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Value & Cents

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Intellectual Property: Issues and Opportunities in Bankruptcy



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Some eight years after its bankruptcy filing, on Jan. 24, 2017, Nortel Networks Inc.'s chapter 11 plan received confirmation in both Canada's and the District of Delaware's bankruptcy courts.¹ Essential to the plan was the settlement of an unprecedented cross-border dispute over how to allocate approximately \$7.3 billion from asset sales, \$4.5 billion of which was attributable to Nortel's patent portfolio, which included more than 6,000 U.S. and foreign patents and patent applications for wireless, wireless 4G, data networking, optical, Internet search, semiconductor and social networking technology.²

The winning bid — submitted in July 2011 by a consortium that included Apple Inc., Ericsson Inc., Microsoft Corp., Research in Motion Ltd. and Sony Corp. — represented a 400 percent premium to Google's stalking-horse bid of \$900 million. Google had said that it wanted the patents to protect itself from the increase in patent litigation in the tech world.³ However, as another bidder observed after being priced out of the auction and thereby prevented from purchasing the patents as a protective measure for its clients, while the winning bid was a “shockingly big number,” the patents held strategic value. “Each company had different reasons why they didn't want Google to own the patents.... The value was driven by the desire to ensure [that would not happen].”⁴

In contrast to the Nortel auction, consider the Eastman Kodak auction in December 2012.⁵ The

\$525 million winning bid for debtor Eastman Kodak's portfolio of 1,100 digital-imaging patents, submitted by a group that included Apple Inc., Amazon.com Inc., Microsoft Corp. and Samsung Electronics Co.,⁶ represented a discount of nearly 80 percent to the approximately \$2.6 billion initially estimated by the company's experts. Reasons given for the discount were the U.S. International Trade Commission's ruling that Kodak's “crown jewel” camera preview patent — for which it had sought damages of \$1 billion for infringement — was invalid, and the encumbrances associated with Kodak's licensing and cross-licensing practices.⁷ Complicating matters further, Apple had filed suit claiming ownership rights to 10 of Kodak's patents, while its spinoff (FlashPoint Technology Inc.) claimed ownership to the patents claimed by Apple plus an additional three, which delayed the auction.⁸ As these two cases illustrate, understanding how the value of intellectual property (IP) is affected by the rights and economic benefits associated with its existence is crucial to maximizing the value of a related claim in bankruptcy.

IP Characteristics

IP is a unique class of intangible asset that is different from other intangibles in how it is created, developed and protected. Intangible assets are economic resources, often created in the normal course of business, that lack physical presence but have value due to the rights, benefits and privileges that

1 Matt Chiappardi, “Nortel Wins Plan Confirmation After 8 Years in Ch. 11,” *Law360* (Jan. 24, 2017), available at law360.com/articles/884093/nortel-wins-plan-confirmation-after-8-years-in-ch-11 (subscription required; unless otherwise specified, all links in this article were last visited on Jan. 28, 2019).

2 Lance Duroni, “Judges Clear \$4.5B Nortel Patent Sale,” *Law360* (July 11, 2011), available at law360.com/articles/256986/judges-clear-4-5b-nortel-patent-sale (subscription required).

3 Jacqueline Bell, “Apple, Microsoft, Others Win Nortel Patents for \$4.5B,” *Law360* (July 1, 2011), available at law360.com/articles/255286/apple-microsoft-others-win-nortel-patents-for-4-5b (subscription required).

4 Elizabeth Woyke, “An Insider on the Nortel Patent Auction and Its Consequences,” *Forbes* (July 7, 2011), available at forbes.com/sites/elizabethwoyke/2011/07/07/an-insider-on-the-nortel-patent-auction-and-its-consequences/#7230f25559a3.

5 *Law360*, available at law360.com/articles/402879/print?section=bankruptcy (subscription required).

6 Maria Chutchian, “Apple, Kodak Make Peace Over Digital Camera Patents,” *Law360* (Feb. 6, 2013), available at law360.com/articles/413317/apple-kodak-make-peace-over-digital-camera-patents (subscription required).

7 Lisa Uhlman, “ITC Ruling Could Be Nail in Kodak Patent Sale's Coffin,” *Law360* (July 23, 2012), available at law360.com/articles/363142/itc-ruling-could-be-nail-in-kodak-patent-sale-s-coffin (subscription required).

