Intellectual Property in Bankruptcy

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Intellectual Property Valuation and Insolvency Issues

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Generally Accepted Intellectual Property Valuation Standards

- Several professional organizations promulgate IP professional valuation standards:
  - American Institute of Certified Public Accountants
  - National Association of Certified Valuators and Analysts
  - Institute of Business Appraisers
  - American Society of Appraisers
  - Appraisal Foundation (USPAP)

Intellectual Property Valuation Considerations

- IP is unique among commercial intangible assets: it can be both (1) owned and operated by the debtor and (2) licensed to a noncompeting operator
- Unlike other commercial intangible assets, IP is often sold or licensed separately from the developer's business enterprise
- Debtor IP can often have a greater value in exchange than its value in use
- There is often a different value for the same IP (1) to the debtor/licensor, (2) to the licensee, (3) to a creditor, and (4) to the market

Intellectual Property Valuation Considerations (cont.)

- The analyst may use different valuation methods and different valuation variables depending on whether the analysis is to value the IP to (1) the debtor/licensor, (2) to a licensee, (3) to a creditor, or (4) to the market
- IP value is directly influenced by the debtor/licensor ability to maintain and protect the IP
- IP value is directly related to the specific bundle of legal rights transferred in the (1) sale or (2) license

Intellectual Property Valuation and Insolvency Issues

By Robert F. Reilly, CPA

Introduction

Many valuation analysts ("analysts") and legal counsel ("counsel") understand the reasons to value the debtor company business enterprise or equity within a bankruptcy context. And, many analysts and counsel are familiar with the generally accepted business valuation approaches and methods for such bankruptcy valuations. However, not all analysts and counsel are familiar with the reasons to value the debtor company's intellectual property within a bankruptcy context. This discussion presents both the general and the Bankruptcy Code definitions of intellectual property. This discussion explains both the general and the bankruptcy-related reasons to value commercial intellectual property. This discussion describes the generally accepted intellectual property valuation approaches and methods. Finally, this discussion presents bankruptcy-related examples of each of the generally accepted intellectual property valuation approaches.

First, this discussion summarizes the various types of intellectual property assets and the many reasons why analysts may be asked to value commercial intellectual property.

Second, this discussion focuses on the specific reasons why analysts may be asked to value 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.

Finally, this discussion suggests common analyst caveats and report writing guidelines for intellectual property valuations performed within a bankruptcy context.

Types of Intellectual Property

For bankruptcy purposes, the term intellectual property is defined in Section 101 of the Bankruptcy Code. Section 101, subsection 35A, provides the following definition of intellectual property:

> 35(A) 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 nonbankrutpcy law.

Accordingly, the Bankruptcy Codes does not include trademarks and trade names within the definition of intellectual property. This exclusion is further discussed below.

For all purposes outside of the bankruptcy context, there are four types of intellectual property:

- Patents
- Trademarks
- Copyrights
- Trade secrets

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

Patents, trademarks, and copyrights are created under and protected by federal statutes. Trade secrets are created under and protected by 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 discussion, the debtor company is assumed to be the intellectual property owner (and possibly the licensor) or the intellectual property non-owner operator (i.e., the licensee). Therefore, this discussion generally applies whether the debtor company holds an inbound license or an outbound license for the subject intellectual property. Accordingly, in this discussion, the debtor company is generally referred to as “the owner/operator.”

For purposes of this discussion, the above-listed four intellectual property types may be expanded 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.

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 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 a debtor company 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 procedures manual can hold a copyright and be a trade secret. The same drawings and schematics can be in a patent, have a copyright, and be a trade secret.

Because the debtor company can own two or more intellectual properties, the analyst may be asked to assign values to the individual intellectual property for bankruptcy, fair value accounting, income tax accounting, property tax accounting, and many other purposes.

In addition, 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. The damages analysis should consider each of the affected intellectual properties, but the 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 manufacturer may need to analyze the intercompany transfer price considerations of each intellectual property application.

General Reasons to Value Intellectual Property

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 of the common transactional and notational reasons to estimate intellectual property value. This list demonstrates that there are numerous commercial reasons (most unrelated to a bankruptcy proceeding) to value an owner/operator's intellectual property.
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 on a body of knowledge documented in a set of professional literature.

Analysts who perform bankruptcy-related valuations should be familiar with these reasons, approaches, and standards. This is because parties to bankruptcy litigation will often allege that intangible asset valuations are fictional constructs based on de novo methodologies. Therefore, parties to a bankruptcy action should understand that intellectual property valuation is not the invention of one or more parties who are trying to gain some sort of an advantage in the bankruptcy proceeding.

Generally Accepted Intellectual Property 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 in the valuation of trade secret proprietary information or 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 in the valuation of patents, trademarks, and certain copyrights. For such intellectual property, it is common for the debtor company to license the intellectual property use 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 in the valuation of patented or unpatented (trade secret) processes or technologies. The income approach is also applicable in 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 debtor company 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.

Each of these generally accepted valuation approaches will be further explained—and illustrated—later in this discussion.

Bankruptcy-Related Reasons to Value Intellectual Property

This discussion summarizes the common reasons why an analyst may be asked to value intellectual property within a commercial 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 may retain an analyst to assess the debtor's solvency prior to the date of the Chapter 11 bankruptcy filing. The creditors may want to claim that (1) the debtor was in fact solvent prior to the bankruptcy filing and, therefore, (2) 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 other 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, opine on, and testify to the debtor's solvency prior to the date of the bankruptcy filing. Such a solvency analysis includes consideration of all of the debtor's assets—including intellectual property.

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

In a Chapter 11 matter, the trustee may retain an analyst to opine that the debtor company was insolvent on the pre-bankruptcy transfer dates. Alternatively, the affected creditors often retain an analyst to opine that the debtor company 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 company or liabilities assumed by the debtor company 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 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 company was insolvent—i.e., whether the debtor liabilities exceeded the debtor assets at fair valuation,
2. whether the debtor company was expected to be able to pay its debts (including principal and interest payments) as such debts matured, and
3. whether the debtor company had an unreasonably small amount of capital to continue to be able to operate as a going concern.

The fair valuation of the debtor's assets include consideration of the debtor intellectual property.

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 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 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 debts greater than the value of the debtor company 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 may retain an analyst to opine that the price of the proposed Section 363 asset sale is fair, thereby providing adequate protection to the creditors and the other bankruptcy stakeholders. 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 the DIP to sell off some of the debtor company assets included in the bankruptcy estate. Such DIP assets subject to sale may be a subsidiary, division, other business unit—or intellectual property—of the debtor company. 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, and 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.

Accordingly, the analyst is often retained to assess, opine on, and testify as to whether a proposal 363 asset (including intellectual property) sale transaction is fair—or not fair—to the bankruptcy estate stakeholders.

Reason 4: DIP Entering into Inbound or Outbound Intellectual Property License Agreements (Section 363)

As mentioned above, Section 363 covers the "use, sale, or lease of property" within a bankruptcy estate. Therefore, in addition to sales of the bankruptcy estate assets, Section 363 also covers both inbound and outbound intellectual property licenses entered into by the DIP.

The trustee (or the DIP) may wish to enter into such intellectual property license agreements for operating purposes or cash flow generation purposes. However, the estate may enter into such intellectual property licenses only if such agreements are fair to the bankruptcy estate stakeholders.

The trustee is responsible to ensure that (1) the estate receives no less than a fair price for outbound licenses and (2) the estate pays no more than a fair price for inbound licenses. And, the trustee is responsible to ensure that such an intellectual property license does not decrease the security of the secured creditors.

The analyst may be asked to analyze, opine on, and testify as to the fairness of the proposed intellectual property license agreement. Investment bankers and industry advisors are sometimes asked to opine on the fairness of Section 363 asset sales. However, an analyst is uniquely qualified to opine on the fairness of a Section 363 intellectual property license agreement.

Reason 5: 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 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 analyst is often asked to answer these questions: (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 6: Bankruptcy Rules Regarding a Secured Creditor's Interest (Rules 3012 and 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 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 quotations 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 less) 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 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 7: Reorganization Plan Confirmation (Section 1129)

An analyst may be asked to review the proposed reorganization plan. The analyst may be asked to assess, opine on, and testify as to whether the proposed reorganization plan is "reasonable." Also, the analyst may be 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.

The analyst may be called on to analyze, opine on, and testify as to the proposed plan of reorganization in a bankruptcy. This assessment of the proposed plan of reorganization will consider all financial aspects of the plan—in addition to any intellectual property-related considerations. 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 8: 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”), an analyst 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 plan 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.

An analyst often testifies in such bankruptcy hearings regarding the 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 provisions 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 9: Secured Creditor Relief from the Automatic Stay (Section 362)

An 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 conditions are met.

First, related to the secured property, the debtor 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.

An analyst may be called on to provide expert testimony related to both of these two questions with regard to a Section 362 motion.

The following 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 10: 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 the debtor’s 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.

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

Reason 11: The Zone of Insolvency and the Debtor Company Director Duties

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

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

Accordingly, the board of directors of a financially troubled company will often retain an analyst to advise the board as to whether or not the company is operating in—or near—the zone of insolvency.

Reason 12: Rejection of Debtor's Intellectual Property Licenses (Section 365)

Section 365(n) allows the trustee in the bankruptcy estate to reject an executory contract in which the debtor is an outbound licensor to a right to intellectual property. If the trustee makes such a contract rejection, the intellectual property licensee has certain rights specified in Section 365(n).

An analyst may be asked to assist the trustee in the decision of whether or not to reject the debtor's outbound intellectual property licenses. An analyst may be asked to assist the licensee(s) in the assessment of the licensee rights in the case of the trustee's rejection of this debtor intellectual property license.

Particularly with regard to the Section 365(n) rejection of the debtor's intellectual property licenses, it is noteworthy that under Section 101 (35A), intellectual property is defined as patents, copyrights, and trade secrets—but not trademarks. Therefore, generally, the courts have ruled that debtor trademark license agreements are not subject to the provisions of Section 365(n).

Bankruptcy Reasons to Value Intellectual Property Summary

Intellectual property valuation issues frequently arise in commercial bankruptcy proceedings. Therefore, an analyst may be asked 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 company, the secured creditors committee, the unsecured creditors committee, and other parties in interest to the proceeding (e.g., contract counterparties, unions, joint ventures, etc.).

This section summarized many of the reasons why an intellectual property valuation may be performed within a bankruptcy context. In addition, this section summarized many of the issues that an analyst commonly encounters when preparing such a bankruptcy valuation.

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, an analyst typically attempts to use all three valuation approaches to value the debtor company 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 intellectual property 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 actual 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 debtor company owns the intellectual property.

Some analysts consider trended historical costs as a cost approach measure. In such a 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 would 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 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 estimates the amounts (if any) of intellectual property physical deterioration, functional obsolescence, and economic obsolescence. In this estimation, the analyst considers 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
= 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 Debtor Company (“Debtor”) computer software.

All of the Debtor 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.

