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ADVOCATE'S EDGE

Court upholds reasonable royalty testimony

What's behind the curtain?
Recognize the importance of M&A due diligence

Valuation vs. lost profits
Quantifying damages for breach of fiduciary duty

How *not* to quantify "external obsolescence"

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Court upholds reasonable royalty testimony

Reasonable royalty damages in patent infringement cases are frequently based on the tried-and-true *Georgia-Pacific* factors. But that methodology isn't the only approach courts will accept, as demonstrated by *Summit 6, LLC v. Samsung Electronics Co., Ltd., Samsung Telecommunications America, LLC*. The court's opinion in that case also clarified some other critical issues regarding damages testimony.

The methodology under attack

Summit 6 (Summit) owns a patent related to processing digital content, including digital photos. It sued Samsung for patent infringement based on Samsung's use of a process for sending photos via portable devices using multimedia messaging service (MMS). The jury found infringement and awarded Summit $15 million. On appeal to the Federal Circuit Court of Appeals, Samsung challenged the admissibility of the testimony of Summit's damages expert.

The expert began by estimating that cellular carriers pay Samsung $14.15 to include a camera component in its phones, based on Samsung's annual reports, internal cost and revenue spreadsheets and interrogatory responses. He then estimated 20.8% of camera users used the camera's infringing features. To arrive at this estimate, the expert relied on surveys commissioned by Samsung in the ordinary course of its business and another survey he found on his own.

Thus, the expert concluded that 20.8% of Samsung's $14.15 per unit revenue for including the camera in each phone — $2.93 — was due to the infringing features. Using Samsung's annual reports to estimate its profit margins and capital asset contributions, the expert ultimately concluded that $0.56 of the $2.93 revenue per device was attributable to the infringement.

> Because neither party had a stronger negotiating position, the expert assumed they would have split the amount evenly to reach a reasonable royalty of $0.28 per device.

He further testified that, to determine a reasonable royalty at a hypothetical negotiation, the parties would focus on allocating the $0.56 benefit to Samsung from using the patent. Because neither

Additional methods for reasonable royalty calculations

The court in *Summit 6* (see main article) noted that estimating a reasonable royalty isn't "an exact science." The factual record could support a range of reasonable royalties, rather than a single value. Likewise, there may be more than one reliable method for estimating a reasonable royalty.

The Federal Circuit Court of Appeals identified the following examples of potentially reliable methods:

- Using the royalty rate from sufficiently comparable licenses,
- Valuing the infringed features based on comparable features in the marketplace,
- Valuing the infringed features by comparing the accused product to noninfringing alternatives, and
- Applying the "analytical method," which focuses on the infringer's projections of profit for the infringing product.

The court noted that every approach has certain strengths and weaknesses. But it cautioned that the fact that one approach may better account for one aspect of a royalty estimate doesn't make the other approaches inadmissible.

party had a stronger negotiating position, the expert assumed they would have split the amount evenly to reach a reasonable royalty of $0.28 per device. Based on that royalty and the number of infringing devices sold, he estimated a total reasonable royalty of $29 million.

The methodology's admissibility

Samsung argued that the expert's testimony should have been excluded because:

- The methodology was unpublished, created specifically for the case and never before used by the expert or another expert,
- The expert's premise that a feature's use is proportional to its value was incorrect, and
- His use of surveys wasn't reliable because he isn't a survey expert.

The Federal Circuit dismissed all of these claims, finding that the methodology was based on reliable principles and was sufficiently tied to the facts of the case.

That the methodology wasn't peer reviewed or published didn't necessitate its exclusion. The fact-based nature of the expert's testimony "made it impractical, if not impossible, to subject the methods to peer review and publication." If an expert otherwise reliably uses scientific methods to reach a conclusion, lack of textual support goes to the weight, not the admissibility, of the testimony.

As to the notion that a feature's use is proportional to its value, the court explained that an invention used more frequently is generally more valuable than a comparable invention used infrequently. Furthermore, frequency of expected use is related to predicted value.

Finally, the Federal Circuit held that the expert need not be a survey expert to testify about the information compiled by third-party surveys — as long as the information is of a type reasonably relied on by experts in the field to form opinions on the subject.

