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Evaluating brand-rich transactions: IP issues for corporate board members

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Evaluating brand-rich transactions: IP issues for corporate board members*

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A significant portion of large-scale merger and acquisition (M&A) activity in the US and Europe relates to brand-driven or brand-rich transactions. As used here, brand-rich transactions are those in which: (1) the target's trademarks and related marketing intangibles are among the primary assets sought by the acquirer; and (2) a substantial share of the purchase price is accounted for by the value of the acquired trademarks and related marketing intangibles.

In every M&A situation, the board of directors of the acquiring entity has substantial supervisory responsibilities with respect to identifying and evaluating potential targets, pricing and structuring the deal, and integrating the acquired entity. In recent years, all of these aspects have experienced material changes. Market forces and regulatory actions have substantially reshaped the landscape of requirements faced by publicly traded corporations in the areas of internal oversight, accountability and financial reporting. In parallel, the importance of intellectual property in general, and trademarks in particular, as drivers of M&A activity has continued to rise. Hence, board members of companies that are likely to pursue brand-rich acquisitions must gain command of certain issues and concepts that are key elements of the new order.

The purpose of this article is to provide board members with a practical checklist of IP-related issues for use in the evaluation of brand-rich transactions. The focus of the article is on issues stemming from three areas that have evolved significantly in recent years: corporate oversight; financial reporting; and taxation.

The issues presented here are articulated in the form of questions which board members should ask early and often when discussing potential brand-rich acquisitions with senior executives of their corporations. While not all-inclusive or exhaustive, the checklist below addresses many key areas for which board members should seek cogent, complete position statements from company management and/or external advisers.

It should be noted that even though this article is written primarily from a US perspective, most of the issues and concepts presented are also applicable to boards of directors and supervisory boards of European companies. While differences may exist between US and European boards with respect to structure, stated mission, and/or constituencies represented, boards on both sides of the Atlantic share many commonalities with respect to their supervisory duties in transactional settings.

Corporate oversight

In the US, with the passage of the Sarbanes-Oxley Act of 2002 (the Act), directors are more accountable to shareholders and bear greater responsibility for oversight of company management. The Act explicitly spells out heightened responsibilities of the board's audit committee. Concomitantly, the general atmosphere in the field of corporate governance has moved in the direction of greater accountability for board members.

Section 302 of the Act is particularly relevant to brand-rich transactions because it mandates CEO and CFO attestation regarding their company's financial statements (which include representations as to the value of acquired trademarks). Acquired trademarks pose a significant challenge for compliance with the Act given the difficulty inherent in the valuation of this type of asset. Section 404 of the Act is also highly relevant to brand-rich transactions since it requires assessment by management of the state of the internal controls of the company (which includes assessment of the internal controls of any

*The subjects addressed in this paper are presented for illustrative purposes but are not intended to reflect a comprehensive review of financial reporting, corporate oversight or taxation issues related to intellectual property assets. Financial reporting determinations, corporate oversight procedures and tax-planning opportunities must be assessed on the basis of the particular factual, legal and regulatory circumstances of each case. This article reflects the views of the authors and not necessarily those of CRA International Inc or its employees.

recently acquired company). The latter puts pressure on directors to ensure that, during the due diligence phase of a potential transaction, their company fulfils its responsibilities by assessing the trademark-related risks and threats lurking behind the target's doors.

In view of the above, board members of the acquiring entity may want to evaluate a number of issues:

Are the target's procedures and controls for utilising, monitoring and protecting trademarks adequate under the Act?
What processes does the target have in place for identifying and executing opportunities for creation of shareholder value from trademarks? What future liability could the target's trademark portfolio potentially create under the Act? Does the acquirer have structures and/or processes adequate to integrate and manage the newly acquired trademarks?

What trademark-related risks exist that may impact the acquirer's operations and financial condition in the future?
Consider risks such as: challenges to validity and/or ownership; duration, strength and geographic span of legal protection; existing and potential litigation; and licensing conflicts and contingencies.

Have the target's required disclosures regarding trademarks been sufficient under the Act?
Is there any risk of intervention by regulators or shareholder lawsuits due to insufficient disclosure by the target's management?

What are the potential implications for the acquired trademarks from disclosure requirements under the Act?
What is the balance between necessary disclosure and the protection of proprietary information? What processes are in place within the acquirer's organisation for identifying and/or monitoring material developments relating to the acquired trademarks?

