

2004 Edition, Volume 2

VALUING INTELLECTUAL PROPERTY

Intellectual property (“IP”) is receiving increased attention today as it captures headlines. Earlier this year, for example, Microsoft got hit with a \$565 million penalty (the company is appealing) for infringing the patents of a Chicago company, Eolas, which has one employee and claims to own the way Web browsers work with other programs. PC makers Hewlett-Packard and Gateway are each suing the other for infringing each other’s PC patents. Toronto’s All Computers has sued Intel for violating its patents on the ways high-speed microchips operate. In June, another Canadian firm, Wi-LAN, sued Cisco for violating its Wi-Fi patents. Additionally, IP is often the target asset in many of today’s mergers and acquisitions.

IP encompasses a specifically identified bundle of legal and contractual rights. These rights are generally registered under and protected by specific federal and state statutes. These rights help create the intellectual properties value.

This article, which is the first in a series discussing the value of IP and intangible assets (IP is a subset of intangible assets), will present an overview of intellectual properties. In the future, we will explore the valuation methodology in valuing specific IP and intangible assets.

The general types of intellectual properties include:

1. Marketing-related - such as trademarks, trade names, service marks and logos
2. Technology-related – patents
3. Artistic-related - literary, musical, artistic, etc. copyrights
4. Data processing-related - computer software
5. Engineering-related - trade secrets and related engineering documentation.

As stated above, the legal attributes of IP affect its valuation. First, most IP has a specified legal life. Not all intangible assets have this. Additionally, the legal recognition and protection afforded to IP give it more external commercialization opportunities. IP owners can enter into license, joint venture or development agreements. There is also more judicial precedent regarding IP than other intangible assets. These factors help reduce the risk associated with intellectual property and enable the IP owner generally to enjoy higher royalty rates and pricing multiples than do other intangible assets.

Some of the more common reasons for valuing IP include:

- * Transactional - pricing for a sale or purchase, license agreement, allocation of equity in a joint venture.
- * Financial reporting - implementing purchase accounting for business combinations, periodic revaluations of goodwill and other intangibles
- * Federal taxation - substantiating charitable contribution or abandonment loss deductions
- * State and local taxation - establishing initial transfer price and periodic royalty rate for intercompany/interstate licenses
- * Commercialization - structuring/opining on joint venture, development, and license, equity/asset allocation in commercialization entity formation/dissolution
- * Litigation - estimating economic damages, lost profits, unjust enrichment and appropriate royalty rates in infringement.

The need to understand the value of IP has increased dramatically in recent years. VMI has seen this in the increasing number of intellectual property appraisals it has performed.

In some situations, it is necessary to assemble a team of professionals to properly perform a defensible valuation analysis. For example, our last newsletter discussed the deductions taken by large corporations donating patents to charity (largely to universities.) In performing patent appraisals relating to such donations for the IRS, we have worked with a team that includes a subject matter expert (an expert in the technology covered by the patent) and a Registered U.S. Patent Attorney or Agent. Such a team may be necessary to assess: a) the breadth of the claims; b) the ease of detectability of infringement; and, c) likelihood of use/ease of workaround.

REASONABLE COMPENSATION

In the valuation of a privately-held businesses, sometimes the most important issue is the level or reasonableness of the compensation of officers/shareholders. For corporate income taxes purposes, the IRS is also concerned with the reasonableness of compensation.

Some in the Circuit Courts have indicated that they believe that the task of calculating a maximum amount of reasonable compensation ordinarily involves judgment calls, generalizations, and very rough approximations. Judge Tannenwald has observed that in valuation disputes (and reasonable compensation disputes are often a subset of valuation disputes) there is often "an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise".

In *Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner*, supra at 179, the Court of Appeals for the Tenth Circuit listed nine factors to be considered, with the situation as a whole being considered and no single factor being decisive. These nine factors are:

1. The employee's qualifications;
2. the nature, extent, and scope of the employee's work;
3. the size and complexities of the business;
4. a comparison of salaries paid with the gross income and the net income;
5. the prevailing economic conditions;
6. a comparison of salaries with distributions to shareholders;
7. the prevailing rates of compensation for comparable positions in comparable concerns;
8. the salary policy of the taxpayer as to all employees; and
9. in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

The jurisprudence of the Court of Appeals for the Ninth Circuit is set forth in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1244-1245 (9th Cir. 1983), revg. T.C. Memo. 1980-282. It believes that in evaluating the reasonableness of compensation paid to a shareholder-employee it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment.

