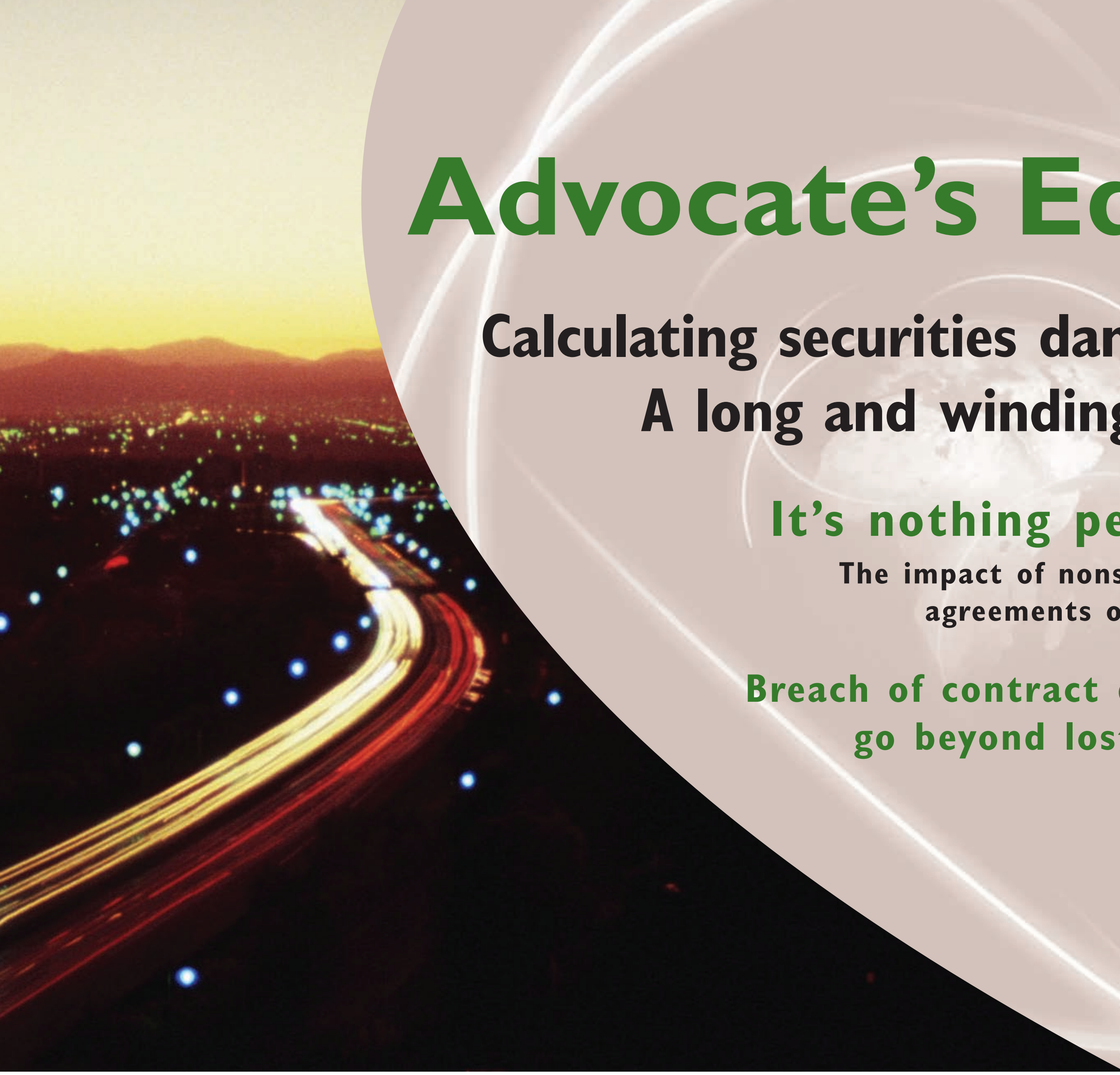

Advocate's Edge

Calculating securities damages: A long and winding road

It's nothing personal

The impact of nonsolicitation agreements on goodwill

Breach of contract damages go beyond lost profits

March/April 2006 **PLUS!** Facts of life: Determining the useful life of intellectual property

Calculating securities damages: A long and winding road

Shareholders continue to bring suits against public companies and their boards of directors under federal securities laws in increasing numbers. They typically allege that the company failed to provide full and fair disclosures of material information, resulting in inflated stock prices. With shareholders joining forces to form class actions, damage awards can be substantial.

The calculation of damages in these cases is a complicated, multistep process. Experts must determine the "true value" of the company's stock during the relevant period and, from that, estimate the shareholders' damages.

