

## Economy Pulse Check: Valuation, Finance, and Exchange of Intellectual Property

The rising tide of the recession has brought with it a wave of change in our approach to commerce; but perhaps no transition has provided as much optimism as the growing share of commerce involving intellectual property (IP) assets. Intellectual property has been increasingly recognized as a burgeoning asset class, an important financing tool, and a revenue-generating instrument for exchange. Acknowledging this phenomenon, the United States has joined a global initiative to help push a common knowledge of this use of intellectual property and to facilitate a legal regime that promotes the many opportunities for intellectual property in commerce. The initiative has focused on three chief areas: IP valuation, IP finance, and IP exchange.



### IP Valuation

Accurately valuing intellectual property has never been reduced to a simple process—much less a standardized one—and this has slowed the emergence of a robust market for exchanging intellectual property assets. Various methods frequently used for tangible assets have been applied in the arena of intangible assets, including an income approach, a cost-based approach, and a value-added approach. A market-comparables approach is not yet conceivable because there has never been open information and significant price discovery in intellectual property transactions. This is, of course, a product of confidentiality and nondisclosure elements of patent law, resulting in the majority of patent transactions occurring at arm's length and behind closed doors.

Another wrinkle in standardizing IP valuation is that the term “value” has different meanings to various parties in an IP transaction. The value of a core operational patent owned by a company holds much more “value” to that company than just cost or the income derived from the patent, because it may create a competitive advantage that cannot be quantified. Similarly, the value of intellectual property to a licensee is different than it is to a licensor, in that the market

price cannot completely account for the utility the licensee derives from the IP asset in the operation of a business. Other factors must also be taken into account, such as how vulnerable the patent is to dilution and the term of life left under legal protection. The context of valuation must also be considered. Valuers' incentives will differ depending on whether the valuation occurs in the context of financial reporting, tax reporting, a merger or acquisition, or a license negotiation.

In light of the need for standardization and the lack thereof, national and international initiatives have begun the process of establishing standards for IP assets. In 2001, the U.S. Financial Accounting Standards Board released Statement 142, which recognized accounting standards for “good will and intangible assets” acquired through transaction involving a merger or an acquisition.<sup>1</sup> To discuss the development of a standard method, the following year, the Licensing Executives Society developed an Intellectual Assets Reporting Standards Committee composed of accounting experts, intellectual asset managers, academicians, lawyers, and industry representatives.<sup>2</sup> Two years later, the Internal Revenue Service joined the movement by issuing a notice regarding charitable contributions of intellectual property, in which the agency asserted that a determination of fair market value of a patent must account for, “among other factors: (1) whether the patented technology has been made obsolete by other technology; (2) any restrictions on the donee's use of, or ability to transfer, the patented technology (see Rev. Rul. 2003-28, Situation 3); and (3) the length of time remaining before the patent's expiration.”<sup>3</sup> Thereafter, following the comments of the American Society of Appraisers at the Patent Donation Roundtable in 2004, the IRS promulgated a stricter standard for appraising intellectual property, including a definition of a “qualified appraiser” as one who has “verifiable education and experience in valuing the type of property subject to the appraisal.”<sup>4</sup>

Following the lead of these standard-setting entities, a series of recent entrepreneurial endeavors have attempted to create reliable IP valuation systems. Ocean Tomo LLC, an intellectual asset merchant bank based in Chicago, has patented their PatentRatings System, which assesses and compares the subject intellectual property with more than seven million U.S. patents using a systematic technology that analyzes certain cumulative characteristics of patents within a pool, including

the likelihood of producing economic returns. On the international platform, in 2008, in conjunction with the International Organization for Standardization, the German Institute for Standardization released a report entitled “General Principles of Proper Patent Valuation,”<sup>5</sup> which many professionals agree may be the basis for an international standard for IP valuation.

### IP Finance

As individuals and small businesses look to secure funding during a credit freeze, finance innovation has led to a jump in IP-based funding. In 1997, David Bowie, the British singer and actor, opened the public’s eyes when he issued asset-backed bonds on the basis of future royalties and raised more than \$55 million. This year, Annie Leibovitz, the famed photographer, secured \$16 million in loans by pledging her life’s work of copyrighted material. The practice is not exclusively available for celebrities; companies are turning to their intellectual property to boost their pool of collateral, especially in the software and biotechnology industries. It is apparent that banks and investors will be more inclined to offer money for a pledge of assets consisting of cash flow, such as the royalty streams that come from licensed IP rights, rather than a pledge of implicit assets, such as patents used internally for operations. The latter will require additional proof of potential liquidity. For the former, funds such as Royalty Pharma and Altitude Capital Partners have surfaced in recent years for the purpose of investing money in IP-rich companies in return for pledging IP rights or royalty streams.

