BCC Advisers Litigation & Valuation Report

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The virtual reality of today's legal meetings

During the pandemic, virtual meetings have been used widely for various legal purposes, including court hearings, depositions, settlement talks and M&A negotiations. This trend is expected to continue even after the pandemic ends. Here are some potential pitfalls and ways to avoid them when conducting virtual meetings or testifying remotely.

Working smarter

An important lesson learned in 2020 is that a physical presence may not necessarily be required in various legal situations. Working remotely has generally reduced travel costs and professional fees, while improving efficiency.

Instead of paying for plane tickets and lodging and transferring boxes of documents, financial experts may appear on a computer screen and look through documents with file-sharing tools. But transitioning from in-person to remote work arrangements may require experts to hone new technology and communication skills.

Avoiding pitfalls

The transition to virtual interactions hasn't been seamless for legal professionals. Unexpected disruptions during virtual business meetings — such as rustling papers, crosstalk and faltering Internet connections — are common. However, people tend to be more forgiving in informal settings. Trials and depositions are more formal. There's only one chance to make a good impression during a hearing, and distractions can quickly discredit an expert witness's professionalism and credibility.

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To avoid potential pitfalls, consider conducting test runs and using remote technology and collaboration tools during the *pretrial* phase to work out any kinks before the hearing begins. A general rule of thumb when using technology is: Expect the unexpected. Anticipate possible glitches and develop a backup plan. For example, you and your expert should have a secondary source of Internet service (like a hot spot on a cell phone), a backup battery (in case of power outages), and alternate hardware devices (such as laptops, tablets, smart phones, microphones and cameras) that can be powered up in a pinch.

Planning considerations

One way to retain the intangible aspects of in-person meetings and expert testimony is to use up-to-date videoconferencing technology, instead of telephone or audioconferences. High-definition videoconferencing equipment can, for example, detect slight physical changes, such as smirks, eyerolls, wrinkled brows and even beads of sweat. These nonverbal cues may be critical to assessing an expert's honesty and reliability, especially during cross examination.

Pandemic reminder: Recycled valuation reports can be perilous

Valuations generally deliver a conclusion of value for a *specific* purpose as of a *specific* date. So, unless you need to value an asset as of the same date and for the same purpose, reusing a previous valuation can lead to inaccurate results, not to mention admissibility problems in court.

This issue has been highlighted during the COVID-19 pandemic. The values of many businesses changed dramatically in 2020, causing previous valuation reports to become outdated and irrelevant.

For example, a New York City restaurant was valued at $500,000 as of June 30, 2019, for gift tax purposes. If the owner had used this value to settle her divorce a year later, it's likely that the value of the business would have been overstated. Why? Market conditions had changed significantly from the 2019 valuation date. Specifically, the restaurant had incurred substantial debt during the pandemic. And its executive chef (a key person) relocated to Florida to take advantage of more-favorable market conditions.

Also be aware that the *purpose* of a valuation has a significant impact on value. For example, the value of a minority interest in a business for gift tax purposes is usually based on fair market value, often with discounts for lack of control and marketability. But the value of the same interest in a divorce is usually based on fair value, which is statutorily defined.

In light of these differences, reuse of a valuation report prepared for one purpose to value the same (or similar) business interest for another purpose isn't recommended. An updated report can shed new light on the situation and improve the desired outcome.

When preparing for a video presentation, encourage experts to maintain "eye contact" with the camera, rather than reading entirely from his or her notes. This means looking directly into the camera (not the computer screen) which can take some getting used to.

It's also important to evaluate the background that will appear behind the expert as he or she testifies. The background should look professional, even if the expert works from a home office. Be sure it's free from distractions, such as family pets, doorbells, clutter and personal items. Heavy backlighting and windows can become distracting, too.

In addition, the move to virtual testimony underscores the importance of having a comprehensive written report that explains how the expert arrived at his or her conclusions. A written report can supplement the expert's verbal testimony and provide the trier of fact with a resource to refer to during deliberations, which, in larger cases, may occur days or weeks after the expert testifies.

Changing times

Going virtual offers many benefits that are expected to outlast the pandemic, such as lower costs and improved efficiency. Over the last year, attorneys and experts have been forced to learn how to use virtual tools and overcome potential downsides. Now that the legal community has transitioned from legacy operating practices to technology-driven practices, there may be no turning back. When choosing an expert witness, it's critical to consider his or her comfort level with the latest virtual meeting tools.

