

# — Advocate'sEDGE —



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# Putting a price on intangibles

*Intellectual property requires valuation smarts*

Intellectual property (IP) such as patents, copyrights and trademarks can present some of the most difficult business valuation challenges. The American Society of Appraisers (ASA) has recognized this by issuing a standard for valuing such intangible assets. The standard, known as BVS-IX, *Intangible Asset Valuation*, gives attorneys an idea of what to expect from their valuation experts and provides a baseline for evaluating the work of opposing experts.

## MANY CONSIDERATIONS

Qualified appraisers generally apply one or more of three methods when valuing an intangible asset such as IP. Under the income approach, the

appraiser considers the economic benefits that are reasonably attributable to the subject asset and the risks associated with realizing those benefits.

With the market approach, the appraiser considers the relevant differences between the subject and guideline assets. And with the cost approach, he or she considers the direct and indirect costs associated with the reproduction or replacement of the subject asset and accounts for any loss of value due to functional or economic obsolescence or reduced life expectancy.

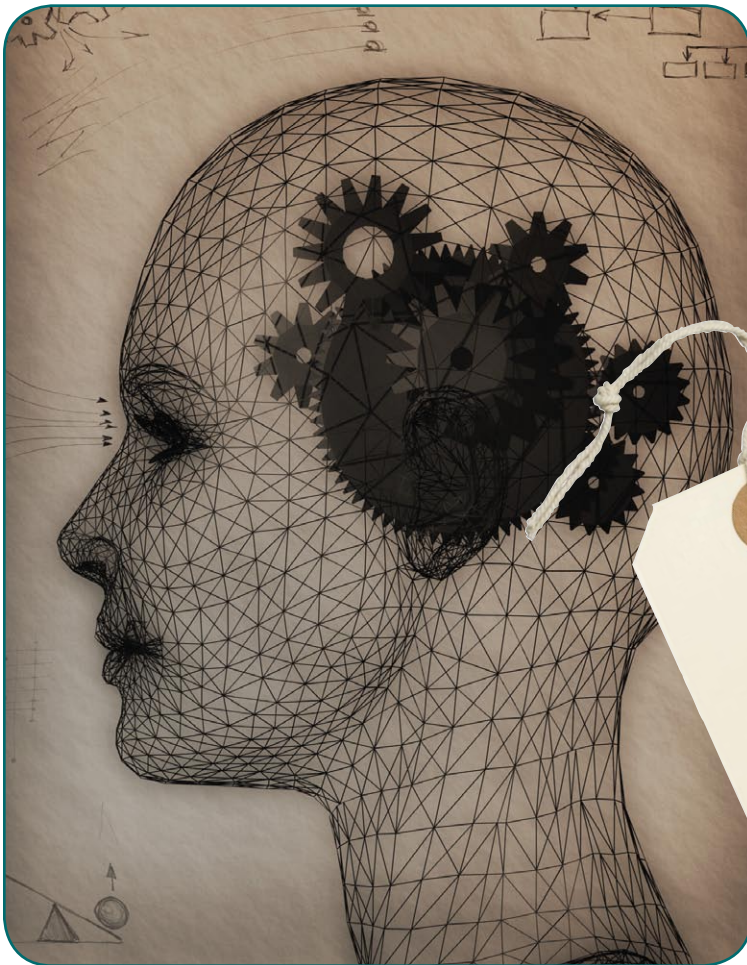
The ASA standard for intangible property enumerates several factors that appraisers — whichever valuation approach they take — should consider when valuing an intangible asset, such as its history and expected remaining economic and legal life. Appraisers are also expected to consider the type of intangible asset to be valued, and apply any additional factors, as appropriate. (See “ASA standard leaves no stone unturned,” on page 3.)

## PATENT-SPECIFIC FACTORS

When valuing a patent, appraisers generally consider an extensive list of additional factors:

### Scope of protection.

Examples include jurisdictional coverage, status of registrations and maintenance fee payments, breadth of patent claims, and alternatives to the patented invention.



