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When is a *Daubert* challenge justified?

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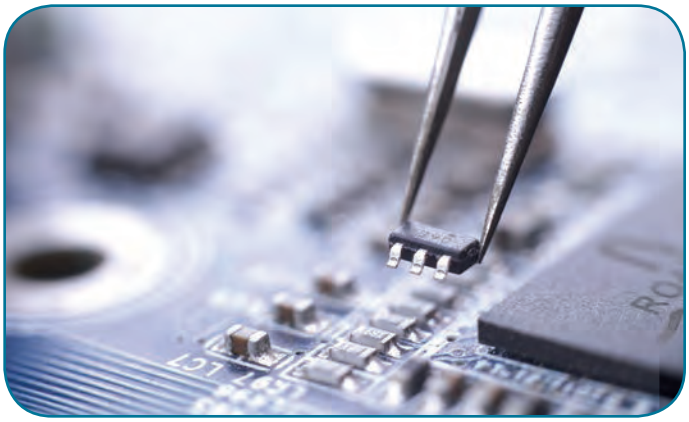
A district court judge recently noted that the percentage of successful *Daubert* challenges to damages in patent cases is "exceedingly small." Yet, he said, "Every once in a great while, a *Daubert* challenge to a patent damages expert is justified." The judge found that to be the case in *Dynetix Design Solutions, Inc. v. Synopsys, Inc.* where the patent expert's reasonable royalty testimony was neither reliable nor tied to the facts.



THE EXPERT'S TESTIMONY

Calculating a reasonable royalty is a two-step process. First, an expert determines the revenue pool implicated by the infringement (the royalty base). Then, the expert determines the percentage of that pool adequate to compensate the plaintiff for that infringement (the royalty rate).

> *The law required the expert to tailor the royalty rate to the specific facts of the case — including the particular technology, industry or party.*

In *Dynetix*, the plaintiff's expert began by determining the royalty base. The patented feature was only one of many features in the defendant's product. Nevertheless, the expert determined that the royalty base would be the entire sales of the product because the defendant hadn't separately sold any smaller unit with the patented component. He didn't further apportion the royalty base to account for nonpatented features.

Moving on to the royalty rate, the expert divided the gross margin of the infringing product between the two parties equally. He then applied the *Georgia-Pacific* factors for determining reasonable royalties to alter the rate. Focusing on the third and fourth factors — the nature and scope of the hypothetical license in terms of exclusivity and the licensor's policy for maintaining its patent monopoly by limiting licensing — he reduced the royalty rate to 19%. After making a couple more adjustments, the expert reached a royalty rate of 14.25%. He applied that rate to the royalty base for the relevant time period and concluded that the reasonable royalty would be about $156 million. Because only one of the two components originally accused of infringement remained in the case, he ultimately apportioned 75% of the royalty to the remaining component, resulting in a royalty of about $117 million.

THE COURT'S REASONING

The district court rejected the royalty base, finding that the expert had failed to apportion profits between the patented feature and the numerous noninfringing features in the defendant's product. Although he was correct that the smallest salable infringing unit was the defendant's entire

LIMITS TO THE GATEKEEPER ROLE

The Supreme Court's *Daubert* decision assigned district courts a "gatekeeper" role in admitting expert testimony and evaluating its reliability. But a recent case demonstrates that this role has limits.

Manpower, Inc. v. Insurance Co. of the State of Pennsylvania involved a dispute over reimbursement for business interruption losses under an insurance policy. The insured's forensic accounting expert opined on the total loss, and the insurance company moved to exclude the testimony, claiming it wasn't the product of reliable methodology.

The district court found that the expert had followed the insurance policy's prescribed methodology for calculating losses. However, the reliability of the expert's calculations turned on whether he'd used reliable methods when selecting numbers for the projected total revenues and expenses. The court held that the expert's method for projecting revenues wasn't reliable due to his estimated growth rate, and it excluded his testimony. The insured party appealed.

