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Valuation Perspectives

"Your Valuation Solution"

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Federal Court Resurrects 25% Rule of Thumb to Calculate Ongoing Royalty

***Douglas Dynamics v. Buyers Products Co.*, 3-09-cv-00261 (W.D. Wis.)(Sept. 22, 2011)**

A jury found the defendant liable for infringing two of the plaintiff's patented snowplow assemblies and awarded approximately \$1.1 million in damages for past infringement. After the verdict, the federal district court denied the plaintiff's request for a permanent injunction and instead invited the parties to negotiate a reasonable royalty for any prospective infringement.

Parties were 'miles apart.' The parties agreed that an ongoing royalty rate should exceed the effective 3.3% awarded by the jury for past infringement, but they were "miles apart" as to what that rate should be, the court observed. The defendant suggested a 5% ongoing royalty based on applying wholesale prices to the snowplow assemblers. In contrast, the plaintiffs wanted a 44% royalty rate to apply to the assemblies that the defendant sold between the jury's entry of an award and the court's denial of an injunction, and a 16% royalty rate for any sales thereafter.

These factors also affected the parties' suggested royalty rates, as when, during trial, the plaintiff could not offer any instances of actual lost sales due to the defendant's infringing plows. Instead, the evidence suggested that the defendant's sales were driven not by the patented technology, but by its lower price point.

"On the other hand," the court noted, during a hypothetical negotiation, the plaintiff would not have known the impact of defendant's entry into the market with a plow that offered even minor advances compared to its own. Further, a reasonable royalty should "leave some room for profit," the court explained. "Otherwise it makes little sense to enter into an ongoing royalty at all." In light of all these considerations, the plaintiff's suggested range of 16% to 44% was "simply too high," the court held. These rates would not only cut all of the defendant's profits, but would mean selling infringing plows at a loss.

Begin with the 25% benchmark. Instead, the court was persuaded to start with the approach used by the

district court in *Paice LLC v. Toyota Motor Corp.*, 609 F. Supp. 2d 609 F. Supp. 2d 620 (E.D. Tex. 2009), on remand from *Paice LLC v. Toyota Motor Corp.*, 504 F.3d 1293 (Fed. Cir. 2007). In that case, the federal district court applied the "25% rule of thumb" as a starting point for setting the plaintiff's post-verdict royalties, ultimately taking 25% of the defendant's profit margin to reach an ongoing royalty of 2.25%.

In this case, 25% of the defendant's 12.9% profit margin was 3.225%. The court found an additional 2% was reasonable, particularly since the defendant "offered" a reasonable royalty rate of 5% and its continued use of infringing plows would only provide a slight increase in sales.

Based on this assessment, the court believed that the plaintiff would have leveraged its position to nearly double the pre-verdict rate of 3.3%, and awarded an ongoing rate of 6.225% for "every infringing snowplow assembly" that the defendant has sold or will sell from the time of the jury verdict to the patents' expiration.

Court Vacates \$1.3B in Copyright Damages for Lack of 'Real World' Data

***Oracle USA, Inc. v. SAP AG*, 2011 WL 3862074 (N.D. Cal.)(Sept. 1, 2011)**

In a high-profile infringement litigation, a jury awarded the plaintiff (Oracle USA) \$1.3 billion in damages against the defendant SAP, the world's largest business application software manufacturer. Not only was the jury award the largest ever for copyright infringement, but its magnitude equaled SAP's fourth quarter 2010 net income.

On appeal SAP claimed the award was "grossly excessive" and based on "fictitious" evidence. In particular, since Oracle admitted that it never would have licensed the software in the "real world" and no comparable licenses existed, its expert simply "invented" the price of a hypothetical license, the defendant argued, relying on factors such as the amount that Oracle executives claimed they would have charged

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for a license (unsupported by any benchmark deals), and the value of the infringed technology as a whole, including the costs of acquisition and development.

The U.S. District Court agreed, finding the plaintiff's expert "confused the jury" by presenting "fictitious and speculative negotiating factors" that he purportedly derived from *Georgia-Pacific*, but which actually came from the "self-serving" testimony by Oracle executives.

