to conclude a Delta product patent revenue growth rate (or, in this case, decay rate).

Exhibit 6 presents the projection of the Delta product line revenue and profit over its expected 10-year RUL. The analyst estimated an appropriate capital charge on all of the Pi Company contributory assets, including working capital assets, tangible assets, and routine (non-patent) intangible assets. This contributory asset analysis is summarized on Exhibit 7.

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Exhibit 7 Pi Company Valuation of Pharmaceutical Patent on Delta Product Income Approach—Yield Capitalization Procedure Contributory Asset Capital Charge Analysis

	FYE 12/31/15 \$000				
<u>Tangible Assets Capital Charge:</u>					
Beginning Tangible Assets [a]	12,034,000				
Capital Expenditures [a]	1,162,971				
Depreciation Expense [a]	<u>(2,249,209)</u>				
Net Tangible Assets	10,947,762				
Consolidated Pi Company Revenue [a]	9,691,426				
Net Tangible Assets as % of Consolidated Revenue	113%				
Routine Intangible Assets Capital Charge:	[a]	[b]			
	Fair	Estimated			
	Market	Required	Annual		
	Value	Rate of	Return		
	\$000	Return	\$000		
Trademarks/Trade Names	970,000	11%	106,700		
Internally Developed Computer Software	2,510,000	11%	276,100		
Trained and Assembled Workforce	580,000	11%	<u>63,800</u>		
Total Contributory Intangible Assets			446,600		
	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19
	\$000	\$000	\$000	\$000	\$000
Consolidated Pi Company Revenue [a]	9,691,426	9,382,534	9,027,219	8,665,762	8,280,712
Intangible Assets Capital Charge (from above analysis)	446,600	446,600	446,600	446,600	446,600
Intangible Asset Capital Charge as % of Consolidated Revenue	4.6%	4.8%	4.9%	5.2%	5.4%

Footnotes:

[a] From the Pi Company business plan.

[b] Based on the Pi Company weighted average cost of capital.

In order to control the number of exhibits, let's assume that Pi Company has the same 11 percent cost of capital as presented in the previous Tau Company (market approach) example (see Exhibit 5). Accordingly, the analyst used 11 percent as the Pi Company weighted average cost of capital—or present value discount rate.

Based on the income approach valuation analysis summarized in Exhibit 6, the analyst estimated that the fair market value of the hypothetical Pi Company patent on the Delta product was \$790 million, as of January 1, 2015.

Valuation Synthesis and Conclusion Procedures

In the valuation synthesis and conclusion process, the analyst should consider the following question: Does the selected valuation approach(es) and method(s) accomplish the analyst's assignment? That is, does the selected approach and method actually quantify the desired objective of the analysis, such as:

- a defined value,
- a transaction price,
- a third-party license rate,
- an intercompany transfer price,
- an economic damages estimate,
- an intellectual property bundle exchange ratio, and
- an opinion on the intellectual property transaction fairness.

The analyst should also consider if the selected valuation approach and method analyzes the appropriate intellectual property bundle of legal rights. The analyst should consider if there were sufficient empirical data available to perform the selected valuation approach and method. That is, the valuation synthesis should consider if there were sufficient data available to make the analyst comfortable with the analysis conclusion. And, the analyst should consider if the selected approach and method will be understandable to the intended audience for the intellectual property valuation.

INTELLECTUAL PROPERTY VALUATION ANALYTICAL ISSUES AND CAVEATS

As described above, issues related to the intellectual property valuation are commonplace within a bankruptcy context. Related financial issues (e.g., corporate solvency, transactional fairness, reasonableness of a business plan, reasonably equivalent value in a property transfer) are also common within the bankruptcy environment. Analysts who perform bankruptcy-related intellectual property valuations should be familiar with (1) the analytical issues that are specific to a bankruptcy valuation and (2) the caveats that help analysts address these issues.