The court of appeals acknowledged that district court judges have "considerable leeway" in determining whether particular expert testimony is reliable. It pointed out, though, that a district court "usurps the role of the jury … if it unduly scrutinizes the quality of the expert's data and conclusions rather than the reliability of the methodology."

The appellate court concluded that the district court's concerns here implicated not the reliability of the expert's methodology but the resulting conclusions. The district court took issue with his selection of certain data, but the selection of data inputs to apply in a model is a question separate from the reliability of the methodology reflected in the model itself.

The appellate court cautioned that it wasn't saying an expert can rely on data with no quantitative or qualitative connection to the methodology. Experts must use the type of data on which specialists in the field would reasonably rely.

product, he shouldn't have ended his analysis there. He also needed to determine the infringing component's value relative to the entire product's other components. This failure to apportion alone justified exclusion of his opinion.

However, the court also rejected the royalty rate, finding that the expert's analysis only compounded the problems with his opinion. Half of the gross margin for the infringing profits may indeed have been "one reasonable starting point," but the law required the expert to tailor the royalty rate to the specific facts of the case — including the particular technology, industry or party. As the court explained, "an arbitrary starting point is impermissible under *Uniloc*."

In *Uniloc*, the Federal Circuit rejected a "25% rule of thumb" profit margin for starting the royalty rate calculation. The 50% starting place here, the district court said, was even more arbitrary because the expert based it solely on his own experience and judgment, without considering analogous licenses offered in the industry or the nature of the patented component as a small and optional feature in the product.

Notably, the court's striking of the expert testimony wasn't the end of the matter. Instead, the court granted the plaintiff five days to submit a new expert report on damages.

HERE TO STAY

Some have questioned the "gatekeeper" role of courts in admitting and evaluating the reliability of expert testimony. (See "Limits to the gatekeeper role" above.) Yet many courts continue to exclude testimony based on *Daubert* objections. So it's important for attorneys to keep abreast of developments in this area and always work with qualified experts.

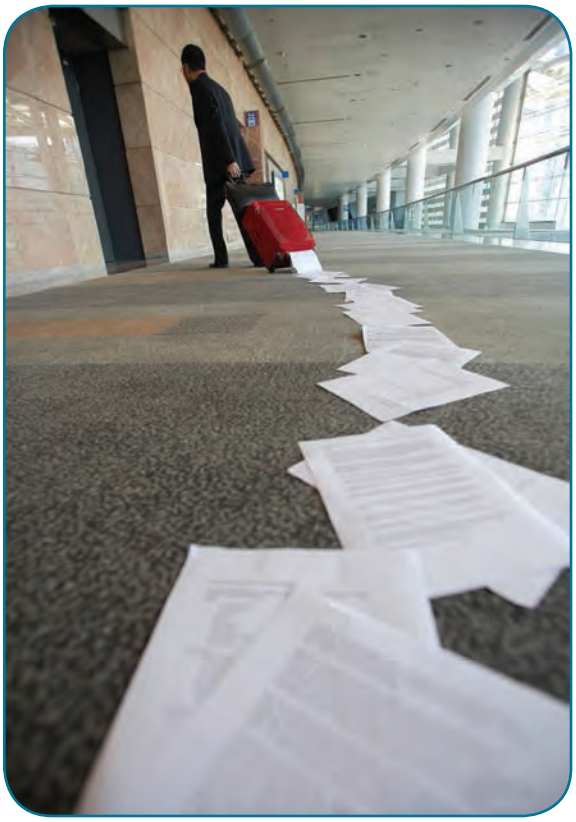
Following the paper trail

How financial statements reveal corporate fraud

The U.S. economy is finally recovering from the effects of the recession, but at least one major financial risk remains — corporate fraud. Fortunately, a fraud expert can help companies and investors minimize losses from fraudulent conduct by scrutinizing a business's financial statements.

