

Business Valuation Monitor

Value creation perspectives for corporate executives and the investment community August 2010

A wealth of information in financial disclosures may be useful in intellectual property litigation

Are you IP transaction savvy?

In this article, we explore the effect of accounting standards on the way acquired patented technology value is quantified and reported on financial statements, and the potential implication of financial reporting on reasonable royalty damages quantification, out-licensing, and securitization, as well as the proactive role attorneys, intellectual asset managers and fiduciaries may take to avoid intellectual property transaction-related disaster.

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In disputes involving Intellectual Property rights (IP), the financial reporting of acquired patent technology and other intangible assets at fair value may significantly affect subsequent damages calculations. The financial and economic assumptions used to value acquired IP pursuant to accounting standards may be an area that litigants focus on in IP disputes. This article is important for both outside and corporate IP litigation and transactional attorneys, as well as intellectual asset managers (IAM), all of whom may have a role in the valuation of IP for financial reporting

subsequent to a merger or acquisition. Pursuant to accounting standards¹ for business combinations, companies may complete a number of quantitative analyses to assess the value of intangible assets and resulting goodwill. Most of the time, companies hire accredited appraisers to assist them in assessing these values as the requisite valuation skill set is often not available in-house. In many situations these analyses should involve IAMs and/or in-house patent counsel, given the numerous and varying constituencies that may receive the valuation reports, and particularly as they may be discoverable and relevant to the quantification of damages in potential litigation subsequent to the transaction.

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A wealth of information in financial disclosures may be useful in intellectual property litigation (continued)

Corporate mergers and acquisitions frequently result in the transfer of intangible assets, including IP rights, valuable or not. Post-closing, these IP rights and their fair values, as defined in Accounting Standards Codification (“ASC”) 805 (formerly SFAS 141R) and ASC 820 (formerly SFAS 157) are stated as an asset on the acquiring company’s balance sheet, and may be the subject of a number of subsequent business and financial activities, including securitization, out-licensing, taxation, and litigation.

As a result, when intangible assets, including patented technology and other IP, are important to the value of a transaction, an acquiring company should consider cross-functional teams that can appropriately participate in the appraisal process. An acquiring company may also want to consider how business plans and required financial statement disclosures could be utilized by other intended or unintended users beyond the current transaction (e.g., insurance, out-licensing, and litigation damages).



Financial Accounting Standards Board—Statement of Financial Accounting Standard 141R

ASC 805 requires that the acquisition-method of accounting be used to account for business combinations in the United States. Under these rules, acquired assets must be recorded at fair value on a company’s balance sheet. International Financial Reporting Standard 3 (IFRS 3) contains a similar requirement. As such, intangible assets must be analyzed, and a fair-value determination must be made in connection with all acquisitions. These initial determinations of fair value may have haunting effects on buyers who are later faced with litigation over these acquired intangibles. While there are dozens of intangible assets listed in the appendix to ASC 805 standards, examples include:

Technology-based assets

- Patented technology
- Software
- Unpatented technology
- Databases
- Trade secrets

Marketing-related assets

- Trade names, trademarks
- Service marks, collective marks
- Trade dress
- Newspaper mastheads
- Domain names
- Non-competition agreements

Contract-based assets

- Licensing agreements
- Advertising, service, supply contracts
- Lease agreements
- Franchise agreements
- Use rights such as route authority
- Employment contracts
- Operating/broadcast rights

Customer-related assets

- Customer lists
- Order backlogs
- Contractual customer relationships
- Non-contractual customer relationships

Artistic-related assets

- Plays, operas, ballets
- Literary works
- Musical works
- Pictures, photographs
- Video and audiovisual materials

Determining the fair value of an intangible asset is no easy task. Company management, qualified professional appraisers, and valuation consultants may expend many hours assessing the value of each asset. Some of this work may take place prior to closing, but most often, the financial reporting activities occur concurrently or shortly after the acquisition. In the most common scenario, the buyer (usually with the help of qualified appraisers) prepares a detailed valuation report, complete with supporting schedules and exhibits, which is then reviewed at length by its auditors.