Analytical Issues in Bankruptcy Valuations

Analysts who value intellectual property within the commercial bankruptcy context should be familiar with the following common analytical issues:

1. There is no Bankruptcy Code definition (or standard) for the term “value.” Analysts who practice in this discipline sometimes use fair value, fair market value, market value, other standards of value. Bankruptcy Code Section 506 provides that “value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.” However, this statutory guidance does not provide an actual standard of value.
2. The analyst’s use of hindsight in the bankruptcy valuation is discouraged. The courts seem to adopt the so-called “known or knowable principle” with regard to the analyst only using information that was knowable as of the defined valuation date. Of course, in many bankruptcy matters, there is usually a controversy among the opposing analysts over when actual events (favorable or unfavorable) would have been known or knowable as of the defined valuation date.
3. The analyst’s reliance on (and due diligence regarding) the company management-prepared financial projections should be justified. The questions that the analyst typically considers with regard to the use of management-prepared financial projections in the bankruptcy valuation may include the following:
 - How contemporaneous are the projections to the valuation date?
 - Were the projections prepared after the valuation date but, if so, were they still prepared based on assumptions that were known or knowable as of the valuation date?
 - Were the various unreconciled versions of the management-prepared projections?

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- What was the purpose for which the management projections were prepared?
 - How skilled has company management been historically in preparing financial projections?
 - How reliable is the selected set of management-prepared projections?
 - Should the analyst consider various projection scenarios?
 - Were the financial projections ever relied on by an independent party (e.g., auditors, regulators, financing source)?
4. The analyst should document a replicable and transparent selection of valuation variables. The questions that the analyst typically considers with regard to the use of valuation variables in the bankruptcy valuation may include the following:
- Should the valuation variables reflect the current financial state of the debtor corporation?
 - Should the valuation variables reflect reorganized financial state of the debtor corporation?
 - Should the valuation variables reflect a willing buyer/willing seller or an industry average set of assumptions?
 - How does the assumed financial condition of the debtor corporation affect the selected cost of capital components (e.g., the k_d , k_e , debt/equity ratio) and the concluded weighted average cost of capital (WACC)?
 - How does the assumed financial condition of the debtor corporation affect the terminal value expected long-term growth rate?
 - Should the selected discount rate relate to the operating risk of the debtor company or to the performance risk of the specific financial projections?
5. The analyst should consider the fact that current interest rates are still at historically low levels. The questions that the analyst typically considers with regard to the selected interest rate in the bankruptcy valuation cost of capital analysis may include the following:
- How should the currently low risk-free rate of return affect the selection of the cost of debt capital?
 - How should the currently low corporate bond interest rates affect the selection of the cost of debt capital?
 - Can the debtor corporation actually realize such low capital costs?
 - Does an understated WACC calculation overstate the debtor corporation business value?
6. The analyst should be prepared to explain and defend the reasonableness of the analyst's due diligence procedures. The questions that the analyst typically considers in the due diligence process of the bankruptcy valuation may include the following:
- Does the bankruptcy assignment involve a contemporaneous valuation or a retrospective valuation?

