

ADVOCATE'S EDGE



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What's the fairest method of apportionment?

Court rules on damages from breached lawnmower improvement

When patents covering multicomponent inventions are infringed, a key question is: How should damages be “apportioned” to adequately compensate the patentee for only losses due to infringement of a product improvement? In *Exmark Manufacturing Co., Inc. v. Briggs & Stratton Power Products Group, LLC*, the U.S. Court of Appeals for the Federal Circuit specifically addressed whether apportionment should be based on the royalty base or the royalty rate.

Mower manufacturers meet in court

Exmark and Briggs are competitors in the high-end commercial lawn mower industry. In 2010, Exmark filed a lawsuit against Briggs for allegedly infringing its patent on a mower with improved flow control baffles. (A baffle is a metal structure under the mower deck that directs air flow and grass clippings.)

A jury found that Briggs had willfully infringed Exmark's patent, and so awarded Exmark about \$24 million in compensatory damages. The U.S. District Court for Nebraska subsequently doubled the jury's award as enhanced damages for willful infringement. Briggs appealed to the Federal Circuit. Among other things, the defendant argued that the district court erred by denying its request for a new trial on damages.



Court cuts down defendant's argument

The parties agreed that apportionment was required. But Briggs contended that Exmark's damages expert should have separated the value of the baffle from the accused mower's other features through the royalty base rather than through the royalty rate.

With a multicomponent product, a patentee must apportion the damages between the patented improvement and the conventional components.

The Court of Appeals noted that the patented improvement related to the mower's flow control baffle purportedly improves the quality of cut in a manner that distinguishes it from prior technology. The remaining limitations in the relevant patent claim recited conventional mower features, such as a mower deck, a side discharge opening and a power means for operating the mower.

With a multicomponent product, a patentee must apportion the damages between the patented improvement and the conventional components. This helps ensure that the patentholder is compensated for only the patented improvement, rather than the entire product.

On appeal, the court rejected Briggs' assertion that the apportionment must be achieved through the royalty base. It decided that apportionment can be addressed in several ways, including “by careful selection of the royalty base to reflect the value added by the patented feature [and/or] ... by adjustment of the royalty rate so as to discount the value of a product's non-patent features.”

FRE catches up with the times

Over the last 25 years or so, electronically stored information (ESI) has become a major evidentiary source. The Federal Rules of Evidence (FRE) haven't always kept up with times, but two amendments that took effect January 1, 2018, move the rules into the 21st century by streamlining the admissibility of digital evidence.

The amendments to FRE 902 expand the categories of self-authenticating evidence that require no extrinsic evidence of authenticity to be admitted. Specifically, FRE 902(13) permits self-authentication of certified records generated by an electronic process or system that produces an accurate result. Examples include an operating system's automated log of all USB devices connected to the computer or a smartphone's record of each photo's time, date and GPS coordinates.

In addition, FRE 902(14) allows self-authentication of certified data copied from an electronic device, storage medium or file authenticated by a process of digital identification. An example is a hash value that identifies data from an electronic source based on its contents.



As long as Exmark adequately and reliably apportioned damages between the improved and conventional features of the accused mower, the court determined that the plaintiff could use the entire accused mower as a royalty base and then apportion damages through the royalty rate. The essential requirement, the Court of Appeals explained, "is that the ultimate reasonable royalty award must be based on the incremental value that the patented invention adds to the end product."

Case is remanded for new trial on damages

The defendant's argument regarding the royalty base was ultimately rejected. But the Court of Appeals agreed with the defendant that the damages opinion provided by Exmark's expert was inadmissible. The court found that the expert had failed to adequately tie her proposed reasonable royalty rate to the facts of the case.

One way to satisfy this requirement is through a proper analysis of the 15 *Georgia-Pacific* factors.

These factors take into account the importance of inventive contribution in determining the royalty rate that would have emerged from hypothetical negotiations between the parties.

According to the court, the expert did discuss each of the factors. But she concluded "with little explanation" that Exmark and Briggs would have agreed to a 5% royalty rate on sales of the accused lawn mowers as the value for the improved baffle. The court found her opinion "devoid of any analysis" tying the evidence or specific *Georgia-Pacific* factors to that rate.