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

Exhibit 1
Debtor 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
Equals: Total Replacement Cost New			214,600
Less: Depreciation and Obsolescence [f]			13,300
Equals: Replacement Cost New Less Depreciation			201,300
Fair Market Value of the Debtor Company Software 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 KnwoledgePLAN 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 tin 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 Debtor 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 Debtor 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 Debtor 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			$13,300,000

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

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

Profit Margin Comparison		Operating Profit Margins		
Selected Industry Sectors		4/1/13-3/31/14	4/1/12-3/31/13	4/1/11-3/31/12
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%

			Adjusted Operating Profit Margins			
Selected Guideline Public Companies	Ticker		for 2014/2013	for 2013/2012	for 2012/2011	Three-Year Average
Accenture plc	ACN	[c]	11.6%	11.4%	11.6%	11.5%
Advisors 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%

Selected Guideline Public Companies			
High Operating Profit Margins	29.0%	32.7%	33.2%
Low Operating Profit Margins	-0.5%	0.5%	0.8%
Median Operating Profit Margins	8.7%	6.7%	9.5%
Average Operating 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.

Market Approach Valuation Methods

An analyst typically attempts 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 debtor company 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. When the CUT method relies on arm's-length license agreements, this analysis is often referred to as the relief from royalty (RFR) 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.

First, the analyst researches 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 debtor company 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, and so on.

Second, the analyst verifies the transactional information by confirming that (1) the transactional data are factually accurate and (2) 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 intellectual property sale or license.

Third, the analyst selects 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 develops a comparative analysis for each selected unit of comparison.

Fourth, the analyst compares the selected guideline or comparable intellectual property sale or license transactions with the actual intellectual property, using the selected elements of comparison. Then, the analyst adjusts the sale or license price of each guideline transaction for any differences between the guideline intellectual property and the debtor company 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 selects pricing metrics for the actual 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 selects the subject-specific pricing metrics based on the analyst's comparison of the debtor company intellectual property to the guideline intellectual property.

Sixth, the analyst applies the selected subject-specific pricing metrics to the actual intellectual property financial or operational fundamentals (e.g., revenue, income, number of drawings, number of lines of code, etc.). This procedure typically results in several market-derived value indications for the debtor company intellectual property.

Seventh, the analyst reconciles 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 summarizes and reviews (1) the transactional data and (2) the quantitative analyses (i.e., the various pricing metrics) that resulted in each value indication. Finally, the analyst resolves 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 debtor company management to explore whether the debtor has entered into any intellectual property license agreements (either inbound or outbound).

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 debtor company in all ways except one. The debtor company, of course, owns the actual intellectual property. Ideally, the selected guideline companies should provide a meaningful benchmark to the debtor—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 customers. Ideally, the guideline companies produce the same type of products or services.

And, ideally, the only difference should be that the debtor company has an established trademark and the guideline companies have generic trademarks. Or, the debtor company owns the actual patent and the guideline companies produce unpatented (and presumably inferior) products.

Because of the economic benefit that the intellectual property provides, the debtor company 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 debtor company 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 debtor company's superior profit margin).

This implied royalty rate (derived from the excess profit margin) is then multiplied by the debtor company 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 DIP Company (DIP) trademarks and trade names.

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

Present Value of Discrete Projection Period Trademark Income:	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]	37%	37%	37%	37%	37%
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% [e]	0.9492	0.8551	0.7704	0.6940	0.6252
Present Value of Trademark Income	103,264	90,061	78,068	67,510	58,115
Sum of Present Values of Trademark Income	397,018				

Present Value of Terminal Period Trademark Income:	
Fiscal 2020 Normalized Trademark Income [f]	$ 92,954
Direct Capitalization Multiple [g]	7.579
Terminal Value of Trademark Income	704,498
Present Value Factor @ 11%	0.6252
Present Value of Terminal Value	$ 440,452

Trademark Valuation Summary:	
Present Value of Discrete Period Trademark Income	$ 397,018
Present Value of Trademark Terminal Value	440,452
Fair Market Value of the DIP Trademarks (rounded)	$ 840,000

Footnotes:
[a] Revenue projection provided by DIP Company 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 DIP Company expected effective income tax rate.
[d] Calculated as if cash flow is received at midyear.
[e] Based on the DIP 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 (after the 5-year projection period).

DIP is a telecommunications company. The analyst is instructed that the appropriate valuation date is as of January 1, 2015.

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 DIP, the CUT trademark license data are all related to the telecommunications industry.

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

Trademark Licensor	Trademark Licensee	Comparable Uncontrolled Transaction (CUT) Trademark License Description	License Start Year	License Royalty Rate Range Low	License Royalty Rate Range High	License Upfront/ Flat Fee
Southwestern Bell Telephone Company	Telecom Group	Telecom Group agreed to a compensation fee or "royalty" for the right to the name, reputation, and public image of the Southwestern Bell Telephone Company.	2012	5.0%	5.0%	NA
Cable and Wireless PLC	Hong Kong Telecommunications Ltd.	Cable and Wireless entered into an agreement with 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 an exclusive 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	2.5%	4.0%	$2.5 million minimum guarantee
Nextel	Nextel Partners	An alliance between a private U.S. company and a publicly owned U.K. spin-off company includes a license agreement for rights to use the Nextel brand name. The licensee owns its own spectrum and provides services as Nextel.	2012	0.5%	1.0%	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

Trademark Licensor	Trademark Licensee	Comparable Uncontrolled Transaction (CUT) Trademark License Description	License Start Year	License Royalty Rate Range Low	License Royalty Rate Range High	License Upfront/ Flat Fee
Global Communications International, Inc.	Unical Enterprises, Inc.	An exclusive 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. A nonexclusive right to use the following trademarks: B Office, Bell Symbol, Bell mark, Northwestern Bell. All of the above are in connection with corded telephones, cordless telephones, answering machines, and integrated telephone/answering devices.	2013	2.1%	2.2%	NA
Virgin Enterprises Limited	NTL Inc.	The licensee entered into a trademark license agreement under which it is entitled to use certain Virgin trademarks within the United Kingdom and Ireland related to Internet, television, fixed line telephony, and mobile telephony.	2013	0.25%	0.25%	£8.5 million minimum annual royalty

NA = Not applicable

Indicated CUT License Agreement Royalty Rate Range

	Low Indications	High Indications
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 DIP present value discount rate. This discount rate is used to present value the royalty income projection over the trademark expected RUL.

Exhibit 5
DIP 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, *The Federal Reserve Statistical Release*, as of 12/31/14
General Equity Risk Premium	7.10%		*Stocks Bonds Bills & Inflation*, Morningstar Inc. 2014
Multiplied by: Industry Beta	1.05		
Industry-Adjusted General Equity Risk Premium		7.4%	
Size Equity Risk Premium		0.7%	2nd decile, *Stocks Bonds Bills & Inflation*, Morningstar Inc. 2014
Company-Specific Equity Risk Premium		2.0%	Analyst's estimate
Indicated Cost of Equity Capital		14.6%	
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, *The Federal Reserve Statistical Release*, as of 12/31/14
General Equity Risk Premium	6.20%		*Stocks Bonds Bills & Inflation*, Morningstar Inc. 2014
Multiplied by: Industry Beta	1.05		
Industry-Adjusted General Equity Risk Premium		6.5%	
Size Equity Risk Premium		0.7%	2nd decile, *Stocks Bonds Bills & Inflation*, Morningstar Inc. 2014
Company-Specific Equity Risk Premium		2.0%	Analyst's estimate
Indicated Cost of Equity Capital		13.7%	
Method #3: Build-Up Model			**Source**
Risk-Free Rate of return		4.5%	20-year U.S. Treasury bond, *The Federal Reserve Statistical Release*, as of 12/31/14
General Equity Risk Premium		7.2%	*Stocks Bonds Bills & Inflation*, Morningstar Inc. 2014
Industry Equity Risk Premium		0.0%	Morningstar Inc. SIC code 4813, average 2011–2014
Size Equity Risk Premium		0.7%	2nd decile, *Stocks Bonds Bills & Inflation*, Morningstar Inc. 2014
Company-Specific Equity Risk Premium		2.0%	Analyst's 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 Equity Capital (cont.):

Method #4: Duff & Phelps, LLC, Risk Premium Report Model						Source
Risk-Free Rate of Return					4.5%	20-year U.S. Treasury bond, *The Federal Reserve Statistical Release*, as of 12/31/14
Equity Risk Premium Over Risk-Free Rate						
	Global Corp. Fundamental $MM	Regression Equation Variables: Constant	Regression Equation Variables: Coefficient	Risk Prem. Over Risk-Free Rate [a]		
Book Value of Equity	977	17.397%	-2.949%	8.6%		Duff & Phelps, LLC, *Risk Premium Report 2014*
5-Yr. Avg. Net Income	1,169	14.216%	-2.715%	5.9%		
Total Assets	15,397	18.036%	-2.725%	6.6%		
5-Yr. Avg. EBITDA	4,957	15.583%	-2.709%	5.6%		
Total Revenue	9,877	16.420%	-2.192%	7.7%		
# 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%	Analyst's estimate
Indicated Cost of Equity Capital					13.6%	

Cost of Debt Capital:

Before Tax Cost of Debt Capital	7.6%	DIP cost of debt
Income Tax Rate	37%	DIP 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%	

Footnote:

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

Based on discussions with DIP 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 (i.e., a 5-year discrete period plus a 15-year terminal period).

Based on the market approach valuation analysis summarized in Exhibit 3, the analyst concluded a fair market value of $840 million for the DIP 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 debtor company 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.

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

1. gross or net revenue,
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, there are several categories of valuation methods that are typically used to value debtor company intellectual property:

1. Valuation methods that quantify an incremental level of intellectual property income – That is, the debtor company 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 debtor company 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 debtor company 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 debtor company 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 debtor company overall business. These assets are typically called contributory assets. The analyst then multiples 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 debtor company 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 debtor company overall business enterprise income. The analyst then allocates or "splits" this total income between (1) the debtor company tangible assets and routine intangible assets and (2) the intellectual property. The profit split percent (e.g., 20 percent, 25 percent, etc.) to the intellectual property is typically based on the analyst's functional analysis of the debtor company business operations. This functional analysis identifies the relative importance of (1) the intellectual property and (2) the contributory assets to the production of the debtor company total business income.
5. Valuation methods that quantify comparative income – That is, these methods compare the debtor company 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 debtor company 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 concludes 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 debtor company 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 Insolvent Company ("Insolvent") pharmaceutical product patent. As described below, the Insolvent patent is used to manufacture the Magic pharmaceutical product line.

The analyst is instructed that the appropriate valuation date is January 1, 2015.

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

		Pro Forma Years									
Valuation of the Magic Product Patent	Notes	12/31/15 $000	12/30/16 $000	12/30/17 $000	12/30/18 $000	12/31/19 $000	12/30/20 $000	12/30/21 $000	12/30/22 $000	12/31/23 $000	12/30/24 $000
Magic Product 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 Magic Product Attrition Rate 23%	[a]										
Revenue Attributable to the Magic 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
Percentage 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%		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 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 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 Income (2015–2024)		789,949									
Indicated Fair Market Value of the Magic Product Patent		$790,000									

Footnotes:

[a] Considers the historical weighted decay rates for the Magic patented product revenue.

Magic Product	2012	2013	2014	Three-Year Average
Weighted Annual Revenue Decay Rate	23.4%	23.6%	23.3%	23.4%

[b] Represents 77% of the Magic product revenue in 2015 based on the estimated attrition rate. Thereafter, the Magic product 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 Magic product and (2) the return on working capital estimated based on the Insolvent Company weighted average cost of capital (WACC).