- Did the analyst have access to the debtor corporation management and/or to other relevant parties?
 - Did the analyst consider that the parties’ memories and perceptions of pre-petition events and conditions often change over time?
 - Did the analyst recognize the fact that only a limited amount of debtor corporation documents may be available?
 - Could the analyst’s industry research be subject to various interpretations?
 - Did the analyst appreciate the fact that hindsight is always “20/20” when performing a retrospective valuation analysis?
7. The analyst should consider all of the income tax effects on the debtor corporation value. The questions that the analyst typically considers in the income tax deliberations during the bankruptcy valuation may include the following:
- What is the debtor’s effective income tax rate?
 - What is the amount of the debtor’s cash income tax expense?
 - What is the value of the debtor corporation deferred tax assets or tax liabilities?
 - What is the debtor’s expected use of NOLs and other income tax attributes?
 - How will a possible change of ownership affect the debtor corporation’s tax attributes?
 - How will a possible change of ownership affect the debtor corporation’s asset tax basis?
8. The analyst should avoid the use of industry so-called valuation rules of thumb as a specific valuation method. The questions that analysts typically consider with regard to the interpretation of industry valuation rules of thumb may include the following:
- Are there any industry rules of thumb with regard to financial metric pricing multiples?
 - Are there any industry rules of thumb with regard to operational metric pricing multiples?
 - Are there any industry rules of thumb that may imply values of debtor company intangible assets/contingent liabilities (e.g., capitalization of debtor corporation operating leases)?
 - Are there any industry rules of thumb for consideration with regard to any of the individual financial projection variables?
 - Do the industry rules of thumb assume the average company in the subject industry?
 - If they are valid, how are the industry rules of thumb supported by any empirical transaction data?
9. The analyst will typically perform a cash flow test within a solvency analysis, and such a solvency analysis may be prepared for many bankruptcy purposes. The questions that the

analyst typically considers with regard to the solvency analysis cash flow may include the following:

- Should the analyst include the corporation’s raising of either new debt capital or new equity capital during the cash flow test projection period?
- Should the analyst consider the debtor’s current credit availability during the cash flow test projection period?
- Should the analyst consider any debtor corporation asset sales during the cash flow test projection period?
- Did the analyst adequately consider the longest term debtor corporation debt outstanding in the cash flow test projection period?
- Did the analyst adequately consider any debtor corporation debt balloon payments later in the cash flow test projection period?

10. The analyst should consider the appropriateness of applying a market approach in an inactive transaction market. The questions that the analyst typically considers with regard to the use of the market approach in an inactive market may include the following:

- Are there any sufficiently comparable public companies available for consideration in the market approach analysis?
- Are there any sufficiently comparable merger and acquisition (M&A) transactions available for consideration in the market approach analysis?
- Is there a sufficiently active current market for the debtor company assets or securities?
- How reliable are any “backsolve” valuation method sale transactions of the debtor company securities with regard to providing meaningful valuation guidance?

Analyst Caveats for Performing Bankruptcy Valuations

Analysts may consider the following practical caveats with regard to the preparation of intellectual property valuations within a bankruptcy context:

1. The analyst should accept legal counsel’s advice and instructions; the analyst should also:
 - Document all of the legal counsel’s instructions
 - Document all of the legal counsel’s definitions of technical legal terms
 - Not practice law without a license
 - Let the legal counsel take responsibility for all legal issues related to the bankruptcy
2. Legal counsel is not always totally forthcoming with the analyst; the analyst should also:

- Be aware of any “creeping commitments” (or unintended expansions) regarding the scope of work in the analyst’s engagement
 - Be aware of any legal counsel-imposed limitations on the analyst regarding access to all of the documents in the case
3. The analyst should document, document, document—both in the valuation workpapers and in the valuation report; in particular, the analyst may:
- Document all debtor corporation management and other party interviews
 - Document all due diligence procedures performed
 - Document why the analyst selected or rejected each valuation method that was considered in the analysis
 - Document why the analyst selected or rejected each valuation variable that was considered in the analysis
 - Document why the analyst selected or rejected each set of financial projections that was relied on (or not relied on) in the analysis
 - Use contemporaneously prepared financial projections relied on by others (including management), if possible, and not use financial projections prepared after litigation (if possible)
4. The analyst should use generally accepted valuation approaches, methods, and procedures in the bankruptcy valuation; in particular, the analyst typically should not:
- Use de novo valuation methods (or use de novo valuation method naming conventions)
 - Rely on “rules of thumb” pricing methods to achieve specific value indications to include in the final value conclusion
5. The analyst should use confirmatory valuation approaches and methods in the bankruptcy analysis; in particular, the analyst may:
- Explain the valuation synthesis and conclusion process
 - Explain the quantitative (or qualitative) value conclusion process so that it is replicable, transparent, and auditable
6. The analyst should use confirmatory source documents, if possible; in particular, the analyst may:
- Look for confirmatory source documents
 - Look for contradictory source documents
 - Explain the process and reasoning for selecting the specific source documents relied on
 - Look at and consider all source documents that are made available to the analyst in discovery or otherwise
 - Avoid wearing “hindsight blinders”—i.e., the process of excluding post-valuation date documents that contain pre-valuation date information