Living in the material world

To recover damages in securities actions, shareholders must show that the corporation misrepresented or omitted *material* information. Damages experts, therefore, look for statistically significant price changes in stock that cannot be explained by ordinary market activity.

They begin by comparing daily changes in stock prices with corresponding changes in a benchmark index. This may be an index that covers the relevant company's industry, a broader index like Standard & Poor's or NASDAQ, or a custom index composed of comparable companies. Changes in the company's stock price should correlate generally with the selected index, as evaluated with a simple regression model and excluding earlier periods that saw volatile or unusual movements in either price.

Weighing the effects of multiple simultaneous disclosures, however, can be difficult.

From there, experts use the relationship between the corporation's stock price and the index to project stock price changes. Then they compare the projections to the actual price changes. If the actual changes are statistically different from the projected changes, experts ascertain whether the changes were the result of corrective disclosures of information previously misrepresented or omitted. If so, the disclosure has corrected some degree of the distorted stock price, but price inflation is evidenced.

Experts also conduct a study of events during and after the damages period to determine whether the inflated stock price was attributable solely to the misrepresentation or omission or was affected by general economic conditions, industry-specific circumstances or events within the company. Weighing the effects of multiple simultaneous disclosures, however, can be difficult.

Finding true value

Once experts conclude that a material misrepresentation or omission created a statistically significant price change, the next step is to discern the stock's "true value," that is, the price at which the stock would have traded during the damages period absent any misrepresentations or omissions. The difference between the stock's true value and its actual price is the stock price inflation.

Several methods are available to calculate true value, including:

Constant dollar. Experts use the dollar change in stock price after the corrective disclosure to calculate the stock price inflation for each day prior to the disclosure. This method can work well for short damages periods with little expected fluctuation in the overall securities markets.

Constant percentage. Experts use the percentage change in stock price after the corrective disclosure to measure the stock price inflation for each day prior to the disclosure. This method is often preferred for longer damages periods because it avoids overstatements of stock price inflation when the amount of inflation diminishes as the period progresses.

Constant value. Experts assume that the stock price after the corrective disclosure indicates the stock value for the entire damages period. This approach may be advised when the misrepresentation or omission relates to the company's overall operations and earnings.

An expert might use a single method or a combination, but the selection and weight given to each method depends on the particular facts and circumstances.

Laws resulting from 1929 crash are basis for today's securities claims

Misrepresentations and omissions by public companies can cause investors to purchase overpriced stock, which can lead to substantial economic damages or induce mergers and acquisitions transacted at inaccurate prices. Bearing this in mind, Congress enacted two laws to govern the American markets following the stock market crash of 1929: the Securities Act of 1933 and the Securities Exchange Act of 1934.

Section 11 of the 1933 act covers liability for false registration statements associated with initial public offerings, secondary offerings and acquisitions, requiring full disclosure of all material facts. It specifically addresses registration statements that contain an "untrue statement of a material fact" or omit a material fact required to be stated or necessary to make its statements not misleading. Under the law, shareholders can sue every signer of such a statement, as well as a company's directors and partners, accountants, engineers, appraisers and underwriters.

The 1934 act, which created the Securities and Exchange Commission, requires publicly traded companies to disseminate all relevant information that might affect the price of a security to investors. It calls for publicly held companies to continually disclose information about their business operations, financial conditions and management. Rule 10b-5, which implements the law, expressly declares that omitting such information is as much a violation of the law as providing inaccurate information.

Estimating aggregate damages

The final step is to determine the aggregate shareholder damages. Experts often estimate these damages based on the proportional trading model. This model uses data on outstanding shares and trading volume to estimate the number and price of shares exchanged during the damages period. It then incorporates the stock's true value and price inflation to reach aggregate damages based on the number of damaged shares. The proportional trading model assumes that every share in the "float" (that is, outstanding and available for trading) has an equal probability of trading on any day.

Some critics claim that this model's single-trader approach can inflate damages estimates. This has led to the emergence of a two-trader model, which accounts for investors who buy and hold stock *and* for those who trade more frequently. The participation of frequent traders reduces the number of shares in play because some shares are traded multiple times during the damages period. Some courts have rejected the single-trader approach to proportional trading, so using the two-trader model may be a good idea.

Shareholder litigation on the rise

Recent financial scandals have shaken investor confidence and led shareholders to scrutinize corporate representations. In this environment, it's likely that shareholder suits will become more common. Attorneys and financial experts need to be prepared to tackle the complex challenges of evaluating and measuring the impact of corporate communications on stock prices. ✧

It's nothing personal

The impact of nonsolicitation agreements on goodwill

A recent Florida case, *Held v. Held*, addressed the effect of nonsolicitation and nonpiracy agreements on business goodwill in a divorce context. The court was asked to decide whether there's any distinction between such agreements and noncompete agreements when classifying goodwill as "personal" or "enterprise." In many states, personal goodwill is not considered a marital asset subject to equitable distribution.