		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Working Capital - % of Insolvent Company Consolidated Revenue		-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%	-7%
Working Capital Requirement (times Magic 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)	(1,840)

[f] Equals the sum of projected capital expenditure allocated to the Magic product 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 Insolvent Company Consolidated Revenue (see Exhibit 7)		113%	113%	113%	113%	113%	113%	113%	113%	113%	113%
Tangible Assets Requirement (times Magic product line revenue)		4,038,767	2,941,962	2,089,816	1,457,02 5	997,520	768,090	591,430	455,401	350,659	270,0070
Return on Tangible Assets	11%	444,264	323,616	229,880	160,273	109,727	84,490	65,057	50,094	38,572	29,701

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

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

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

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

Exhibit 7
Insolvent Company
Valuation of Magic Pharmaceutical Product Patent
Income Approach—Yield Capitalization Procedure
Contributory Asset Capital Charge Analysis

Tangible Assets Capital Charge:	FYE 12/31/15 $000
Beginning Tangible Assets [a]	12,034,000
Capital Expenditures [a]	1,162,971
Depreciation Expense [a]	(2,249,209)
Net Tangible Assets	10,947,762
Consolidated Insolvent Revenue [a]	9,691,426
Net Tangible Assets as % of Consolidated Revenue	113%

Routine Intangible Assets Capital Charge:	[a] Fair Market Value $000	[b] Estimated Required Rate of Return	Annual 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%	63,800
Total Contributory Intangible Assets			446,600

	12/31/15 $000	12/31/16 $000	12/31/17 $000	12/31/18 $000	12/31/19 $000
Consolidated Insolvent Revenue [a]	9,691,426	9,382,534	9,027,219	8,665,762	8,280,712
Intangible Assets Capital Charge (from the above analysis)	446,600	446,600	446,600	446,600	446,600
Intangible Assets Capital Charge as % of Consolidated Insolvent Revenue	4.6%	4.8%	4.9%	5.2%	5.4%

Footnotes:
[a] From the Insolvent business plan.
[b] Based on the Insolvent weighted average cost of capital.

In order to reduce the number of exhibits, let's assume that Insolvent has the same 11 percent cost of capital as presented in the previous DIP (market approach) example (see Exhibit 5). Accordingly, the analyst used 11 percent as the 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 Insolvent patent on the Magic product was $790 million, as of January 1, 2015.

Valuation Synthesis and Conclusion Procedures

In the intellectual property 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 with in the bankruptcy environment.

An analyst who performs bankruptcy-related intellectual property valuations should be familiar with (1) the analytical issues that are specific to bankruptcy valuation and (2) the caveats that help analysts address these issues.

Analytical Issues in Bankruptcy Valuations

The analyst who values 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?
   - 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 company?
   - Should the valuation variables reflect reorganized financial state of the debtor company?
   - 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 company affect the selected cost of capital components (e.g., the kd, ke, debt/equity ratio) and the concluded weighted average cost of capital (WACC)?
   - How does the assumed financial condition of the debtor company 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 company actually realize such low capital costs?
   - Does an understated WACC calculation overstate the debtor company 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 company 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 company 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 company 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 company 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 company tax attributes?
   - How will a possible change of ownership affect the debtor company 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 debtor'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 company asset sales during the cash flow test projection period?
- Did the analyst adequately consider the longest term debtor company 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

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

1. The analyst may 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 work papers and in the valuation report; in particular, the analyst may:
    - Document all debtor company 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
7. The analyst should consider all debtor company intangible assets in the bankruptcy valuation analysis; in addition, the analyst should consider all debtor company 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 approach, market approach, and cost approach valuation methods; and
8. reconciled all value indications into a final intellectual property value 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 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 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 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).

CPAs typically have a great deal of credibility with parties involved in a bankruptcy. CPAs typically have the credentials to be qualified as expert witnesses. CPAs are typically familiar with the financial accounting and taxation aspect of IP valuation.

Many CPAs 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 CPAs are not particularly comfortable with judgment-based (compared to rules-based) valuation methods and procedures, and intellectual property valuations are often a relatively small part of the practice of most accountants.

Economists (particularly PhDs) often 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 intellectual property valuations.

However, economists can 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 intellectual property 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 may 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.

Valuation analysts may have varying academic or professional backgrounds. This discussion includes individuals in this category if they have completed professional training and received 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 (that grants the ABV credential), American Society of Appraisers (that grants the ASA credential), Institute of Business Appraisers (that grants the CBA credential) and National Association of Certified Valuators and Analysts (that 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 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 may be called on to value a debtor company's intellectual property for a variety of bankruptcy-related reasons. This discussion summarized both the general reasons and the bankruptcy-related reasons to value commercial intellectual property. This discussion summarized and illustrated the generally accepted intellectual property valuation approaches, methods, and procedures.

In addition, this discussion suggested common analyst caveats related to performing bankruptcy-related 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 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 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.

Intersection Between

Bankruptcy and Non Bankruptcy Law

OVERVIEW OF INTELLECTUAL PROPERTY ISSUES IN DISTRESSED SITUATIONS

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I. LICENSE ISSUES

A. Section 365 Basics

In a chapter 11 proceeding, the debtor company will seek to use the time afforded by the automatic stay against creditor action during a case to reorganize around key assets. Frequently, when a stand-alone reorganization is not possible, the company's efforts will focus on selling assets to the highest bidder. A debtor (or chapter 11 trustee in the rare case where one is appointed to displace the debtor's management) has the ability to assume and assign "executory contracts" unless prohibited by applicable non bankruptcy law. The key factor in evaluating whether a license agreement is "executory" is whether performance remains due on each side so that failure to complete performance by either party would be a material breach. In addition to the power to assume and assign, the debtor or trustee also has the power to reject burdensome executory contracts.

Thus, as part of a restructuring or a sale in chapter 11, the company will make a determination on each contract (including each license) as to whether it deems such contract "executory" and if so whether it desires to assume, assume and assign, or reject such contract. In a chapter 7 liquidation case, the chapter 7 trustee will make a similar determination on each contract. Once the debtor or trustee makes the assumption or rejection decision, the decision will be presented to the court for its review and approval in accordance with Section 365 of the Bankruptcy Code.

The nondebtor party to each such contract will be affected significantly by the decision and must therefor (i) pay close attention to the proceedings, (ii) exercise its rights to try to reach its desired business result and (iii) be prepared to respond aggressively to any action by a debtor or trustee that might be beneficial to the debtor or creditors but disastrous for the affected nondebtor IP counterparty.

One initial issue that the nondebtor licensor or licensee should analyze is whether the license is in fact executory and therefor subject to an assumption or rejection in the first place. The Bankruptcy Code does not contain a definition of the term "executory contract." Two recent cases help demonstrate that the decision about "executoriness" is not simple. Specifically, in *In re Exide Technologies, 607 F.* 3d 957 (3d Cir. 2010) the Third Circuit determined that a perpetual, royalty-free trademark license was not an executor contract and thus not subject to assumption or rejection by the licensor debtor. In contrast, *In re Interstate Bakeries Corporation*, 690 F.3d 1069 (8th Cir. 2012) the Eighth Circuit determined that a similar license was executory and thus could be assumed or rejected by the licensor debtor. However, the Eighth Circuit has subsequently vacated that panel decision and reheard the matter en banc in September of 2013. In 2014, the Eight Circuit ruled that the license at issue was not executory and thus could not be rejected by the debtor/licensee, *In re Interstate Bakeries Corp.,* 751 F.3d 955 (8th Cir 2014).

If executory, the debtor (or trustee) must comply with various requirements of Section 365 in order to assume including curing any existing defaults, other than defaults relating to the insolvency or financial condition of the debtor, the commencement of a bankruptcy case, the appointment of a trustee, or the satisfaction of a penalty provision relating to non-monetary obligations.

B. Section 365's Prohibition on Assignment when Prohibited by Applicable Law

One critical exception to the general rule of Section 365 regarding assumption, assignment and rejection of executory contracts is that assignment is not permitted when applicable non-bankruptcy law excuses a non-debtor party from accepting or rendering performance from a third party. Thus, once the issue of "executoriness" is determined, a separate analysis is needed as to whether relevant applicable law operates to preclude a party from accepting performance from a third party over its objection -- an issue that will depend in part on the particular jurisdiction where the case is pending.

Specifically, Section 365(c) of the Bankruptcy Code provides in part that an executory contract may not be assigned when "applicable law excuses a party, other than the debtor, to such contract ... from accepting performance from or rendering performance to an entity" other than the debtor. The classic example of such a contract is a personal services contract: state laws prevent a party from forcing a counterparty to accept personal services from a third party not selected by the counterparty.

Courts have determined that patent, copyright and trademark law also constitute "applicable law" which preclude a debtor from attempting to force its counterparty licensor from accepting performance from a third party licensee. Cases reaching this conclusion include:

1. Patent cases such as *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986 ("[i]t is well settled that a nonexclusive 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 In re Catapult Entertainment, 165 F.3d 747, 750 (9th Cir. 1999) (nonexclusive patent licenses cannot be assigned by a debtor licensee).

2. Trademark cases such as *In re N.C.P. Mktg. Group Inc.*, 337 B.R. 230, 237 (D. Nev. 2005), aff'd, 279 Fed. Appx. 561 (9th Cir. 2008); In re XMH Corp., 647 F.3d 690, 695 (7th Cir. 2011) (holding that trademarks are personal and thus not assignable under trademark law without the consent of the trademark owner/licensor).

3. Copyright cases such as *In re Patient Educ. Media*, 210 B.R. 237, 240-43 (Bankr. S.D.N.Y. 1997); *In re Golden Books Family Ent. Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001); *ITOFCA Inc. v. MegaTrans Logistics Inc.*, 322 F.3d 928, 941 (7th Cir. 2003) (determining that nonexclusive copyright licenses are personal to transferees who cannot assign it to a third party absent the copyright owner's consent).

Courts have also analyzed the issue of whether an exclusive IP license similarly restricts an assignment by a debtor licensee without the nondebtor licensor's consent. On this issue, the courts have reached differing results. Some courts have ruled that exclusive patent licenses (like non exclusive patent licenses) are nonassignable without the patent owner's consent. See, e.g., *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002) (to hold otherwise would render an exclusive license the equivalent of an outright assignment which would contravene well established federal law); see also *Proteo Tech Inc. v. Unicity Intern. Inc.*, 542 F. Supp. 2d 1216, 1219 (W.D. Wash. 2008). With respect to assignments of exclusive copyright licenses, some courts have determined to allow assignment reasoning that under applicable copyright law, an exclusive copyright license conveys an "ownership" interest. See, e.g., *In re Golden Books Family Ent. Inc.*, 269 B.R. at 319. Other courts such as *Gardner v. Nike Inc.*, 110 F. Supp. 2d 1282, 1287 (C.D. Cal. 2000) have concluded that exclusive copyright licensees do not have the right to assign absent the copyright owner's consent.

C. <u>Current Circuit Split Regarding Assumption</u>

The specific language of Section 365 contains a drafting ambiguity that has injected an additional level of complexity into the analysis of assumption and assignment issues – and the rights of nondebtor licensors facing a counterparty's licensee's bankruptcy case. Specifically, Section 365(c) provides that a debtor or trustee cannot "assume or assign" an executory contract when applicable law would prevent assignment.