Focus on infringement

Federal court provides guidance on reasonable royalty evidence

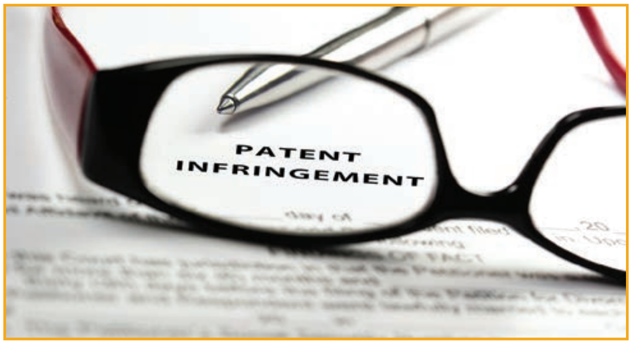
In *Meridian Manufacturing, Inc. v. C&B Manufacturing, Inc.*, the U.S. District Court for the Northern District of Iowa ruled on various pretrial motions, including *Daubert* motions to exclude expert testimony on reasonable royalty damages. The court determined that certain evidence should be excluded, while other evidence should be admitted. The ruling provides valuable guidance on the standards that damages experts are expected to meet in patent infringement cases.

Hypothetical negotiation

In patent infringement cases, plaintiffs are generally entitled to recover damages based on lost profits but never less than "reasonable royalties." A common methodology for determining a reasonable royalty is to estimate the royalty rate that would have been agreed to in a hypothetical negotiation taking place just before the infringement began.

Under this method, experts generally consider 15 factors listed in the landmark *Georgia-Pacific* case. These factors are:

1. Existence of an established royalty,
2. Rate paid by the licensee for comparable patents,
3. Nature and scope of the license,
4. Licensing policy,



5. Business relationship of licensor and licensee,
6. Effect of selling the product to promote other products of a licensee,
7. Duration of the patent and term of the license,
8. Established profitability, commercial success and current popularity,
9. The utility and advantages of the product over older ones,
10. Nature of the patented invention and benefits to those who used it,
11. The extent the licensee used the product and the value of that use,
12. The customary industry portion of the profit or selling price,
13. How much profit should be credited to the invention,
14. Hypothetical license negotiation when the infringement began, and
15. Testimony of qualified experts.

Agricultural patent

In *Meridian*, the patent at issue was for an agricultural trailer designed to help farmers transport large seed bags or boxes to planters in the fields. The court ruled that the defendant's trailer infringed specific claims in the plaintiff's patent, generally dealing with guide plates used to facilitate the positioning of seed boxes. The defendant redesigned its trailer, but the parties still disagreed about whether the new design resolved the infringement issue.

The defendant's expert explained that, because the patentable feature (the guide plates) was one of many features, apportionment of damages between the guide plates and other features was appropriate. However, no information was available to base an apportionment analysis on.

Reasonable royalty analysis

Instead, the defendant's expert proposed a reasonable royalty of no more than the defendant's cost to develop and implement an alternative, non-infringing design. This analysis implied a lump sum royalty of $15,000 to $30,000.

The plaintiff argued that it was improper to "cap" reasonable royalty rates at the cost of implementing the cheapest available non-infringing alternative. But, under the facts and circumstances of the case, the court opined that it was reasonable to assume that the licensee in a hypothetical negotiation wouldn't have paid a royalty greater than the cost of the defendant's redesign.

The plaintiff's expert estimated reasonable royalties based on rates ranging from 3% to 10% of sales. He assessed damages based on a combination of reasonable royalties and lost profits ranging from $3.7 million to $5.7 million. This analysis relied on several *Georgia-Pacific* factors, particularly the second factor (the rate paid by the licensee for comparable patents).

The court found the expert's testimony on reasonable royalty damages inadmissible, because he failed to show how the technologies in the licenses he relied on were comparable to the technology at issue. Additionally, he cited certain other *Georgia-Pacific* factors, but he failed to explain how those factors would influence the parties in a hypothetical royalty rate negotiation.

Detailed analyses are critical

In *Meridian*, the court's discussion of reasonable royalty damages illustrates how it's critical for experts to fully explain their methodologies. A court concluded that "superficial recitation of the *Georgia-Pacific* factors, followed by conclusory remarks" isn't enough. ■

White v. White

Is appreciation separate or marital property?

When dividing property in a divorce case, courts in most states distinguish between *separate* and *marital* property. Generally, separate property isn't subject to division, while marital property is. Separate property may include property a spouse brings into the marriage (that is, property he or she owned before getting married), as well as property received by a spouse during marriage by gift or inheritance, or through an award from a lawsuit.

