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Patent infringement: Scrutinizing the “entire market value” rule

Proving damages in patent cases is rarely straightforward, particularly when the infringing item is only a small feature of a larger product. A federal district court’s response to a *Daubert* challenge in *AVM Technologies, LLC v. Intel Corp.* demonstrates why parties in patent infringement cases should expect close scrutiny when an expert computes damages based on the sales of the larger product.



ARE THE ROYALTIES REASONABLE?

AVM Technologies holds a patent on an improved dynamic logic circuit. It sued Intel, alleging that its now defunct Pentium® 4 Processor used circuitry that infringed the patent. AVM submitted an expert report stating that it was entitled to reasonable royalty damages of \$150 million to \$300 million, based on Intel’s sales of its processor. Intel filed a *Daubert* motion to exclude the expert’s testimony.

The Delaware court explained that, when a company is accused of infringement on small elements of multicomponent products, calculating a royalty on the entire product carries a

considerable risk that the patentee will be improperly compensated for noninfringing components of the product. The general rule, therefore, is that royalties should be based on the “smallest salable patent-practicing unit.”

The entire market value rule is an exception to this principle. It allows a patentee to calculate damages based on the entire market value of the infringing product if the patentee demonstrates that the patented feature creates the “basis for customer demand” or “substantially create[s] the value of the component parts.” This test, the court said, can be met only by showing that the patented feature alone causes customers to purchase the accused products.

SETTLEMENT AGREEMENTS WERE NO BASIS FOR DAMAGES



When sued by AVM Technologies for patent infringement (see main article), Intel challenged the AVM financial expert’s use of four litigation settlement agreements to establish damages, on the basis that he didn’t compare the value of the technology covered by the licenses that resulted from those agreements and the value of the AVM patent. Intel also argued that three of the agreements were portfolio licenses and therefore not comparable to a license for a single patent.

The district court found that AVM must show that the prior licenses were truly comparable to the license these parties would have negotiated — as to both the scope of the licenses and the technology and value of the patents licensed — before it could introduce this evidence to the jury. The court determined that no reasonable juror could consider the three broad portfolio license agreements comparable in scope to a license for AVM’s patent. As to the fourth license, the expert’s report didn’t indicate that he had done any analysis to compare the benefits and value of the technology.

It's not enough to show that the patented feature is viewed as valuable, important or even essential.

Intel argued that AVM's expert's opinion concerning damages should be excluded because it failed to satisfy the *Daubert* standard for reliability. Specifically, it asserted that the expert's calculation of a reasonable royalty rate made no effort to apportion the percentage of Intel's revenues that was attributable to the patent and therefore violated the general rule.

AVM countered that the expert didn't use the entire market value rule to determine a reasonable royalty rate. Moreover, it argued, even if he had used the rule to perform his calculation, it wouldn't be improper because the Intel processors were the smallest salable unit.

IMPROPER COMPENSATION

The court found that the use of a multicomponent salable unit that is greater than the patented feature — even if it's the smallest

salable unit — would improperly compensate the patentee. Further, the court said, the difficulty in determining the royalty base in a situation like this isn't a reason to accept an unreliable method.

According to the court, the expert's report provided little, if any, basis for allowing his testimony about a royalty based on Intel's sales of processors. Even assuming that dynamic logic circuits were the single most important part of Intel's microprocessors, it was "still a long haul to conclude that they 'drive demand' for the entire microprocessor."

DELAYED DECISION

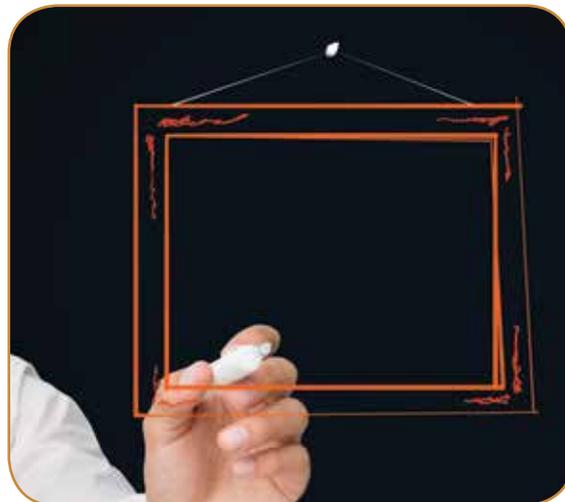
The court believed that the expert's testimony should be excluded. But it opted to hear live testimony from the expert, with cross-examination, before issuing a final decision. After a hearing, where the expert based his calculation not on Intel's processor sales but on a different theory, the court ultimately excluded the expert's testimony. ▶

Experts put damages assessments in the frame

Without a framework for assessing damages, jurors are more likely to make outsize awards that punish the entire company and its stakeholders rather than the offending individuals or company division. Here's where financial experts come in. By breaking a company down, putting profits into perspective and explaining such concepts as net worth and fair market value (FMV), experts provide a context for a reasonable damages award.

