

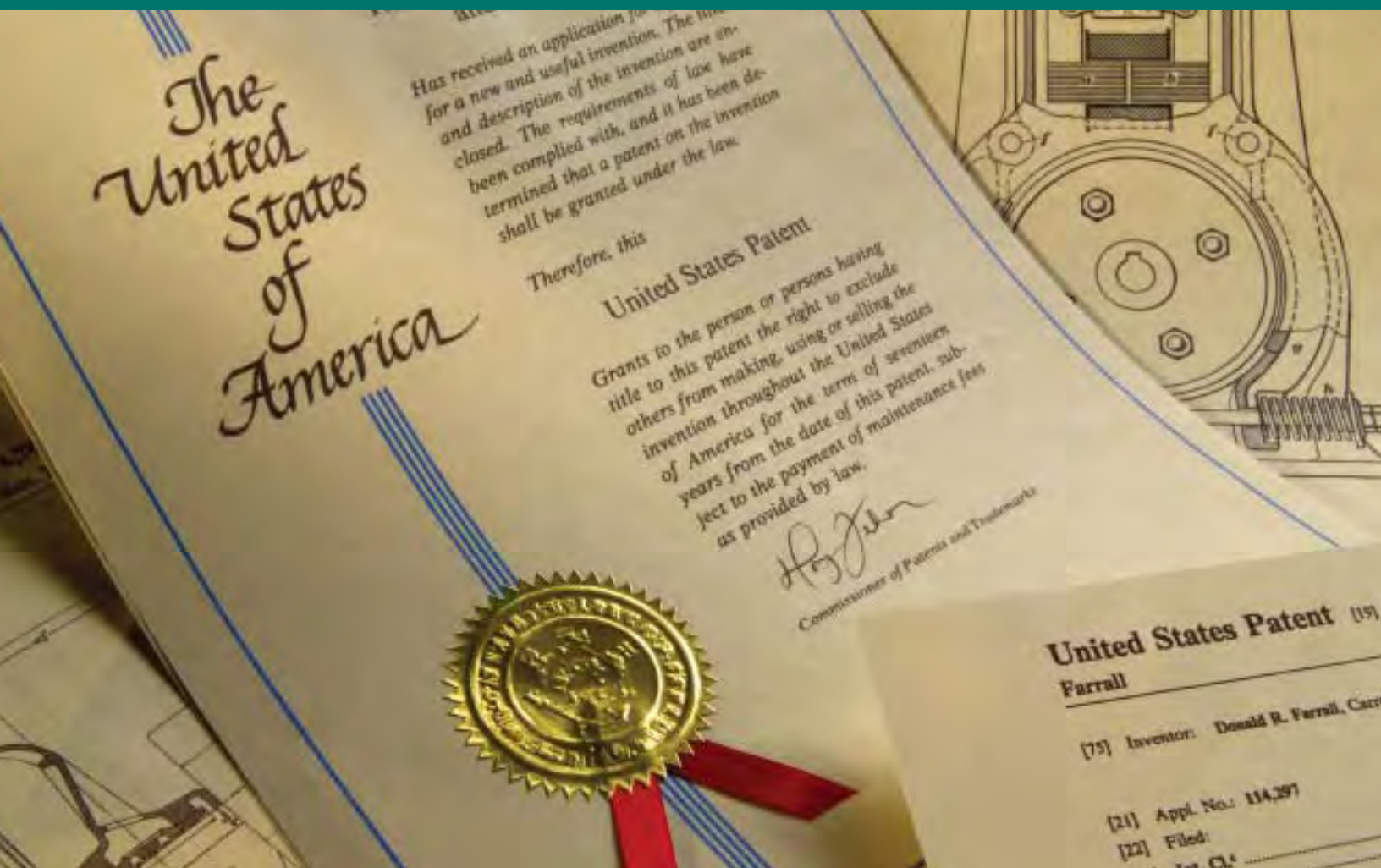
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Insights

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FOCUS ON INTELLECTUAL PROPERTY



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Willamette Management Associates
Thought Leadership

Insights

Insights, the journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from lawyers, accountants, bankers, and other thought leaders of the valuation and forensic services community. Please address your comments or suggestions to the editor.

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2015 Recipient of the Apex Literary Award

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Forethoughts

This *Insights* issue focuses on intellectual property (IP) matters. This *Insights* issue includes discussions by prominent legal, valuation, and damages experts involved in both tort and breach of contract litigation. These litigation matters relate to patent infringement, misappropriation of trade secrets, trademark infringement, and copyright infringement. Our discussions focus on judicial decisions in the last few years that have had a major impact on calculating damages in patent infringement matters. Our discussions focus on relevant patent infringement case law and new methodologies for calculating reasonable royalty damages.

This issue also features discussions on IP licensing advisory and IP forensic analysis matters. This issue presents discussions from legal experts describing the proper structuring of licensing agreements to address potential patent validity challenges, the challenges of a license agreement in a Chapter 11 bankruptcy case, and the risk management/IP insurance coverage solutions.

Finally, this *Insights* issue discusses considerations in a forensic royalty audit engagement and in a customer relationships valuation analysis.

Our firm focuses on the following IP areas:

1. Forensic analytics and expert testimony on quantification of damages (lost profits, reasonable royalty, diminution of value, unjust enrichment, out-of-pocket expenses)
2. Valuation and financial opinions of IP for purposes of M&A transactions, market assessments, licensing transactions, taxation, litigation, bankruptcy and reorganization, insurance, financing collateral and securitization for lenders, intercompany use and transfers, financial accounting, ad valorem taxation, and strategic planning
3. Forensic accounting and investigative services for license compliance and licensing support, which include third-party royalty audits and consulting on underpaid royalties

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Thought Leadership

Allocating Additional Profits between the Patentee and the Infringer Using the Footprint Methodology

Aaron R. Fahrenkrog, Esq., and John K. Harting, Esq.

Federal Circuit case law requires that a proper reasonable royalty award isolate the value of the patented invention from any nonpatented features. However, the court has provided little judicial guidance on the important question of how to allocate that value between the patentee and the infringer. The authors propose a solution using the application of a unified damages methodology, called the “footprint” method. This method answers two questions to provide a framework for determining the proper allocation of value between patentee and infringer. First, “How much would the infringer have been willing to pay in exchange for the additional value it enjoyed from using the invention?” And, second, “How much would the patentee have been willing to accept based on the effect the infringer’s practice of the invention had on the patentee’s business?”

INTRODUCTION

If nothing else, current Federal Circuit case law is clear on one thing: in calculating a reasonable royalty owed for a defendant’s infringing acts, some effort should be taken to identify the value of the patented invention separate from the value of the nonpatented features. That said, judicial guidance is conspicuously absent on one important question: After identifying profits attributable to the claimed invention, how should those profits be allocated between the patentee and the infringer?

The court has said only what *not* to do. Do *not* use the “25 percent rule.”¹ Also, do *not* apply the Nash Bargaining Solution unless you can establish that the facts of the case satisfy the theory’s underlying assumptions.²

This lack of judicial guidance hampers efficient litigation. Parties may litigate a case through trial merely to challenge an opposing expert’s methodology on this open question with the hope of a home-run result. Patentees may choose not to invest in a meritorious enforcement effort because of the risk

at the trial court and on appeal. And trial courts are left with the burden to determine what constitutes an acceptable methodology for allocating additional profits proven to have resulted from the invention.

Recently, in the headline-grabbing case *Smartflash v. Apple*, the trial court sua sponte found error in its own damages jury instructions shortly after trial, vacating a \$533 million jury award.³

We propose a solution, referred to as the “footprint” method, named after the Federal Circuit’s explanation in *ResQNet.com v. Lansa*⁴ that “the trial court must carefully tie proof of damages to the claimed invention’s footprint in the market place.”

The “footprint” method relies on rigorous economic and evidentiary principles. It provides a defensible path to satisfy the requirements for a reasonable royalty award. The footprint method can accommodate varied factual scenarios including those unique to standard-essential patents. It also extends to lost profits and harmonizes the analyses for lost profits and reasonable royalty damages.



THE FOOTPRINT METHODOLOGY

Patent infringement remedies depend on the economic impact caused by the invention to either (1) the patentee or (2) the infringer. The footprint method begins with an economic principle and then incorporates a practical causation analysis to achieve a consistent method for all types of infringement remedies.

The footprint method originated as a repeatable and reproducible method for determining an appropriate range for reasonable royalty damages. The footprint method rests on three practical procedures:

1. Alternatives – Identifying alternatives to the claimed invention
2. Technical quantification – Quantifying the additional technical benefits achieved by the invention compared to the alternatives
3. Economic quantification – Translating the invention’s additional technical benefits to resulting additional profit versus using a noninfringing alternative

The results of these procedures can inform the analysis not only for reasonable royalty damages, but also lost profits damages and injunctive relief. In other discussions, we have focused the “footprint” damages methodology primarily on establishing the amount of additional profit attributable to the invention.⁵

In this discussion, we describe the three basic procedures of that analysis and then turn to a fourth procedure component: a method, based on case-specific evidence, for allocating that additional profit between the patentee and the infringer to determine a reasonable royalty. As such, in this discussion, we

use the footprint method to propose a solution to the Federal Circuit’s as-yet unanswered riddle.

To be clear, we use the term “allocation” differently than the courts use “apportionment.” “Apportionment” generally refers to the obligation to attribute damages only to patented features, excluding nonpatented features from the damages model. Our “footprint” analysis, as described in other discussions, incorporates the apportionment obligation.⁶

In this discussion, we use the term “allocation” to describe the process after apportionment of dividing the resulting value between the patentee and the infringer in a hypothetical negotiation.

In short, litigants and courts can properly allocate additional profits by answering two questions. First, “How much would the infringer have been willing to pay in exchange for the additional profit it enjoyed?” Second, “How much would the patentee have been willing to accept based on the effect the infringer’s practice of the invention would have on the patentee’s business?”

The answers to these questions provide the framework for determining the proper allocation of additional profit between patentee and infringer.

The method discussed below certainly requires investment of time and resources. The “shortcut” methods previously taken in patent litigation, however, have now been rejected by the Federal Circuit.

Therefore, we propose a rigorous solution compliant with that Federal Circuit law and supported by fundamental principles of causation and evidence.

ESTABLISHING AND ALLOCATING ADDITIONAL PROFIT USING THE FOOTPRINT METHODOLOGY

The footprint method determines additional profit attributable to the invention using the formula:

$$\Delta P_{\text{INF}} = (R_{\text{INV}} - R_{\text{ALT}}) + (C_{\text{ALT}} - C_{\text{INV}})$$

The variables in the equation are as follows:

ΔP_{INF}	The infringer’s additional profit attributable to the invention over alternatives
R_{INV}	The revenue obtained by the infringer by using the invention instead of a non-infringing alternative
R_{ALT}	The revenue the infringer would have obtained using a noninfringing alternative instead of the invention

C_{ALT}	The costs the infringer would have incurred using a noninfringing alternative instead of the invention
C_{INV}	The costs the infringer incurred while using the invention instead of a noninfringing alternative

The next three sections describe the procedures in the analysis to reach the equation above. And, the subsequent sections describe how to allocate ΔP_{INV} between patentee and infringer consistent with Federal Circuit precedent.

Step One: Identifying Alternatives to the Claimed Invention

The first procedure is to define possible “alternatives” to practicing the claimed invention. The basic question for identifying alternatives is: What could the infringer have done instead of practicing the claimed invention?

An “alternative” is any feature that falls outside the scope of the patent claim or is authorized to practice the patent claim. Alternatives may come from the prior art, from later developed noninfringing features, from hypothetical noninfringing features that could have been developed, or from business alternatives such as discontinuing the infringing product.

Step Two: Quantifying the Additional Technical Benefits Achieved by the Invention as Used by the Infringer

The second procedure is to determine the technical benefits achieved by using the invention instead of an alternative. Ask: What difference does the invention make compared to the alternative?

If the invention relates to a manufacturing process, then the technical benefits may be the difference in yield achieved by the patented process over the alternative. If the invention relates to a component, like a computer chip, then the technical benefits may be the difference in speed or power consumption achieved by the patented component compared to an alternative design.

If the invention is a component used within a multifeature consumer product, then the technical benefit might be the impact on consumer-facing features like screen resolution or battery life compared to an alternative.

The goal of this procedure is to determine the ability to produce a numerical value isolating and quantifying the technical benefit of the invention.

Step Three: Translating the Invention’s Additional Technical Benefits to the Infringer’s Additional Profit

The third procedure is to translate the technical benefits to the economic benefit attributable to the invention. Ask: How much additional money did the patentee or infringer make during the infringement versus the amount that would have been achieved using absent infringement?

This procedure can be expressed using basic accounting principles. Profit (P) equals revenue (R) minus costs (C):

$$P = R - C$$

The footprint methodology introduces causation into this equation by evaluating the equation under two scenarios informed by the alternatives analysis described above:

1. *Actual*: what occurred during the period of infringement
2. *Hypothetical*: what would have occurred if the infringer had used a noninfringing alternative instead of the invention

For the actual scenario, we use the designation “INV” (standing for “with the invention”). For the hypothetical scenario, we use the designation “ALT” (standing for “with an alternative”). The profit achieved in the actual scenario in which the infringer used the invention is:

$$P_{INV} = R_{INV} - C_{INV}$$

The profit achieved in the hypothetical scenario in which the infringer would have used a noninfringing alternative is:

$$P_{ALT} = R_{ALT} - C_{ALT}$$

To incorporate causation, the footprint methodology evaluates the difference (ΔP) between:

1. the profit achieved during the infringer’s use of the invention (P_{INV}) and
2. the profit that could have been achieved had the infringer used a noninfringing alternative instead (P_{ALT}).

By taking the difference between these profit scenarios, the footprint approach apportions out all value from nonpatented features and isolates the difference in profit (ΔP) caused by the infringer’s use of the invention.

$$\Delta P = P_{INV} - P_{ALT}$$

Substituting in the equations for P_{INV} and P_{ALT} and rearranging the variables, the result is the basic footprint equation, synthesizing tort causation and economic quantification:

$$\Delta P = (R_{INV} - R_{ALT}) + (C_{ALT} - C_{INV})$$

The equation can be applied from either the patentee's perspective (evaluating the patentee's revenue and costs) or the infringer's. That is, the revenue and cost variables can represent either:

1. the patentee's difference revenues and costs in the actual (with infringement) and hypothetical (without infringement) scenarios, ΔP_{PAT} or
2. the infringer's revenues and costs in the actual and hypothetical scenarios, ΔP_{INF} .

In a reasonable royalty analysis, the likely most critical value is ΔP_{INF} , the additional profit achieved by the infringer from using the invention.

The hypothetical negotiation postulates that the infringer would have voluntarily paid some royalty in exchange for the opportunity to enjoy that profit. The question is, "how much?"

Step Four: Allocating Additional Profit between Patentee and Infringer

The allocation question is: "What happens after ΔP_{INF} is determined?" How much of the additional profit goes to the patentee, and how much to the infringer?

ΔP_{INF} in full likely does not represent the value of a reasonable royalty. This is because an economically rational licensee would not pay, as a royalty, the full amount of economic benefit it expected to achieve. The additional profit ΔP_{INF} should be allocated in some way to reach the appropriate reasonable royalty.

The allocation analysis is framed by two questions. First, what would the infringer have been willing to pay to enjoy the additional profit ΔP_{INF} it achieved by using the invention? Second, what would the patentee have been willing to accept in exchange for a license?

EVALUATING A BASELINE ROYALTY BASED ON THE INFRINGER'S EXPECTATIONS

A baseline for allocating additional profit ΔP_{INF} can be established by recognizing that the license

royalty represents an investment for the infringer. The royalty is an investment of capital made with the expectation of a predicted return.

Determining damages for *past* conduct allows the benefit of knowing how much money the infringer actually made, ΔP_{INF} , by using the invention instead of an alternative.

If the patentee can introduce evidence of the infringer's expected return on similar investments (a concept explored in further detail below), then the patentee can use that expected return to perform a discounted cash flow analysis on ΔP_{INF} that results in a baseline allocation of ΔP_{INF} between patentee and infringer.

Here's an example of how this objective may be accomplished.

First, we define two additional variables:

1. ROI_{INF} is the infringer's typical expected percentage return on investment, expressed as the total money returned. That is, if the infringer expects to make \$1.50 on a \$1.00 investment, this variable is expressed as 150 percent (not as 50 percent).
2. $Baseline_{INF}$ is the amount the infringer would have been willing to invest at the date of hypothetical negotiation in order to generate the additional profit, ΔP_{INF} , it enjoyed from the use of the invention.

With these variables, ΔP_{INF} can be defined in terms of the resulting return on the infringer's "investment" in a reasonable royalty fee negotiated at the time it began infringing. That is, additional profit is the reasonable royalty investment multiplied by the preferred return on investment.

As a result, we can calculate the baseline amount the infringer would have been willing to pay by dividing additional profit by ROI:

$$Baseline_{INF} = \Delta P_{INF} \div ROI_{INF}$$

The baseline amount that the infringer may have been willing to pay is represented by the additional profit divided by the infringer's expected return on investment. This is a simplified version of the analysis an economist may actually perform, which could also incorporate a temporal component such as the varying cash flow provided by the invention over time.

This analysis can be performed on the basis of additional profit for each infringing product or process, the total additional profit from all infringing products or processes, or something in between. If performed on a per-product basis, the analysis could result in an appropriate base percentage rate or per-

unit royalty to then be applied to each sale of an infringing product made by the infringer.

If performed on the total additional profits achieved by the infringer, it could result in a baseline lump-sum value, which could itself be converted into an appropriate running rate. The form of the royalty depends on other evidence introduced by the parties, including the form of royalties the parties have agreed to in prior licenses.

Evidence of an infringer's expected return on investment (ROI_{INF}) in a patent licensing transaction might come from prior IP transactions, other technology transactions, or the infringer's investment policies and business decisions in general.

When the profit allocation methodology is expressed as a typical evaluation of return on investment, the relevant evidence pool available to establish that concept expands.

Using this method, patentees and accused infringers will not be restricted in their damages proof to prior licenses for which "comparability" often is decided on a seemingly arbitrary basis.

EVALUATING A BASELINE ROYALTY BASED ON THE PATENTEE'S EXPECTATIONS

It may also be possible to establish a baseline royalty by evaluating how much the patentee would have been willing to accept in exchange for granting a license to the infringer. The "investment" the patentee makes in exchange for a return (the royalty) may contain two components.

First, the patentee invests by encumbering its patent portfolio with a license to the infringer, which can have several effects including the loss of the patentee's right to exclude, exhaustion of the ability to generate royalties from the infringer's downstream customers, and potentially diminished value of the licensed patents and the portfolio as a whole as a result of the encumbrance.

Second, the patentee invests by accepting any actual economic harm that may result from the licensee's practice of the invention, especially where such harm (for example, related but not "convoyed" sales) is not compensable under a lost profits theory.

By this description alone, it is apparent that quantifying the patentee's "investment" in the transaction, using admissible evidence, likely will be more difficult than quantifying the additional profit made by the infringer.



In many cases, calculating a baseline royalty by focusing on the infringer's return on investment may provide the most straightforward and executable approach.

Neither party should ignore the patentee's investment and expected return, however. If the patentee has economic evidence of how it has measured the value of its patent portfolio—and the impact on that value of prior patent licenses or sales—it may be able to show that it would expect a higher baseline rate in exchange for the investment it makes in terms of diminished value resulting from the license to the infringer.

In the "hypothetical negotiation" of patent infringement litigation, in which the infringer has in effect forced the patentee to offer a license, the court might give more weight to a quantified value the patentee is willing to accept than the quantified value the infringer would have been willing to pay. This principle could mitigate the risk that reasonable royalty damages may in effect impose a compulsory license.

Here, we offer an illustrative methodology for calculating a baseline royalty from the patentee's investment in the license transaction.

First, we express the patentee's investment as ΔP_{PAT} , the resulting difference in the patentee's economic position if it did not grant a license to the infringer. This profit comprises two components as discussed above.

First, ΔP_{DIM} , the diminished value of the patentee's IP rights as a result of the license. Second, ΔP_{HARM} , the economic harm suffered by the patentee as a result of the infringer's practice of the invention (for example, if the patentee lost sales of nonpatented products because the licensee had the right to practice the invention in competition).

The equation for the patentee's investment is:

$$\Delta P_{PAT} = \Delta P_{DIM} + \Delta P_{HARM}$$

Having defined ΔP_{PAT} —the amount of money the patentee *lost* because of the infringement—the same ROI approach discussed above can be used to determine how much money the patentee would expect to receive in exchange for a license.

From the patentee's perspective, its lost money ΔP_{PAT} is the investment, and the royalty is the amount of money it receives in exchange for that investment.

Two other variables round out the analysis:

1. ROI_{PAT} is the patentee's typical expected percentage return on investment.
2. $Baseline_{PAT}$ is the amount the patentee would have been willing to accept at the date of hypothetical negotiation in order to enjoy its preferred return on its investment.

The patentee's baseline royalty ($Baseline_{PAT}$) can then be expressed as its investment (ΔP_{PAT}) multiplied by its expected return (ROI_{PAT}):

$$Baseline_{PAT} = \Delta P_{PAT} \times ROI_{PAT}$$

Calculating both $Baseline_{PAT}$ and $Baseline_{INF}$ can indicate a definable range of results for a license agreement in a hypothetical negotiation. They provide quantified values, based on case-specific evidence, for the proper allocation of additional profit achieved by the infringer from using the invention.

In particular, if $Baseline_{INF}$ exceeds $Baseline_{PAT}$ (that is, the infringer would have been willing to pay an amount greater than the patentee would have been willing to accept), then there exists a range within which the parties would have been willing to agree on a hypothetical royalty rate.

If $Baseline_{PAT}$ exceeds $Baseline_{INF}$, then there is uncertainty about the rate at which the parties could have agreed in a hypothetical negotiation, but the methodology still has produced alternatives to present to the factfinder to weigh the evidence about bargaining power and determine the most likely result.

Either way, the methodology has produced values supported by the evidence specific to the case, establishing potential allocation of additional profits tailored to the facts and not based on shortcuts.

In this discussion, we do not attempt to explore all the ways that the proposed method may be modified and applied based on the facts and evidence available in each case. Creative parties and

economists will develop other methods for calculating both the infringer's and the patentee's baseline royalties.

Here, we introduce this extension of the footprint methodology as a means for litigants and courts to establish, using admissible evidence, a proper baseline allocation of additional profits attributable to the invention between the patentee and the infringer.

ACCEPTABILITY OF THE FOOTPRINT METHOD COMPARED TO REJECTED METHODS

The roots of the footprint method are causation and economics. The method combines theoretical economic principles with the actual facts of the case as established by the evidence.

The Federal Circuit's commentary on the "25 percent rule" and on the "Nash Bargaining Solution" methods to allocating additional profit illuminate how the approach outlined above improves upon these prior methods, resulting in an admissible methodology.

The "25 percent rule of thumb" arose from *empirical* licensing research, concluding that royalty rates typically amounted to 25 percent of the profit on a patented device.⁷

Patentees would apply the "rule" to establish a baseline royalty rate as 25 percent of the infringer's profit on the infringing device and adjust that baseline according to the *Georgia-Pacific*⁸ factors.

In the *Uniloc* case, the Federal Circuit held "as a matter of Federal Circuit law that the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation."⁹

The "Nash Bargaining Solution" derives from the *theoretical* work of mathematician John Nash. It proposes that, under certain circumstances in a negotiation, the parties will negotiate to a "solution" in which both parties receive the same profit.¹⁰ The Nash Solution arose from theoretical work, not empirical research.

In the *VirnetX* case, the Federal Circuit vacated a reasonable royalty award in which incremental profits had been allocated between patentee and infringer by applying the Nash Solution.¹¹

The court found that the patentee had not "sufficiently establish[ed] that the premises of the theorem actually apply to the facts of the case at hand."¹²

Underlying the rejection of both the 25 percent rule and the Nash Bargaining Solution is the requirement of evidence “tied to the particular facts” of the case.¹³

An empirical conclusion, like the 25 percent rule, almost by definition cannot be analogized to the facts of any particular case because it is based on different economic transactions (licenses negotiated under different facts).

A theoretical method could be applied, but the party applying the theory should carry its burden of establishing—with case-specific evidence—that the theory’s underlying assumptions are indeed true for that particular case.

The footprint method for calculating additional profit and then allocating it between patentee and infringer applies a theoretical method augmented by evidence to tailor the approach to the facts of each case. The patentee’s or the infringer’s expected return on investment should be established with evidence.

Because the footprint equation does not produce any results without causation evidence and quantification evidence establishing the variables, it is necessarily bound to the facts of each case. The Federal Circuit’s critiques of the 25 percent rule and the Nash Bargaining Solution should not apply to the footprint method.

CONCLUSION

The market for patent rights demands a solution to the problem of allocating, between patentee and infringer, profit attributable to the invention and economic loss attributable to licensing the invention.

Currently the case law offers no solution. By extending the footprint method to calculate base-line royalties based on expected return on investment, the parties can provide a defensible allocation method rooted in causation, quantification, and evidence.

Notes:

1. Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292, 1315 (Fed. Cir. 2011).
2. VirnetX, Inc. v. Cisco Sys., Inc., 767 F.3d 1308, 1325 (Fed. Cir. 2014); Good Tech. Corp. v. MobileIron, Inc., No. 5:12-cv-05826-PSG, Dkt. 436 (N.D. Cal. July 5, 2015); Content Guard Holdings, Inc. v. Amazon.com, Inc., et al., No. 2:13-cv-1112-JRG, Dkt. No. 825 at 17-18 (E.D. Tex. Aug. 6, 2015) (denying motion to exclude damages opinion applying Rubenstein bargaining model where the plaintiff “articulate[d] each premise of the Rubenstein model and cites to specific evidence from [the expert’s] report

that supports the premise,” while also using ‘Defendant-specific evidence as inputs to some of the premises’); see also A. Fahrenkrog, L. Drew, & J. Harting et al., “A Guide to Understanding the Federal Circuit’s VirnetX Opinion,” *Law360* (October 14, 2014) (explaining the difference between eliminating the Nash Solution completely and requiring that it fit the facts of the case).

3. Smartflash LLC v. Apple Inc., No. 6:13-cv-447-JRG, Dkt. 581 (E.D. Tex. July 27, 2015).
4. ResQnet.com, Inc., v. Lansa, Inc., 594 F.3d 860, 872 (Fed. Cir. 2010).
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11. Id. at 1331-34.
12. Id. at 1332.
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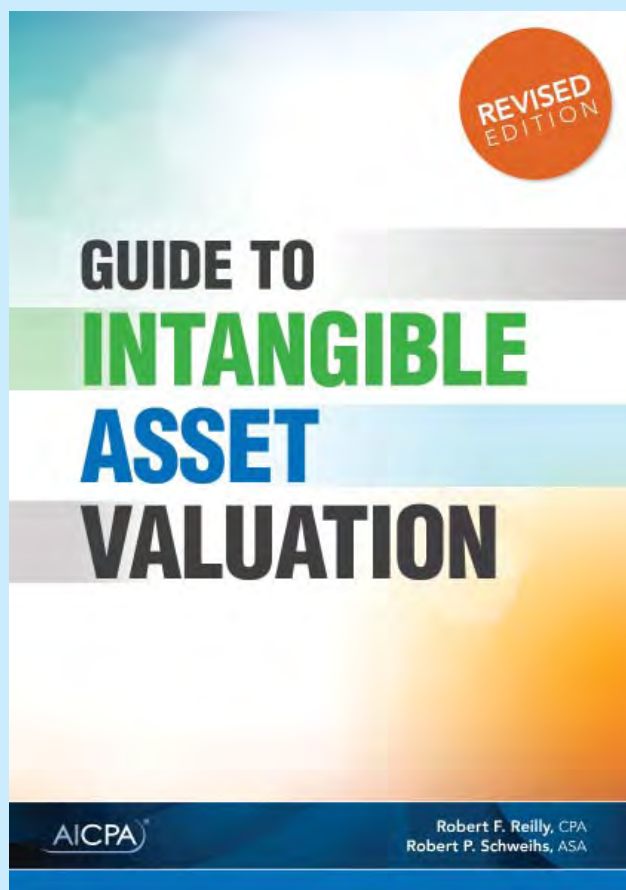
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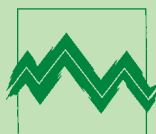
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Guide to Intangible Asset Valuation

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Calculating Damages in Misappropriation of Trade Secrets Matters

Shawn D. Fox, CPA

This discussion explores the unique considerations related to calculating damages in misappropriation of trade secrets cases. This discussion includes an analysis of plaintiff's damages remedies in trade secret cases, including plaintiff's actual loss, defendant's unjust enrichment, valuation of trade secrets, and reasonable royalty, and defendant's rebuttal strategies for reducing and/or eliminating plaintiff's damages. It is important that the analyst link the damages to the alleged misappropriated trade secret(s) and tie the damages remedies to the specific facts and circumstances of the case.

INTRODUCTION

Trade secrets litigation is on the rise, particularly due to an increase in unauthorized use of electronic information through mobile devices and data storage from corporate insiders or partners (e.g., employees, management, board of directors, consultants, independent contractors, suppliers/vendors), competitors, and perpetrators of cyber espionage/data theft (e.g., hackers, organized criminals, foreign governments).^{1,2}

Calculating damages in a misappropriation of trade secrets experts can be a complex exercise due to varying state laws that apply to these cases. These state laws encompass employment, intellectual property, tort, contract, and white-collar criminal law.

A report issued by the U.S. Chamber of Commerce states that “publicly traded U.S. companies own an estimated \$5 trillion worth of trade secrets.”³

Misappropriation of trade secrets cases are generally brought in state court and appealed via local circuits to U.S. Supreme Court. U.S. litigation statistics show a large increase in cases of misappropriation of trade secrets: the number such cases doubled between 1988 and 1995; doubled again

from 1995 to 2004; and is expected to double yet again by 2017.⁴

According to the Federal Bureau of Investigation (FBI), the number of economic espionage and theft trade secrets cases handled by its Counterintelligence Division increased by 60 percent from fiscal year 2009 to the end of fiscal year 2013.⁵

The impact of trade secrets misappropriation and economic espionage in the United States has been estimated to be approximately \$350 billion, which represents more than 2 percent of the U.S. gross domestic product.⁶

Factors behind the increase in the trade secrets litigation include the following:

1. Digital technology
2. A mobile workforce
3. The rising value of intellectual property, which include trade secrets
4. The adoption of the Uniform Trade Secrets Act
5. The flexible definition and characteristics of trade secrets
6. An increase in international threats
7. The decision whether to pursue trade secret or patent protection⁷

The top 11 reported settlements of litigation matters involving trade secrets legal claims are included in Table 1.⁸

This discussion contemplates the following topics:

- Definition of trade secret
- Definition of misappropriation
- Plaintiff's remedies in misappropriation of trade secrets matters
- Plaintiff's lost profits
- Defendant's profits
- Valuation of trade secrets
- Reasonable royalty
- Defendant's rebuttal strategies for damages calculations
- Proposed Defend Trade Secrets Act of 2015 (DTSA)

DEFINITION OF TRADE SECRET

The two commonly used definitions of trade secrets are from the:

1. Uniform Trade Secrets Act (UTSA) and
2. U.S. Economic Espionage Act (EEA).

According to Section 1.4 of the UTSA, a trade secret

means information, including a formula, pattern, compilation, program, device, method, technique, or process that:

- (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and
- (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.¹⁰

Some form of the UTSA has been enacted by 47 states and the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. It is important to note that there are variations and significant differences among the states that have adopted UTSA.¹¹

The three state exceptions on the UTSA include New York, Massachusetts, and North Carolina.^{12,13}

- New York generally follows the Restatement (Third) of Unfair Competition.

- Massachusetts trade secret law is based on a combination of statutory law and common law principles.
- North Carolina has adopted a state statute, which codifies several of the key principles of the UTSA.

Even though 47 states have adopted some form of the UTSA, there are significant differences in the state statutes for items such as the definition of a trade secret, definition of misappropriation, exemplary damages, awarding of attorneys' fees (non-uniform tests for bad faith), statutes of limitations, definition of a person, differences in damages measured by a reasonable royalty, adoption of inevitable disclosure doctrine, and so on.

In addition, some states did not enact all provisions of the UTSA and some states enacted unique statutory provisions.¹⁴

According to Section 1839 of the EEA, a trade secret

means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if:

- (A) the owner thereof has taken reasonable measures to keep such information secret; and
- (B) the information derives independent economic value, actual or potential, from not being general known to, and not being readily ascertainable through proper means by, the public.¹⁵

According to Section 757 of the New York First Restatement of Torts, certain factors are

to be considered in determining whether given information is one's trade secrets are:

1. the extent to which the information is known outside of the business;
2. the extent to which it is known by employees and others involved in the business;
3. the extent of measures taken to guard the secrecy of the information;

Table 1
Top 11 Litigation Settlements Involving Trade Secrets
Page 1 of 2

Rank	Amount	Settlement Payee	Case Name
#1	\$1.1 billion (VW agreed to pay \$100 million and buy at least \$1 billion of auto parts from GM).	General Motors Corp.	<i>General Motors Corp. v. Lopez de Arriortua</i> , 2:96-CV-71038-NGE, E.D. Mich. (Jan. 1997)
#2	\$400 <i>Compuware Corp. v. IBM Corp.</i> , 2:02-cv-70906-GCS, E.D. Mich. (Mar. 2005) million paid by IBM to settle trade secret and antitrust claims (IBM agreed to license \$140 million in Compuware software and buy \$260 million in Compuware services).	Compuware Corp.	<i>Compuware Corp. v. IBM Corp.</i> , 2:02-CV-70906-GCS, E.D. Mich. (Mar. 2005)
#3	\$340 million paid by AT&T to settle trade secret, patent, and bankruptcy claims relating to the failed “At Home” broadband business multiple actions settled (May 2005).	Bondholders’ Liquidating Trust	Multiple actions settled (May 2005)
#4	\$290 million paid by Semiconductor Manufacturing International Corp. (SMIC) to settle trade secret, patent, and breach of contract claims stemming from the 2005 settlement (see No. 7),	Taiwan Semiconductor Manufacturing Company (TSMC)	Multiple actions in California Superior Court and China settled (November 2009)
#5	\$288 million paid by Toshiba Corp. in 2006 to settle legal claims including misappropriation of trade secrets and infringement of patents pertaining to Lexar’s NAND flash-memory ships technology in the U.S. Original jury award was for \$465.4 million.	Toshiba Corp.	<i>Lexar Media, Inc. v. Toshiba Corp.</i> , CV-812458, California Superior Court, Santa Clara County (2005)
#6	\$275 million paid by Kolon Industries Inc. to DuPont Co. that included upfront and ongoing payments for trade secrets case involving fiber used to manufacture bulletproof vests and an \$85 million in criminal fines. The jury award was \$919 million. ⁹	E.I. du Pont de Nemours	<i>E.I. du Pont de Nemours & Co. v. Kolon Industries, Inc.</i> , 3:09-CV-00058, U.S. District Court, Eastern District of Virginia (Sept. 2011) – settled in 2015
#7	\$175 million paid by Semiconductor Manufacturing International Corp. (SMIC) to settle trade secret and patent claims.	Taiwan Semiconductor Manufacturing Company (TSMC)	Multiple actions in U.S. District Court, California Superior Court, ITC, and Taiwan District Court settled (January 2005)

Table 1
Top 11 Litigation Settlements Involving Trade Secrets
Page 2 of 2

Rank	Amount	Settlement Payee	Case Name
#8	\$75 million paid by Hilton to settle trade secret, fraud, unfair competition, conversion, and multiple other claims	Starwood Hotels	<i>Starwood Hotels & Resorts Worldwide v. Hilton Hotels Corp.</i> , 09-cv- 03862, S.D.N.Y. (Dec. 2010)
#9	\$75 million paid by A10 in trade secret, patent, and copyright action. The original jury award was \$112 million.	Brocade Communications Systems	<i>Brocade Communications Sys. Inc. v. A10 Networks Inc.</i> , 5:10-cv-03428, N.D. Cal. (Aug. 2012)
#10	\$65 million cash paid by Alnylam Pharmaceuticals, plus \$10 million promised in milestone payments, plus transfer of 150 patents and patent applications to Tekmira, plus royalty streams in future products	Tekmira Pharmaceuticals Corp	<i>Tekmira Pharms. Corp. et al. v. Alnylam Pharms. Inc., et al.</i> , 11-1010-BLS2, Business Litigation Session of the Massachusetts Superior Court (Nov. 2012)
#11	\$61 million paid by Morningstar, Inc.	Business Logic	<i>Business Logic Holdings v. Ibbotson Associates</i> , 2009-CH-46687, Illinois Circuit Court, Cook County Law Division (July 2014)

4. the value of the information to the owner and its competitors;
5. the amount of effort or money expended on developing the information; and
6. the ease or difficulty with which the information could be properly acquired or duplicated by others.¹⁶

Trade secrets are not registered and/or identified with any government agency. Some examples of trade secrets include the following:

- Recipes (e.g., the formula for Coca-Cola soft drinks)
- Manufacturing processes
- Engineering drawings/blueprints/notebooks
- Algorithms (e.g., Google's search algorithm)
- Measurements
- Test results
- New ideas
- Tools
- Negative information on unsuccessful experiments
- Databases/data compilations/data files

- Customer information
- Supplier information
- Pricing information
- Profit margin information
- IT systems and applications
- Strategic business plans/marketing plans and analyses
- Updates to existing products
- Surveys (e.g., *The New York Times* Best-Seller List)
- Virtual assets
- Other confidential and proprietary business information and know-how

A recent high profile matter involving access of a proprietary database was a case where a couple of employees of the St. Louis Cardinals baseball team were being investigated for accessing into the internal database of the Houston Astros baseball team. The allegations were that they wanted "to steal vital player information from the opposing team, but their motivation was much more vindictive.