FICTIONAL FINANCES

Corporate fraud often is concealed when a company intentionally misrepresents material information in its financial reports. Such misrepresentations can result from the misapplication of accounting principles, overly aggressive estimates of figures and material omissions. For example, financial statements might report fictitious revenues or conceal expenses or liabilities to make a company appear more profitable than it truly is.



To cover fraud, perpetrators often conceal or omit information that could damage or improperly change the bottom-line results that appear in financial statements. Such omissions include:

- Events likely to affect future statements, such as impending product obsolescence, new competition and potential lawsuits,
- Liabilities such as loan covenants or contingency liabilities,
- Accounting changes that materially affect financial statements — including methods of accounting for depreciation, revenue recognition or accruals — and are subject to disclosure rules, and
- Related-party transactions, or those with a party with whom a member of management has a financial interest.

Perpetrators also might engage in fraudulent manipulation, particularly in the areas of revenues, expenses, reserves and one-time charges. Falsified financial statements can recognize sales prematurely, improperly value sales transactions (by, for example, inflating the per unit price) or report phantom sales that never occurred. Conversely, expenses can be manipulated by delaying their recognition — whether to match the expenses with their corresponding revenue or to avoid reporting a loss. Another trick is to improperly capitalize expenses so they appear on the company's balance sheet rather than its income statement.

In some cases, fraudulent financial statements show reserves that have been calculated using bad-faith estimates. For example, fraudsters could justify a smaller amount of reserves by underestimating the percentage of uncollectible receivables. One-time charges, such as a write-off of goodwill or charge for research and development costs for a specific product, can further distort financial statement figures.

READING BETWEEN THE LINES

When fraud is suspected, a CPA can dig into complex financial statements and uncover manipulation that might not be apparent to the untrained eye. A fraud expert begins by reviewing the suspicious statements for unusual trends and relationships. Any leads are followed by more intensive forensic accounting work, such as analysis of specific transactions, journal entries, work papers and supporting documentation. This type of examination goes far beyond a standard annual audit.

The CPA also may employ several types of analyses. *Vertical analysis* compares the proportion of each financial statement item — or groups of items — to a total within a single year that can be measured against industry norms. *Horizontal analysis* compares current data with data from previous years to detect patterns and trends. *Financial ratio analysis* calculates ratios from the current year's data and compares those with previous years' ratios for the company, comparable companies and the relevant industry. The expert, of course, must have experience in the subject industry and be able to recognize noncompliance with Generally Accepted Accounting Principles.

In fact, noncompliance is a significant red flag for financial statement fraud. The Association of Certified Fraud Examiners (ACFE) has identified several other behavioral red flags, including employees who live beyond their means and exhibit a cavalier attitude toward internal controls.

KEEP A LID ON FRAUD COSTS

The ACFE has estimated the median loss in financial statement fraud schemes at $1 million — to say nothing of the public relations damage that rogue executives who manipulate the numbers can cause. With their vast experience in crawling over financial statements, qualified CPAs can help limit your clients' losses.

Standards of value: A cheat sheet

Attorneys aren't expected to be valuation experts. That's why they hire professional appraisers when clients need a company or business interest valued for litigation, tax or other purposes. But a basic understanding of the various standards of value enables you to work more effectively with your expert — and better serve your clients.

FAIR MARKET VALUE

The most widely recognized standard of value is fair market value (FMV), which is almost always used for valuing business interests for estate and gift tax purposes. The IRS defines FMV as the price at which the property would change hands between a hypothetical buyer and seller who have reasonable knowledge of the relevant facts and are under no compulsion to enter into the transaction.

FMV reflects the price at which a transaction would occur under the conditions that existed as of the valuation date. For some standard-setting bodies, FMV represents the highest and best use that the property could be put to on the valuation date, taking into account special uses realistically available. It doesn't matter whether the owner has actually chosen that use for the property.

FAIR VALUE

According to the Financial Accounting Standards Board, fair value (FV) is the price it would take — in an orderly transaction between market participants — to sell an asset or transfer a liability in the market where the reporting entity would typically transact for the asset or liability.