In considering the reasonableness of compensation "from the perspective of a hypothetical independent investor", the Court of Appeals for the Ninth Circuit in *Elliotts, Inc.* applies a five factor test:

1. The employee's role in the company;
2. a comparison of the compensation paid to the employee with the compensation paid to similarly situated employees in similar companies (external comparison);
3. the character and condition of the company;
4. whether a conflict of interest exists that might permit the company to disguise dividend payments as deductible compensation; and
5. whether the compensation was paid pursuant to a structured, formal and consistently applied program.

UPCOMING WORKSHOPS

Value Management Inc. is co-sponsoring and speaking at a workshop for owners of privately-held businesses valued at \$2 million or more. The workshop is entitled "Ownership Transition, ESOPs & Wealth Preservation: Succession Planning Strategies for Privately-held Business". Some of the topics that will be discussed are:

- * What is an ESOP?
- * Employee Stock Ownership Plans and Business Succession
- * Appraising the Privately-held Business
- * Financing the ESOP Transaction
- * Investing in Qualified Replacement Property

Two workshops will be held. The first is on October 19, 2004 at the Wyndham Franklin Plaza at 17th & Race Streets in Philadelphia. The second is on October 20, 2004 at the York Holiday Inn & Conference Center at 2000 Loucks Rd. in York, PA. Both will be from 8:30 to 11:30 a.m. and include a continental breakfast. If you or any of your clients are interested in attending, please call Anita at 215-598-9310.

VMI SPONSORSHIPS

Value Management Inc. continues to support the Philadelphia Estate Planning Council (the "PEPC"), the largest estate planning council in the nation. VMI will sponsor the PEPC's September 21, 2004 luncheon program held at the Union League in Philadelphia. Natalie B. Choate, Esq., of Bingham McCutchen LLP (Boston, MA) will give a presentation on "The 100 Best and Worst Ideas for Your Client's Retirement Benefits". Please contact us if you would like to attend or receive a copy of the handout.

On September 22-23, 2003, VMI will be a sponsor of the 9th Annual Multi-State ESOP Conference. The New Jersey/New York and Pennsylvania/Delaware Chapters of the ESOP Association will meet at the Hilton Scranton & Conference Center in Scranton, PA. This two day conference is for companies with ESOPs and for ESOP professionals.

VMI will be a sponsor at the Pennsylvania Bar Institute's (the "PBI") Estate Law Institute. The PBI's 11th Annual Estate Law Institute will be at the Pennsylvania Convention Center on Thursday, December 8 and Friday, December 9, 2004.

VMI HIGHLIGHTS

Value Management Inc. welcomes Jim Spencer, CFA, MBA as our newest Financial Analyst. With an MBA from New York University, Jim brings more than thirty years of experience in financial analysis. Most recently, he was the investment officer of Bethlehem Steel's Pension Trust and was responsible for securities analysis,

company research and industry analysis for an actively managed common stock portfolio. He also held various financial positions at Westinghouse, including investment manager, portfolio manager, and manager of corporate planning and asset/liability management. Jim is a Chartered Financial Analyst and has direct experience in the energy, manufacturing, pharmaceuticals, devices, hospital supplies, biotech and financial services industries. Jim's e-mail address is jbs@valuemanagementinc.com. Welcome Jim.

Andrew Wilusz, ASA, Director of Mergers and Acquisitions at VMI, was recently elected Second Vice President of the Montgomery County Estate Planning Council. He will serve in this position in the 2004-2005 year.

In his capacity as co-chair of the Philadelphia Estate Planning Council's (PEPC) Ethics Committee, Andrew co-authored an article with Adam Kazan, CPA, entitled "Do the Right Thing". The article, which appeared in the June 2004 issue of Trusts & Estates magazine, accompanied an updated Ethics Matrix created by the PEPC's Ethics Committee. Contact our office if you would like to have a pdf version e-mailed to you.

Ed Wilusz, ASA, CFA, President of Value Management Inc., was recently appointed to the Board of Directors of Pearl S. Buck International (PSBI). PSBI is a private non-profit organization with the mission of improving the quality of life and expanding opportunities for children, promoting and understanding the values and attributes of other cultures, the injustice of prejudice, and the need for humanitarianism throughout the world.

Value Management Inc.
Corporate Office
758 Durham Road
Newtown, PA 18940

Telephone: (215) 598-9310

Fax: (215) 598-0589

E-mail: info@valuemanagementinc.com