**Risk of patent exploitation.** This includes the likelihood of infringement, invalidity, technological or economic barriers to successful commercialization, and alternative innovations that could reduce the patent's economic benefit.

**Public and private information.** This encompasses information about the patent and comparable or competing technologies that's available from sources like the U.S. Patent and Trademark Office (USPTO), the Securities and Exchange Commission (SEC) and market research.

**Patent portfolio factors.** These include relevant synergies enabled by the aggregation of rights, such as the elimination of blocking patent rights.

*The expert reviews public and private information about the subject trademark and comparable or competing marks.*

## COPYRIGHTS AND TRADEMARKS

Copyright valuations, on the other hand, must recognize the scope of protection, including jurisdictional coverage, status of registrations and renewals, and whether the copyright relates to the original work or a particular derivative. Value also is affected by any public and private information that may be available regarding the copyrighted work, and comparable or competing works.

As for trademarks, valuers account for the ability of the holder to extend the trademark to related products and services without infringing on the trademarks of others. The valuator must also consider the nature and extent of protections afforded by any registrations and determine the possibility of abandonment due to nonuse and of the mark becoming generic. Finally, the expert reviews public and private information about the subject trademark and comparable or competing marks, such as USPTO data, public disclosures filed with the SEC, market analysis and research, and surveys.

## ASA STANDARD LEAVES NO STONE UNTURNED

The American Society of Appraisers' intellectual property standard, BVS-IX, *Intangible Asset Valuation*, includes an extensive list of factors for valuers to consider to reach an accurate appraisal of an asset. They include:

- ▶ The economic benefits, direct or indirect, that the asset is expected to provide to its owner during its life,
- ▶ Previous or existing litigation involving the asset,
- ▶ The distinction between an undivided interest and a fractional interest in the asset resulting from, for example, shared ownership or a licensing agreement, and
- ▶ The feasibility and character of potential commercial exploitation of the asset.



## SOME FLEXIBILITY

In most circumstances, appraisers document the relevant factors they considered when valuing a specific intellectual property asset. Note, however, that the ASA standard permits appraisers to depart from any provision where professionals deem it's warranted — as long as the departure is disclosed. But be wary of valuations that fail to make this kind of disclosure, whether presented by your appraiser or an opposing expert. ▶

# Secrets behind securities fraud

Thanks to the widespread popularity of retirement accounts and college savings plans, growing numbers of individuals, entities and institutions have poured into the securities and commodities markets in recent years. Increased participation has, in turn, led to increased opportunities for — and incidents of — fraud. When victimized investors turn to the courts for redress, experienced financial experts are essential to building a strong case.

## PONZIS, PYRAMIDS, PUMP AND DUMPS

Criminals have found many ways to use the securities markets for ill-gotten gains, but these are among the most popular securities fraud schemes:

**Ponzi.** This type of fraud became a household name this past year with the discovery of several such schemes, including that of notorious financier Bernie Madoff. Ponzi schemes use funds collected from new investors to pay off earlier investors, rather than using profits from the purported underlying business. No underlying business in fact exists; the scheme's only source of funding is its victims.

*Ponzi and pyramid schemes are more likely to collapse early in recessionary environments because the pool of potential victims shrinks.*

**Pyramid.** Pyramid schemes are similar to Ponzis, with money from newer victims going to pay off earlier victims. In pyramid schemes, however, the victims are induced to recruit additional victims through recruitment commissions. This can keep a pyramid scheme going indefinitely — or until it runs out of fresh blood.



**Pump and dump.** These schemes create artificial buying pressure for a specific security — usually a low-trading volume stock in the over-the-counter securities market — that's largely controlled by the fraud perpetrator. Thieves typically use deceptive sales practices and false public information releases to encourage investors to buy shares. Once the stock's price is artificially pumped up, the fraudsters quickly sell off, or dump, their shares at a profit.