Financial reporting
In the late 1990s, the US Financial Accounting Standards Board (FASB) set out to correct a long standing financial reporting/disclosure problem: the use of different accounting methods (on an elective basis) by publicly traded companies engaged in M&A activity which caused similar business combinations to produce dramatically different financial reporting results. In 2001, the FASB issued standards requiring additional valuation and disclosures with respect to acquired intangible assets and goodwill (Statement of Financial Accounting Standards (SFAS or Statement) No 141, *Business Combinations*; and SFAS No 142, *Goodwill and Intangible Assets*).

SFAS 141 requires the acquirer to allocate the purchase price paid for its target to determine the value of all material assets of the target's business and to recognise (in the acquirer's balance sheet) intangible assets apart from goodwill. SFAS 142 applies to the subsequent accounting for those assets after the initial recognition on the balance sheet. SFAS 142 requires that goodwill and indefinite-lived intangible assets (such as certain trademarks) not be amortised based on a formulaic approach (eg, straight line), but be reviewed for possible value impairment annually or more frequently, as needed.

It should be noted that in many European countries, financial reporting standards pertaining to the initial recognition and subsequent amortisation/impairment of acquired intangibles and trademarks generally parallel the above-mentioned FASB standards (see, for example, IAS 36, IAS 38 and IFRS 3).

More recently, in September 2006, the FASB issued SFAS No 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Included in this framework are requirements that fair value of an asset be determined based on the price that would be received from a "market participant". Further, the framework requires the determination of value based on the market participants' view of the "highest and best use" of the asset, independent of the buyer's intended use. The expanded disclosures required by SFAS 157 will include the effect of certain of the new fair value measurements on earnings (or changes in net assets) for an accounting period.

In view of the above, board members of the acquiring entity may want to evaluate a number of issues:

If the target and the acquirer are negotiating for the purchase of the target's stock, there will be no bargaining for the value of the target's individual assets and, therefore, no direct evidence of arm's-length pricing for these assets. Under these circumstances, could the acquirer pursue a strategy for the purchase price allocation that maximises the value allocated to certain assets (eg,

goodwill) and minimises the value allocated to other assets (eg, trademarks)?
What is the rationale behind such a strategy? What are the risks associated with implementation of such a strategy?

Are there any other contexts in which the acquirer may be required to take a position regarding the value of the acquired trademarks and, if so, how can different value positions for different contexts be reconciled?
What are the potential contexts in which the need for a valuation of the acquired assets might arise? Will the acquired trademarks be used in the future as collateral for debt? Are there differences between valuation/amortisation positions contemplated for financial reporting and tax-related uses? Can these differences be reconciled with defensible arguments? How do valuation/amortisation positions contemplated or taken for financial reporting and/or tax-sensitive uses affect positions contemplated or taken in infringement litigation (and *vice versa*)?

What processes are in place for identifying and valuing the target's trademarks, other intangible assets and goodwill in compliance with SFAS 141 and SFAS 157?
How will a determination be made as to whether the acquired trademarks have finite lives (and, therefore, should be amortised regularly) or indefinite lives (and, therefore, should be tested periodically for impairment)?

What is (are) the reporting unit(s) of the acquirer into which the target's trademarks (and other assets) should be assigned for impairment testing under SFAS 142?
Are there defensible alternatives in this regard and, if so, what are the pros and cons of each of these alternatives? How will the assets be utilised by the acquirer and should a separate reporting unit be created for assignment of some or all of the assets?

Does either party in the transaction have an IP holding company (IHC) that owns and licenses intellectual property?
If so, how does this affect the reporting unit assignment and future impairment testing under SFAS 142? Do the target's IP licence agreements from the IHC to the operating subsidiaries satisfy the arm's-length standard? How do these licence agreements affect the asset values to be recorded under SFAS 141 and future impairment testing under SFAS 142?

How do the existing risks associated with the target's trademarks affect the valuation of these assets?
What is the timeframe for materialisation or dissipation of these risks?

If the target has made acquisitions since the advent of SFAS 141 and SFAS 142, has it been conducting asset impairment testing internally or has it engaged independent appraisers?
How robust are these analyses, and will they withstand scrutiny from the acquirer's auditors?

What will be the impact of SFAS 157 on our financial statements?
What will be the effect on our earnings and balance sheet of the new definition of fair value as applied to the acquired trademarks? How will this alter the way we account for our acquisitions? How will SFAS 157 affect the way that our assets are valued under SFAS 141 and 142?

