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The Role of FAS 141 Valuations in IP Litigation

By Brad L. Pursel and Mike R. Annis

FAS 141 valuations can have a significant impact on the way infringement litigation is conducted and on a case's eventual outcome. The purpose of patent protection is to provide the patentee proper economic return in the acquisition of the patent, as demonstrated in *King Instruments Corp. v. Perego*, 65 F.3d 941, 950, 36 U.S.P.Q.2d (BNA) 1129, 1135 (Fed. Cir. 1995). As such, a jury should consider the valuation of the infringed asset at the time of its acquisition when assessing alleged damages caused by infringement of that asset and determining the proper economic return for that infringed asset. An acquiring company has an incentive to maximize earnings by attributing purchase value to goodwill (which does not result in amortization expense) instead of intangible assets like IP (which typically result in amortization expense).1

FAS 141 valuations may be particularly useful to a defendant if the plaintiff previously allocated only nominal value to the infringed IP. Failure to list and allocate purchase price to IP pursuant to FAS 141 may indicate that none of the purchase price was paid for that IP. For example, *In re Simon Transp. Servs. Inc.*, 292 B.R. 207, 215, 217 (Bankr. D. Utah 2003), relied on balance sheets prepared under FAS 141 that failed to assign a fair value to certain intangible assets as proof that those assets were not paid for in the transaction. Moreover, a difficult fact pattern would likely develop if the plaintiff failed to list or value the acquired IP at all. Conversely, a plaintiff who properly valued—or even overvalued—the now-infringed asset when it was acquired may reap a benefit in litigation. In *Integra Lifesciences I, Ltd. v. Merck KGaA*, 331 F.3d 860, 871, 66 U.S.P.Q.2d (BNA) 1865, 1872-73 (Fed. Cir. 2003), the court found overvalued assets in a license agreement initially resulted in a questionable $15,000,000 award, vacated and remanded on other grounds, 545 U.S. 193, 74 U.S.P.Q.2d (BNA) 1801 (2005).

The Role of 'Purchase Price' in Patent Litigation

The amount paid by a plaintiff in acquiring a company with desired patents is unquestionably relevant in the calculation of damages should those patents later be asserted in litigation. Litigants have long stressed the importance of balancing the consideration paid for declared assets against damages claimed for their subsequent infringement. For example, in *Integra Lifesciences I,* the Federal Circuit vacated a jury's award of damages because it was not supported by sufficient evidence, particularly in regard to the overall value of assets at issue in the suit.

The Federal Circuit also determined that the jury's $15,000,000 reasonable royalty damage award failed to account for numerous factors, including the purchase price ($20,000,000) paid by the plaintiff for Telios, the company that previously possessed the patents in question. The court discussed the purchase price in its entirety, not the prices allocated to individual parts of the company, stating that the company had been purchased "together with all of its products, patents, and know-how." The acquisition took place in December 1996, and was therefore unaffected by

1 Brian Andreoli & Ed Dembitz, *Valuation of Intangibles for Financial and Tax Purposes* . . . or *EPS v. The IRS*, 55 Tax Exec. 218, 219 (2003).

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FAS 141. According to the court, the $15,000,000 infringement award, when compared to the overall acquisition price, seemed unbalanced for infringement of only some of Telios's patents. On remand, the district court for the Southern District of California reduced the royalty-based damage award to $6,375,000.[2] In reaching its decision, the district court followed the Federal Circuit's remand directive and specifically considered the purchase price of Telios and its assets. The district court found that the patent in question represented a large percentage of Telios's value, reduced the jury's original award by nearly two-thirds, and determined that the now-reduced damage award was "not unbalanced in comparison to the purchase price."

The U.S. District Court for the District of Minnesota recently interpreted the seemingly unbalanced calculus from *Integra Lifesciences I* and its effect on damages awarded for the infringement of patents that were later sold without an allocated value. In *Spectralytics, Inc. v. Cordis Corp.*, 650 F. Supp. 2d 900, 914-15 (D. Minn. 2003), the jury awarded plaintiff Spectralytics Inc. royalty-based damages of $22,350,000, which defendants Cordis Corp. and Norman Noble Inc. challenged as excessive in a post-trial motion for judgment as a matter of law.

