

# Litigation &

V a l u a t i o n

# REPORT

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## What's the damage?

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# What's the damage?

## Advantages of assessing damages early in IP cases

**I**n litigation, the parties typically focus on liability first — and then worry about damages. After all, why spend a lot of time and money investigating and analyzing potential damage awards if there's a chance the defendant won't be liable at all?

But in some cases, it pays to evaluate damages early. Under the right circumstances, this strategy provides many advantages, including helping to focus the parties' discovery efforts and reducing litigation costs in the long run.

### An intellectual exercise

A valuation expert analyzes a variety of interrelated factors in IP cases. The expert determines the extent to which the plaintiff's injuries were caused by the defendant's infringement as well as the extent to which those injuries were caused by external factors, such as economic or market conditions.

Complicating matters further, plaintiffs in IP cases are often entitled to alternative forms of damages. And some courts have held that there is no single method by which a plaintiff must prove lost profits. In patent cases, for example, plaintiffs typically seek to recover their lost profits — that is, the profits they would have earned



“but for” the defendant's infringement. However, the plaintiff's lost profits sometimes are difficult to prove, often *because* of the infringement. In those cases, to prevent unjust enrichment, the plaintiff may be able to recover profits the *defendant* earned or is expected to earn as a result of its wrongful conduct.

Alternatively, if lost profits are small or are difficult to quantify, a plaintiff is entitled to recover — at a minimum — a reasonable royalty for the defendant's use of the plaintiff's invention.

### Damages drive litigation strategies

With so many potential methods to measure damages, it's important to conduct at least a preliminary evaluation of damages early in the case. These damages may take the form of:

**Plaintiff's lost profits.** Lost profits are calculated based on the profits the plaintiff would have earned “but for” the infringement. In this case, the expert analyzes the plaintiff's operations, past financial performance and sales projections. He or she also considers the plaintiff's cost structure to identify variable costs avoided as a result of lost sales. In addition, other factors may come into play, such as the infringer's ability to cut into the plaintiff's sales with a noninfringing product.

**Defendant's profits.** The unjust enrichment damages measure seeks to deprive the defendant of the fruits of its wrongful conduct. Here, discovery and analysis efforts focus on the defendant's actual and projected sales and costs. The expert weighs the impact of factors other than the alleged infringement on the defendant's profits.

For example, the defendant may have the ability to generate greater profits than the plaintiff because of lower costs, a more famous brand, a better location, superior manufacturing capabilities or a more effective distribution network.

**Reasonable royalties.** If lost profits can't be proven, a plaintiff may be entitled to reasonable royalties

damages. A reasonable royalty is generally defined as the amount a willing licensor and a willing licensee would have negotiated at the beginning of the infringement period.

### *Narrowing the damages issues as early as possible reduces discovery and expert witness costs.*

Royalty amounts are influenced by a variety of factors, including royalties actually received by the plaintiff from other licensees, royalty rates paid for “comparable” patents, the plaintiff’s established licensing policies, the

established profitability of the patented product, and the value attributable to any nonpatented elements or enhancements the licensee provided.

#### **Consider the costs**

Although these examples involve patent litigation, the principles also apply in other types of IP litigation as well as non-IP cases.

Focusing exclusively on liability in the early stages of litigation and leaving damages for later may generate a lot of unnecessary costs. Narrowing the damages issues as early as possible reduces discovery and expert witness costs. How? The expert can pinpoint relevant financial data and documents and avoid unnecessary time collecting and analyzing data that will have little impact on results. □

## ESOPs put a premium on business valuation

**E**mployee stock ownership plans (ESOPs) offer many benefits to business owners and their employees. To preserve these benefits, a qualified, independent appraisal of the company’s stock is essential. ESOPs raise unique valuation issues, so the ESOP should engage a valuation expert who’s familiar with the rules and regulations.

#### **The fabled ESOP**

An ESOP is a qualified retirement plan, similar in many ways to a 401(k) or profit-sharing plan. But instead of investing contributions in a selection of mutual funds and other securities, ESOPs invest primarily in the sponsoring company’s stock.

