by Frank Bruno

Adding Value

Technology Escrow and Your Market Valuation

Technology escrow has emerged as a valuable tool to use for building and protecting market valuation. Coupled with proactive intellectual property management, technology escrow can dramatically impact merger, acquisition and divestiture (MAD) strategies. Technology escrow has moved beyond a means for ensuring mission-critical software and business processes are protected to enhancing the value of these assets through a change in business ownership or corporate direction.

Market landscapes constantly evolve. In today's business environment, MAD activities require more accurate and timely market valuations. Compared to tangible assets, the economic value of intellectual capital has increased dramatically. The growing reliance on software applications for critical business functions is but one factor raising intellectual capital market valuation. For the technology developer, protecting unique software and related processes is crucial to market valuation. For the technology licensee, guaranteeing the continuity of key software through changing business environments is a growing concern, and protecting this intellectual capital has become a means of increasing business valuation.

INCREASING VALUE OF INTELLECTUAL PROPERTY

The valuation of companies has changed in a fundamental way in the last three decades. It used to be that the sum total of a company's tangible assets minus liabilities, also called the book value, made up the bulk of a company's market value. In a study done of 3,500 companies in 1978, 95 percent of their market value was book value. But business valuation has shifted dramatically toward intangible assets, including intellectual property. By 1998, the typical book value component of market value had decreased to 28 percent.

Nowhere perhaps is the increasing significance of intellectual property more evident than in the technology sector. Indeed, technology companies—most notably Internet companies—continue to challenge traditional concepts of valuation. The technology sector also is characterized by constant merger and acquisition activity, not to mention joint development and strategic alliances. In February 2005 alone, there were more than 20 high-tech acquisitions, including activity by Microsoft, IBM and Intel. The sizes of these acquisitions ranged from several million U.S. dollars to several billion U.S. dollars for acquisitions by telecom providers SBC Communications and Verizon. And at the core of any such activity is the valuation of the business, what you bring to the table.

A technology company's value is intrinsically tied to its intellectual property such as software, hardware or secret formulas. Tangible assets are protected by physical security and insurance. And intellectual property must be protected by patents, trademarks and copyrights. But these traditional tools have had difficulty keeping pace with the rapidly changing landscape of technology and the technology marketplace itself. Technology escrow has emerged as a crucial component to protect and leverage one's intellectual property. A proactive and strong intellectual property management policy can have a dramatic impact on the value of your business.

RESTRUCTURING AND THE ROLE OF INTELLECTUAL PROPERTY

More than any other major market segment, technology companies are constantly restructuring themselves. This can be in the form of mergers, acquisitions or various types of divestitures. Fundamental to the success of any of these ventures is a credible valuation of the businesses involved. The market value of one's intellectual property has come to play a significant role in this restructuring activity.

It has been estimated that between two to five emerging technology companies are acquired for every one that makes an initial public offering. Acquisition has long been a valid exit strategy within the high-tech sector, and a target's appeal has much to do with their intellectual property. Of the top reasons listed for an acquisition, almost all involve intellectual property:

- Acquire key technology
- Acquire a new distribution channel
- Assure a source of supply
- Eliminate a competitor
- Expand or add a product line
- Gain creative talent
- Gain expertise and entry in a new market
- Gain a time-to-market advantage
- Increase earnings per share

It is interesting to note that this list, compiled for the technology market, places little emphasis on tangible assets.

There is also the breaking up of companies, leveraged buyouts, joint development agreements and strategic alliances. Integral to all these activities is a sound, certified valuation of the business, an increasingly larger component of which is intellectual property.

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SFAS 141 AND 142

Regulatory bodies and the professional accounting community have recognized the importance and challenge of valuing intangible assets, including intellectual property. In 2001, the Financial Accounting Standards Board (FASB) issued two statements clarifying how intangible assets should be reflected on balance sheets. According to their summaries, the reasons for issuing both Statement of Financial Accounting Standards (SFAS) 141 and 142 were stated as follows:

"Analysts and other users of financial statements, as well as company managements, noted that intangible assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many transactions. As a result, better information about intangible assets was needed."

SFAS 141 (Business Combinations) specifically attempts to deal with the value of intangible assets in the context of mergers and acquisitions. SFAS 141 identifies five categories of intangible assets:

- Customer-related (customer lists and relationships, and production backlog)
- Artistic-related (books, photographs and advertising jingles)
- Contract-based (leases, franchise agreements and employment contracts)
- Technology-related (patents, software and secret recipes)
- Marketing-related (non-compete agreements, Internet domain names and trade names).

Much of these assets were previously covered in financial statements as goodwill, but now need to be identified and accounted for separately. The technology sector continues to challenge the traditional definitions of intellectual property. For example, Internet domain names did not exist when many trade name laws were drafted, and new domain name management services have emerged to specifically protect a company's Internet domain names. Technology escrow can protect and enhance the valuation of certain intangible assets, specifically technology-related assets such as software.

