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Litigation & Valuation

REPORT

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Emerging from bankruptcy

Valuation is critical to a successful fresh start

Because of today's precarious economy, many companies have filed or are planning to file for reorganization under Chapter 11 of the Bankruptcy Code. Once a company emerges from bankruptcy, obtaining an accurate estimate of its reorganization value as well as the fair value of its assets will help ensure its survival. Therefore, garnering the assistance of valuation and other financial experts throughout the process is essential.

Context is everything

A company's reorganization value lays the foundation for development and confirmation of the reorganization plan. Reorganization value is based on fair value — essentially, the price a willing buyer would pay for the emerging entity — but it's important to understand the context surrounding the valuation process.

Although traditional valuation principles and approaches apply, reorganization value is driven by negotiations between the debtor and its creditors, whose primary concern is how much they'll be paid. That, of course, will depend on the company's cash-flow potential and risk profile. Realistic, well-documented valuations and earnings projections can go a long way toward convincing creditors that a company's reorganization plan is feasible.

Making a fresh start

Reorganization value also affects a company's ability to use "fresh start accounting," which is one of the most important potential benefits of reorganization. It enables the business to emerge from bankruptcy with no beginning retained earnings or deficit. The company also resets the values of all its assets and liabilities to fair value.



Combined with other bankruptcy benefits — such as the opportunity for a business to rid itself of undesirable leases and other unfavorable financial obligations, as well as to reduce interest expense — fresh start accounting can provide the new entity with a welcome competitive advantage.

Because not all companies qualify for fresh start accounting, obtaining a postbankruptcy valuation is critical. Companies

emerging from Chapter 11 proceedings are subject to Accounting Standards Codification (ASC) Topic 852 — *Reorganizations*. Under ASC 852, a company is entitled to adopt fresh start accounting if:

- ◆ The reorganization value of the emerging entity's assets immediately before confirmation is less than the total of all postpetition liabilities and allowed claims, and
- ◆ Holders of existing voting shares immediately before confirmation receive less than 50% of the emerging entity's voting shares.

The standard emphasizes that this loss of control by the company's shareholders must be substantive, not temporary.

According to ASC 852, reorganization value approximates not only the entity's fair value before considering liabilities, but also the amount a willing buyer would pay for the entity's assets immediately after the restructuring.

Requirements are complex

Valuation in a bankruptcy context requires the valuator to consider several complex, interrelated accounting standards. For accounting purposes, an entity emerging from Chapter 11 is treated like a newly acquired company. As a result, it needs to follow ASC 805 — formerly Statement of Financial Accounting Standards (SFAS) No. 141(R) — which outlines the applicable accounting standards for business combinations.

To comply with ASC 805, a valuator must determine the fair value of the company's identifiable tangible and intangible assets and allocate the business's reorganization value among them. Any portion of that value that exceeds the allocated amount must be reported as goodwill.

Complicating matters further, if a company has multiple reporting units, the reorganization value must be allocated among those units. This requires the valuator to analyze financial projections contained in the reorganization plan, examine each reporting unit's

discounted cash flow, allocate income and expense items among the units, and identify intellectual property and other intangible assets used by each unit.

Determining the fair value of assets also involves compliance with ASC 820 (formerly SFAS 157), which requires the valuator to determine each asset's "exit price." This is the price that would be agreed on by "market participants." Estimating an asset's fair value is particularly challenging in the current environment because a number of markets are inactive and the value of many assets is depressed.

Although traditional valuation principles and approaches apply, reorganization value is driven by negotiations between the debtor and its creditors, whose primary concern is how much they'll be paid.

Finally, companies emerging from bankruptcy shouldn't overlook the tax implications of fresh start accounting. For example, resetting the values of assets and liabilities to fair value typically causes financial and tax reporting to diverge. The emerging company must record a deferred tax liability (or, in some cases, a deferred tax asset) to reflect differences between an asset's value for financial reporting purposes and its tax basis. It's important to consider the impact of this and other postbankruptcy taxation issues on the business's reorganization plan.

Tap into an expert's expertise

Valuation is critical to achieving the best outcome for a company emerging from a Chapter 11 reorganization. In addition to understanding generally accepted valuation principles, valuation experts involved in bankruptcy proceedings should also be proficient in other disciplines, including accounting, finance and tax. ◆

Looking ahead *and* behind to determine lost earnings

When an employee is let go against his or her will, he or she may turn to litigation, seeking damages for lost earnings. Such damages also may be sought by a plaintiff who has suffered an injury that affects his or her ability to work.

