

— Advocate'sEDGE —



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Trolling for trouble

How patent aggregators complicate infringement damages

The number of patent infringement lawsuits has climbed dramatically in recent years. Many experts attribute the jump to the slew of claims brought by patent aggregators — also known as “nonproducing entities” or the less flattering but more familiar term, “patent trolls.” Patent aggregators differ from traditional patent holders in several important ways, and these differences can affect how patent infringement damages are calculated.

3 REMEDIES AVAILABLE

Patent aggregators are companies that serve no other function than to purchase patents — often from bankrupt companies. The aggregators then sue or extract licensing fees against businesses with products related to the patents. Targeted businesses often lack the resources necessary to defend a costly patent case in court, and court verdicts or settlements in an aggregator’s favor give it greater leverage to obtain licensing fees from other entities.

A patent aggregator has no need to maintain a monopoly. As a nonparticipant in the relevant marketplace, it doesn't have to worry about harming its competitive position.

Patent holders generally pursue three types of remedies for infringement: 1) permanent injunctions, 2) lost profits and 3) reasonable royalties. Since the 2006 U.S. Supreme Court decision in *eBay Inc. v. MercExchange, L.L.C.*, though, patent holders are no longer automatically entitled to an injunction upon a finding of infringement. To obtain an injunction, the patent holder must satisfy the four-factor test, which places greater

RELIEF ON THE HORIZON?

This past summer, Reps. Jason Chaffetz (R-Utah) and Peter DeFazio (D-Oregon) introduced H.R. 6245 to protect technology companies from frivolous lawsuits by patent aggregators. The Saving High-tech Innovators from Egregious Legal Disputes (SHIELD) Act would allow prevailing defendants to recover litigation costs from the plaintiff in cases where the court finds the plaintiff didn't have a reasonable likelihood of succeeding in court.

The bill is limited in scope, applying only to patents for software and computer hardware. But according to DeFazio's office, it's supported by a broad coalition of software and computer hardware companies, consumer groups and venture capitalists.

weight on the competitive relationship between the holder and the defendant. Because patent aggregators aren't in direct market competition with their defendants, few have been able to obtain permanent injunctions.

Lost profits are another unlikely avenue for aggregators to pursue. By definition, aggregators don't manufacture or market any products, making it difficult — if not impossible — for them to establish lost profits. This leaves reasonable royalties. The unusual circumstances surrounding these patent cases, however, can make calculating reasonable royalties challenging.

GEORGIA-PACIFIC FACTORS

To determine reasonable royalties in a patent infringement case, courts generally consider 15 factors known as the *Georgia-Pacific* factors. Although some factors may not be relevant to a particular case, courts have held that the testifying expert should at least consider each one in his or her analysis.

In *Uniloc USA Inc. v. Microsoft Corp.*, the U.S. Court of Appeals for the Federal Circuit (which hears all appeals related to patent cases) cited three of the 15 factors as being particularly important to the reasonable royalty determination. Those factors look at:

1. Actual royalties received by the patent holder for licensing the patent at issue,
2. Royalties paid by licensees of comparable patents, and
3. The portion of profit that may be customarily allowed in the specific business for the use of the invention or similar inventions.

The Federal Circuit explained that these factors “properly tie the reasonable royalty calculation to the facts of the hypothetical negotiation at issue.”



POTENTIAL PROBLEMS

Notably, the case in which the *Georgia-Pacific* factors were first laid out involved two direct competitors. This isn't true in cases involving patent aggregators.

Moreover, the factors assume that the patent holder is balancing a desire to license the patent to the defendant against its competitive need to maintain a monopoly over the invention. The tighter the rein that the patent holder keeps over its patents through licensing (or by refusing to license), the higher the reasonable royalty it would require to grant a license to the defendant. But a patent aggregator has no need or desire to maintain a monopoly; it exists to license patents. And as a nonparticipant in the relevant marketplace, it doesn't have to worry about harming its competitive position.