"The *New York Times* reported that the hackers' intent was to despoil the reputations of either

Jeff Luhnow or Sig Mejdal. Luhnow was a scouting executive for the Cardinals until 2011 when he accepted a general manager position with their National League rivals, the Astros. Mejdal, a sabermetrics analyst, also left the St. Louis-based team for Houston.”¹⁷

According to reports, “The FBI is still investigating the Cardinals-Astros incident, but initial reports said that Cardinals employees illegally accessed the Astros scouting and personnel database, which was filled with information they deemed to be valuable, they dubbed it ‘Ground Control.’”¹⁸

These types of cybersecurity cases involving theft of trade secrets are increasing with greater frequency in the corporate world.

DEFINITION OF MISAPPROPRIATION

The UTSA states, “For liability to exist under this Act, a Section 1(4) trade secret must exist and either a person’s acquisition of the trade secret, disclosure of the trade secret to others, or use of the trade secret must be improper under Section 1(2).”¹⁹

Misappropriation is defined by the UTSA as:

- (i) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
- (ii) disclosure or use of a trade secret of another without express or implied consent by a person who
 - (A) used improper means to acquire knowledge of the trade secret; or
 - (B) at the time of disclosure or use, knew or had reason to know that his knowledge of the trade secret was
 - (I) derived from or through a person who had utilized improper means to acquire it;
 - (II) acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or
 - (III) derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or
 - (C) before a material change of his [or her] position, knew or had reason to know that it was a trade secret

and that knowledge of it had been acquired by accident or mistake.”²⁰

PLAINTIFF’S REMEDIES IN MISAPPROPRIATION OF TRADE SECRETS MATTERS

The remedies available to a plaintiff include equitable relief (e.g., preliminary injunction or permanent injunction), monetary damages (e.g., compensatory, unjust enrichment, or restitution damages), and legal fees.

According to Section 2(a) of the UTSA:

Actual or threatened misappropriation may be enjoined. Upon application to the court, an injunction shall be terminated when the trade secret has ceased to exist, but the injunction may be continued for an additional reasonable period of time in order to eliminate commercial advantage that otherwise would be derived from the misappropriation.²¹

The UTSA further states that

an injunction should last for as long as is necessary, but no longer than is necessary, to eliminate the commercial advantage or ‘lead time’ with respect to good faith competitors that a person has obtained through misappropriation. Subject to any additional period of restraint necessary to negate lead time, an injunction accordingly should terminate when a former trade secret becomes either generally known to good faith competitors or generally knowable to them because of the lawful availability of products that can be reversed engineered to reveal a trade secret.²²

According to Section 2(b) of the UTSA:

In exceptional circumstances, an injunction may condition future use upon payment of a reasonable royalty for no longer than the period of time for which use could have been prohibited. Exceptional circumstances include, but are not limited to, a material and prejudicial change of position prior to acquiring knowledge or reason to know of misappropriation that renders a prohibited injunction inequitable.²³

According to Section 3(a) of the UTSA:

Damages can include both the actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss. In lieu of damages measured by any other methods, the damages caused by misappropriation may be measured by imposition of liability for a reasonable royalty for a misappropriator's unauthorized disclosure of use of trade secret.²⁴

The UTSA states that the

reasonable royalty alternative measure of damages for a misappropriator's past conduct under Section 3(a) is readily distinguishable from a Section 2(b) royalty order injunction, which conditions a misappropriator's future ability to use a trade secret upon payment of a reasonable royalty. A Section 2(b) royalty order injunction is appropriate only in exceptional circumstances; whereas a reasonable royalty measure of damages is a general option. Because Section 3(a) damages are awarded for a misappropriator's past conduct and a Section 2(b) royalty order injunction regulates a misappropriator's future conduct, both remedies cannot be awarded for the same conduct. If a royalty order injunction is appropriate because of a person's material and prejudicial change of position prior to having reason to know that a trade secret has been acquired from a misappropriator, damages, moreover, should not be awarded for past conduct that occurred prior to notice that a misappropriated trade secret has been acquired.²⁵

A common goal when calculating actual loss damages in a trade secrets litigation matter is to attempt to make the plaintiff "whole" after experiencing the alleged damages event, which may include the following:

- Profits that the plaintiff would have received but for the defendant's act of misappropriation (including lost sales on convoyed/ancillary products or services that would be sold together with the product or service using the trade secret)
- Plaintiff's increased costs caused by defendant's act of misappropriation
- Value of the trade secrets to the plaintiff as of the date of the misappropriation if they

had been destroyed; otherwise their diminution

- Decline in the value of the plaintiff's business
- Plaintiff's costs of research and development of the trade secret
- Plaintiff's cost to restore the effects of the misappropriation of the trade secret
- Price erosion because the plaintiff had to lower prices to compete with the defendant's use of the trade secret

The *Guide to Intangible Asset Valuation* states:

Compensatory damages are also called actual damages. This is the amount of compensation that is necessary to restore the injured party to the economic condition he or she was in before the damages event. If the claimant [plaintiff] receives an award of the compensatory damages, then the claimant should be made whole from the effects of the wrongful act.²⁶

The goal of calculating unjust enrichment in a trade secrets litigation matter is to attempt to eliminate the benefit of the unlawful misappropriation of the ill-gotten benefits, profits, or advantages acquired by the defendant, which may include the following:²⁷

- Defendant's profits on sales attributable to use of the trade secrets through increased revenue
- Defendant's saved research and development
- Defendant's time savings and/or acceleration to market
- Defendant's cost efficiencies and increased operating profits
- Defendant's risk reduction and increased business value from lower risk associated with future cash flow
- Value of the trade secrets taken by the defendant as of the date of the misappropriation

According to Section 3(b) of the UTSA:

If willful and malicious misappropriation exists, the court may award exemplary damages in an amount not exceeding twice any award under Subsection 3(a).²⁸

According to Section 4 of the UTSA:

If (i) a claim of misappropriation is made in bad faith, (ii) a motion to terminate a proceeding is made or resisted in bad faith, or (iii) willful and malicious misappropriation exists, the court may award reasonable attorney's fees to the prevailing party.²⁹

According to Section 6 of the UTSA:

An action for misappropriation must be brought within 3 years after the misappropriation is discovered or by the exercise of reasonable diligence should have been discovered.³⁰

The EEA is a federal statute for criminal prosecution of theft of trade secrets. The primary objectives of the EEA are to protect national and economic security.

According to Section 1831 of the EEA, an individual can be sentenced to prison for up to 15 years and receive a criminal fine of up to \$5,000,000, and any organization that commits economic espionage will be fined the greater of \$10,000,000 or three times the value of the stolen trade secret to the organization for economic espionage.

The penalties for commercial trade secret theft include up to a 10-year prison sentence (for an individual) and a fine of up to \$5 million (for an organization).³¹

PLAINTIFF'S LOST PROFITS

The plaintiff's lost profits are calculated first by determining lost revenue and then deducting the incremental costs that would have been incurred in producing the lost revenue.

The American Institute of Certified Public Accountants (AICPA) *Practice Aid 06-4*, titled "Calculating Lost Profits," states the following:

Lost "net" profit is computed, in general, by estimating the gross revenue³² that would have been earned but for the wrongful act reduced by avoided costs. Avoided costs are defined as those incremental costs that were not incurred because of the loss of the revenue.³³

The following methods are generally used to calculate lost revenue:

- *The before and after method.* The analyst compares the before results of operations to the after results of operations

- *The yardstick (or benchmark) method.* The analyst calculates the plaintiff's revenue using a "yardstick" to compare the subject business to other similar businesses, industry averages or other relevant guidelines.
- *The but for (or sales projection) method.* The analyst calculates the plaintiff's expected revenue without the alleged misappropriation of trade secrets in comparison to actual revenue after the harmful event.
- A method based on the terms of the underlying agreement (confidentiality agreement, noncompete agreement, nondisclosure agreement, etc.)

The lost revenue is generally calculated from these models by taking the projected "but for" revenue, minus the plaintiff's actual revenue during the loss period.

The AICPA *Lost Profits Practice Aid 06-4* states the following with regard to the before and after method:³⁴

- "This method compares the plaintiff's performance before the event or action causing lost profits to the plaintiff's performance after that event or action."
- "The plaintiff's prior experience, which can be determined from the plaintiff's historical accounting records, is generally subject to dispute less than other components of the calculation. In addition, the plaintiff's experience subsequent to the defendant's act can be determined, at least up through a date near to the date at which the calculation is made, from the plaintiff's historical accounting records."
- "The practitioner, however, should consider other factors [such as seasonality, unusual/nonrecurring factors, capacity considerations, market share, etc.] that could have affected the plaintiff's level of revenues and demonstrate how those factors have been taken into consideration."

The AICPA *Lost Profits Practice Aid 06-4* states the following with regard to the yardstick method:

- "This method utilizes a 'yardstick' that is used to estimate what the revenues and profits of the affected business would have been. Examples of possible yardsticks that might be employed in the calculation include the following:
 - The performance of the plaintiff at a different location

- The plaintiff's actual experience versus past budgeted results
- The actual experience of a similar business unaffected by the defendant's actions
- Comparable experience and projections by nonparties
- Industry averages
- Pre-litigation projections"
- "When using this method, the practitioner will need to demonstrate the plaintiff's operations are sufficiently comparable to the 'yardstick' used. This could require that the yardstick company be in the same geographic area and/or operates under similar conditions."
- "In addition, as with the 'before and after' method, the practitioner may need to consider other factors that could have caused the plaintiff's performance to differ from the yardstick selected and show how those factors have been taken into consideration."

The underlying theory of lost profits damages calculated using the "but for" method is that "but for" for the defendant's misappropriation of trade secrets, the plaintiff would have received a higher level of revenue and profits.

The "but for" method may consider the following:³⁶

- Company financial projections/budgets/forecasts prepared prior to the harmful event
- Establishing support for the underlying foundation for the company financial projections/budgets/forecasts prepared prior to the harmful event
- The market share that the plaintiff would have attained but for the misappropriation of trade secrets (estimating revenue based on market trends)
- Economic modeling
- Impact of changes in price and volume

The AICPA *Lost Profits Practice Aid 06-4* states the following with regard to calculation based on the terms of the contract that:

In some instances, the lost profits calculation is made in relation to a specific contract. In that instance, many of the elements of the calculation may be set forth in the contract document, i.e., the number



of units to be sold, unit prices, etc. In this situation, a model might be developed that calculates the revenues anticipated under the terms of the contract.³⁷

After determining the amount of lost revenue, the analyst will need to calculate the costs associated with the generation of those lost revenue. In calculating plaintiff's lost profits, profits are generally measured on a contribution margin basis, which is typically measured as lost revenue minus incremental costs.

The AICPA *Lost Profits Practice Aid 06-4* states that, "[t]he costs should be deducted from lost revenues in order to calculate lost profits are generally referred to as avoided costs. *Avoided costs* are those costs that would have been incurred in connection with the generation of the lost revenues but were not incurred."³⁸

Incremental costs are the costs associated with producing the additional number of the "but for" sales volume level.

The analyst can use several methods of cost estimation in his/her analysis of the incremental costs that should be deducted from lost revenue.

Some of the considerations include the following:³⁹

- Analysis of cost structure for cost of goods sold and operating expenses (direct costs and indirect costs) in the determination of fixed versus variable (costs may be fixed, variable, or semivariable)
- Use of nonstatistical methods of cost estimation (account analysis, direct assignment, accounting estimates, cost accounting allocations, ratio analysis, graphical approaches, industrial engineering, etc.) or statistical methods of cost estimation (e.g., regression analysis, attribute sampling, survey data)

The *Guide to Intangible Asset Valuation* states: Incremental expenses should represent only those expenses that were not incurred because the lost revenue was not realized. The most obvious example of an incremental expense is direct production costs. Other examples of incremental expenses that may be deducted from the lost revenue estimate include selling expenses, the variable component of overhead expenses, marketing expenses, advertising expenses, and any royalties that would have been paid on foregone production.⁴⁰

Historical and future lost profits may be calculated in misappropriation of trade secrets matters; however, it is important for the plaintiff's attorney to review the relevant state's statutes and substantive case law for situations in which the analyst is calculating future lost profits. It is also important for the analyst to consider the portion of profits attributable to the trade secret(s).

According to an article published in *Inside Counsel*, "Where the market is damaged due to defendant's disclosure of the trade secret, the plaintiff may also recover certain provable future profits based on historical data or the fair market value of the trade secret if the defendant had disclosed the trade secret publicly."⁴²

There are some states that limit the loss period to a "head-start" period. There are also situations in which a court may award the monetary damages to compensation for the defendant's past use of the trade secret in addition to a permanent injunction to prevent the defendant's future use of the trade secret.

Both an award of future lost profits and permanent injunction may be considered an impermissible double recovery.⁴³

A risk-adjusted discount rate is applied to the plaintiff's future lost profits. The discount rate includes a component for the time value of money (inflation) and risk inherent in future lost profits. The future lost profits are generally discounted back to the date of the misappropriation of trade secrets or the current date (such as date of report or trial).⁴⁴

The discount rate should include an analysis of the risk of the misappropriated trade secret(s).

DEFENDANT'S PROFITS

AICPA *Practice Aid 06-4*, titled "Calculating Lost Profits," states:

In certain situations, such as cases involving unfair competition or the misappropriation of trade secrets, an accounting of the profits realized by the defendant may be used as the measure of the plaintiff's lost profits. In obtaining an accounting of the defendant's profits, the plaintiff is only entitled to receive value of the unjust enrichment of the defendant through disgorgement, i.e., the defendant is required to surrender profits attributable to the misappropriation or bad act to the plaintiff. To the extent that profits are attributable to other factors, the defendant would not have to disgorge those amounts. In some jurisdictions (and for some causes of action), the plaintiff only has the burden to identify the revenues associated whereas the defendant has the burden to prove both the costs incurred in generating the revenues as well as apportioning the profits between the misappropriation and other profit generators.⁴⁵

The UTSA states: "As long as there is no double counting, Section 3(a) adopts the principle of the recent cases allowing recovery of both a complainant's actual losses and a misappropriator's unjust benefit that are caused by misappropriation."⁴⁶ Thus, the analyst cannot use the same lost sales for calculating plaintiff's lost profits and unjust enrichment of defendant's profits.

The plaintiff typically has the burden of proving the defendant's revenue and then the defendant generally has the burden to prove deductions and offsets from revenue. Typically, the misappropriator will need to prove that the expense item was paid and it was attributable to the sales using the misappropriated trade secrets.

Certain allowable deductions may include the costs of materials, services, and labor incurred in producing the goods or services; insurance premiums; building repairs; allocated percentages of overhead costs; and selling, marketing, and advertising costs.

There are some jurisdictional differences on which expenses can be deducted from revenue. It is important for the plaintiff's attorney to review the relevant state's statutes and substantive case law for situations in which the analyst is calculating an accounting of the defendant's profits to determine which expenses should be deducted from revenue.

In general, a plaintiff's lost profits calculation subtracts incremental expenses from revenue; whereas, an accounting of the defendant's profits may be calculated by either:

1. subtracting incremental expenses from revenue or
2. subtracting fully allocated expenses (incremental and fixed expenses) from revenue.

For example, U.S. courts are split on the issue of overhead allocation in an accounting on the defendant's profits for an unjust enrichment calculation.^{47,48}

It is important for the plaintiff's attorney to review the relevant state's statutes and substantive case law for situations in which the analyst is calculating future unjust enrichment for defendant's profits.

According to a recent Business Valuation Resources program titled "Measuring Unjust Enrichment," "Future unjust enrichment is becoming more common."⁴⁹

VALUATION OF TRADE SECRETS

In misappropriation of trade secret cases, the standard of value usually is a fair market value type standard based on what a reasonable investor would have paid for the trade secrets.

Fair market value is defined by the American Society of Appraisers (ASA) Business Valuation Standards Glossary as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."⁵⁰

There are three generally accepted approaches to valuing trade secrets:

- *Cost approach.* The cost approach is based on the economic principle of substitution. The general principle of the cost approach is that a prudent investor would pay no more for a trade secret than the cost necessary to replace and/or protect the trade secret. The value of the trade secret is determined by aggregating the costs involved in its development.
- *Market approach.* The market approach is based on an analysis of trade secret acquisition transactions or trade secret licenses to value the subject trade secret(s).



- *Income approach.* The income approach is used to estimate a value of a trade secret if the trade secret produces any measure of either operating income or license income.

There are four general cost components that generally should be considered in the cost approach analysis to value a trade secret:

1. *Direct costs.* "Direct costs include material, labor, and overhead costs incurred directly by the intangible asset creator."⁵¹
2. *Indirect costs.* "Indirect costs may also include material, labor, and overhead costs. In this case, these costs are incurred directly by the creator. . . . The indirect costs are, of course, ultimately paid by the intangible asset creator. These costs are paid to individuals and organizations that are outside of the inventor's organization."⁵²
3. *Developer's profit.* "First, from the perspective of the developer of any intangible asset, the developer expects a return of all of the direct and indirect costs (including material, labor, and overhead costs) related to the development process. Second, the developer expects a return on all of the direct and indirect costs (including material, labor, and overhead costs) related to the development process."⁵³
4. *Entrepreneurial incentive.* "The entrepreneurial incentive is the amount of economic benefit required to motivate the intangible asset creator to enter into the development process. From the perspective of the

creator, entrepreneurial incentive is often perceived as an opportunity cost.”⁵⁴

Below is a list of items to consider when using a cost approach to value trade secrets:

- The cost approach is sometimes used in situations when the trade secret does not generate an income stream or there is no guideline trade secret acquisition transaction or license market data.
- Reproduction cost is the level of expenditures needed to reproduce an exact replica of the asset.
- Replacement cost is the level of expenditures necessary to develop an asset with similar utility.
- Value = Replacement cost new – physical deterioration – economic obsolescence – curable functional and technologies obsolescence.
- The conclusion under the cost approach may not reflect the value of the trade secret to its owner.
- The cost approach is sometime used to calculate the floor value of the subject trade secret.

The most common methods to value trade secrets using a market approach include the following:

1. Sale comparison method. This method relies on guideline acquisition transaction data of trade secrets.
2. Relief from royalty method. This method relies on guideline license transaction data of trade secrets. The royalty rate is generally applied to the trade secret owner's revenue or financial metric to estimate the trade secret value. This method is considered a hybrid market and income approach.

The hypothetical royalty payment should reflect the amount that an operator or licensee would be willing to pay in an arm's-length transaction to a third-party owner or licensor in order to obtain the use of the trade secret.

Other royalty considerations may include changes in parties' competitive positions, nature and extent of use by defendant, availability of alternative trade secrets, and so on.

A market approach is rarely used to value trade secrets because of very limited acquisition and license transactions and the difficulty of comparing one trade secret to another trade secret.

Trade secrets by their very nature are unique and secret. It is important for the analyst to adjust for differences in the trade secret transaction data and the subject trade secret.

It is very difficult to find a large data set of guideline licensing data to value trade secrets. Additionally, many times license agreements for trade secrets are bundled with patent license agreements or other intellectual property agreements.

In situations involving bundled license agreements, the analyst will generally need to apportion the total value among the various intellectual properties included in the license agreement.

There are three primary components of an income approach used to value a trade secret:

1. Projected amount of income attributable to trade secrets
2. Duration of the income projection period – remaining useful life of the trade secret
3. Income capitalization rate (discount rate minus growth rate)

The following discussion presents a summary of income approach valuation methods that can be relied upon to value trade secrets:

1. Valuation method that quantifies an incremental amount of revenue or a decremental amount of cost (also known as with-and-without method).

In this method, “(a) the owner/operator will generate a greater amount of revenue by owning or operating the intangible asset compared to not owning or operating the intangible asset or (b) the owner/operator will experience a lower amount of cost by owning or operating the intangible asset compared to not owning or operating the asset. The owner/operator revenue could increase because the intangible asset results in new products, new customers, an increased market share, an increased total market, increased units sold, increased unit selling price, decreased products and so on. The owner/operator operating cost could decrease because the intangible assets results in decreased production cost, decreased selling expense, decreased administrative

expense, decreased research and development expense, or decreased interest expense.”⁵⁵

It is important that the benefits of the trade secret are the only difference in both scenarios.

2. Valuation method that relies on a hypothetical agreement that the owner and the operator will share (or split) the expected profits associated with the commercial exploitation of the trade secret (also known as profit-split method).

“That is, the owner and the operator agree to split the total business profit (often measured as earnings before interest and taxes) related to the intangible asset commercialization. Another way to conceptualize the profit split category of valuation methods is that the owner provides the intangible asset and the operator provides the working capital assets, the tangible personal property and real estate assets, and the routine intangible assets used in the business. Each party (the owner and the operator) receives a split of the total business operating profit commensurate with their relative contribution to that business.”⁵⁶

This method is somewhat similar to the relief from royalty market method. The primary difference is the derivation of the royalty rate.

3. Valuation method that relies on a differential level of income.

“The phrase *differential level of income* simply means the difference in the amount of income. That is, these methods compare the owner/operator using the intangible asset to a benchmark income measure. The benchmark income measure would be (a) the owner/operator income without the intangible asset, (b) the owner/operator income using a prior generator of the intangible asset, (c) an industry average level of profitability, (d) a level of profitability earned by identified guideline companies, or (e) some other benchmark income measure. The differential income measure does not necessarily have to be owner/operator operating income, net income, or net cash flow. Rather, the differential income could be measured by the difference in just about any owner/operator financial fundamental.”⁵⁷

4. Residual income methods that typically start with the owner/operator’s total business income.

“In applying these methods, the analyst identifies all of the owner/operator contributory assets. Contributory assets are all of the other assets—other than the actual intangible asset—that are used to produce the owner/operator income. Next, the analyst applies a fair rate of return on investment to each of the contributory asset categories. Typical contributory asset categories include net working capital assets, real estate and tangible personal property assets, and routine intangible assets (like, intangible assets other than the subject intangible asset). The analyst multiplies the fair rate of return by the value of each contributory asset category to conclude a contributory asset charge. The total business income less than the total contributory asset charge equals the residual (sometimes called *excess*) return. The residual income is the amount of owner/operator’s income associated with the intangible asset.”⁵⁸

These methods are generally used in situations in which the trade secret is the primary driver of cash flow.

Another important test for the analyst to consider is the value of the trade secret(s) in relation to the overall enterprise value of the company. This can be especially relevant in situations when there are multiple trade secrets held by the plaintiff.

REASONABLE ROYALTY

In situations in which the damages cannot be calculated based on plaintiff’s actual loss or defendant’s unjust enrichment, a reasonable royalty can be used to calculate damages caused by the misappropriation of trade secrets. A reasonable royalty damages calculation is used relatively less frequently than plaintiff’s actual or defendant’s unjust enrichment in misappropriation of trade secrets cases.

The reasonable royalty rate method generally calculates what a third-party licensor would pay to a third-party licensee for an arm’s-length use license related to the misappropriated trade secret(s).

Additionally, the royalty rate may be based on documentation between the parties (which shows the value that the parties placed on the misappropriated trade secrets) or other existing licensing agreements with other third parties for the trade secrets.

The *Guide to Intangible Asset Valuation* states:

The reasonable royalty rate method models the scenario in which the respondent approaches the owner/operator in good faith and negotiates an arm's-length license for the lawful use of the intangible asset [trade secret]. The principle supporting this method is that the licensee would be willing to pay a fair royalty rate for the inbound license of the claimant's intangible asset and the licensor would be willing to accept a fair royalty rate for the outbound license of the claimant's intangible asset.⁵⁹

In comparison to other types of intellectual property (patents, copyrights, and trademarks), there are significantly fewer licensing agreements pertaining to trade secrets. Additionally, analysts may consider the factors used to determine reasonable royalty from patent infringement case law, which is well-developed.

A reasonable royalty considers both the royalty base and the royalty rate. A royalty rate can generally be based as a percentage of gross revenue, percentage of net revenue, percentage of cost savings, per unit, lump sum, or some other basis agreed to by the parties. Trade secrets are generally licensed either on an individual stand-alone basis, or as a component of a patent or a broader intellectual property license agreement.

There are several sources of royalty rate data, which include the following:⁶⁰

- ktMINE (www.ktmine.com)
- RoyaltySource (www.royaltysource.com)
- RoyaltyStat (www.royaltystat.com)
- Consor (www.consor.com)
- MARKABLES (www.markables.net)
- *Licensing Economic Review*
- *Licensing Royalty Rates* published by Wolters Kluwer and authored by Gregory J. Battersby and Charles W. Grimes

Below is a summary of royalty rate methods used to calculate a reasonable royalty rate in misappropriation of trade secrets matters:

1. *Incremental profit method*. "Using a weighted average cost of capital analysis, the analyst compares the owner/operator to other companies in the marketplace that don't own the intangible asset. The investment method considers the expected return (profits) from all of the company assets (including both tangible assets and

intangible assets), including the infringed intangible asset. A weighted average return on assets (based on the returns of other companies) is applied to the assets of the alleged infringing company. This results in an estimate of the profits that the company would earn if it did not utilize the infringed intangible asset. This profits measure (in other words, as if no infringement event occurred) is then compared to the actual profits of the infringing company. This comparison results in a measure of the incremental profits from the alleged infringement. This measure of infringement-related incremental profits can then be used to estimate a reasonable royalty rate."⁶¹

2. *Differential income method*. "The analyst uses a discounted cash flow analysis in which the analyst prepares two alternative cash flow projections. The first cash flow projection is prepared to reflect the owner/operator's prospective results of operations with the effects of the damages event. The second cash flow projection is prepared to reflect the owner/operator's prospective results of operation without the effects of the damages event. The difference between these two discounted cash flow analyses indicates the damages amount. The differential income (that is, the difference between the two cash flow analyses) is divided by the owner/operator's annual revenue to estimate a reasonable royalty rate."⁶²
3. *Comparable uncontrolled transaction method*. "This analysis compares the intangible asset to third-party comparable uncontrolled transaction involving the license of similar intangible assets. This market-derived, third-party license royalty rate analysis considers factors such as:
 - the relevant time period of the third-party licenses,
 - the financial condition of both licensor and licensee parties,
 - the exclusivity of the license,
 - any relevant government regulations,
 - any nonmonetary compensation included in the license, and
 - the [remaining useful life] RUL of the licensed intangible asset."⁶³
4. *Comparable profit margin method (also known as the analytical method)*. "A reasonable royalty rate can be based on the

expected (or historical) profit margin of the owner/operator company compared to a normal profit margin (based on guideline companies operating in the same or similar industry that do not use a comparative intangible asset).”⁶⁴

In the matter of *Sabatino Bianco, M.D. v. Globus Medical, Inc.*,⁶⁵ the court set an ongoing royalty rate of 5 percent on defendant’s future sales for a maximum of 15 years.

Despite the defendant’s argument that any “head start” it received had dissipated before trial so an ongoing royalty should not apply, the court reasoned that defendant failed to present evidence regarding its “head start” theory at trial, so this was no basis to dispute the ongoing royalties.

The court noted that this was a proceeding to set the ongoing royalty rate so the jury’s verdict was the proper starting point for making the determination of ongoing royalties.” This decision was affirmed by the federal circuit.

This case involved a doctor who was awarded \$4.3 million and future royalties in connection with three misappropriated trade secrets involving the company’s top-selling spinal fusion devices.^{66,67}

DEFENDANT’S REBUTTAL STRATEGIES FOR DAMAGES CALCULATIONS

Below is a list of certain defendant rebuttal strategies that an analyst should consider:

- The plaintiff has not proved that its damages were caused by defendant’s misappropriation of trade secrets—no nexus between the misappropriation of trade secrets and the actual loss.⁶⁸
- The damages amounts claimed or portions thereof, are unrelated to the alleged trade secret misappropriation.⁶⁹
- The loss period for damages for the time it would have taken to independently develop the trade secret or reverse engineer the trade secret is reduced.⁷⁰
- Some portion of the damages is comprised of an impermissible double-recovery.⁷¹
- Defendant did not use the trade secret information (an example may include the doctrine of inevitable disclosure—inevitable disclosure is an inference that the former employee will inevitably use former employer’s trade secrets in carrying out the

same duties for a new employer—state laws vary significantly on these issues).⁷²

- Whether the plaintiff has not adequately defined/identified its trade secrets.⁷³
- The plaintiff only included a damages model based on misappropriation of all of the trade secrets and failed to apportion damages among trade secrets or other legal claims.⁷⁴
- Alleged trade secret information is already in public domain and knowledge through public disclosure is not due to any act of the defendant.⁷⁵
- Alleged trade secret information was independently developed by defendant without access to the trade secret information.⁷⁶
- Alleged trade secret information was not kept secret in confidence and treated as confidential.⁷⁷
- Alleged trade secret information can be easily reversed engineered.⁷⁸
- Alleged trade secret information does not provide competitive advantage.
- Losses to the business were caused by changes in consumer demand for a product or service incorporating the trade secret or noninfringing alternative products.
- Plaintiff’s damages do not meet the test of reasonable certainty for recovery of damages.
- Plaintiff did not indicate to employees, vendors, suppliers, consultants, etc. that certain information and/or know-how was considered to be a trade secret.
- The economic remaining useful life of the trade secret is lower than the period asserted by the plaintiff.

PROPOSED DEFEND TRADE SECRETS ACT OF 2015 (DTSA)

The House and Senate each proposed identical legislation (H.R. 3326 and Senate Bill 1890) titled the “Defend Trade Secrets Act of 2015” (DTSA). This proposed act would create a federal private right of action for misappropriation of trade secrets cases. In addition:

The proposed legislation attempts to authorize a private civil action in federal court for the misappropriation of a trade secret that is related to a product or service used in, or intended for use in, interstate or foreign commerce. Additionally, the proposed

legislations seeks to (a) create a uniform standard for trade secret misappropriation; (b) provide parties pathways to injunctive relief and compensatory damages; and (c) create remedies for trade secret misappropriation that are similar to other violations of intellectual property rights, for example, including exemplary damages and attorneys' fees available in the event of willful and malicious misappropriation of a trade secret. An interesting feature of the DTSA 2015 is the availability of an ex parte seizure order for plaintiffs fearful of the dissemination of their trade secret(s). The proposed ex parte seizure allows for the government to seize property necessary to prevent the propagation or dissemination of the trade secret prior to giving notice of the lawsuit to the defendant.⁷⁹

The DTSA also differs from the USTA on the following items:⁸⁰

- Statute of limitations period is increased to five years from three years
- Allows for recovery of treble exemplary damages versus double
- Allows for an ex parte seizure order, which allows for a plaintiff to take proactive steps to have the government seize its trade secrets prior to giving notice to the defendant (which goes far beyond what a court is willing to do under existing state law)

CONCLUSION

Trade secrets litigation is on the rise and will continue to increase in the future. There are a lot of approaches to calculating damages in a misappropriation of trade secrets litigation matter. It is important that the analyst use a damages remedy that relates to the facts and circumstances of the case and be flexible in his/her approach to calculating damages.

In addition, there are significant differences in state law, and the analyst should work with counsel to review relevant state statutes and case law in the jurisdiction that applies to the case.

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Selection of a Reasonable Royalty Rate to Measure Economic Damages for Trademark and Patent Infringement

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Damages analysts are often asked to estimate a reasonable royalty rate to measure economic damages for purposes of trademark and patent infringement. Although the bodies of law related to trademark and patent infringement are different from one another, the principles and concepts used to estimate a reasonable royalty rate for these types of intellectual property are fairly similar. This discussion summarizes the methods and procedures that analysts use to estimate a reasonable royalty rate. And, this discussion describes the factors and circumstances that analysts should consider when selecting a reasonable royalty rate for trademark and patent infringement purposes. Finally, this discussion focuses on the comparable uncontrolled transaction method, a commonly used method for selecting a reasonable royalty rate.

INTRODUCTION

The preferred measure of damages in U.S. patent infringement litigation is lost profits. If, however, actual lost profits damages cannot be established, which is most often the circumstance, then a reasonable royalty for the use of the patent must be determined.¹

For U.S. trademark infringement litigation, damages typically can include the lost royalty income of the trademark owner plus the profits of the infringer.

For both of these types of intellectual property disputes, the analysis of a reasonable royalty can be an appropriate method for calculating damages. Although in practice, the need to analyze a reasonable royalty is generally more applicable to patent infringement disputes. In fact, according to some estimates, more than 80 percent of damages awards in patent litigation include a reasonable royalty payment.²

The underlying principle behind the determination of a reasonable royalty rate is that the selected royalty rate represents a reasonable indication of

the value for use of the patent or trademark (the “subject intellectual property”). The reasonable royalty can be calculated based on:

1. an established royalty for the subject intellectual property,
2. the infringer’s profit projections for infringing sales, or
3. a hypothetical negotiation between the intellectual property owner and the infringer for use of the subject intellectual property.³

This reasonable royalty is often expressed as a royalty rate (on a percentage basis) multiplied by a royalty base (the revenue derived from the infringing activity).