Weight, not admissibility

Throughout its opinion, the court emphasized the distinction between the admissibility and the weight of reasonable royalty testimony. Once an expert has been qualified, it said, the trial court's inquiry focuses on his or her methodology and whether it's sufficiently tied to the facts. Disputes over the expert's credibility or the accuracy of the underlying facts are for the jury to settle. ■

What's behind the curtain?

Recognize the importance of M&A due diligence

In today's rough-and-tumble world of mergers and acquisitions (M&As), it's critical for buyers to get to know sellers and their top executives, test their representations about asset condition and financial performance, and ferret out common fraud schemes. Fortunately, a fraud expert can help you avoid investing in a losing venture.

Is the seller really on *your* side?

The majority of occupational fraud is perpetrated by rank-and-file workers and lower-level managers. But fraud committed by owners and executives can be the most financially damaging, according to the Association of Certified Fraud Examiners' biennial *Report to the Nations on Occupational Fraud and Abuse*. Without adequate M&A due diligence, unwary buyers could fall victim to false representations by sellers that never pan out after the deal closes — or they may inherit a hornet's nest of white collar crime and embezzlement by employees.

> Looking beyond the financial statements might offer insight into business practices that provide motives to perpetrate fraud and cultural conditions that enable fraud to thrive.

Even if a company has fraud policies and internal controls in place, owners and executives can override them. These individuals also have access to financial statements, as well as incentives — such as bonuses for exceeding certain growth targets, or to inflate the company selling price — to falsify them.

So, it's essential to perform background checks on, at the very least, your target's owners and C-suite executives. A thorough check can uncover past involvement in criminal embezzlement, theft, forgery and other types of fraud, as well as involvement in civil litigation. It could also reveal falsified items on their resumés and other pertinent personal claims.

Are these scams "creative" accounting or financial misstatement?

Owners and managers can use "creative" accounting techniques to artificially inflate a company's value, such as prebooking revenues, leaving stale receivables on the books, recording phantom inventory or deferring expense recognition.

For example, a company might record sales early — and expenses late — in order to create the illusion of increased profits. Or a business might provide loans to major customers so that they can make large product purchases and give the appearance that the company's sales are booming. Fraudsters might even hide liabilities, falsify transactions with related parties, overvalue receivables and securities, and overstate inventories to boost the selling price. All of these scams either artificially boost profits or asset values (or downplay liabilities) to maximize the selling price.

What else should you watch out for?

In other cases, your acquisition target might be rife with dishonest employees, who could be engaged in any number of fraud schemes — from stealing IT equipment and colluding with suppliers to skimming from petty cash and falsifying their expense reports. Fraud schemes are complex and varied, so they can be hard to expose. To prevent yourself from inheriting the seller's problems, it's important to tour the company's facilities and interview management.

Looking beyond the financial statements might offer insight into business practices that provide motives to perpetrate fraud and cultural conditions that enable fraud to thrive. For example, domineering executives may feel entitled to break accounting rules and coerce other employees to participate in such activities.

Similarly, businesses that offer financial incentives for employees to meet high, even unrealistic, sales growth numbers — particularly if employees are meeting them — merit a closer look. High employee turnover and worker, customer and vendor complaints are also strong indicators that something is amiss. Finally, if the seller tries to restrict your due diligence team's access to financial data or prevent them from speaking with key employees, be wary.

How fraud experts can help you

With any acquisition, fraud is almost always a deal breaker. A forensic accountant can be a useful addition to the due diligence team. These experts use their accounting, auditing and investigative skills to detect signs that an M&A target is cooking the books — or the seller itself is a victim of fraud. ■

Valuation vs. lost profits

Quantifying damages for breach of fiduciary duty

Business valuations play a critical role in many types of litigation. But they have their limits, as illustrated in a recent ruling by the Supreme Court of Mississippi. The high court decided that a valuation analysis was inappropriate when determining damages in cases involving breach of fiduciary duty or usurpation of corporate opportunity. Here's where the judge instructed the trial court to look instead.

Trial court crafts independent damages assessment

Limestone Products (Limestone) was jointly owned and operated with a line of credit personally guaranteed by its two owners. The business sold rock, predominantly to a company owned by one of its owners. Following the death of an owner in August 2006 and his estate's refusal to guarantee the line of credit, the surviving owner formed Delta Stone, a new corporation that operated on the same property, used the same facilities and sold rock to the same clients.

> The state supreme court faulted the trial court's use of the net book value to arrive at the total sum of damages due Limestone.

