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Valuation & Litigation

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Growth rate becomes critical to lost profits calculation

In commercial cases involving lost profits, selecting an appropriate growth rate is a critical step in calculating damages. It's also one of the most challenging. Depending on the amount at stake and the length of the damages period, adjusting the growth rate by just a few percentage points can have a significant effect on the outcome.

Whether you represent the plaintiff or the defendant, it's essential that your damages expert thoroughly analyze the factors that influence expected revenues and profits. As one plaintiff recently learned the hard way, failing to do so can jeopardize the admissibility of damages evidence.

A collapsing damages case

In *Manpower Inc. v. Insurance Company of the State of Pennsylvania*, a federal district court excluded the testimony of a forensic accountant retained by the plaintiff to calculate its business-interruption loss.

The case involved the June 15, 2006, collapse of a building in Paris, France, that housed the offices of a Manpower subsidiary, Right Management ("Right"). Right was covered under Manpower's \$15 million "all risk" insurance policy. The policy contained a business interruption provision that covered Right's lost profits and extra expenses while it was unable to conduct business at the insured premises.



The plaintiff's damages expert opined that Right suffered lost profits of €5,125,830 (roughly \$7.2 million) and incurred extra expenses of €2,377,746 (roughly \$3.3 million) during the 14-month interruption period. The defendant's insurance company moved to exclude the expert's testimony regarding lost profits under Federal Rule of Evidence 702, arguing that his conclusions were produced by unreliable principles and methods.

Plaintiff's method found wanting

The court granted the defendant's motion, finding that the expert's general approach was sound but that his method of selecting the growth rate wasn't. The expert forecast the revenues that Right would have earned during the interruption period but for the building collapse, and he subtracted the company's actual revenues during the period. Next, he projected Right's total expenses during the period and subtracted its actual continuing expenses to arrive at noncontinuing expenses. Finally, he

deducted Right's noncontinuing expenses from lost revenues to arrive at a business interruption loss equal to net lost profits plus continuing expenses.

To project Right's lost revenues, the expert used revenues during the five-month period immediately preceding the collapse (January to May 2006) as a base period and applied a growth rate to those revenues to extrapolate lost revenues during the interruption period. He arrived at the growth rate by comparing base-period revenues to those during the same period in the previous year. Revenues during the first five months of 2006 were 7.76% higher than revenues during the first five months of 2005.

The defendant challenges

The defendant challenged the plaintiff's use of the 7.76% growth rate, arguing that there were several other growth rates he should have considered, including the company's 4.79% annual growth rate from 2003 to 2006 and its 3.8% growth rate from January 2005 to May 2006. The expert's rationale for selecting the 7.76% rate was that Manpower had recently acquired Right and installed new management in an effort to turn the company around. Those efforts, he said, paid off beginning in late 2005, so the company's growth in early 2006 was a good predictor of its future growth.

The court granted the defendant's motion, finding that the expert's general approach was sound but that his method of selecting the growth rate wasn't.

The fatal flaw in the expert's method was that he assumed — based on nothing more than conversations with company managers — that Right's growth in the months leading up to the building collapse

SUPPORTING THE COURT'S DECISION

In *Manpower Inc. v. Insurance Company of the State of Pennsylvania* (see main article), the court took issue with the expert's use of a short base period, noting that his analysis might have been more reliable had he used historical data going back to 2003. By relying on a five-month period, the expert essentially treated Right Management ("Right") as a new business, for which projecting lost revenues requires greater precision.

To compensate for this lack of a track record, experts should examine other indicators, such as the track records of comparable companies, the growth rates of the overall economy and the industry's growth rate to assess the reasonableness of projected revenues. But the expert in Right performed no such analysis.

was the result of new management. He further assumed that the company's growth would continue unabated during the 14-month interruption period. He "did no economic analysis of the various factors affecting Right's revenues," the court observed, "and did not make any effort to determine whether the growth Right experienced in the first five months of [2006] was the result of factors other than new management."

The company's growth spurt might have been caused, for example, by industry conditions that may or may not have continued throughout the interruption period. Or it might simply have been an aberration. Without a thorough analysis of the various economic factors that affected the company's growth, there was no basis for selecting one growth rate over another. The court cited other flaws in the case as well. (See "Supporting the court's decision" above.)