8 Chutchian, *supra* n.6.

they convey to the owner.⁹ Examples include contracts, customer lists, distribution networks, goodwill, loan portfolios, litigation awards, noncompete covenants, and a trained and assembled workforce.¹⁰ By comparison, while a subset of intangible assets, and of a firm's goodwill, IP is created consciously through the intellectual effort of specifically identifiable individuals, and is registered and legally protected by federal and state statute.¹¹

The four main categories of IP are patents, trademarks, copyrights and trade secrets.¹² A patent is a governmental grant that excludes those other than the inventor from using, making or selling the covered invention. To be patented, an idea must be deemed novel and nonobvious by the U.S. Patent and Trademark office. The term of a patent is 20 years, measured from the date of the application. However, the validity of a patent can be challenged in litigation at any time. In general, there are three types of patents. Utility patents relate to machines, devices and processes. Design patents pertain to the visual appearance of a product. Plant patents cover asexually reproduced, distinct and new varieties of plant, other than tuber propagated plants or those found uncultivated.

A trademark is a word, slogan, design, picture or symbol that is used to identify and distinguish a product.¹³ Narrowly defined, the term applies only to the symbols that are used to identify a product. Broadly interpreted, it includes service marks, certifications, trade names and trade dress. In addition to promoting the sale of the owner's products, trademarks serve to identify the owner of the products, their source and expected quality. Trademarks that are proven to be used in interstate or international commerce are protected under the Lanham Act. However, as trademarks, trade names and service marks are not included in the definition of "intellectual property" in § 101(35A) of the Bankruptcy Code, licensees are at risk if the licensor files for bankruptcy.

A copyright is a grant of protection for specific, concrete works of expression.¹⁴ Examples of works that can be copyrighted include art, books, software, musical compositions, screenplays, sound recordings, motion pictures and television shows. The owner of a copyright has an exclusive right to reproduce, perform, display or license a copyrighted work. The term of a copyright for works created after Jan. 1, 1978, is equal to the life of the author plus 70 years. For made-for-hire works, the term is 95 years from the first publication or 120 years from creation, whichever comes first. The requirements for a work to be afforded copyright protection are that it is original, creative and fixed in a medium of expression.

Under the Uniform Trade Secrets Act,¹⁵ a trade secret is characterized as a "formula, pattern, compilation, program device, method, technique, or process that derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable via proper means by, other persons who can obtain economic value from its disclosure or use; and is the subject of efforts that are reasonable under the circumstances to maintain its

secrecy." Accordingly, for owners to preserve the value of a trade secret, they must act to preserve its secrecy. Absent reasonable efforts to do so, the courts will not recognize a claim for violation of a trade secret. This might be accomplished through the use of nondisclosure and confidentiality agreements, restricting access to confidential information, employment contract provisions that refer specifically to trade secrets and by communicating to employees the importance of the company's trade secrets and that they will be protected.

Accounting Implications

The costs incurred to research and develop new products, services and processes internally are charged to expense when incurred.¹⁶ However, acquired IP is recognized on the balance sheet based on its fair value as an asset separate and distinct from goodwill¹⁷ if it (1) has an underlying contractual or legal basis or (2) can be separately sold, transferred, licensed, rented or exchanged.¹⁸

Subsequently, IP having a finite useful life is amortized over its useful life (less residual value),¹⁹ which may vary depending on factors that include expected use; the useful life of other assets related to the property; legal, regulatory and contractual provisions; and the effects of obsolescence, demand, competition and maintenance expenditures.²⁰ IP having an indefinite useful life,²¹ is not amortized, however, but tested annually for impairment,²² as is true for IP with a finite useful life.²³

Impairment for IP with a finite useful life is determined by examining whether its carrying amount is recoverable along with comparison of its carrying and fair value. A carrying amount is not recoverable if it is greater than the sum of the undiscounted cash flows expected to result from the use and disposition of the asset. If the carrying value is greater than the asset's fair value, an impairment loss is recognized for the amount by which it exceeds fair value.²⁴ For IP with an indefinite life, the asset's fair value is compared with its carrying value, and if less, an impairment loss is recognized for the difference.²⁵