Some courts have opted to read the three words "assume or assign" literally. That is, such courts have refused to allow a debtor licensee to merely assume a nonexclusive intellectual property license on the grounds that such a license is non assignable under applicable nonbankruptcy law. Four Circuit Courts of Appeal (the Third, Fourth, Ninth and Eleventh) have adopted the hypothetical test and ruled that if a contract cannot be assigned under applicable non-bankruptcy law, then it cannot be assumed <u>or</u> assigned by the debtor-licensee. See *In re West Elecs., Inc.*, 852 F.2d 79, (3d Cir. 1988); *RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra Corp.*), 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm't, Inc.* 165 F.3d 747 (9th Cir. 1999); *City of Jamestown v. James Cable Partners*, L.P. (*In re James Cable Partners, L.P.*) 27 F.3d 534 (11th Cir. 1994).

Two other Circuit Courts of Appeal(the First and Fifth) have rejected that view. See *Institut Pasteur 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 (5th Cir. 2006). Instead, these two Circuits have adopted an alternative test knows as the actual test. Under the actual test, a debtor licensee is prevented from assuming a license <u>only</u> if it intends to assign it without the consent of the licensor. If the debtor merely plans to assume the license without attempting to assign, then the debtor is authorized to do so.

The implication of this Circuit split is monumental. In "hypothetical test" jurisdictions, debtor licensees confront the reality of not only being precluded from assigning their IP licenses, they are also precluded from merely attempting to assume such licenses. In contrast, in "actual test" jurisdictions, debtor licensees who do not intend to assign are free to at least assume their IP licenses. The Circuit split is likely to be resolved by the Supreme Court at some point. In 2009, Justice Kennedy was joined by Justice Breyer in issuing a statement on the denial of a petition for writ of certiorari in the case of *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*, 556 U.S. 1145 (2009). In the statement, Justice Kennedy described the division in the courts as "an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization" and that in a different case "the Court should consider granting certiorari on this significant question."

D. Lubrizol, the 1988 IP Amendments and Sunbeam

The power granted to a debtor to assume, assume and assign or reject is fundamental to the bankruptcy process. The impact of the power on the rights of intellectual property licensees was highlighted in the 1985 Fourth Circuit decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4^{th} Cir. 1985). In that case, pre bankruptcy, Richmond granted Lubrizol a nonexclusive license of certain patents. After filing for bankruptcy, Richmond rejected the license agreement. The Fourth Circuit held that under the Bankruptcy Code as it then existed, when Richmond rejected the license, Lubrizol, as the patent licensee, lost its rights under the license.

In response to this decision, in 1988 Congress enacted Section 365(n) to the Bankruptcy Code expressly granting licensees of "intellectual property" an option to elect to either (i) treat a rejected IP agreement as terminated or (ii) retain all rights, including rights to enforce any exclusivity provisions in the license and related or ancillary agreements, for the duration of the license and any extensions. At the same time, Congress amended the Bankruptcy Code to define the term "intellectual property" — a definition that included patents and copyrights but specifically did not include trademarks.

Thus, as a result of Section 365(n), now when a debtor is a licensor and seeks to reject a license of "intellectual property" as defined by the Bankruptcy Code, the nondebtor licensee has the statutory right to continue to retain its rights if it so elects. Specifically, Section 365(n) provides the nondebtor licensee with the right to continued usage as long as the licensee continues to pay royalties that are due and waives any right to setoff. However, the licensee making the election will not obtain any future updates, support or protection from infringement from the licensor. Upon the rejection, in other words, the debtor licensor is relieved of its obligations to perform. Nondebtor licensees of rejected contracts should pay careful attention to the language of any proposed sale order to ensure that the Section 363(n) rights are preserved and not subject to any argument that such rights are waived by the typical "free and clear" language in a typical sale order.

As noted above, the defined term "intellectual property" in the Bankruptcy Code does not include trademarks. Accordingly, the 1988 IP Amendments enacted in response to Lubrizol did not specifically grant a nondebtor trademark licensee the right to elect to retain its rights in the event of an executory license rejection by a debtor trademark licensor.

Recently, courts have begun to analyze further the rights of nondebtor trademark licensees when a debtor licensor rejects despite the lack of explicit protection in Section 365(n). For example, in *Sunbeam Products v. American Manufacturing*, 686 F.3d 372 (7th Cir. 2012) the Seventh Circuit held that the rejection of a trademark license does not constitute a termination of the nondebtor licensee's rights under the rejected contract., This result, of course, contrasts with the analysis of Lubrizol and has given trademark licensees of debtor licensors newfound support for retention of their licensee rights in the event of a rejection by a licensor – despite the omission of trademarks from the definition of "intellectual property" added to the Bankruptcy Code by the 1988 IP Amendments. As helpful as the Sunbeam opinion is to nondebtor trademark licensees, the decision leaves open several points about the scope of the licensee's rights which will be resolved only through further litigation or legislation.

II. RECENT CASES OF INTEREST

A. *In re: Trump Entertainment Resorts, Inc.*, 526 B.R. 116 (Bankr. D. Del. 2015)

As noted above, the *Sunbeam Products* decision supports a nondebtor trademark licensee's ability to retain its rights after the debtor licensor rejects its trademark licensing contract. *Sunbeam* did not address the implications of a bankruptcy filing by a licensee on the nondebtor licensor. That issue was examined in *In re: Trump Entertainment Resorts, Inc.*, which concerned the ability of a debtor to assume a trademark licensing agreement it had entered before declaring bankruptcy.

Trump Entertainment Resorts, Inc. ran three hotel casinos in Atlantic City, New Jersey. In a 2010 Trademark License Agreement, Trump AC Casino Marks, LLC, granted Trump Entertainment Resorts the exclusive right to use the Trump name, likeness and other "Trump Marks" in connection with the operation of the hotel casinos. The license was perpetual, but subject to termination if the licensees failed to use the Trump Marks in a manner consistent with the quality a consumer has come to expect from the Trump name.

Finding such deficiency in quality, Trump AC initiated a state court action to terminate the Agreement in August, 2014. In September, 2014, that action was stayed after Trump Entertainment Resorts filed for chapter 11 bankruptcy. Under the Debtors' proposed reorganization plan, the debtors proposed to assume the Trademark License Agreement, and continue to use the Trump Marks in the operation of its hotel casino, the Taj Mahal. Trump AC promptly filed for relief from the automatic stay, in order to proceed with the state court action.

In granting Trump AC's motion, the Court was guided by the Third Circuit's *West Electronics* decision. *In re West Elecs., Inc.*, 852 F.2d 79 (3d Cir. 1988). With respect to Bankruptcy Code Section 365(c)(1), the Third Circuit follows the "hypothetical test" as discussed above in Part III. Whether a debtor licensee may assume an executory contract depends on the debtor licensee's hypothetical ability to assign the contract. If the debtor could hypothetically assign the contract, regardless of actual intention, the Third Circuit interprets §365(c)(1) as precluding assumption if "applicable law" excuses the nondebtor party from accepting or rendering performance. In *West Electronics*, since applicable law excused the nondebtor party, the Court held the nondebtor party was entitled to relief from the automatic stay in order to continue proceedings to terminate the non assumable contract.

Following *West Electronics*, the Bankruptcy Court of Delaware examined the applicable law governing trademarks, federal trademark law. The Court found that "under federal trademark law, trademark licenses are not assignable in the absence of some express authorization from the licensor." Furthermore, the Court found that assignment of trademark licenses is prohibited "under circumstances where it is clear that the identity of the licensee is crucial to the agreement." Finding both criteria met, the Court granted Trump AC's motion and lifted the automatic stay, despite the fact that the Debtors had no intention of actually assigning the license.

B. *In re CTLI, LLC*, No. 528 B.R. 359 (Bankr. S.D. Tex. 2015)

A strong presence on social media is important, if not imperative for most businesses. Many businesses invest heavily in cultivating their social media accounts, and view them as assets with real value. However, upon insolvency, individual owners of a business debtor may try to prevent these accounts from becoming property of the bankrupt estate. The U.S. Bankruptcy Court for the Southern District of Texas recently held that business social media accounts are correctly classified as property of a company's bankrupt estate.

In re CTLI, LLC, No. 528 B.R. 359 (Bankr. S.D. Tex. 2015), concerned social media accounts created by Jeremy Alcede, the former owner of Tactical Firearms. After declaring chapter 11 bankruptcy, Tactical Firearms reorganized as Debtor CTLI, LLC. Once 100 percent ownership was transferred to a new owner, the Court ordered Mr. Alcede to turn over all passwords for the Debtor's social media accounts. Mr. Alcede refused to comply, arguing the Tactical Firearms Facebook Page and the Twitter account "@tacticafirearm" were his personal accounts, not property of the business. The Court rejected this claim, analogizing Facebook users' "likes" of the page to traditional subscriber or customer lists. Just as a subscriber list contains valuable information that can be used to contact customers, a Facebook page allows a business to communicate directly with customers who have "liked" the page.

In its opinion, the Court acknowledged the potential difficulty of distinguishing between personal and business social media accounts where small business owners' personal identities are closely intertwined with the identity of the business. In holding the accounts property of the Debtor, not Mr. Alcede, the Court considered a variety of factors. The facts that the Facebook page linked directly to Tactical Firearms' webpage, the page was used to post status updates relating to, and promoting the business, and that Mr. Alcede granted other employees access to the page for the purpose of posting business related status updates, convinced the Court the page was property belonging to the reorganized Debtor.

The court weighed similar factors to decide that the Twitter account "@tacticalfirearm", was also property of the reorganized Debtor, not personal property of Mr. Alcede. The account was named after the business had a reorganized description of the business, and was linked to the business's web page. These facts, the Court said, raised the presumption that the Twitter account was property belonging to the Debtor.

Finally, the Court stated it need not concern itself with calculating the portion of goodwill resulting from the social media accounts that was attributable to Mr. Alcede in his professional capacity, from the portion attributable to the business. The Court recognized that some of the accounts' "fans" and "followers" were likely a result of Mr. Alcede's professional goodwill, but dismissed the issue, stating that any truly professional goodwill will follow the professional.

C. *In re Crumbs Bake Shop, Inc.* 522 B.R. 766 (Bankr. D.N.J. 2014)

Crumbs Bake Shop, Inc. was a manufacturer, supplier and retailer of cupcakes and other baked goods. To capitalize on its success, Crumbs entered into a representation agreement with Brand Squared Licensing ("BSL"). Under the Representation Agreement, BSL was to procure and manage license agreements with third parties. Under these agreements the third parties were granted permission to use the Crumbs' trademark and trade secrets in exchange for royalties. Collectively, BSL procured and managed six licensing agreements on behalf of Crumbs.

On July 11th, 2014, Crumbs filed for chapter 11 bankruptcy. On the same date, the Debtors entered into an Asset Purchase Agreement with Lemonis Fischer Acquisition Company, LLC ("LFAC"), under which LFAC would buy substantially all of the Debtors' assets. The licensing agreements were specifically excluded from the assets to be sold to LFAC and a provision in the Proposed Sale Order stated "…title and interest in and to the Purchased Assets shall pass to the Purchaser at Closing free and clear of all liens, claims, interests, and encumbrances, including, but not limited to…any leasehold interest, license or other right, in favor of a third party". On August 27th, 2014, the Court approved the sale free and clear of liens, claims, encumbrances and interest.