From an analyst perspective, the selection of a reasonable royalty rate is typically one of the most hotly contested aspects of an intellectual property economic damages dispute. This is because the process of determining a reasonable royalty rate can be different for each intellectual property infringement engagement.

The procedures to developing credible and defensible intellectual property royalty rates are as follows:

1. Provide a thorough analysis of the relevant functions, risks, and economics associated with the subject intellectual property.
2. Develop an accurate understanding of the facts and circumstances of the specific case and the applicable law of the relevant jurisdiction.

In addition, it is important that analysts have a clear understanding of the general factors and circumstances that affect the pricing of intellectual property royalty rates.

Related to selecting a reasonable royalty rate for intellectual property economic damages purposes, this discussion summarizes:

1. the methods and procedures used to estimate reasonable royalty rates and
2. the factors and circumstances that analysts often consider.

REASONS TO ESTIMATE INTELLECTUAL PROPERTY ROYALTY RATES

There are numerous reasons why analysts are routinely asked to perform intellectual property royalty rate analyses. Generally, these various reasons may be aggregated into the following categories:

1. Litigation claims and dispute resolution (the subject of this discussion)
2. Transaction pricing and structuring
3. Intercompany use and ownership transfers
4. Financial accounting and reporting
5. Taxation planning and compliance
6. Financing collateralization and securitization
7. Bankruptcy and reorganization
8. Management information and strategic planning

Within this general list, there are numerous other individual reasons to analyze intellectual property. These other reasons are beyond the scope of this discussion.

REASONABLE ROYALTY INFRINGEMENT DAMAGES

Patent infringement damages are governed by federal patent law 35 U.S.C. Section 284. According to this statute, damages may be awarded to a patentee for use made of his or her invention by an infringer.

The damages amount should be adequate to compensate for the lost profits associated with infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs.

Trademark infringement damages are generally governed by the Lanham Act, 15 U.S.C. Section 1117. This statute defines trademark infringement damages as the profits of the infringer plus any damages sustained by the trademark owner.

The courts generally interpret these statutes to mean that if actual lost profit damages cannot be ascertained, then a reasonable royalty for the use of the infringed intellectual property must be determined.⁴

In other words, for both of these types of intellectual property disputes, if lost profits damages cannot be proven, the intellectual property owner is entitled to damages based on a reasonable royalty for the use of the subject intellectual property.

In practice, the analysis of a reasonable royalty is rare in Lanham Act cases because the focus is usually on unjust enrichment and apportionment of infringer's profits. However, this statute does allow for a reasonable royalty as an appropriate form of damages for trademark infringement.

The statutes that govern intellectual property damages do not provide any specific guidance for calculating reasonable royalty damages.

There is, however, a substantial body of judicial precedent regarding the selection of trademark and patent royalty rates for purposes of infringement damages litigation. While the body of case law related to patents is distinct from trademarks, the general principles and concepts used to develop reasonable royalty rates for these types of intellectual property are fairly similar.

Analysts can consider this judicial guidance when selecting an appropriate method to estimate a reasonable royalty rate for intellectual property infringement damages purposes.

JUDICIAL GUIDANCE ON FACTORS TO CONSIDER WHEN SELECTING A REASONABLE ROYALTY

The governing rule in the selection of a reasonable royalty is that the royalty must reflect the value attributable to the infringement, and no more.⁵

The reasonable royalty can be calculated based on an established royalty for the subject intellectual property, the infringer's profit projections for infringing sales, or a hypothetical negotiation for use of the subject intellectual property between the intellectual property owner and the infringer.⁶

One frequently cited framework related to the estimation of a reasonable royalty is presented in *Georgia-Pacific v. U.S. Plywood Corp.* (“*Georgia-Pacific*”).⁷

In that case, the court listed a series of factors that can be used to support the determination of a reasonable royalty (the “*Georgia-Pacific* factors”).

The *Georgia-Pacific* factors are summarized as follows:

1. The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty
2. The rates paid by the licensee for the use of other patents comparable to the patent in suit
3. The nature and scope of the license, as exclusive or nonexclusive; or as restricted or nonrestricted in terms of territory or with respect to whom the manufactured product may be sold
4. The licensor's established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention or by granting licenses under special conditions designed to preserve that monopoly
5. The commercial relationship between the licensor and licensee, such as, whether they are competitors in the same territory in the same line of business; or whether they are inventor and promoter
6. The effect of selling the patented specialty in promoting sales of other products of the licensee; the existing value of the invention to the licensor as a generator of sales of his nonpatented items; and the extent of such derivative or convoyed sales
7. The duration of the patent and the term of the license

8. The established profitability of the product made under the patent; its commercial success; and its current popularity
9. The utility and advantages of the patent property over the old modes or devices, if any, that had been used for working out similar results
10. The nature of the patented invention; the character of the commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention
11. The extent to which the infringer has made use of the invention; and any evidence probative of the value of that use
12. The portion of the profit or of the selling price that may be customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions
13. The portion of the realizable profit that should be credited to the invention as distinguished from nonpatented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer
14. The opinion testimony of qualified experts
15. The amount that a licensor (such as the patentee) and a licensee (such as the infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement; that is, the amount that a prudent licensee—who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention—would have been willing to pay as a royalty and yet be able to make a reasonable profit and which amount would have been acceptable by a prudent patentee who was willing to grant a license

Recent judicial precedent indicates that the application of the *Georgia-Pacific* factors to any royalty rate analysis can be considered as a general analytical approach, and it should not merely be applied as a requirement in all cases.⁹

That is, the use of any or all of the *Georgia-Pacific* factors is not required by the courts to be part of an intellectual property infringement royalty rate analysis.¹⁰

If the *Georgia-Pacific* factors are used as part of a royalty rate analysis, the analyst should fully

analyze the applicable factors, rather than cursorily reciting all 15 factors.¹¹

The courts have made this point clear, noting:¹²

Although we have never described the *Georgia-Pacific* factors as a talisman for royalty rate calculations, district courts regularly turn to this 15-factor list when fashioning their jury instructions. Indeed, courts often parrot all 15 factors to the jury, even if some of those factors clearly are not relevant to the case at hand. And, often, damages experts resort to the factors to justify urging an increase or a decrease in a royalty calculation, with little explanation as to why they do so, and little reference to the facts of record.

As an example, *Georgia-Pacific* factor 15 implies that a hypothetical reasonable royalty should leave an infringer with a profit. Some valuation damages analysts wrongly assume that reasonable royalty calculations must provide for such profit in all situations. Yet the Federal Circuit warns against blindly constraining a reasonable royalty analysis to the *Georgia-Pacific* factors in this manner.

The Federal Circuit has stated, “[A]lthough an infringer’s anticipated profit from use of the patented invention is ‘[a]mong the factors to be considered in determining’ a reasonable royalty, the law does not require that an infringer be permitted to make a profit.”¹³

If the analyst chooses to rely on the relevant *Georgia-Pacific* factors to support a royalty rate analysis, it is important to include some explanation of both why and to what extent the factors affect the royalty calculation. The relevant factors may also need to be adapted on a case-by-case basis depending on the characteristics of the subject intellectual property.¹⁴

If any of the *Georgia-Pacific* factors are excluded from the royalty rate analysis, the analyst should have a good reason for the exclusion (even if the reason is not explicitly included in the analysis).

If properly applied, the analyst can rely on the *Georgia-Pacific* factors as a framework to support the determination of a reasonable royalty. Within this framework, the analyst should rely on generally accepted royalty rate estimation methods that are applicable to the relevant jurisdiction.

GENERALLY ACCEPTED METHODS USED TO ESTIMATE A REASONABLE ROYALTY RATE

There are several generally accepted methods that analysts typically use to estimate a reasonable royalty rate for trademark and patent infringement damages purposes. These methods include the following:

1. Incremental profit method—a weighted average cost of capital analysis of the infringer’s actual profits with and without the use of the infringed intellectual property
2. Differential income method—a discounted cash flow analysis of the infringer’s projected profitability with and without the use of the infringed intellectual property
3. Comparable profit margin method—a comparative analysis based on the profitability of the subject intellectual property owner/operator and comparable companies that do not use the subject intellectual property
4. Comparable uncontrolled transaction (CUT) method—a comparative analysis based on third-party sale or license transactions involving similar intellectual property

The selection of an appropriate royalty rate method is generally based on the facts and circumstances of each specific case. In some instances, however, the selection of an appropriate intellectual property royalty rate method may be a legal determination. The analyst should consult with client legal counsel early in the analysis process to determine which methods may or may not be acceptable based on statutory authority, judicial precedent, or administrative ruling.

When estimating a reasonable royalty rate for economic damages purposes, it is common for the analyst to use a combination of royalty rate methods. The combination reflects the different factual circumstances that could lend themselves to different reliable methodologies.

Ultimately, whatever royalty rate methodology is used should be:

1. legally permissible in the relevant jurisdiction and
2. sufficiently tied to the facts and circumstances of the case.

The analyst will often apply a market-based method as part of the royalty rate selection process. This is because “the market”—that is, the economic environment where arm’s-length transactions between unrelated parties occur—can typically provide the best indication of a reasonable royalty.

One market-based method commonly used to estimate a reasonable royalty rate is the CUT method. This method is commonly used because trademarks and patents are frequently sold or licensed in arm’s-length transactions.

The CUT method requires the analyst to collect and analyze market-derived transactional data regarding the sale or license of comparable IP. Comparability is determined based on such characteristics as type, use, profit potential, and the industry in which the subject intellectual property functions.

If properly analyzed, the results derived from the CUT method generally provide a direct and reliable measure of a market-based royalty rate for the subject intellectual property.

THE CUT METHOD ROYALTY RATE SELECTION PROCESS

While the CUT methodology is relatively simple, the practical application of the CUT method involves a complex and rigorous analytical process.

The general procedures of the CUT method are summarized as follows:

1. Define the subject intellectual property.
2. Analyze the quantitative and qualitative factors of the subject intellectual property; this may include the determination of an appropriate royalty base.
3. Identify the appropriate criteria for selecting comparable sale or license transactions, such as intangible asset type, intangible asset use, industry in which the intangible asset operates, date of sale, and so on.
4. Select comparable sale or license transactions.
5. Verify that the comparable transactional data is factually accurate and reflect arm’s-length market considerations; this step includes reading the comparable transactional data.
6. Analyze the comparable transactional data to develop appropriate royalty rate metrics.

7. Select a royalty rate specific to the subject intellectual property.
8. Apply the selected royalty rate to the subject intellectual property metrics.

The analyst should examine each comparable sale or license transaction for terms and conditions that would justify elimination, adjustment, or reliance on the underlying data.

It is generally appropriate for analysts to eliminate from consideration those anomalous observations that cannot be normalized or adjusted. However, it is generally inappropriate for analysts to eliminate from consideration those anomalous observations simply because they fall outside of the typical observation range.

DEFINING THE ANALYSIS SUBJECT

An important initial procedure in a reasonable royalty rate analysis is to define the analysis subject. Defining the analysis subject will help the analyst (1) determine an appropriate royalty base and (2) identify comparable sale and license transactions.

Trademarks and patents are types of intellectual property. Intellectual property is a special and distinct subset of commercial intangible assets. There are four main types of intellectual property.

These intellectual property types include the following:

1. Trademarks
2. Patents
3. Copyrights
4. Trade secrets

Each of these four types of intellectual property is legally created under and protected by a specific federal or state statute. Each of these intellectual property types can be associated with a number of related other intangible assets.

Defining the analysis subject is an important procedure in any royalty rate analysis, and it is especially important when using the CUT method. This is because the credibility of the CUT method is based on identifying comparable transactions involving comparable property.

In order to be considered “comparable” to the subject intellectual property transaction, an uncontrolled sale or license transaction need not be identical to the subject transaction, but must be sufficiently similar that it provides a reliable measure of an arm’s-length result.

THE APPROPRIATE ROYALTY BASE

Another important procedure in the analysis of the subject intellectual property is the determination of the appropriate royalty base.

The royalty base for both trademark and patent damages measurements are typically subject to the “entire market value rule” (EMVR). This rule “permits recovery of damages based on the value of the entire apparatus containing several features, where the patent-related feature is the basis for customer demand.”¹⁵

Broadly speaking, where the patented feature drives customer demand for the entire infringed product, the EMVR permits the patent owner to treat all revenue from the infringing product as an appropriate royalty base.

In particular, the courts have held that application of the EMVR in the context of patent royalties requires adequate proof of three conditions:

1. The infringing components should be the basis for customer demand for the entire machine including the parts beyond the claimed invention.
2. The individual infringing and noninfringing components should be sold together so that they constitute a functional unit or are parts of a complete machine or single assembly of parts.
3. The individual infringing and noninfringing components should be analogous to a single functioning unit.¹⁶

In practical terms, the EMVR is defined as the “smallest salable infringing unit with close relation to the claimed invention.”¹⁷ This unit may represent a single component employed in a larger product, such as one of several computer processor circuit boards incorporated into a computer server.

The courts have scrutinized the application of the EMVR more closely in recent years. In one recent example, a district court excluded the testimony of the plaintiff’s damages expert for improperly applying the EMVR in determining the reasonable royalty for an infringing feature of the defendant’s product. The court explained that the damages expert provided no evidence that “the systems’s entire value derived from that single feature.”¹⁸

If, however, the patented features do not prove to be the basis of customer demand, or otherwise meet the requirement for the EMVR, the royalty base may need to be apportioned to the relevant patented features, even if those features are not independently saleable.

Apportionment seeks to limit an infringer’s damages to the contributed value of the patented technology. This principle seeks to avoid the situation where the aggregate royalties from components would be greater than the value of the product itself.

When preparing an intellectual property infringement analysis, analysts should work with legal counsel early in the analysis process to determine the appropriate royalty base.

SOURCES OF INTELLECTUAL PROPERTY SALE OR LICENSE TRANSACTIONS

The analyst can rely on a number of data sources in order to identify comparable sale or license transactions. These data sources include government databases, news and industry trade publications, and third-party subscription-based royalty rate databases.

Examples of third-party intellectual property sale or license transaction databases include the following:

1. Business Valuation Resources ktMINE database
2. Royalty Connection database
3. RoyaltySource Intellectual Property database
4. Royalty Range European Royalty database
5. RoyaltyStat, LLC
6. Industry-specific databases

These third-party royalty rate data providers collect transactional data involving intellectual property (including trademark and patent) sale or license agreements from publicly available sources, such as Securities and Exchange Commission (SEC) filings, news articles, industry trade publications, and company press releases.

The analyst can search these royalty rate databases to identify sale or license transactions that have factors comparable to the relevant factors of the subject intellectual property.

In recent years, the courts in infringement cases have taken a very conservative approach to comparability. Analysts that testify to the comparability of royalty rate data need to select data that is sufficiently similar to the subject intellectual property that it provides a reliable indication of a comparable arm’s-length royalty rate. These data typically

“[R]aw transactional data obtained from third-party databases typically contain information that is not relevant or comparable to the subject transaction.”

should include actual sale or license transactions involving comparable intellectual property.

Other types of royalty rate data include industry royalty rates and royalty rates derived from surveys. Generally, the courts have considered these types of data to be too broad to provide relevant, comparable royalty rate data. For this reason, the analyst ordinarily should use these types of data as a reasonableness check and not as the primary indication of a reasonable royalty rate.

In a 2015 decision, a district court excluded the testimony of the plaintiff's damages expert based on an improper reasonable royalty analysis.¹⁹

The court noted that the expert's opinion relied on nonspecific or irrelevant royalty rate data, including the following:

1. Licenses obtained from RoyaltySource that were not comparable to the patented technology
2. Generalized royalty rate studies that the court noted were no better than applying an impermissible “rule of thumb” analysis

This decision is only the latest in a line of recent cases where the courts have demanded more analytical rigor in the determination of a reasonable royalty.

A damages expert should read and understand license agreements and other royalty rate data and consider how that material applies to the facts and circumstances of the present case before formulating a royalty-rate-based damages analysis.

ADJUSTING TRANSACTIONAL DATA

The raw transactional data provided from sale or license transaction databases often will need to be adjusted to increase their comparability to the subject intellectual property. This is because the raw transactional data obtained from third-party databases typically contain information that is not relevant or comparable to the subject transaction.

Examples of normalization adjustments commonly used to increase the comparability of the raw transactional data to the subject transaction include the following:

- Upfront fixed payments
- Milestone fixed payments
- Minimum/maximum fixed payments
- Litigation settlements
- Intercompany transfers
- Equity as part of license
- Short/long license terms
- Sale transaction—not a license transaction
- Royalty rate based on different metrics (e.g., percent of sales or percent of profits)
- Royalty on sublicense income
- Multiple intellectual property in the license
- Product sale/distribution agreements
- Relation to other agreements

ELEMENTS OF COMPARISON

The significant and unique attributes of intellectual property can vary greatly. For comparative analysis purposes, however, intellectual property attributes can generally be categorized into 10 common elements of comparison. These elements of comparison can be used to select and analyze CUT sale or license transactions.

The 10 common elements of comparison are as follows:²⁰

1. The legal rights or type of intangible asset ownership conveyed
2. The existence of any special terms or arrangements (for example, between the buyer or licensee and the seller or licensor)
3. The existence, or absence, of arm's-length sale or license conditions
4. The economic (especially the risk and expected returns) conditions existing in the appropriate secondary market at the time of the sale or license transaction
5. The industry in which the intellectual property is used
6. The geographic or territorial characteristics associated with the sale or license transaction
7. The term or duration characteristics of the sale or license transaction
8. The use, exploitation, or obsolescence characteristics of the sale or license transaction
9. The economic characteristics of the sale or license transaction

10. The inclusion of other assets in the sale or license transaction (this element may include the sale or license of a bundle or a portfolio of assets, such as the use patented and unpatented products, marketing assistance, trademarks, product development, or other contractual rights)

Not all of the above listed elements of comparison may be applicable in all cases. The elements of comparison relied on to select and analyze CUT sale or license transaction data should relate to the relevant attributes of the subject intellectual property.

The analyst can use the elements of comparison to develop a comparative analysis focused on the similarities and differences between the comparable intellectual property and the subject intellectual property. This comparability analysis will help the analyst select truly comparable sale and license transaction data and develop a credible and defensible, reasonable royalty rate.

CONCLUSION

This discussion summarized the methods and procedures used to estimate intellectual property royalty rates and the factors and circumstances that analysts often consider when selecting a reasonable royalty rate for intellectual property economic damages purposes.

For most of these types of intellectual property disputes, the analysis of a reasonable royalty is a frequently relied on and generally accepted method for calculating damages.

From an analyst perspective, the selection of a reasonable royalty rate is typically one of the contested aspects involved in an intellectual property economic damages dispute. This is because the process used to determine a reasonable royalty rate can be different for each intellectual property infringement engagement.

In order to develop credible and defensible intellectual property royalty rates, analysts should:

1. provide a thorough analysis of the relevant functions, risks, and economics associated with the subject intellectual property;
2. analyze the general factors and circumstances that affect the pricing of both the subject intellectual property and comparable intellectual property royalty rate transactions; and
3. work closely with counsel to develop an accurate understanding of the facts and circumstances of the specific case and the applicable law of the relevant jurisdiction.

Notes:

1. Hansen v. Alpine Valley Ski Area, Inc., 718 F.2d 1075, 1078 (Fed. Cir. 1983).
2. *PwC 2014 Patent Litigation Study* (PricewaterhouseCoopers LLP, 2014): 10.
3. Wordtech Sys. v. Integrated Network Solutions, Inc., 609 F.3d 1319 (Fed. Cir. 2010).
4. Hansen v. Alpine Valley Ski Area, Inc.
5. Ericsson, Inc. v. D-Link Systems, Inc., No. 2013-1625, -1631, -1632, -1633 (Fed. Cir. Dec. 4, 2014).
6. Wordtech Sys. v. Integrated Network Solutions, Inc., 609 F.3d 1319 (Fed. Cir. 2010).
7. 318 F. Supp. 1116 (S.D.N.Y. 1970).
8. Technology and IP Law Glossary (<http://www.ipglossary.com/glossary/georgia-pacific-factors/#.VoMi2vkrJD8>).
9. WhitServe, LLC v. Computer Packages, Inc., No. 2012-1206, -1261 (Fed. Cir. Aug. 7, 2012).
10. Ibid.
11. Ibid.
12. Ericsson, Inc. et al. v. D-Link Systems, Inc.
13. Monsanto Co. v. Ralph, 382 F.3d 1374 (Fed. Cir. 2004).
14. Ibid.
15. State Industries, Inc. v. Mor-Flo Industries, Inc., 883 F.2d 1573, 1580 (Fed. Cir. 1989).
16. Cornell v. Hewlett-Packard Co., 609 F.Supp.2d. 279 (N.D.N.Y. 2009).
17. Ibid. See also Laser Dynamics, Inc. v. Quanta Computer, Inc., 694 F.3d 51, 67 (Fed. Cir. 2012).
18. Ibid.
19. Chico's Fas, Inc. v. Clair, 2015 U.S. Dist. LEXIS 71716 (June 3, 2015).
20. Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants, Inc., 2014), 260.

"[T]he process used to determine a reasonable royalty rate can be different for each intellectual property infringement engagement."

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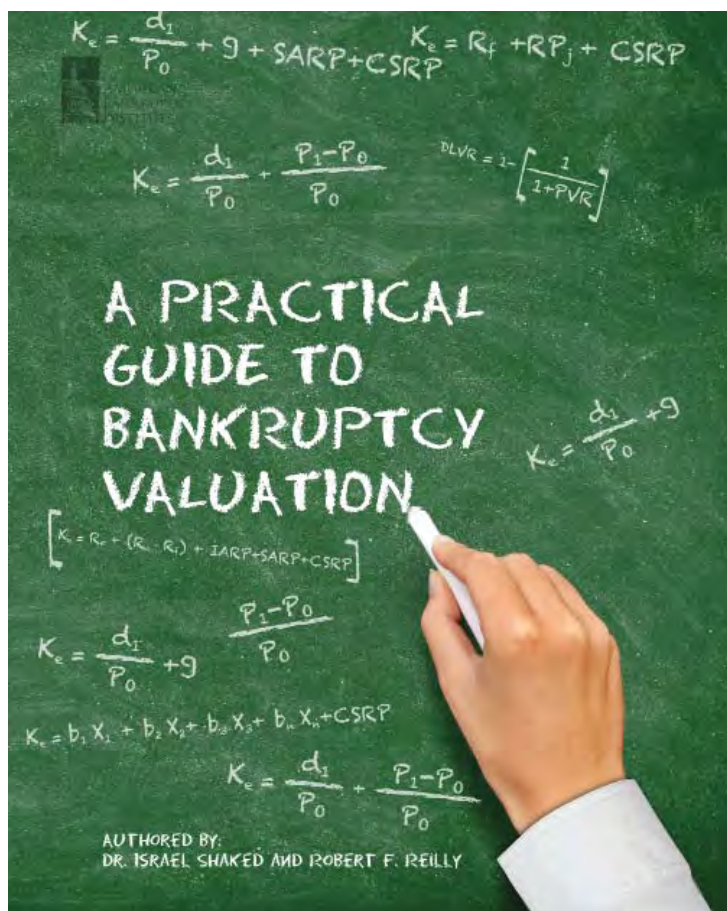
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Glossary



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Best Practices

Laches: The Federal Circuit Sheds New Light on an Old but Still Vital Patent Defense

Bart Starr, Esq.

The doctrine of laches remains alive and relatively well in patent litigation, and this is good news for alleged infringers. Patent owners and alleged infringers alike should continue to take seriously the potential impact of a viable laches defense. Why? Because a finding of laches can eviscerate or eliminate entirely the types and scope of monetary relief (e.g., past monetary damages) and, in certain cases, equitable relief sought by a patent owner who files an otherwise-winning patent-infringement action but who unreasonably and inexcusably delays filing suit.

INTRODUCTION

On most days, the U.S. Court of Appeals for Federal Circuit—the last word in patent law, short of the Supreme Court—is perfectly content to ignore copyright law.

The Federal Circuit understandably sticks primarily to its patent-related knitting and allows the other 13 frequently divided Courts of Appeal and the Supreme Court to sort out the conflicts and intricacies of copyright law, trademark law, and countless other varieties of legal jurisprudence.

But a Supreme Court *copyright* laches opinion from last year compelled the *en banc* Federal Circuit's to address and (to a degree) bless the age-old doctrine of *patent* laches in *SCA Hygiene Products v. First Quality Baby Products*.¹

THE LAW OF LACHES

To fully understand the Federal Circuit's *SCA* decision, it's first necessary to understand the basic elements of and rationale behind the doctrine of laches (not to be confused with the separate and distinct doctrine of estoppel).

The doctrine of laches, colloquially referred to as “sleeping on one's rights,” is invoked in many areas of the law and has long been a weapon, albeit a relatively underused one, in an alleged patent infringer's arsenal.

Laches is “an equitable defense to a claim for patent infringement” that requires proof by the alleged infringer of two elements by a preponderance of the evidence:

1. A patent owner's unreasonable and inexcusable delay in filing suit *and*
2. Material prejudice suffered by the alleged infringer as a result of the delay.²

Material prejudice to an alleged infringer may be “either economic or evidentiary,” and, in the case of economic prejudice, the court “must look for a *change* in the economic position of the alleged infringer during the period of delay”³ [emphasis in original].

In determining whether laches applies, a court must consider and weight “all pertinent facts and equities,” including “the length of delay, the seriousness of prejudice, the reasonableness of [the

patentee's] excuses, and the defendant's conduct or culpability."⁴

Unlike estoppel, which can bar an entire legal action or claim, laches necessarily "bars relief on a patentee's claim only with respect to damages accrued prior to suit."⁵ The *equitable* doctrine of laches and its impact on patent infringement damages must of course be considered along with its *statutory* counterpart in the U.S. Patent Act—specifically 35 U.S.C. § 286—which typically limits a patent owner's monetary recovery of past damages to the six-year period before the lawsuit was filed.⁶

"The stated difference in the effect of laches and estoppel has served well to emphasize that more is required in the overall equities than simple laches if an alleged infringer seeks to wholly bar a patentee's claim."

THE SUPREME COURT'S *PETRELLA* DECISION

To fully understand the Federal Circuit's *SCA* decision, it's also necessary to understand the Supreme Court *copyright* opinion that compelled an *en banc* Federal Circuit to address the continued viability of laches in the *patent* context. That copyright case was *Petrella v. Metro-Goldwyn-Meyer, Inc.*⁷

The statute of limitations that determined the outcome of *Petrella*⁷ provides that "[n]o civil action shall be maintained under the provisions of this title unless it is commenced within *three years* after the claim *accrued*"⁹ [emphases added].

Over the years when the case was pending, *Petrella* inevitably became known as the "Raging Bull" case because the case centered on a screenplay, authored by Frank Petrella and registered in 1963, about the life of the 1940s- and 1950s-era boxing champion Jake LaMotta, also known as the "Raging Bull."

In 1980, Metro-Goldwyn-Meyer, Inc. (MGM) released the renowned film *Raging Bull*, directed by Martin Scorsese and starring Robert De Niro.¹⁰

Eighteen years later, in 1998, Paula Petrella—Mr. Petrella's daughter and the sole owner of the copyrighted screenplay following her father's death in 1981—informed MGM about her ownership of the copyright in the screenplay and warned that MGM's production or exploitation of any derivative work, including MGM's continued marketing and distribution of the *Raging Bull* film through DVD sales and other means, infringed Petrella's copyright in the 1963 screenplay.¹¹

Petrella's and MGM's lawyers exchanged letters over the next two years without resolution, and Petrella repeatedly threatened legal action against



MGM. Finally, on January 6, 2009, Petrella filed a copyright infringement suit against MGM in the Central District of California.¹²

Notably, Petrella sought both monetary and injunctive relief, but only for MGM's use and distribution of the *Raging Bull* film on or after January 6, 2006, the date falling three years before the suit was filed.¹³

The district court granted summary judgment in MGM's favor and concluded that despite the fact Petrella's suit sought relief only for those acts of infringement occurring within three years of filing, Petrella's entire complaint and claims (not just her requests for monetary and injunctive relief) were barred by laches because, according to the court, Petrella had unreasonably delayed by not filing suit until 2009 (recall that MGM had first been accused of infringement and threatened with litigation in 1998).¹⁴

The court also concluded that MGM was materially prejudiced by Petrella's delay because MGM had "made significant investments in exploiting the film" since it was first released in 1980.¹⁵

On appeal by Ms. Petrella, the Ninth Circuit affirmed the district court's grant of summary judgment, because MGM had arguably been infringing for decades and because the court concluded it was therefore bound by its precedent that if "any part of the alleged wrongful conduct occurred outside of the [three-year] limitations period, courts presume that the plaintiff's claims are barred by laches."¹⁶

At Ms. Petrella's request, the Supreme Court granted certiorari to address the district court's and 9th Circuit's laches-based rejection of Petrella's claims and "to resolve a conflict among the Circuits on the application of the equitable defense of laches to copyright infringement claims brought within the three-year look-back period described by Congress."¹⁷

The Supreme Court focused on the question of whether “the equitable defense of laches [] may bar relief on a copyright infringement claim brought within Section 507(b)’s three-year limitations period.”¹⁸

Since MGM had committed allegedly infringing acts (e.g., continuing to market and distribute the Raging Bull film) *within* the three-year period before Petrella filed suit, the Court answered this question in the negative, holding that laches “*cannot* be invoked to preclude adjudication of a claim for damages brought within the three-year window” set forth in Section 507(b)¹⁹ [emphasis added].

The Supreme Court added, however, that “[a]s to *equitable relief*, in extraordinary circumstances, laches may bar at the very threshold the particular [equitable] relief requested by the plaintiff” and that a copyright owner’s delay in filing suit “can always be brought to bear at the remedial stage, in determining appropriate injunctive relief, and in assessing the profits of the infringer attributable to the infringement”²⁰ [emphasis added] (citing 17 U.S.C. Section 504(b)).

In support of its holding, the Court took notice that it had “never applied laches to bar in their entirety claims for discrete wrongs occurring within a federally prescribed limitations period,” and inviting individual judges to set a time limit other than the [three-year limit] Congress prescribed” would “tug against the uniformity Congress sought to achieve when it enacted § 507(b).”²¹

In holding that Section 507(b) of the Copyright Act essentially trumped the judicially created laches defense in the copyright context, at least under the facts presented in *Petrella*, the Court also noted that the Copyright Act’s three-year period set forth in Section 507(b)’s “allows a copyright owner to defer suit until she can estimate whether litigation is worth the candle” and while she “will miss out on damages for periods prior to the three-year look-back, [] her right to prospective *injunctive* relief should, in most cases, remain unaltered”²² [emphases added].

With respect to Petrella’s request for *injunctive* relief (versus *monetary* relief) against MGM’s further infringement, the Court noted that “[s]hould Petrella ultimately prevail on the merits, the District Court, in determining appropriate injunctive relief and assessing profits, may take account of her delay in commencing suit,” MGM’s “reliance on Petrella’s delay,” and MGM’s “early knowledge of Petrella’s claims,” among other factors.²³

Notably, Justice Ginsburg, writing on behalf of the majority of the Supreme Court, explicitly invoked an “incident of injury” rule under which a copyright claim brought under 17 U.S.C. Section 507(b) *generally* “arises or ‘accrues’ *when an infringing act occurs*,” not when an infringing act

is discovered or reasonably should have been discovered by the copyright owner²⁴ [emphasis added].

At the same time, however, Justice Ginsburg observed in a footnote that “nine Courts of Appeal have adopted, as an alternative to the incident-of-injury rule, a ‘discovery rule,’ which starts the limitations period when ‘the plaintiff discovers, or with due diligence should have discovered, the injury that forms the basis for the claim.’”²⁵

Query whether the Supreme Court majority held in *Petrella* that:

1. the “incident of injury” rule (i.e., the “date-the-infringement(s)-occurred” rule) is now the law and that the Court, therefore, has, with a wave of its collective hand, overruled the “discovery rule” adopted by the great majority of the Courts of Appeal or
2. whether Justice Ginsburg’s statement regarding the “incident of injury” rule and the accompany footnote is mere dicta for purposes of the time of “accrual” of a copyright claim under 17 U.S.C. Section 507(b).

The answer to that question, whatever it may be, has a tremendous impact on whether certain meritorious copyright-infringement claims may be filed and maintained under Section 507(b).²⁶

Apparently to provide alleged patent infringers with a modicum of hope, the Court added that in cases involving “extraordinary circumstances” that would create an unjust hardship for a defendant and/or third parties, “the consequences of a delay in commencing suit may be of sufficient magnitude to warrant, at the very outset of the litigation,” denial of certain equitable relief sought by the plaintiff and may also be considered by the court when “determining appropriate injunctive relief and in assessing the ‘profits of the infringer attributable to the infringer.’”²⁷

In the end, the Court emphasized that Petrella’s case and requested relief were not barred by laches, that Section 507(b) “makes the starting trigger an infringing act committed three years back from the commencement of suit,” that her “action was commenced within the bounds of [the three-year] time-to-sue provision,” and that the case did not “present extraordinary circumstances” that would prevent maintenance of the lawsuit or any of the monetary or injunctive relief sought by Petrella.²⁸

THE FEDERAL CIRCUIT’S *EN BANC* PATENT DECISION IN *SCA*: A REACTION TO *PETRELLA*

The Federal Circuit took the *SCA* case *en banc* to address two questions:

1. Whether, in light of the *Petrella* decision, the defense of laches remains “applicable to bar a claim for damages based on patent infringement occurring within the six-year damages limitations period established by 35 U.S.C. Section 286.
2. Whether laches should ‘be available under some circumstances to bar an entire infringement suit for either damages or injunctive relief’ in light of Supreme Court precedent and the absence of a true statute of limitations for patent-infringement claims.

As for the first question, the court answered in the affirmative, noting that Congress codified a laches defense in Section 282 of the Patent Act that bars recovery of legal relief such as pre-filing damages, including damages resulting from infringing acts occurring within six years of filing.

Notably, the court’s conclusion that laches was implicitly included among the defenses provided in 35 U.S.C. Section 282 was based primarily, if not exclusively, on commentary by Pasquale Joseph (“P. J.”) Federico, a long-time Patent Office official described in the *SCA* opinion as a “principal draftsman” of the 1952 Patent Act recodification.

As for the second question, the court also answered in the affirmative, noting that (as the question was posed) “under some circumstances” laches can bar a patent lawsuit seeking damages under 35 U.S.C. Section 284, that laches may also bar injunctive relief, and that a patent owner’s unreasonable and/or inexcusable delay in filing suit should be considered by a court, along with the other factors set forth in *eBay Inc. v. MercExchange, LLC*,²⁹ in determining whether to grant an injunction.

The facts of *SCA* were relatively straightforward. In October 2003, *SCA* sent First Quality a letter alleging that a product made and sold by First Quality infringed *SCA*’s ‘646 patent.