Defendants argued that the jury's damage award was unbalanced and clearly excessive because it greatly exceeded the proposed net worth of Spectralytics Inc. in a potential sale transaction negotiated before the infringement ($2,800,000) and exceeded the actual sale price of the company, including its patent portfolio, when Spectralytics Inc. was acquired by Preco Industries after the infringing activity ($4,000,000). The acquiring company, Preco Industries, allocated roughly $1,700,000 of the purchase price to goodwill, which included the purchased patents-in-suit. As part of the transaction, Preco additionally promised to pay 25% of any proceeds realized from the subject patent

2 *Integra Lifesciences I, Ltd. v. Merck KGaA*, No. CV 1307-B(AJB), 2004 WL 2284001, at *1 (S.D. Cal. Sept. 7, 2004).

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litigation. Regardless, in its post-trial submission, the defendant argued that the plaintiff attributed no value to the patent in the acquisition. It is not stated in the decision whether Preco performed a valuation pursuant to FAS 141.

In denying defendant's motion, the court dismissed the impact of the proposed sale as "weak evidence" because it took place before the patent-in-suit issued. Similarly, the court disregarded information related to the actual sale of the company, rejecting the argument that a specific monetary value to a patent is required at the time of transaction. The court concluded that, even though the patent's value was "unknown and not individually specified in 2003," it was nonetheless not "worthless," and a reasonable jury could have given such evidence little value in reaching its determination of damages.

The Discoverability of FAS 141 Valuations

Valuations prepared pursuant to FAS 141 should no doubt be discoverable in cases involving the alleged infringement of acquired IP under the standards set forth Rule 26(b) of the Federal Rules of Civil Procedure. Rule 26(b) sets forth broad standards for discovery, allowing parties to obtain discovery for any non-privileged matter that is relevant to a claim or defense of any party.[3] It is well settled that a plaintiff's financial records are relevant for purposes of calculating damages in an action for patent infringement, as shown in *Phase Four Indus., Inc. v. Marathon Coach, Inc.*, No. 04-4801 JW, 2006 WL 1465313, (N.D. Cal. May 24, 2006), stating that the financial statements of plaintiff from the time of its acquisition of the patent-in-suit may pertain to damages and therefore, are relevant and discoverable. In addition, in *Funai Elec. Co., Ltd. v. Orion Elec. Co., Ltd.*, Nos. 02Civ.2605(AGS)(JCF), 01Civ.3501(AGS)(JCF), 2002 WL 1808419, at *7 (S.D.N.Y. Aug. 7, 2002), the court ruled that the financial statements of the plaintiff were "clearly relevant to a determination of damages" and therefore discoverable.

Accordingly, valuations prepared pursuant to FAS 141 should be discoverable in cases involving the alleged infringement of acquired IP. Although courts have not specifically referenced FAS 141 when ruling on the discoverability of financial statements in the context of infringed IP, at least one court has compelled discovery of a company's financial statements and other documentation related to its acquisition of a company that previously owned the patent-in-suit. In *Ferko v. Nat'l Ass'n for Stock Car Auto Racing*, 218 F.R.D. 125, 139–40 (E.D. Tex. 2003), the court ruled that financial documents produced pursuant to Statement of Financial Accounting Standards (SFAS) No. 141 and 142 were protected by the attorney-client privilege when those documents were produced by an outside consultant at the insistence of counsel in anticipation of a possible Securities Exchange Commission audit.

In *Fresenius Med. Care Holding Inc. v. Baxter Int'l., Inc.*, 224 F.R.D. 644, 653–54 (N.D. Cal. 2004), at least one of the patents-in-suit was acquired when the cross-plaintiff, Baxter International, Inc. (Baxter) purchased Althin Medical Inc. (Althin). At issue was Fresenius's motion to compel predicated on Baxter's failure to respond to eight document requests relating to its acquisition of Althin.

The United States District Court for the Northern District of California determined that "[t]he amount paid to acquire a company with desired patents, and the amount allotted to a particular patent is relevant to the establishment of a reasonable royalty." In granting the motion to compel, the court ruled that discovery of the evaluation and acquisition of Althin was permissible, as was discovery of the evaluation of Althin's various assets.

Admissibility of FAS 141 Valuations

The most likely scenario in which prior FAS 141 valuations of IP would be admitted is when the valuations are used in support of or opposition to expert witness testimony about damage calculations because of the valuations' impact on

3 Fed. R. Civ. P. 26(b).

opinions regarding reasonable royalty determinations. This is shown in *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120, 166 U.S.P.Q. 235, 238 (S.D.N.Y. 1970), which lists the factors used to determine a reasonable royalty, including expert testimony (the fourteenth factor). There are two aspects of a reasonable royalty calculation to which FAS 141 valuations are undoubtedly relevant: the royalty rate itself and the base to which it is applied.