After the Court approved the sale, BSL filed a motion asserting that under §365(n) of the Bankruptcy Code licensees can elect to retain the rights granted to them by their respective contracts. BSL additionally sought any royalties that would be due under the contracts, if the licensees elected to retain their rights. LFAC then entered a motion for an order in aid of the Court's prior Sale Order, approving the sale of assets, free and clear of liens, claims, encumbrances, and interests. The Court was asked to determine the parties' respective rights under the Sale Order.

The Court's analysis focused on Bankruptcy Code Section §365(n), which provides for licensees of intellectual property of a debtor-licensor to elect to retain their rights under a licensing agreement, regardless of the debtor's rejection. The Court declined to adhere to a narrow construction of §365(n). Instead, it found that trademark licensing agreements do not fall outside the scope of §365(n) simply because trademarks are not specifically included in the definition of "intellectual property" found in §101(35A) of the Code. Based on the legislative history surrounding the adoption of §365(n), the Court found trademark licensees' rights were to be determined on a case by case basis. Examining the facts of this case, the Court found that stripping the licensees of their contractual rights would result in an inequitable outcome.

The Court additionally held that §363(f) does not trump §365(n) where the consent of the licensee is absent. The Court disagreed with LFAC's argument that the licensees gave implied consent when they did not object to the Sale Motion. The Court found that the ten words of the Proposed Sale Order, which extinguished the licensees' rights, were so vague and so deeply buried within the twenty-ninie page document that it would be inequitable to presume the licensees had adequate notice. Thus, lacking adequate notice, the licensees' failure to object did not constitute implied consent. Since consent was not granted, §363(f) did not override §365(n). Therefore, the licensees could retain their rights under their respective licensing agreements if they chose to do so. Finally, the Court held that because the license agreements were specifically excluded from the sale to LFAC, any royalties due under the license belonged to the Debtor, not to LFAC.

LFAC appealed to the Bankruptcy Appeals Court. However, LFAC and the Debtors reached a settlement before briefs were filed and the Court dismissed the appeal.

D. *In re RadioShack Corp.*, No 15-10197 (Bankr. D. Del. May 20, 2015)

As part of RadioShack's bankruptcy proceedings, the Debtor sought Court approval of the sale of certain intellectual property and related assets. The related assets of the proposed sale included 67 million customers' personally identifiable information (PII). The PII consisted of the customer's full name, physical address, phone number, email address (if on file), and twenty-one other categories of transaction data. Seventeen State Attorney Generals raised objections to the proposed sale due to the nature of the related assets. On May 14, 2015, the Debtors, the Attorney Generals, and the proposed purchaser, General Wireless Operations Inc., commenced mediation.

As a result of the mediation, an agreement was reached that may have implications for any future sale of personally identifiable information. The most salient point of the agreement is that the purchaser agreed to only purchase email addresses that have been active within two years prior to the sale. In addition, the purchaser agreed to notify by email all customers whose email addresses were purchased within 60 days of the sale. The agreement requires that the notification clearly explains how General Wireless came to be in possession of the customer's email address and information and provides an opportunity for the customer to opt out of receiving further communications. Any customer who opts out within 7 days, or any customer whose email bounces back, will not have their personally identifiable information transferred to General Wireless.

Additionally, of the twenty-one original categories up for sale, General Wireless agreed to purchase only seven: the store number, the ticked date and time, the SKU number, the SKU description, the SKU selling price, the tender type, and the tender amount. The Debtor specifically agreed not to sell customer phone numbers and credit or debit card numbers.

III. ABI Commission

The ABI Commission to Study the Reform of Chapter 11 published its Final Report and Recommendations on Dec. 8, 2014. The Commission's recommendations included certain provisions addressing intellectual property issues.

Part V.A.4 of the Report focuses on "intellectual property licenses," while Part V.A.5 of the Report concentrates on trademark licenses.

In Part V.A.4, the Commission set forth the following "Recommended Principles":

- A trustee should be able to assume an intellectual property license in accordance with section 365(a) of the Bankruptcy Code notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement.

- The trustee should be able to assign an intellectual property license to a single assignee in accordance with section 365(f) notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. If the trustee seeks to assign an intellectual property license under which the debtor is a licensee to a competitor of the nondebtor licensor or an affiliate of such competitor, the court may deny the assignment if the court determines, after notice and a hearing, that the harm to the nondebtor licensor resulting from the proposed assignment significantly outweighs the benefit to the estate derived from the assignment. The nondebtor licensor should bear the burden of proof in any such hearing.

- Foreign patents and copyrights should be included within the definition of "intellectual property" set forth in section 101(35A) and subject to section 365,including section 365(n). In addition, foreign trademarks should also be included in this definition, subject to the limitations and conditions imposed on domestic trademarks under the recommended principles in Section V.A.5, Trademark Licenses.

In Part V.A.5. the Commission set forth the following "Recommended Principles":

- "Trademarks," "service marks," and "trade names," as defined in section 1127 of title 15 of the U.S. Code, should be included in the definition of "intellectual property" under the Bankruptcy Code. Section 101(35A) of the Bankruptcy Code should be amended accordingly.

- If a debtor is a licensor under a trademark, service mark, or trade name license and the trustee elects to reject that license under section 365, section 365(n) should apply to the license, with certain modifications. The nondebtor licensee should be required to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed trademark, service mark, or trade name; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed trademark, service mark, or trade name. The trustee should maintain the right to oversee and enforce quality control for such products or services and should not be under any continuing obligation to provide products or services to the rejected licensee. In addition, the concept of "royalty payments" under section 365(n) should be expanded to include "other payments" contemplated by the trademark, service mark, or trade name license.

CONCLUSION

The worlds of insolvency and intellectual property will continue to collide. Added to the mix will be international issues as companies with valuable IP across the world become subject to insolvency proceedings. One example of an international insolvency contest over IP was the well publicized Fourth Circuit opinion in the Qimonda case, Jaffe v. Samsung Electronics Co., Ltd, 737 F.3d 14 (4th Cir 2013), cert. denied, No. 13-1304 (Oct. 6, 2014). Look for similar disputes to continue to arise as parties seek to extract value from a distressed company's IP assets and the courts struggle to apply insolvency and intellectual property laws to new and novel fact patterns.

Intellectual Property Overview

ABI Midwest
Bankruptcy Institute
October 15, 2015
Kansas City, MO

Speaker:
Patricia Smink Rogowski
Panitch Schwarze Belisario & *Nadel LLP*

What is Intellectual Property?

- Any creation of the mind.
  - Inventions, Literary and Artistic Works, Symbols, Names, Images, and Designs
- Can be bought, sold, licensed, exchanged, given away.
- Four kinds of IP:
  - Patents – U.S. Const., Art. 1, §8
    35 USC §§1-376
  - Copyrights – U.S. Const., Art. 1, §8
    17 USC §§101-810
  - Trademarks – U.S. Const., Art. 1, §8
    (Commerce clause; 15 USC §§1051-1128; and State law)
  - Trade Secrets – State Law

Why is IP Important?

- 50 years ago, tangible assets (real estate, equipment and inventories) represented 78% of assets of U.S. non-financial corporations; today, the proportion of tangible assets is less than 50%
- IP and goodwill (annual investment in intangible assets) has grown from 4% of GDP to 34.8% in less than 30 years.
- In 2010, US IP assets were believed to be worth $5.8 trillion.

What is a Copyright?

- Author of an original work has the exclusive rights to:
  - Reproduce the copyrighted work
  - Prepare derivative works based upon the work
  - Distribute copies of the work to the public
  - Perform the copyrighted work publicly
  - Display the copyrighted work publicly
  - Prevent others from doing these things

- Copyright protects an “original works of authorship.”
- Exists at the point work is “fixed in any tangible medium of expression.”
  - Written down
  - Live broadcast that is recorded
  - Storage of computer program

9/10/15

What can be Copyrighted?

- Original works of authorship
  - Modicum of creativity
  - Independently created -- not copied from someone else
- Protected works under the Copyright Act
  - Literary works
  - Musical works, including any accompanying words
  - Dramatic works, including any accompanying music
  - Pantomimes and choreographic works
  - Pictorial, graphic, and sculptural works
  - Motion pictures and other audiovisual works
  - Sound recordings
  - Architectural works

- Derivative works
- Copyright does NOT protect: facts, ideas, processes, procedures, systems, methods of operation

Obtaining a Copyright

- Automatically covered once work is fixed in tangible form → no forms to file or fees to pay

HOWEVER

- Recommended:
  - **Register copyright at US Copyright Office**
    - Costs as little as $55 to register
    - In the U.S., you must have applied for a copyright registration before you can file a lawsuit to stop infringement.
    - Required to receive statutory damages and attorney's fees
  - **At a minimum, mark your work with a copyright symbol, year of publication and owner name → © 2015 ABI**

Who Owns Copyright?

- Ownership of copy of work is **NOT** ownership of the copyright.
- **Work for Hire** = work done by salaried employees within scope of employment = owned by employer.
- Work done by independent contractor is **NOT** owned by entity paying for the work unless there is a written contract to assign the copyright rights.
- Copyright can be assigned – must be in writing.
- Joint owners must account to co-owner.

Copyright Duration

- Post Jan. 1, 1978 --
- Life of author + 70 years
- Works for Hire post Jan. 1, 1978 –
- 95 years from publication or 120 years from creation (whichever expires first)
- Different term for pre Jan. 1978.
- Most 1923 and earlier works now in public domain.

Copyright Enforcement

Copyright infringement requires two showings:

1. Infringer had access to the copyrighted work;
2. Accused infringing work is substantially similar.

Limits on Copyright Protection

- **First Sale Doctrine:** resale of a lawfully obtained copyrighted work does not violate an author's exclusive distribution rights

- **Fair Use Doctrine:** use of a copyrighted work for purposes such as criticism, comment, news reporting, teaching, scholarship, or research, is not an infringement of copyright

Is this Fair Use?

9/10/15

What are Trademarks?

- Distinctive words, phrases, names, symbols, or devices that allow consumers to identify the source of goods or services. Also consider characters, colors, sounds, and scents.

- Service marks refer to marks applied in connection with providing services.

4 Types of Trademarks

Strongest Mark

- Arbitrary or fanciful marks → "Kodak"
  - Inherently distinctive
  - No showing of secondary meaning required
- Suggestive marks → "Coppertone"
  - Inherently distinctive
  - No showing of secondary meaning required
- Descriptive marks → "Alo" (Aloe product)
  - Require a showing of secondary meaning
- Generic terms → "Aspirin"
  - <u>NOT</u> entitled to trademark protection

Weakest Mark

Obtaining a Trademark

Trademark rights develop in two ways:

1. USE YOUR BRAND IN MARKETPLACE = "common law"

2. USPTO REGISTRATION = "federal law"
   - **"Regular" application**: applicant must confirm that trademark has been in use in "interstate commerce" within the U.S.
   - **"Intent to use" application**: applicant must declare that she has a *bona fide* intent to use the trademark in the U.S.

Trademarks

- ™ → Can be used when trademark is not registered.
- ® → Can **only** be used once USPTO registers the mark.
- A US registered trademark has a first 10-year term, and can be renewed for future additional 10-year terms so long as you continue to use the trademark in the US.
- Declaration of use due during first term – between year 5 and 6.