Bottom line

With the expert's opinion excluded from evidence, the district court's damages award was vacated, and the case was sent back for a new trial on the damages. The court's ruling illustrates that, while apportionment may be accomplished through either the royalty rate or the royalty base, expert opinions must be tied in to the facts of the case and the *Georgia-Pacific* factors to survive appellate review. ■

Valuation matters when a company is liquidating

Even in a bull market, some businesses struggle to make ends meet. Eventually, owners may decide to close the doors and liquidate a distressed company's assets. Outside financial experts can help owners make informed decisions about the distressed company's future and maximize liquidation proceeds. Experts can also help potential buyers of financially distressed businesses determine the appropriate asking price and conduct acquisition due diligence. Here are the details on these types of engagements.

How to value a business in distress

One of the most important questions a financial expert can answer is: How much is the distressed company worth? Although business valuation experts typically calculate a company's value as a going concern, certain financial trends — such as recurring net losses, declining sales and severely reduced liquidity — may suggest that the business would be more valuable if it were liquidated. Generally, liquidation value is relevant when the company's historical and expected earnings don't contribute incremental value beyond its net tangible asset value.

There are two types of liquidation value, according to the *International Glossary of Business Valuation Terms*:

- 1. Orderly liquidation.** In an orderly liquidation, assets are sold piecemeal over a reasonable period of time to maximize proceeds.
- 2. Forced liquidation.** Forced liquidation value assumes assets will be sold as quickly as possible, possibly in an auction.

Timing, bankruptcy laws and judicial mandates all help a valuation expert

determine the appropriate premise of value. Liquidation value often serves as a “floor” for business value. It also can help owners decide whether to file for Federal Bankruptcy Code Chapter 7 (liquidation) or Chapter 11 (reorganization). In addition, it helps stakeholders evaluate the viability of spin-offs and mergers, out-of-court loan workouts, management buyouts, and reorganization plans.

Where to start

When estimating liquidation value, experts typically start with the balance sheet. The book values of liabilities generally are accurate, but assets may require adjustments to estimate recoverability and current market values. For example, a distressed company may expect to receive 50 cents on the dollar for inventory and 70 cents on the dollar for receivables reported on the balance sheet.

Experts also must consider the existence of unrecorded items, such as patents, trademarks, customer lists, claims for back taxes, warranties and pending lawsuits. If a company decides to liquidate, the expert must factor in liquidation expenses, such as lease obligations, severance pay and professional fees. Usually, money is set aside in an escrow account for these incidentals before



the company distributes liquidation proceeds to creditors and investors.

Alternatively, valuation professionals can help buyers of distressed businesses determine their targets' *strategic* value — or value based on the specific buyer's investment requirements and expectations. For example, a buyer may be willing to pay more than liquidation value for a company that provides synergies, economies of scale or expanded market share.

How experts can help beyond valuation

Beyond valuation matters, financial experts can advise distressed businesses on such issues as negotiating debt restructuring with creditors and coordinating bankruptcy filings. They can provide fairness opinions for management buyouts and third-party acquisitions and help implement reorganization plans. Valuation experts also might work

with, or serve as, court-appointed receivers and turnaround consultants.

When creditors file fraudulent conveyance lawsuits, valuation experts can help determine the facts by performing a solvency analysis. The expert's subsequent solvency opinion determines whether the allegedly fraudulent transfer has left the company unable to service its debt obligations or continue normal business operations.

Need help?

A distressed business often needs an expert who specializes in bankruptcy consulting. When evaluating a potential candidate, assess the expert's financial expertise and knowledge of bankruptcy law, as well as his or her communication skills. Strong communication is essential when it's time to negotiate with investors, creditors and other concerned parties. ■

For richer, for poorer

Factoring valuation into premarital agreements

It's a well-known statistic that roughly half of U.S. marriages end in divorce. So, many people enter into premarital agreements before they tie the knot, especially when they've been previously married and accumulated significant wealth. Couples might be tempted to cut corners on hiring a valuation expert to help draft the agreement, but that mistake could cost them later — especially if one of the parties owns a business.

Disclosing assets and values

State laws regarding the validity of premarital agreements vary. They generally require the agreements to satisfy several requirements, including a disclosure of each party's assets.

