

Using Expert Witnesses in Business & IP Valuation Cases:

The Expert's Viewpoint

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Part 1: Maximizing the Benefit of an Expert

Types of Experts

Industry

Corporate Finance and M&A

Restructuring/Bankruptcy

Securities and Other Markets

Intellectual Property

Valuation

Damages

Corporate Governance

Due Diligence

Antitrust

IP: Combining Special Knowledge and Damages Experts

Valuation and Process-Related Expertise

- Many litigations requiring valuation expertise also require process-related expertise. Examples include:
 - Company sale process
 - Financing process
 - Definitive agreement negotiation
 - Due diligence
 - Projection creation, and
 - Corporate governance
- Consider whether same expert can address both valuation and process-related issues

When Might You Not Want An Expert

- The facts and issues in my case are easily comprehensible
- A lay witness could be used to explain the facts and issues in a comprehensible manner
- If the trier-of-fact in my case is a judge, is the judge well-versed in the sophisticated concepts that are the subject of my case?
- Do I need an expert witness to offer opinions and conclusions that may not easily be reached by the trier(s)-of-fact?
- Do I need an expert to help me (a) better understand the strengths and weaknesses of my case and (b) present the best case?

Expert's Role Defined by Rule 702

- Codifies *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993)
- Rule 702
 - the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
 - the testimony is based on sufficient facts or data;
 - the testimony is the product of reliable principles and methods; and
 - the expert has reliably applied the principles and methods to the facts of the case.
- Expert testimony is inadmissible for subjects within lay knowledge
- Expert's qualifications based on knowledge, skill, experience, training and/or education

Selecting the Right Expert

- Expertise, Experience and Credentials. Key Considerations:
 - CV
 - Interview
 - Enthusiasm
 - Speaking Skills
 - Written Skills
 - Publications
 - Bias
 - Ethics and Reputation
 - Credibility
 - Reliability
 - Prior Challenges
 - Conflict Checks
 - Reference Checks
 - Supporting Team
- Prior experience as an expert can be helpful but be sensitive to problem of “hired gun”
- Evaluation “real world” v. academic experience
- Level of engagement
- Industry familiarity can provide a big edge for valuation expert
- Ability to be a devil’s advocate is valuable trait in an expert
- Advantages of individual v. firm of experts

Role of Deal Investment Banker

- General rule of thumb that one should not use the banker on deal as expert in deal litigation
 - Discoverability
 - Bias issues
 - Changing role over life of a transaction (negotiator to opinion provider)
 - Errors made in haste can be corrected by expert
 - Fairness opinions may address a different question than required in litigation
- Bankruptcy courts may be more open to hearing expert testimony from persons who help manage the company
- Contemporaneous investment banking analysis often helpful as valuation “fact” witness – fact that expert advised company in transaction affects weight given to testimony

Maximizing the Benefits of Your Expert - Discovery

- Experts should be brought in early but important to maintain privilege
 - Consulting experts can pursue areas of inquiry for the legal team separate and apart from the work of the testifying expert
 - Be aware of the new federal rules (Rule 26) v. state rules and which apply
 - Make sure expert, counsel, and client understand at outset whether communications and draft reports will be discoverable
 - Communications with management may be helpful but they are discoverable and the information may appear to be after-the-fact – the existing record may be more credible
 - Different rules apply for non-testifying experts, but need to keep the roles separate
- Experts can
 - Evaluate themes, theses, strategies and the overall merits of the case and test for damages
 - Educate the legal team on the technical issues of the case
 - Strengthen the discovery process (strengths/weaknesses in facts, material holes in information/research, drafting of discovery requests and deposition questions)
 - Determine the best negotiating position for settlement discussions

Maximizing the Benefits of Your Expert – Report

- Guidelines for report writing
 - Organization
 - Address the audience
 - Summarization
 - Exercise rigor
 - KISS (“Keep it simple, stupid”)
- Report content
 - Include key facts/chronology to aid in deposition – deposition not a memory test
 - Provide investment banking, industry, and academic support for all key methodologies employed or include compiled databases to support opinions that may not be addressed in published works

Depositions of Experts: Items to Consider/Explore

- Always urge the expert to start and continue preparing for deposition and trial as early as possible
- Think about trial cross-examination
- Use your expert to assist in question preparation
- Think about expert's prior consistent/inconsistent analyses/opinions
- Explore everything the expert did/did not do in connection with the analysis – were all facts considered, were all relevant analyses performed
- Explore industry, investment banking and academic sources that contradict the methodology employed and/or findings
- Explore calculation errors
- Explore bias
- Explore rejection of prior testimony
- Confirm that all opinions set forth in report
- Was analysis independent? Explore communications and relationships with lawyer and client
- Reveal and test assumptions

Maximizing the Benefits of Your Expert – Testimony

- Advice for experts on testimony
 - Listen
 - Do not advocate, explicate
 - Consistency in demeanor and style is critical
 - Only give the opinions that you honestly hold
 - Be prepared for anything
 - Take your time
 - Ask clarifying questions
 - Use your report
 - Read every exhibit you are handed
 - Keep your answers short

Maximizing the Benefits of Your Expert – Trial

- Guidelines for trial preparation
 1. Use demonstratives and visual aids
 2. Even the best experts need leadership and training
 3. Budget adequately for trial preparation and trial
 4. Schedule trial and travel plans well in advance

Cross-Examination of Opposing Expert

- Limit to high points
- Show that not familiar with industry
- Use concessions from deposition
- Show bias
- Show not familiar with how court has applied relevant valuation principles
- Show not familiar with record and facts pertinent to analysis
- Show assumptions were not reasonable