Pump and dump schemes typically are more prevalent in bull markets. But Ponzi and pyramid schemes have a higher incidence in times of economic crisis and fear, as anxious investors seek ostensibly low-risk investments that promise high returns. Ponzi and pyramid schemes are more likely to collapse early in recessionary environments because the pool of potential victims shrinks and fraud perpetrators are unable to pay off earlier rounds of investors.

## UNLEASHING THE FINANCIAL EXPERT

After the Madoff scheme was uncovered in 2008, an army of financial and forensic experts was brought in to locate what was left of the misappropriated

funds and to trace the transactions that led to huge losses. In many securities fraud cases, however, experts are retained before illegal activity is a certainty to look for signs of fraud and wrongdoing.

Most investigations include close scrutiny of accounts, invoices, purchase orders, e-mail and text messages, and any other potentially relevant sources of evidence. One piece of evidence frequently can lead to another. A qualified expert can identify those red flags that, standing alone, might not stir suspicion, and use them to build a case.

In Madoff's case, for example, his consistently high rate of returns (even when other institutional investors were losing money) raised suspicions among

some industry peers. Starting with such an anomaly might have led a financial expert to Madoff's complicated trading strategies, and then to the fact that he relied on a three-person auditing firm to verify billions of dollars on his firm's financial statements.

## ON THE MONEY TRAIL

Unfortunately, securities fraud perpetrators are always coming up with new ways to cheat investors. Increasingly common schemes keeping experts on their toes include advance fee, unregulated hedge fund, broker embezzlement and late-day trading schemes. Whichever type of fraud you encounter, forensic accountants are ready to help assemble the evidence and testify in court. ▶

## *Lost profits damages*

# The trouble with start-ups and never-started-at-alls

Although calculating lost profits damages for businesses involved in litigation is always complicated, damages experts can use the company's historic financial statements to make their projections. They can, that is, if the business has a history. Calculating damages for early-stage and never-launched businesses requires a different set of analytical tools — including industry data — if experts are to prove to a court's satisfaction that their damages estimates are reasonably certain.

## THE BIG GAP

The problems when estimating damages for new or never-launched businesses stem from a lack of data. Experts generally project the plaintiff business's lost revenues and adjust that amount by appropriate profit margins. They typically base revenue projections on data related to the company's



own projections, its historical performance and its industry, as well as on larger economic conditions and forecasts.

With a new business, experts typically face inadequate or nonexistent performance data and insufficient business data that can be correlated with trend information. How then can a damages expert project revenues and profit margins that will stand up in court?

## MARKET DATA TO THE RESCUE

Fortunately, those calculating lost profits need only determine them to a reasonable certainty. An expert, then, might be able to apply industry growth rate projections to individual company data to develop multiple revenue projections, varying the combinations of actual and projected data.

If the results from the different projections fall within the same range, experts can proceed to use company-specific data to develop cost structures. But if company data is sparse, they may need to determine market share and estimated penetration based on models and studies of new-product lifecycles. They can validate revenue projections with data from governmental agencies, trade associations and other sources that track expected demand, prices and cost structures.

When determining profit margins for new businesses, experts again run into insufficient historical performance data or internal forecasts. Instead, they may rely on internal data and reports, industry forecasts, and other information sources to develop profit margins.

## DISCOUNTS HAVE CURRENCY

As with all calculations of this kind, experts apply a discount to projected lost profits. Courts recognize the need for such discounts on two bases. First, a plaintiff can invest its award and earn an additional return on it — meaning that a plaintiff who receives an undiscounted amount of lost profits would stand to recover more than its actual damages.

Second, projected lost profits necessarily carry an element of uncertainty. In the case of a new business, the discount must reflect the increased risk usually associated with young ventures and the possibly unrealistic — and unreliable — nature of the company's own projections.