The distinction between separate and marital property is less clear when the value of an asset that's classified as *separate* property increases during the marriage. That appreciation may be considered *marital* property in certain situations, which can have a significant impact on the division of property in divorce.

Active vs. passive appreciation

When classifying appreciation on separate property for divorce purposes, many states distinguish between active and passive appreciation. *Active* appreciation — appreciation because of the efforts of one or both spouses — is generally treated as *marital* property subject to division.

Passive appreciation — attributable to external factors such as inflation, market forces, regulatory changes and the efforts of others — is usually classified as *separate* property.

This distinction can be complex in practice, however. Some assets generate only passive appreciation, such as a certificate of deposit owned before marriage that earns a fixed rate of interest. But certain assets can generate a combination of active *and* passive appreciation.

Case in point

In *White*, the spouses disagreed about how to classify the appreciation of an investment account. The husband, a financial advisor, had opened the account with his separate property, a $100,000 inheritance. He allocated the investments using modern portfolio theory — the same approach he used for his clients — and reinvested the earnings each year. Five years later, when the couple divorced, the account was worth well over $300,000. The husband asserted that the increase in value was passive appreciation and was, therefore, *separate* property.

But the Nebraska Supreme Court rejected this argument, because he failed to prove that some or all of the appreciation wasn't attributable to his or his wife's efforts. The court listed several examples of evidence that could have established the growth in value was attributable, at least in part, to passive factors, including:

- Evidence of some benchmark of general market growth,
- Evidence that some or all of the annual rate of return was guaranteed or statutorily prescribed, and
- Evidence that he relied on recommendations from or management by a third party.

In contrast, the evidence showed that his efforts in employing modern portfolio theory — evidence of *active* appreciation — contributed to the account's impressive returns. Therefore, the court found that the appreciation was *marital* property that should be included in the marital estate and subject to division.

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Note that state laws and legal precedent vary significantly from jurisdiction to jurisdiction; so, it's important to consider state statutes and case law in the proper jurisdiction. However, family court judges may sometimes look to other states for guidance on how to value marital assets, especially when there's not much relevant precedent in a case's venue.

Experts add value

It's common for investment portfolios and private business interests that start out as separate property to have elements of both active and passive appreciation. A business valuation professional can help the parties allocate appreciation between the two categories based on the facts of the case. ■

3 methods to estimate value for buy-sell purposes

The COVID-19 pandemic has had a significant impact on business values. Some companies have increased in value, while many others have lost value. During these volatile conditions, it's wise for business owners to review the valuation provisions in their buy-sell agreements to ensure that they reflect current conditions and will produce a fair price for departing owners.

When an event triggers a buyout, buy-sell agreements usually call for one of the following three valuation techniques:

1. Prescribed formulas. Some agreements call for a simplified formula, such as a multiple of earnings or revenue, to set the buyout price for a departing owner's interest. However, these prescribed formulas are unlikely to produce an accurate value, especially with the passage of time.

For example, suppose the value of ABC Co. increased significantly during the pandemic. ABC's buy-sell agreement includes a valuation formula of four times annual earnings from the end of the most recent fiscal year. If an owner left ABC in June 2020 and the buyout price was based on earnings as of December 31, 2019 — before the pandemic affected the company's performance — the formula would likely understate the market value of the departing owner's shares.

2. Negotiated prices. Requiring the parties to negotiate a buyout price when an owner departs allows the parties to factor in recent events. But forcing the owners to agree on a fair price in a potentially high-stress, adversarial environment invites litigation if the parties are unable to reach an agreement. A potential way to lower this risk is to provide for an independent appraisal if the parties can't agree on a price within a specified period.

3. Independent appraisals. Obtaining outside appraisals may seem time-consuming and costly, but it's often a smart use of resources. Business valuation professionals provide objective, market-based evidence of the company's current market value, which can help diffuse stress and reduce potential conflicts.

Some agreements call for each side to hire a separate valuator. Then, if the opinions differ significantly, the parties might average the results or hire a third expert to bridge the gap.

Valuation professionals also can be useful *before* a triggering event happens. When drafting or reviewing a buy-sell agreement, a valuator can help select the appropriate valuation method and evaluate whether the agreement covers all the value-related bases. This input can be particularly valuable because certain technical issues may fall outside the comfort zone of many attorneys and business owners. Examples include the appropriate standard of value (fair market value, fair value or strategic value), level of value (controlling; marketable, minority; or nonmarketable, minority) and preferred expert qualifications.

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