Part 2: Understanding the Expert's Damages and Valuation Work

Damages Awards

Damages Awards can be imposed on a defendant with:

1. Cause or causation—What is the theory of damages?
 - Benefit of the bargain
 - Reliance
 - Unjust enrichment
 - Valuation – overpayment/underpayment
2. Proof that damages occurred
3. Amount of damages

Evaluation of Damages

- Damages Analysis and Damages Calculations
 - Damages Analysis = Causation
 - Damages Calculations = Valuation/Computation
 - Mitigation
- Basic Conceptual Approaches to Damages
 - **“Before and after” method** – value before v. value after, financial results/prices before or after to results/pricing during damage period
 - **“But for”/projection model method** – projects income “but for” the damaging event v. actual income
 - **“Comparable/Yardstick” method** – projects damages based on comparables unaffected by the damaging acts
 - **“Market share” method** – antitrust method recognized by some courts to calculate lost profits
 - **“Opportunity cost” method** – IP method equal to the sum of cost of development, historical opportunity cost and projected opportunity cost

Overview of Intellectual Property Damage Remedies

Comparison of IP Damages				
<u>Patent</u>	<u>Trademark</u>	<u>Copyright</u>	<u>Trade Secret</u>	<u>Right of Publicity*</u>
Lost Profits	Lost Profits	Lost Profits	Lost Profits	Lost Profits
N/A	Unjust Enrichment	Unjust Enrichment	Unjust Enrichment	Unjust Enrichment
Royalty	Royalty	Royalty	Royalty	Royalty
Head Start	Corrective Advertising	N/A	Head Start	Corrective Advertising

*ROP is granted under state law and is recognized to varying degrees in 38 states, with varying regulations on damages.

Valuation – Business Litigation

- M&A Litigation
 - Valuation in a fairness opinion context
 - In stock for stock deal, probably have to value consideration received
- Appraisal
 - Fair value under Delaware’s appraisal statute provides shareholders with the right to their proportional share of the going concern excluding potential merger synergies
 - Statutory litigation related to fair value – public and private deals
- Fiduciary litigation
 - Relevance of “fair price”
 - Damages – change in value of business due to breach of fiduciary duties or statutory wrong
- Securities and financing-related valuations

Valuation - Bankruptcy

- Preference and fraudulent transfer claims
 - Solvency and reasonably equivalent value analyses
- 363 Sale v. Reorganization
- Plan feasibility – value of company in Chapter 11 plan and financing structure
- Adequate protection for DIP financing
- Liquidation analysis

Standard Valuation Methodologies

Methodology	Advantages	Limitations
Comparable Companies Analysis (Market Approach)	<ul style="list-style-type: none"> ➤ Reflects current, market-based valuation information 	<ul style="list-style-type: none"> ➤ Financial information available for the companies is generally limited to historical data and 1-2 years Revenues and EBITDA forecasts – no long-term projections ➤ Current market multiples may be market driven and may not be representative of long-term growth prospects ➤ Does not take into account control premium ➤ Comparability of the data (e.g., accounting, lease v. own) ➤ Analysis of comparability required to place the subject company within the range of multiples
Comparable Companies Analysis with Control Premium (Market Approach)	<ul style="list-style-type: none"> ➤ Reflects current, market-based valuation information ➤ Takes into account control premium 	<ul style="list-style-type: none"> ➤ Same as above, excluding not considering a control premium
Precedent Transactions Analysis (Market Approach)	<ul style="list-style-type: none"> ➤ Reflects direct evidence of value in an acquisition context – including any ‘control premium’ 	<ul style="list-style-type: none"> ➤ Similar constraints as publicly traded companies analysis ➤ Precedent multiples depend on market conditions at the time of the transaction
Discounted Cash Flow Analysis (Income Approach)	<ul style="list-style-type: none"> ➤ Reflects expected future cash flow of the business – directly related to the business being valued 	<ul style="list-style-type: none"> ➤ Financial information is necessarily based on the judgment of management preparing projections ➤ Does not include any “synergies” available to an acquirer

Valuation Analysis – Discount Cash Flow Analysis

- Discounted cash flow analysis (the income approach) is favored by many Courts, especially Delaware Chancery
- However, the assumptions underlying a DCF result are subject to debate and potential manipulation
 - Projections – reliability and timing/context of their creation
 - Terminal value – substantial percentage of the value of most DCF analysis under a going-concern assumption
 - Discount rate – capital structure, equity beta, market premium and size premium
- Many Delaware opinions have supported terminal value perpetual growth rates well in excess of the growth rate of the economy.

Primary IP Valuation Methodologies

- In addition to the market approach and income approach, IP valuations use two other primary methodologies:
 - Cost Approach
 - Relief from Royalty Approach
- Many alternative valuation methodologies exist. See Anson, Weston, *IP Valuation and Management*, Chicago, ABA, 2010.
- Whether using historical or future costs, the basic underlying principle is that of Substitution

IP Valuation – Relief From Royalty Method

- This method is a combination of the income approach and the market approach, where comps can be found
- The present value of the future or past royalty streams is the measure of damages
- Far too many royalty rate valuations are based on theoretical “marketplace royalty rates” that have no relationship to the marketplace
- Royalty rate rules of thumb
 - 25 Percent Rule
 - 5 Percent of Sale Rule
 - Variable Profit Split Rule
- Establishing royalty rates
 - Operating analysis
 - Industry averages
 - Comparable transactions
 - Hypothetical negotiations

Discussion