The FV standard usually is applied for financial reporting purposes. But it's also used in shareholder or divorce litigation and is generally defined by state law in such cases. In many states, FV for litigation involving dissenting shareholders is considered to be the pro rata share of a controlling level of value. Thus, control and/or marketability discounts generally aren't applied.

INVESTMENT VALUE

Investment value represents the value of an asset to a specific investor. For real estate purposes, it's typically defined as the value of an investment to a particular investor or class of investors based on their investment requirements. Value is estimated by discounting an anticipated income stream while also considering potential benefits from synergies such as revenue enhancement or lower expenses.

Investment value can vary from FMV for several reasons. These include contrasting estimates of future income and different perceptions of risk. There may also be income status differences and synergies with other operations owned or controlled by the investor. In shareholder litigation, investment value is based on earning power. But the appropriate discount or capitalization rate typically is a consensus rate that isn't specific to any investor.

INTRINSIC VALUE

Intrinsic value usually is employed when valuing an equity share to determine its "real worth." Also known as fundamental value, intrinsic value considers an asset's primary value. Relevant factors include:

- The value of the company's physical assets,
- Expected future interest and dividends payable,
- Expected future earnings, and
- Expected future growth rate.

Some appraisers use the term "intrinsic value" to refer to investment value. Others use it to describe the independent analysis of an investment analyst, banker or financial manager. And courts don't always clearly define the term, either. Therefore, appraisers are challenged to establish a clear, upfront definition with clients and attorneys.

SIFTING THE OPTIONS

How do valuation experts decide which standard to apply when performing a business appraisal? Professional judgment certainly factors into the decision. And the appropriate standard often is determined by state or federal statute, case or administrative law, or specific court orders. Corporate documents, such as buy-sell agreements or articles of incorporation, also might dictate the applicable standard.

Tax issues may make dividing a CRT difficult

When dividing assets in divorce, charitable remainder trusts (CRTs) usually are split 50-50 into two separate trusts, in accordance with IRS Revenue Ruling 2008-41. Tax issues, however, can make such divisions trickier than they might first appear.

RELIEF FROM EXCISE TAX

Two types of CRTs, charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs), are considered "split-interest trusts." This means that they generally are subject to Section 507(a) of the Internal Revenue Code (IRC) as if they were private foundations. The provision imposes a termination or excise tax when a private foundation's tax status is terminated. But does the transfer of assets from a private foundation (or CRT) to another private foundation (or CRT) — as when divorce assets are split — trigger the tax?

Because distributions are made pro rata, the remainder interest is preserved for charitable interests.

Revenue Ruling 2008-41 notes that, in the case of such a transfer pursuant to an "adjustment, organization or reorganization" that "includes a significant disposition of assets," the transferee foundation isn't treated as a newly created organization and the excise tax doesn't apply. This disposition of assets includes the transfer of a total of 25% or more of the fair market value (FMV) of the net assets of the original private foundation to one or more private foundations.

In the scenario above, 100% of a CRT's FMV would be transferred. Thus, no excise tax applies.

DISQUALIFIED PERSONS

However, CRATs and CRUTs also are subject to IRC Sec. 4941(a)(1), which imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation. Self-dealing includes any direct or indirect transfer of the income or assets of a private foundation to a disqualified person. It also includes use of such income or assets by — or for the benefit of — a disqualified person.

Although Revenue Ruling 2008-41 states that divorcing spouses might be disqualified persons with respect to their original trust (creating the potential for self-dealing), spouse recipients are insulated from self-dealing with respect to their interests upon the trust's division. Because distributions are made pro rata, neither spouse receives any additional interest in the original trust's assets and the remainder interest is preserved for charitable interests.

PROPER DIVISION

In general, trusts that are properly divided during divorce will still qualify as CRTs — and thus avoid certain taxes. So be sure to work with financial professionals experienced in handling these types of assets.