States that have adopted the Uniform Premarital Agreement Act (UPAA) apply a "fair and reasonable" standard to such disclosures. Here, spouses must fairly and reasonably disclose their property and financial obligations, unless their spouses voluntarily and expressly waive their disclosure rights or possess actual knowledge of the property and obligations.

Other states have adopted a "full and fair" standard. This generally means that each spouse has a sufficient understanding of the nature, extent and value of the other spouse's assets to make an informed decision to relinquish rights to them. The agreement should specify whether stated values reflect fair market value (FMV), fair value, book value or another standard of value.

Valuing business interests

A couple may prefer to simply stipulate to the value of property, including business interests, rather than hire an expert to determine asset values. That can be a risky move, because values can often change over time. Moreover, a court could subsequently find the stipulation doesn't fulfill the disclosure requirement and reject the premarital agreement.

The risk is even greater if other indications of FMV exist. For example, a business might have key person insurance, life insurance, loans or other arrangements that require a statement of value — or a business interest might have been recently valued for the owner's previous divorce, another shareholder's divorce or a shareholder's probate. If the stipulated value doesn't match an appraised value, a court might find it falls short of the requisite standard.

Finally, a stipulated value may fail to account for discounts that a valuation expert would apply to reach FMV. For example, if a spouse owns a minority interest in a closely held business, the



value may need to be reduced for the interest's relative lack of control and marketability.

Reality check

As a trusted advisor, you can help clients stay grounded during the excitement of premarital activities. A solid, enforceable premarital agreement can provide some protection if things don't work out. And it takes time to secure the details, including the valuation provisions for closely held businesses. ■

Data analytics roundup

When it comes to fraud detection, the amount of available data in the company's paper and electronic records can seem staggering. Fortunately, the field of data analytics continues to advance, arming qualified financial experts with the tools to mine massive mounds of data effectively and efficiently. Association analysis, outlier analysis and cluster analysis are among the detection techniques that have rapidly gained footholds in today's data-driven world.

Association analysis

Association analysis can be used to uncover relationships between data points. For instance, it's the basis for Amazon's "frequently bought together"

feature and how Netflix makes suggestions based on previous selections.

In the fraud arena, this technique can help identify suspicious relationships by quantifying the odds of a combination of data points occurring together — in other words, the likelihood that, if one data point occurs, another will, too. If the combination occurs at an atypical rate, a red flag goes up. For example, association analysis might find that a specific supervisor tends to be on duty when inventory theft occurs.

Outlier analysis

Outliers generally refer to data points outside the norm for a given data set. In many types of data

analysis, outliers are simply disregarded, but these items come in handy for fraud detection. Have you ever been contacted by your credit card issuer after making a large or out-of-town purchase? That's outlier analysis in action.

In cluster analysis, similar data points are grouped into a set and then further subdivided into smaller, more homogeneous clusters.

Experts trained in forensic accounting techniques know how to distinguish and respond to different types of outliers. Contextual outliers are significant in certain contexts but not others. For example, when experts examine financial statements, a big jump in wages at a retailer might be notable in April but not in December, when seasonal workers come aboard.

Collective outliers are a collection of data points that aren't outliers on their own but deviate significantly from the overall data set when considered as a whole. For instance, if several executives at a public company sold off substantial blocks of their stock in the business on the same day, it would present a collective outlier that might signal suspicious behavior.

Cluster analysis

In cluster analysis, similar data points are grouped into a set and then further subdivided into smaller, more homogeneous clusters. Data points within a cluster are

similar to each other and dissimilar to those in other clusters. The greater the similarities within a cluster and the differences between clusters, the easier it is for an expert to develop rules that apply to one cluster but not the others.

Cluster analysis has long been used for market segmentation of consumers. But it's also of value in detecting fraud, particularly when combined with outlier analysis. Outlier clusters — those that are farthest from the nearest cluster when the clusters are mapped out on a chart — generally are the first to merit extra scrutiny for suspicious activity.

For example, suppose a forensic accountant is hired to evaluate group life insurance claims for fraud. The expert could use cluster analysis to group claims. Additional testing would then target high-risk groups, such as clusters of large beneficiary payments, large interest payments and long lags between submission and payment. Cluster analysis helps make an expert's work more efficient and less costly for clients.

Stay focused

Don't let the mountains of data overwhelm you or your clients. Qualified financial experts know the right tools to zero in on the telltale evidence of fraud. ■