Trade Dress

- Nonfunctional
- Distinctive

Product packaging may be inherently distinctive.

Product design – never inherently distinctive; must prove secondary meaning – customers associate product design with its source.

What are Trade Secrets?

- Any information that derives independent economic value by being kept a secret.
- A trade secret lasts as long as it is kept a secret.

Obtaining a Trade Secret

How Do You Keep a Secret?

- Courts have identified these factors:
  - Is the information known outside of the business?
  - Is the information known by employees and others involved in the business?
  - What measures were taken to safeguard the secrecy?
  - What is the value of the information to the business and to competitors?
  - What effort and/or investment was expended to develop the information?
  - How easy is it for others to duplicate or acquire the information?

Helpful Tips

- Take reasonable steps to ensure that your secret information is not disclosed.
- Have all employees sign employment agreements with non-compete and non-disclosure provisions.

- Know that your competitors can discover your secrets lawfully using methods like reverse-engineering.
- No protection against “independent development”.

What is a Patent?

Contract between an Inventor and Society

- Disclose how to make and use the invention.
- Receive the right to exclude others from making, importing, using, offering to sell and selling the invention.
- While patent is in force, public may learn from the disclosure and try to “design around”.
- When patent expires, public is free to practice invention disclosed in patent.

Benefits of Patenting

- Term of exclusive right – 15 or 20 years.
- Stop others from making, importing, selling, or using your invention without your permission.
- Prevent competitors from "knocking off" your product.
- Use patent as asset that may be licensed or pledged as collateral for a loan.
- Enhance company image

3 Types of US Patents

- **Utility Patents**: processes, machines, articles of manufacture, or compositions of matter

  Types of utility applications:

  Provisional – "placeholder" that is not examined by USPTO.

  Non-provisional – a "regular" application that will be examined.

  Continuing – asserts priority to an earlier non-provisional.

3 Types of US Patents

- **Design Patents**: ornamental design for an article of manufacture
- **Plant Patents**: new variety of asexually reproduced plants

Method of Concealing Partial Baldness (U.S. 4,022,227)

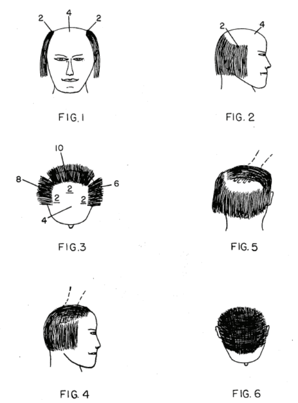


FIG. 1 FIG. 2 FIG. 3 FIG. 5 FIG. 4 FIG. 6

US00D731379S

(12) **United States Design Patent**
Behmer et al.

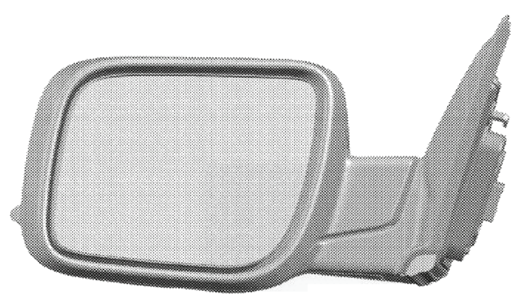
(10) **Patent No.:** **US D731,379 S**
(45) **Date of Patent:** ** **Jun. 9, 2015**

(54) **VEHICLE MIRROR**

(71) Applicant: **Ford Motor Company**, Dearborn, MI (US)

D609,152	S	2/2010	Bucher et al.		
2005/0259340	A1 *	11/2005	Fimeri et al.	....	359/879
2006/0103957	A1 *	5/2006	Olijnyk et al.	....	359/872

OTHER PUBLICATIONS



When Apple Inc. unveiled the iPhone in 2007, it had applied for more than **200** patents for the device.

Is Your Invention Patentable?

1. **Patent-Eligible**: Invention's subject matter must be eligible for patent protection
   - Processes
   - Machines
   - Manufactured items
   - Compositions of matter
   - Some software
   - Some business methods
   - **NOT** – ideas, abstract thoughts, laws of nature

"Anything under the sun that is made by man [sic, or woman!]."

***---Diamond v. Chakrabarty*, 447 U.S. 303 (1980)**

Is Your Invention Patentable?

2. **Useful:** The invention must be useful or serve some practical purpose.

NO Pet Rocks!

Is Your Invention Patentable?

3. **Novel:** Is your invention new and different from what is disclosed in prior patents, publications and products anywhere in the world?

9/10/15

Is Your Invention Patentable?

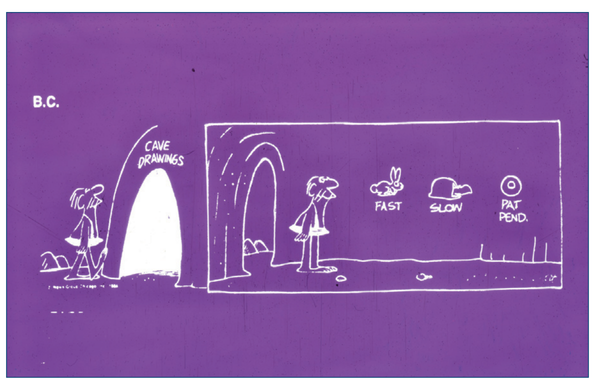
4. **<u>Not Obvious</u>:** Your invention is not a trivial variation on prior solutions to the same problem; your invention is not already suggested to persons working in the field.

4 Legs

VERSUS

3 Legs

How long does it take?



Patent pending status can last 3 or more years in the US.

Maintain Your Patent

Patent Type	Term	Maintenance
Utility	If filed before June 8, 1995, longer of 17 years after issue date or 20 years from earliest filing date	Fee due 3.5, 7.5 and 11.5 years after issue date, but may be paid within 6-mo. grace period with extra fee
	If filed after June 8, 1995, 20 years from earliest filing date	3.5, 7.5 and 11.5 years after issue date, but may be paid within 6-mo. grace period with extra fee
Design	15 years if filed on or after May 13, 2015; Otherwise 14 years.	None
Plant	20 years from earliest filing date	None

Enforcing Your Patent

- Patent owners may sue an infringer only in a federal district court.
- Once infringement demonstrated, the court may award to the patent owner:
  - Injunction
  - Money damages
    - Lost profits, or
    - Reasonable royalty

Patent Ownership

- Co-inventors share equally in patent rights, unless they have requirement to assign these rights to another (e.g., their employer in an employment agreement).
- Problems arise when employees from different companies work on an invention together (e.g., Company-Company, Company-University, University-University).
- Problems arise when "outside consultants" are used.
- Before work starts, collaborators should agree in writing regarding who will own what.

Can Have Multiple IP Rights in One Product

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Intellectual Property Law

American Bankruptcy Institute
35th Annual Midwest Bankruptcy Institute

Business Track: Intellectual Property in Bankruptcy

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*Panitch Schwarze Belisario & Nadel LLP;
Wilmington, Del.*

Rebecca S. Stroder
*Mandiant, a division of FireEye, Inc., Kansas
City*
Professional Development Track: Negotiating

John G. Loughnane, Moderator
Nutter McClennen & Fish LLP; Boston

Objectives

High Level Overview of Basic IP Assets (IP 101)

Overview of Section 365 and Treatment of IP Licenses in BK

Overview of IP Valuation Issues and Considerations

Trending Issues: IP and Technology Issues of Critical Importance in Today's Business World

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    35 USC §§1-376
  - Copyrights – U.S. Const., Art. 1, §8
    17 USC §§101-810
  - Trademarks – U.S. Const., Art. 1, §8
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HOWEVER

- Recommended:
  - **Register copyright at US Copyright Office**
    - Costs as little as $55 to register
    - In the U.S., you must have applied for a copyright registration before you can file a lawsuit to stop infringement.
    - Required to receive statutory damages and attorney's fees
  - **At a minimum, mark your work with a copyright symbol, year of publication and owner name → © 2015 ABI**

Who Owns Copyright?

- Ownership of copy of work is **NOT** ownership of the copyright.
- **Work for Hire** = work done by salaried employees within scope of employment = owned by employer.
- Work done by independent contractor is **NOT** owned by entity paying for the work unless there is a written contract to assign the copyright rights.
- Copyright can be assigned – must be in writing.
- Joint owners must account to co-owner.

Copyright Duration

- Post Jan. 1, 1978 --
- Works for Hire post Jan. 1, 1978 –
- Different term for pre Jan. 1978.
- Most 1923 and earlier works now in public domain

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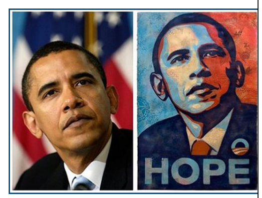

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  - Inherently distinctive
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  - Require a showing of secondary meaning
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  - NOT entitled to trademark protection

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- Receive the right to exclude others from making, importing, using, offering to sell and selling the invention.
- While patent is in force, public may learn from the disclosure and try to "design around".
- When patent expires, public is free to practice invention disclosed in patent.

Benefits of Patenting

- Term of exclusive right – 15 or 20 years.
- Stop others from making, importing, selling, or using your invention without your permission.
- Prevent competitors from "knocking off" your product.
- Use patent as asset that may be licensed or pledged as collateral for a loan.
- Enhance company image

3 Types of US Patents

- **Utility Patents**: processes, machines, articles of manufacture, or compositions of matter

  Types of utility applications:

  Provisional – “placeholder” that is not examined by USPTO.

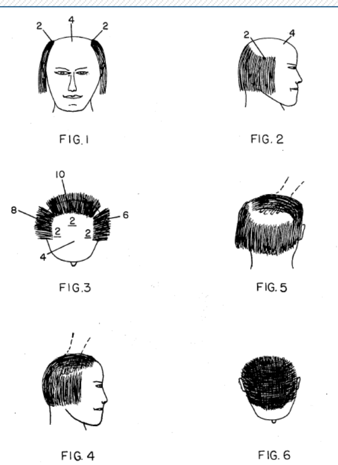
  Non-provisional – a “regular” application that will be examined.

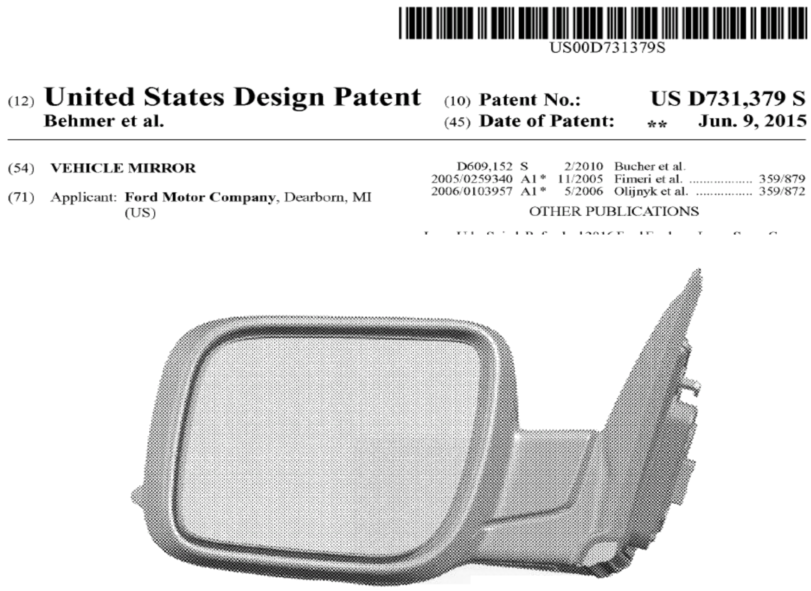
  Continuing – asserts priority to an earlier non-provisional.