Events and circumstances that might be considered in an impairment analysis for IP having an indefinite life include increases in production and operating costs; decreases in revenues, cash flows and earnings as compared to prior-period actual and budgeted results; legal, regulatory, contractual and political influences; industry, market and macro-economic conditions; and firm-specific changes in management or key personnel, strategy and customers, financial distress and litigation.²⁶ For IP with a finite life, factors that might be considered include a decrease in market price; adverse changes in how the asset is being used and its physical condition, regulation and business environment; costs in excess of that expected to acquire or construct the asset; prior- and current-

16 A.S.C. 730-10-25-1.

17 A.S.C. 350-30-25-2.

18 A.S.C. 805-20-25-10.

19 A.S.C. 350-30-35-1.

20 A.S.C. 350-30-35-3.

21 A.S.C. 350-30-35-4.

22 A.S.C. 350-35-18.

23 A.S.C. 350-35-14.

24 A.S.C. 360-10-35-17.

25 A.S.C. 350-30-35-19.

26 A.S.C. 350-30-35-18B.

9 Robert F. Reilly and Robert P. Schweihls, *Valuing Intangible Assets* (McGraw-Hill 1999) at pp. 4-13.

10 *Id.* at p. 65.

11 *Id.* at p. 20.

12 Weston Anson, *IP Valuation and Management* (American Bar Association 2010) at p. 13.

13 *Id.* at p. 16.

14 *Id.* at p. 20.

15 *Id.* at p. 22.

period operating or cash-flow losses, or a forecast of ongoing losses attributable to the asset's use; and an expectation of greater than 50 percent that the asset will be sold or disposed of before the end of its useful life.²⁷

Valuation in Bankruptcy

IP is valued for a variety of reasons, including to support sale transactions, financial reporting, joint ventures, tax payments, financings and infringement litigation.²⁸ In cases of bankruptcy or financial distress, the need can arise from a liquidation, an orderly disposition with each asset sold individually with normal exposure to appropriate markets, a reorganization of the company accompanied by asset sales, or with the company continuing as a recapitalized going concern.²⁹ If in a liquidation, orderly disposition or formal reorganization, and depending on the standard and premise of value applied, the valuation might be lower than that for a going concern, since the longer a company's IP lies commercially dormant as a consequence of bankruptcy (which may or may not be true), the greater the chance that the value of its IP could decline.

Where the facts and circumstances of the case indicate a decline in the value of the IP, and again depending on the standard and premise of value applied, it might be appropriate to apply a discount to the valuation. It has been suggested that in bankruptcy, discounts to going-concern value could range from a low of 10 to 20 percent to a high of 90 percent in a liquidation,³⁰ with the value of IP in some cases decreasing by as much as 2 to 10 percent per month. Also, where comparable IP is available as a consequence of bankruptcy and competition, transaction prices might be lower than otherwise.

In re Nortel Networks Inc., et al.

The *Nortel* case is particularly noteworthy in illustrating the use of IP valuation in bankruptcy, and of how different valuation standards, premises, methods, legal rights and economic benefits attributable to its existence over its useful life affect its valuation. In litigation over how the \$7.3 billion in liquidation proceeds should be allocated, the spreads between the claims of the parties (which differed by billions of dollars) resulted from differences in their claims on Nortel's IP.³¹ Nortel's U.S. proposal, supported by the U.S. creditors' committee and various bondholder groups, argued that the U.S. entity had generated nearly 70 percent of the firm's total revenue and had contributed more than \$5 billion in assets to the liquidation sale, and that the proceeds should be allocated based on the fair market value of the assets it contributed, which would give the unit approximately \$5.3 billion, 74.3 percent of the patent proceeds and 72.6 percent of the whole.

27 A.S.C. 360-10-35-21.

28 Gordon V. Smith and Russell Parr, *Valuation, Exploitation, and Infringement Damages* (John Wiley & Sons Inc. 2005), pp. 6-8.

29 Anson, *supra* n.12 at pp. 10-11.

30 *Id.* at pp. 108-09.

31 Jamie Santo, "Nortel Trial Over \$7.3B Liquidation Pool Comes to an End," *Law360* (Sept. 24, 2014), available at law360.com/articles/580717/nortel-trial-over-7-3b-liquidation-pool-comes-to-an-end (subscription required); Jamie Santo, "Nortel Canadian Units Seek Full \$4.5B From Patent Sale," *Law360* (May 13, 2014) available at law360.com/articles/537241/nortel-canadian-units-seek-full-4-5b-from-patent-sale (subscription required); Jamie Santo, "Nortel Units Spar Over Patent Sale in \$7B Liquidation Fight," *Law360* (May 12, 2014), available at law360.com/articles/536781/nortel-units-spar-over-patent-sale-in-7b-liquidation-fight (subscription required).