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A wealth of information in financial disclosures may be useful in intellectual property litigation (continued)

The valuation report typically contains the concluded value of each identifiable intangible asset acquired and other important information and supporting documentation. For example, with regard to patented technology, it may include information about licensing agreements, comparable licensing transactions, expected future sales covered by patented technology, and royalty rates.

During the past seven years, thousands of transactions have been completed by public companies in the United States, and an even larger number of private transactions have closed. For example, in 2007, public filings for more than 500 transactions spanning a variety of industries disclosed newly revised fair values for many intangible assets. These disclosures have future implications extending beyond the financial reporting context. In fact, these disclosures may be used by future litigation opponents to both challenge and quantify damages accounted for in IP litigation.

Discovery of documents prepared in connection with IFRS 3, ASC 805 and ASC 820

Once a company becomes involved in litigation over an intangible asset, all documents, reports, calculations, financial statements and other things associated with that asset may become subject to discovery. Generally, under the discovery rules, a litigation opponent has the right to request access to all information related to the valuation of the subject intangible assets. Such a

request, depending on the scope, can cast a wide net, encompassing a myriad of documents previously thought to be unrelated to litigation. This can include the work papers of independent third party valuation firms. Once opponents gain access to documents related to the valuation of intangible assets, even those pertaining to fair-value determinations following acquisition, the documents may become strategic weapons for the litigation opponent. In other words, a past valuation of intangibles might have the unintended effect of weakening the scope of protection afforded to them under the law. The following scenarios set forth examples of how implementation of ASC 805 may affect lawsuits involving intangible assets.

Acquired intellectual property scenarios and potential litigation considerations

Consider the following scenarios related to the identification and valuation of intangible assets including patents and trade secrets for financial reporting.

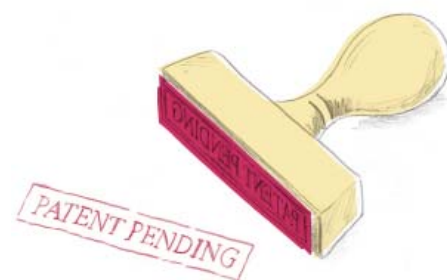
Scenario 1: Alpha Buyer (Alpha) acquires Small Seller (Small). In the transaction, Alpha considers the patented technology of Small, a portfolio of patents, to be an identifiable intangible asset as defined by purchase-accounting standards, and highly valuable. Alpha intends to use the patented technology in the continued operations of the business and also sees a need to enforce the patent rights against infringers. Alpha has also identified opportunities to license

some of the patents acquired from Small to third parties non-exclusively in alternative fields of use. It has been disclosed in the due diligence process that on more than one occasion Small has corresponded with allegedly infringing companies inviting them to license, but it never filed a patent infringement lawsuit. There are between eight to 10 years remaining until expiration of the patents in the Small portfolio.

In the fair value appraisal process, Alpha retains the services of an independent consulting firm to determine the fair value of all assets acquired, including the patent portfolio. The engagement is managed through Alpha's accounting department, reviewed and approved by Alpha's independent auditors, and will be disclosed to shareholders through audited financial statements. Documentation related to licensing is requested by in-house counsel, but neither in-house counsel nor IAM practitioners participate in the valuation or accounting process. In the valuation of the patented technology, a royalty rate of three percent of sales is deemed both reasonable and applicable to the entire portfolio. Further, the economic life of the patented technology is limited to two years due to expected future technological obsolescence. As a result, the value of patented technology acquired from Small is stated on the balance sheet at \$5 million. This amount is relied upon by bankers and the investing public.

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Four years later, Alpha files suit against an alleged infringer identified by Small prior to closing. Unaware of the ASC 805 report and purchase price allocation conclusions, damages experts retained by outside counsel on behalf of Alpha apply the *Georgia-Pacific* factors, conclude that a reasonable royalty of seven percent of sales is reasonable and estimate reasonable royalty damages are somewhere in the range of \$20 million over the prior four years.