Which aspects of the due-diligence and post-acquisition valuation work should be done by an independent third party?
To what extent does our institutional knowledge meet the level of rigour required? How can potential liability be mitigated by seeking qualified outside opinions?

Taxation

Taxation is another area worthy of careful consideration when evaluating brand-rich transactions. In the US, acquisition of substantial trademark assets generally presents both compliance requirements and planning opportunities at the state/local, federal (ie, national) and international levels. Tax-related decisions made by the acquirer during the deal structuring phase and/or around the transaction's closing may affect the economic value of the deal. Such decisions may also have long-term implications which will affect, favourably or adversely, shareholder value.

In view of the above, there are a number of questions board members of the acquiring entity may want to evaluate. Some of the most important are discussed below.

What are the short-term and long-term ramifications of electing to treat the proposed transaction for tax purposes as a stock deal v as an asset deal? How do these two options compare with respect to quantum and risk of projected tax liabilities/savings?
In most large-scale M&A transactions,

trademarks are transferred as a result of the acquirer purchasing the target company's stock, not a collection of individual assets. However, following the acquisition, the buyer can make an election under IRC Section 338 to treat the transaction, for tax purposes, as an acquisition of all of the assets of the target company at fair market value in a single transaction.

One benefit of the Section 338 election to the acquirer is the ability to step up the balance sheet value of each of the acquired assets to reflect an appropriate share of the purchase price paid for the target company. In the case of a trademark that was self-developed by the target, the pre-acquisition book value will typically be *de minimis* (in the US, for tax purposes, self-developed marks are shown in balance sheets at cost). The step-up process enables the buyer to record the acquired trademarks at (or closer to) fair market value. The amortisation of the acquired trademarks may then be effected on the basis of the stepped-up value (over a 15-year period under Internal Revenue Code Section 197). Amortisation of acquired trademarks represents an opportunity to reduce the acquirer's taxable income by applying a non-cash expense against earnings, and effectively, reduce the cost of acquired trademarks.

Are we planning to take identical positions regarding the value of the acquired trademarks (as a portion of the target's purchase price) for tax and financial reporting purposes?

If not: (1) why not?; (2) how can the positions we plan to take in each of these contexts be reconciled?; and (3) what are the risks associated with taking different value positions in these two contexts?

Have we considered deal structures that give us the right to use the target's trademarks without effecting a change of ownership as a way to mitigate business risk and/or obtain different tax treatment for payments associated with these trademarks? What are the pros and cons of such structures v an outright purchase?

The acquisition target and the prospective acquirer may come to an agreement under which the target's trademarks are excluded from the assets transferred as part of the transaction based on business strategy and/or taxation considerations. Instead, the parties may agree to a deferred or contingent sale whereby the target retains ownership and control of its trademarks, but grants the acquirer a licence to use the marks for a period of time in exchange for royalty payments contingent on productivity or use of the marks. These agreements typically include an option for sale of the marks at the end of the contract's term for a pre-set amount or a formula-derived price.

Internal Revenue Code Section 1253 provides regulations regarding the tax treatment of payments under trademark, franchise, and trade name deferred sale transactions. If a transaction satisfies Section 1253, contingent serial payments made as part of the transaction qualify for treatment as an ordinary business expense.

What are the potential tax-related benefits of placing ownership of the acquired trademarks in a wholly owned IHC?

In the present situation, would an IHC serve as a vehicle for tax planning at the state and local level only, or could it also be used at the global (ie, multi-country) level? What alternatives exist for the domicile of this IHC and what are the potential risks and rewards associated with each of these alternatives?

How will the acquired trademarks be integrated into our existing global tax-planning structures and inter-company transfer pricing for trademark licences between affiliated parties?

Do the acquired trademarks present new/different opportunities for tax-planning initiatives? If so, what are the risks and rewards of each of these potential initiatives?

Conclusion

In recent years, key aspects of the US regulatory landscape for M&A transactions have experienced significant changes aimed at greater transparency and accountability. Financial reporting disclosure requirements and accounting rules for publicly traded companies have changed, necessitating greater attention to the specific assets involved in a transaction. New federal laws focus greater attention on how companies exercise control over their assets and how they report the financial performance of those assets. These changes explicitly place greater scrutiny on intangible assets such as trademarks and result in an expanded universe of issues for board members to consider throughout all phases of brand-rich transactions. Learning about these issues and rigorously examining the corresponding views of senior management are critical for board members' performance of their supervisory duties.

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