BREAKING IT DOWN

Damages experts can break companies down into their individual parts to give jurors the proper perspective regarding the responsible division or



department. Jurors should understand that the specific division can be sufficiently punished even if the award won't significantly affect the overall company.

By breaking a company down, experts can increase the likelihood that jurors will look at the defendant as a business composed of many individual employees — rather than viewing it as an unfeeling, monolithic entity. This approach also can be used to identify other individuals who will be hurt by a disproportionate award, such as a company's stockholders and perhaps even its rank and file employees.

WHAT PROFITS ARE — AND AREN'T

Profits realized as a result of the defendant's misconduct are integral in determining an appropriate damages award. The financial expert's role is to clearly establish actual or expected profits from such conduct. In addition, the jury must understand that actual profits constitute a small percentage of total revenues or total sales. A company's historic net profits, for example, might be 5% of total revenues.

At the same time, the expert must take into account any expenses incurred as a result of claims that grew out of the transgression — including those associated with recalls or redesigns. So it's important to explain to jurors that revenues or sales are *not* the same as profits.

ASSET FORMS

Often, plaintiffs point to the defendant's total assets as an indication of how large an award must be to be truly punitive. But net worth is generally a better measure of a company's ability to pay because it includes liabilities as well as assets.

Even then, the assets portion — particularly their “form” — must be examined carefully. For example, are they liquid? A company's assets may be fixed (such as equipment and real estate) or in another form also not easily converted to cash, such as intellectual property. In fact, converting some assets to cash can make it difficult — if not impossible — for a business to continue operating.

Both plaintiffs and defendants also need to examine the FMV of assets rather than their book value. Assets typically are recorded at book value, but their FMV can vary substantially, and such changes in value are generally not reflected in financial statements. A financial expert can help keep the jurors' focus where it needs to be, rather than on unsound or “shortcut” damages calculations.

CASH FLOW AND LIABILITIES

The defendant's ability to access cash also should be considered when awarding punitive damages. After all, the harder it is to put together funds to pay an award, the more punitive it will be.

When examining a company's cash flow, financial experts look at the business's ability to generate cash in the future. Companies with a current high net worth may not be able to generate strong earnings in the future. On the other hand, companies with a current negative net worth due to high initial costs may be positioned to garner impressive profits in the future.

Finally, the expert can explain to the jury the impact of liabilities on the defendant's financial statements, as well as on its overall financial status. Many times, conduct that precipitates punitive damages claims also triggers multiple claims against the defendant, as in mass torts or class actions. By the time a particular claim reaches the punitive award stage, the defendant may already have been found liable for significant claims.

ROLE OF THE EXPERT WITNESS

One of the most important contributions financial experts can make in damages litigation is to construct a framework juries can use when assessing damages. It's not enough to build this framework while calculating reasonable damages. The expert also must clearly communicate it to jurors from the witness stand. ▀

Excess earnings method

Higher valuation of law practice prevails in divorce case

In divorce, the value of a spouse's interest in a professional practice can play a significant role in the final financial outcome. However, such appraisals can result in a range of values. For example, in a recent Virginia case, *Wright v. Wright*, the two experts' valuations differed by almost \$1 million. Eventually, the higher value prevailed — thanks to the court's acceptance of a frequently challenged methodology.

TRIAL COURT'S RULING

The Wrights married in 1986 and separated in July 2008, at which time they resided in Virginia. The husband, an attorney, had joined Hunton & Williams in 1991 and become an equity partner in 1994. At the time of the divorce, he was the head of the firm's Capital Real Estate Finance Group and was compensated at the third highest compensation level out of the 16 levels for equity partners.



The appellate court rejected the contention that the bottom-up methodology is appropriate only when pertinent financial data is unavailable.

The wife's expert in the divorce trial opined that the marital value of the husband's law practice was about \$1.5 million. The trial court accepted this value for equitable distribution purposes, finding it was more credible than the value of approximately \$500,000 provided by the husband's expert.

THE APPEAL

On appeal, the husband challenged the wife's expert's methodology. The appeals court described the methodology as "bottom-up," which is known in some states as the excess earnings method.

It observed that use of the method had been approved by the court in a previous case (*Howell v. Howell*) involving the determination of the marital value of the law practice of another Hunton & Williams equity partner. In that case, the wife's expert began by comparing the husband's average income for three years to that of a peer group. The difference between the two equaled the excess earnings due to the husband's association with the firm (practice goodwill), not earnings due to his personal efforts (professional and personal goodwill).

The wives' experts in both cases projected excess earnings over the husband's expected career with the firm. Using the discounted future earnings method, they calculated the present value of the husband's total future excess earnings.

