Litigation & Valuation REPORT

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Determining patent infringement damages

The ultimate "what if" scenario

One thing that makes litigation so challenging is the constant need to answer "what if" questions. What would the plaintiff have earned if the defendant's negligence hadn't caused her injuries? What would the company's profits have been if the defendant hadn't breached the contract?

By definition, the answers to these questions are uncertain. But courts usually give plaintiffs the benefit of the doubt. After all, it was the defendant's wrongful conduct that created the uncertainty in the first place. If the plaintiff can establish damages with reasonable certainty, then recovery is possible.

What about patent infringement?

Calculating patent infringement damages introduces new twists into the what-if equation. The presence of the infringer in the marketplace complicates the analysis. And even though patent owners are entitled to recover lost profits, patent law guarantees a minimum recovery of "reasonable royalties."

The availability of royalty damages as a backup in the event lost profits are deemed too speculative may cause courts to demand greater precision in proving lost profits.

How do you establish lost profits?

Measuring lost profits in patent infringement cases is simple in theory: Lost profits are a result of a decrease in revenues from lost sales — sales the patent owner would have made if the infringement had never happened — less the avoided costs of producing those sales. (Owners of design patents can also recover damages based on the infringer's profits.)

Computing avoided costs in patent infringement cases is similar to other types of cases. But estimating lost sales presents some unusual challenges.

Damages experts need to paint a picture of what would have happened if the infringement hadn't occurred. And it isn't just a matter of removing the infringer from the picture and dropping the plaintiff into its place.

The expert must ask whether the infringer would have had the ability to market a noninfringing product and, if so, determine the impact such *lawful* competition would have had on the patent owner's profits.

The expert also needs to consider other potential causes — apart from the infringement — of harm to the patent owner's business.

It's tempting to look at the infringer's sales and conclude that the patent owner would have matched those sales if its patent hadn't been infringed. But that logical leap may not be justified.

Perhaps the infringer is better positioned to sell the product because of special production facilities, superior marketing capabilities or a bigger advertising budget. Or maybe the infringer has access to superior distribution channels or is in a more desirable location.

Brand loyalties should also be considered. Just because consumers bought a product from the infringer doesn't mean they would have bought a comparable product from the patent owner. These and other factors must be

taken into account in estimating the amount of sales the patent owner would have made.

What is the patent owner's capacity to produce?

After the valuator estimates potential lost sales, he or she must consider the patent owner's capacity to produce the additional product. This requires analysis of both the patent owner's physical production capacity and its use level during the infringement period.

In some cases, the plaintiff may claim that even though it lacked the ability to equal the infringer's sales, it would have expanded its manufacturing capacity to meet the demand.

Although this is a difficult assertion to prove, a valuator may support it with evidence of a track record of plant expansions to meet demand or a discussion of expansion in business plans or budgets. The plaintiff must also demonstrate that it had the resources to finance such an expansion.

Is the price right?

After establishing lost sales, the valuation expert must identify the appropriate unit price to arrive at a damages figure. The unit price may be the price the patent owner charges for its own sales, or it may be the price the infringer charges in actual transactions.

Keep in mind, though, that the infringer may receive a higher price because it offers a superior warranty or some other added value, so adjustments may be required.

Perhaps competition with the infringer depressed prices for both parties. If the patent owner can show that it would have received a higher price absent the infringement, then it can recover lost profits not only on its lost sales but also on the sales it *did* make.

But estimating these damages isn't simply a matter of multiplying the patent owner's actual sales by the price differential. The expert must also consider the "price elasticity of demand" — the effect that a higher unit price would have had on the patent owner's actual sales during the infringement period.

