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Expert May Use Public Information for Company Valuation

***Superior Offshore International, Inc. v. Schaefer,* 2012 U.S. Dist. LEXIS 174841 (Dec. 11, 2012)**

Before filing for Chapter 11 bankruptcy, the plaintiff provided subsea construction and diving services to the oil and gas industry. The defendants were members of the board of directors prior to its initial public offering (IPO) in April 2007. In connection with the bankruptcy, a special committee representing the plaintiff sued, alleging breaches of the duty of care and duty of loyalty and good faith, as well as self-dealing; for example, the defendants approved a $28 million special dividend to the board's chairman and awarded him the full benefit of an increased IPO that left the company undercapitalized and unable to continue operations. Also, two defendants failed to disclose and pursue more lucrative offers for the *Achiever*, a vessel the company tried to sell.

Both sides retained experts. In its pretrial *Daubert* motion in federal court (S.D. Tex.), the plaintiff sought to exclude the testimony of the defendants' two experts regarding the company's capitalization at the time of the IPO. They used public information, including the prices at which the company's stock traded following the IPO and the views of security analysts who worked for the underwriters that had performed due diligence on the plaintiff one year before the IPO. (The opinion does not indicate the experts' valuations.)

A defendants' expert also critiqued the factors and valuation methodology the plaintiff's expert used in appraising the *Achiever*. While he had valued the vessel at $100 million in a 2007 business appraisal, he increased the amount to $135 million after the plaintiff had retained him.

***Daubert* safeguards are less critical.** Regarding the company's capitalization, the plaintiff claimed the experts used unreliable information; as to the vessel appraisal, it argued the expert lacked experience in appraising marine vessels. The court dispensed with both objections quickly.

Although reliance on publicly available information is not always the preferred methodology, the court said, "it could be an acceptable procedure when the company's stock is trading in an efficient market." This was seemingly the case here because one source of information was the securities analysts who worked for the underwriters and thus had more access to internal information than other analysts.

As to the plaintiff's second objection, the defendants' expert did not testify about vessel appraisal generally, but specifically to address the plaintiff's expert's method and unexplained change in the vessel's value.

In denying the motion, the court noted that the case would be tried to the court, not a jury. In *Daubert,* the Supreme Court's main concern was guarding against jury confusion and exposure to unreliable testimony. Here the court was easily capable of determining whether the experts' testimony was helpful and how much weight to give it.

Court Affirms No Portion of Value Is Attributable to Personal Goodwill

***Burnett v. Burnett,* 2012 Ind. App. Unpub. LEXIS 1477 (Nov. 29, 2012)**

The husband was an anesthesiologist in a large practice with 68 partners. The total number of partners had remained fairly stable, with every partner holding an equal ownership interest. However, under an operating agreement, they received unequal distributions based on a formula (which the opinion does not provide). The 32

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partners who joined since 2001 had paid $100, and those who left received $100 plus a termination benefit.

Actual earnings versus industry standard. At divorce, the wife presented expert testimony from a credentialed business valuator to quantify the husband's business interest, including its intangible value, that is, goodwill. Because Indiana considers only goodwill attributable to the enterprise community property, the expert eliminated the husband's personal goodwill from his calculation, using a variation of the excess earnings method.

He found the following factors indicated goodwill that inhered in the business:

- The practice was an organization with a formalized structure that required every partner to execute a covenant not to compete;
- The entity, not the individual partners, owned contracts with multiple facilities, and its ability to generate revenue did not depend heavily on the personal services that any one partner performed;
- The business's name did not feature individual partners, and its identity remained unchanged despite the arrival or departure of partners;
- The practice alone determined what partner would provide services at what facility; the husband was able to work at a facility regardless of his personal relationship with patients or surgeons; and
- As a partner in the business, the husband did not need to expend time on nonbillable activities, including finding and scheduling work and billing and collecting for it.

To determine personal goodwill, the expert reviewed industry data from a trade group about the number of billable units that anesthesiologists record annually and the compensation that corresponds with a specific production level. The husband's billable units for 2009 indicated he was slightly below the 90th percentile in terms of productivity. At the same time, his earnings exceeded those of anesthesiologists at the 90th percentile. The expert used the difference between his actual earnings and the industry standards to capitalize the excess earnings.

As to the calculated value of the husband's interest, the expert said it applied under different assumptions, including the sale of the practice, the sale of the husband's interest, and the husband's remaining a partner or leaving the business. He concluded that the investment value was $337,000 and the fair market value was $253,000.

The trial found the expert's methodology properly eliminated personal from enterprise goodwill. The noncompete agreements and the practice's long-standing exclusive contracts with multiple facilities suggested it would continue to have value even if the husband withdrew. "This," the court said, "is indicative of enterprise goodwill." Ultimately, it adopted the appraiser's lower value and found the business interest was worth $253,000.

The husband challenged the valuation in the state Court of Appeals, claiming the trial court failed to separate personal from enterprise goodwill.

No there there. The law is well settled and requires that "goodwill that is based on the personal attributes of the individual is excluded from the marital estate," the appellate court said, citing *Yoon v. Yoon,* 711 N.E.2d 1265 (1999). The value that exists in the patient base and would be transferrable to a buyer who does not bring the same attributes to the business as the individual physician is enterprise value, the court continued.

The evidence supported the trial court's valuation based on the expert's calculation. Moreover, the court stated, the lower court's "extensive findings of fact and conclusions of law" made it easy to discern what portion of the expert's aggregate value was attributable to the husband's personal goodwill: "none."

Expert's damages in cookie case ≈ crumbles

In a new *Daubert* decision, Judge Richard Posner of the U.S. Court of Appeals for the 7th Circuit continues on his judicial quest for tightening the gatekeeping role in patent cases. Although the plaintiff's expert was "highly qualified" and competent to estimate damages in the case—which involved a patented formula for creating cookies free of trans fats—she made several critical errors in her opinions and calculations.