In discovery, the ASC 805 report is produced by Alpha in response to discovery requests. The report, prepared outside of the litigation context, provides that the patented technology should have been obsolete two years earlier and that Alpha believed a three percent royalty was reasonable. How will this be perceived by a trier of fact?

Scenario 2: Alpha acquires Small, but this time Alpha determines that while trade secrets are identifiable, they do not have any fair value. Three months after closing, professionals acquired through the transaction leave Alpha to work for another firm, allegedly taking trade secret information with them. Alpha files suit for misappropriation of trade secrets, claiming \$10 million in damages. However, through discovery the defendant shows that Alpha's own balance sheet assigns no value to the trade secrets it acquired from Small. Did the trade secrets exist?

As these hypothetical scenarios demonstrate, decisions associated with the financial reporting of IP can have far-reaching and unexpected implications.

Not only the concluded fair value of intangible assets, which may or may not be consistent with damages, but also the underlying economic assumptions and final arms-length royalty rate used in the valuation, can raise a number of significant questions and affect the viability of future IP claims and associated damages.

Implementing ASC 805 and applying ASC 820: process steps to consider

Companies should consider involving attorneys and advisors in identifying acquired intangible assets and assessing assumptions used to value them as required under ASC 805 and ASC 820. Because ASC 805 relates specifically to business combination accounting, it is not surprising that the common practice is to involve corporate accounting and finance personnel. But due to the increasingly important role of IP in today's economy, prudent financial executives may also consult other advisors as well on an as needed basis. Based on the relative importance of IP to the negotiated price of the transaction and future operations of a company, buyers must do their part to obtain the requisite information and guidance necessary to support a proper valuation of their newly acquired assets. Financial executives might solicit the advice of the professionals including in-house patent counsel, outside patent counsel, research and development managers, and product-line managers, as well as accounting advisors and valuation specialists.

Companies should maintain independence from independent appraisers or consultants retained to assist with ASC 805 valuations. But there are a number of ways to appropriately involve counsel and other advisors in the process. Specifically, with regard to patented technology, attorneys and consultants may participate in information gathering through various methods, including management interviews.

Additionally, business plans, financial statements, and other documentation relied upon in the appraisal process may be scrutinized as they relate to damages in future litigation. For example, companies should be cognizant about broad conclusions and other representations which could be used in litigation. Such information may include: IP obsolescence; product revenue forecast; risk and required rates of return; profit attributable to the IP; and royalty rates.

Presentation of this information could significantly impact the remedies available to a company enforcing its IP rights. Specifically, records pertaining to the valuation of IP could have an effect on the quantification of damages associated with any infringement or misappropriation.

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Summary

Companies involved in business combinations should consider the relationship between FASB reporting requirements and the future enforcement of rights associated with intangible assets. Failure to do so could leave businesses vulnerable to unforeseen arguments by litigation opponents relying solely on internal documentation prepared during the time of acquisition.

Increased transparency resulting from evolving financial reporting requirements and civil discovery rules requires forethought and diligence in the preparation of documents supporting ASC 805 valuations. Revised business practices in the area of post-closing valuation could significantly benefit companies in future efforts aimed at protecting these highly bargained for intangible assets. •

The content of this article reflects the opinions of the authors, and does not represent the opinions of their respective firms.

¹ Accounting standards require certain information to be disclosed in financial statements relating to acquired intangible assets, including intellectual property. See International Financial Reporting Standard 3, Statements of Financial Accounting Standard ASC 805 and Statement of Financial Accounting Standards ASC 820.

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With more than 20 years of experience, Bryan Benoit, Partner of Grant Thornton LLP Economic Advisory Services practice specializes in valuation, forensic accounting and investigations and has testified as an expert on damages at arbitration and trial. He is a Certified Licensing Professional, Certified Public Accountant Accredited in Business Valuation, and a Certified Valuation Analyst. He has been quoted in the Wall Street Journal and Harvard Business School case studies, and is the author of several articles and seminars. Contact Bryan at 832.476.3620 / Byran.Benoit@gt.com or visit www.GrantThornton.com/valuation.

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