15 factors in determining a reasonable royalty

Valuators typically consider the following factors — first outlined in *Georgia-Pacific Corp. v. United States Plywood Corp.* — in calculating reasonable royalty damages in patent infringement cases:

1. Royalties received by the patent holder for licensing the patent in question.
2. Royalty rates licensees paid for "comparable" patents.
3. The nature and scope of the license: Is it exclusive or nonexclusive? Is it restricted in terms of territory or with respect to whom the product may be sold?
4. The patent holder's established licensing policies.
5. The relationship between licensor and licensee: Are they competitors in the same territory or line of business? Are they inventor and promoter?
6. The patent's duration and the license's term.
7. The licensed item's value in generating sales of the licensee's other products.
8. The patented product's established profitability.
9. The patented product's utility and advantages over old modes or devices.
10. The patented invention's nature and benefits.
11. The extent to which the infringer has used the invention, and that use's value.
12. The portion of the profit or selling price customarily allowed for the invention's (or comparable invention's) use.
13. The portion of the profit that should be credited to the invention as distinguished from nonpatented elements or improvements the infringer added.
14. Qualified experts' opinions.
15. The amount a willing licensor and a willing licensee would have negotiated at the beginning of the infringement period.

Considering these factors helps to provide a clearer picture of the amounts at stake.

What's a reasonable royalty?

To calculate reasonable royalty damages, the expert must consider a number of business, financial, accounting, marketing and other factors. Generally, a reasonable royalty is the amount a willing licensor and a willing licensee would have agreed to at the beginning of the infringement period.

But some courts have pointed out that such hypothetical negotiations should not be taken too far. It's important to avoid a situation where a competitor could, in effect, exact a license from the patent owner simply by infringing. These courts suggest that the infringer's actual profits should also be taken into account.

What are the interrelationships?

Establishing patent infringement damages is a complex and challenging endeavor. It demands expert witnesses who understand the interrelationships among several different disciplines — including accounting, finance, economics, industrial engineering, management science, marketing and statistics. ❑

What seems to be the trouble?

Valuing a financially troubled business is much like valuing a healthy one. The valuator scrutinizes financial information and examines the business and its industry to assess the company's ability to generate earnings. But troubled companies don't behave in quite the same way as healthy companies, so valuators must approach them a little differently.

One important difference is that while healthy companies are almost always valued as going concerns, a troubled company may be worth more in liquidation. So the valuator needs to determine its liquidation value for comparison.

Also, valuators usually use income-based methods, such as discounted cash flow analysis, to value troubled companies. Market-based methods, in which a valuator applies price-to-earnings multiples or other measures derived from transactions involving comparable companies, are difficult if not impossible to use. Most market data is drawn from transactions involving healthy companies, which can't be applied to troubled companies without complex — and often problematic — adjustments.

For healthy companies, past performance is often a reliable predictor of future success. But for troubled companies, valuations must be essentially forward-looking. The key is to identify what caused the company's financial distress, determine whether the problem can be fixed and develop a picture of the company's future earnings after management has turned operations around.

One of a valuator's biggest challenges in valuing a troubled company is normalizing its operating results. Most valuations, even of healthy companies, involve some normalization. The valuator adjusts the company's operating results to exclude unusual items — such as nonrecurring income or expenses. This allows him or her to project earnings under "normal" conditions.

Determining the causes of a company's poor performance is critical. If the company got into trouble because of poor management or excessive debt, it could have a great deal of value to a buyer with a stronger management team or greater access to capital. But if the company is struggling because of reduced demand for its products or services or because its technology has become obsolete, it may be difficult — if not impossible — to restore it to profitability.

Valuing a financially troubled company involves many of the same methods, approaches and concepts as valuing a healthy one. But troubled companies operate under extraordinary circumstances, so the rules are different. A valuator experienced with troubled company valuations can help you understand and apply these rules.

Keeping discounts and premiums under control

The type and percentage of ownership interest being valued presents a special challenge to business valuators. Why? A company's value isn't necessarily equal to the sum of its parts.

That's because a minority interest's proportionate share of a company's total value is usually discounted to reflect lack of control and other disadvantages. Conversely, a majority interest may be valued at a premium because it confers the ability to exercise control over the company's management.

Debunking common misconceptions

Many business owners and attorneys misunderstand when and how to apply control discounts and premiums. One common misconception is that a valuator automatically subtracts a discount for lack of control when valuing a minority interest and automatically adds a control premium when valuing a controlling interest.