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7. The analyst should consider all debtor corporation intangible assets in the bankruptcy valuation analysis; in addition, the analyst should consider all debtor corporation contingent liabilities in the bankruptcy valuation analysis
8. The analyst should consider the expected income tax affects in all of the bankruptcy valuation (and solvency, fairness, and related opinion) analyses; in that consideration, the analyst may:
 - Consult with an independent income tax expert, if one is needed
 - Consult with an income tax expert colleague, if one is available
9. In bankruptcy-related litigation, the analyst should be mindful that “your expert report is your best friend”; the analyst should be mindful that:
 - The valuation analyst’s report should be clear, convincing, and cogent
 - The valuation analyst’s report should be replicable and transparent
 - The valuation analyst’s report should be adequately supported with source documents
 - The analyst should also be mindful of the expert report caution that: “If it’s not in the report, you didn’t do it”
10. The analyst should know his or her own technical limitations in performing the valuation; that is, the analyst should rely on third party specialists for input into the valuation, when needed; such third party specialists may include:
 - Industry experts
 - Tax accounting experts
 - Financing accounting experts
 - Real estate appraisal experts
 - Personal property appraisal experts
 - Other experts

INTELLECTUAL PROPERTY VALUATION REPORT WRITING GUIDELINES

There are numerous objectives of a bankruptcy-related intellectual property valuation report. Of course, the analyst wants to persuade the report reader (whether the reader is a potential sale/license transaction participant, the debtor, a creditor, a judge or other finder of fact, etc.). The analyst also wants to defend the intellectual property value conclusion.

In order to accomplish these objectives, the content and format of the valuation report should demonstrate that the analyst (1) understood the specific intellectual property valuation

assignment; (2) understood the debtor's intellectual property and the subject bundle of legal rights; (3) collected sufficient debtor financial and operational data; (4) collected sufficient industry, market, and competitive data; (5) documented the specific debtor's intellectual property economic benefits; (6) performed adequate due-diligence procedures related to all available data; (7) selected and applied all applicable income-, market-, and cost-approach valuation methods; and (8) reconciled all value indications into a final intellectual property analysis conclusion.

The final procedure in the intellectual property analysis is for the analyst to defend the value conclusion in a replicable and well-documented valuation report. The written valuation report should:

1. explain the intellectual property valuation assignment;
2. describe the debtor's intellectual property and the subject bundle of legal rights;
3. explain the selection or rejection of all generally accepted valuation approaches and methods;
4. explain the selection and application of all specific analysis procedures;
5. describe the analyst's data gathering and due diligence procedures;
6. list all documents and data considered by the analyst;
7. include copies of all documents that were specifically relied on by the analyst;
8. summarize all of the qualitative analyses performed;
9. include schedules and exhibits documenting all of the quantitative analyses performed;
10. avoid any unexplained or unsourced valuation variables or analysis assumptions; and
11. allow the report reader to be able to replicate all of the analyses performed.

In order to encourage the report reader's acceptance of the intellectual property valuation report conclusion, the report should be (1) clear, convincing, and cogent; (2) well organized, well written, and well presented; and (3) free of grammar, punctuation, spelling, and mathematical errors.

In summary, the effective (i.e., persuasive) intellectual property valuation report will tell a narrative story that (1) defines the analyst's assignment; (2) describes the analyst's data gathering and due diligence procedures; (3) justifies the analyst's selection of the generally accepted intellectual property valuation approaches, methods, and procedures; (4) explains how the analyst performed the valuation synthesis and reached the final value conclusion; and (5) defends the analyst's intellectual property value conclusion.

