The Basics in Valuation of Intellectual Property Assets

by Jennifer McCollough

Over the course of the last two generations, the business and legal world has morphed from an industrial-focused society to one that owes its strength, growth, and future on the intangible assets of our country’s collective intellectual property (IP). As a result, the industrial and business base has become an increasingly complex environment where we all must live and operate. For example, enactment of the America Invents Act, the Sarbanes-Oxley Act, § 482 of the IRS Code, ASC 805, and ASC 350 all affect corporations in connection with IP. Moreover, initial public offerings, mergers and acquisitions, and litigation have thrust IP holdings into an increasingly critical position in global economics and taxation in particular. The issue of IP valuation recently came to a head in a high profile case in the U.S. Tax Court involving over $1.5 billion plus interest and fees in liability regarding the redetermination of income-tax deficiencies. Moreover, several pending cases involve liability in the tens of billions of dollars. Nonetheless, some organizations fail to understand the value of and the risks to their IP, even when that IP accounts for a high percentage of the company’s value.

Defining Intellectual Property

Intellectual property is a general term for the set of intangible assets owned and legally protected from outside use or implementation without consent. While traditional IP generally refers to copyrights, patents, trademarks, and sometimes trade secrets, some tax professionals refer to IP interchangeably as intellectual property or intangible property, which is broader in scope. Nonetheless, given its ability to provide competitive advantages, a traditional IP asset provides the same protective rights as physical property when properly obtained and maintained. This protection is critical since it prevents replication by potential competitors, which poses a serious threat in, among others, a web-based environment or the mobile technology sector.

A company or organization that owns IP can realize its value either internally, for its own processes or provision of goods and services to customers, or externally through legal mechanisms such as royalty rights. Internationally, there is an extensive system for defining, protecting, and enforcing IP rights. This is accomplished through treaties and organizations such as the Agreement on Trade-Related Aspects of Intellectual Property Rights, World Intellectual Property Organization, World Customs Organization, United Nations Commission on International Trade Law, World Trade Organization, and the European Union. Enforcement of IP rights on a national level is discussed below.

Types of Intellectual Property

Traditional IP can be divided into four distinct types: (1) copyright, (2) trademark, (3) patent, and (4) trade secret.

Copyright

Among the most widely used type of IP, copyright is a form of protection granted to the authors of original works of authorship, both published and unpublished. In other words, a copyright protects a tangible form of expression (i.e., a book, work of art, or music), rather than the idea or subject matter itself. Under the original Copyright Act of 1909, publication was generally the key to obtaining a federal copyright in the United States. However, the Copyright Act of 1976 changed this requirement. Copyright protection now applies to any original work of authorship immediately from the time that it is created in a tangible form. This means that an author does not necessarily need to register a work with the U.S. Copyright Office in order to receive copyright protection. But, an author can enhance the legal protection on the work if it is registered. An author can also protect his or her work by giving the public notice of the copyright using the symbol ©. This does not assure the author that no outside party can legally claim it, so again, registration is encouraged. The eight types of original works of authorship listed in the Copyright Act of 1976 include:
1. literary works;
2. musical works, including any accompanying words;
3. dramatic works, including any accompanying music;
4. pantomimes and choreographic works;
5. pictorial, graphic, and sculptural works;
6. motion pictures and other audiovisual works;
7. sound recordings; and
8. architectural works.  

As for duration, the standard legal life of copyright protection is generally the life of the author plus 70 years. There are exceptions to this rule if, for example, an employee creates the work in the scope of employment or the work was commissioned.

Trademark

Trademarks are another common type of IP. A trademark, as defined by the Lanham Act, “includes any word, name, symbol, or device, or any combination thereof—(1) used by a person or (2) which a person has a bona fide intention to use in commerce and applies to register [in the U.S. Patent and Trademark Office (PTO)], to identify and distinguish [the] goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown.” In addition to registration with the PTO, a trademark can be developed through use. The benefit of registering the trademark is that the trademark is (1) presumed to be valid and (2) will not be subject to geographic limitations within the United States.

A trademark is valuable because it “may represent investment made in advertising and quality assurance testing.” A company that developed and invested in a quality product wants consumers to identify the product. A trademark associated with that subject product allows the trademark holder to achieve that objective.