Making a case

In cases involving lost profits, work closely with your damages expert to ensure that you select a growth rate that's both reasonable and supported by sound, well-documented economic analysis. As the *Manpower* case illustrates, failure to do so can have devastating consequences. ♦

Patent infringement damages

Federal Circuit gives thumbs down to “25% rule”

In *Uniloc USA, Inc. v. Microsoft Corporation*, the Court of Appeals for the Federal Circuit rejected the often-criticized but widely accepted “25% rule of thumb” used to calculate reasonable royalty damages. The court also clarified and limited use of the “entire market value” in determining an appropriate royalty base.

New trial on damages

Uniloc claimed that Microsoft’s product activation feature in certain Office and Windows products

infringed upon Uniloc’s patent for an antipiracy software registration system. Microsoft’s feature requires users to input a 25-character alphanumeric product key to use its products. At trial, the jury found Microsoft liable for willful infringement and awarded Uniloc \$388 million in damages.

The district court granted Microsoft’s motion for judgment as a matter of law (JMOL) on noninfringement and lack of willfulness. It also granted Microsoft’s alternative motions for a new trial on noninfringement and willfulness, as well as a new trial on damages. On appeal, the Federal Circuit reversed the JMOL on infringement, reinstating the jury’s verdict, but affirmed the JMOL on lack of willfulness. The court also affirmed the district court’s grant of a new damages trial because the award was “fundamentally tainted by the use of a legally inadequate methodology.”

Rule “fundamentally flawed”

In patent infringement cases, plaintiffs are entitled to recover their lost profits, but in no event less than a “reasonable royalty.” Lost profits can be difficult to prove, so reasonable royalties are the more common remedy. Typically, a reasonable royalty is calculated based on the outcome of a hypothetical preinfringement negotiation, using the Supreme Court’s *Georgia-Pacific* factors as a framework.

In *Uniloc*, the plaintiff’s damages expert applied the 25% rule of thumb to establish a baseline royalty rate. He relied on Microsoft’s “appraisal process,” which valued product keys between \$10 and \$10,000, depending on usage. Selecting \$10 as the “isolated value of product activation,” Uniloc’s expert hypothesized that 75% of that value would be retained by Microsoft and 25% — or \$2.50 — would go to the patent owner.



Using \$2.50 as a baseline rate, the expert considered the *Georgia-Pacific* factors to determine whether they required any adjustments. He concluded that they didn't, and multiplied the \$2.50 rate times the number of infringing product licenses (225,978,721) to arrive at reasonable royalty damages of \$564,946,803.

Despite widespread use of the 25% rule of thumb, the Federal Circuit rejected it, finding it a “fundamentally flawed tool.”

Despite widespread use of the 25% rule of thumb, the Federal Circuit rejected it, finding it a “fundamentally flawed tool.” Even though the rule is purportedly derived from “careful examination of years of licensing and profit data, across companies and industries,” it’s essentially arbitrary because it “fails to tie a reasonable royalty base to the facts of the case at issue,” including the unique relationship between the parties and between the patent and infringing product.

“Check” rejected

The Federal Circuit also rejected the expert’s reliance on the “entire market value rule” as a “check” on the reasonableness of his royalty conclusion. Using pie charts to illustrate his point, the expert showed that his \$564,946,803 royalty figure was only 2.9% of Microsoft’s total revenue of \$19.3 billion for Office and Windows, a fraction of typical royalty rates of 10% or more for software. He also used this data to belittle Microsoft’s royalty figure, which represented 0.0003% of total revenue.

The court acknowledged that reasonable royalties can be assessed based on the entire market value of the infringing product, but only if the patented feature creates “the basis for customer demand” or “substantially create[s] the value of the component parts.” That wasn’t the case in this situation, where product activation was a minor component of the overall product.

Review your evidence

Federal Circuit rulings on patent issues generally are binding throughout the United States, so the court’s repudiation of the 25% rule of thumb is significant. If you’re involved in patent litigation, be sure to evaluate your damages evidence in light of *Uniloc*. ♦

3 ways to communicate with a valuation professional

Nothing’s more frustrating than sitting down for a consultation with a valuation professional and finding that you don’t fully understand the process and how an appraiser arrives at a certain value. To avoid miscommunication, make sure you follow these three simple instructions.

1. Let your valuator educate you

You undoubtedly understand how to run your business, but do you know how to place a value on it?

Probably not. That’s why you need to listen to and learn from your business valuator. He or she can help you understand the various standards of value.