In the United States, recent legislation and policy changes have helped to facilitate the use of intangible assets to secure credit. The American Recovery and Reinvestment Act of 2009 provides for \$255 million in funding to the U.S. Small Business Administration (SBA) for new deferred loans of up to \$35,000, to be used by small businesses to pay off existing debt and, more important, allows the SBA to accept “any available collateral” to secure the loan.<sup>6</sup> In March 2009, the SBA also revised its policy of loans secured by good will and intangible assets. Originally, the SBA had limited lender use of SBA-backed loans to finance good will at a maximum of 50 percent of the loan amount up to \$250,000. After lenders expressed concern that the limit would stop business acquisitions at a time when they need to be facilitated, the SBA lifted the limit and now reviews these loan applications.<sup>7</sup>

IP finance is also without critical standards, and it lies at the intersection of two bodies of law—commercial law and IP law—which do not always move in tandem. For this reason and because of the emerging possibilities, the United States and the international community are attempting to harmonize the two. On March 10, 2008, the World Intellectual Property Organization met in Geneva to discuss the topic of IP finance, specifically “ways in which improvements in law or financing practices may assist IP rights hold-

ers to manage their IP assets for greater value, and thereby assist Member States in setting-up appropriate national strategies in the field of IP.”<sup>8</sup> This meeting comes on the heels of a United Nations initiative under the UN Commission on International Trade Law, Working Group VI. In 2007, the commission promulgated its much-anticipated Legislative Guide on Secured Transactions to help member states standardize their offering of low-cost credit, but it was structured around the use of tangible goods and receivables. Identifying its possible clash with respective IP laws, the guide does not apply “to the extent [that it is] inconsistent with intellectual property law”<sup>9</sup>; instead, Working Group VI is in the process of preparing an IP annex to the guide, which purports to proffer standards for IP finance worldwide. The group had its final meeting from April 27 to May 1, 2009, in New York to complete the IP annex.

### IP Exchange

As the market develops, intellectual property continues to transform into an asset that can be traded. As stated above, the largest inhibitor to the market’s development is a lack of price information and a common stage for buyers and sellers. University directors for technology transfer and IP commercialization con-

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front this issue daily. Nevertheless, certain ventures are now shaping the market, including open IP auctions, online IP exchanges, and other IP investment vehicles and futures products.

The concept of auctioning intellectual property is not completely novel. Private IP auctions have been held in the context of bankruptcy or dissolution of a business. In 2006, however, Ocean Tomo hosted the first public IP auction in San Francisco, recording sales of almost \$3 million. Since then, Ocean Tomo's IP auctions have resulted in more than \$120 million in sales and licensing transactions. This year, auctions are slated for San Francisco in the spring, Hong Kong in the summer, and Paris in the fall.<sup>10</sup> These auctions help to set price standards, and parties can find one another on a common stage, erasing the transaction costs usually associated with searching for buyers or sellers. This year, Ocean Tomo is also poised to offer the first financial exchange with an IP focus through the bank's Intellectual Property Exchange International, which purports to act as an underwriter for IP transactions, mirroring a securities offering for a patent. Ocean Tomo will also offer futures products based on IP rights, called Unit License Rights and Tradable Technology Baskets, which aim to construct a secondary market for IP rights.

IP exchanges have reached the online forum as well—at ventures such as Yet2.com, iBridge Network, and Ocean Tomo's Dean's List. Intellectual property assets can be placed for public viewing on these exchanges, and confidential information regarding the IP is made available via password-protected data rooms or by contacting the seller. For research institutions, exchanges such as the iBridge Network and SparkIP have become lucrative, because they allow free listings, although for limited times. Even though these exchanges provide valuable exposure for sellers, the impact of their success is debatable. Still, transaction costs for the assets sold on these exchanges seem to be decreasing.

These entrepreneurial endeavors are not the only ones to have emerged in IP commerce. In a letter sent to President Obama on March 4, the U.S. chapter of the Licensing Executives Society called for the new administration to improve the market for innovation. Specifically, the letter proposed three initiatives designed to do the following: (1) provide gap funding for development of critical technology, (2) preserve intellectual property policies that promote both innovation and competition, and (3) support greater access to publicly and privately developed technology.<sup>11</sup>

We will have to keep a watchful eye on Washington as well as the world to see when these initiatives—whether they involve IP valuation, finance, or exchange—are pursued and developed. **TFL**

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#### Endnotes

<sup>1</sup>Financial Accounting Standards Board, Statement 142, *Good Will and Intangible Assets* (2001).

<sup>2</sup>Licensing Executives Society, Press Release, "Accounting Standards in the New Economy: Licensing Executives Address Reporting the Value of Intellectual Property" (April 24, 2002).

<sup>3</sup>See IRS Notice 2004-7, "Charitable Contributions of Patents and Other Intellectual Property," found at [www.irs.gov/irb/2004-03\\_IRB/ar10.html](http://www.irs.gov/irb/2004-03_IRB/ar10.html) (last visited March 10, 2009).

<sup>4</sup>26 U.S.C. § 170(f)(11).

<sup>5</sup>German Institute for Standardization, *PAS 1070 "General Principles of Proper Patent Valuation"* (2007).

<sup>6</sup>American Recovery and Reinvestment Act of 2009, § 506.

<sup>7</sup>U.S. Small Business Administration, Press Release, "SBA Revises Goodwill Lending Provisions in SOP; Will Consider Higher Limits Case-by-Case" (March 5, 2009).

<sup>8</sup>World Intellectual Property Organization, Information Meeting on Intellectual Property Financing, found at [www.wipo.int/meetings/en/2009/ip\\_fin\\_ge\\_09/](http://www.wipo.int/meetings/en/2009/ip_fin_ge_09/) (last visited March 11, 2009).

<sup>9</sup>United Nations Commission on International Trade Law, *Legislative Guide on Secured Transactions* (2007).

<sup>10</sup>As a result of recent restructuring at Ocean Tomo, the auctions scheduled for summer and fall 2009 may be postponed to 2010.

<sup>11</sup>Licensing Executives Society, Press Release, "Licensing Executives Society (USA & Canada) Calls on Obama Administration to Improve the Market for Innovation" (March 4, 2009).