Valuation Approach Must Match Facts and Circumstances

***AmBase Corp. v. United States*, 2011 WL 3891942 (Fed. Cl.)(Aug. 31, 2011)**

As the U.S. Court of Federal Claims notes at the beginning of its opinion, this is one of the last of the *Winstar*-related cases to come out of the savings and loan crisis of the late 1980s and the government's enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).

Court needed to determine the value of the breach. By 1986, and at the behest of federal regulators, the Carteret Savings Bank had acquired four failing, FSLIC-backed thrifts. In 1987, the AmBase corporation acquired Carteret's holding company. Just a year later, however, Congress passed FIRREA and eliminated supervisory goodwill as counting toward regulatory capital requirements. To comply with the new law, Carteret took immediate action, shedding assets, beefing up loan loss reserves, and adding capital from the parent. In 1991, the bank also successfully enjoined federal regulators from disregarding its supervisory goodwill and briefly returned to profitability. Despite capital infusions from its parent, however, the bank couldn't maintain sufficient capital and was placed in receivership. The bank and its parent company subsequently sued the federal government. And in a first opinion, the Federal Court of Claims found the government liable for breach of contract.

As a preliminary matter, the court found that the plaintiffs satisfied the requirements of federal law on contract damages: foreseeability, causation. And substantial factor. Thus, there was sufficient evidence that the breach was a "substantial factor" in the bank's failure.

Market value trumps earnings models. As its final issue, the court determined damages. The plaintiffs' expert, a university finance professor, presented three alternative calculations:

- \$251.4 million, based on the market value of the bank at the time of its 1989 acquisition by AmBase;

- \$782.2 million, based on the bank's 1989 cash flows and its 2008 terminal value; or
- \$920.7 million, representing the bank's market value in a "non-breach" world.

The court rejected the latter two approaches, based primarily on the expert's use of the Gordon Growth Model. As one of the defendants' rebuttal witnesses testified, the Gordon Growth Model "can only be used with firms with . . . very stable growth over time."

On the whole, the court accepted the expert's market value approach, which began with the price that AmBase paid for the bank (\$266 million) in 1989. At the time, two investment banks had evaluated the deal and concluded that it was fair. In addition, the stock market independently valued the bank at \$198 million just before the transaction. In light of the additional obligations that AmBase undertook as part of the deal, even one of the defense experts admitted that the final purchase price reflected a control premium that was "within the realm of reason."

Accordingly, the court agreed that the \$266 million sale price was a "reasonable measure of the fair market value of the bank prior to the breach." After the acquisition, however, the bank was no longer publicly traded, so the plaintiffs' expert could no longer use the bank's market-to-book ratios to determine value. Instead, he applied the average rate of increase in the market-to-book ratios from 46 publicly traded comparable thrifts (7.4%) to the bank's pre-acquisition ratio (0.869) to calculate a post-acquisition ratio (0.934). Applying the latter to the bank's post-acquisition book value (\$269.3 million) resulted in a market value of \$251.4 million at the time of the breach.

The court accepted the expert's use of an industry "index," derived from his selection of comparables. It also found that tracking the thrift industry's growth in 1989 was conservative because—even though FIRREA didn't pass until the end of the year, the market was already absorbing the impact of the legislation, which helped to suppress thrift values. Finally, the plaintiffs' expert effectively captured the increase in the bank's "classified assets," which took place just before the 1989 breach.

At the same time, one of the defendant's experts reduced the bank's pre-breach value (\$269.3 million) by the \$77.2 million in loan loss reserves that federal regulators were requiring from the bank several months before FIRREA. Applying the mean market-to-book ratio of the industry (0.934) to this adjusted book value yielded an adjusted market value of \$179.4 million for the bank.

In response, the plaintiffs argued that regulators

actually reduced the required loan loss reserves to \$49.8 million, and the court accepted this lesser amount. After applying the industry ratios, it concluded that the adjusted market value of the bank at the time of the breach was \$205 million, and ordered the defendant to pay damages in this amount.

Intercompany asset transfers are attracting regulatory attention worldwide

Intercompany transfers of assets are under intense and increasing scrutiny by tax authorities around the world. The amount of income tax paid to each country affected by a transfer is determined by the prices charged within multinational companies. Transfer pricing rules and guidelines govern virtually all intercompany transactions. If you or your clients have multinational operations, valuations are essential to the tax filing process.