Individual *Georgia-Pacific* factors can prove problematic, as well. For example, are actual royalties reliable indicators of “reasonable” royalties if they were obtained as the result of litigation or the threat thereof? After all, a reasonable royalty generally is defined as the amount that a hypothetical willing buyer and willing seller would agree upon as an appropriate payment at the time of the infringement. But postinfringement royalty rates aren't determined strictly by ordinary arm's-length negotiations between willing parties.

Parties might agree to a royalty rate they otherwise wouldn't agree to simply to avoid or settle litigation, and that rate may be higher than the rate a willing buyer would have agreed to at the time of infringement. Similarly, reasonable-royalty damages awarded by a court or jury frequently are higher than the actual royalty rates in the relevant industry because the award is compensating for infringement, rather than just representing a licensing agreement in the absence of infringement.

YOUR EXPERT MAKES THE DIFFERENCE

Infringement litigation involving patent aggregators shows no sign of dropping off in the near future. Your expert's ability to discern and explain any problems with the damages claimed by patent aggregators could make a major difference to your client's bottom line. ▶

Daubert *in the courts*

Despite challenge, shareholder damages expert prevails

The *Daubert* standard for expert testimony has been around for about 20 years now, so one would expect it to be well understood. However, a recent district court ruling in a shareholder lawsuit, *Stuckey v. Online Resources Corp.*, suggests that's just not so.

BREACH OF CONTRACT

Internet Transaction Solutions (ITS) entered into a merger agreement with Online Resources Corporation (ORC) in 2007. As part of the agreement, ITS shareholders were given a choice between receiving payment for their shares as cash, ORC stock or both. Out of the \$45 million purchase price, the shareholders chose to receive almost \$25 million in ORC stock.

The shareholders subsequently sued ORC for, among other things, breach of contract arising from failure to file a registration statement, which prevented the shareholders from trading their ORC stock. They chose business valuator Espen Robak as an expert witness to calculate the damages. ORC, however, filed a motion to exclude him.

LIMITS OF EXPERTISE

ORC argued that Robak didn't possess the requisite expertise to calculate damages in the case because he hadn't heard of a specific Delaware Supreme Court decision prior to beginning work on the shareholders' case. The court hearing that case had earlier determined that the 2001 Delaware case, *Duncan v. TheraTx, Inc.*, provided the applicable measure of damages suffered by shareholders who were prevented from trading.

But the court found ORC's argument unpersuasive. The court explained that it doesn't expect scientific, technical or financial experts to know of particular cases that describe methods by which damages can be calculated. The law, after all, isn't their area of



expertise. Rather, the court said, it's the "quantification of *inputs* into the *Duncan* formula that fall into Mr. Robak's expertise." And his qualifications — president and founder of a valuation firm and a nationally recognized expert on business valuation, restricted and illiquid securities, securities design, levels of value, and liquidity discounts — indicated Robak was capable of performing such quantifications.

RELIABILITY NOT AT ISSUE

ORC further argued that Robak's proposed testimony wasn't reliable because he'd failed to correctly apply the methodologies in *Duncan* to

the facts. ORC contended that, when performing his calculation, Robak had incorrectly used an intraday stock price, rather than the highest closing price, as the input for highest intermediate price. ORC also questioned the starting and ending points he'd used when calculating a selling period.

A court's task isn't to determine whether an expert's opinion is correct but whether it rests on a reliable foundation.

The court, however, held that these issues didn't go to the calculation's reliability but to its weight, credibility and accuracy. A court's task, it said, isn't to determine whether an expert's opinion is correct but whether it rests on a reliable foundation as opposed to, for example, an unsupported speculation. It concluded that the parties here were "arguing about specific numbers that have been input into the *Duncan* formula, which is an improper basis upon which to exclude expert testimony."