In addition to providing valuable employee benefits, ESOPs create an exit strategy for the company’s owners and generate a variety of tax benefits. The company can fund the ESOP with stock or cash. Either way, its contributions are tax deductible. Cash contributions can be used to buy stock from the owners. And if the ESOP owns at least 30% of the company’s outstanding stock, the owners can defer the capital gain on the sale of



company stock to the ESOP by reinvesting the proceeds in qualifying domestic businesses. (In addition, recent legislation has greatly increased the tax benefits for S corporations that are 100% owned by ESOPs.)

A “leveraged ESOP” is an extremely effective tool that allows business owners to create liquidity for their shares in a tax-advantageous manner. When an ESOP borrows money and uses it to purchase stock from the current owners, the company makes tax-deductible contributions

to cover the interest and principal payments. The tax benefits make leveraged ESOPs a powerful tool for raising capital.

### Value judgments

Given the potential for abuse, ESOPs are governed by strict federal regulations designed to protect employees. ESOP fiduciaries that fail to act in the participants' best interests risk liability for breach of fiduciary duty. They may also be subject to excise taxes on prohibited transactions, such as selling stock to the ESOP at inflated prices.

ESOPs are prohibited from paying more (or less) than adequate consideration for the employer's stock. A qualified, independent appraiser must determine the fair market value (FMV) of a closely held company's ESOP shares both annually and when shares are acquired from the existing owners. Plan fiduciaries are responsible for arranging regular appraisals.

Appraisers use traditional valuation techniques to value ESOP shares, but the regulated structure of an ESOP can impact the valuation process.

### Marketing rights

The value of stock in closely held companies is generally discounted to reflect its relative lack of marketability. ESOPs are required to give participants "put options" — that is, the right to sell the stock back to the company

### Price protection

ESOPs often acquire company stock in stages. This can create a problem for existing participants because debt incurred to finance a new purchase dilutes stock prices for redemption purposes.

To avoid this result, many ESOPs provide for the original participants' stock to be valued without considering the impact of the new debt. Because this sort of price protection dilutes the value of the newly acquired stock, however, it's important for the appraiser to consider these provisions in his or her analysis.

when the participant's employment ends. In effect, the ESOP structure creates a built-in market for the shares.

An appraiser considers the impact of put options on the stock's marketability and, in turn, on its FMV. In weighing the impact, the appraiser determines whether employees' put rights are enforceable and whether the company can reasonably be expected to have adequate financial resources to meet its repurchase obligations.

### Control issues

One challenge in an ESOP valuation is determining whether a control premium or minority interest discount should apply to stock transferred to the plan. Generally, a control value is appropriate if the ESOP acquires control over the company "in form and in substance."

If an ESOP obtains a controlling interest in the company's voting stock, but another party retains control *in fact*, a minority value may be called for. Making this determination is difficult and requires a careful analysis of all the facts and circumstances.

In addition, it's important to keep in mind that many experienced ESOP experts don't apply discounts and premiums, but attempt to quantify the attributes of control (if any) in the normalized or projected cash flows. In determining value for a potential sale to an ESOP, the normalized and projected cash flows should reflect the cash flows that are (or will be) theoretically available to the ESOP. In other words, it may be inappropriate to make control-related normalization adjustments or apply a control premium if these adjustments aren't expected to actually change post-ESOP.

### Debt and taxes

Valuing stock in a leveraged ESOP is particularly challenging because the debt used to finance the stock purchase has an impact on value. Immediately after the ESOP transaction, the company's equity value declines because of the new debt it has incurred. Technically, the debt is the ESOP's obligation, but, because of the close relationship between the company and the ESOP, the debt is also treated as the company's liability for accounting purposes.

The impact of the debt is partially offset, however, by the ESOP's unique tax benefits. Ordinarily, companies are allowed to deduct interest paid on business debts. But a company generally can deduct its entire ESOP contribution. Because these contributions are, in most cases, equal to the payments on the ESOP loan, the company effectively deducts *both interest and principal*.

