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Intellectual property is playing a critical role in today’s technology-driven world. And as IP owners aggressively protect their rights, patent infringement litigation is becoming increasingly common.

U.S. patent law authorizes a court to award damages “adequate to compensate for the infringement but in no event less than a reasonable royalty” for the infringer’s use of the invention. Reasonable royalties represent the statutory minimum, but plaintiffs often are able to recover greater amounts in the form of lost profits. How both are determined depends on a variety of factors.



Computing reasonable royalties

A reasonable royalty generally is defined as the amount that a hypothetical willing buyer and willing seller would agree upon as an appropriate payment for the use of the patent. Some courts may be willing to award royalties at a higher rate to serve as a deterrent to infringement. The rationale is that, if plaintiffs aren’t entitled to something beyond a reasonable royalty, infringement becomes a vehicle that allows competitors to effectively extract court-imposed licenses from patent owners.

Courts normally apply the 15 “Georgia-Pacific” factors to determine a reasonable royalty:

1. Established royalties — that is, actual royalties received by the patent holder for licensing the patent at issue.
2. Rates paid by licensees of comparable patents.
3. Nature and scope of the license (exclusive vs. nonexclusive, field or industry of use, geographic restrictions).
4. Patent holder’s licensing policies (no licensing, restricted licenses only).
5. Commercial relationship between the patent holder and the licensee (competitors, joint venturers, inventor and promoter).
6. Effect of the infringement on sales of the licensee’s other products.
7. Duration of the patent and term of the license.
8. Established profitability, commercial success and current popularity of products made under the patent.
9. Utility and advantages of patented products over old modes or devices used for similar purposes.
10. Nature of the patented invention, character of its commercial form as produced by the licensee and benefits to users of the invention.
11. Extent of use of the invention by the licensee and value of that use.
12. Portion of the profit that may be customary in the industry to allow for the use of the invention or similar inventions.
13. Portion of the profit attributable to the use of the invention vs. nonpatented elements added by the infringer.
14. Opinion testimony of qualified experts.
15. Amount that a reasonable licensor and licensee would have agreed upon for the license, immediately prior to the infringement.

Not all of the factors are relevant in every case, but in determining reasonable royalty damages experts consider whether each factor is relevant, and, if so, its impact.

Recovering lost profits

Plaintiffs rarely settle for reasonable royalties, instead seeking lost profits whenever possible. The Sixth Circuit established the benchmark for lost profits damages in *Panduit Corp. v. Stahl Bros.*, outlining four components a plaintiff must establish to recover damages: 1) demand for the patented product; 2) an absence of acceptable noninfringing substitutes; 3) the patent holder's manufacturing and marketing capacity to exploit the demand; and 4) the amount of profits the patent holder would have earned but for the infringement. Other courts have held that there's no one "right" method for computing lost profits, but the *Panduit* criteria represent the most common approach.

Some of the *Panduit* components have evolved over time, though, including requiring an absence of acceptable noninfringing substitutes. Since its decision in *State Industries, Inc. v. Mor-Flo Industries, Inc.*, the Federal Circuit has allowed plaintiffs to recover lost profits based on market share if acceptable substitutes are available. The infringer's sales are allocated to the other sellers in the market on a pro-rata basis, thereby accounting for the effect legal competition would have had on the plaintiff's profits.

Similarly, several courts have clarified the phrase "manufacturing and marketing capacity." These courts consider whether a defendant's manufacturing and marketing capacities are stronger than the plaintiff's, examining factors such as production facilities, marketing expertise and budgets, distribution channels and brand loyalty.

If a plaintiff succeeds in satisfying *Panduit*, it must put forth a unit price. The unit price could be the price the plaintiff charges on its sales or the price the defendant charged, assuming their products were sufficiently comparable. Of course, the competition

BEYOND ROYALTIES AND PROFITS

In some cases, plaintiffs can recover damages in addition to reasonable royalties or lost profits. Theories include:

Price erosion. Price erosion is based on the infringer's presence in the marketplace. But for that presence, the argument goes, the plaintiff could have sold its product at a higher price. Proving price erosion requires a comprehensive market analysis of competitive factors, such as market shares, price elasticity and the plaintiff's cost structures. An expert also will adjust for the laws of supply and demand to formulate the state of the market in the absence of the defendant.

Lost collateral sales. A plaintiff may seek damages for diminished sales of items related to the patented product. The manufacturer of a patented razor, for example, may also suffer losses in sales of unpatented razor blades. To recover under this theory, the plaintiff must show that a product's patent-related features drive customer demand and that the patented and unpatented components combine to form a functional unit.

Accelerated market entry. In cases where a patent was nearing its expiration date at the time of the infringement, a plaintiff might assert that the defendant enjoyed accelerated market entry. By earning a place in the market earlier than legally allowed, the defendant causes the plaintiff to lose sales and profits even after patent protection has lapsed.