Regardless of the reason for the lawsuit, when placing a value on lost earnings, the valuator looks not only behind, at the plaintiff's past earnings, but also ahead, estimating the plaintiff's future earnings.

Looking into the future

Calculating lost past earnings — or earnings the plaintiff would have received from the time of the incident until trial — is relatively simple. Estimating *future* earnings, however, can be complex. Why?

Unless the plaintiff is unable to work at all, the expert must make two calculations: 1) the earnings the plaintiff would have enjoyed but for the defendant's wrongful act, and 2) the plaintiff's actual expected earnings. The plaintiff's damages are generally equal to the present value of the difference between those two numbers.

Past earnings trends can be a good predictor of future earnings, but they may need to be adjusted.

Getting the whole picture

The first step in establishing *future* earnings is to analyze the plaintiff's *past* earnings (salary, benefits, bonuses, commissions) to establish a level of base earnings from which to extrapolate. If the plaintiff has worked for the same employer



for several years with a consistent pattern of annual increases, determining his or her base earnings is relatively straightforward. If the earnings history is erratic, however, the expert takes into account the reasons — such as health problems or lifestyle choices — in arriving at base earnings.

It also may be necessary to adjust base earnings for unusual or nonrecurring payments, such as a signing bonus, or for gaps in work time, such as leaves of absence. The expert further considers variable compensation, such as commissions, performance bonuses and overtime.

Of course, past earnings trends can be a good predictor of future earnings, but they may need to be adjusted. For example, an individual plaintiff may recover lost earnings well beyond what his or her earnings history might suggest if the plaintiff's education, skills and experience suggest a higher level of future earnings.

In analyzing historical earnings trends and projecting future earnings, an expert considers the impact of seasonal variations and economic trends that may distort past earnings patterns. The expert also analyzes the plaintiff's promotion history and evaluates the likelihood that promotions will continue at the same rate in the future.

If the case involves employment discrimination, the plaintiff's earnings history may not be a reliable indicator of his or her earnings potential. Under those circumstances, the valuator may need to rely on the earnings of other employees in comparable positions.

Understanding the value of benefits

Placing a monetary value on benefits is another challenge. Benefits can range from health insurance and retirement plans to company cars and meals, and they can be a significant component of earnings. The plaintiff may not remember — or even be aware of — all of the benefits he or she receives, so it's important to use the discovery process to make sure all benefits are accounted for.

In some cases, using statistical evidence, such as average employee benefits as a percentage of salary, may be appropriate. But if an employee's benefits are substantial, the valuator may choose to value each benefit separately.

Wrapping it up

The final stage of valuing lost earnings is determining the loss period. The appropriate loss period can have a significant impact on the overall damages award.

Typically, the loss period extends from the date the plaintiff was discharged or otherwise prevented from working until he or she secures comparable employment. If the plaintiff can't work or is no longer able to achieve the previous level of earnings, the loss period may extend over his or her entire work-life expectancy.

Knowing when to call in an expert

In this age of company downsizing, the number of lost earnings damages cases may increase. Determining such damages isn't an easy task, however — it requires the skills and experience of a valuation expert. ♦

Reasonable royalty calculations demand sound expert analysis

Federal courts are cracking down on what they see as sloppy practices in calculating reasonable royalty damages in patent infringement cases. In *ResQNet.Com, Inc. v. Lansa, Inc.* the U.S. Court of Appeals for the Federal Circuit threw out an award of more than \$500,000 and remanded the case for redetermination of damages.

According to the Federal Circuit, the award "relied on speculative and unreliable evidence divorced from proof of economic harm linked to the claimed invention."

Patent infringement

ResQNet involved the plaintiff's patented terminal emulation technology, a system that links PCs with mainframe computers. The defendant marketed a terminal emulator program, called NewLook, which was found to infringe on one of the plaintiff's patents.

The U.S. District Court for the Southern District of New York awarded damages of \$506,305 for past infringement based on a hypothetical royalty of 12.5%, plus prejudgment interest. In arriving at this royalty rate, the plaintiff's damages expert relied on

seven licenses, five of which included various non-patented services (and may or may not have involved the patent at issue) and two of which arose from the settlement of litigation over the infringed patent.