Trial court finds enterprise goodwill

The Helds ended their marriage after 33 years. Early on, the husband took over his father's insurance agency after inheriting a share in it. Eventually, he assumed 100% ownership. In 1979, he shifted the agency's focus to high-risk hazard insurance for beachfront condominiums, selling primarily to Florida condo associations. At the time of the final divorce hearing, the agency serviced 60 customer accounts.

At trial, the parties stipulated to an adjusted book value for the agency of about $3 million, but they "hotly contested both the existence and value of the company's enterprise goodwill." The court valued the goodwill at approximately $7.6 million, finding that enterprise goodwill accounted for 37% of the assets equitably distributed.

The trial court assumed that in any sale of the agency, the husband would be required to sign a nonsolicitation/nonpiracy agreement not to solicit existing customers but would not be required to sign a noncompete agreement. A nonsolicitation agreement would prohibit the husband from stealing back any of the agency's 60 or so existing customers, but it would not prevent him from soliciting business from the other 6,000 to 7,000 condo owners in the area. Based on this assumption, the trial court concluded that a purchaser of the agency would not benefit from any of the husband's personal goodwill.

Appellate court weighs in

The appellate court reversed the trial court, citing the "seminal Florida case concerning the goodwill of a business as a marital asset." In that case, the court defined enterprise goodwill as "property of an intangible nature commonly defined as the expectation of continued public patronage." It defined personal goodwill as "a person's probable future earning capacity." The court found that only enterprise goodwill is relevant to equitable distribution, although personal goodwill is relevant to alimony.

The appellate court in *Held* reasoned that, if the agency's value exceeded the value of its assets only if the husband signed a noncompete agreement, then that excess value clearly was attributable to his personal reputation. Further, the court found no distinction between nonsolicitation and noncompete agreements for purposes of distinguishing enterprise from personal goodwill; both limit the seller's ability to conduct business with existing clients.

A change in equitable distribution may necessitate revisiting the calculation of alimony payments.

Thus, the trial court's calculation of enterprise goodwill included an aspect of personal goodwill — the husband's personal relationships with the 60 clients. Goodwill qualifies as a marital asset, the appellate court explained, only when it exists "separate and apart from the reputation or continued presence of the marital litigant."

Expert testimony criticized

The appellate court also scrutinized the testimony of the wife's expert, which the trial court had relied on as the basis for its valuation. The expert reviewed data on sales of comparable businesses obtained from a Web site. He admitted he didn't know whether those sales contemplated the principals' continued involvement in the business or whether noncompete, nonsolicitation or nonpiracy agreements were involved.

In the absence of adequate expert testimony, the appellate court found the record devoid of any competent, substantial evidence of the agency's fair market value.

Back to square one

The appellate court remanded the case for recalculation of the equitable distribution. The court observed that a change in equitable distribution may necessitate revisiting the calculation of alimony payments. Even though *Held* doesn't apply outside Florida, it shows the complexity surrounding goodwill in the context of marital dissolutions and drives home the importance of retaining qualified valuation experts who get it right the first time. ✧

Breach of contract damages go beyond lost profits

In commercial cases involving breach of contract, the parties often turn automatically to lost profits damages as the solution. Lost profits certainly have their place in such cases, but other types of damages and remedies also might be available.

Lost profits basics

Financial experts often invoke business valuation techniques when determining lost profits because the cash flows associated with a contract resemble those considered when valuing a business. In the context of lost profits, experts measure the amount of income lost as a result of the contract breach and apply an appropriate discount rate to obtain the present value. The discount rate varies depending on the facts of the case and accounts for the risk that profits wouldn't have been achieved even without the breach, as well as the time value of money.

Experts begin with a theory of damages, such as "but for the defendant's failure to deliver the parts as promised, the plaintiff would have sold more vehicles." From there, they weigh questions about just how many units the plaintiff would have sold and how much profit the plaintiff would have enjoyed on those sales.

Experts also consider alternative damages theories in anticipation of alternative interpretations of a specific case's law and facts. For each theory under consideration, experts should be prepared to explain to the trier of fact which expenses were considered, which were not, and why.

A spectrum of remedies

Lost profits may come to mind first, but here are other remedies available for breach of contract to keep in mind:

Compensatory damages. These damages, including lost profits, aim to give the plaintiff the "benefit of the bargain" contemplated by the contract. Other compensatory damages might include costs the plaintiff reasonably incurs to secure a replacement contract with another party or otherwise mitigate its damages.