But valuation adjustments can't be applied in a vacuum. Valuators can't determine whether adjustments are appropriate until they know what they're adjusting.

Consider the "guideline public company" valuation method. Under this method, a valuator determines a company's value by referring to comparable companies' publicly traded stock market prices. Because public company stock prices are based on minority interest trades, this method produces a minority level of value. In other words, the market price *already* reflects the minority interest's lack of control, so if a valuator takes an additional discount, he or she is "double dipping."

If, on the other hand, the valuator uses the guideline public company method to value a controlling interest, a premium might be appropriate.

Different valuation methods yield different levels of value. Take the "guideline merger and acquisition (M&A) method," for example. Under this method, the valuator determines value by referring to prices at which entire companies (or substantial interests in them) have changed hands. This method generally produces a control level of value, because M&A transactions usually involve transfers of controlling interests.

In this case, using a control premium is inappropriate because control is already reflected in the guideline prices. But using a discount for lack of control might be appropriate for a minority interest.

Using income-based methods

Income-based valuation methods — such as discounted cash flow — can yield a control or a minority value, depending on the valuator's assumptions.

Under the discounted cash flow method, a valuator calculates the present value of projected future cash flows. Whether the result is a control or minority value depends on whether the cash-flow projections include "elements of control." This phrase refers to a controlling shareholder's ability to enhance value by directing or influencing business policies.

Consider owner compensation. Owners who work in a business often receive above-market compensation. If a valuator projects cash flow based on "normalized" compensation levels, then arguably the resulting figure is a control level of value. The reason is that only a

controlling shareholder would have the power to reduce executive salaries to market levels, thereby boosting the company's income and increasing shareholder value.

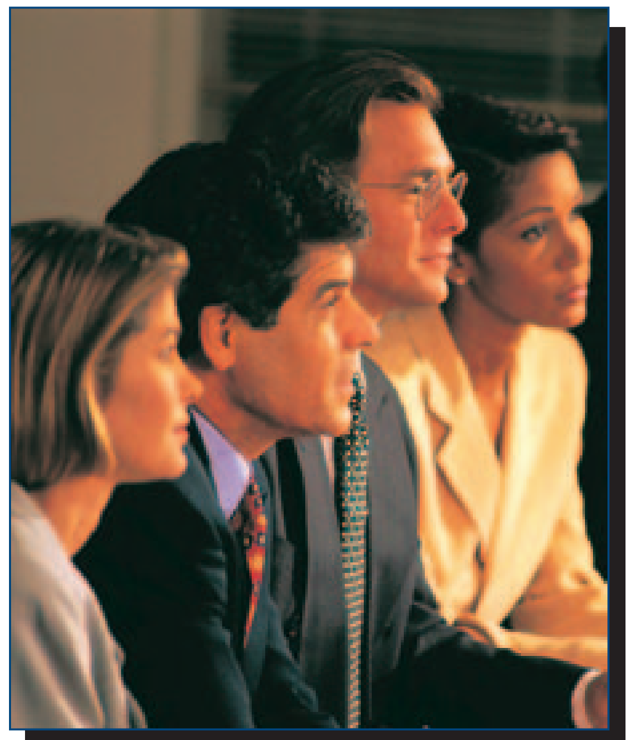
Comparing apples to apples

As these examples illustrate, discounts for lack of control only come into play when a valuator determines a minority interest's value using a method that produces a control level of value. Conversely, a control premium may be appropriate if the valuation method yields a minority level of value.

When using valuation discounts and premiums, valuators must ensure that they're comparing apples to apples and oranges to oranges. Until they know this, determining the appropriate adjustment is impossible. ❑

Recent ruling defines importance of subsequent events

In a recent case involving a limited liability company's (LLC's) attempt to squeeze out a minority member, a federal appeals court permitted appraisers to consider a deal that closed after the valuation date in valuing the member's interest. For the plaintiff, the ruling meant the difference between receiving $11 million for his shares, or only $1.50.