In November 2003, First Quality wrote *SCA*, alleging that the ‘646 patent was invalid in light of a prior art patent. In July 2004, *SCA* requested reexamination of its own ‘646 patent in light of the patent cited by First Quality.

Although it was not required to do so, *SCA* never informed First Quality about the ‘646 patent reexamination, First Quality apparently never learned about the reexamination, and, “from First Quality’s point of view, *SCA* dropped its infringement allegations against First Quality after First Quality argued the patent was invalid in the November 21st letter.”

In March 2007, the U.S. Patent and Trademark Office (PTO) confirmed the patentability of all original claims of the ‘646 patent. First Quality did not sit on its hands after it wrote *SCA* alleging that the ‘646 patent was invalid.

In the three and one-half years after it wrote *SCA* in November 2003 and before the PTO ultimately confirmed the patentability of the ‘646 patent in March 2007, First Quality had significantly expanded its potentially infringing product offerings by spending at least \$10 million to purchase at least four additional product lines.

Under these facts, the Western District of Kentucky granted First Quality’s motion for summary judgment as to laches and equitable estoppel. On appeal, a Federal Circuit panel affirmed the district’s grant of summary judgment as to laches and “rejected *SCA*’s argument that the Supreme Court’s *Petrella* decision abolished laches in patent.”

The panel instead felt bound by the *en banc* Federal Circuit’s previous and thorough opinion on laches in *A.C. Aukerman Co. v. R.L. Chaides Construction Co.*³⁰

As noted above, the *Aukerman* court had expressly affirmed that laches was alive and well in the patent litigation context, holding that laches is “an equitable defense to a claim for patent infringement” and was “well established at the time of recodification of the patent laws in 1952.”³¹

In *SCA*, the Federal Circuit was placed in the position of dealing with the Supreme Court’s recent copyright decision in *Petrella* and with the reconciliation of two separate, distinct, and (at least to some Federal Circuit judges) irreconcilable sections of the Patent Act:

1. 35 U.S.C. Section 286, which limits recovery of past damages to the six years before a patent-infringement complaint is filed
2. 35 U.S.C. Section 282, which, as noted above, has implicitly included laches as one of the affirmative defenses to allegations of patent infringement since the recodification of the patent laws in 1952

Not surprisingly, the majority of the Federal Circuit in *SCA* repeatedly invoked its previous *en banc* decision in *Aukerman* in holding that “[b]y its terms, § 286 is a damages limitation [that] does not preclude bringing a claim,” that Congress codified a laches defense more than 60 years ago in Section 282(b)(4)’s “catch-all provision,” that the court saw “no substantive distinction material to the *Petrella* analysis” between Section 286 of the Patent Act and

Section 507(b) of the Copyright Act considered in *Petrella*, and that the Section 286 damages limitation and the Section 282 laches defense “must continue to coexist” in patent litigation.

The Federal Court’s holding that laches “remains a viable defense to legal relief in patent law” is critical because, as the Federal Circuit observed, “without laches, innovators have no safeguard against tardy claims demanding a portion of their commercial success.”

Also, unlike in copyright cases (in which knowledge of, and proof of access to, the copyright material is required), a patent case (in which innocent infringement, independent invention, and lack of knowledge of the patent are no defense) may involve a defendant who is oblivious to its infringing activity and may be unable to “estimate its exposure when making its initial investment decision.”

The important takeaways (some old, some new) from the *SCA* opinion are these:

- In patent cases, laches remains a viable defense for an alleged infringer that can bar recovery of pre-filing monetary damages based on a reasonable royalty or, in some instances, the patent owner’s lost profits.
- Absent “egregious circumstances, [and] when injunctive relief is inappropriate, the patentee remains entitled to an ongoing royalty,” and “equity normally dictates that courts award ongoing royalties, despite laches.”
- Laches *may* but does not *necessarily* bar permanent injunctive relief, and “district courts should consider all material facts, including those giving rise to laches, in exercising its discretion” under the Supreme Court’s controlling *eBay* decision to grant or deny a permanent injunction against further patent infringement.³²
- Like the commonly invoked defenses of invalidity and noninfringement, laches is another available statutory defense implicitly included in Section 282 of the Patent Act since at least 1952, despite the fact that the term “laches” appears nowhere in Section 282.
- Unlike estoppel, laches does not operate to bar an entire suit. Laches bars past, pre-filing monetary damages and, in some cases, may also bar ongoing monetary relief and/or permanent injunctive relief.

CONCLUSIONS AND RECOMMENDATIONS

Until and unless the Supreme Court decides otherwise, laches remains a potentially potent defense to patent infringement. Not surprisingly, given the razor-thin 6-to-5 victory for alleged infringers in the Federal Circuit’s *SCA v. First Quality* decision, *SCA* filed a petition for writ of certiorari in the Supreme Court (No. 15-927) in January of this year. That petition remains pending and undecided as of the publication of this article.

To the author, the most confusing and troubling aspect of the Federal Circuit’s *SCA* decision was that the court saw “no substantive distinction material to the *Petrella* analysis” between Section 286 of the Patent Act (which by its express terms sets a time limitation on patent *damages*, not a time limitation on the filing of a lawsuit) and Section 507(b) of the Copyright Act considered in *Petrella*, which establishes as three-year “clock” to *file* a copyright lawsuit and makes no mention of damages or other relief.

In addition, the fact that the defense of laches is not expressly recited in 35 U.S.C. Section 282(b) and the fact that the Federal Circuit relied upon the Federico commentary as a basis (if not *the* basis) for concluding that laches is included under 35 U.S.C. Section 282(b)(4) as a patent infringement defense may understandably concern some, if not most, Supreme Court justices.

The author, however, believes that laches will remain a viable and important defense against patent infringement allegations, even if the issue of laches in the patent context is taken up and reconsidered by the Supreme Court, since no consideration of the Copyright Act or the *Petrella* decision is required to analyze laches in the patent context.

As noted by the Federal Circuit, the Patent Act includes *both* a laches defense codified in 35 U.S.C. Section 282 *and* a six-year time limitation on the recovery of damages codified in 35 U.S.C. Section 286, and both provisions of the Patent Act “can coexist in patent law.”

The Supreme Court has not been reluctant during the past few years to disagree with Federal Circuit opinions addressing critical patent issues and standards.

The Supreme Court, however, typically is not in the business of striking or amending federal *statutes* absent a clear conflict between Congress’s language and intent. The author believes that *SCA*’s petition for certiorari in the Supreme Court will be denied, or that the Supreme Court would affirm the viability of laches as a defense to allegations of patent infringement.

Our recommendations for alleged patent infringers? Don't hesitate to plead and prove the defense of laches in cases in which the patent owner (e.g., a nonpracticing entity that purchased a patent and lay in wait until an alleged infringer with deep pockets emerged) has unreasonably or inexplicably delayed filing suit for years after it knew or should have known of your client's allegedly infringing activity.

Including or omitting a laches defense in your answer can make the difference between a patent owner:

1. going home empty handed or
2. recovering significant past damages and receiving either ongoing royalty payments or a permanent injunction.

And for patent owners? Recognize and deal with laches, which likely is not going away any time soon. Don't invite a finding of laches under the Federal Circuit's SCA decision and other authority (e.g., *Aukerman*) by unnecessarily delaying assertion of your potentially valuable patent rights.

If your patent is being infringed, and you have conducted the necessary investigation and due diligence, take action by (from the most aggressive to least aggressive):

1. filing a complaint, serving the summons and complaint, and commencing litigation;
2. filing a complaint and, afterwards, inviting settlement discussions or mediation during the pre-service period allowed under Rule 4(m) of the Federal Rules of Civil Procedure; or
3. informing the alleged infringer of your infringement concerns and inviting further discussions or alternative means of dispute resolution (a side effect of which can be a declaratory judgment action filed by the alleged infringer against you in an inconvenient and/or unfavorable forum).

Patent litigation can be expensive, disruptive, and tempting to avoid, but sleeping for years on your patent rights may eventually result in a rude awakening under SCA.

Notes:

1. *SCA Hygiene Products v. First Quality Baby Products*, No. 2013-1564, 807 F.3d 1311 (2015) (en banc). The SCA court's sharply divided, six-to-five opinion can be found at <http://www.cafc.uscourts.gov/node/18997>.

2. See *A.C. Aukerman Co. v. R.L. Chaides Co.*, 960 F.2d 1020, 1032 (Fed. Cir. 1992) (en banc).
3. *Id.* at 1033.
4. 960 F.2d at 1034.
5. *Id.* at 1040-41.
6. See 35 U.S.C. § 286 (“[N]o recovery shall be had for any infringement committed more than six years prior to the filing of the complaint or counterclaim for infringement in the action.”).
7. *Petrella v. Metro-Goldwyn-Meyer, Inc.*, 134 S. Ct. 162 (2014), the Supreme Court's opinion for which may be found at <http://www.supremecourt.gov/opinions/13/1301013>.
8. 17 U.S.C. § 507(b).
9. *Id.*
10. 134 S.Ct. at 1970-71.
11. *Id.* at 1971.
12. *Id.*
13. *Id.* at 1971-72.
14. *Id.* at 1971-72.
15. *Id.* at 1972.
16. *Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 997 (9th Cir. 2006).
17. 134 S.Ct. at 1972.
18. *Id.* at 1967.
19. *Id.*
20. *Id.*
21. *Id.* at 1975.
22. *Id.* at 1976.
23. *Id.* at 1978.
24. 134 S.Ct. at 1969.
25. *Id.* at n.4.
26. See, e.g., Bart A. Starr, *Fixing Copyright's Three-Year Limitations Clock: The Accrual of an Infringement Claim under 17 U.S.C. § 507(b)*, 78 WASH. U. L.Q. 623 (2000) (proposing adoption of the “discovery” rule by all courts).
27. *Petrella*, 134 S.Ct. at 1967, 1977 (citing *Chirco v. Crosswinds Communities, Inc.*, 474 F.3d 227 (6th Cir. 2007) as “illustrative” of such “extraordinary circumstances”).
28. *Id.* at 1975, 1978.
29. *eBay Inc. v. MercExchange, LLC*, 547 U.S. 388 (2006).
30. *A.C. Aukerman Co. v. R.L. Chaides Construction Co.*, 960 F.3d 1020 (Fed. Cir. 1992) (en banc).
31. *A.C. Aukerman*, 960 F.2d at 1027, 1029.
32. See *eBay Inc. v. MercExchange, LLC*, 547 U.S. 388 (2006).

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An Exceptional Development: Toward a Unified Standard for Recovering Attorneys' Fees in Trademark Litigation

Brian K. Brookey, Esq.

This discussion includes an analysis of recent trademark infringement cases and current trends affecting the recovery of attorneys' fees in trademark infringement matters, including the Supreme Court's definition of "exceptional" and the impact of the Octane Fitness patent infringement decision on trademark infringement matters.

INTRODUCTION

In 2014, the Supreme Court overruled Federal Circuit precedent, changing (and, most observers believe, lowering) the showing that must be made for a successful litigant in a patent case to recover attorneys' fees. The Supreme Court did not address the effect of its decision on trademark infringement matters under the Lanham Act.

As lower courts begin to grapple with that issue, certain trends are becoming apparent. At long last, there is likely to be a uniform standard in trademark infringement matters for recovering attorneys' fees—a standard that is identical to that now applicable in patent cases.

THE SUPREME COURT'S DEFINITION OF "EXCEPTIONAL"

Nearly two years ago, in *Octane Fitness v. ICON Health & Fitness, Inc.*,¹ the Supreme Court changed the standard for obtaining attorneys' fees in patent infringement cases. The statutory basis for such awards is set forth in 35 U.S.C. Section 285: "The court in exceptional cases may award reasonable attorney fees to the prevailing party."

In *Octane Fitness*, the Court noted that this is a discretionary standard that for decades was applied using a "holistic, equitable approach." However,

that approach changed with the Federal Circuit's decision in *Brooks Furniture Mfg., Inc. v. Dutalier Int'l, Inc.*²

The Federal Circuit held in *Brooks Furniture* that a patent case may be deemed exceptional only "when there has been some material inappropriate conduct related to the matter in litigation, such as willful infringement, fraud or inequitable conduct in procuring the patent, misconduct during litigation, vexatious or unjustified litigation, conduct that violates Fed.R.Civ.P. 11, or like infractions."³

The Supreme Court criticized the *Brooks Furniture* test as a "more rigid and mechanical formulation" than had been used in the past.⁴

Instead, the Supreme Court held that the word "exceptional" should be given its plain meaning. The Court cited such dictionary definitions of "exceptional" as "uncommon," "rare," or "out of the ordinary."

Therefore, a case is "exceptional" when it "stands out from others with respect to the substantive strength of a party's litigating position . . . or the unreasonable manner in which the case was litigated."⁵

The Supreme Court rejected the *Brooks Furniture* test, which "superimposes an inflexible framework onto statutory text that is inherently flexible," in favor of a test in which a district may find a case "exceptional" by using its discretion in light of the totality of the circumstances.⁶

The Supreme Court also held that the evidentiary standard for determining whether a case is exceptional should be preponderance of the evidence, jettisoning the Federal Circuit's clear and convincing evidence standard.⁷

Although the Supreme Court did not expressly state that its holding applies to trademark litigation under the Lanham Act,⁸ it did note that the Lanham Act contains an identical exceptional case standard.

The Supreme Court also cited with approval a D.C. Circuit case that defined "exceptional" in the context of the Lanham Act as meaning "uncommon" or "not run-of-the-mill."⁹

Since *Octane Fitness* was decided, numerous district and appellate courts have struggled with the question of whether its flexible standard for patent cases should apply to requests for attorneys' fees in trademark infringement matters.

DOES—OR SHOULD—OCTANE FITNESS APPLY TO TRADEMARK CASES?

The Federal Circuit has exclusive appellate jurisdiction over patent matters, and until *Octane Fitness*, the *Brooks Furniture* standard applied nationwide to patent litigation. District Court trademark matters are appealable to regional circuits, with the different circuits adopting various tests for determining when a case is "exceptional."¹⁰

In his opinion in *Nightingale Home Healthcare, Inc. v. Anodyne Therapy, LLC*,¹¹ Judge Richard Posner attempted to clarify the term "exceptional case" in the Lanham Act context, noting the "surprising lack of agreement among the federal courts of appeals concerning its meaning in the Act."¹²

The court held that a Lanham Act case is exceptional for purposes of awarding fees "if the losing party was the plaintiff and was guilty of abuse of process in suing, or if the losing party was the defendant and had no defense yet persisted in the trademark infringement or false advertising for which he was being sued, in order to impose costs on his opponent."¹³

This standard did not appear to catch fire with other circuits, or with other district courts within those circuits; courts instead continued to apply their own standards.¹⁴

But in light of *Octane Fitness*, Judge Posner's vision of a nationwide standard for determining exceptionality in trademark infringement matters

finally may be fulfilled. So far, two circuit courts have held that the *Octane Fitness* test applies to trademark infringement matters.

First, in *Fair Wind Sailing, Inc. v. Dempster*,¹⁵ a unanimous Third Circuit panel "imported" the *Octane Fitness* analysis into its consideration of the standard for determining whether a trademark infringement case was exceptional.

The court cited a number of reasons for doing so, including that the Lanham Act's statutory attorneys' fee provision is identical to that in the Patent Act—and in fact, the latter was cited by Congress in adopting the former.¹⁶

A few months later, the Fourth Circuit, citing *Fair Wind*, stated that it saw "no reason not to apply the *Octane Fitness* standard when considering the award of attorneys fees under § 1117(a)."¹⁷

No other circuit court has yet decided whether to apply *Octane Fitness* to a motion for attorneys' fees in a trademark case.¹⁸ However, trends are developing among district courts as well.

Several district courts that have looked at the issue have, for many of the reasons cited by *Fair Wind* and *Georgia-Pacific*, agreed that *Octane Fitness* should apply to trademark infringement actions. These courts include the Northern District of Alabama,¹⁹ the Middle District of Florida,²⁰ and the Southern District of New York.²¹

Other district courts appear to have simply applied *Octane Fitness*, alone or in conjunction with previous tests established by regional circuits, without commentary.²²

The District Court for the District of Columbia avoided the issue entirely in the colorfully named *Greene v. Brown*, finding that because plaintiff was eligible for fees under the separate standard for trademark counterfeiting (15 U.S.C. Section 1117(b)), the court "need not consider the applicability of the *Octane Fitness* test" to award fees.²³

A few other courts have bucked the trend, refusing to follow *Octane Fitness* when determining whether a trademark infringement case is exceptional. For example, in *Wagner v. Mastiffs*,²⁴ the Southern District of Ohio acknowledged that *Octane Fitness* bears "at least some relevance" to Lanham Act actions, but declined to follow it in favor of the still-prevailing Sixth Circuit test.

Another court similarly found that even though the attorneys' fee provisions in the Patent Act and the Lanham Act are "nearly identical," and even though the Supreme Court in *Octane Fitness* cited a trademark case for a definition of "exceptional,"

“[W]e are moving toward the national standard for determining “exceptionalism” in trademark cases that has eluded courts in the past.”

because the court’s holding was limited to patent cases, “the Second Circuit cases interpreting the fee provision of the Lanham Act remain good law and represent binding precedent on this Court.”²⁵

Similarly, after discussing *Octane Fitness* in a manner that suggested it was going to follow it, the Northern District of California declined to do so in *Apple Inc. v. Samsung Electronics Co., Ltd.*²⁶

There, the court reasoned that because *Octane Fitness* is “best interpreted as overturning the Federal Circuit’s ‘overly rigid test for awarding attorneys’ fees’” in *Brooks Furniture*, and because the Ninth Circuit’s test in Lanham Act cases was already more flexible, the Ninth Circuit rule survived *Octane Fitness* and continues to apply to trademark infringement matters.²⁷

With numerous cases grappling with whether *Octane Fitness* applies to Lanham Act cases, can Judge Posner’s dream of a national standard ever be realized? The answer appears to be yes, despite the conflict among district courts.

The clear trend, as exemplified by the Third and Fourth Circuits, is to apply *Octane Fitness* when determining whether a trademark infringement case is “exceptional” for purposes of awarding fees.

When and if district court decisions make their way to other circuit courts of appeal, it would seem likely that those courts would take a similar approach as the one the Third and Fourth Circuits have adopted.

That the attorneys’ fee clauses are nearly identical, and that the Supreme Court expressly relied on an existing Lanham Act definition in defining “exceptional” in patent cases, are strong arguments for extending *Octane Fitness* to trademark matters. This could lead to a nationwide standard, adopted circuit by circuit.

If a circuit split arises (e.g., if the Ninth Circuit adopts the reasoning of the well-respected Judge Koh in the *Apple v. Samsung* matter), the Supreme Court will need to step in to finally define for all circuits what test to use in Lanham Act cases.

The Supreme Court would very likely extend its own *Octane Fitness* test to trademark matters. This is because of reasons discussed by post-*Octane Fitness* lower courts, but also for another important reason.

That is, over the last several years, the Supreme Court has issued decisions signaling that patent cases are not entitled to special rules and should be treated like other lawsuits.

For example, in *Medimmune, Inc. v. Genentech, Inc.*,²⁸ the court emphasized the generally applicable standard for determining whether there is a case or controversy sufficient to maintain an action for declaratory judgment, and criticized the Federal Circuit’s patent-specific test as conflicting with that standard.

Earlier, in *eBay Inc. v. Mercexchange, L.L.C.*,²⁹ the court held that a successful patentee seeking a permanent injunction must meet the traditional test for obtaining such relief applicable to all other cases, similarly rejecting a patent-specific test handed down by the Federal Circuit.

And just last year, the Supreme Court approved a change to the Federal Rules of Civil Procedure that seemed to permit a patentee to state a claim without meeting the minimal standards of notice pleading required in other cases.³⁰

Given the trend towards treating patent cases like any other, it would be surprising for the Supreme Court to hold that “exceptional” in the context of patent litigation means one thing, while that same term would have a different meaning under the Lanham Act.

This judicial philosophy, combined with the Court’s express invocation of and reliance on trademark definitions in *Octane Fitness*, indicates that when and if the issue reaches the Supreme Court, the Court most likely will apply the *Octane Fitness* definition of “exceptional” to the Lanham Act.

CONCLUSION

Intellectual property litigation can be very expensive, and the possibility of obtaining attorneys’ fees can affect everything from litigation budgeting to settlement negotiations.

The Supreme Court decision in *Octane Fitness* provided clarity to patent litigants and lawyers that remains lacking in the parallel world of trademark infringement litigation.

However, the current trends, the language of *Octane Fitness* itself, and the apparent Supreme Court philosophy rejecting special rules for patent cases, all indicate that we are moving toward the national standard for determining “exceptionalism” in trademark cases that has eluded courts in the past.

The only question is whether this standard will be established by circuits all falling into line, or by the Supreme Court resolving a circuit split. In either case, it appears to be only a matter of time before the “jumble” of varying tests bemoaned by Judge Posner³¹ is replaced by a single standard governing trademark infringement actions, wherever they may be brought.

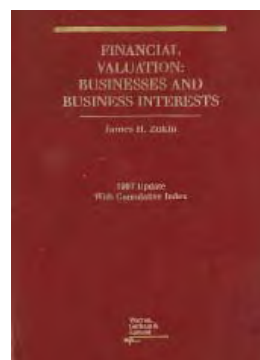
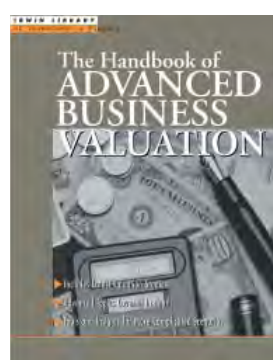
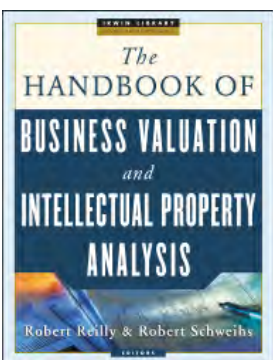
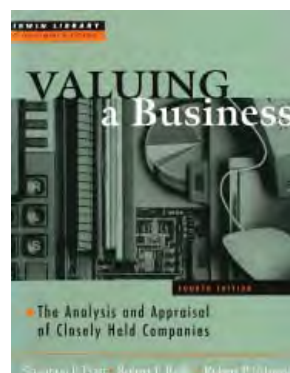
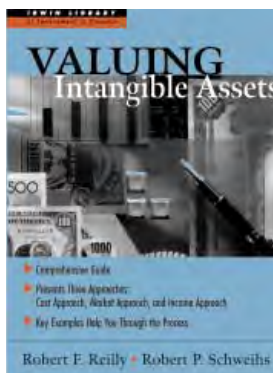
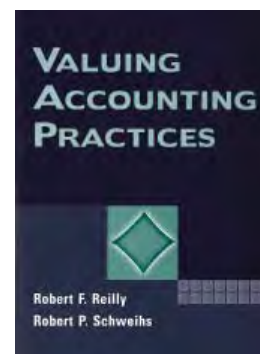
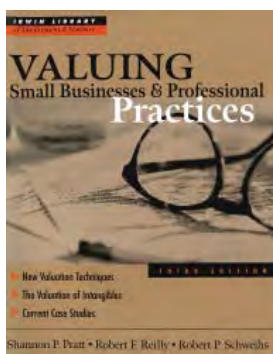
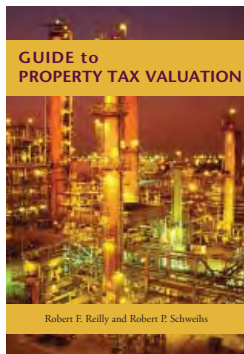
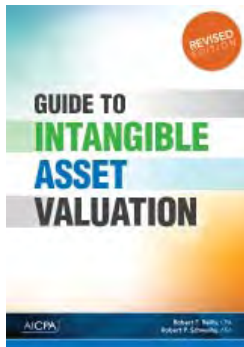
Notes:

1. ___ U.S. ___, 134 S.Ct. 1749 (2014).
2. 393 F.3d 1378 (Fed. Cir. 2005).
3. *Id.* at 1381.
4. 134 S.Ct. at 1754.
5. *Id.* at 1756.
6. *Id.* at 1756-57.
7. *Id.* at 1758.
8. 15 U.S.C. § 1051 et seq.
9. 134 S.Ct. at 1756, 1757, citing, *inter alia*, *Noxell Corp. v. Firehouse No. 1 Bar-B-Que Restaurant*, 771 F.2d 521, 526 (D.C. Cir. 1985).
10. For a summary of the standards employed by the various circuits, see 5 J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition*, § 30:100 n.3, at 30-267 through 3--269 (4th ed. 2015).
11. 626 F.3d 958 (7th Cir. 2010).
12. *Id.* at 960.
13. *Id.* at 963-964.
14. See, e.g., *FLIR Systems, Inc. v. Sierra Media, Inc.*, 965 F.Supp.2d 1184, 1200-1201 (D. Or. 2013) (citing *Nightingale* but applying the pre-existing Ninth Circuit test instead); *Thomasville Furniture Industries, Inc. v. Thomas*, No. 10-00130-RLV-DSC (W.D.N.C. 2012) (noting that the D.C. and Fourth Circuits prefer a “hybrid approach” to determining exceptionality, rather than the Seventh Circuit’s approach); *Empire Today, LLC v. National Floors Direct, Inc.*, 788 F.Supp.2d 7, 31 (D. Mass. 2011) (rejecting an argument based on the *Nightingale* test and instead applying the “more relevant standard for attorneys’ fees in the First Circuit”).
15. 764 F.3d 303 (3rd Cir. 2014).
16. *Id.* at 314-315.
17. *Georgia-Pacific Consumer Products LP v. Von Drehle Corp.*, 781 F.3d 710, 719-21 (4th Cir. 2015).
18. In *Slep-Tone Entertainment Corp. v. Karaoke Kandy Store, Inc.*, 782 F.3d 313, 317-18 (6th Cir. 2015), the Sixth Circuit, indicating that it believed *Octane Fitness* should apply to that trademark matter, remanded the case to the district court with instructions to “assess the applicability of *Octane Fitness*.” Unfortunately, the lower court never got the chance; after remand, the case was dismissed based on the bankruptcy of one defendant. See Case No. 10-cv-00990-DCN (N.D. Ohio), Dkt. No. 136.
19. *Donut Joe’s, Inc. v. Interveston Food Services, LLC d/b/a/ Donut Chef*, No. 13-CV-1578-VEH (N.D. Ala. 2015) (the court agrees with the other courts that have considered the question that the standard in *Octane Fitness* also applies to the Lanham Act’s attorney fees provision”).
20. *Florida Van Rentals, Inc. v. Auto Mobility Sales, Inc.*, No. 13-cv-1732-T-36EAJ (M.D. Fla. 2015) (“Although *Octane Fitness* dealt with a claim arising under the Patent Act’s provision for attorneys’ fees, 35 U.S.C. § 285, its holding applies also to 15 U.S.C. § 1117(a), the analogous provision in the Lanham Act”).
21. *River Light V, L.P. and Tory Burch LLC v. Lin & J International, Inc., et al.*, No. 13cv3669(DLC) (S.D.N.Y. 2015) (finding that the Court’s construction of the term “exceptional” in the patent context “offers guidance” in trademark matters).
22. See, e.g., *Albrecht v. Tkachenko*, No.14-05442-VC (N.D. Cal. 2015); *Marketquest Group, Inc. v. Bic Corporation*, No. 11-cv-618 BAS (JLB) (S.D. Cal. 2015).
23. *Greene v. Brown*, No. 11-2242, (CKK) (D.D.C. 2015), at n.8.
24. Nos. 08-CV-00431, 09-CV-00172 (S.D. Ohio 2014).
25. *Romag Fasteners, Inc. v. Fossil, Inc.*, No. 10cv1827 (JBA) (D. Conn. 2014).
26. No. 11-CV-01846-LHK (N.D. Cal. 2014).
27. *Id.* at n.1.
28. 549 U.S. 118, 132 n. 11 (2007).
29. 547 U.S. 388, 393-94 (2006).
30. The new Rules eliminate Form 18, a form patent infringement complaint that required much less detail than that required in other cases under the Supreme Court cases *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). Again, the Federal Circuit had decided that in light of Form 18, generally applicable pleading standards did not apply to patent cases. See *In re Bill of Lading Transmission*, 681 F.3d 1323, 1333-35 (Fed. Cir. 2012).
31. *Nightingale*, *supra*, 626 F.3d at 961.

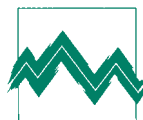
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I Want to Use My Licensed Intellectual Property in My Company's Chapter 11 Case by Assuming My Already Existing License, but My Lawyer Tells Me We Are in the Wrong State to Do It. Really?

Mark Stingley, Esq., Morgan T. McCreary, Esq., and Michelle M. Masoner, Esq.

Our Circuits are divided on whether a debtor-in-possession can assume the intellectual property license that the debtor company was using under a license before the Chapter 11 case was filed. Some Circuits employ the "hypothetical test" and some Circuits apply the "actual test." These two diametrically opposed tests make the results about whether an intellectual property license can be assumed dependent upon where the case is filed. This discussion explores these tests and the American Bankruptcy Institute Chapter 11 Reform Commission recommendation on the subject.

INTRODUCTION

The ability of a debtor-in-possession to assume or assign executory contracts under 11 U.S.C. Section 365 in the context of intellectual property law is the subject of a Circuit split.

This discussion examines the debtor-in-possession's power under Section 365 to assume and assign intellectual property licenses in a Chapter 11 bankruptcy and reviews the current Circuit split over the two adopted analytical formats: the hypothetical test and the actual test.

This discussion also discusses the American Bankruptcy Institute Commission's ("Commission") recommendations to adopt the actual test.

Under Bankruptcy Code Section 365(a) and (d), a debtor-in-possession may assign, assume or reject executory contracts and unexpired leases in a Chapter 11 restructuring even if the agreement expressly prohibits the assignment or assumption.¹

Therefore, in carrying on its business through and after bankruptcy, the debtor-in-possession will typically assume profitable contracts and reject nonprofitable contracts.

Similarly, in the context of intellectual property licenses, where the debtor-in-possession licensee would like to continue to use the licensed intellectual property in its own business, especially where the debtor relies heavily on the license to run its business, the debtor-in-possession licensee will seek to assume the license.

However, depending on the jurisdiction, the debtor-in-possession licensee may not be permitted to assume, or assign, the license, even if the debtor-in-possession does not intend to assign the license to a third party.

Therefore, a conflict arises between intellectual property concepts of monopoly and nonassignability and the goals of the bankruptcy court in maximizing value for all parties.

THE DEFINITION OF EXECUTORY CONTRACTS

Under Section 365, only contracts which are executory may be assumed, assigned, or rejected.² If the

contract is assumed, the debtor-in-possession will continue performing under the terms of the original contract. The debtor-in-possession may assign contracts to third parties, who will then perform under the contract with the other original contracting party.

If the contract is rejected, the debtor-in-possession is effectively permitted to breach the contract. The Bankruptcy Code contains exceptions to the debtor-in-possession's ability to assign, assume, and reject executory contracts.

The Bankruptcy Code does not explicitly define "executory contracts." Bankruptcy courts most often cite the *Countryman* definition in determining, on a case-by-case basis, whether a contract is executory.

Under the *Countryman* definition, an executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the performance of the other.³

Courts generally characterize intellectual property licenses as executory contracts because the licensor and the licensee owe each other a continuing material obligation.⁴

Therefore, the general nonbankruptcy rules requiring consent to assign certain types of intellectual property licenses have treated such licenses as executory contracts and have considered their assignability under Sections 365(a) and (f).⁵

ASSUMPTION AND ASSIGNMENT OF EXECUTORY CONTRACTS IN THE CONTEXT OF INTELLECTUAL PROPERTY LAW

While Section 365(a) generally permits the assignment and assumption of executory contracts, in the context of intellectual property licenses, a conflict arises between the Bankruptcy Code and intellectual property law.

An important exception to Section 365(a) is found under Section 365(c), which forbids the assignment or assumption of a contract where applicable nonbankruptcy law would bar the assignment, regardless of whether the contract is silent, or specifically prohibits such an assignment.⁶

Section 365(c) bans the assignment of executory contracts that qualify as personal service contracts. Licenses are often classified as personal to the

licensee, because it is presumed that the licensor chose the licensee for reasons specific to that licensee.⁷

Intellectual property law typically treats licensing agreements, such as nonexclusive patent licenses, like personal contracts, and unless the licensor consents, the law precludes performance by a party other than the original licensee.⁸

This conflict between the Bankruptcy Code and intellectual property law affects the debtor-in-possession's ability to "assume *and/or* assign" intellectual property licenses after the filing of a Chapter 11 bankruptcy. Courts should balance the interest of the nondebtor licensor and the goals of Chapter 11.

For instance, intellectual property licensors may have only intended to provide licenses to the debtor-in-possession. If that debtor-in-possession licensee assigns the license to a third party, the licensor could be obliged to license its property to an unwanted party.

On the other hand, a debtor-in-possession depends on these licenses, sometimes to sustain its entire operation. Thus, in order to reorganize, a debtor-in-possession must be able to assume, or "assume and assign," these contracts to a third party.

The question of whether intellectual property licenses are "assumable *and/or* assignable" has created a circuit split. The Ninth, Third, Eleventh, and Fourth Circuits apply the "hypothetical" test, which effectively prohibits the assumption of these intellectual property license agreements.

On the other hand, the First and Fifth Circuits apply the "actual test" which may permit the assumption of the license—upon satisfying the other conditions of Section 365.

THE HYPOTHETICAL TEST

The Ninth, Third, Eleventh, and the Fourth Circuits have adopted the hypothetical test.⁹

In the hypothetical test, the plain meaning of Section 365(c) dictates that the debtor-in-possession cannot "assume and assign" an executory contract, if applicable nonbankruptcy law would preclude the debtor-in-possession from assigning the license to a third party regardless of whether the debtor-in-possession has the intent to assign the license.

The controlling logic of the hypothetical test is that the identity of the debtor-in-possession, or the entity performing under the license agreement, is material to the agreement.¹⁰

Under the law, the debtor-in-possession is a separate, distinct legal entity from the prebankruptcy debtor. Therefore, to permit the debtor-in-possession to assume the license would have the same effect of an assignment to a third party.

Thus, the determinative question under the hypothetical test is, “could the debtor-in-possession assign the contract to a third party under applicable non-bankruptcy law?”

If the answer to that question is no, then the debtor-in-possession may not assume the contract. Effectively, the hypothetical test prevents the debtor-in-possession from assuming the license without the consent of the nondebtor licensor.

The Ninth Circuit’s ruling from *In re Catapult Entertainment, Inc.* (“Catapult”) used the hypothetical test to determine that federal patent law prohibits the debtor-in-possession from assuming or assigning nonexclusive patent licenses without the licensor’s consent.

In *Catapult*, Perlman licensed patents to Catapult. Catapult subsequently filed its Chapter 11 petition. Prior to filing its petition, Catapult entered into a merger agreement in which it would be the surviving entity. Catapult then filed a motion to assume the patents at issue.