3 Types of US Patents

- **Design Patents**: ornamental design for an article of manufacture
- **Plant Patents**: new variety of asexually reproduced plants

Method of Concealing Partial Baldness (U.S. 4,022,227)





US00D731379S

(12) **United States Design Patent**
Behmer et al.

(10) **Patent No.:** **US D731,379 S**
(45) **Date of Patent:** ** **Jun. 9, 2015**

(54) **VEHICLE MIRROR**

(71) Applicant: **Ford Motor Company**, Dearborn, MI (US)

D609,152 S	2/2010	Bucher et al.		
2005/0259340 A1 *	11/2005	Fimeri et al.	....	359/879
2006/0103957 A1 *	5/2006	Olijnyk et al.	....	359/872

OTHER PUBLICATIONS

When Apple Inc. unveiled the iPhone in 2007, it had applied for more than **200** patents for the device.

Is Your Invention Patentable?

1. **Patent-Eligible**: Invention's subject matter must be eligible for patent protection
   - Processes
   - Machines
   - Manufactured items
   - Compositions of matter
   - Some software
   - Some business methods
   - **NOT** – ideas, abstract thoughts, laws of nature

"Anything under the sun that is made by man [sic, or woman!]."

***---Diamond v. Chakrabarty*, 447 U.S. 303 (1980)**

Is Your Invention Patentable?

2. **Useful:** The invention must be useful or serve some practical purpose.

NO Pet Rocks!

Is Your Invention Patentable?

3. **<u>Novel</u>:** Is your invention new and different from what is disclosed in prior patents, publications and products anywhere in the world?

Is Your Invention Patentable?

4. **<u>Not Obvious</u>:** Your invention is not a trivial variation on prior solutions to the same problem; your invention is not already suggested to persons working in the field.

4 Legs

VERSUS

3 Legs

How long does it take?

Patent pending status can last 3 or more years in the US.

Maintain Your Patent

Patent Type	Term	Maintenance
Utility	If filed before June 8, 1995, longer of 17 years after issue date or 20 years from earliest filing date	Fee due 3.5, 7.5 and 11.5 years after issue date, but may be paid within 6-mo. grace period with extra fee
	If filed after June 8, 1995, 20 years from earliest filing date	3.5, 7.5 and 11.5 years after issue date, but may be paid within 6-mo. grace period with extra fee
Design	15 years if filed on or after May 13, 2015; Otherwise 14 years.	None
Plant	20 years from earliest filing date	None

Enforcing Your Patent

- Patent owners may sue an infringer only in a federal district court.
- Once infringement demonstrated, the court may award to the patent owner:
  - Injunction
  - Money damages
    - Lost profits, or
    - Reasonable royalty

Patent Ownership

- Co-inventors share equally in patent rights, unless they have requirement to assign these rights to another (e.g., their employer in an employment agreement).
- Problems arise when employees from different companies work on an invention together (e.g., Company-Company, Company-University, University-University).
- Problems arise when "outside consultants" are used.
- Before work starts, collaborators should agree in writing regarding who will own what.

Can Have Multiple IP Rights in One Product

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INTELLECTUAL PROPERTY AND BANKRUPTCY

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Objectives

- Provide practitioners an overview of IP issues relevant in BK
- Discuss Two Circuit Splits
  - Licensee Rights After Rejection (Lubrizol v. Sunbeam) – Cupcakes
  - Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical) -- Trump

IP in BK Overview

In General

- The Code does not contain a comprehensive structure for dealing cleanly with IP issues.
- As a result -- a hodgepodge of cases, some of which conflict.
- Critical rights can be lost – or won – when the two worlds of IP and BK intersect.

IP in BK Overview

Section 365(a) provides "[T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor"

- Assumption
  - cure default
- Assignment
  - Anti assignment clauses generally nullified
  - Applicable nonbankruptcy law
  - Adequate assurance of future performance
- Rejection
  - Leads to prepetition claim

Section 365(n) – discuss later

IP in BK Overview – Section 365

Two preliminary issues:

1. Is the Contract exectuory?

The key factor in evaluating whether a license agreement is "executory" is whether performance remains due on each side so that failure to complete performance by either party would be a material breach.

One initial issue that the nondebtor licensor or licensee should analyze is whether the license is in fact executory and therefor subject to an assumption or rejection in the first place.

The Bankruptcy Code does not contain a definition of the term "executory contract."

IP in BK Overview – Section 365

The decision about "executoriness" is not simple.

In *In re Exide Technologies, 607 F.* 3d 957 (3d Cir. 2010) the Third Circuit determined that a perpetual, royalty-free trademark license was not an executory contract and thus not subject to assumption or rejection by the licensor debtor.

In contrast, *In re Interstate Bakeries Corporation*, 690 F.3d 1069 (8th Cir. 2012) the Eighth Circuit determined that a similar license was executory. However, the Eighth Circuit subsequently vacated and after rehearing en banc ruled that the license at issue was not executory and thus could not be rejected by the debtor/licensee, *In re Interstate Bakeries Corp.,* 751 F.3d 955 (8^{th} Cir 2014).

Years of litigation in these cases and others over a very fundamental issue.

IP in BK Overview – Section 365

2. Is Assignment Prohibited by Applicable Law?

Assignment is not permitted when applicable non-bankruptcy law excuses a non-debtor party from accepting or rendering performance from a third party.

Thus, once the issue of "executoriness" is determined, a separate analysis is needed as to whether relevant applicable law operates to preclude a party from accepting performance from a third party over its objection -- an issue that will depend in part on the particular jurisdiction where the case is pending.

IP in BK Overview – Section 365

The classic example of such a contract is a personal services contract: state laws prevent a party from forcing a counterparty to accept personal services from a third party not selected by the counterparty.

Courts have determined that patent, copyright and trademark law also constitute "applicable law" which preclude a debtor from attempting to force its counterparty licensor from accepting performance from a third party licensee in certain circumstances.

Cases listed in the materials.

IP in BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

- *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F. 2d 1043 (4th Cir. 1985).
  - Pre bankruptcy, Debtor granted Lubrizol a nonexclusive license of certain patents.
  - Post bankruptcy, Debtor rejected the license agreement.
  - The Fourth Circuit held that under the Bankruptcy Code as it then existed, when the Debtor rejected the license, Lubrizol, as the patent licensee, lost its rights under the license.

IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

- In response to Lubrizol, in 1988 Congress enacted Section 365(n) to the Bankruptcy Code
- Expressly grants licensees of "intellectual property" an option to elect to either (i) treat a rejected IP agreement as terminated or (ii) retain all rights, including rights to enforce any exclusivity provisions in the license and related or ancillary agreements, for the duration of the license and any extensions.

IP in BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

- Section 365 (n) applies where (a) trustee rejects AND (b) debtor is a licensor of a right to intellectual property.
- Section 101(35A) defines intellectual property as:
  - (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.

Current BK Code definition of "IP" does NOT expressly include trademarks, trade dress, or service marks

IP in BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

Before Rejection: Section 365(n)(4)

- Upon written request of licensee:
- Trustee must (to the extent provided in the license or any supplementary agreement) perform license or provide IP to licensee, AND
- Trustee must not interfere with certain rights of licensee

IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

Trustee's duties after licensee elects to retain its rights under Section 365:

- Trustee must allow licensee to exercise its rights. 365(n)(2)(A)
- To the extent provided in a license, Trustee must provide IP held by trustee to the licensee upon licensee's request. 365(n)(3)(A).
- Trustee must not interfere with rights of licensee. 365(n)(3)(B).

IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

Licensee's duties after retention of rights

- Licensee must make all "royalty paments" under the contract (as the same may be extended). 365(n)(2)(B)
- Licensee is deemed to have waived (i) rights of setoff and (ii) administrative expense claims arising from the performance of the contract. 365(n)(2)(C).

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IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

- Sunbeam Prods. V. Chicago American Mfg., LLC, 686 F.3d 372 (7th Cir. 2012)
  - Pre bankruptcy, Debtor licensed patents and trademarks to CAM.
  - Debtor subject of an involuntary bankruptcy.
  - Sunbeam bought assets out of the bankruptcy, including the Debtor's patents and trademarks.
  - The bankruptcy trustee rejected the agreement with CAM.
  - Sunbeam brought an adversary proceeding in Bankruptcy Court.

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IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

- The Bankruptcy Court allowed non-debtor licensee continued use of trademarks on "equitable grounds."
- The Circuit Court instead focused on 365(g) and its indication that rejection "constitutes a breach."

  Rejection (which equals breach) does not equal rescission.
- "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."
- *Compare this result to Lubrizol.*

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IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

Remembering This Circuit Split Through the Cupcake Case

Crumbs Bake Shop, Inc., 522 B.R. 766 (Bankr. D.N.J. 2014)

- Debtor was a manufacturer, supplier and retailer of cupcakes and other baked goods.
- Pre bankrutpcy, Debtor contracted with Brand Squared Licensing ("BSL") for BSL to procure and manage license agreements with third parties. Under these agreements the third parties were granted permission to use the Debtor's trademark and trade secrets in exchange for royalties.
- Debtor sought to sell substantially all of its assets. Sale included the underlying IP, but excluded several license agreements including BSL deals.
- After sale, Debtor sought to reject several trademark license agreements.

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IP IN BK -- Circuit Split 1 – Rights of a Non-Debtor Licensee Under a Rejected License

- BSL filed a motion asserting that under §365(n) of the Bankruptcy Code licensees can elect to retain the rights granted to them by their respective contracts.
- The Bankruptcy Court held that it would be "inequitable to strip the within Licensees of their rights in the event of a rejection, as those rights had been bargained away by Debtors."
- "Trademark Licensees can be protected by section 365(n), notwithstanding the omission of 'trademarks' from the Bankruptcy Code definition of 'intellectual property.'"
- Sale free and clear does not trump 365(n) rights where the licensee does not consent to the sale.
- Parties settled before appeal decided.

IP IN BK -- Circuit Split 2 – Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical)

Section 365 contains a drafting ambiguity that has injected complexity into the analysis of assumption and assignment issues – and the rights of nondebtor licensors facing a counterparty's licensee's bankruptcy case.

Section 365(c) provides that a debtor or trustee cannot "assume or assign" an executory contract when applicable law would prevent assignment.

Some courts have opted to read the three words "assume or assign" literally – refusing to allow a debtor licensee to merely assume a nonexclusive intellectual property license on the grounds that such a license is non assignable under applicable nonbankruptcy law.

IP IN BK -- Circuit Split 2 – Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical)

Four Circuit Courts of Appeal (the Third, Fourth, Ninth and Eleventh) have adopted the hypothetical test and ruled that if a contract cannot be assigned under applicable non-bankruptcy law, then it cannot be assumed or assigned by the debtor-licensee.

IP IN BK -- Circuit Split 2 – Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical)

Two other Circuit Courts of Appeal (the First and Fifth) have rejected that view. Instead, these two Circuits have adopted an alternative test knows as the actual test.