Enhanced damages. Patent law allows for treble damages for willful infringement. An award of enhanced damages lies in the court's discretion but must be commensurate with the level of culpability. The court will weigh factors such as whether the infringement was deliberate, whether any attempts were made to conceal infringement, the defendant's remedial actions, and the defendant's size and financial condition.

created by the infringement may have pushed down the price for both parties.

Framing a damages strategy

As businesses increasingly rely on patented intellectual property, more attorneys will find themselves facing the decision between reasonable royalties and lost profits. A damages expert can help you determine the best strategy for pursuing patent damages and structure the necessary discovery requests. ✧

True value

Setting the purchase price in a buy-sell agreement

Buy-sell agreements play an instrumental role in many closely held companies, providing an avenue for liquidity and ownership transition. An agreement's valuation provision — which is typically based on a formula or an independent appraisal — is critical.

Agreement benefits

Properly structured buy-sell agreements offer several benefits to owners of closely held businesses. They can be used to:

- ✓ Restrict ownership to family members or specific individuals,
- ✓ Preclude stock transfers that could endanger a company's S-corporation status,
- ✓ Provide liquidity for the family of a deceased shareholder,
- ✓ Create an exit strategy for shareholders, and
- ✓ Avoid misunderstandings and disputes.

The valuation stage in particular is ripe for disputes. An agreement must be very clear about the standard of value and how a valuation figure is determined, whether by formula or independent appraisal.

Potential valuation formula pitfalls

A formula may seem like the simplest way to set the purchase price in a buy-sell agreement. But even with ostensibly straightforward formulas, problems can arise. After all, a formula that treats all parties fairly at the time the agreement is drafted may not do so down the road.

Valuation formulas generally rely on objective elements such as earnings multiples, book value or adjusted book value. But a formula cannot account for subjective elements such as the specific company risk premium and the business's expected future



growth rate. Some objective elements, like the state of the economy or the industry, may also escape consideration in formulas.

It is possible, too, that the parties might misinterpret the term “fair market value.” Minority interest owners may mistakenly interpret the term to mean a pro-rata share of the company's value as a whole, without grasping the impact of marketability and control discounts that can dramatically reduce the value of their interests.

If an agreement must depend on a valuation formula, the formula should incorporate some flexibility. It should take into account economic, industry and company-specific factors to increase the odds of reaching a reasonable capitalization rate under the build-up method, which uses subjective factors.

Advantages of independent appraisals

Independent appraisals are generally preferable to rigid formulas. A full valuation will consider both objective elements — such as risk-free rates of return, equity risk premiums and small-company risk premiums — and subjective elements.

And the IRS is more likely to accept an independent appraisal than a valuation formula in determining the value of a business interest for estate and gift tax purposes. If the IRS believes a formula was intended to accomplish testamentary goals, it might disregard the valuation and assess additional taxes. In many cases, the cost of convincing the IRS that a valuation formula is fair exceeds the cost of conducting periodic appraisals.

Valuation methods primer

An appraiser may rely on one or more of several common valuation methods:

Book value (net asset value). Under this method, value basically is a business's net worth, based on the assets and liabilities on its books. The method is simple, but it relies on historical costs, which often fail to capture accurate values over time for assets like real estate and intangibles.

Capitalization of earnings. The appraiser estimates an acceptable rate of return on a buyer's investment in the business, reflecting the risk related to the business. The rate of return is applied to the anticipated earnings stream, based on the business's average net earnings over several years.

Excess earnings method. The appraiser estimates the value of the company's net tangible assets and applies an appropriate rate of return to determine

earnings attributable to those assets. These earnings are subtracted from the company's total earnings to arrive at excess earnings — that is, earnings above a fair return on net tangible assets. The appraiser applies a capitalization rate to excess earnings to estimate the value of the company's goodwill and other intangibles.

Discounted cash flow. The DCF method projects future net cash flows over a period by adjusting earnings for noncash expenses and deducting a reasonable sum for future capital expenditures and liability payments. An appraiser determines the present value using a discount rate.

Sales multiples. The appraiser applies an industry multiplier to the business's average revenue stream over several years, also using rules of thumb that reflect the performance of the average business in the industry.

Staying current

Regular valuations (preferably annually) can help avoid disputes and ensure that adequate funding is available if a triggering event occurs. If a buy-sell agreement uses a formula approach, the parties should update the valuation provisions at least once a year to make any necessary adjustments to the formula in light of any recent changes to the business. ✧

Forensic experts can help you comply with new electronic discovery rules

Last spring, the U.S. Supreme Court approved amendments to the Federal Rules of Civil Procedure that address the discovery of electronically stored information (ESI). The amendments are intended to accommodate differences between electronic and conventional discovery. Attorneys working with electronic discovery should involve forensic experts early in the process. An expert can provide critical input when framing the ground rules that will govern the discovery of ESI.