Similarly, a trade name or trade dress also offers some legal protection, but neither is registered with the PTO. A trade name is the name of a product or business entity while trade dress refers to the way a product or service is displayed and promoted. To qualify for trade dress protection, it must be (1) inherently distinctive or have acquired secondary meaning, (2) primarily non-functional, and (3) the junior use should cause a likelihood of confusion.

As for duration, a trademark does not expire as long as it continues to be in use. Under the Lanham Act, the trademark will be considered “abandoned” after three years on non-use. A trademark owner should use the symbol to identify a trademark. The ® symbol, on the other hand, can only be used if the symbol has been registered and approved by the PTO.

Patents

Patents are the most valuable, costly, and difficult IP to obtain. Once issued from the PTO, a patent confers “the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States” for a statutory period of time, usually 20 years from the earliest filing of the patent. Internationally, the Patent Cooperation Treaty provides a unified procedure for filing patent applications to protect inventions in each of its contracting states.

There are three types of patents granted by the PTO: utility patents, design patents, and plant patents. The most common is the utility patent, which is issued “for any method or process, machine or manufacturing implement, combination or composition of matter, or any new or useful improvement upon earlier processes. The utility patent protects functionality and is designed to cover new methods and machinery, etc., used in the manufacture or production of any type of item.” A design patent, on the other hand, can be issued for “any new, original and ornamental design for an article of manufacture” and is issued for a period of 14 years. In other words, design patents can cover one or more of the shape, color, ornamentation, or texture of an object. Design patents gained some notoriety when Apple famously obtained a jury verdict of over $1 billion in a case against Samsung, $980 million of which could be attributed to infringement of the design patents. Lastly, a plant patent may be issued for an asexually reproduced “distinct and new variety of plant.”

Patent prosecution is the process of obtaining a patent. Initially, the inventor, sometimes through counsel, files an application with the PTO following technical conventions containing words and drawings to clearly demonstrate how to make and use the invention, to explain why this invention is novel and different from previous inventions (known as the prior art), and in the “claims,” describes precisely what aspects of the invention deserve patenting. An examiner then examines the patent application and searches for relevant prior art. If the examiner finds that the application does not comply with requirements, an “Office Action” is issued explaining the examiner's objections and requesting that they be addressed by amending the application in view of the existing prior art. The applicant may respond to the objections by arguing in support of the application, or making amendments to the application to bring it into conformity. Alternatively, if the examiner's objections are valid and cannot be overcome, the application may be abandoned. This process is continued until the patent is in a form suitable for grant, the applicant abandons the application, or a hearing is arranged to resolve the matter.

As of March 16, 2013, the U.S. recognizes the first-to-file rule pursuant to the America Invents Act. In other words, the right to a patent for a given invention lies with the first person to file a patent application for protection of that invention, regardless of the date of actual invention. It is therefore beneficial for an inventor to file an application as soon as possible.

Trade Secrets

A trade secret represents any information that has economic value and is not generally known by the public. In other words, a trade secret is any idea or fact that is not disclosed by a business. A trade secret is a unique form of IP in that it does not have a defined duration and can remain a trade secret for the lifetime of the firm. The most popular example is the recipe for Coca-Cola. To be deemed a trade secret, the information must meet several requirements: that it is genuine and not obvious, provides the owner with competitive or economic advantage and thus has value, and is reasonably protected against disclosure. Examples of trade secrets include the aforementioned recipes, business methods, strategies, tactics, or any other piece of information that gives the business a competitive advantage.

Under the newly enacted federal Defend Trade Secrets Act (DTSA), a trade secret consists of:

- all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if—
(A) the owner thereof has taken reasonable measures to keep such information secret; and

(B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by another person who can obtain economic value from the disclosure or use of the information.\(^23\)

Prior to enactment of the DTSA, trade secrets were generally protected by state law under a state’s adoption of the Uniform Trade Secrets Act (UTSA). The UTSA was published by the Uniform Law Commission in 1979 and amended in 1985. The DTSA differs from the UTSA in that it authorizes a private civil action in federal court for trade secret misappropriation and provides for injunctive relief, compensatory damages, and exemplary damages, as well as the recovery of attorney’s fees in the event of willful or malicious misappropriation. In a recent dispute regarding fig jam, a jury in Pennsylvania awarded Dalmatia Fig Spread $2.5 million in damages for trade secret misappropriation, trademark infringement, and counterfeiting.\(^23\) That award could potentially top $5 million after the trademark damages are trebled due to counterfeiting.\(^24\)