In *Wright*, the husband argued that the circumstances in *Howell* were distinguishable from those in his case. The bottom-up method in *Howell* was used in large part due to the unavailability of partnership financial data (which the firm had successfully quashed). But in *Wright*, the wife's expert's testimony strongly suggested that the expert had more financial information at his disposal.

COURT'S CONCLUSIONS

The court of appeals rejected the contention that the bottom-up methodology is appropriate only when pertinent financial data has been quashed or is otherwise unavailable. It found that neither *Howell* nor any other authority suggests such a rule.

Among the appellate court's conclusions were that the trial court was entitled to find credible the wife's expert's testimony that the bottom-up methodology is preferred over other approaches. It also found that the wife's expert's opinion was "better reasoned and more credible" than the husband's expert's and that the wife's expert had "better isolated [practice] goodwill by determining what an attorney's law firm interest value with [the] husband's skill, knowledge and experience value would be if he was in a firm that lacked the attributes of [the] husband's law firm."

The trial court's acceptance of the \$1.5 million value was upheld.

METHOD TO THE MADNESS

In this case, the appellate court also agreed with the lower court that the husband's expert's adjustments and discounts were "arbitrary." Retaining a qualified financial expert can help your clients avoid results like those suffered by the husband in this case. ▀

New COSO guidelines focus on fraud — do your clients?

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has released the long-awaited revision of its *Internal Control — Integrated Framework*, updating internal control guidelines that dated back to 1992. Among other changes reflecting today's more complicated business models, the new framework directly addresses the need to consider the risk of fraud as part of an organization's internal control system.

LEADERSHIP AND GUIDANCE

COSO is a joint initiative of the American Accounting Association, the American

Institute of Certified Public Accountants, Financial Executives International, the Institute of Management Accountants and the Institute of Internal Auditors. Since 1985, COSO has offered both research and guidance on internal controls, enterprise risk management and fraud deterrence.

The original COSO framework is widely regarded in the accounting and financial community as the preeminent guidance for designing and implementing internal controls over financial reporting and for assessing their effectiveness. Organizations can use COSO's framework to design and implement internal control systems

that reflect the many changes in business and operating environments that have occurred during the past two decades. The new framework can help organizations apply internal controls more broadly to operations and reporting objectives and to develop a better understanding of how to assess internal controls for effectiveness.

5 COMPONENTS

COSO's new framework recognizes a direct relationship between internal control objectives (what an organization tries to achieve in relation to operations, reporting and compliance), components (what's required to achieve the objectives) and structure (the organization's operating units, legal entities and "other"). It lays out 17 principles related to five internal control components:

1. Control environment,
2. Risk assessment,
3. Control activities,
4. Information and communication, and
5. Monitoring activities.

The new framework can help organizations apply internal controls more broadly to operations and reporting objectives.

The overarching components remain unchanged. Unlike the original, though, the new framework provides guidance on conducting fraud risk assessments within the risk assessment component. It highlights the expectations of regulators and other stakeholders regarding an organization's efforts at fraud deterrence and detection.



IDENTIFYING FRAUDULENT FINANCIALS

The new framework explains that, "as part of the risk assessment process, the organization should identify the various ways that fraudulent [financial] reporting can occur." These include management bias — for example, in selecting accounting principles — as well as:

- ▶ The degree of estimates and judgments in external reporting,
- ▶ Fraud schemes common to the organization's industry sectors and markets,
- ▶ Geographic regions where the organization does business,
- ▶ Incentives that may motivate fraudulent behavior,
- ▶ The nature of technology and management's ability to manipulate information,
- ▶ Unusual or complex transactions subject to significant management influence, and
- ▶ Vulnerability to management override and circumvention of existing controls.

According to COSO, the failure to adequately assess fraud risks for each objective would constitute a major deficiency in the organization's internal control structure.

VALUE OF EXPERTISE

Internal control deficiencies could come back to bite a company that finds itself in court. Qualified fraud experts can help your clients conduct comprehensive fraud assessments and implement effective controls — and testify to that effect should it become necessary. ▶

The experience you need. The service you want.

Whether you are dealing with matters of contract disputes, fraud investigations or other economic damages, you need accountants who have extensive experience in preparing and presenting complex commercial cases. In other words, you need Arnie & Company.

For more than a decade, our firm has provided the legal community, business owners and other individuals throughout Texas with prompt, accurate and effective accounting, consulting and litigation support services that include:

- ▶ Contract dispute and analysis
- ▶ Fraud investigations
- ▶ Lost profit analysis
- ▶ Securities claims
- ▶ 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.

Thanks to the firm's commitment to delivering outstanding service, Arnie & Company has become a trusted advisor to many leading law firms and businesses in the Houston, Dallas, and Austin areas. Our clients include numerous Fortune 500 companies in various industries, as well as significant privately held companies and individuals.

We welcome the opportunity to put our experience and advanced knowledge of commercial damage analysis and forensic accounting to work for you and your clients. Please call us at 713-840-1634 and let us know how we can be of assistance. ▶

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