Pretrial and production issues

Amended Rule 16 establishes a process for the parties and the court to address early issues pertaining to the disclosure and discovery of ESI. And Rule 26(f) is amended to direct parties to discuss discovery of ESI if such discovery is expected, including the form and preservation of ESI, problems associated with reviewing ESI and the assertion of privilege after production.

The notes to Rule 26(f) encourage attorneys to consider early depositions of “individuals with special knowledge of a party’s computer systems” and warn against failing to address preservation issues early in the litigation. Both of these areas are best handled with the aid of electronic evidence experts.

Rule 26(a) specifically adds ESI as a category of information subject to disclosure very early in a case. Rule 26(b) limits a party’s obligation to produce ESI that is “not reasonably accessible because of undue burden or cost.” The producing party carries the burden of making the required showing.

The rule also tackles inadvertent production of privileged material. It provides a procedure for claiming privilege or protection from disclosure as “trial-preparation material,” as long as the producing party gives notice within a reasonable time that inadvertently produced ESI is privileged. The receiving party must promptly return, sequester or destroy the information until judicial disposition of the issue.

The amendments firmly establish the relationship of ESI to other areas of discovery. Rule 33(d) expressly provides that interrogatory answers that require review of “business records” also involve a search of ESI. Rule 34 makes ESI a separate category of production from “documents,” authorizes a requesting party to specify the form of production and provides an opportunity for the responding party to object.



The default form for producing ESI is that “in which it is ordinarily maintained or in a form or forms that are reasonably usable.” A responding party need not produce the same ESI in more than one form.

An expert can help bolster a party’s argument on responsiveness as well as reasonable accessibility.

Routine destruction of ESI

The amendments recognize that many companies routinely delete electronic data without any intent to destroy evidence. Rule 37 creates a safe harbor that protects a party from sanctions for failure to produce ESI if the party took “reasonable steps to preserve” ESI when it knew or should have known the information was discoverable. The safe harbor also applies if the failure occurred because information was lost during “routine, good-faith operation” of a party’s ESI system.

Extracting relevant data

Identifying and extracting relevant data from the mountains of information produced also requires forensic expertise. And the amendments don't include bright-line rules for determining whether produced data is responsive. An expert can help bolster a party's argument on responsiveness as well as reasonable accessibility.

The new world of e-discovery

The FRCP amendments take effect on Dec. 1, 2006, unless Congress intervenes. It is not expected to do so. Parties that fail to satisfy the new electronic discovery requirements could face costly sanctions, from fines to adverse jury instructions to default judgments. Forensic experts can help minimize these risks. ✧

TAKING A BYTE OUT OF CRIME *AN INTRODUCTION TO COMPUTER FRAUD*

Virtually every phase of computer operations is vulnerable to fraudulent manipulation. A particular phase may serve as the ultimate target of a fraud scheme, a tool in the commission of the scheme or both. While computer fraud can take many forms, the following types of fraud are common:

Computer manipulation. Computer manipulation fraud usually targets intangible assets represented in a data format, such as deposited money or credit card information. Advances in remote access to databases replete with such data provide fraudsters with the opportunity to carry out their schemes from afar. Because assets stored in data format frequently boast a much higher value than other economic assets, the losses from their theft can be significant.

Program manipulation. Program manipulation is performed by a fraudster with knowledge of the particular computer system and program. The perpetrator can leverage that knowledge to alter existing programs or tuck new programs into the computer system. Fraudsters can exploit such manipulated programs to perform unauthorized functions. Program manipulation is tricky to uncover and often goes undetected for long periods of time.

Input manipulation. The most common type of computer fraud involves the manipulation of input, usually through the intentional entry of false data, like credits for merchandise returns that did not actually occur. A fraudster needs no specialized knowledge or expertise — just access during the input phase of operations. Input manipulation is easy to do and difficult to detect.

Output manipulation. Output manipulation typically is accomplished by manipulating output-related computer codes. One of the outputs of an automated teller machine, for example, is cash. Fraudsters can encode false electronic data on the magnetic strips on bank and credit cards to induce an ATM to dispense money.



Document manipulation. Two types of document manipulation, or forgery, implicate computers. Documents stored in electronic form can be forged by changing or copying the original documents. Technological developments, like high-quality home laser printers, also make forgery more likely. Little computer expertise is required to create counterfeit checks, invoices, letterhead and other documents, either with or without originals.

Understanding the most common types of computer fraud makes it easier to uncover schemes. But computer and other types of fraud are dynamic and take advantage of ongoing technological developments. Forensic specialists can prove invaluable in the virtual hunt.