Also pending under the DTSA is a case seeking injunctive relief in the driverless car business. Specifically, Waymo sought injunctive relief alleging that a former manager downloaded more than 14,000 files to start a competing company that was eventually acquired by Uber for $680 million. A partial preliminary injunction was granted that, among other things, bars Uber from using the files in question; requires the company to return them to Waymo; prevents the manager from working on the technology; requires additional disclosures from Uber about how the materials have already been used; and grants further expedited discovery. The judge additionally referred the case to the Department of Justice for potential prosecution based on “compelling evidence” that Waymo’s “former star engineer” had taken thousands of confidential files before leaving the company for Uber—and that Uber “likely knew or at least should have known” what was happening.\(^25\) Notwithstanding potential criminal prosecution, it appears the DTSA could lead to billions in liability as time progresses.

**Why Value Intellectual Property?**

IP is a central element establishing value and potential growth in the global economic environment and in the development of business models. Additionally, U.S. and international accounting practices place pressure on companies to recognize and value all identifiable intangible assets of a firm as part of a transaction.\(^26\) Accordingly, there are a multitude of reasons to conduct IP valuation, including, but not limited to, financial accounting, income tax accounting, assessment of target company business values, debt financing, bankruptcy or reorganization, determination of royalty rates, transfer pricing, litigation support and defense, business formation or dissolution, strategic planning, and corporate governance.

Overall, proper valuation of IP, followed by measures to protect that value, have become a key element of the success and viability of a modern company. This was validated by former Federal Reserve Chairman Ben Bernanke where he discussed the importance of intangible capital, specifying that its accumulation has accounted for more than half of the increase in U.S. output-per-hour during the past several decades.\(^27\)

**Methodologies for Valuing Intellectual Property**

The three basic methods of valuing IP include the following:

- **Cost-based valuation** basically comprises the cost of replacement, taking into consideration both how much it cost to create the asset historically and how much it would cost to replace the intangible asset at current market rates.\(^28\)
- **Market-based valuation** is based on what similar assets sold for. This method looks at comparable market transactions, whether sale or purchase, of similar assets to arrive at conclusions of value, often using comparable uncontrolled transactions.\(^29\)
- **Income-based valuation** looks at the stream of income attributable to the intellectual property based on the historical earnings and expected future earnings.\(^30\) It is sometimes referred to as the weighted average cost of capital.

These methods can be applied concurrently or in a combined approach to arrive at a final valuation.\(^31\) There are also a multitude of proprietary and specialized approaches to valuation, including the subtraction theory of value, a profit-split approach, and the VALMAPRICE and Brand Value Equation proprietary methodologies.\(^32\) There are several important factors to establish and take into consideration when performing an IP valuation, including:

- Clear identification of the IP
- Unambiguous title to the asset
- Qualitative and quantitative characteristics of the IP
- Earnings capacity and profitability relating to the IP
- Market share supported by, or as a result of, the IP
- Legal rights and restrictions, competition, barriers to entry, and risks associated with the IP
- Product life cycles and positioning
- Historical growth and prospects for the future\(^33\)

**When IP Should Be Valued**

As enumerated above, there are a multitude of reasons when it is fairly obvious that IP valuation needs to occur. But it is also important for companies who derive a significant portion of their value to engage in a proactive IP valuation program to mitigate risk. According to Marsh, a company engaged in insurance brokerage and risk management, when it comes to the frequency, focus, and organizational levels where valuation will occur, different types of IP assets are treated differently as outlined in their table:\(^34\)

<table>
<thead>
<tr>
<th>When Should Assets Be Valued?</th>
<th>Goodwill</th>
<th>Indefinite-lived Intangible Assets</th>
<th>Amortizable Intangible Assets and Other Long-lived Assets</th>
</tr>
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<tbody>
<tr>
<td>Frequency</td>
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<td>Lived at which Impairment Test Is Performed</td>
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<tr>
<td>Reporting unit</td>
<td>Trigger-based</td>
<td>Individual asset combined unit of accounting</td>
<td>triggers-based Asset group</td>
</tr>
<tr>
<td>Focus</td>
<td>Impaired fair value of goodwill</td>
<td>Individual asset fair value</td>
<td>Recovery of carrying amount of the asset group</td>
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</table>

As for frequency, a “triggering event” is defined as an event or change in circumstance indicating that the carrying amount of an asset may not be recoverable. For example, a natural disaster such as an...
earthquake or hurricane can impair assets where buildings or other assets are severely damaged or destroyed. Another example includes the loss of an essential supplier or customer where a company’s operations or financial performance may be significantly affected.  