The court, however, adopted the hypothetical test and ruled that Catapult was not permitted to assume the contracts. The court held that it was bound by the plain meaning of Section 365(c)(1). The court reasoned that the plain language of the statute “link[s] non-assignability under ‘applicable law’ together with a prohibition on assumption in bankruptcy.”¹¹

Therefore, if applicable law would bar a debtor-in-possession’s subsequent assignment of the license, the debtor-in-possession may not assume the executory contract without the consent of the nondebtor—even if the debtor-in-possession does not intend to assign the contract.

The court reasoned that the plain language of the statute dictates that the question as to whether the contract is assignable is “whether ‘applicable law excuses a party from accepting performance from or rendering performance to an entity other than . . . the debtor-in-possession.’”¹²

The court set forth that the applicable law overrides the Bankruptcy Code where the applicable law prohibits assignment on the rationale that the



identity of the contracting party is material to the agreement.

The court reasoned that because under federal patent law, a nonexclusive patent license is “personal and assignable only with the consent of the licensor,” the plain language of Section 365(c) dictates that the debtor-in-possession may not assume, or assign, an intellectual property license without the consent of the debtor-in-possession.

THE ACTUAL TEST

The First and Fifth Circuits apply the actual test.¹³

The actual test looks at each case to determine if the debtor-in-possession “actually” intends to assign the executory contract. The actual test operates under the assumption that the debtor-in-possession is not materially distinct from the prebankruptcy entity that is the party to the executory contract.

In support of this assumption, the Court held that “[w]here the particular transaction envisions that the debtor-in-possession would assume and continue to perform under an executory contract, the bankruptcy court cannot simply presume as a matter of law that the debtor-in-possession is a legal entity materially distinct from the prepetition debtor with whom the nondebtor party . . . contracted.”¹⁴

The actual test contemplates what is best for both the nondebtor licensor and the debtor-in-possession, and focuses, not on the entity performing, but “ensuring that the nondebtor party . . . will receive the full benefit of [its] bargain.”¹⁵

Thus, by applying the actual test, courts promote the enforcement of these contracts, and the debtor-in-possession's right to assume these contracts, as well as ensuring that the nondebtor continues to receive its benefit under the contract. The unassignable contract can be assumed if the debtor-in-possession intends to continue performing under the terms of the contract.

Therefore, the debtor-in-possession would be prohibited from assuming the contract if it intends to assign the contract to a third party. The actual test recognizes that a debtor seeking to emerge from a Chapter 11 bankruptcy as a reorganized entity may want to simply assume the license and continue to use the license post-bankruptcy.

To permit licensors to cancel these contracts effectively permits the licensors to cancel contracts that they would otherwise be obligated to perform, but for the debtor's bankruptcy. The actual test is said to better accomplish the intent of Congress.¹⁶

The First Circuit used the actual test to determine that the subject license was assumable. In *Pasteur*, CBC and Pasteur entered into a series of cross-license agreements.

Each agreement prohibited the licensee from assigning or subleasing the license to others. CBC subsequently filed a Chapter 11 petition, and as part of that petition CBC asserted that it would assume the cross-licenses and then sell all of its stock to a subsidiary.

The subsidiary also happened to be a direct competitor of Pasteur. Pasteur alleged that the sale of the stock amounted to assumption of patent cross-licenses and assignment to a third party. Pasteur argued that the reorganized entity is a different entity than the pre-petition entity because it sold all of its shares and is now owned by a new company.

The court disagreed and ruled that the stock sales are not mergers and that under the terms of the cross-licenses, CBC was permitted to transfer its license rights with any affiliated company, such as the subsidiary in this case.

The court based its holding primarily on the recognition that the debtor-in-possession would lose the right to assume the contract even though it never intended to assign the contract to a third party.

Further, the court asserted that it cannot be presumed that the debtor-in-possession is a materially distinct entity from the prepetition debtor. The court emphasized the importance of focusing on the performance actually to be rendered by the debtor-

in-possession; and to ensure that the nondebtor will receive the full benefit of its bargain.

THE DIFFERENCE BETWEEN THE PLAIN MEANING AND THE CONSTRUCTED MEANING OF SECTION 365

The significant difference between the actual test and the hypothetical test is found in the reading of the Code. Courts that have adopted the hypothetical test strictly construe Section 365, or take its "plain meaning," to mean that the debtor-in-possession may not "assume *or* assign" the license agreement if nonbankruptcy law would prohibit the assumption or the assignment.

Section 365 states that "[t]he trustee [debtor-in-possession] may not *assume or assign* any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties."

Thus, the hypothetical test adheres to the plain meaning of Section 365, in that a debtor-in-possession may not assume *or* assign the license if nonbankruptcy law would prohibit the assignment without the consent of the nondebtor.¹⁷

However, under the actual approach, the statute is read as the debtor-in-possession may not "assume *and* assign" the license if nonbankruptcy law would prohibit the assignment. Meaning that the debtor-in-possession may assume the license, if it intends to continue to perform under the original agreement, but may not thereafter assign the license.

Because the actual test does not believe that the identity of the one performing under the license is material, the actual test takes into account the reality of the circumstances and whether the debtor-in-possession actually intends to assign the license.¹⁸

This analytical difference has a determinative impact on a debtor-in-possession's ability to assume intellectual property license.

THE PROBLEMS WITH HYPOTHETICAL TEST AND THE REASONS FOR USING THE ACTUAL TEST

While the hypothetical test adequately addresses the interests of nondebtor licensors and their interest in protecting their property, it completely ignores the goals of a Chapter 11 reorganization.

The hypothetical test contemplates a scenario where the Chapter 11 debtor-in-possession, after giving adequate assurance, proposes to carry on its regular business and comply with the terms of the contract, but nevertheless permits the nondebtor party to cancel the contract regardless of whether the debtor-in-possession intends to assign the contract.

The hypothetical test enables nondebtors to utilize *ipso facto* clauses without ever having to put them in the contract. By utilizing Section 365(e)(2), in applying intellectual property law, it excuses the nondebtor from performing/accepting performance from another regardless of whether the contract prohibits or restricts assignment or assumption (e.g., regardless of nonassignment clause).

Under the hypothetical test, licensors, or nondebtors, are effectively permitted to avoid contracts under which they would otherwise be obligated to perform if not for the debtor-in-possession's bankruptcy.

Justice Kennedy summarized the problems with the "hypothetical" approach by stating that:

The hypothetical test is not, however, without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim-and resell at the prevailing, potentially higher market rate-the rights it sold to the debtor.¹⁹

The actual test has several benefits that facilitate the reorganization process. The actual test promotes the policy of holding the nondebtor parties to their obligations. The actual test also places more weight on maximizing the value of the estate while adequately addressing the nondebtor's interest in protecting its property rights.

The actual test helps prevent a nondebtor from terminating a license that the debtor-in-possession licensee relies on in its business. Preventing the debtor-in-possession from assuming its profitable contracts would contradict the purpose of Chapter 11 and would hinder the debtor-in-possession's ability to reorganize and continue its business.

Moreover, there are safeguards in place to ensure the nondebtor licensor is adequately protected. A condition to assuming any contract under Section 365(a) is that the debtor-in-possession must cure all defaults and provide adequate assurance of future performance.²⁰

Thus, the actual test ensures that the nondebtor party gets the benefit of its bargain, while at the same time, facilitating the goals of Chapter 11.

"The actual test also places more weight on maximizing the value of the estate while adequately addressing the nondebtor's interest in protecting its property rights."

THE COMMISSION'S RECOMMENDATIONS: THE MODIFIED ACTUAL TEST

The American Bankruptcy Institute formed a Commission to study the reform of Chapter 11. Based on the Commission's recommendations and findings, the Commission voted to codify the "actual approach" to permit the debtor-in-possession to assume and assign executory intellectual property licenses.

The Commission reasoned that while nondebtor licensors are understandably concerned with being required to maintain a license with an unwanted party, the fact that the debtor-in-possession should provide adequate assurances of future performance in order to assume the executory contract ensures that the nondebtor licensor would still be receiving the benefit of its bargain.

The Commission emphasized that the actual identity of the entity performing under the license is not as critical as the ability to pay, maintain the quality and integrity of the intellectual property, and comply with all the obligations under the license.

A condition to assuming an executory contract under Section 365 is that the debtor-in-possession must cure all defaults and provide adequate assurances of the performance under the agreement.

Thus, the Commission findings mirror the First Circuit's conclusion in that the identity of the individual/entity performing under the contract is not material, and the focus should be on ensuring the nondebtor party receives the full benefit of its bargain.²¹

Additionally, the Commission determined that the debtor-in-possession should be able to assign intellectual property licenses under Section 365 regardless of the applicable nonbankruptcy law or provisions to the contrary in the license.

The Commission asserted that the identity of the licensee is only relevant if the debtor-in-possession intends to assign the license to a direct competitor of the licensor. Therefore, to account for this possibility, the Commission determined the debtor-in-possession may assign an intellectual property license under Section 365 if the nondebtor licensor is unable to demonstrate that the repercussions of the assignment outweigh the benefit to the estate.

Thus, the Commission concluded the court could deny the assignment if the nondebtor licensor carried this burden of proof.

CONCLUSION

This divide between the purpose of intellectual property law and the goals of Chapter 11 has a great impact on the rights of licensors and licensees throughout bankruptcy. Ultimately, a debtor-in-possession's ability to assume an intellectual property license—regardless of whether the nondebtor licensor consents—depends on the jurisdiction of the bankruptcy case.

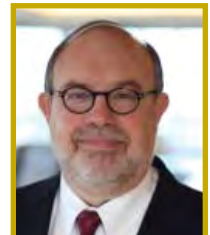
Therefore, until this issue is brought to the Supreme Court, or Congress codifies a solution, it is of the utmost importance for licensors and licensees to understand how their rights are affected in their jurisdiction.

Notes:

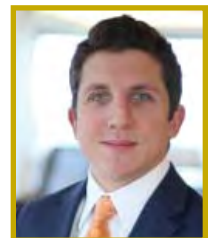
1. 11 U.S.C. § 365(a), (d).
2. 11 U.S.C. § 365(a).
3. *In re Sunterra Corp.*, 361 F.3d 257, 264 (4th Cir. 2004); Prof. Vern Countryman, *Executory Contracts in Bankruptcy*, Part 1, 57 Minn. L. Rev. 439, 460 (1973).
4. *Id.*; *In re Catapult Entm't, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999).
5. In most jurisdictions, nonexclusive licenses generally are not assignable over licensor's objection. However, exclusive licenses are generally assignable over objection of Licensor. *Everex*

Systems v. Cadtrak (In re CFLC, Inc.), 89 F.3d 673 (9th Cir. 1996); *Leicester v. Warner Bros. Corp.*, 232 F.3d 1212 (9th Cir. 2000).

6. 11 U.S.C. § 365(c).
7. *PPG Indus. Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1093 (6th Cir. 1979).
8. *In re Catapult*, 165 F.3d at 750.
9. *N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc.* (In re N.C.P. Mark. Gr., Inc.), 279 F. App'x. 561 (9th Cir. 2008), *cert. denied*, 129 S. Ct. 1577 (2009); *In re Sunterra Corp.*, 361 F.3d 257, 260 (4th Cir. 2004); *In re Catapult*, 165 F.3d 747 (9th Cir. 1999); *City of Jamestown v. James Cable Partners, L.P.* (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994); *In re West Elec.*, 852 F.2d 79 (3d Cir. 1988) (gov't contract).
10. *In re Catapult*, at 750.
11. *Id.* (quoting 1 DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, *BANKRUPTCY* § 5-15 at 474 (1992)).
12. *In re Catapult*, at 752.
13. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997) *abr* by *Hardemon v. City of Boston*, No. 97-2010, 1998 WL 148382 (1st Cir. Apr. 6, 1998); *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006).
14. *Institut Pasteur*, at 493.
15. *Id.*
16. *In re Catapult*, 165 F.3d at 749.
17. *In re Catapult*, 165 F.3d 747, 749-750.
18. *Id.* at 751.
19. *N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc.*, 556 U.S. 1145, 129 S. Ct. 1577 (2009).
20. § 365(b).
21. *In re Catapult*, 165 F.3d 747, 749-750.



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Risk Management and Intellectual Property Insurance Coverage

Don Glazier

As intellectual property (IP) assets continue to increase in value and importance to more companies, the need to protect those IP assets increases. Many look to insurance as part of the solution to help manage the risks associated with claims of IP infringement. The marketplace offers various risk transfer solutions that warrant consideration as part of any entity's risk management strategy.

INTRODUCTION

Basic risk management analysis involves assessing the probability of an event and multiplying it by its impact.

Applied at a personal level, the chance of a fire burning my house to the ground or a repairman being seriously injured are small. However, the impact of those events are potentially huge—nowhere to live, my largest investment gone, and a catastrophic financial judgment against me.

In business, risk assessment is part of management's responsibilities and many companies have a dedicated risk manager or an entire department focused on this area. Insurance represents perhaps the most important element for an enterprise's risk management strategy.

Stripped to its core, insurance simply involves shifting a particular risk to another entity, which agrees to accept it for an agreed upon price. Risks of fire, wind, and other insurance "perils" have well-established avenues of coverage through property insurance.

Companies address their liability exposures through various lines of insurance—including directors and officers liability insurance for claims against management and all types of variations of professional liability errors and omissions coverage.

Among the risks facing companies, those associated with intellectual property (IP) present less obvious insurance solutions.

It goes without saying that IP assets are certainly worthy of protection and risk management consideration. For many organizations, IP represents the largest and most valuable asset, providing its biggest competitive advantage. And, the importance of IP continues to increase.

As an indicator, the number of patents granted by the United States Patent and Trademark Office continues to increase steadily, increasing by 14 percent over last year.

While robust risk management can decrease both the likelihood and severity of infringement claims, resolving these matters many times involves an expensive legal battle.

Consequently, infringement has the potential to diminish the value of IP assets and potentially an entity's financial survival.

Despite the risks presented in the IP area, the insurance marketplace does not as of yet offer a single, all-inclusive insurance product addressing all facets of the exposure.

As described below, the insurance industry does, however, present solutions for certain aspects of IP risk, either through more widely held insurance products or more specialized offerings.

MULTICOVERAGE POLICIES

Comprehensive General Liability Insurance

Most business entities purchase some form of comprehensive general liability insurance (CGL) coverage. Those policies are a logical first place to look upon receipt of an IP-related lawsuit.

Depending upon what is alleged in the suit, CGL policies may respond with defense and indemnity, but are limited in scope and do not provide blanket coverage for all types of IP infringement claims ranging from copyright infringement to patent infringement.

Under the insuring provisions in CGL policies, there is often coverage for what is known as “advertising injury.” Depending upon the wording of the particular policy, coverage for advertising injury often exists with respect to claims made against the insured for copyright infringement as well as trademark and trade dress (product design and packaging) infringement.

The alleged infringing activity must be a direct result of the actual advertising itself. Patent infringement is often excluded from coverage.

Since alleged infringement can occur in many situations not involving advertising, it is apparent that a CGL policy, even with advertising injury liability coverage, may only offer limited value in IP risk management.

Another problem with the CGL policy coverage is that an infringement can be construed as an intentional act, implicating a policy exclusion, and providing a basis for the carrier to deny coverage for the claim submitted.

In light of the fact that the CGL policy is not normally considered a primary source of protection for third-party claims based on allegations of IP infringement, there are a number of other potential sources of insurance coverage for IP related risks.

Media Liability Insurance

Media liability policies may extend coverage to claims that many times would otherwise be excluded under other liability policies. Media liability insurance is a specialized type of errors and omissions insurance that offers protection against claims brought by third parties.



These policies are most commonly purchased by media and entertainment insureds including traditional and online publishers, broadcasters, and companies with significant marketing activities. Any company with a market-facing presence may benefit from looking at media liability insurance.

These policies cover liability resulting from a wide range of claims, which depending on the insured's particular policy terms, may include allegations of defamation, disparagement (including product disparagement), copyright infringement, plagiarism, and other unauthorized use of material, names, or trademarks.

Media liability policies can be coupled with an errors and omissions insuring section, which protects companies from claims involving professional negligence in their work for customers.

Media liability coverage is generally not written on standard form policies. Instead, most media liability insurers manuscript policy forms to meet their insured's specific needs. In that regard, the policy normally extends only to claims arising out of the insured's "business," which is defined in the policy.

The breadth of this definition can have a significant impact on the scope of coverage provided. As such, careful consideration should be given to make sure this term accurately reflects all the entity's media activities prior to purchasing coverage.

Cyber Liability Insurance

Another line of insurance coverage designed mainly to focus on a non-IP-type of risk, but which may also offer some protection from IP-related litigation is a cyber liability policy.

While most attention related to cyber insurance focuses on data breaches and privacy issues, policies often provide multimedia liability coverage similar to stand-alone media policies that provide protections for IP-related exposures. The policies may provide protection for liability stemming from claims alleging copyright, trademark, or other IP infringement claims.

IP ONLY POLICIES

Patent Only Policies

The insurance marketplace has not embraced insurance coverage for exposures associated with patents to the same extent as other intellectual property risks such as copyright or trademark. Patent exposures are different—difficult to underwrite, adjust claims, and expensive to resolve.

Some insurers who had ventured into insuring patent-related exposures suffered significant losses and eventually exited that market segment. As a consequence, most policies that cover other IP exposure such as copyright or trademark will specifically exclude patent claims from coverage.

There have been a few exceptions to those carriers not willing to consider patent-related risk. Certain specialized insurers offer insurance products of different varieties that can help serve as risk management tools for those who either own patents or are worried about claims from other patent owners.

Besides patent coverage, these policies will also cover alleged infringement for other types of IP rights addressed in other policies. The underwriting process involved in obtaining insurance for patent-related claims is more involved than that for other lines of coverage, but the insurance is available in various forms.

Defense and Indemnity Policy

To protect insureds from claims asserting patent infringement, insurers offer policies that cover claims that stem from the insured's use, distribution, advertising, and/or sale of its products. The policies typically cover defense costs associated with the claim, damage awards, and settlement payments.

However, the policies will typically not cover willful infringements or potential infringements that the insured knew about at the time policy was put into place.

Defense Only Policy

Due to the specialized and many times uniquely technical nature of patent litigation, defense costs are many times significant. Because of this exposure, carriers may offer a policy only covering the defense cost portion of the total loss associated with a patent infringement claim.

The policies would not cover the amounts needed to resolve the claim by way of paying for a settlement or judgment. Nonetheless, defense only policies can offer a valuable risk transfer option.

IP Withdrawal Expense

As not all patent litigation turns out in favor of the insured, insurers can offer a component of coverage to reimburse the insured for costs associated with removing a product from the marketplace as directed by a court.

The insurer will cover the costs and expenses such as transportation to withdraw the product from the distribution chain as well as relabeling, destruction and disposal of the product, packaging or labeling materials.

IP Abatement Policy

Enforcement or abatement insurance is a unique plaintiff's policy, which reimburses the litigation expenses to enforce IP rights against infringers. The insurance is available, however, only for insureds who are likely to prevail in such claims. To obtain this coverage, outside independent patent counsel must provide an opinion that the patent in question is valid.

The value in abatement coverage is that it protects companies who possess a valid patent but cannot protect their asset because of the significant expense that will be incurred in pursuing an infringing party, especially when the infringer is well funded and can wear down the patent owner through a war of attrition in the courts.

Representations and Warranties Insurance

Another insurance product that offers protection in connection with IP is representations and warranties (R&W) insurance. This insurance product is designed to protect parties entering into a transaction such as merger, acquisition, or joint venture from losses which may arise as a result of events or circumstances that are not disclosed prior to such transaction.

As such R&W insurance protects against the loss of anticipated benefits, that is, valuable IP assets from the transaction that were represented to exist, or against, potential liabilities that were represented not to exist.

INSURANCE COVERAGE ISSUES

Regardless of the type of insurance under consideration to protect against IP-related risks, a fundamental question always involves how much insurance is appropriate and conversely, how much risk to retain.

The patent only insurance marketplace offers various limits of liability ranging from \$1 million to significantly larger limits including multiple layered programs in the tens of millions of dollars.

The decision as to how much insurance to purchase depends first and foremost on the entity's underlying risk management philosophy. Is the insurance designed to protect against a catastrophic, potentially business-ending claim, typically by a business competitor?

If so, the insured should purchase large limits of liability with a commensurately large self-insured retention. Such a program would keep relatively small claims as part of the company's retained cost of business.

On the other hand, if the concern is small claims, such as those brought by nonpracticing entities (NPE), a small limits policy, with a relatively small self-insured retention may provide the best answer.

Along with considering how much risk to retain through a self-insured retention, insurers will many times require a co-insurance percentage applicable to all loss payments. Those provisions require the insured to pay a percentage, in the range of 20 to 25 percent, of all costs incurred in the claim to provide that the insured keep some "skin in the game."

As found in every insurance policy, there are certain types of claims that insurers do not wish to cover. Therefore, they add exclusions to the policies to carve those out.

Common exclusions in liability policies which cover IP claims can include the following:

1. Fines or penalties, including punitive, exemplary, treble, or multiple damages
2. Infringement actually known by the insured prior policy inception
3. Losses or expenses arising from willful infringement, although this exclusion often

requires final adjudication by a court or other body before it becomes effective

Policies may also exclude coverage for any counterclaims, retaliatory lawsuits, or certain administrative proceedings and require authorization for an appeal should the insured not prevail in the initial lawsuit.

"The decision as to how much insurance to purchase depends first and foremost on the entity's underlying risk management philosophy."

NONINSURANCE RISK MANAGEMENT OPTION OF DEFENSIVE ACQUISITION

Defensive acquisition represents a unique risk management option used by some entities exclusively in connection with patents. Designed mainly to address NPE claims, defensive acquisition involves using capital contributed from similarly situated entities facing such claims to preemptively acquire patent assets and rights prelitigation.

Each entity that contributes capital to the pool to purchase patents receives a license to every patent owned. Possessing a license precludes the NPE from being able to bring suit in connection with those patents.

SUMMARY

The options available to address IP risk management continues to develop. The insurance marketplace assesses the opportunities presented by developments in IP exposure and considers its risk-taking appetite depending on perceived opportunities.

Any entity facing IP risk of some sort would benefit from a risk management assessment. Companies should seek the assistance of a knowledgeable insurance broker in looking at the insurance products available that might provide valuable risk transfer options.

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Negotiating and Drafting Licenses to Address Potential Patent Validity Challenges

Michael Stolarski, Esq.

In January 2007, the Supreme Court handed down a decision in MedImmune v. Genentech, holding that a licensee did not have to terminate or breach a license agreement to have standing to bring a declaratory judgment action that a licensed patent is invalid.¹ In the aftermath of this decision, licensors began including a variety of agreement provisions intended to discourage licensees from challenging the validity of a licensed patent. However, the effectiveness of these provisions, particularly those that prohibit a licensee from ever challenging the validity of a licensed patent, continues to be an issue. In the wake of what some commentators have described as an “anti-patent” tendency of the courts,² what can a licensor do to avoid having to litigate the validity of a licensed patent with its licensee?

LEGAL BACKGROUND ON NO-CHALLENGE PROVISIONS AND LICENSEE ESTOPPEL

Determining whether to include a restrictive covenant in a patent license preventing the licensee from challenging the validity of the licensed warrants a brief review of the case law on this topic.

In 1950, the Supreme Court in *Automatic Radio Mfg. Co. v. Hazeltine Research* announced a general rule “that a licensee under a patent license agreement may not challenge the validity of the licensed patent.”³ However, this “general rule” did not persist.

Nineteen years after the Supreme Court decision in the *Hazeltine* case, the Supreme Court had an opportunity to review the *Hazeltine* decision and the rule of patent licensee estoppel.

In *Lear Inc. v. Adkins*,⁴ the Supreme Court reviewed again the question of whether licensee should be prevented from challenging a patent covered by a license agreement with the inventor.

The Supreme Court overruled the *Hazeltine* decision that licensee estoppel is the “general rule,” holding that “in the accommodation of (1) the common law of contracts, and (2) the federal law of patents requiring that all ideas in general circulation be dedicated to the common good unless they are protected by a valid patent, the technical requirements of contract doctrine must yield to the demands of the public interest in the typical situation involving the negotiation of a license after a patent has issued.”⁵

Of particular interest in considering the viability of restrictions on the ability of the licensor to challenge the validity of a patent, the court cited with approval its earlier holding in *Pope Manufacturing Co. v. Gormully*.⁶

In *Gormully*, the court was confronted with a license agreement containing a provision that required the licensee to not dispute the validity of the licensed patents. In affirming the lower court’s decision not to grant specific performance of the agreement to the licensor, the Supreme Court stated, in pertinent part, that:

The real question is whether the defendant can estop himself from disputing patents which may be wholly void, or to which the plaintiff may have no shadow of title. . . . It is as important to the public that competition should not be repressed by worthless patents as that the patentee of a really valuable invention should be protected in his monopoly, and it is a serious question whether public policy permits a man to barter away beforehand his right to defend against unjust actions or classes of actions, though in an individual case he may doubtless assent that a judgment be rendered against him, even without notice.⁷

In essence, the *Gormully* decision seems to contemplate weighing the public interest in not being subject to invalid patents with the individual's ability to resolve litigation in a manner that may restrict their behavior going forward.

After *Lear*, a number of lower courts found no-contest provisions in licenses to be unenforceable.⁸

In *Medimmune v. Genentech*, the Supreme Court again reviewed the issue of a licensee's ability to challenge the validity of a licensed patent.

In *Medimmune*, the Supreme Court granted certiorari to review a Federal Circuit's decision dismissing a declaratory judgment complaint by a licensee in good standing to challenging the infringement and validity of a licensed patent for lack of subject matter jurisdiction.

In 1997, Genentech licensed Medimmune to an existing patent and a pending patent application. The license agreement required Medimmune to pay royalties on the sales of "Licensed Products."

The license further defined the royalty-bearing products as an antibody that would infringe either licensed patent unless the patent had expired or been determined to be invalid by a court.

Upon issuance of the second patent in 2001, Genentech informed Medimmune that it was required to pay royalties under the second patent.

However, since entering into the license and the issuance of the second patent, Medimmune's sale of licensed products increased to over 80 percent of its revenue since 1999.

In an effort to avoid a patent infringement action from Genentech, Medimmune responded by paying the royalties under protest and filing the underlying declaratory judgment action alleging that royalties

were not owing under the second patent because the patent was not valid or infringed.

The Supreme Court held that Medimmune was not required to terminate its 1997 license agreement before seeking declaratory judgment that the underlying patent is invalid, unenforceable, or not infringed and remanded the proceedings.

Of importance to this analysis is the Supreme Court review of Genentech's argument that a party to a contract cannot challenge the validity of the patents while continuing to enjoy its benefits; that is, the quid pro quo for the license was licensee's willingness to forego such challenges.

In response to Genentech's argument the Court stated, in pertinent part, that:

Of course, even if it were valid, this argument would have no force with regard to petitioner's claim that the agreement does not call for royalties because their product does not infringe the patent. But even as to the patent invalidity claim, the point seems to us mistaken. To begin with, it is not clear where the prohibition against challenging the validity of the patents is to be found. It can hardly be implied from the mere promise to pay royalties on patents "which have neither expired nor been held invalid by a court or other body of competent jurisdiction from which no appeal has been or may be taken," App. 399. Promising to pay royalties on patents that have not been held invalid does not amount to a promise *not to seek* a holding of their invalidity.⁹

In the aftermath of *Medimmune*, commentators read the court's decision as implying that the court might enforce a provision in the license agreement under which the licensee agreed not to challenge the validity or noninfringement of the patents covered by the license.¹⁰

In response to the decision, licensors began including no-challenge clauses in their license agreements.

One such license agreement was entered into less than four months after the issuance of the *Medimmune* decision and later became the subject of a decision by the Second Circuit Court of Appeals.

In *Rates Technology Inc. v. Speakeasy, Inc.*,¹¹ the Second Circuit Court of Appeals, on transfer from the Federal Circuit Court of Appeals, reviewed

“[I]t is clear that the licensor cannot rely on a no-challenge clause to prevent the licensee from subsequently challenging the licensed patent,”

a district court’s holding that a no-challenge clause in the April 30, 2012, license agreement was unenforceable.

The no challenge provision read as follows:

Speakeasy hereby warrants and represents to RTI that on and after the execution date of this Covenant Speakeasy will not anywhere in the world challenge, or assist any other individual or entity to challenge, the validity of any of the

claims of the Patents or their respective foreign counterpart patents or their respective foreign counterpart patent applications, except in defense to a Patent infringement lawsuit brought under the Patents against Speakeasy, its [products and services], and except as otherwise required by law.¹²

The license agreement further included a following liquidated damages clause which would be triggered by a breach of the no-challenge provision:

In the event that the above representation is incorrect then Speakeasy agrees that it shall pay to RTI as liquidated damages the additional amount of Twelve Million U.S. (\$12 Million) Dollars plus all legal expenses necessary to collect this added amount.¹³

In affirming the District Court’s dismissal of RTI’s complaint-seeking enforcement of the liquidated damages provision agreement, the Second Circuit noted that competing policy decisions may affect the enforceability of a no-challenge provision.

In particular, the court reviewed the public interest in resolving litigation disputes against the public interest in eliminating invalid patents.

The court went on to differentiate a license agreement made prior to litigation between the parties with one entered into in settlement of ongoing litigation where the parties have had an appropriate opportunity to explore the merits of an invalidity challenge.

After reviewing these competing policies, the court held that covenants barring future challenges to a patent’s validity entered into prior to litigation are unenforceable.¹⁴

Recently, the Patent Trial and Appeal Board (PTAB) reviewed the applicability of a no-challenge clause between the parties to an inter partes review.

In *Dot Hill Corp. v. Crossroads Systems Inc.*,¹⁵ the patent owner responded to a petition for review arguing that a previous settlement agreement between the parties containing a no-challenge clause warranted denial of the petition.¹⁶

In response to the patent owner’s argument, the petitioner replied that the PTAB was not given jurisdiction by Congress to consider the patent owner’s estoppel argument.¹⁷

Siding with the petitioner’s position, the PTAB found that there was no statutory basis for affirmative estoppel-based defenses precluding institution of an inter partes review and instituted the requested review.¹⁸

POTENTIAL STRATEGIES FOR THE LICENSOR

Given the above legal background, it is clear that the licensor cannot rely on a no-challenge clause to prevent the licensee from subsequently challenging the licensed patent, except in limited circumstances.

However, there are other strategies that may be implemented to maintain the intended relationship with the licensee.

- **Portfolio Licensing.** To the extent that you are licensing competitors and have a number of patents that may be relevant to their product portfolio, the more patents that the license covers the less likely you are to face invalidity challenges.

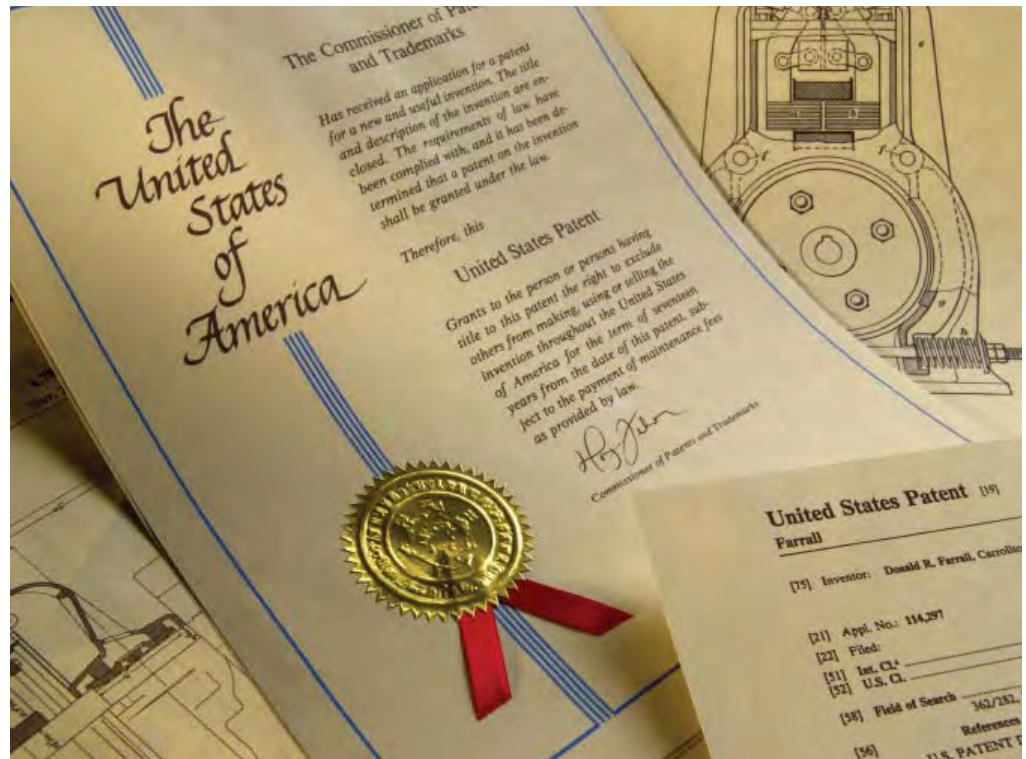
Obviously, the decision whether to proceed with a portfolio license depends on the size of the portfolio and an understanding of the competitive environment.

Among the important issues to consider is whether certain patents in the portfolio cover important product features that differentiate your products from those of your competitors in the marketplace. A portfolio license by necessity must include a license back from your licensee of appropriate scope.

- **Hybrid Licenses.** Consider whether you have other intellectual property that may be included in the agreement.

To the extent you have trade secrets or software which implement the technology that you are willing to license in exchange for an appropriate royalty, a licensee is less likely to challenge the validity of a patent that is encompassed by the license.

In the event that the licensee does challenge the patent validity, the royalty stream accountable to the licensed technology or software should continue during and after the challenge to the licensed patent.



While a no-challenge clause is likely to be unenforceable except in the case of litigation settlement agreements, there are other provisions which may deter a licensee from challenging a licensed patent.

Among the potential provisions to consider are the following:

- Add an option to terminate the license (or at least the license to the challenged patent) in the event the licensee initiates an invalidity proceeding.
- Require that the licensee pay attorney's fee and costs in the event that the challenge is unsuccessful.
- Identify a patent-friendly jurisdiction and venue where a licensee would be required to challenge the patent.
- Include a notice provision requiring the licensee to inform you before initiating any challenge, requiring that the parties confer before initiating the proposed challenge regarding the basis for the challenge in an effort to resolve the issue.
- Include a provision modifying the royalty in the event of a challenge and a decision in your favor by increasing the royalty rates or accelerating the royalty payments.

- Consider requiring a nonrefundable lump sum royalty payment in the event of a challenge.
- Since most license negotiations are not concluded without significant deliberations about the patents and technology at issue, consider summarizing the effort engaged in by the parties.
- Define the licensed products broadly to capture the technology covered by the licensed patents.

Many of the licenses the author sees generally define the licensed products as any product that may infringe a valid claim of any of the licensed patents.

This definition leaves in question what particular products are subject to the license as well as the validity of the patents at issue, which are the very concerns that started the *Medimmune* case.

- Consider the term of the license and whether it should be limited to a specific term or the lives of the patents at issue.

CONCLUSION

Your ability to implement these strategies and incorporate some of these provisions in your

“[T]he potential reward in both monetary royalties and the freedom of action to proceed with your business that can be achieved through licensing your intellectual property can be . . . well worth the effort involved.”

agreements obviously will depend on the nature and strength of the intellectual property at issue as well as the relative bargaining positions of the parties involved.