Most tax authorities follow guidelines set by the OECD, of which the U.S. is a member, which require “arm’s length” transfer pricing. This means that prices recorded should be the same as prices that would have been negotiated between unrelated parties.

As with all compliance valuations, the first line of defense against an audit of transfer pricing is documentation. Our firm has access to the leading databases that provide this kind of market-based support for international tax filings, so that appropriate asset values can be assigned at the business unit or other level, as required. For instance, many transferred assets include intellectual property, so cross-border applications of royalty agreements or other intangibles need to be documented carefully by a financial expert to confirm their “arm’s length” nature.

US and international valuation standards continue to merge

Business valuation standards have been more “harmonized” internationally than the standards in other professions—law for instance. And, the effort to push for complete harmonization got a big push recently from the international group responsible for professional standards.

Recently, this Private Sector Taskforce of Regulated Professions and Industries released its final report to G-20 deputies. The report responds to the G-20’s

request for the International Valuation Standards Council (IVSC), the member of the taskforce that reviews business valuation methods, to analyze the gaps in regulatory convergence.

To close the gaps across financial professions and industries, the taskforce’s report recommends that the G-20:

- Maintain its momentum and ambition for global regulatory reform and convergence;
- Discourage unilateral national regulatory reforms that are inconsistent with international standards; and
- Support the development, adoption, and implementation of one set of globally accepted high-quality international standards for each of financial reporting, auditing, valuations, and actuarial services.

This convergence trend will make it easier for businesses with cross-border compliance and other valuation needs. “The IVSC fully supports the analysis and recommendations of the Private Sector Taskforce,” said Michel Prada, chair of the IVSC board of trustees, in a press release. Significantly, the same release also announced that the IVSC had just signed a memorandum of understanding with the International Private Equity Valuations (IPEV) board. As part of their proposed cooperation, the two bodies plan to prepare and publish technical guidance and methodology for international PE and also venture capital valuations.

Must an LLC Turn Over the Valuation Records of Its Subsidiary?

DFG Wine Co., LLC v. Eight Estates Wine Holdings, LLC, C.A. No. 6110-VCN (Del. Ch.) (August 31, 2011)

The Delaware Chancery Court just provided a good checklist of documents to request and require in a “books and record” action by the controlling member of a limited liability company (LLC), particularly when the purpose of the request is to ascertain the value of the member’s holdings, not just in the LLC but in its subsidiary. In this case, the LLC held the assets of a company that owned and operated eight wine brands. When the subsidiary started to flounder, the LLC’s limited partners petitioned the Delaware Chancery to access the books and records of the LLC as well as the subsidiary. The LLC objected under Delaware

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law, maintaining that since the subsidiary was near insolvency, the valuation was zero (or a simple matter of mathematics), so the request was “meaningless.” The LLC also said the relevant operating agreements gave members no separate contractual right of access to the sub’s records.

The court disagreed on both points. The operating agreements gave members inspection rights equal to those provided by Delaware law. And under the case law, since the defendant had no separate value from the subsidiary, it would be “unfair” to require the member to attempt to value its holdings without providing access to the records of the LLC’s only asset—in particular, those records pertaining to value, the court held. It then approved most of the petitioner’s 16-item request for books and records, excepting only those that did not relate directly to value (e.g., the subsidiary’s ability to pay its creditors) and permitting redaction for trade secrets.

About Our Firm.....

Our firm has years of experience assisting attorneys and business owners in determining value for litigation support, gift and estate tax planning, marital dissolution, buy and sell agreements, and business sale purposes. Whether you are determining the fair market value of a closely held business interest for sale, gift, or estate planning, knowing what your company is worth is one of the most important financial aspects of being in business.

In addition, you may use a business valuation as a management and planning tool. Besides acting as a scorecard that will help management determine whether the company is gaining or losing value, the valuation provides a better understanding of the real profitability of the business. Whatever reason you have for needing a business valuation, John R. Janicek, CPA P.C. is prepared to assist you in being your valuation solution.

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