The estate sued the surviving owner seeking lost profits. In the liability stage of a bifurcated trial, the court found that the owner had breached his fiduciary duty to Limestone by usurping a corporate opportunity.

In the damages phase, the estate's expert estimated lost profits of about $1.36 million, which was calculated based on the alleged diversion of nearly 650,000 tons of rock from Limestone to Delta Stone from 2003 to 2011. He added $169,129 to account for loss of assets, bringing the total loss to about $1.54 million. The estate's portion would have been half of that figure.

The expert for the surviving owner didn't conduct a lost profits analysis. Instead he estimated the "net book value" of Limestone. He arrived at a total net book value of $125,546 and stated that the estate was owed half of that amount.

The court then performed an independent assessment of the damages, stating that the assessment of future lost profits should be based on historical profits. It determined, therefore, that the future lost profits amounted to about $105,000 and added that to the net book value provided by the defense expert, for total damages of about $230,000.

The court ordered the defendant to pay the total amount for his usurpation or, if the parties agreed to dissolve Limestone, half of that amount. The court of appeals affirmed, and the estate appealed to the state supreme court.

High court rejects approach

The state supreme court faulted the trial court's use of the net book value to arrive at the total sum of damages due Limestone. Net book value, the court pointed out, is an accounting term that's not directly related to the actual value of a corporation's assets. As such, "it should not be considered as part of the calculation of damages for a recovery based on the claims of breach of fiduciary duty or usurpation of corporate opportunity."

Moreover, the court said a business valuation analysis isn't the appropriate standard for a claim of breach of fiduciary duty or usurpation. In such cases, the defendant must pay "for the entire loss suffered by the corporation as a result of the breach."

Words matter

In this case, the court ruled that the estate's loss should be based on future lost profits, because rock prices had increased significantly after the breach occurred. So, Limestone's historical performance wasn't a reliable indicator of its postbreach lost profits. The damages calculation also should consider lost profits beyond 2012, inventory diverted from Limestone to Delta Stone and unpaid rent due to Limestone pursuant to a lease agreement. As a result, the case was reversed and remanded to determine the estate's *entire* loss. ■

How *not* to quantify "external obsolescence"

External obsolescence is a measure of a property's loss in value as a result of factors beyond the physical boundaries and beyond the owner's control. It often relates to a business enterprise that operates at a special-purpose property (a property with one practical use) such that a change in industry conditions could cause the taxpayer to incur a reduction in revenue, profit margin or return on investment.

Case in point

In a recent Minnesota Supreme Court case, a business challenged the property tax assessment on its ethanol plant, and its expert computed external obsolescence to be 33.3% each for 2009, 2010 and 2011. The county estimated obsolescence reductions at 45%, 35% and 25%, respectively. However, the Tax Court calculated the respective reductions to be only 16%, 8% and 0%. The stark difference in the Tax Court's calculation and the parties' positions constituted millions of dollars in assessed value.

To arrive at its 33.3% external obsolescence reductions, the taxpayer's expert relied primarily on the 40% decline in general commercial market values and the industrywide decrease in the profit margins of ethanol caused by, among other things, overcapacity. The county's expert based his estimates on four acquisitions of ethanol products. He also cited overcapacity and deteriorating profit margins as factors contributing to the property's external obsolescence.

The Tax Court concluded that total U.S. ethanol production capacity was the appropriate quantitative standard in order to measure external obsolescence. It found only about 84% of the capacity was used in 2009 and about 92% in 2010, leaving 16% and 8% unused, and no unused capacity in 2011.

Problems with the Tax Court approach

The Minnesota Supreme Court found the Tax Court's calculation "clearly erroneous" for failing to explain why it used capacity alone as a proxy for external obsolescence and whether such a methodology was an accepted approach. It also pointed out that both parties' experts considered capacity as merely one element in the determination of external obsolescence.

The Tax Court rejected entirely, without explanation, the decline in ethanol profit margins that both experts found to be a primary consideration. The Minnesota Supreme Court deemed this "particularly confounding because the capitalization of the income loss attributable to the negative market influences is a generally respected approach to calculating external obsolescence."

No methodology mandate

While it remanded the case, the court was careful not to mandate a particular methodology or endorse either party's calculation. It said the Tax Court could adopt a methodology different from those advanced by either party — as long as it adequately explains its reasoning and the evidence supports the alternative methodology. ■