First, after speaking with the plaintiff's scientific expert, she concluded there was no acceptable, noninfringing substitute for the patented formula, a factor that substantially boosted her royalty rate.

Her reliance was allowable, the judge ruled, but her inquiry failed to establish whether cookies made with a substitute would actually sell. For that information, she could have talked (but didn't) to the plaintiff's industrial baking expert as well as its marketing and consumer experts. "I don't understand why" she didn't talk to these experts, Posner said, and struck her conclusion that there was no noninfringing alternative that would have cost the defendant something less than a "hefty royalty" to implement.

Even if there was no "perfect" substitute for the patented formula, any royalty for infringement "would depend on the cost, in higher production costs and loss of business to competitors, of the best imperfect substitute," the judge observed, "and [the plaintiff's expert] offered no evidence about either cost." Instead, she relied on three comparable licenses to project the maximum amount of profits the defendant put at risk by failing to secure a license. However, one of the agreements involved a lump-sum payment and a licensee "wholly dissimilar" to the defendant; another concerned a complex litigation settlement that the expert failed, in any way, to analyze. Only the third license might "possibly" support a reasonable royalty, the judge held, limiting the expert's testimony to this basis but dismissing her market share calculations as unreliable.

Test Case Considers Proper Framework for RAND Royalty Rates

***Microsoft Corp. v. Motorola, Inc.*, 2012 LEXIS 152244 (Oct. 22, 2012)**

Global organizations such as the International Telecommunications Union (ITU) and the Institute of Electrical and Electronics Engineers (IEEE) set common technological standards so that the world's various electronic products will all work together. Compliance often requires members to use another's patented technology. To protect against possible abuses of market power, the international rules require owners of such **"essential»** patents to license them at "reasonable and non-discriminatory," or RAND, rates.

In this case, both Microsoft and Motorola are members of the ITU and IEEE. Motorola owns two "essential" patents that fell within the standards, which it offered to license to Microsoft on a worldwide, nonexclusive basis beginning at a 2.25% royalty per compliant product (for products such as its Xbox 360). Microsoft declined the offer and filed a complaint in federal district court (W.D. Wash.), alleging breach of contract. Microsoft also asked the court for a judicial accounting of a RAND royalty rate for each of the two patents in suit.

Motorola retained a damages expert to calculate a RAND royalty as well as a consumer survey expert to examine the usage and value of certain patented features in Microsoft's Xbox 360. On the other side, Microsoft retained a team of three experts to conduct a RAND rate analysis. Prior to trial, each party challenged the other's experts under the *Daubert* standard.

In particular, Motorola's expert used a modified *Georgia-Pacific* framework to determine the RAND royalty the parties would have reached in a hypothetical negotiation. He began with the 2.25% rate in Motorola's offer and then adjusted it up or down according to his analysis of the *Georgia-Pacific* factors. To confirm the initial starting rate, he also reviewed existing licenses involving Motorola's entire portfolio of standard essential patents—including the two at issue—as well as Motorola grants involving just one of the patents. He also consulted Motorola's technical experts to affirm how the patented technology fit into the applicable standards, i.e., its role as being essential to compliance. (Note: The court opinion does not reveal the expert's ultimate RAND rate.)

Microsoft didn't challenge the expert's use of the *Georgia-Pacific* framework. Instead, it claimed the licenses Motorola's expert relied on were not comparable because they broadly covered all of Motorola's standard essential patents, including those for cellular telephone technology and that the expert improperly focused on the "hold up" value of the patents at issue. That is, rather than assess the original or stand-alone value of the patented technology, he only valued the patented technology once it became "essential" under the governing standards. Finally, Microsoft argued that he improperly used the entire value of its accused products to reach his royalty rate, in contravention of *Uniloc USA Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011).

Microsoft's criticisms went to the weight of the evidence, the court ruled, noting that Xbox owners were "arguably more likely" to understand the technical terms of the survey and that the expert did in fact include a margin of error for his conclusions. Accordingly, it permitted the survey expert to testify at the RAND hearing.

As a final matter, the court considered Motorola's challenge to Microsoft's three damages experts, who believed the proper framework for determining a RAND royalty rate is an "*ex ante*, multilateral negotiation" involving full participation of essential-patent holders as well as all potential implementers.

Given the lack of publication or peer review for Microsoft's proposed multilateral methodology, "the typical manner for establishing" its reliability under the *Daubert* standard is "not met in this case," the court said.

Nevertheless, this did not immediately disqualify the experts' testimony under the *Daubert* standard, which is flexible enough to accommodate new technical or scientific methods, the court noted. Under these circumstances, federal law simply requires the experts to explain "precisely how they went about reaching their conclusions and point to some objective source—a learned treatise, the policy statement of a professional association, ≈ or the like—to show they have followed the scientific evidence method, as it is practiced by (at least) a recognized minority of scientists in their field."

Here, the experts' analysis for reconstructing a hypothetical negotiation sought to respond to two "well-founded" and "widely recognized" concerns of hold-up value and stacking, the court said. Under the circumstances of this case and given the flexibility of the *Daubert* standard, it permitted Microsoft's experts to present their "multilateral" framework at the RAND rate hearing.

Editor's Note: In mid-November 2012, the court held the RAND hearing and took the issue of determining an ongoing royalty rate under advisement. According to news reports, the Seattle-based judge asked the parties to file further briefs by Dec. 14, 2012, and may render a final decision by early spring. See, e.g., www.pcworld.com/article/2015542/microsoftmotorola-trial-ends-first-phase-with-judge-to-set-fair-royalty-rate.html.

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