In valuing ESOP shares, appraisers often take the tax benefits into account by calculating the present value of

expected future income tax savings associated with the ESOP loan payments. Complicating matters further, these savings decline over time as the debt is repaid.

### Beyond face value

These are just a few of the many complexities that affect ESOP valuations. A qualified, independent appraiser who understands the unique characteristics of ESOP shares can develop and document a valuation that will withstand government scrutiny. □

## Be reasonable

### Court weighs in on reasonable compensation

In valuing a closely held business, evaluating the reasonableness of owner compensation can be challenging for appraisers. A recent California case provides valuable guidance on the factors appraisers need to consider in determining reasonable compensation.

#### What's normal?

Business owners often draw larger-than-usual salaries for tax purposes. On the other hand, sometimes they take smaller salaries to boost the company's reported earnings.

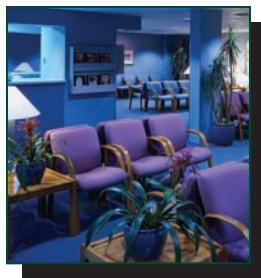
To develop a realistic picture of a company's earnings, valuers "normalize" owner compensation and other items. By removing "owner bias," they are better able to predict the company's financial performance in the hands of a prospective buyer. Normalizing these items can significantly affect value.

To determine normal compensation, valuers typically look at a variety of factors, including the owner's role in the business and salary levels for comparable positions in other companies.

#### The *Mandelbaum* of reasonable compensation?

In its 1995 decision in *Mandelbaum v. Commissioner*, the U.S. Tax Court outlined 10 factors that are still used today to determine valuation discounts for lack of

marketability. Some in the valuation community are now calling a recent California Court of Appeals decision the "*Mandelbaum* of reasonable compensation."



*Ackerman v. Ackerman* involved the valuation of the husband's Newport Beach, Calif.-based plastic surgery practice in connection with a divorce. His wife challenged the value placed on the practice's goodwill.

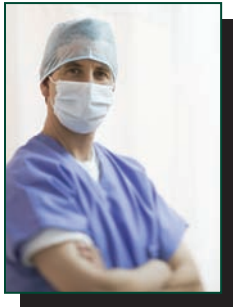
The trial court had determined goodwill using the excess earnings approach. "Broadly put," the appellate court explained, "the excess earnings approach is predicated on a comparison of the earnings of the professional in question with that of a peer whose performance is 'average.'"

#### Survey says?

The wife's counsel didn't object to the use of the excess earnings approach, but they challenged the court's determination of reasonable compensation for the husband's peers.

The parties' expert witnesses used different compensation surveys to determine reasonable compensation. The wife's

expert relied on the *Physician Compensation and Production Survey* by the Medical Group Management Association (MGMA). The survey broke down statistics by region, specialty (the husband was a surgeon) and years in practice. Relying on data for the Western states, he determined reasonable compensation to be \$291,000.



The husband's expert relied on data from the American Medical Association's *Physician Socioeconomic Statistics* surveys for the United States, arriving at a reasonable compensation figure of \$515,000. He calculated total revenue for self-employed

surgeons, professional expenses for self-employed physicians in the "surgeons" category and net income of self-employed surgeons. Next, he calculated net income as a percentage of total revenue. Finally, he took the husband's net income as a percentage of total revenue and applied it to the husband's gross revenue to calculate reasonable compensation as a percentage of his gross revenue.

The husband's expert also conducted an informal survey of plastic surgeons in the Newport Beach area, concluding that the husband "generates almost the 'average' amount of revenue."

### Quality control measures?

The trial court had problems with both experts' analyses. Regarding the MGMA survey, it was "troubled by [what a national survey of the Western states has] to do with a plastic surgeon who is doing essentially cosmetic surgery in Newport Beach."

The court also noted the difficulty of relying on reasonable compensation statistics for employees, commenting that it "boggles the mind" to think that someone earning as much as the husband would go to work for an employer for one-third as much. Further, neither national survey was "sufficiently fine-tuned and honed to our area here to be particularly valuable," the court explained, and neither party supplemented the survey data with a vocational rehabilitation specialist or other expert more familiar with the local market.