A controversial proposal

Brian Froelich was a member and CEO of Senior Campus Living LLC (SCL), a Maryland-based developer of large, campus-style retirement communities. In the fall of 1997, SCL was pursuing a large project in Springfield, Va., called Greenspring Village. The company considered Greenspring critical to its future success.

Equitable Real Estate Investment Management, Inc. (Equitable) agreed to provide $26 million in mezzanine financing for Greenspring if SCL first secured $55 million in construction financing. SCL found a willing lender, but the loan was predicated on a personal guarantee from John Erickson, SCL's founder. Erickson had sold the company to Froelich and others in a leveraged buyout the previous year, but he still had a substantial financial interest in it.

Shortly after Erickson agreed to the guarantee, SCL's board of directors removed Froelich as CEO and replaced him with Erickson. Equitable then postponed the closing and said it would need an additional $35 million in personal guarantees to do the deal.

Erickson agreed to provide these guarantees if SCL's board reclassified all its preferred and common interests into a single class of common interests. An independent appraisal of the company's fair market value would be the basis for the reclassification. The board approved Erickson's proposal, as did 15 of the LLC's 16 members. Froelich was the lone dissenter.

The reclassification placed Erickson in an extremely favorable position. He had $160 million in preferred interests in SCL and owned 30% of its common

interests. Froelich had $8 million in subordinate preferred interests and 26% of its common interests.

The upshot was that if the appraiser set the company's value at $160 million or less, the common and subordinate preferred interests would be nearly worthless and Erickson would end up owning virtually all of the common interests.

SCL's appraiser valued the company at $155 million and Erickson ended up with 99.9% of the new common interests. Froelich, his remaining interest eradicated by a squeeze-out merger, was left with $1.50. The day after the reclassification, SCL closed on the financing of the Greenspring project.

The $11 million question

Froelich sued SCL, Erickson and others for breach of fiduciary duty and fraud. He also sought an appraisal under Maryland's dissenting shareholder statute. The court threw out the fraud and breach of fiduciary duty claims, but granted Froelich's demand for a statutory appraisal.

The court appointed a three-member panel to value SCL. All three appraisers arrived at a fair value of $176 million. Based on the panel's valuation, the court awarded Froelich $11.2 million for his interest in the company.

A major issue on appeal was that two of the three appraisers adopted a $34 million value for the Greenspring project. Under the dissenting shareholder statute, fair value is determined on the date the shareholders approve the challenged transaction and "may not include any appreciation or depreciation which directly or indirectly results from the transaction objected to or from its proposal."

SCL asserted that the $80 million in Greenspring financing resulted from the transaction Froelich objected to — the reclassification. Thus, the court should disregard any appreciation in SCL's value attributable to Greenspring. (See "When is it okay to consider subsequent events?" below.)

The court's finding

The court of appeals found that the subsequent closing on the Greenspring financing provided evidence of SCL's value on the valuation date. The boost in the company's value did not result from the reclassification, the court said.

Even though the reclassification was needed to obtain Erickson's guarantee, which in turn was needed to secure the financing from Equitable, the evidence showed that this scenario was just one option among many for financing the project.

As the court explained, "[T]he appraisers could reasonably look to the Nov. 6 closing for evidence of the Greenspring project's financeability (and hence value) on Nov. 5."

The value of experience

As this case illustrates, the distinction between subsequent events that *affect* value and subsequent events that *reflect* value may not be clear-cut. An experienced business valuator can develop the evidence and demonstrate its impact on value. ❑

When is it okay to consider subsequent events?

Events that take place after the valuation date generally fall into two categories:

1. Those that increase or decrease the company's value, and
2. Those that don't affect value but provide evidence of the company's value on the valuation date.

Events in the second category — such as an arm's-length sale of shares shortly after the valuation date — are properly considered in determining fair market value. A valuator can consider subsequent events that *affect* value if they were *foreseeable* on the valuation. This is based on the assumption that willing buyers and sellers would consider the likelihood of such events in setting a price.

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– *The Electronic Accountant*, September 2000 –

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