TRADITIONAL PROTECTIONS ARE NOT SUFFICIENT

Traditional intellectual capital protections such as patents, copyrights, trademarks and trade secrets are certainly required, but alone they are simply not sufficient in the volatile high-tech landscape. Conceived in a very different era, these protections are reactive in nature; they come into play after an alleged infringement. On their own, they are not tools designed to provide the immediate, certifiable and quantifiable data required for high-tech businesses to maneuver, grow and prosper. Filing and receiving approval for a patent can take years. And if infringed, the legal system can take longer to render any judgment. In many high-tech scenarios, any business window of opportunity is gone in the time it might take to file a patent. This situation is only exacerbated by the global nature of technology markets.

Internally, the initiation and management of these protections are distributed in an organization. They are typically paper-based and frequently dependent upon multiple third parties: government bureaucracies, legal council and, ultimately, courts. Copyrights of internally developed technology may originate with engineering or development teams. Patents are typically driven from the legal department. And trademarks usually involve marketing and corporate counsel. Therefore, the pace of communication may not provide management with the best assessment of real value. What is needed is a coordinated approach to identify, protect and provide management timely information with which they may fully exploit the value of genuine intellectual capital.

PROMOTING STRONGER VALUATION

The technology business environment demands faster identification and better management of intellectual capital. Technology business executives need more current data on their intangible assets. As recognized in SFAS 141 and 142, business executives require more information on the value of their intellectual property than had been provided by previous accounting standards. What is required is a demonstrable, creditable definition and valuation prior to any legal recourse. In technology, it is extremely difficult to protect one's business retroactively. In the context of a restructuring and valuation, it is almost impossible to be retroactive: once a deal is done, the only recourse would be the courts.

As a component of an active intellectual capital management strategy, use of technology escrow enforces a better definition of intellectual capital. The mere exercise of placing technology and supporting material in an escrow account forces better identification of what is genuine intellectual capital. It encourages departments to work together to identify and prioritize an organization's technology portfolio. Identification is the first step for business management and accountants to effectively value intellectual property.

If an organization's technology escrow partner also provides a real-time browser tool, the communication of what is perceived

KEY TERMS DEFINED

Intangible Assets are nonphysical assets, such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities and contracts (as distinguished from physical assets), that grant rights and privileges and have value for the owner. This would include technology properly documented and protected through patent, copyright or other legal means.

(Source: International Glossary of Business Valuation Terms)

Intellectual Property or **Intellectual Capital** is considered an intangible asset, and it includes more than the technology itself. Intellectual Capital bundles knowledge resources (how the "production functions"—that is, the constellation of employees, users, processes and technologies—work.) Intellectual capital enables a company to make a difference to users via its knowledge resources.

(Source: VentureLine MBA Glossary)

Market Value is the price at which buyers and sellers trade similar items in an open marketplace. In the absence of a market price, it is the estimated highest price a buyer would be warranted in paying and a seller justified in accepting, provided both parties were fully informed and acted intelligently and voluntarily.

(Source: VentureLine MBA Glossary)

Technology Escrow is the practice of securing access to the technology at issue, which is usually, but not always, software source code, and any other proprietary materials necessary to maintain the technology for the benefit of all parties to a technology transfer (typically a license) agreement.

to be of value crosses departmental and hierarchical boundaries. Management has more immediate knowledge of what has been identified as of real value to the company. With more current and complete data, management can better leverage and position itself in a volatile market. It also allows for more effective communication outside the company, in appropriate manners and under more control of management. A real-time tool also encourages the regular updating of escrowed intellectual property.

With tangible assets, everyone understands and expects insurance for valuable equipment or facilities. Technology escrow can help project that same impression for intellectual property—which is typically much harder to quantify. Aggressively protecting one's intellectual property with a recognized escrow agent projects the image of market value and savvy management. If an organization has taken such care to identify and protect its intellectual investment, certainly there must be genuine value.

Technology escrow can't replace traditional protections but must be used in conjunction with patents, copyrights, trademarks, etc. For a miniscule investment compared to even the smallest merger or acquisition transaction, technology escrow can go a long way toward validating, perhaps even increasing, business value.

In intellectual property ownership disputes, courts have been pushed to the forefront of deciding complicated technology ownership issues. Not often being experts themselves, judges have frequently looked to what is standard practice in the industry or at least what other comparable companies have done. Technology escrow has long been a best practice in contract management, and an escrow agent is by definition an independent and neutral third party. If legal recourse does occur, a technology escrow arrangement could go a long way to buttressing an organization's case.

Technology escrow goes to the heart of encouraging strong intellectual capital management in the volatile technology marketplace. Real-time escrow applications provide the speedy and secure access to data required for management to adapt to market conditions. Better, more current information about their intellectual property value provides management with more options. In addition, it can provide a management or investment team with attractive options based on increased valuation. A management team fully apprised of intellectual property value can be more proactive in different, ever-changing market scenarios.

The technology sector is distinguished for its pace of change and realignments. The ability to rapidly identify intellectual capital and proactively leverage its value in the market is a clear competitive advantage. A strong business valuation will allow you to merge or acquire more successfully, at a greater value. It will allow you to partner with less risk, as your intellectual contribution will be clearly defined, demonstrable and appropriately valued. Technology escrow is now a significant component of growing and protecting one's market valuation.

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