MOTION DENIED

The court ultimately denied ORC's motion to exclude Robak's testimony. As the court noted, ORC was free to question the witness's expertise and inputs in cross-examination, but exclusion of Robak on such grounds was inappropriate under *Daubert*. ▀

The ultimate intangible

Valuing a trained and assembled workforce

Intangible assets — including a trained and assembled workforce — increasingly represent a significant piece of many companies' total value. Your clients may need to know the value of their human capital for financial reporting, merger, litigation and other purposes. And if they've recently reduced their workforces due to economic pressures, they should consider getting a fresh appraisal.

3 VALUATION METHODS

As with most assets, appraisers value an assembled workforce using one or more of three valuation methods.

1. Market. This method takes into account actual market transactions involving comparable companies. However, because it's unusual for a company involved in a transaction such as a merger to value its workforce separately from other assets, this method's efficacy may be limited.

2. Income. Here, an appraiser measures the present value of future economic benefits, such as cash flows or earnings. The income method is particularly suitable for professional firms and other service businesses where it's possible to measure the income individual or groups of employees generate.

3. Cost. This is the most common way to estimate the value of an assembled workforce. A valuator calculates recruiting, hiring and training costs associated with a company's workforce and then estimates the investment that would be required to duplicate it.



When using the cost method, a valuator may estimate the *reproduction* cost — or the cost of creating an exact duplicate of an existing workforce. Or, the expert may measure the *replacement* cost, which is the cost of creating a workforce capable of matching the existing workforce’s output.

FURTHER CONSIDERATIONS

Replacement cost can produce a more speculative value than reproduction cost. Such calculations may require valuers to hypothesize a workforce that looks different from the current one — for example, a group made up of fewer employees with better skills. Valuers then make numerical adjustments to reflect differences in labor costs and other factors.

When using the cost approach, valuers also consider characteristics of the existing workforce that affect value. Say, for example, that the current workforce includes many highly compensated, long-time employees. It may be appropriate to reduce its value to reflect the possibility of re-creating the workforce with equally skilled but lower paid, younger employees. However, when making such adjustments, valuers must consider whether existing employees belong to labor unions or have employment contracts that might make it difficult for their employers to replace them.

IMPETUS FOR APPRAISAL

Companies seek workforce appraisals most frequently for financial reporting reasons. While a company’s workforce isn’t treated as a separate asset for the purpose of accounting for business combinations, it may be relevant for other financial reporting purposes such as determining appropriate “capital charges” when valuing other intangible assets or supporting goodwill value.

Businesses may also need to value their workforce when they’re pricing or negotiating a sale or merger. Many prospective business buyers consider a trained and assembled workforce essential to the value of a transaction — particularly in sectors where employees require highly specialized skills or extensive training. The value of the selling company’s assembled workforce can represent a floor, or minimum, value.

Other situations that may prompt a workforce appraisal include:

Income or property taxes. For federal income tax purposes, an assembled workforce acquired in a taxable transaction is an amortizable intangible asset. And, in many states, the value of a company’s assembled workforce and other intangible assets can be excluded from its property tax base.

Litigation. A company may need to estimate damages an employee or former employee has caused by breaching an employment or noncompete agreement.

Downsizing. Occasionally, companies use workforce appraisals to determine whether layoffs make financial sense. Although downsizing can reduce payroll and benefits costs, it can also negatively affect the business by reducing the value of its workforce.

MERE NUMBERS

How can mere numbers capture the skills, talents and knowledge embedded in a workforce? Human capital appraisals are often necessary, but rarely easy. If your client requires one, be sure to hire an experienced valuation professional. ▸



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- ▶ Shareholder derivative actions
- ▶ Purchase/Sales agreement warranty claims
- ▶ Legal and accounting malpractice claims
- ▶ Intellectual property analysis
- ▶ Other economic damage claims

Arnie & Company has an especially strong depth of experience in the analysis of commercial damages and in conducting forensic investigations. Dennis Arnie is both a Certified Public Accountant and a Certified Fraud Examiner. He has frequently testified as an expert witness in a variety of state and federal courts and various arbitration hearings.

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