Assets potentially affected and in need of review include goodwill, intangibles, other long-lived assets, investments, inventories, and receivables. There are multiple definitions of goodwill. For instance, goodwill can be described as the value of an entity’s image or reputation, or, in other words, “the corporate identity umbrella brand, flagship brand, or marketplace advantage.” The American Institute of Certified Public Accountants described goodwill as all those intangibles and supporting assets that contribute to the advantage that an established business has over a comparable business that is about to be started. For example, an established business has, among other things, an image, customer base, reputation, and perceptions. From a pure accounting perspective, goodwill may be viewed as the value of all the intangible assets in excess of a company’s tangible asset value. Legally, however, it is important to note the distinction that goodwill specifically attaches to a piece of IP, particularly with respect to trademarks since a trademark is inextricably linked to the trademark that describes the brand.

The term intangible asset is a broadly used term that could refer to a multitude of applications. Treas. Reg. § 1.482-4(b), for example, defines intangible with respect to determining taxable income in connection with the transfer of intangible property as:

- an asset that comprises any of the following items and has substantial value independent of the services of any individual—
  1. Patents, inventions, formulae, processes, designs, patterns, or know-how;
  2. Copyrights and literary, musical, or artistic compositions;
  3. Trademarks, trade names, or brand names;
  4. Franchises, licenses, or contracts;
  5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
  6. Other similar items. For purposes of § 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

It is important to note that once all of the intangible assets have been valued, any excess value remaining can be described as goodwill. Accordingly, a more general definition of intangible assets includes the following characteristics:

- There should be some proof of its existence in the form of, among others, a contract, registration, or database.
- The intangible asset should have a specific lifespan or a lifespan that can be determined and/or that can be renewed.
- The intangible asset should have similar or referable assets to be found elsewhere in the marketplace.
- The value of the intangible asset can be quantified.

Given the many intricacies and complexities involved in IP valuation, it is advisable to engage a qualified, independent valuation specialist. To that end, it should be noted that pursuant to the Sarbanes-Oxley Act of 2002, auditors are unable to perform these services for their audit clients since that constitutes a conflict of interest. But a company that engages in a proactive IP valuation program that at a minimum defines the value of its IP and then identifies, assesses, and evaluates risk impacts is better positioned to realize the upside potential of an organization’s intellectual property.

Endnotes

3 ASC 805 and ASC 350 (formerly FASB 141 and FASB 142) are Statements of Financial Accounting Standards enacted by the Financial Accounting Standards Board. The primary goal of both is to empower investors with better financial information. ASC 805 and ASC 350 were enacted to address critical issues of accuracy in financial reporting.
6 Additional assets sometimes defined as IP include domain names, internet assets, and software.
11 Id.
20 While the America Invents Act was signed by President Barack Obama on Sept. 16, 2001, the first-to-file rule was enacted 18


26Valuation could be mandated by generally accepted accounting principles (GAAP), a statutory provision, administrative ruling, or a regulatory authority.


28REILLY & SCHWEINER, *GUIDE TO INTANGIBLE ASSET VALUATION* 219.

29*Id.* at 257.


31*Id.*

32ANSON & SUCHY, *FUNDAMENTALS OF INTELLECTUAL PROPERTY VALUATION* 30.

33*Supra*, note 30.

34*Id.*

35*Id.*

36*Id.*

37ANSON & SUCHY, *FUNDAMENTALS OF INTELLECTUAL PROPERTY VALUATION* 11 (emphasis in original).

38*Id.* at 12.

39*Id.* at 13.

40*Id.* at 12.

4126 C.F.R. § 1.482-4 (2011). Beyond the definition of intangible, the intricacies involved in transfer pricing are outside the scope of this article.

42ANSON & SUCHY, *FUNDAMENTALS OF INTELLECTUAL PROPERTY VALUATION* 15.

43*Id.*

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