However, the potential reward in both monetary royalties and the freedom of action to proceed with your business that can be achieved through licensing your intellectual property can be significant to your business and well worth the effort involved.

Notes:

1. *Medimmune v. Genentech*, 549 U.S. 118 (2007).
2. See: e.g., <http://www.ipwatchdog.com/2014/11/13/is-there-an-anti-patent-bias-at-the-federal-circuit/id=52139/>; <http://www.insidecounsel.com/2014/08/13/like-a-wrecking-ball-the-troubling-trend-of-patent>.
3. *Automatic Radio Mfg. Co. v. Hazeltine Research Inc.* 339 U.S. 827, at 836 (1950).
4. *Lear Inc. v. Adkins*, 395 U.S. 653 (1969).
5. *Id.*, at 655.
6. 144 U.S. 224 (1892).
7. *Id.*, at 234.
8. See: e.g., *Bendix Corp. v. Balax, Inc.*, 471 F.2d 149, 158 (7th Cir. 1972) (holding the clause in a license agreement which stated that licensee “will not contest the validity of any patent which is now a part of this agreement during the life of this agreement” is null and void under *Lear*); *Panther Pumps & Equip. Co., v. Hydrocraft, Inc.*, 468 F.2d 225, 231 (7th Cir. 1972) (“[I]n 1969, the Supreme Court held that a licensee is not estopped to challenge the validity of a patent; in view of that holding, the “no contest” provision in [a] license is plainly unenforceable.”); *Plastic Contact Lens Co. v. W.R.S. Contact Lens Labs., Inc.*, 330 F. Supp. 441, 443 (S.D.N.Y. 1970) (“Each such defendant likewise violated the no-contest covenant of the respective license agreements, but that covenant does not estop defendants from challenging the patent’s validity”); *Congoleum Industries, Inc. v. Armstrong Cork Co.*, 366 F. Supp. 220, 232 (E.D. Pa. 1973) (aff’d, 510 F.2d 334 (3d Cir. 1975)) (“The decision in *Lear* struck down the enforceability of contractual provisions which preclude licensees from contesting the validity of the licensed patent.”); *Kraly v. Nat’l Distillers & Chem. Corp.*, 319 F. Supp. 1349, 1353 (N.D. Ill. 1970) aff’d, 502 F.2d 1366 (7th Cir. 1974) (concluding that “the *Lear* reasoning vitiates the force and effect of the covenant not to contest the validity of the patent . . .”); *Blohm & Voss AG v. Prudential-Grace Lines, Inc.*, 346 F. Supp. 1116, 1141 (D. Md. 1972) (rev’d on other grounds, 489 F.2d 231 (4th Cir. 1973)) (“*Lear* certainly held that a licensee was not, by virtue of a license, estopped to raise the question of invalidity of the patent when sued for infringement. A fortiori, clauses specifically negating this right are invalid.”); *Massillon-Cleveland-Akron Sign Co. v. Golden State Advert. Co.*, 444 F.2d 425, 427 (9th Cir. 1971) (holding a no-contest clause was in “direct conflict with the ‘strong federal policy’ referred to repeatedly in *Lear*, as was the estoppel doctrine and the specific contractual provision struck down in that decision.”); *Robintech, Inc. v. Chemidus Wavin, Ltd.*, 450 F. Supp. 817, 821 (D.D.C. 1978) (“Though no-contest clauses indubitably are unenforceable against the licensee under *Lear*, . . . such a clause, standing alone, is unlikely to constitute patent misuse, particularly if the patentee has indicated, as did defendant here, that the clause will not be enforced.”); *Wallace Clark & Co. v. Acheson Indus., Inc.*, 401 F. Supp. 637, 639 (S.D.N.Y. 1975) (“The effect of *Lear* was to render unenforceable any license agreement provision that attempts to prevent the licensee from contesting the validity of the patent as a defense to an action by the licensor to enforce the license agreement.”).
9. *Id.*, at 135.
10. See, e.g., <http://www.paulweiss.com/media/103975/NYLJ2-1-07.pdf> and <http://www.finnegan.com/resources/articles/articlesdetail.aspx?news=d16c3352-ac57-4cd7-a84d-5ad5525281a1>
11. *Rates Technology Inc. v. Speakeasy Inc.*, 685 F.3d 163 (2nd Cir. 2012).
12. *Id.*, at 165.
13. *Id.*, at 165.
14. *Id.*, at 172.
15. *Dot Hill Corp. v. Crossroads System Inc.* Case IPR2015-00822 (PTAB, February 27, 2015).
16. *Id.*, Paper No. 13 (PTAB, June 16, 2015).
17. *Id.*, Paper No. 16 (PTAB, July 17, 2015).
18. *Id.*, Paper No. 20, (PTAB, Sept. 17, 2015).

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Considerations in Forensic Royalty Audit Engagements

Natasha Perssico

Licenses are becoming an increasingly common means for intellectual property owners to reap some benefit from their inventions without having to manufacture a product or employ a process themselves. Therefore, the royalty audit is an important tool for licensors who want to successfully manage their intellectual property. This procedure serves to ensure that the licensor receives the agreed upon level of benefits (in the form of royalty payments) as outlined in the licensing agreement. Licensing agreements can be inherently complex contracts. Further, evidence from royalty audits shows that licensees perform very poorly in self-reporting royalties. When the potential for litigation or disputes over royalty amounts is possible, the royalty audit should be conducted by a forensic analyst who is experienced in reviewing and analyzing complex financial information.

INTRODUCTION

Owners of intellectual property (IP) will often license IP to a third party in exchange for payments based on usage (usually referred to as royalties).

Licenses serve to capture the full market value of IP by providing the IP owner with the means to benefit from the IP without having to singularly expend all efforts towards manufacturing and marketing the products associated with the IP. Using different forms of licenses, the owner of the IP can engage in distribution and marketing of the invention by imposing appropriate terms and conditions of sale, use, and further development of the technology.¹

A licensee is beholden to the binding contractual obligations within a license agreement. However, a core issue with licensing agreements is that most of these agreements rely upon the licensee to self-report royalties.²

ISSUES IN UNDERREPORTED ROYALTIES BY LICENSEES

Licensee self-reporting presents a unique issue in that licensees appear prone to misinterpreting the con-

tractual language in the license agreement, thereby leading to underreported royalties. Numerous reports on the findings of royalty audits reveal that the under-reporting of royalties is a commonplace occurrence.

According to one royalty compliance report published in 2013, whether due to intentional or unintentional causes, up to 89 percent of audited licensees underreport and underpay royalties.²

REASONS FOR CONTRACT NONCOMPLIANCE

Many reasons exist for contract noncompliance, ranging from instances of fraud to simple administrative errors in aggregating data or errors in performing calculations.

Some of the more common reasons for noncompliance with licensing agreements include the following:

- Intentional fraud or reckless misinterpretations of the contractual agreement
- Sales or transfers by the licensee to related parties in transactions that do not reflect arm's-length pricing

- Unintentional mistakes in interpreting the license agreement
- Intentional or unintentional omission of new, updated, or changed products
- Inappropriate or noncontractual deductions in the calculation of net sales
- Application of rebates, discounts, or other sales incentives to licensed products in a manner that underreports license-related sales
- Inappropriate attribution of value to licensed products on bundled product sales

According to the Invotex study, the frequency rate of common underreporting errors are as follows:

- 55 percent of licensees underreport sales
- 38 percent misinterpreted the licensing agreement
- 28 percent overstated deductions
- 15 percent made calculation errors
- 8 percent misapplied royalty rates
- 7 percent underreported sublicenses
- 5 percent applied improper transfer pricing
- 3 percent underreported benchmarks.^{3,4}

BENEFITS OF THE FORENSIC ROYALTY AUDIT

The most obvious benefit of the royalty audit is the recovery of royalty underpayments. Evidence from findings of royalty audits conducted by auditors and royalty compliance investigation professionals suggest that royalty recoveries are within the magnitude of 5 to 20 times the cost of conducting the royalty audit.⁵

In addition to the recovery of royalty amounts due to discoveries made during the actual conduct of the royalty audit, evidence from certain royalty audit case studies suggests that licensees will often report a self-corrected royalty amount from a self-conducted audit once they are informed that a royalty audit will take place.

Additionally, the royalty audit has the potential to reveal the unauthorized use of licensed property. The unauthorized use of licensed property could be a troublesome circumstance for the licensor, resulting in possible damage to the licensor's reputation or creating legal risks.⁶

Conducting regular royalty audits typically has the effect of deterring inappropriate reporting of royalty amounts by licensees. Regardless of whether the underreported royalty amounts result from intentional or unintentional means, the royalty

audit serves as a powerful tool that the licensor should utilize on a regular basis.

If a royalty underpayment issue does exist, it is in the licensor's best interest to discover the problem before the expiration of any statutes of limitations. Otherwise, depending on the state in which the suit is brought forth, recovery of the underpayments may become impossible.

For example, in *Shell Oil Co. v. Ross*, Shell entered into a mineral lease with the Ross family in 1961. Under the terms of the lease, Shell was obligated to pay the Rosses a royalty equal to 1/8 of the amount realized from the sale of any gas produced from the land. Shell did not consistently calculate the 1/8 interest based on the third-party gas sale price.

The Ross family sued over these discrepancies in 2002, which was outside the Texas four-year statute of limitations for a contract claim. But, plaintiffs argued that the claims were not barred because of the fraudulent concealment doctrine, which tolls limitations when a person attempts to conceal his wrongdoing until the risk period is over.

Plaintiffs argued that Shell had concealed the fact that it was underpaying the royalties because Shell's royalty statements did not reflect the amount that Shell was actually receiving from the third-party gas sales.⁷

The trial court ruled that Shell breached the lease by paying royalties to the Ross family based on a weighted average between 1988 and 1994 instead of the actual prices for that time period. The jury agreed with the plaintiffs and awarded damages to the Ross family.

However, the Texas Supreme Court reversed. The court acknowledged that the royalty statements did not reveal that the Ross family was being underpaid. However, the court's position is that the Ross family had a duty to investigate the royalty statement, and "make themselves aware of relevant information available in the public record."⁸

In other words, the Ross family had the ability and duty to conduct a royalty audit.

Licensors should also take care to stay apprised of how the changing technological and business environment affects the amount of royalties that are due for their intellectual property. In the music industry, recent court cases and settlements point to an apparent consensus that digital music sales should be treated as licenses instead of as sales, with the former yielding a substantially higher royalty rate.

In 2014, Warner Music Group Corp. agreed to pay upwards of \$11.5 million and increase the percentage paid for royalties going forward for digitally downloaded music, which will now be treated as a license, instead of the lower royalty

yielding category of sales.⁹ In 2015, Universal Music agreed to a similar settlement of a class action lawsuit.¹⁰

The issue of whether digitally downed music should be classified as a license or as a sale was first presented on a large scale in the landmark case *F.B.T. Productions v. Aftermath*. Plaintiffs for the case argued that digitally downloaded Eminem songs should be treated as licenses instead of sales since F.B.T Productions was not incurring expenses to package and sale any physical product.¹¹

WHAT IS A FORENSIC ROYALTY AUDIT AND WHO SHOULD CONDUCT THE INVESTIGATION?

A royalty audit is an analysis or investigation of a licensee's compliance with the contractual license agreement. Financial compliance is generally determined through an examination of the accounting books and records of the licensee and its sublicensees.

Evidence from royalty audit engagements suggests a significantly high level of royalty contract noncompliance on the part of the licensee. Licensees are inclined to underreport royalty amounts via a myriad of mechanisms.

Therefore, experienced forensic accountants and other forensic investigation professionals are typically better suited to successfully conduct royalty audit functions involving any schemes or mechanisms to obfuscate correct royalty amounts due.

Further, when legal disputes do arise, forensic professionals, who have skills tailored to detecting fraud or misrepresentation, often are best-suited to conducting royalty audits and communicating those findings to a court or in arbitration.

Auditors have historically been criticized for employing a "check-the-box" mentality when conducting auditing procedures. Audit regulators have been lobbying for increased use of professional judgment in the audit of complex financial statement accounts.

However, auditors seem to interpret audit standards as increasingly prescriptive.¹² Forensic professionals are arguably less inclined to employ a mechanical or check-the-box audit approach to decisions in those situations in which it is most important to make decisions based on professional judgment.

Engaging the services of an experienced forensic accountant with royalty audit experience is especially judicious when there is a possibility of contentious disagreement and litigation associated with the royalty audit.

USE OF DATA ANALYTICS IN FORENSIC ROYALTY AUDITS

The volume of data and electronic information has increased substantially over the last few years. This increase is changing the way companies manage and extract value from data.

Therefore, it is imperative that the royalty audit team has extensive experience in dealing with complex and massive data sets within the context of corporate disputes. Specifically, analysts should have experience in reviewing transactions and methodologies relevant to the licensing of IP in order to determine if royalty payments are compliant with the terms of the licensing contract.

Our data analytics methodologies provide complete and efficient results through the creation of data warehouses and the utilization of data mining. This is typically accomplished through the use of various software tools, databases, and programming languages.

FORENSIC ROYALTY AUDIT PLANNING

Royalty audits begin with a planning phase. Therefore, during the planning process, the audit team will work closely with the client (the licensor) to determine if there are red flags with regards to sales that should be highlighted during the audit.

Some events and circumstances that raise the level of concern include a history of issues in communication between the licensor and licensee, any analysis by the licensor that indicates the possibility of underreported licensed products, analysis that points to possible errors in interpretation of the licensing agreement by the licensee, and any questionable reporting practices by the licensee, to name a few.

During the planning phase the audit teams should also work to develop a thorough understanding of both the license agreement as well as the licensor's interpretations of the licensing agreement where interpretations may be applicable.

To the extent possible, prior to communication with the licensee, the audit team should become familiar with the licensee's accounting and royalty reporting methods, processes, and reporting. The royalty audit timeline and all required document requests should then be clearly communicated to the licensee.

EXECUTION OF THE FORENSIC ROYALTY AUDIT

During a royalty audit, certain key procedures should be undertaken. As previously mentioned, the

forensic royalty audit team should gain a thorough understanding of the licensing agreement as well as a solid understanding of the way the licensor interprets the licensing agreement.

Most royalty audits are based on testing some form of sales (unit, gross, or net) and careful consideration should be given to these calculations. Special attention should also be given to ambiguous contract language, especially when the possibility of litigation over royalty payments exists.

Examples of common contract provisions that require special consideration include the adjustments made to gross sales in arriving at net sales (net sales is a common royalty payment base), the methodology for the allocation of sales returns by the licensee in determining net sales for royalty payment calculations, the basis and methodology for the calculation of tiered royalty payments, and the treatment of subsequent products that utilize the licensed property, to name a few areas.^{13,14}

The royalty audit team should recalculate the royalty amounts that should have been paid based on appropriate interpretations of the licensing agreement.

This calculation should then be compared to actual royalties paid. The licensee's royalty reporting and payment records are tested for thoroughness and accuracy.

Part of this process should include reconciliation between licensee-prepared royalty reports and the licensee's accounting records such as inventory reports, invoices, and purchase records.

Depending on the volume of transactions and the level of assessed risk, the testing could be performed on a sample or complete transaction review basis. Any differences between royalty amounts due and royalty amounts paid should be analyzed, and, to the extent possible, specific causes for the variances should be identified.¹⁵

Interpersonal skills are also important during the forensic royalty audit. In most royalty audits, the audit team must also take into consideration the ongoing nature of the licensor/licensee relationship and take care to solicit direct, meaningful, and accurate information from the licensee while maintaining a nonhostile approach that does not damage the licensor/licensee relationship.

CONCLUSION

A royalty audit is a contract compliance investigation that requires special forensic investigation and in-depth auditing skills. Licensors are well served by employing their right to conduct a royalty audit of licensees.

Royalty audit findings suggest benefits for licensors of recovered royalty amounts as well as signaling to licensees that any unscrupulous royalty reporting practices will be unacceptable.

"[T]he audit team must also . . . take care to solicit direct, meaningful, and accurate information from the licensee while maintaining a nonhostile approach that does not damage the licensor/licensee relationship."

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Methods for Valuing Customer Relationships: Use of the Multi-Period Excess Earnings Method or the Distributor Method?

Lisa H. Tran and Irina Vrublevskaya

The income approach is a common approach used in the valuation of customer-related intangible assets. Within the income approach, the multi-period excess earnings method is a common method to value customer relationships. In recent years, valuation analysts have used the distributor method, also an income-based approach, as an alternative method to valuing the customer relationship intangible asset. This discussion describes the two valuation methods and provides guidance on the appropriate use of each method.

INTRODUCTION

Companies may devote significant human and financial resources to develop, maintain, and upgrade their customer relationships. More broadly, customer-related intangible assets consist of the information collected from repeat transactions, with or without underlying contracts. Companies can lease, sell, buy, or otherwise trade such information, generally organized as customer lists or customer databases.

Although customer lists are often sold, licensed, or rented, there are relatively few transactional reasons for analyzing customer intangible assets. Customer intangible assets are typically sold as part of a going-concern business enterprise. This is because it is unusual for the owner/operator to sell the customer relationships outright and then continue to operate the business without the established customer relationships.

Therefore, there are relatively few fee simple interest sales of customer relationship assets between a willing buyer and seller. The owner/operator either uses its customer relationships or sells the business including the relationships to a new owner/operator. As such, valuation analysts

may be called on to value customer relationships for financial accounting, taxation, or litigation purposes.

The analyst may need to value customer relationships for the following purposes:

1. Financial accounting, which may arise in acquisition accounting, impairment testing, and fresh start accounting
2. Tax planning and compliance, which may include cancellation of debt income solvency analysis, transfer price analysis, property tax value of exempt or taxable intangible assets, and valuation of intangible assets to establish the tax basis of assets contributed in a formation or the gain/loss on assets distributed in a dissolution
3. Forensic and litigation reasons, such as lost profit or economic damages related to a breach of customer or supplier contract or noncompetition agreement; family law disputes; shareholder disputes; condemnation or eminent domain actions; or income, gift, estate, or property tax disputes

All three generally accepted valuation approaches (cost, market, and income) may be applicable in

the valuation of customer-related intangible assets. Based on the type of customer-related intangible asset and the purpose of the valuation analysis, some valuation approaches and methods may be more applicable than others.

The income approach is a common approach used in the valuation of customer-related intangible assets. Within the income approach, the methods typically used to value customer relationships include the multi-period excess earnings method (MPEEM) and the distributor method (DM). While the MPEEM is a common method used to value customer relationships, the DM has been recognized in recent years as an alternative method.

This discussion summarizes the use of the MPEEM and the DM in the customer relationship valuation and the strengths and weaknesses of each method. Considering the MPEEM and the DM, the analyst may select all appropriate methods for valuing the customer relationship asset based on the facts and circumstances of the subject asset and the availability of required data.

COMMON ELEMENTS OF CUSTOMER RELATIONSHIPS

When determining if a customer relationship asset exists, the analyst should consider several elements that create that intangible asset.

Information

For a customer relationship asset to exist, it should have an informational component, or factual information about the customer that is important and useful to the company.

This information may include such attributes as name, address, telephone number, email address, social security number, customer account number, credit rating, insurance information, or other third-party payer information. It may also include account information, date of first and last purchase, accounts receivable balance, trends, the amounts purchased (last year, greatest, etc.), customer payment record, and other account information.

Further, the informational element may include information relating to the customer's purchase preferences, frequency, seasonality, trends, purchase responses to sales, promotions, solicitations, and price changes, and purchase responses to new offerings. It takes time and money to assemble, maintain, and use the customer account information. The company maintains this information in order to manage its customer relationships and

motivate its customers to continue purchasing the goods or services offered by the company.

Expectation

The company has the expectation of repeat patronage from its customers based on the customers' historical purchase activity, which creates value for customer-related intangible assets. This expectation translates into the expectation of future revenue, income, and cash flow.

Customer contracts formally codify the expectation of future transactions from customer relationships. Even in the absence of contracts, companies will seek to build on past interactions with customers in order to sell them products and services in the future.

There are two traits of repeat patronage that are important in valuing customer relationships. First, every customer contact will not lead to an expectation of repeat patronage. For example, the quality of interaction with a walk-in retail customer is typically not considered adequate enough to lead to reliable expectations of recurring business.

Second, even when adequate information is present, not all expected repeat patronage may be attributable to customer-related intangible assets. This is because some companies may operate in monopolistic or near-monopolistic industries, where repeat business can be directly attributable to a deficient availability of acceptable alternatives to the company's products or services.

In addition, recurring patronage may also be more appropriately attributable to the strength of the company's trade names or brands. However, typically, if the company continues to provide satisfactory products or services and use the customer information effectively, it may expect reasonable continued patronage.

Lifespan

Customer-related intangible assets create value over a finite period of time. Without efforts to continually reinforce the customer relationship, customer lists will decrease over time due to customer mortality, the effects of competition, or the emergence of alternate products and services. In addition, the concept of present value further erodes the economic benefits of sales to existing customers in the distant future. As a result, customer relationships are assets whose economic value decreases with the passage of time.

Dependence

Customer-related intangible assets are often dependent on the existence of several other assets

to generate value for the company. Typically, most assets of a company, including fixed assets and intellectual property, are essential in creating products or providing services to its customers. Through the sale of the products or services, the company is able to develop relationships and collect information from its customers.

Consequently, the value of the customer relationships depends on the company's ability to sell products and services in the future. As a result, in order for companies to extract value from customer-related intangible assets, they must have other assets in place.

Components

The customer base is the sum of the (1) customer list, (2) customer account information, and (3) expected future business with the customer. The customer list, which typically includes just the customer name or identification and contact information, is a tangible component of the customer base and the physical manifestation of the intangible asset. Companies may rent or license customer lists for noncompeting purposes.

The customer account information component, typically contained within a database, includes purchase history and trends, as well as customer preferences and responses to promotions. This information allows the company to maintain and develop a relationship with the customer. This information typically has a greater value-in-use than value-in-exchange to the company.

Expected future business that the company anticipates with the customer is a function of the age and expected remaining useful life of the relationship. The customer's purchase history and the company's ability to influence the customer's future purchases also influence the expected future business component. Customer relationship value depends significantly on this component of the customer base.

The customer base typically includes all of the existing customers as of the valuation date. For some purposes, the analyst may define the customer base as both the current customer relationships with a finite life and the goodwill component of future relationships (all expected future customer relationships from new customers replacing current customers as they retire).

Some customers may enter into specific contracts with the company. Many types of customers do not enter into contracts but typically continue to do business with the company as long as they are satisfied. The company expects the satisfied customer to continue purchasing goods or services.

For example, although a physician does not have a contract with the patient, he expects the patient to return to his office when the patient needs medical care. This intangible asset is typically called the "customer relationship asset."

Order or production backlogs are also considered to be customer-related intangible assets. While a customer list can be sold or exploited, an order backlog or a contract has a confirmed income stream associated with it.

In the customer relationship analysis, it is important to determine if the subject is a single customer, the sum of all individual customers, or the assembled collection of all customer relationships. Customers are typically categorized by the type of product or service they buy. Commonly, customers of the same type or in the same industry will be influenced by similar factors, exhibit similar consumption patterns, have similar risk factors, and be similarly affected by competitive influences.

FACTORS TO CONSIDER IN THE VALUATION OF CUSTOMER RELATIONSHIPS

Although all three generally accepted approaches may be used in the valuation of a customer relationship intangible asset, some may be more applicable than others.

The cost approach is frequently used to value customer databases or related intangible assets and to estimate the informational content value of the customer or customer database. However, the cost approach may not be feasible if replacement or recreation periods for an asset are long. This approach does not value the business expectation value of the customer relationship. Thus, it is used infrequently in valuing customer relationship assets.

The market approach may generally be used to value customer lists because there are sufficient data regarding the sale or license of customer lists. However, the analyst should note that these transactions provide data regarding the rental or sale of the customer lists for noncompetitive purposes, and that companies continue to own their customer relationships.

Further, intangible assets are typically unique and are frequently sold with other components of a business enterprise. Therefore, the market approach is frequently untenable in the valuation of customer relationship intangibles due to lack of transactional data for sufficiently comparable assets.

Therefore, the income approach is frequently used to estimate the value of customer-related

intangible assets. When valuing intangible assets using an income approach, the analyst typically selects an appropriate valuation method for each of the assets based on its characteristics and significance in generating revenue for the company.

The income approach methods commonly used to value customer relationship intangible assets are as follows:

- Multi-period excess earnings method
- Distributor method
- Relief from royalty method
- “With and without” method
- Greenfield method
- Differential cash flow method

Generally, the primary asset of a company is valued using the MPEEM, while a secondary intangible asset is valued using one of the other methods. The majority of acquired, going-concern companies own at least one asset that would be expected to be valued using the MPEEM.

The asset most responsible for the revenue and income-generating ability of a company is generally considered a primary asset. The primary asset often varies depending on the nature of a company and its industry. The primary asset of most service businesses is their customer relationships.

However, customer relationships are an important intangible asset for companies in many different industries. Customer-related intangible assets are a common type of intangible personal property. This is because nearly every company has recurring customer relationships.

MULTI-PERIOD EXCESS EARNINGS METHOD

The MPEEM is commonly used to value the primary income-generating asset of a company or of a segment of a company. The MPEEM estimates value based on the expected future excess earnings stream attributable to a particular asset. Typical intangible assets identified as primary income-generating assets include customer-related intangible assets and other so-called “enabling intangible assets.”

Application of the MPEEM

In the MPEEM, the analyst estimates revenue and cash flow derived from the subject intangible asset, such as customer relationships, and then deducts

portions of the cash flow that can be attributed to supporting, or contributory, assets. These contributory assets include trademarks and trade names or tangible assets that contributed to the generation of such cash flow. The resulting excess cash flow attributable to the subject asset is then discounted at a rate of return commensurate with the risk of the subject asset.

In applying the MPEEM, the analyst should perform the following procedures:

- Identify the asset(s) to be valued
- Identify the stream of revenue associated with the subject asset
- Estimate attrition rates for the subject asset
- Estimate expenses and cash flow associated with the subject asset
- Estimate and deduct contributory asset charges
- Estimate the rate of return for the subject asset
- Discount the remaining cash flow to present value
- Add any tax amortization benefit, if applicable

The analyst should identify the expected lifespan, or the remaining economic life of the subject asset. The analyst also should identify the revenue stream, or the cash flow, associated with the particular group of assets (including the subject asset and any contributory assets necessary to support the earnings associated with the subject asset), over the expected lifespan of the subject asset. This future revenue stream and cash flow are most commonly estimated using prospective financial information (PFI) prepared by company management.

For intangible asset valuations prepared for fair value accounting purposes only, the analysis should rely on market participant assumptions. Further, the analyst should consider that the appropriate growth rate to use for the revenue associated with the subject asset may be different than the consolidated company growth rate and may require stratification based on the customer mix or product mix.

Attrition

When valuing customer-related assets using the MPEEM, the analyst should identify the portion of revenue expected to be generated through repeat customers existing as of the valuation date. The estimated future revenue is derived from the revenue per customer and the number of retained customers. Because customer relationship assets

derive value within a finite period, the number of customers providing repeat business is expected to decrease over time.

Attrition is the measurement of the rate of decay or loss of existing customers. The analyst may have to conduct statistical analysis of historical customer turnover and revenue growth rates to estimate the expected attrition. However, historical customer data may not be available and the analyst may have to rely on management estimates or industry data to develop customer attrition rates. Once estimated, the attrition rate or factor is then applied to the projected revenue stream in order to separate the revenue into existing and future customer revenue.

There are two factors that may affect attrition: inherent advantage and the nature of the business.

An inherent advantage exists when a customer gains a specific advantage in purchasing one company's products or services over another (e.g., if a company has a unique product or there are high switching costs). Further, the company business model may be the principle driver of customer retention. For example, companies working on an engagement basis over long periods of time typically have lower attrition rates than companies without stable recurring revenue generating customer relationships.

In addition, geographical reach, expected competitive environment, and the state of the industry may have an impact on customer attrition. If the company operates in an industry that is moving toward obsolescence, customer retention could potentially decrease. If competition is expected to increase, but the number of customers in the industry is not expected to increase significantly, customer retention can potentially decrease as well.

The type of analysis used to estimate the attrition rate may have a significant impact on the indicated attrition factors and the customer relationship value. In a constant rate attrition analysis, an attrition rate is identified for each period for which prior period customer purchase information is available. The analyst then concludes a single rate based on the attrition rates indicated for each period that is held constant throughout the remaining useful life of the subject customer relationship asset. This analysis focuses on the attrition of relationships or the revenue attributable to the relationships.

Although the constant rate attrition analysis requires only limited information about whether a customer made a purchase during each period, no distinction is made between customer relationships based on the size of the purchase or the age of the relationship.

Frequently, this factor may have a direct impact on the expected attrition rate and a significant impact on the customer relationship value. This is because revenue may be concentrated in a certain group and may not necessarily be reflected in the number of relationships that have been lost. For example, a company may lose only 2 customers but 20 percent of revenue, or on the contrary, lose 100 customers but only 1 percent of revenue.

An actuarial attrition analysis or a variable attrition rate analysis considers variations in attrition rates based on the age of the customer relationship. This analysis results in an indicated attrition rate for each relationship age. The use of this analysis typically requires at least five to seven years of purchase information to ascertain the relationship between age and attrition. The variation in attrition rates based on customer size can be incorporated in both the actuarial attrition analysis and the constant rate attrition analysis by focusing on revenue rather than on the customer relationships.

Once projected revenue attributable to the customer base existing as of the valuation date has been identified, the earnings can be estimated based on the expected profitability of the business. The analyst should consider only the operating costs relevant to the existing customer base from a market participant perspective.

Existing customer relationships may be more profitable than the company's average profitability or future customer relationships because the company may have to incur expenses in developing new customers.

Expected sales and marketing costs necessary to acquire new customers and company-specific cost synergies are not relevant and should not be considered in projecting the earnings from existing customers. Typically, it is expected that near-term revenue and earnings would be generated by the existing assets for most companies.

In addition, increases or decreases in working capital should not be deducted from the customer relationship cash flow. Further, backlog revenue should be subtracted from the customer relationship revenue after applying any attrition factors.

Contributory Assets

As discussed previously, there are other assets that need to be in place for companies to be able to extract value from customer-related assets. If the earnings from the customer relationship asset depend on other assets, the analyst needs to estimate the contributory asset charges to isolate the "excess" cash flow attributable to the customer relationship asset from the estimated earnings.

Possible contributory assets may include working capital; machinery, equipment, land, and buildings; assembled workforce; and other intangible assets, such as brand name, trademark, technology, and noncompete agreements. Excess assets, such as excess land or capacity, that do not contribute to the projected cash flow associated with the customer relationships should not be considered as contributory assets.

In order to estimate the contributory asset charges, the analyst should:

- identify and value all contributory assets,
- determine the revenue base,
- estimated the rate of return for each contributory asset, and
- subtract the earnings attributable to the contributory assets to estimate excess earnings attributable to the customer relationships.

Any costs associated with the other “supporting” assets that could contribute to the income from the customer relationship asset should be deducted. The amount that should be deducted is typically the alternative costs for the contributory assets or the income such assets would generate in a different use if they were not used in connection with the customer relationship asset.

In essence, the contributory asset charge represents the economic “rent,” or a charge equivalent to the return on and the return of, an asset necessary to produce the goods or services of the company. The analyst should, therefore, reduce the cash flow attributable to the customer relationship intangible asset by the required return on the contributory assets.

The contributory assets should be at market participant levels. In order to reflect market participant levels, the analyst may analyze the fundamentals of guideline publicly traded companies and industry peer group ratios, such as the working capital to sales ratio or fixed asset ratio.

To the extent that the projected cash flow reflects excess or deficit levels of contributory assets, the analyst should adjust the cash flow to reflect a normalized level. For example, if the company has negative or low working capital, but a market participant would need working capital as a contributory asset, the analyst may have to estimate a reasonable working capital charge based on the working capital of an industry peer group or guideline companies. The appropriate level of fixed assets should be determined for each year of the projection.

The required levels for some contributory assets, such as working capital, fixed assets, and workforce, are likely to scale with revenue. However,

to estimate the contributory asset charge on the other intangible assets, such as trade name, the analyst may have to rely on an alternative valuation approach or method.

The return on and the return of assets used in the contributory asset charge should reflect the appropriate risk for each asset, with financing rates for the property and equipment and higher rates for intangible assets. The analyst should consider the level of debt and equity financing that can be obtained on an asset.

When more than one asset can be identified as a primary asset and the analyst chooses to apply a dual MPEEM to value both of the primary assets, there are several methods the analyst can use to estimate the contributory asset charges to be applied to both primary assets.

These methods include the hierarchy method, the cross-charge method, the partial separation method, and the separation method. However, to avoid using a dual MPEEM and the related contributory asset charge issues, the analyst may apply the MPEEM to one primary asset and an alternative valuation method, such as the relief from royalty method or the “with and without” method, to the other primary asset.

After adjusting the projected cash flow for contributory asset charges, the remaining “excess” cash flow is attributable to the customer relationship intangible asset. This “excess” cash flow is then discounted to a present value using an appropriate rate of return to estimate the market value of the customer relationship intangible asset. The analyst should determine whether a tax amortization benefit adjustment is appropriate in the analysis.

When estimating an appropriate discount rate, the analyst should consider the risk in the customer relationship asset. The analyst should consider such risk factors as switching costs, product/service differentiation, barriers to entry, level of customer purchasing power, customer concentration, and competitive rivalry.

The analyst should reconcile the internal rate of return with the discount rate as the reconciliation may highlight asset cost of capital issues, as well as allocation issues. If the internal rate of return exceeds the discount rate, there may be optimistic cash flow, unique synergies in the cash flow, or an inadequate risk assessment in the discount rate.

Strengths and Weaknesses of the MPEEM

There are several advantages and disadvantages in using the MPEEM to value the customer relationship

intangible asset. Some of the advantages include the following:

- The MPEEM is useful as a check on the reasonableness of a purchase price allocation.
- The MPEEM allows analysts to understand the relationship between revenue and earnings generated by existing assets, as well as revenue and earnings attributable to unidentified assets.
- The MPEEM provides analysts with the ability to reconcile to the entity value and demonstrates that the calculation of contributory asset charges does not create or destroy the aggregate asset value.

There are also several disadvantages or challenges when relying on the MPEEM that the analyst should consider. These include the following:

- Reasonable remaining useful life may be difficult to estimate.
- The use of a finite remaining useful life for the customer relationships may significantly understate the value of the customer relationship intangible asset (effectively indicating that a thriving business will have no customer relationships in the future), thereby overstating the value of residual goodwill.
- The MPEEM is dependent on the reasonable estimation of expected cash flow.
- Future assets may also be included by management in estimating the expected cash flow and excess income.
- The value of cash flow beyond the projection period is not taken into consideration, as it is with a typical discounted cash flow analysis, due to attrition and the assumed finite remaining useful life of the intangible asset.
- Attrition rates may be difficult to estimate due to lack of historical data, erratic buying patterns, and difficulty in determining when a customer is considered to be lost.
- The MPEEM suffers from the inability to recognize all relevant going-concern components in the contributory assets charges.
- All “excess” income is attributed to an amortizable intangible asset and/or goodwill.
- When multiple intangible assets exist, “excess” income needs to be allocated amongst the intangible assets.