## LOOKING TO THE COURTS

The decision of the Court of Appeal of the State of California, Fourth Appellate District, Division 3, in *Parlour Enterprises Inc. v. Kirin Group Inc.* provides some valuable

lessons in how experts can help establish reasonable certainty of damages for new businesses. The *Parlour* court criticized the plaintiff's expert for relying on "groundless pro forma projections" when making his calculations and for failing to prove similarities between the subject company and similar businesses in his market study.

In addition to the importance of expert testimony "supported by tangible evidence with a 'substantial and sufficient factual basis' rather than by mere 'speculation and hypothetical situations,'" *Parlour's* outcome suggests that experts use:

- ▶ Market surveys and analyses, particularly if the market is established,
- ▶ Business records of similar companies,
- ▶ Prelitigation financial projections, and
- ▶ The plaintiff's, or a third party's, prior experience in the same or similar business or industry.

And, of course, the expert should use as much economic and financial data for the subject company as is available.

## EXPERTISE IS ESSENTIAL

Calculating lost profits damages for start-ups and businesses that never even got as far as starting up is a complicated task. Be sure you engage an expert with actual experience with these types of companies. It can mean the difference between your client getting the damages it deserves (perhaps giving the venture a second chance) or walking away with significantly less — possibly even nothing. ▶



# New data sheds light on *Daubert* challenges

PricewaterhouseCoopers (PWC) has been studying *Daubert* challenges to financial expert witnesses since 2000. Its latest round of data shows a continued increase in the number of *Daubert* challenges and reveals some of the factors critical to the outcomes in financial expert testimony challenges.

## LACK OF RELIABILITY

According to PWC's study of 2000–2007 challenges, lack of reliability is closely associated with the exclusion of testimony. In each year examined, it was the leading cause of a financial expert opinion being excluded in whole or in part. (Other major reasons were lack of relevance and lack of qualifications.) In 2007 alone, 75% of the exclusions of financial expert testimony were attributable to the unreliability of the work.

*Lack of reliability was the leading cause of a financial expert opinion being excluded.*

The study identified several “unusual and untested analytical methods” that rendered financial expert testimony inadmissible for unreliability in one or more courts. Business valuations, for example, were deemed unreliable for using unorthodox methodologies such as the “straight-line ramp-up” approach instead of accepted methodologies like income, cost or market. They also were disqualified for failing to consider discounted cash flow analysis as a check against the comparable companies method, and for calculating a business's terminal value by deducting capital expenditures from projected earnings before interest, taxes, depreciation and amortization (EBITDA).

As for damages testimony, applying “consumption theory” to prove damages by estimating losses over a period of time by examining the value of cash assets at two points in time was considered unreliable. Also cited was the use of an unreliable “confusion and dilution” survey to prove damages in trademark infringement litigation.

## DETAILS MATTER

PWC's study determined that the jurisdiction where expert testimony is challenged also influences its success rate. For example, from 2000 to 2007, the Eleventh U.S. Circuit Court of Appeals was more likely to exclude financial experts (69% of testimony excluded in whole or in part) than the First Circuit, which excluded only 21% of challenged financial experts. Overall, *Daubert* challenges to financial experts were heavily concentrated in the Second, Third, Fifth, Sixth and Seventh Circuits.

Further, certain types of financial experts are challenged more frequently. Half of all financial expert challenges were directed at economists, accountants and statisticians. And some legal matters were more likely to see challenges than others, including breach of contract and fiduciary duty disputes. Financial expert testimony was most often excluded in fraud matters.

## READ BETWEEN THE LINES

The data shows that experts are more likely to have their testimony excluded where the court finds a lack of reliability in either the inputs used or the methodology applied. This highlights the importance of retaining qualified experts who satisfy the reliability standards set out in *Daubert* and Rule 702 of the Federal Rules of Evidence, as well as similar state rules. When hiring a financial expert, also consider the jurisdiction and type of matter and be particularly discerning where the risk of testimony exclusion is high. ▀