Georgia-Pacific factors

When a patent is infringed, U.S. patent law allows the holder to recover its lost profits, which in no event are to be less than a “reasonable royalty.” Typically, a reasonable royalty is calculated based on the amount that would have been agreed to in a hypothetical negotiation occurring immediately before the infringement began.

In determining this amount, courts generally consider the 15 factors established in the landmark case of *Georgia-Pacific Corp. v. U.S. Plywood Corp.* Pertinent factors in this case included:

- ◆ The nature of the patented invention,
- ◆ The extent of the infringer’s use of the invention,
- ◆ Actual royalties received by the patent holder for licensing the patent,
- ◆ Rates paid by licensees for comparable patents,
- ◆ The established profitability of products that use the patented technology,
- ◆ The patent’s duration, and
- ◆ The lease term.

In *ResQNet*, one of the many ways the plaintiff’s evidence fell short was that the plaintiff’s expert relied exclusively on only one of the *Georgia-Pacific* factors: royalties received for actual licenses of the patent at issue. He dismissed the other factors, with scant explanation, as having “no real impact here.”

Speculative evidence

The specific licenses the expert relied on also proved to be a problem for the plaintiff. Five of the seven licenses furnished both software and services, such as training, maintenance, marketing and upgrades. These licenses involved high royalty rates in the 25% to 40% range. And they didn’t refer to the patent at issue or



show “any other discernible link” to the technology involved in the case.

“The inescapable conclusion,” the Federal Circuit said, “is that [the plaintiff’s expert] used unrelated licenses on marketing and other services — licenses that had a rate nearly eight times greater than the straight license on the claimed technology in some cases — to push the royalty up into double figures.”

The other two licenses were “straight licenses” — that is, they were limited to the technology in question. But they were also unreliable measures of a reasonable royalty. Both licenses arose out of the settlement of patent litigation. One was a lump-sum stock payment that couldn’t be converted into a running royalty rate. The other applied an ongoing rate that averaged substantially less than 12.5%.

Noting that the hypothetical negotiation of a reasonable royalty occurs *before* infringement, the Federal Circuit explained that license terms arising in a litigation context are not reasonable indicators of an “established royalty” because they may be strongly influenced by a desire to settle the matter and avoid further litigation.

The Federal Circuit also found that the district court’s award was unduly influenced by the defendant’s decision not to offer expert testimony to rebut the plaintiff’s damages calculations. The plaintiff had the burden of proof, the Federal Circuit explained, and the defendant had no obligation to rebut until the plaintiff “met its burden with reliable and sufficient evidence,” which the plaintiff failed to do in this case.

Important guidance

ResQNet provides valuable guidance for lawyers involved in patent litigation, and shows the importance of considering *all* of the *Georgia-Pacific* factors in calculating a reasonable royalty, particularly when actual licenses of the technology in question are unreliable.

Moreover, it’s a good idea for defendants to provide expert rebuttal testimony, regardless of weaknesses in the plaintiff’s case. Even though such testimony is technically unnecessary if the plaintiff fails to meet its burden of proof, relying on an appeals court to prove the defendant’s point can be a costly exercise. ♦

VALUATION INTERVIEWS HELP TELL THE WHOLE STORY

Interviewing a company’s management team is a critical component of the valuation process. But a client’s CEO or other top executive may resist these interviews because of time constraints, confidentiality concerns, or fear of alerting employees to a major event, such as a sale or bankruptcy.

Despite these challenges, it’s important to make management interviews happen whenever possible. In a litigation setting, a court order may be required for your valuation expert to interview the opposition’s management.

Why are management interviews so important? Because financial statements and other documents simply don’t tell the whole story. Value depends on qualitative, subjective factors that a valuator simply can’t glean from numbers alone. Examples include management depth, dependence on key personnel, planned acquisitions or other growth strategies, competitive advantages or disadvantages, industry trends and risk factors. Gaining this type of information is best accomplished via on-site interviews that include a tour and inspection of the premises and operations.

Not only do management interviews improve the valuation process, but the *absence* of such interviews can hurt your case when a business is being valued in a litigation context. A court may discount or even reject a valuator’s assumptions about projected earnings, business or financial risk, asset values, and other key factors unless they’re backed up by management interviews. A court is also more likely to find your valuation expert to be credible if he or she conducted interviews, made site visits and took other steps to look beyond the numbers to get the story behind them.

Even if you successfully arrange for management interviews, they’re of little value if the subjects are uncooperative or untruthful. In some cases, it may be necessary to use depositions to extract the information your valuation expert needs.