Under the actual test, a debtor licensee is prevented from assuming a license only if it actually intends to assign it without the consent of the licensor. If the debtor merely plans to assume the license without attempting to assign, then the debtor is authorized to do so.

Significance of the Test:

- In "hypothetical test" jurisdictions, debtor licensees are precluded not only from assigning their IP licenses, they are also precluded from merely attempting to assume such licenses.
- In contrast, in "actual test" jurisdictions, debtor licensees who do not intend to assign are free to at least assume their IP licenses.

IP IN BK -- Circuit Split 2 – Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical)

The Circuit split is likely to be resolved by the Supreme Court at some point.

In 2009, Justice Kennedy was joined by Justice Breyer in issuing a statement on the denial of a petition for writ of certiorari in the case of *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*, 556 U.S. 1145 (2009).

In the statement, Justice Kennedy described the division in the courts as "*an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization"* and that in a different case "*the Court should consider granting certiorari on this significant question*."

IP IN BK -- Circuit Split 2 – Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical)

- Remembering this Circuit Split Through the Trump Case
- In re: *Trump Entertainment Resorts, Inc. et al., 526 B.R. 116 (Bankr. D, Del., 2015)*
- Trump Entertainment Resorts, Inc. ran three hotel casinos in Atlantic City, New Jersey. In a 2010 Trademark License Agreement, Trump AC Casino Marks, LLC, granted Trump Entertainment Resorts an exclusive, perpetual right to use the Trump name, likeness and other "Trump Marks" in connection with the operation of the hotel casinos but subject to termination if the licensees failed to use the Trump Marks in a manner consistent with certain quality standards.
- Finding such deficiency in quality, Trump AC initiated a state court action to terminate the Agreement. Thereafter Trump Entertainment Resorts filed for chapter 11 bankruptcy. Under the Debtors' proposed reorganization plan, the debtors proposed to assume the Trademark License Agreement, and continue to use the Trump Marks in the operation of its hotel casino, the Taj Mahal.
- Trump AC filed for relief from the automatic stay, in order to proceed with the state court action.

IP IN BK -- Circuit Split 2 – Debtor's Rights to Assume an IP License where no Intent to Assign (Actual v. Hypothetical)

In granting Trump AC's motion, the Court noted that the Third Circuit follows the "hypothetical test".

Whether a debtor licensee may assume an executory contract depends on the debtor licensee's hypothetical ability to assign the contract.

The Bankruptcy Court held that "under federal trademark law, trademark licenses are not assignable in the absence of some express authorization from the licensor."

The Court granted Trump AC's motion and lifted the automatic stay, despite the fact that the Debtors had no intention of actually assigning the license

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Intellectual Property Valuation and Insolvency Issues

2015 Midwestern Bankruptcy Institute
Sponsored by the American Bankruptcy Institute and University of Missouri-Kansas City School of Law

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Willamette Management Associates

Portland, Oregon • *Chicago, Illinois* • *Atlanta, Georgia*

Bankruptcy Reasons to Value Intellectual Property

- Preference claims and debtor solvency (Section 547)
- Fraudulent transfers and debtor solvency (Section 548)
- Asset sales and adequate protection (Section 363)
- DIP entering into inbound or outbound license agreement (Section 363)
- Decrease in the value of a creditor's interest (Section 361)
- Bankruptcy rules regarding a secured creditor's interest (Rules 3012 and 3018)
- Plan of reorganization confirmation (Section 1129)
- Cram down of a plan of reorganization (Section 1129)

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Bankruptcy Reasons to Value Intellectual Property (cont.)

- Secured creditor relief from the automatic stay (Section 362)
- IP collateral valuations for DIP financing
- Assessing the zone of insolvency and debtor company director duties
- Rejection of debtor's IP licenses (Section 365)

Generally Accepted Intellectual Property Valuation Approaches and Methods

- Market approach methods
  - Relief from royalty method
  - Comparable uncontrolled transactions method
  - Comparable profit margin method
- Cost approach methods
  - Replacement cost new less depreciation method
  - Reproduction cost new less depreciation method
  - Trended historical cost less depreciation method
- Income approach methods
  - Multiperiod excess earnings method
  - Capitalized excess earnings method
  - Incremental income method
  - Differential income method
  - Profit split method
  - Residual profit split method

Standards of Value and Premises of Value

- Standards of Value
  - Fair market vale
  - Fair value
  - Investment value
  - Owner value
  - Use/user value
  - Acquisition value
- Premises of Value
  - Value in continued use
  - Value in place
  - Value in exchange—orderly disposition
  - Value in exchange—forced liquidation
- Standard of value may be based on pending transaction
- Premise of value may be based on highest and best use analysis

Generally Accepted Intellectual Property Valuation Standards

- Several professional organizations promulgate IP professional valuation standards:
  - American Institute of Certified Public Accountants
  - National Association of Certified Valuators and Analysts
  - Institute of Business Appraisers
  - American Society of Appraisers
  - Appraisal Foundation (USPAP)

Intellectual Property Valuation Considerations

- IP is unique among commercial intangible assets: it can be both (1) owned and operated by the debtor and (2) licensed to a noncompeting operator
- Unlike other commercial intangible assets, IP is often sold or licensed separately from the developer's business enterprise
- Debtor IP can often have a greater value in exchange than its value in use
- There is often a different value for the same IP (1) to the debtor/licensor, (2) to the licensee, (3) to a creditor, and (4) to the market

Intellectual Property Valuation Considerations (cont.)

- The analyst may use different valuation methods and different valuation variables depending on whether the analysis is to value the IP to (1) the debtor/licensor, (2) to a licensee, (3) to a creditor, or (4) to the market
- IP value is directly influenced by the debtor/licensor ability to maintain and protect the IP
- IP value is directly related to the specific bundle of legal rights transferred in the (1) sale or (2) license

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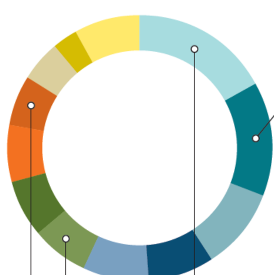
What Every Lawyer Needs to Know About Cybersecurity

PRESENTED BY: Rebecca Stroder
Senior Director – Legal FireEye/Mandiant

Think you're not a target? You're wrong.

Industries Where Mandiant Investigated Intrusions



In 2014 we noted changes in the number of engagements at companies in several key industries:

- ↑ **Retail—up from 4% to 14%**
- ↓ **Media & Entertainment—down from 13% to 8%**

Several industries that had previously represented a minor portion of our investigations emerged as notable targets:

- **Business & Professional Services**
- **Government & International Organizations**
- **Healthcare**

17% Business & Professional Services	**7%** Legal Services
14% Retail	**7%** High-Tech & IT
10% Financial Services	**6%** Healthcare
8% Media & Entertainment	**5%** Transportation
8% Construction & Engineering	**3%** Aerospace & Defense
7% Government & International Organizations	**8%** Other

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Think you haven't been compromised? You're probably wrong about that too.

Industry	Deployments Compromised
Agriculture	100%
Auto/Transportation	100%
Education	100%
Healthcare/Pharm	100%
Retail	100%
Energy/Utilities	98%
High Tech	97%
Telecom	97%
Financial Services	96%
Average	96%
Federal government	95%
State and Local government	95%
Legal	95%
Chem/Manu/Mining	94%
Services/Consulting	94%
Entertainment/Media/Hospitality	91%
Insurance	90%
Aerospace/Defense	76%

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They Go Undetected for Months or Years

Time from Earliest Evidence of Compromise to Discovery of Compromise

median number of days that threat groups were present on a victim's network before detection

↓ **24 days less than 2013**

Longest Presence: 2,982 days

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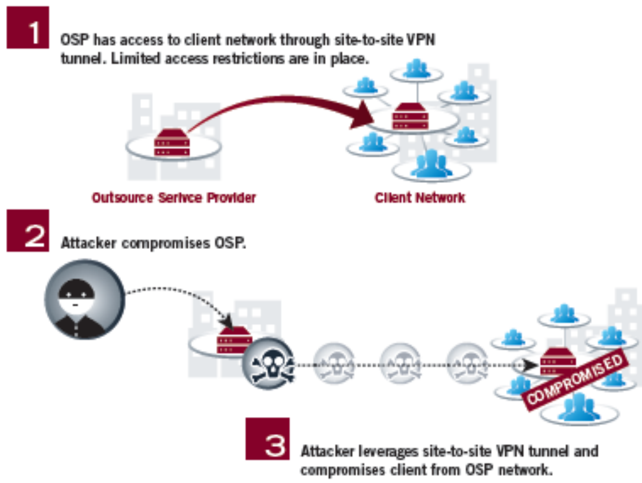
They Get in Through Third Parties

COMPROMISE VIA OUTSOURCED SERVICE PROVIDER (OSP)



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Timeline of a Breach

- Dec. 18 – Data Breac h Expo sed
- Dec. 19 – Company confirms breach. Congress calls for action. State attorneys general create coalition to address breach
- Dec. 20 – first of 40 class action lawsui ts filed
- Dec. 22 - CEO sends email to customers telling them that issues are resolved. They're not. Senators call for FTC/CFPB investigati ons
- Dec. 30 – Congress ional hearings held.
- Jan. 13 – Com pany anno unce s reme dial actio n
- Jan. 29 - Derivativ e suit filed against Board and Executiv es
- Feb. 4 – Senate Judiciary Committe e Hearing
- March 26 – FTC invest igatio n annou nced

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How Do You Prepare?

- Make sure your IT department works with you to conduct training to all employees on cybersecurity issues, such as phishing/spearphishing, document handling procedures, password protocols, etc.

- Review insurance policies for cyber exclusions (and buy a cyber policy).
  - Revision by Insurance Services Office, Inc. (ISO) to standard CGL policy forms effective on or after **May 1, 2014** in all but four U.S. states/territories.
    - Exclusion of coverage for claims arising from the access or disclosure of confidential information.
    - In addition to third-party damage claims, eliminates coverage for costs of:
      - Notifications
      - Credit monitoring
      - Forensic investigations
      - Public-relations campaigns
      - Other expenses typically related to data breach

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Common Mistakes

- "Fixing" the problem by deleting files, re-imaging, etc.

- Using only internal personnel to address the breach

- Assuming the SI or other IT service provider can handle the investigation/remediation work (some can, many can't, and in a lot of cases, that outsourced service provider is the problem)

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Common Mistakes

- Failure to instigate litigation hold
  - (=destruction of evidence)
- Not engaging outside counsel
- Response policy (IT/Info Sec vs. Legal) not coordinated
- Messaging: making uncoordinated/inaccurate public statements (Remember: multiple audiences)
- No awareness of insurance coverage

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What You As Counsel Can Do Today

- Schedule a meeting with your CSO/CISO/IT Director to ask about your firm's incident response plan
- Make a simple inventory of the types of information you have (e.g., employee records, patient records, credit card info, client personal info like SSNs, trade secrets), and where within your network that information is housed.
- Once you've done this, build a matrix of notification requirements (federal, state and international) specific to those types of information.
- Add cybersecurity to the next BOD or all-partner meeting agenda
- Review insurance policies and work with your broker to research cyber coverage.
- Join the FBI's InfraGard (www.infragard.org), and find a "SIG" (special interest group) specific to your industry (e.g., Legal SIG)

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Questions