DISTRIBUTOR METHOD

The DM is not as commonly used as the MPEEM to value the customer relationship asset, even though the DM is simply one application of the MPEEM. The main theory behind the DM is that “a business is composed of various functional components (such as manufacturing, distribution, and intellectual property) and that market-based data may be used, if available, to reasonably isolate the revenue, earnings, and cash flow related to these functional areas.”¹

The DM assumes that the returns to a customer-related asset are comparable to the economic profits generated by a hypothetical intermediary (i.e., the distributor).

The DM is appropriate to use when another intangible asset (i.e., a technology or trademark) other than the customer relationship asset is determined to be the primary asset of the company, while the customer relationship asset is determined to be the secondary asset. The DM is used most frequently in valuations where the brand is the primary asset.

The DM is also appropriate to use when relevant market data is available. In the DM, a royalty rate is determined for the customer relationship asset based on the profit margins of comparable distribution companies operating in the same industry and applied in a MPEEM. The determination of the appropriate royalty rate includes a downward adjustment for contributory asset charges.

When a company has strong-branded and recognizable products, retailers and distributors (i.e., the company’s customers) want to sell the company’s products due to consumer demand, not due to the customers’ relationship with the company. The relationship with the distributors is based on the company’s ability to provide the desired products in a timely and efficient manner, analogous to the distributor’s relationship with its customers in providing the products in a timely manner.

The distributor’s operating margin reflects the importance of the intellectual property relative to the customer relationship. The distributor earns lower margins on more unique or proprietary products, which reduces the value generated by the customer relationship function. For products that are less unique, the customer relationship adds more value, which increases the distributor’s margins.

The initial inputs, revenue, growth, and attrition rates, used in the DM are similar to the inputs used in the MPEEM to value the customer relationships. After the initial inputs in the DM, the fundamentals (i.e., the margin and contributory asset charges) of a distributor in the same industry are applied to the resulting revenue stream associated with the customer relationship.

Since the margin and contributory asset charges are based on those of the distributor, the DM may be viewed as a profit split method. The margin of the distributor is already reduced by the cost of any other intellectual properties (e.g., technology and brands) captured within the distributor's cost of goods sold.

Since the cost of other intellectual properties is already included in the distributor's cost of goods sold, contributory asset charges should include only charges for working capital, tangible assets, and assembled workforce. These contributory asset charges are expected to be low for distributors.

Distributors often have rapid turnover in assets, thus reducing the amount of working capital requirement. Tangible asset requirements are also expected to be low. This is because distributors typically do not manufacture any products and, thus, do not own such capital assets. The contributory asset charge for assembled workforce is expected to be lower as well, as only the contributory asset charges on the employees involved in the sales and distribution need to be accounted for.

Exhibit 1 provides a simplified illustrative example of how the DM may be applied. To simplify the Exhibit 1 example, many of the valuation variables are unrealistically simple and are presented for illustrative purposes only. For example, the annual attrition rate and the remaining revenue percentage after annual attrition calculation is deliberately simplified compared to a typical customer relationship valuation.

On June 5, 2012, the Appraisal Practices Board (APB) issued a Discussion Draft of *Best Practices for the Valuation of Customer-Related Assets*. Following the Discussion Draft, the APB issued an Exposure Draft—*The Valuation of Customer-Related Assets*, on December 5, 2013. In the Discussion Draft and the Exposure Draft, the APB describes and explains the DM application.

The Discussion Draft also discusses several advantages to using the DM to value customer relationships, including the following:

- The DM uses market evidence (i.e., the profit margins of distributing companies in the same industry) to develop the expected return from customers.
- The use of the DM to value the customer relationship asset allows the use of the MPEEM to value the other intangible assets of the business (e.g., the technology or trademark) and avoids the challenges caused by multiple applications of the MPEEM, such as cross circular contributory asset charges.

- Using the distributor's margin directly isolates the cash flow attributable to the customer relationship asset.

In response to the APB Discussion Draft, the Committee on Corporate Reporting (CCR) of Financial Executives International agrees that the DM should be an acceptable alternative method if information on comparable distribution companies is available. In fact, some analysts have argued that finding a suitable market proxy for the subject company may be challenging. This is because there are many different types of distributors with different business models.

Further, the DM is applicable to companies that sell directly to the end user. The method is not applicable for companies that sell primarily to distributors, particularly smaller companies that do not have the resources to support a supply chain that extends to end users.

Finally, the contributory asset charges used in the DM do not consider the possible existence of goodwill (e.g., reputation or market position of the distributor) or the existence of other intangible assets such as supplier relationships or preferential contracts that provide the distributor the right to sell certain products or to sell to specific territories.

CONCLUSION

There are a number of methods to value customer-related assets. In the past, the MPEEM was the common method to value customer relationships. However, in recent years, the DM has received attention as an acceptable alternative method in certain circumstances, to value customer relationship assets.

Both the MPEEM and the DM have strengths and limitations. Between the MPEEM and the DM, the selection of the best method for valuing the customer relationship asset will depend on the facts and circumstances specific to the asset being valued and the availability of market data.

Note:

1. *The Valuation of Customer-Related Assets* (exposure draft) (Washington, D.C.: The Appraisal Foundation, December 5, 2013), 27.

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Exhibit 1
Illustrative Client Company
Customer Relationships Intangible Asset Value
Income Approach Distributor Method
As of January 1, 2016

Valuation Variables		Pro Forma Years				
		Year 1	Year 2	Year 3	Year 4	Year 5
		\$000	\$000	\$000	\$000	\$000
Management Revenue Projection		1,000,000	1,040,000	1,081,600	1,124,864	1,169,859
Projected Annual Revenue Growth Rate		4.0%	4.0%	4.0%	4.0%	4.0%
Estimated Customer Annual Attrition Rate		20%				
Remaining Revenue after Customer Attrition [a]		100%	80%	60%	40%	20%
Revenue Attributable to the Remaining Customers after Annual Attrition		1,000,000	832,000	648,960	449,946	233,972
Operating Income (EBIT)		50,000	41,600	32,448	22,497	11,699
Operating Margin		5.0%	5.0%	5.0%	5.0%	5.0%
Less: Estimated Income Tax Expense		40%	(20,000)	(16,640)	(12,979)	(8,999)
Net Operating Income		30,000	24,960	19,469	13,498	7,019
Net Operating Income Margin		3.0%	3.0%	3.0%	3.0%	3.0%
Plus: Depreciation/Amortization Expense		10,000	8,320	6,490	4,499	2,340
Depreciation/Amortization Expense as a % of Revenue		1.0%	1.0%	1.0%	1.0%	1.0%
Less: Contributory Asset Charge [b]		(15,000)	(12,480)	(9,734)	(6,749)	(3,510)
Contributory Asset Charge as a % of Revenue		1.5%	1.5%	1.5%	1.5%	1.5%
Net Cash Flow		25,000	20,800	16,224	11,249	5,849
Implied Royalty Rate		2.5%	2.5%	2.5%	2.5%	2.5%
(Net Cash Flow as a % of Revenue)						
Midyear Discounting Periods		0.50	1.50	2.50	3.50	4.50
Present Value Interest Factor		12%	0.9449	0.8437	0.7533	0.6726
Present Value of Net Cash Flow to Remaining Customer Relationships		23,623	17,548	12,221	7,565	3,513
Total Customer Relationships Intangible Asset Value (rounded)		\$64,000				
EBIT = Earnings before Interest and Taxes						
[a] Typically, the remaining customer relationships revenue after annual attrition should be calculated as each prior year's revenue multiplied by (1 - annual attrition rate). The remaining revenue calculation is deliberately simplified in this example for illustrative purposes only.						
[b] Includes a return on investment contributory asset charge for net working capital balances, tangible asset balances, and an assembled workforce and other Client Company contributory intangible assets.						

A Quantitative Analysis of Damages in Trade Secrets Litigation

John E. Elmore, JD, CPA

Trade secrets constitute an important component of many companies' intellectual property portfolio, and trade secrets are an integral driver of economic growth. Yet there is a surprising lack of empirical research related to the valuation of trade secrets. The collection of U.S. civil case law pertaining to damages awarded for misappropriation of trade secrets offers a potentially rich area of study. This discussion presents a quantitative analysis of damages for trade secrets misappropriation in civil litigation. This damages analysis may also provide insights into the trade secrets valuation.

INTRODUCTION

The misappropriation of trade secrets reflects a significant business risk. Trade secrets are elements of business that drive investment, innovation, and economic growth. Economists estimate that trade secrets comprise roughly two-thirds of the value of companies' intellectual property portfolios and reflect a key competitive advantage.¹

The theft of trade secrets can be more problematic for smaller companies due to a greater reliance on a few trade secrets. In 2009, a Valspar Corporation employee downloaded proprietary paint formulas from his employer's computer system, which he intended to take to a new employer in China.²

The company estimated the value of the formulas at \$20 million, representing an eighth of its entire operating profits.

The valuation of trade secrets is not well studied from an empirical perspective. The collection of U.S. civil case law pertaining to the misappropriation of trade secrets offers a potentially rich area of study. After all, trade secrets are validated in a litigation environment.

No legal trade secret status actually exists until a judgement is rendered by the court, unlike other forms of intellectual property.

Damages are based on this validation and reflect an insightful measure of value. Yet trade secrets case law remains a largely neglected area of valuation research.

This discussion presents a quantitative analysis of damages for trade secrets misappropriation in civil litigation. And, this discussion includes an overview of trade secrets law from a damages analysis perspective.

PRIOR STUDIES

Unlike litigation for patents, trademarks, and copyrights, damages in trade secrets litigation is an understudied subject. A review of the published literature revealed three prior studies of case law. None of the studies provided a substantive analysis of damages in trade secrets civil litigation.

The first study was published in 2006 by John Lerner of Harvard Business School.³ In his study, Lerner analyzed a sample of federal court and state court cases in California and Massachusetts involving trade secrets misappropriation.

Lerner determined that the courts found a trade secrets violation in two-thirds of the cases. Only 9 percent of the cases recorded an award of damages (about 50 of the 583 cases considered). In those



cases where damages were awarded, the average award was \$1.5 million in 2004 dollars.

No statistical data was presented in the published study regarding the range or variability of these damages. Further, the study presented no discussion of the methodologies employed by the courts to determine these damages.

The second study was published by Nicola Searle of the University of St. Andrews in Scotland.⁴ The study analyzed 21 cases of criminal trade secrets misappropriation based on violation of the Economic Espionage Act of 1996 (EEA).

Searle found that the values of misappropriated trade secrets ranged from a low of \$6,000 to a high of \$272 million in 2008 dollars, with a mean of \$4.5 million. But the mean reflected a relatively high variability (the standard deviation was 1.4 times the mean), and Searle noted that 79 percent of the misappropriated secrets in the study were estimated to be worth less than \$5 million.

While informative, it is unclear how well this study of criminal trials translates to damages in civil proceedings.

The third study was published in 2010 by *Gonzaga Law Review* by a team of attorneys from O'Melveny & Myers, LLP.⁵

The study analyzed a sample of federal and state court cases: (1) 358 state appellate court cases from 1995 to 2008 and (2) 394 federal court cases from 1950 to 2008. The selected cases all involved trade secrets issues.

An interesting finding of this study was that 78 percent of the state court cases involved alleged employee misappropriators, as compared to only

58 percent of federal court cases (the remainder pertaining mostly to misappropriation by business partners).

While the study provided a number of statistics characterizing the posture and application of law, it presented no statistics or substantive discussion of damages.

A reason for the dearth of prior studies of trade secrets litigation is the difficulty in compiling and analyzing case data. Neither federal nor state courts systemically track trade secrets litigation, so identifying trade secrets cases is a challenge. And, for many states, cases are published only at the appellate level. Many state trial decisions, therefore, are not available for analysis.

METHODOLOGY

The present study, as summarized in this discussion, comprises a review by the author of federal and state civil court cases involving damages awards for trade secrets misappropriation. The author defined "trade secrets cases" as decisions published from 1950 to 2015 in which a U.S. district court or state appellate court decided a substantive issue based on trade secret civil law.

Such cases were identified initially as cases in which the term "trade secrets" appeared at least three times based on the keyword search of a commercial legal database.

This initial search resulted in the identification of 4,738 U.S. district court decisions and 1,629 state appellate decisions for the 1950 to 2015 period.⁶ A subsequent winnowing process reduced the number of decisions by selecting only those mentioning a derivation of the terms "damages" or "award."

This winnowing process resulted in 717 U.S. district court decisions and 426 state appellate decisions that were potentially relevant to the damages study.

The author then compiled two sample populations. The two sample populations were compiled using a computer algorithm that randomly selected 25 percent of the decisions from each group of potentially relevant federal and state court decisions.

This random selection produced a federal sample population of 180 U.S. federal court decisions and a state sample population of 104 state appellate court decisions.

The author read every case in the two sample populations and coded them based on multiple criteria. The author excluded decisions from the sample populations that failed to present an opinion of damages for each case at hand, including an amount of damages.⁷

This review produced a federal sample population of 42 cases and a state sample population of 42 cases. The author then performed a quantitative analysis based on the sample populations. The findings of this analysis are discussed below.

TRADE SECRETS DEFINED

U.S. trade secret law protects secret, valuable business information from theft and espionage.

A trade secret generally consists of information that conveys a competitive advantage to its holder so long as the information is kept secret by reasonable measures. Whether information qualifies as a trade secret under federal or state law is a question of fact for the court.

One federal court described trade secrets as follows:

A trade secret is really just a piece of information (such as a customer list, or a method of production, or a secret formula for a soft drink) that the holder tries to keep secret by executing confidentiality agreements with employees and others and by hiding the information from outsiders by means of fences, safes, encryption, and other means of concealment, so that the only way the secret can be unmasked is by a breach of contract or a tort.⁸

Trade secrets tend to lose value once they are no longer secret. The court may enjoin a party from disclosing a trade secret and award monetary damages to compensate for the loss of trade secret value in cases of misappropriation.

Ordinarily, the holder possesses no legal rights to exclude others from using a trade secret that has been obtained in good faith, such as by reverse engineering or independent discovery. This circumstance is unique to trade secrets.

Patents, trademarks, and copyrights, on the contrary, convey the right of exclusive use and other legal protection in exchange for public disclosure.



Trade secrets can coexist with patents, trademarks, and copyrights. For example, a trade secret may be based on information related to the use of an issued patent or published patent application that is not disclosed in the patent specification. A trade secret may be based on confidential information used to produce a product that is marketed under a trademark. And, a trade secret may be based on the source code of a software application where the corresponding object code (compiled software) is protected by a copyright.

THE EVOLUTION OF TRADE SECRETS LAW

Trade secrets historically have been protected through state common law using a combination of property, contract, and tort law theories. In one of the first trade secrets cases, for example, a Massachusetts state court held in 1868 that an employee had breached a nondisclosure agreement by disclosing confidential information about the manufacture of certain machinery.⁹

Rather than applying a straight contract remedy, the court provided injunctive relief based on its recognition of the employer's property right in the confidential information.

Trade secrets law developed from the early days in a haphazard manner with protections varying from state to state, often with wide disagreement over legal concepts. In 1939, the *Restatement*

(*First*) of *Torts* reflected the first attempt to unify trade secrets law and to clarify its generally accepted principles.

For many years thereafter, the Restatement was the primary authority cited in most trade secrets cases. The *Restatement* enunciated six factors to consider in determining whether information qualifies as a trade secret, as follows:¹⁰

- The extent to which the information is known outside of the company
- The extent to which it is known by employees and others involved in the company
- The extent of measures taken by the company to guard the secrecy of the information
- The value of the information to the company and to its competitors;
- The amount of effort or money expended by the company in developing the information
- The ease or difficulty with which the information could be properly acquired or duplicated by others

The Uniform Trade Secrets Act

The 1979 *Restatement (Second) of Torts* did not address trade secrets law. To fill the gap, and to further unify and modernize trade secrets law, the National Conference of Commissioners on Uniform State Laws published the Uniform Trade Secrets Act (UTSA).¹¹

The UTSA offered a statutory model that states could decide to adopt. Over time, most did. As of the date of this discussion, the UTSA has been adopted by all states except New York, North Carolina, and Massachusetts. Some states have made amendments to the UTSA, so slight variations exist among a number of the adopting states.

The UTSA was designed to establish common rules for the handling of trade secrets disputes. It provides a broader definition of trade secrets than the *Restatement*. The *Restatement* requires that a trade secret be “a process or device for continuous use in operation of business.”

Many courts interpreted this language to:

1. preclude internal business information from protection because such information is not a process or device and
2. preclude research and development (R&D) information from protection because such information does not reflect continuous use.

The UTSA merely requires that the information (1) derives independent economic value, actual or potential, from not being generally known to—and not being readily ascertainable by proper means by—other persons who can obtain economic value from its disclosure or use, and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.¹²

Under the UTSA, a trade secret can be any information that satisfies these two requirements, including internal business information and R&D information.

Damages for misappropriation of trade secrets under the UTSA is similar to the *Restatement*. Damages can include “the actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing damages for actual loss.”¹³

A plaintiff can be awarded both actual damages and unjust enrichment to the extent that there is no double counting. Double counting can occur when damages calculated under the two theories are based on the same sales transaction.

Damages also can include a reasonable royalty as an alternative form of monetary relief. The UTSA differs from the *Restatement* by expressly providing for injunctive relief.

Monetary relief—whether based on actual loss, unjust enrichment, or a reasonable royalty—is appropriate only for the period in which information is entitled to protection as a trade secret, plus the additional period, if any, in which a misappropriator retains a competitive advantage because of the misappropriation.

Once information is publicly known, it no longer can be considered a trade secret. No monetary damages ordinarily would be awarded for the misappropriator’s use of the information following its loss of trade secret status. But the courts have recognized that the plaintiff may not be made whole if the misappropriator retains a “head start” advantage.

An award of monetary relief based on a period of time after the information loses its status as a trade secret can offset this ill-gotten competitive advantage.

Determination of Damages, Generally

The determination of trade secrets damages involves two primarily goals:

1. To make the victim whole “but for” the misappropriation

2. To strip the misappropriator of any unjust enrichment gained from the misappropriation

These goals are compensatory in nature.

In some cases, the courts may deem it necessary to award punitive or “enhanced” damages for the purpose of creating a disincentive for would-be misappropriators and as a punishment for egregious behavior.

The determination of damages is very case-specific. In *University Computing Company v. Lykes-Youngstown Corporation*, the Fifth Circuit provided the following insight in this 1974 opinion regarding trade secret damages:

Our review of the case law leads us to the conclusion that every case requires a flexible and imaginative approach to the problem of damages. We agree with the Court of Appeals for the Sixth Circuit that “each case is controlled by its own peculiar facts and circumstances,” and accordingly we believe that the cases reveal that most courts adjust the measure of damages to accord with the commercial setting of the injury, the likely future consequences of the misappropriation, and the nature and extent of the use the defendant put the trade secret to after misappropriation.¹⁴

The wide array of facts and circumstances encountered in trade secret cases requires flexibility in the calculation of damages. State legislatures and courts have responded to this need by supporting an assortment of damage approaches for use by plaintiffs and their experts in the calculation of trade secret damages.

Determination of Actual Loss Damages

Actual loss refers to a specific injury to the plaintiff. Often this injury is determined as lost profits based on the incremental operating income attributable to the use of the trade secret.

If lost profits resulted from lost revenue, incremental costs related to this revenue are deducted. These are costs that generally would have been incurred only if the lost revenue had been realized by the plaintiff.

Lost revenue may result from lost sales of the protected product or service, lost sales of complementary products and services (conveyed

sales), and price erosion resulting from the misappropriator’s entry into the market with a competing product or service.

Courts also have accepted determinations of actual loss based on the loss of business value resulting from the misappropriation and the investment value of the trade secret.¹⁵ However, actual loss does not always equate to the investment value of the trade secret to the plaintiff.

The Fifth Circuit in *University Computing Co.* stated:

[N]ormally the value of the secret to the plaintiff is an appropriate measure of damages only when the defendant has in some way destroyed the value of the secret. The most obvious way this is done is through publication, so that no secret remains. Where the plaintiff retains the use of the secret, as here, and where there has been no effective disclosure of the secret through publication, the total value of the secret to the plaintiff is an inappropriate measure.¹⁶

The proper measure of actual loss reflects what is required to make the plaintiff whole. If the plaintiff retains some use of the trade secret, perhaps because it has been used by the misappropriator but not otherwise disclosed to the public, the actual loss may be something less than the investment value of the trade secret to the plaintiff or the full contribution of the trade secret to business value.

Determination of Unjust Enrichment Damages

Under the premise that a defendant was unjustly enriched due to misappropriation, a plaintiff may seek the defendant’s wrongfully gained profits as a remedy. These profits are available as a remedy to the extent that they are not derived from sales considered in the calculation of the actual loss.

When calculating the defendant’s profits, there is divergence among the courts about the means by which deductible costs should be determined.

Generally, for purposes of calculating a defendant’s profits, deductible costs may be based on one of the following:

1. Incremental costs—costs that generally vary with sales volume
2. Direct costs—variable costs and direct overhead costs

3. Fully absorbed costs—all costs including variable costs and direct and indirect overhead costs

Under the federal statutes pertaining to trademark and copyright infringement matters, when the defendant's profits are being sought as damages in trademark and copyright infringement matters, the plaintiff is responsible for identifying gross sales only.¹⁷

The burden then shifts to the defendant to prove deductions for costs and sales unrelated to the wrongful activity. While there is no explicit provision for shifting the burden of proving defendant's profits under the UTSA, some courts have endorsed this type of approach.

The defendant's profits may not be the only measure of its unjust enrichment. In *University Computing*, the Fifth Circuit observed, "the appropriate measure of damages, by analogy to patent infringement, is not what plaintiff lost, but rather the benefits, profits, or advantages gained by the defendant in the use of the trade secret."¹⁸

In some circumstances, the misappropriator may show no profits, yet it derives a benefit or advantage from misappropriation of plaintiff's trade secret nonetheless. This is often the case where the misappropriator uses the trade secret to short-cut product development, saving time and costs. The plaintiff may seek these costs saved as a remedy.

For example, in *Salisbury Labs, Inc. v. Merieux Labs, Inc.*, the court recognized that limiting relief to the defendant's meager profits would have left the plaintiff less than whole.¹⁹

The court awarded \$1 million to the plaintiff based on the calculation that plaintiff's employees had spent in excess of 10,000 hours developing the trade secret. The average wage hour times the number of development hours yielded the estimated development costs.

The defendant's use of the trade secret to avoid these development costs conferred a benefit for which defendant's profits alone did not reflect.

Determination of Reasonable Royalty Damages

Under the 1985 amendments, the UTSA expressly provides for the award of a reasonable royalty in lieu of damages measured by any other methods.²⁰

A reasonable royalty represents compensation for the use of the trade secret that a willing licensor and willing licensee would have negotiated in an

arm's-length setting prior to infringement or misappropriation.

On one hand, a reasonable royalty represents a form of actual loss to a plaintiff under the premise that, had the misappropriator negotiated a license instead of misappropriating, the plaintiff would have generated additional revenue and profits from the license.

On the other hand, a reasonable royalty represents a benefit or advantage wrongfully obtained by the misappropriator, thus also representing a form of unjust enrichment.

The Fifth Circuit in *University Computing* discussed the factors to be considered in determining a reasonable royalty for trade secrets misappropriation:

[T]he proper measure is to calculate what the parties would have agreed to as a fair price for licensing the defendant to put the trade secret to the use the defendant intended at the time the misappropriation took place. . . . In calculating what a fair licensing price would have been had the parties agreed, the trier of fact should consider such factors as the resulting and foreseeable changes in the parties' competitive posture; the prices past purchasers or licensees may have paid; the total value of the secret to the plaintiff, including the plaintiff's development costs and the importance of the secret to the plaintiff's business; the nature and extent of the use the defendant intended for the secret; and finally whatever other unique factors in the particular case which might have affected the parties' agreement, such as the ready availability of alternative processes.²¹

Here, the Fifth Circuit echoed its 1971 seminal opinion in *Georgia-Pacific Corp. v. United States Plywood Corp.*, wherein the court delineated a list of 15 factors to consider in the determination of a reasonable royalty.²²

The *Georgia-Pacific* analysis was originally directed to the determination of a reasonable royalty for patent infringement. It has since been adopted in one form or another for use in nonpatent cases. *University Computing* has been frequently cited in reasonable royalty cases for trade secrets misappropriation.

Some states adopted the 1979 version of the UTSA without the express provision for a reasonable royalty. Even in those states, a review of case law suggests that the reasonable royalty remedy is available. *Veritas Operating Corp. v. Microsoft Corp.*,²³

for example, was decided under the Washington state statute, which makes no mention of a reasonable royalty.

Finding that the defendant's unjust enrichment could be measured by a reasonable royalty, the court denied the defendant's motion to exclude the testimony of the plaintiff's damages expert on this issue.

THE GROWTH OF TRADE SECRETS LITIGATION

Trade secrets litigation has increased substantially in the past few decades in both the federal and state forums. While the earliest trade secrets matters date back to the 1800s, trade secrets litigation was relatively obscure until the 1970s.

The following figures and exhibits illustrate the exponential growth of this area of litigation in recent history.²⁴

Figure 1 presents the number of trade secrets cases in U.S. district courts from 1950 to 2015.²⁵ Federal cases, notably, increased 14 percent per year between 2001 and 2012.

Since 2012, growth has moderated. One explanation for this growth pattern is linked to the increase in patent cases over roughly the same period.

Misappropriation of trade secrets is claimed alongside patent infringement in about a third of federal cases. Some legal commentators have pointed further to an increasing risk of patent invalidation by the courts as motivation for more reliance on trade secret protection.²⁶

However, patenting behavior does not appear to fully explain the increase in trade secret litigation. The percentage of technically based trade secrets involved in litigation has diminished significantly since 2001, as discussed in more detail below.

A more complete explanation would reflect the increasing recognition by the courts of the value of internal business information—such as customer information and business strategies. Adoption of the UTSA has encouraged this judicial recognition.

Figure 2 presents the number of trade secrets cases in state appellate courts for the same period. While state appellate decisions represent a fraction of state court trade secrets matters, they provide a reasonable illustration of the increase in state court cases.

DISCUSSION OF THE FINDINGS

This section discusses the findings of the quantitative analysis of damages in federal and state trade secrets civil litigation.

Figure 1
Trade Secrets Cases in U.S. District Courts per Year
1950–2015

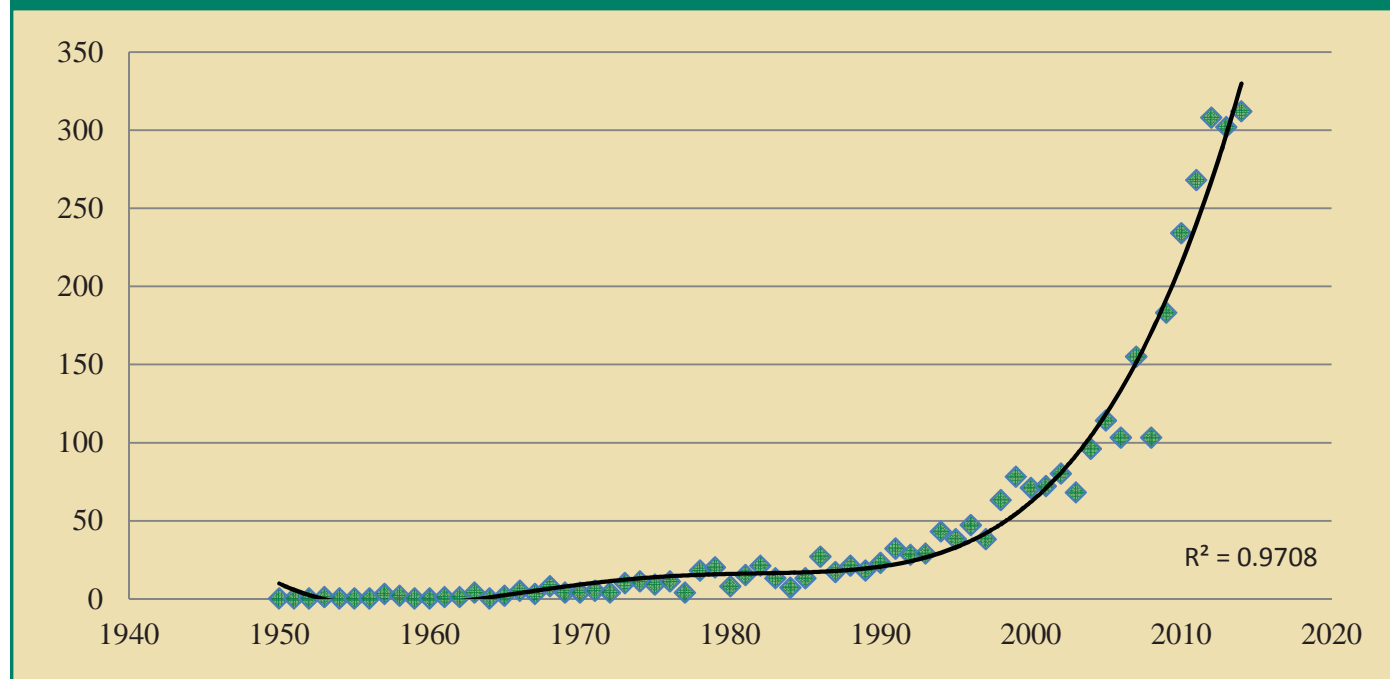
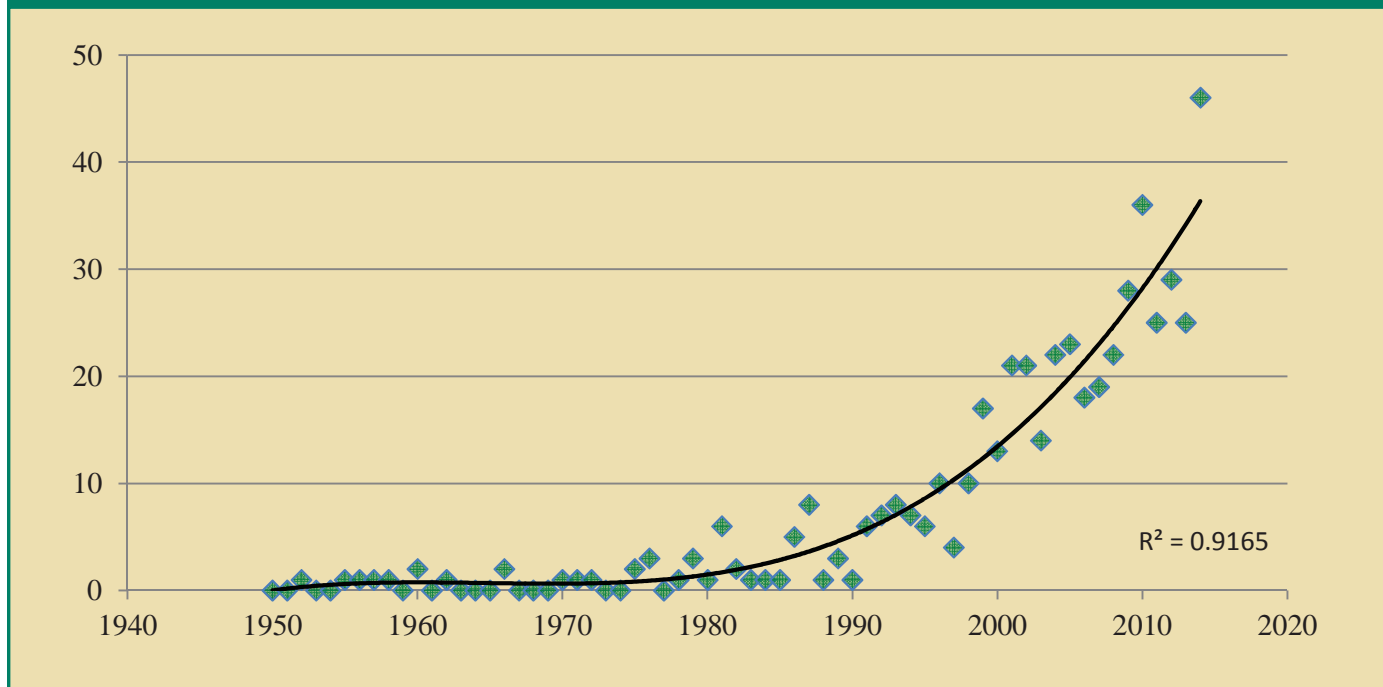


Figure 2
Trade Secrets Cases in State Appellate Courts per Year
1950–2015



Trade Secrets Divide Evenly between Technical and Business Information

For purposes of the analysis, the samples of the trade secrets cases were coded into the following five general categories in order to reflect the type of trade secret(s) that was misappropriated:

1. Business information—customer lists, other customer information, business strategy, marketing plans, information about suppliers, and the like
2. Technical know-how—technical processes, methods, formulas, algorithms, excluding software
3. Software—computer programs
4. Negative information—information typically describing what does not work or what to avoid
5. Other or unknown

Business information includes information internal and external to the business. Theoretically, a distinction in the coding could be made between the internal information (customer information, business strategy, etc.) and the external information (information about suppliers and competitors).

However, judicial opinions often do not provide sufficient clarity or detail to make a proper distinction between the two types of business information.

A judicial opinion, for example, may state that a misappropriator downloaded customer information, marketing plans, and “pricing information,” the latter of which could be interpreted to pertain to supplier pricing information. Further study may be warranted on this issue.

The findings of the analysis with regard to the type of trade secrets are presented in Figure 3. These findings reflect trade secrets for which damages were awarded. The findings are categorized by jurisdiction (federal or state) and time period.