The trial court applied its own "quality control" to the case, invoking a commonsense view of the husband's special training and expertise. Using the husband's expert's methodology as a "curbstone," the court arrived at a reasonable compensation value of \$544,000.

The appellate court found substantial evidence to support this conclusion. Even though the husband's expert relied on a national survey, he also "related the information in [the survey] to an analysis of the husband's practice to ensure his figure was accurate. First, he inserted the husband's gross revenue and net income to see what result he reached. Second, he performed a local survey of Newport Beach plastic surgeons to assess whether his number was correct."

The appellate court stated that, in establishing a goodwill value, a trier of fact may consider:

- The situation of the business premises,
- The amount of patronage,
- The personality of the parties engaged in the business,
- The length of time the business has been established, and
- The habit of its customers in continuing to patronize the business.

The trial court did just that, the appellate court found, considering evidence of the husband's actual business situation, talent, training, expertise and reputation. "The trial court reasonably determined," the appellate court found, "that a plastic surgeon in Newport Beach, Calif. would generate a greater income than the national average."

### Compensating factors?

While compensation studies and related evidence are important, it's also essential to review all facts and circumstances pertaining to the company and its owner. It's true that determining reasonable compensation remains a challenging and somewhat subjective process. However, the recent *Ackerman* case provides courts, attorneys and valuers with welcome guidance for determining reasonable compensation. □

## Make sure the forecast isn't a snow job

**E**stimating a business's expected future earnings is key in a variety of litigation and valuation contexts. Often, management's own forecasts and projections provide the best evidence — if they're prepared in the ordinary course of business and not in anticipation of litigation.

But in some situations — even outside litigation — management may have an incentive to be, shall we say, overly optimistic. Recent research provides guidance on evaluating management forecasts and identifying warning signs that those forecasts may be unreliable.

### Management's role

An independent, objective valuation or damages expert is well suited to prepare or evaluate forecasts of earnings or cash flows, but that doesn't mean management plays no role in the process.

In *Doft & Co. v. Travelocity.com Inc.*, for example, the Delaware Chancery Court observed that courts often prefer forecasts prepared by management in the ordinary course of business. "Management," the court explained, "ordinarily has the best first-hand knowledge of a company's operations."

Management forecasts should be incorporated into valuation or damages analyses when those forecasts are available. At the same time, such forecasts should be viewed with a "healthy skepticism." Appropriate adjustments may need to be made to ensure that estimates are reliable, realistic and based on reasonable assumptions.

### Clouds on the horizon

Writing for the *Journal of Business Valuation*, Teri Lombardi Yohn, a University of Massachusetts accounting professor, describes recent research that identifies and quantifies incentives that might cause management to manipulate financial forecasts. In addition, the research pinpoints other warning signs that forecasts may be unreliable.

The research identifies three situations in which management may have an increased incentive to "manage" earnings. Management may want to avoid:

1. Reporting losses,
2. Reporting decreased earnings, and
3. Missing analysts' forecasts.

Earnings data supports these findings. For example, rather than following statistically predictable patterns, a greater number of companies "just meet" prior year's earnings or analysts' forecasts than "just miss" those targets.

Several other conditions should raise red flags for valuers and damages experts. For example, management forecasts — and the assumptions that support them — should be scrutinized if they're prepared:

- Before an initial public offering or other equity offering,
- In connection with a merger or acquisition, or
- When the company is in danger of violating loan covenants.

Research also shows certain patterns that typical businesses follow over time. For example, though profitability tends to be relatively stable, sales growth tends to decline over time. Management forecasts that show abnormally high sales growth or high growth sustained over an unusually long period of time also should be examined closely.

### Checking the forecast

No one is more intimately familiar with a company's operations and prospects than its own management. For that reason, management forecasts can be a valuable indicator of a company's expected financial performance. But keep in mind that these forecasts should be scrutinized for any signs of bias and adjusted as appropriate. □