Incidental and consequential damages. These cover foreseeable losses caused by the breach, such as the cost of securing an alternative supply source.

Liquidated damages. When actual damages would be difficult to calculate, the contract may specify an amount of damages ("liquidated damages") to be paid in the event of a breach. Courts often are reluctant to enforce liquidated damages clauses, however, scrutinizing them to ensure they're not unenforceable penalty clauses. A court confronted with such a clause will assess the reasonableness of the agreed-upon amount, the parties' intentions, the proportionality of the amount and the actual loss.

Attorneys' fees and costs. Generally, fees and costs are available only if they're expressly provided for in the contract.

Specific performance. If monetary damages would be inadequate, a court can order performance under the contract. Specific performance is usually reserved for real estate transactions or other unique property or goods.

Rescission. This equitable remedy cancels the contract and excuses both parties from further performance. Rescission might include the return of goods and reimbursement of expenses incurred.

Reformation. Contract terms are amended to reflect the parties' intentions at the time of the agreement.

Bear in mind that in all breach of contract cases plaintiffs are expected to take reasonable steps to mitigate their damages. Failure to do so can reduce their recovery.

Other compensatory damages might include costs the plaintiff reasonably incurs to secure a replacement contract with another party or otherwise mitigate its damages.

Keep your options open

Lost profits may seem the obvious remedy in breach of contract cases, but they rarely represent the only recourse. One or more of the remedies and damages described above also may serve to make the nonbreaching party whole. ✧

Facts of life

Determining the useful life of intellectual property

Calculating an asset's remaining useful life (RUL) is critical to the valuation of patents, copyrights, trademarks and other types of intellectual property (IP). RUL is determined by a wide range of factors, requiring data from an equally wide range of sources.

RUL and valuation methods

An intangible asset's useful life generally is defined as the time period over which the asset is expected to contribute — directly or indirectly — to a company's future cash flows. Not surprisingly, the three major valuation approaches each incorporate RUL.

The cost approach employs RUL to estimate obsolescence. The income approach uses RUL to determine the period over which income is projected. And the market approach considers RUL when evaluating comparables and making any necessary adjustments to bring them into line with the subject property.

A well-rounded life

Calculating an IP asset's RUL requires consideration of a variety of factors that determine how long an owner can expect the asset to generate income:

Statutory term. Statutes limit the duration of the holder's rights and protections for many types of IP. Although owners can renew federal trademark registrations and trade secrets don't require registration, patents and copyrights come with specified terms.

Economic and competitive factors. These affect the asset's ability to generate a sufficient return. They include competition, market demand for products that incorporate the IP and production costs.

Contractual factors. RUL can be restricted by use and development contracts, licensing agreements, transfer price agreements and other contracts related to the asset.

Legal factors. If the IP has been the subject of litigation, any resulting court orders or judgments can rein in RUL. An award of infringement damages, for example, requires a determination of the damages period, which, in turn, can limit the subject asset's legal life.

Regulatory constraints. Federal, state or local regulations can abbreviate an IP asset's RUL, such as those issued by agencies like the Food and Drug Administration or the Environmental Protection Agency.

Technological factors. Advances in technology can lead to obsolescence before a statutory term expires. VHS VCRs replaced Betamax VCRs, and now DVD and DVR players are replacing VCRs, with no regard to their respective patents' statutory lives.

Historical product life cycles. Comparing the life cycles of similar IP assets can help estimate RUL. Certain categories of technology tend to follow similar life patterns, from introduction through adoption and growth to maturity.

Expected depreciation and/or decay. An IP asset can experience depreciation or decay caused by decreasing sales or royalty revenues over time.

Gathering the data

Several types of documents and data often prove critical to performing an RUL analysis:

- ☑ Federal registrations — including applications, registrations and renewal documents,
- ☑ Contracts — all relevant commercial contracts (for example, use and development contracts and licensing agreements),
- ☑ Court orders — documents related to past or future damages,
- ☑ Financial statements — both historical and projected, with emphasis on those documents related to revenues and expenses, such as the cost of goods sold,
- ☑ Operations documents — relevant inventories, engineering documents, source codes, and procedures and policies,
- ☑ Usage data — production and sales volume, the number of products in circulation, contracts that reference usage, and
- ☑ Technological data — data related to earlier and competing technologies found in applications, marketing materials and industry journals.

Specific circumstances and assets might implicate additional sources of data pertinent to the RUL question.

Life as we know it

An asset's useful life rests on much more than its statutory term of protection. A comprehensive analysis is needed to reach an accurate and dependable RUL, which, in turn, will produce reliable valuations.