Who Should Perform the Intellectual Property Valuation?

An important consideration in a bankruptcy-related valuation is, what type of professional should perform the intellectual property valuation? There are many categories of professionals who perform intellectual property valuation (and damages, transfer price, etc.) analyses. These categories of professionals include accountants, economists, licensing executives, IP consultants, industry specialists, and valuation analysts. Typically, both the bankruptcy party and the legal counsel will be involved in the decision regarding which category of professional to retain, and the bankruptcy party and the legal counsel need to decide on the appropriate category of professionals before they can interview and retain an individual professional.

Some parties may consider the relative costs of the valuation service in selecting the category of professionals to retain. However, the "cost" of being wrong in this decision process is typically much greater than the "cost" of the professional's valuation fee. For whatever bankruptcy-related purpose that the intellectual property valuation will be used for, the most qualified professional should be retained. When the effectiveness of the intellectual property valuation analysis and report will influence a buyer, seller, lender, licensor, licensee, judicial

finder of fact, etc., the parties should not be concerned about finding a budget-priced valuation professional.

Each of the above-listed professionals has their strengths and weaknesses as an intellectual property valuation candidate, and one category of analyst may be preferred for one type of assignment (such as negotiating a DIP intellectual property license agreement) over another type of assignment (say, testifying as an expert witness in a fraudulent conveyance or preference item dispute).

Accountants (particularly certified public accountants—or CPAs) typically have a great deal of credibility with parties involved in a bankruptcy. Accountants (particularly CPAs) typically have the credentials to be qualified as expert witnesses. Accountants are typically familiar with the financial accounting and taxation aspect of IP valuation. Many accountants perform IP valuations according to rules-based methods, which are often promulgated by the Financial Accounting Standards Board or by the Internal Revenue Service. Such methods are particularly applicable for fair value accounting disclosures or for Internal Revenue Code Section 482 compliance purposes. However, some accountants are not particularly comfortable with judgment-based (compared to rules-based) valuation methods and procedures, and IP valuations are often a relatively small part of the practice of most accountants.

Economists (particularly Ph.D.s.) also have a great deal of credibility with parties involved in a bankruptcy, and they typically have the credentials to be qualified as expert witnesses. In fact, since valuation analysis is one particular type of economic analysis, many regulatory and taxation authorities (e.g., the Internal Revenue Service) often accept economists as intellectual property valuation analysts. This acceptance is particularly true for intercompany transfer price analysis and for other rules-based IP valuations. However, economists can

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sometimes perform very theoretical (and not empirically based) analyses, and are not always familiar with the generally accepted valuation approaches, methods, and procedures. Accordingly, economists' valuation analyses are sometimes difficult for a layperson to understand, and these analyses may not stand up to a contrarian challenge, particularly in a litigation environment.

Licensing executives typically have a great deal of practical experience in negotiating and structuring arm's-length intellectual property license agreements. This experience may cross many types of intellectual property and industries. Therefore, licensing executives often have a great deal of personal and/or anecdotal evidence regarding intellectual property values, royalty rates, and the like. However, because it is anecdotal, this evidence often cannot be independently confirmed. While licensing executives often know how intellectual property valuations are performed, they may not know (or be able to explain) why intellectual property valuations are performed that way.

Licensing executives often also rely on so-called industry rules of thumb and not on the generally accepted valuation approaches, methods, and procedures. Therefore, licensing executives are often more familiar with the licensing profession's practice and procedures than with the valuation profession's practices and standards.

Intellectual property consultants typically assist their employers and clients to develop strategic plans to maximize the value of intellectual property. These plans often start with the process of identifying the debtor's intellectual property. These plans often consider the competitive strengths, weaknesses, opportunities, and threats related to the intellectual property. The plans then analyze how the intellectual property is used by the debtor and how it can be

further commercialized outside of the debtor. These consultants often assist their employers or clients to finance, license, or otherwise monetize the intellectual property.