For example, most appraisals call for “fair market value,” which is the price at which property would change hands in a hypothetical transaction involving informed buyers and sellers not under duress to buy or sell. But some assignments call for a different standard of value. A company that’s considering



acquiring a competitor might be more interested in “strategic value,” which is the value to a *particular* investor. Keep in mind that, in court, a judge may disregard an expert opinion that measures an inappropriate standard of value.

Two bases of value — controlling and minority — typically apply to private business interests. Valuators consider the basis of value when selecting valuation methodology and applying valuation discounts. In addition, valuations are valid as of a specific date and for a specific purpose. Never reuse a valuation prepared for, say, gift tax purposes, later — unless your valuator specifically approves it.

The appraisal purpose dictates which valuation techniques are used. For example, a divorce case might require the valuator to separately value professional and entity goodwill for equitable distribution of the marital estate.

2. Define valuation parameters

It’s important to define the valuation parameters as well as other services that might be required. For instance, consider the report type. An oral presentation may suffice in some situations, such as

preliminary settlement talks or merger consulting. But most assignments call for greater formality.

The appropriate format is a function of the client’s preferences, the valuation purpose and the users of the valuation. For example, the U.S. Tax Court typically substitutes an appraiser’s oral direct testimony with his or her written report. So, detailed written reports are usually necessary for tax-related valuations.

In some situations, financial expertise beyond appraisal is needed. Also, anticipate any ancillary services, such as purchase price allocation and other postacquisition accounting issues, so you can work with your appraiser from the outset to determine which services he or she will handle.

3. Develop an engagement letter

A valuator normally summarizes the project’s details in an engagement letter, which serves as a legal contract between the client and the appraiser. One of the main purposes of the engagement letter is to achieve an understanding between the client and the valuator. Therefore, it should discuss the valuator’s duties, scope and responsibilities, as well as the proposed appraisal costs, retainers and late fees, if applicable.

The appropriate format is a function of the client’s preferences, the valuation purpose and the users of the valuation.

Sometimes, the assignment’s scope or the definition of value changes. In such cases, your valuator probably will require you to sign a revised engagement letter or an addendum to the original contract.

Keep it on track

Once you and your valuator agree on the scope of the valuation, you’ll need to schedule a time for a management interview, as well as deposition and trial dates for litigated engagements. It’s often helpful to compile a timeline for completing major milestones in the valuation process. ♦

Valuing a business with significant real estate assets

Often, a business's value is closely linked to the value of its real estate. In such cases, a valuation approach that yields separate values for the business and the real estate may produce more accurate results. Let's take a closer look.

Primary or secondary role

The impact of real estate on business value depends on the role it plays in the business. For some businesses — such as cemeteries, amusement parks and certain farming operations — their value is inextricably tied to the real estate. Not only is the real estate itself the focus of the business, but it would be difficult or impossible to use it for any other purpose. In these situations, a valuation of the real estate (and, for the most part, the business itself) usually focuses on the property's income-generating potential.



Other businesses have special real estate needs, but their revenues are derived from producing goods or providing services. Examples include gas stations, restaurants and auto dealerships — all of which have specific real estate requirements but whose activities don't focus on the real estate itself. Typically, these properties can be adapted for other uses without exorbitant expense. In these situations, valuers may

separate the business from the real estate and then value each on a standalone basis.

Valuation methodology

Keep in mind that the need for separate valuations of business and real estate arises only when the same person or persons own both. Under those circumstances, business and real estate values may overlap, which isn't an issue when a business rents its facilities from a third party.

Businesses and real estate are generally valued using one or more of the three basic valuation approaches — income, market and cost — although the methods may be somewhat different. Businesses that own their own real estate generally don't record any rental expense; they incur related expenses such as building depreciation, real estate taxes, building insurance, and repairs and maintenance. Also, a real estate appraiser using the income approach may overvalue the real estate if cash flows from the business itself are included in the computation.

Standalone business and real estate valuations often produce more accurate results. A valuator removes real estate-related expenses (such as those mentioned above), determines the real estate's fair market rent and deducts that amount from the business's cash flows as if it were paying rent to a third party. Fair market rent is also used in the income stream on which the real estate's value is based. The business and real estate values are then combined to arrive at the enterprise's total value.

Teamwork required

It's important for business valuers and real estate appraisers to work together. To produce meaningful results, the two experts should agree on a fair market rent for use in valuing both the business and the real estate. ♦