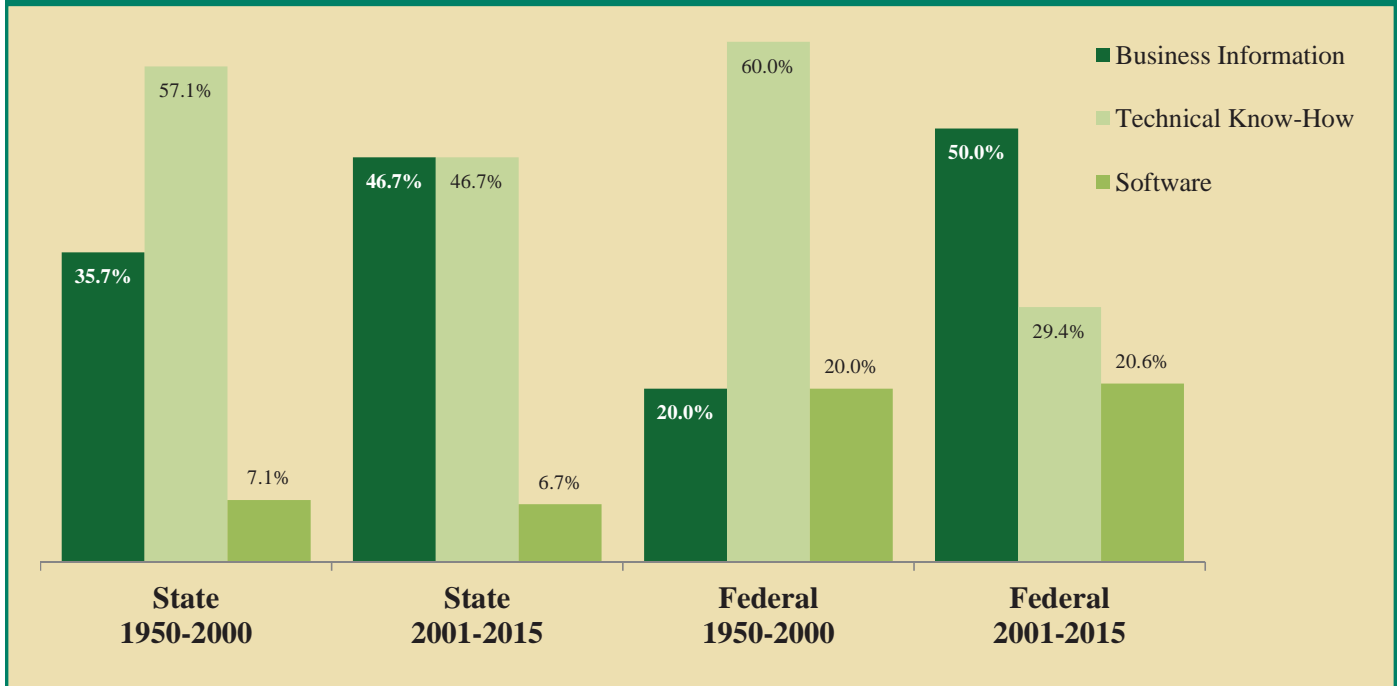
No negative information was expressly identified in the samples by the courts, and none was inferred. The trade secrets discussed in the sample cases were found to be reasonably identifiable as business information, technical know-how, or software.

The findings suggest that business information has gained more importance as a protected trade secret in both the federal and state courts. Business information has now reached parity with technical know-how and software.

Adoption of the UTSA by the states likely has been a driver of this increase, as it broadened the definition of trade secrets to include forms of business information not recognized by the *Restatement*.

This increase is particularly noteworthy in the federal courts, where business information

Figure 3
Type of Trade Secret



increased from 20 percent of trade secrets prior to 2001 to 50 percent in the period thereafter.

One explanation for the significantly greater increase in the federal courts is that trade secrets disputes involving business information have traditionally been pursued in the state courts.

Trade secrets in the federal cases were predominantly technical in nature, in large part due to the linkage between patents and technical trade secrets. Approximately 37 percent of trade secrets misappropriation claims in federal courts were filed with patent infringement claims during the 1950 to 2000 period.

As business information has become more protected, the relative share of technical know-how has decreased. That the relative share of software has remained steady is noteworthy. Its stability on a percentage basis actually reflects a modest increase in the number of cases involving damages awarded for theft of software protected as trade secrets.

Top Industries

The sample trade secrets cases were coded for a number of broadly defined industries. For each case, the primary industry of the trade secret holder was discerned by the author from the information provided in the court decision.

The top 10 industries associated with the trade secrets samples are presented in Exhibit 1.

These industries represent about 80 percent of the trade secrets holders. While confidential technology and business information are utilized for virtually every industry, it is not surprising that most of the industries in the list are technology based.

The federal and state findings differ significantly in certain industries. One plausible explanation for this difference is that:

1. the federal case-related industries tend to be ones where companies rely more on patents for protection (e.g., medical devices and construction tools) and
2. the state case-related industries tend to be the ones where companies tend to rely less on patents and more on secrecy to protect innovations (e.g., chemicals).

Misappropriators Are Predominately Employees and Business Partners

The sample trade secrets cases were coded to indicate whether the misappropriator in each case was:

1. an employee,
2. a business partner, or
3. other.

Exhibit 1 Top 10 Industries

Industry	SIC Codes	1950-2015	
		Federal	State
Information Technology	737	19.0%	19.0%
Miscellaneous Services	738, 76, 89	21.4%	11.9%
Chemical	28	2.4%	14.3%
Consumer Products	20, 23, 25, 30, 35	4.8%	11.9%
Resources and Utilities	29, 46, 49	4.8%	11.9%
Construction	15, 16, 17	9.5%	2.4%
Manufacturing and Industrial Products	35	7.1%	4.8%
Health Care	80	7.1%	2.4%
Medical Devices	38,807	7.1%	0.0%
SIC = Standard Industrial Classification			

State Law Applied

Trade secrets civil law is state law. The sample trade secrets cases were coded to reflect the state law applied. Federal courts select the appropriate state law to apply in adjudicating claims for trade secrets misappropriation. In this vein, federal and state case data were aggregated for this analysis.

The top 10 states for applied law are presented in Exhibit 2. Collectively, these states represent 57 percent of the trade

secrets cases for which damages were awarded. California, Texas, and New York lead the list, which is unsurprising given these states' history as hubs of economic growth and innovation.

However, an analysis of the case data after 2000 indicates the distribution of applied state law has flattened somewhat. This flattening is likely explained, at least in part, by (1) a greater dispersion of economic development among the states and (2) the adoption of the UTSA by all but three states, which broadened the definition of trade secrets and encouraged litigation in more jurisdictions.

Type of Remedy

The sample trade secrets cases were coded to indicate the type of remedy awarded. The types of remedies available are as follows:

1. Nominal damages
2. Compensatory damages
3. Punitive damages
4. Injunction
5. Attorney's fees

A summary of the analysis regarding remedies is presented in Figure 5.

Based on the findings, compensatory damages were awarded in about 90 percent of the cases. In

The term "business partner" is broadly defined to include joint ventures and development agreements between companies.

The findings for identifying the misappropriator are presented in Figure 4. In the state cases, the misappropriator was an employee 85 percent of the time. This finding is consistent with the Almeling, et al., state study which found 77 percent of the state trade secrets cases filed between 1995 and 2009 involved alleged misappropriation by an employee.²⁷

In the federal cases, the identity of the misappropriator was more evenly split between employee (44 percent) and business partner (56 percent). This finding is consistent with the Almeling, et al., federal study that found 52 percent and 40 percent of the federal trade secrets cases filed between 1995 and 2007 involved alleged misappropriation by an employee and a business partner, respectively.²⁸

One plausible explanation for the higher incidence of misappropriation by business partners in federal cases is that disputes involving business partnerships are more likely to satisfy diversity jurisdiction requirements or invoke claims based on federal law, such as patent infringement.

The broad takeaway is that in almost all of the civil cases, the misappropriator is someone the trade secret holder knows.

Figure 4
Misappropriator

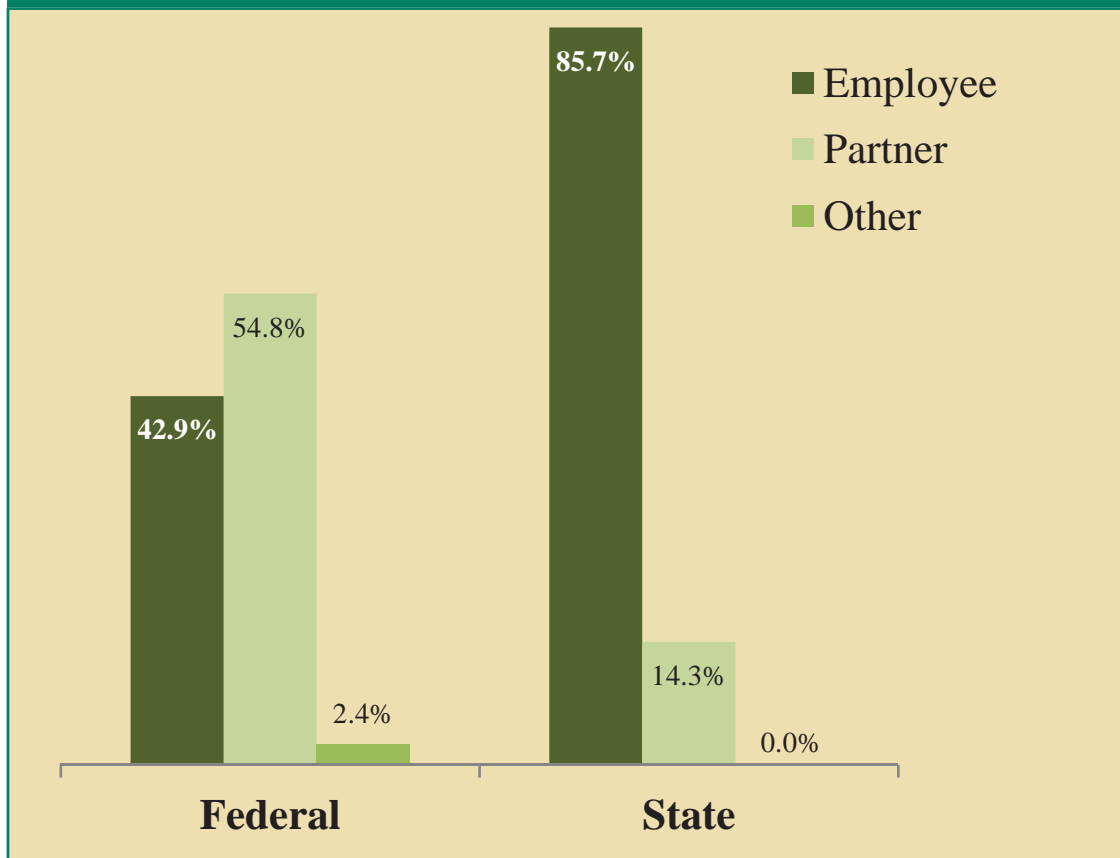
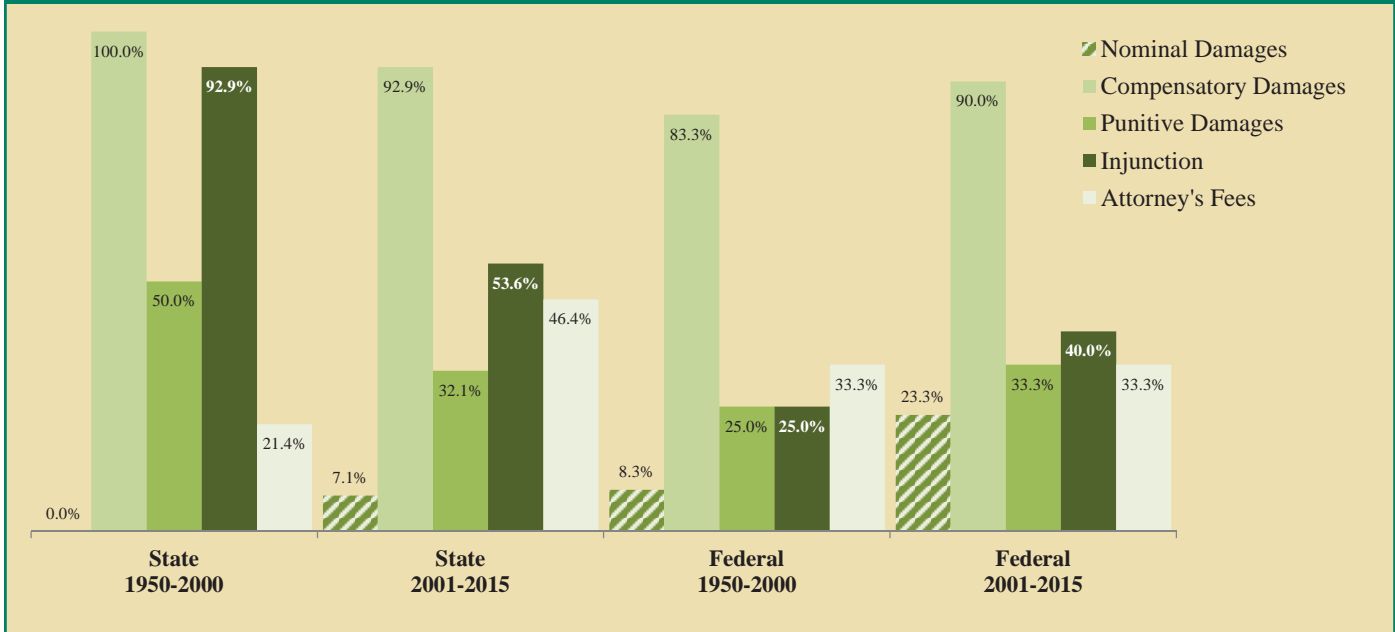


Exhibit 2
State Law Applied

State	1950–2000	2001–2015	1950–2015
California	16.0%	5.1%	8.3%
Texas	8.0%	6.8%	7.1%
New York	8.0%	5.1%	6.0%
Kansas	4.0%	6.8%	6.0%
North Carolina	4.0%	6.8%	6.0%
Iowa	8.0%	5.1%	6.0%
Illinois	4.0%	5.1%	4.8%
Utah	0.0%	6.8%	4.8%
Connecticut	4.0%	5.1%	4.8%
South Carolina	0.0%	5.1%	3.6%

Figure 5
Type of Remedy



the remaining cases, nominal damages (e.g., \$1) were awarded. Punitive damages were awarded in about a third of the cases. As discussed earlier, the sample cases were selected under the presumption of a monetary damages award. The analysis does not address the cases where injunctive relief was awarded but no monetary damages were awarded.

The award of injunctive relief in conjunction with monetary relief has declined significantly in the state courts over time.

One plausible explanation for the decline is the increasing hesitation by the courts of restricting competitive business activity if monetary relief, such as an ongoing reasonable royalty, can provide an adequate remedy for the harm. The plaintiff ordinarily bears the burden of proving that the harm would be irreparable absent an injunction. This issue would benefit from further study.

Compensatory Damages

For the analysis, the federal and state sample cases were coded to indicate the damages theory and dollar amount of the compensatory damages awarded for trade secrets misappropriation. The theory was coded using four categories:

1. Lost profits
2. Unjust enrichment
3. Reasonable royalty
4. Undetermined

The coding could include multiple selections. In fact, approximately 22 percent of federal cases and 13 percent of state cases involved monetary awards for both lost profits and unjust enrichment.

A summary of the damages theory analysis is presented in Figure 6. Lost profits represented the predominant damages theory for the reviewed period. The main difference between the federal and state cases was the greater use of a reasonable royalty in federal decisions.

One plausible explanation for this difference is the federal courts' familiarity with the reasonable royalty from patent litigation. This familiarity likely encouraged its adoption in trade secrets matters.

Moreover, prior to the UTSA, some state courts took a narrow view of a reasonable royalty as a form of actual loss. These courts often required a showing of an established royalty as a condition to awarding a reasonable royalty.

This qualification may help to explain why, for a time, the state courts appeared to favor unjust enrichment where actual loss could not be shown, even after a reasonable royalty was expressly provided through statutory law. In this vein, it is noteworthy that most of the reasonable royalty awards in the state cases sample occurred after 2010.

It is also possible that the difference between the federal and state results is largely a matter of semantics. Some reasonable royalty analyses could have been accepted by the state courts under the

label of unjust enrichment damages.

The labeling ambiguity is understandable given that a reasonable royalty can represent a means to the same end as unjust enrichment: to disincentivize the misappropriation of trade secrets. This issue would benefit from further study.

While the determination of damages is highly subject to the facts and circumstances of each case, a review of previous awards can provide useful benchmarks and insights.

The findings related to the amount of compensatory damages are presented in Exhibits 3 and 4. All amounts are presented in 2015 dollars.

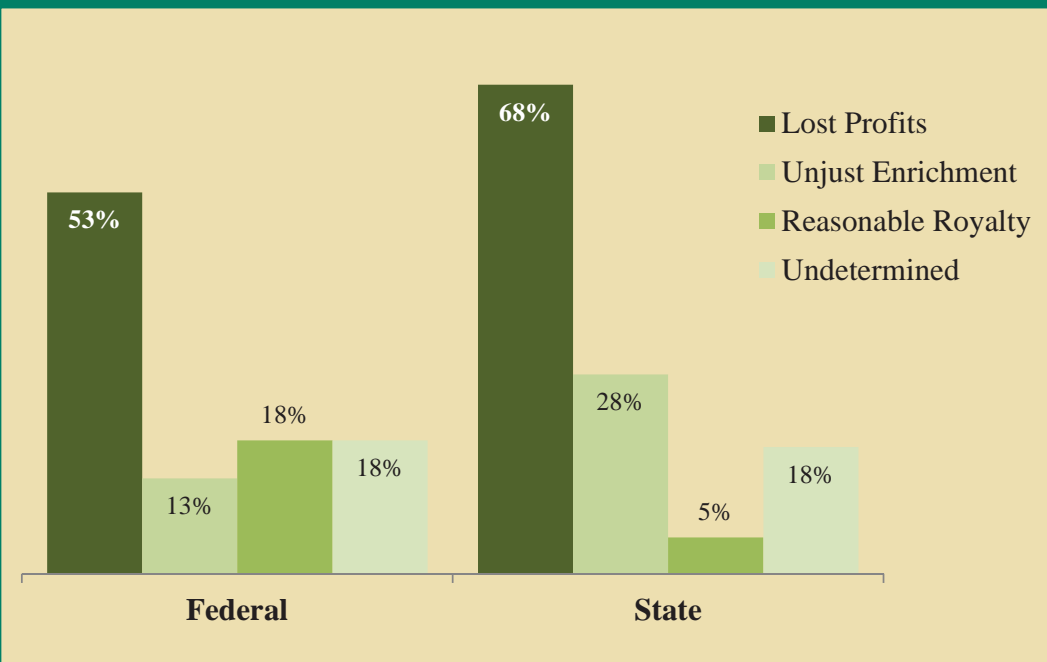
In the federal cases sample, the range was wide for the 1950–2015 period. The low was \$1 (nominal damages) and the high was approximately \$40 million. The average award was approximately \$3 million. This average is somewhat misleading given the relatively high variability of the data (the standard deviation is 2.5 times the mean).

Three-fourths of the awards were less than \$2.5 million. The median award between 2001 and 2015 was approximately \$450,000, falling from nearly \$1 million in the prior era. The median is a better indicator of a typical award.

The state cases sample presented an even wider range of trade secrets damages amounts: a low of \$1 (nominal damages) to a high of \$525 million.

The high amount represented the largest award in the case samples. It pertains to a 2014 decision by the Supreme Court of Minnesota, in *Seagate Technology*,

Figure 6
Compensatory Damages Theory
1950–2015



LLC v. Western Digital Corp.,²⁹ to affirm the trial court's award for unjust enrichment.

Such large awards are rare. Three-fourths of the state court awards for trade secret misappropriation were less than \$575,000. The median state court award was approximately \$200,000.

The distribution of the awards of compensatory damages for the 1950 to 2015 period is presented in Figure 7. The figure illustrates that federal court

Exhibit 3
Compensatory Damages in 2015 Dollars

	1950–2000		2001–2015	
	Federal	State	Federal	State
Minimum	\$1	\$1,178	\$1	\$1
1 st Quartile	416,513	26,500	97,350	54,575
Median	999,741	73,777	443,453	201,676
Mean	4,488,147	663,121	2,470,257	19,073,897
Standard Deviation	11,818,355	1,449,000	5,386,374	99,152,874
3 rd Quartile	1,678,585	205,914	2,436,325	572,486
Maximum	40,053,772	4,634,754	27,553,708	525,000,000
Number	11	14	31	28

Exhibit 4 Compensatory Damages in 2015 Dollars

	1950–2015	
	Federal	State
Minimum	\$1	\$1
1 st Quartile	106,430	32,214
Median	716,580	183,260
Mean	2,998,752	12,936,972
Standard Deviation	7,490,133	80,944,996
3 rd Quartile	2,139,026	511,308
Maximum	40,053,772	525,000,000
Number	42	42

awards tend to be higher: 45 percent exceeded \$1 million. The corollary is that the majority of the awards in federal and state cases were less than \$1 million.

Compensatory damages can be categorized by type of damages methodology. The summary of this analysis is presented in Exhibit 5.

In terms of frequency, lost profits represented the most common damages theory in both federal and state cases. It also yielded the lowest median (approximately \$460,000 for federal cases and \$128,000 for state cases), with the exception of the reasonable royalty in state cases. Unjust enrichment and reasonable royalty damages generally were two to four times higher.

One plausible explanation for this discrepancy is that unjust enrichment, and to some extent reasonable royalty, are theories based on the goal of deterring unfair competition.

Damages under those theories are premised on the improper benefit the defendant has gained from using the misappropriated trade secrets, as opposed to what loss of use, if any, the plaintiff has experienced.

The defendant bears the burden of any uncertainty in determining the appropriate amount of damages to make the plaintiff whole, including the removal of any ill-gotten competitive advantage. This uncertainty likely translates into higher amounts of damages.

Figure 7
Distribution of Compensatory Damages
1950–2015
in 2015 Dollars

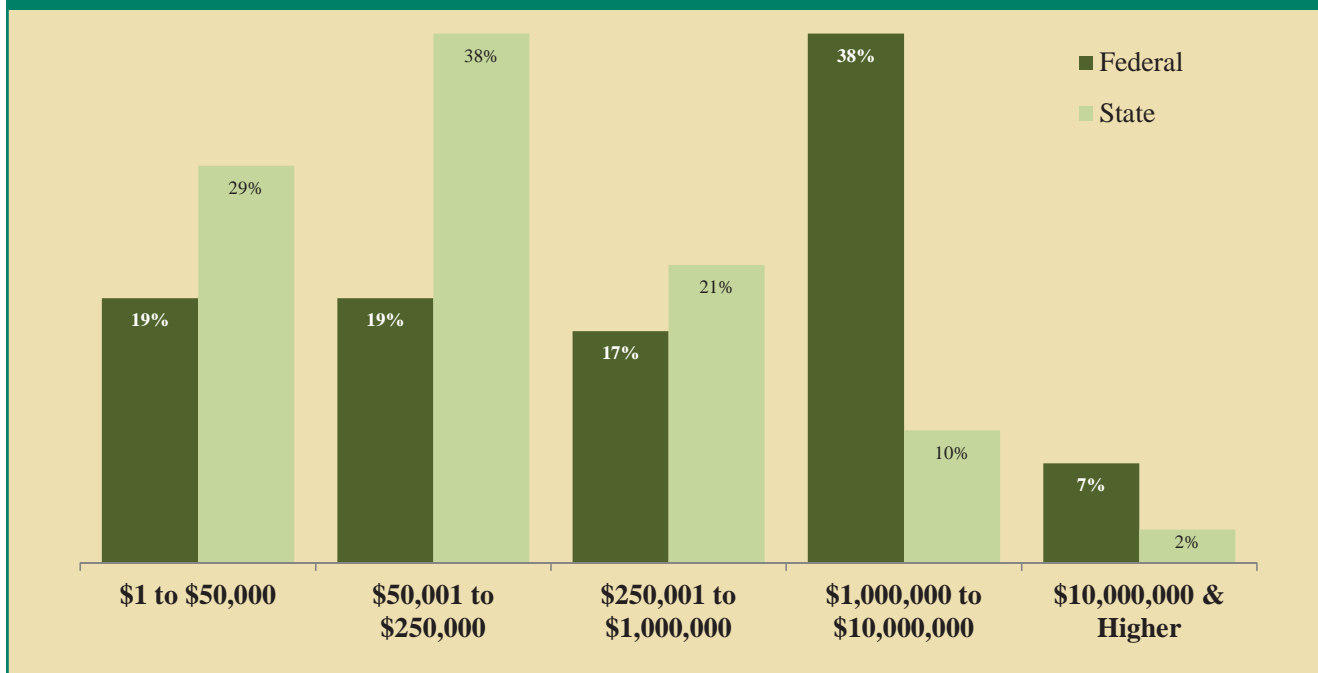


Exhibit 5
Compensatory Damages by Damages Methodology
1950–2015
In 2015 Dollars

	Lost Profits		Unjust Enrichment		Reasonable Royalty	
	Federal	State	Federal	State	Federal	State
Minimum	\$29,010	\$553	\$43,337	\$27,787	\$263,121	\$421
1 st Quartile	108,795	49,224	44,726	121,055	1,202,406	50,316
Median	462,512	128,487	1,856,049	256,947	2,690,799	100,210
Mean	4,036,462	466,516	1,162,142	44,190,202	2,605,355	100,210
Standard Deviation	10,408,530	772,254	1,022,638	151,417,149	1,756,711	141,124
3 rd Quartile	1,955,991	593,452	1,856,049	709,764	4,043,350	150,105
Maximum	40,053,772	3,410,030	2,010,550	525,000,000	4,792,052	200,000
Number	20	27	5	12	7	2

CONCLUSION

Trade secrets constitute an important component of companies' intellectual property portfolio and an integral driver of economic growth. The misappropriation of trade secrets reflects a significant business risk. Yet there is a surprising lack of empirical research related to the valuation of trade secrets.

The collection of civil case law pertaining to the misappropriation of trade secrets offers a potentially rich area of study.

Trade secrets civil litigation has increased substantially in the past few decades in both the federal and state forums. Whereas trade secrets cases were once relatively obscure, the courts now process hundreds of such cases a year.

This discussion presents a first of its kind quantitative analysis of damages for trade secrets misappropriation in civil litigation. Damages reflect a measure of value. Therefore, this analysis of trade secrets damages may also provide insights into the valuation of trade secrets.

Notes:

1. Forrester Consulting, "The Value of Corporate Secrets" (March 2010), available at <http://www.nsi.org/pdf/reports/The%20Value%20of%20Corporate%20Secrets.pdf>.
2. Office of the National Counterintelligence Executive, Report to Congress on Foreign Economic Collection and Industrial Espionage—2009-2011 (October 2011), available at http://www.ncsc.gov/publications/reports/fecie_all/Foreign_Economic_Collection_2011.pdf.
3. Josh Lerner, "Using Litigation to Understand Trade Secrets: A Preliminary Exploration," working paper (August 2006), available at SSRN: <http://ssrn.com/abstract=922520>.
4. Nicola Searle, "Damages Valuations of Trade Secrets: Evidence from the Economic Espionage Act of 1996," working paper of the 4th Annual Conference of the EPIP Association (September 2009).
5. The study was published in two parts: David S. Almeling, et al., "A Statistical Analysis of Trade Secret Litigation in Federal Courts," *Gonzaga Law Review* 45, no. 2 (2010); and David S. Almeling, et al., "A Statistical Analysis of Trade Secret Litigation in State Courts," *Gonzaga Law Review* 46, no. 1 (2011).



6. Note that more than one decision may occur per trial, as the courts may decide on various motions related to a single trial.
7. A mention of nominal damages was interpreted as \$1 if no particular dollar amount was specified.
8. *ConFold Pac. v. Polaris Indus.*, 433 F.3d 952, 959 (7th Cir. 2006).
9. *Peabody v. Norfolk*, 98 Mass. 452 (1868).
10. Restatement (First) of Torts §757, comment b.
11. The National Conference of Commissioners on Uniform State Laws was established in 1892 as a non-profit association to assist states with legislation that brings clarity to critical areas of state statutory law. It published the UTSA in 1979 and further amended it in 1985.
12. Uniform Trade Secrets Act §1(4) (amended 1985).
13. Uniform Trade Secrets Act §3(a) (amended 1985).
14. *University Computing Co. v. Lykes-Youngstown Corp.*, 504 F.2d 518 (5th Cir. 1974).
15. See, e.g., *Cardiovention, Inc. v. Medtronic, Inc.*, 483 F. Supp. 2d 830, 846 (D. Minn. 2007).
16. *University Computing Co.*, supra note 15.
17. See 15 U.S.C. § 1117(a)(3) for trademark damages and 17 U.S.C. § 504(b) for copyright damages.
18. *University Computing Co.*, supra note 15, citing *International Industries, Inc. v. Warren Petroleum Corp.*, 248 F.2d 696, 699 (3d Cir. 1957).
19. *Salsbury Labs, Inc. v. Merieux Labs, Inc.*, 908 F.2d 706, 714 (11th Cir. 1990).
20. Uniform Trade Secrets Act §3(a) (amended 1985).
21. *University Computing Co.*, supra note 15.
22. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970) *aff'd*, 446 F.2d 225 (1971).
23. *Veritas Operating Corp. v. Microsoft Corp.*, 2008 U.S. Dist. LEXIS 112135 (W.D. Wash. 2008).
24. The trend lines shown in both figures reflect an ordinary least squares regression analysis with over 91 percent of the variability in the plotted data explained by the trend line equations ($R^2 > .91$).
25. The number of federal and state cases was determined based on counting the first published decision for each trade secrets case identified from a commercial legal database since 1950, excluding any subsequent decisions related to the same case.
26. See, e.g., Dana Finberg, "Trade Secrets Offer an End-Around to Patent Ineligibility," *The Recorder* (August 19, 2014).
27. Almeling, et al., "A Statistical Analysis of Trade Secret Litigation in State Courts," supra note 6, at 69.
28. *Ibid.*
29. *Seagate Technology, LLC v. Western Digital Corp.*, 854 N.W.2d 750 (Minn. 2014).

John Elmore is a vice president in our Atlanta practice office. John can be reached at (404) 475-2303 or at jeelmore@willamette.com.



On Our Web Site

Recent Articles and Presentations

Robert F. Reilly, a managing director of our firm, authored an article that was published in the Winter 2016 issue of *The Practical Tax Lawyer*. The title of Robert's article is "What Lawyers Need to Know about Distinguishing Personal Goodwill from Entity Goodwill in the Closely Held Company Valuation."

In many tax-related valuations, it is often important for the closely held business owners and their advisers to allocate the total enterprise value between the company-owned entity goodwill and the individual shareholder/employee's personal goodwill. Robert's article summarizes what counsel need to know with regard to the elements of, the separability of, and the documentation of a shareholder/employee's personal goodwill. This article also discusses a recent Tax Court decision: *Bross Trucking v. Commissioner*.

Robert Reilly also authored an article that appeared in the February/March 2016 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article is "Valuation of Health Care Entity Transactions," Part One.

Robert's article summarizes what analysts need to know about the regulatory considerations that affect the valuation of health care entity transfers of property and services. The article also presents analyst common misconceptions related to health care entity valuations.

Robert also authored an article that appeared in the December 2015 issue of *Transaction Advisors*, a monthly journal available at www.transactionadvisors.com. The title of Robert's article is "Distinguishing Personal Goodwill from Entity Goodwill in the Closely Held Company Acquisition."

An extensive abstract of the article is available at <https://www.transactionadvisors.com/insights/distinguishing-personal-goodwill-entity-goodwill-closely-held-company-acquisition>. Subscribers may access the full text of the article. In an acquisition of a closely held company, it is often important for the business buyers and sellers to allocate the total enterprise value between the closely held company—owned entity goodwill and the individual selling shareholder/employee's personal goodwill. Robert's article summarizes the analyst's considerations with regard to the elements of, the separability of, and the documentation of a selling shareholder/employee's personal goodwill and utilizes several key Tax Court decisions as illustration.

Shawn Fox, a managing director of our firm and the leader of our economic damages analysis practice, participated in a video discussion along with Michael Conway, litigation partner and national business litigation practice leader at Shook Hardy & Bacon L.L.P. The title of this video discussion was "Representations & Warranties Insurance—The Claims Expert's Perspective."

In this video, Shawn and Michael were interviewed by Casey Zgutowicz, vice president at Lockton Companies' Chicago office. Shawn discussed key considerations in calculating economic damages on indemnification claims, accounting disputes for the buyer and seller, and the role of the forensic accountant in merger and acquisition disputes. Michael discussed the legal claims involved in situations of material misrepresentations and fraudulent misrepresentation and navigating through coverage issues under a representation and warranties policy (including definition of loss, materiality, exclusions, scope of exclusions, carve-outs, and interpretation of asset purchase agreement, among others). The video can be viewed at <https://vimeo.com/146699664>

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Communiqué

IN PRINT

Robert Reilly, firm managing director, authored an article that was published in the November/December 2015 issue of *Construction Accounting and Taxation*. The title of Robert's article was "The IRS Challenges Taxpayer Transactions Based on the Economic Substance Doctrine."

Robert Reilly also authored an article that was published in the Q4 2015 issue of *Transaction Advisors*. The title of Robert's article was "Structuring Transition Period Payments in Closely Held Company Acquisitions."

Robert Reilly also authored an article that was published in the National Association of Certified Valuators and Analyst's *QuickRead* electronic newsletter dated December 2, 2015. The title of Robert's article was "Guidance from *Bross Trucking v. Commissioner* (2014)."

Robert Reilly also authored an article that was published in the December 2015 issue of the *ABI Journal*. The title of Robert's article was "The Basics on Goodwill Valuation Approaches and Methods."

Robert Reilly also authored an article that was published in the December 2015/January 2016 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article was "Distinguishing Personal Goodwill from Entity Goodwill in Closely Held Company Valuations."

Robert Reilly also authored an article that was published in the Winter 2016 issue of the *American Journal of Family Law*. The title of Robert's article was "Valuation of Intellectual Property in the Marital Estate: Part I of II."

Robert Reilly also authored an article that was published in the November/December 2015 issue of *Construction Accounting and Taxation*. The title of Robert's article was "The IRS Challenges Taxpayer Transactions Based on the Economic Substance Doctrine."

Robert Reilly's article "Structuring Transition Period Payments in Closely Held Company Acquisitions," which appeared in the September 2015 issue of *Transaction Advisors*, was selected as one of the top 10 articles of 2015 by *Transaction Advisors*.

Robert Reilly and Bob Schweih, firm managing directors, co-authored chapter 5 in the Business

Valuation Resources new book *What It's Worth: Accounting Firm Value*, published in 2015. The title of their chapter was "Document Request Checklist for Valuing an Accounting Practice."

Timothy Meinhart, Chicago office managing director, authored an article that was published in the January 2016 issue of *Trusts & Estates*. The title of Tim's article was "Noteworthy Decisions and Settlements."

Chip Brown, Atlanta office managing director, had his article "Q&A with Tim Hauser of the U.S. Department of Labor" that appeared in the Spring 2015 issue of *Insights* included in a presentation given by John Utz (of Utz & Lattan, LLC) at the 16th Annual Fall ESOP Conference sponsored by the Heart of America Chapter of the ESOP Association on August 25, 2015.

Fady Bebawy, Chicago office vice president, authored an article that was published in the January 2016 issue of *Trusts & Estates*. The title of Fady's article was "The Five Marketability Forces Framework."

IN PERSON

Curtis Kimball, Atlanta office managing director, delivered a presentation on June 25, 2015, to the Shreveport Tax & Estate Planning Council Conference. The topic of Curt's presentation was "Valuation Topics 2015."

Shawn Fox, Chicago office managing director, will deliver a webinar on April 19, 2016, for the Iowa Bar Association. The topic of Shawn's webinar is "Guide to Calculating Damages in Patent Infringement Cases."

IN ENCOMIUM

Charles Wilhoite, Portland, managing director, was recognized as the honoree at the 2015 Urban League of Portland Equal Opportunity Awards Day Dinner on September 29, 2015.

Charles Wilhoite was also appointed to the board of directors of Legacy Health in September 2015. Legacy Health has origins dating back to 1875, and it currently operates as the largest nonprofit, locally owned health system in the Portland-Vancouver area, with 6 hospitals and more than 50 clinics; lab, research, and hospice facilities; over 2,500 affiliated physicians; and over 9,000 employees.

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