However, many IP consultants prepare more qualitative than quantitative valuation analyses. Many of the intellectual property analyses are also high-level (i.e., conceptual) rather than empirical (i.e., practical). These consultants often rely more on “black box” types of analyses and less on the replicable generally accepted valuation approaches, methods, and procedures. Also, these consultants may not subscribe to any promulgated professional standards.

Industry specialists typically are not intellectual property specialists, but instead are electronics industry specialists, software industry specialists, telecommunications industry specialists, etc. They are often retired industry executives or consultants who focus on consulting in one or two industries and provide industry clients with financial forecasting, strategic planning, competitive analysis and other consulting services. Industry specialists have often been involved in business brokerage, business start-up, or bankruptcy transactions in their industry. They will perform intellectual property valuations as one of their industry services.

While these industry specialists know a great deal about their industry, they may not know a lot about intellectual property or intellectual property valuation. Accordingly, the justification for their valuation analysis and value conclusion is typically “in my experience” as opposed to empirical data and recognized (and replicable) valuation professional practices and standards.

Analysts may have varying academic or professional backgrounds. Individuals are typically included in this category if they have completed professional training and receiving

professional recognition by one or more of the professional valuation-credentialing organizations.

These organizations typically promulgate intangible asset valuation professional standards, conduct both pre-credential training and post-credential continuing professional education courses and offer comprehensive examination programs leading to a professional credential or accreditation. Such organizations include the American Institute of Certified Public Accountants (grants the ABV credential), American Society of Appraisers (grants the ASA credential), Institute of Business Appraisers (grants the CBA credential) and National Association of Certified Valuators and Analysts (grants the CVA credential).

These professionals typically have the training and credentials to qualify as expert witnesses, and these professionals typically apply generally accepted intellectual property valuation approaches, methods, and procedures. These professionals typically subscribe to—and comply with—the generally accepted valuation profession standards and practices.

Ultimately, the party to the bankruptcy and the bankruptcy counsel have to decide what type of professional is best suited to conduct the debtor intellectual property valuation (or damages, transfer price, etc.) analysis. There should be a match (of experience and expertise) between the selected analyst and the purpose and objective of the assignment. There should also be a match (of personalities and professional philosophies) between the selected analyst and the client.

In the final selection, the type of professional may be less important than the qualifications and the abilities of the individual analyst. Nonetheless, most intellectual property valuations are (at least potentially) subject to a contrarian review.

Therefore, the party to the bankruptcy and the lawyer should select an intellectual property analyst who can deliver a valuation analysis and report (and expert testimony, if needed) that will convince the intended report (or testimony) audience and will stand up to a rigorous contrarian challenge. An analyst who has applied generally accepted valuation approaches, methods, and procedures and an analyst who has complied with generally accepted professional standards and practices may be in the best position to meet that challenge.

SUMMARY AND CONCLUSION

Valuation analysts are often called on to value a debtor company's intellectual property for a variety of bankruptcy-related reasons. This discussion summarized many of the general reasons and the bankruptcy-related reasons for valuing commercial intellectual property. This discussion summarized and illustrated the generally accepted intellectual property valuation approaches, methods, and procedures. In addition, this discussion summarized the analyst caveats related to performing intellectual property valuation analysis—including a description of common data sources and common due diligence procedures.

The final procedure in the intellectual property valuation is the preparation of a clear, convincing, and cogent valuation report. This discussion summarized the attributes related to an effective (i.e., persuasive) intellectual property valuation report. These attributes also relate to the presentation of effective valuation expert testimony.

Finally, this discussion also considered the question of which type of professional should prepare the bankruptcy-related intellectual property valuation. The various categories of professionals each have their respective strengths and weaknesses as intellectual property

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valuation candidates. Ultimately, the most effective type of bankruptcy valuation analyst is one who can defend his or her intellectual property valuation during a rigorous contrarian challenge.