For their part, Nortel's European contingent argued that the allocation should be based on the amount that they had spent in research and development to create the technology, that that was the method used when Nortel sold one of its businesses to Alcatel-Lucent in 2006, and that the fact that Nortel's Canadian business held title to the subject patents was an administrative convenience that did not signify ownership of the IP. On this basis, the European entities argued for \$1.4 billion, 34.7 percent from the patent proceeds, and 19.2 percent of the whole.

The theory underlying the claim of Nortel's Canadian parent, supported by the Canadian creditors' committee, including 20,000 pensioners, was that it held title to all of the patents under an intracompany patent agreement, and that what was granted to the U.S. and European units was a license and not a grant to the IP. Thus, the Canadian parent proposed that it should receive roughly \$6 billion, or 82.2 percent of the entire proceeds, with the U.S. unit getting 13.7 percent and Europe receiving 4.1 percent.

Finally, Nortel's U.K. pension fund, which represented 36,000 pensioners, argued that the interconnected relationships between the parties made it impossible to identify who owned what, more so given that the intracompany R&D agreement did not provide for a company-wide insolvency, and that consequently, the only fair method of allocation was to give each party a *pro rata* share of the entire proceeds, since Nortel operated and branded itself as a single global entity, and since only in that form could the sale value have been realized. Under this theory, the U.K. pension fund proposed giving each claimant an approximate 71 percent recovery on their claims. In the end, the parties settled their differences with \$4.1 billion, or 57 percent, of the liquidation proceeds being distributed to Nortel's estate in Canada; \$1.8 billion, or 24 percent, going to its estate in the U.S.; and the remainder shared by Nortel's affiliates across Europe, Africa and the Middle East, including the U.K.³²

First Principles

While there are a number of methods and procedures that might be appropriate for purposes of valuing IP, with their similarities and differences distilled, they converge into three general approaches: namely, the cost, market and income approaches.³³ The cost approach is based on the economic principle that an investor will not pay more for an asset than the cost to purchase one having equal utility. Using this approach, reproduction cost is measured as the cost to construct or acquire an exact duplicate of the IP, while replacement cost is equal to the cost to recreate the utility of the IP rather than an exact duplicate in form or appearance.

Underlying the market approach is the economic principle that in a competitive market, the supply and demand for an asset will converge to the point where its price is at an equilibrium.³⁴ With this approach, the value of an IP is most often calculated from comparable IP sale transactions or the relief-from-royalty method.

The income approach is based on the economic principle of anticipation, with the IP's value equal to the

32 Chiappardi, *supra* n.1.

33 Reilly and Schweins, *supra* n.9 at pp. 96-98.

34 *Id.* at pp. 101-03, 152.

present value of the expected economic income earned from its ownership, calculated using the yield or direct-capitalization methods.³⁵

Each of these approaches can be used to value a patent, trademark or copyright. To value a trade secret, it is best, if not necessary, to use the income approach.³⁶ Because a trade secret is by definition unique to its owner, the use of the market approach is not feasible, since there cannot be a comparable IP sale or license. The cost approach is similarly inappropriate, as the value of the trade secret might far exceed its costs.

Conclusion

IP differs fundamentally from other intangible assets in that it is created deliberately through the intellectual effort of specifically identifiable individuals, and are legally protected by statutes that serve to protect the rights, benefits and privileges it conveys to its owner. Consequently, as demonstrated by the underlying incentives and values of the winning bids in the Nortel and Kodak auctions, IP ownership can be highly valuable economically as well as strategically.

However, the value of IP can also be transitory due to influences that reduce its useful life or impair its value, as in a bankruptcy auction accompanied by bidder blocking and tackling *à la* Kodak. Realizing the full value of an IP claim therefore requires understanding how its value is affected by the rights and benefits it conveys, and potential changes therein. **abi**

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³⁵ *Id.* at pp. 113, 161.

³⁶ Anson, *supra* n.12 at p. 87.