Attacks against the admissibility of FAS 141 valuations will most likely be in the form of objections that the material is hearsay or irrelevant, or that its prejudicial effect substantially outweighs the probative value of the information. Prospectively, it is difficult to state with certainty how courts will rule on such objections, as each judicial decision of admissibility turns on the individual facts presented, as shown in *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 589 n.7, 27 U.S.P.Q.2d (BNA) 1200, 1204 n.7 (1993). It does seem clear, however, that information relating to how a party values its asserted IP would be admissible to address claims of damage relating to that IP.

Although no record of any court specifically addressing an expert's use of FAS 141 valuations in the context of patent litigation could be found, the U.S. District Court for the District of Colorado addressed the issue in the context of claims of unfair competition.[4] In *Netquote, Inc. v. Byrd,* No. 07-cv-00630-DME-MEH, 2008 WL 2442048, at *1 (D. Colo. Apr. 29, 2008), a federal magistrate judge conducted a hearing on the defendants' motion to exclude the plaintiff's damages expert when the expert's testimony was based on a financial valuation report on NetQuote's business (the Quist report) prepared using the procedures of FAS No. 141. There, the magistrate addressed defendant's hearsay objections, found the Quist report admissible as a business record, and recommended that the expert's testimony be admitted.

4 *Netquote, Inc. v. Byrd*, No. 07-cv-00630-DME-MEH, 2008 WL 2442048, at *1 (D. Colo. Apr. 29, 2008).

Similarly, judicial decisions addressing the discoverability of financial statements reflecting the sale of patents both before and after infringement strongly support the concept that FAS 141 valuations are germane and relevant to damage calculations in IP infringement suits.[5] Although there may be concerns that FAS 141 valuations that assign minimal or no value to a patent-in-suit are overly prejudicial, such evidence should nonetheless be admissible.[6] In *Spectralytics*, no value had been assigned to the patent-in-suit when it was sold after the infringing activity. Following the teachings of *Integra Lifesciences I*, the *Spectralytics* court determined that the trial court did not err in permitting the jury to hear evidence of the company's actual sale in 2003 because that evidence was unquestionably relevant.

Potential Limitations to Using FAS 141 in Patent Litigation

The first and most obvious limitation to using FAS 141 in patent litigation is if not all of a company's patents have been acquired during the sale of a business since FAS 141 took effect. In such a case, many patents will not have been formally valued. There is no current accounting rule requiring companies to allocate value to patents that are developed internally or were acquired prior to FAS 141. Additionally, while GAAP applies to all U.S. business entities, some smaller, privately owned companies might choose not to file statements in accordance with GAAP, although they should for purposes of enhancing their credibility.[7] Other corporations may choose to only prepare financial statements according to GAAP in order to meet lending requirements or for other

5 *Integra Lifesciences I, Ltd. v. Merck KGaA*, 331 F.3d 860, 871-72, 66 U.S.P.Q.2d 1865, 1873 (Fed. Cir. 2003), vacated and remanded on other grounds, 545 U.S. 193, 74 U.S.P.Q.2d (BNA) 1801 (2005); *Fresenius Med. Care Holding Inc. v. Baxter Int'l., Inc.*, 224 F.R.D. 644, 653 (N.D. Cal. 2004); *Spectralytics, Inc. v. Cordis Corp.*, 650 F. Supp. 2d 900, 915 (D. Minn. 2003).

6 See *Spectralytics*, 650 F. Supp. at 914-16.

7 *The Thought Process, Acquisitions and Allocations*, Value Concepts (Jan. 2003), www.valueconcepts.net/Newsletter_01.03.htm.

reasons. However, even among companies that follow GAAP, there still may be some companies that choose not to perform a FAS 141 valuation of acquired IP. Such a situation may occur if the dollar value of an acquisition is below a certain company-specific materiality threshold as determined by the company's independent auditing firm.

An important subset of patent infringement plaintiffs—commonly referred to as "patent trolls"—should also be considered in the FAS 141 context. The so-called patent trolls generally do not practice the inventions claimed and disclosed in their asserted patents. Rather, trolls acquire patents and assert them against others in an attempt to capitalize on the patents' value through licensing or damage awards obtained in infringement litigation.[8] In general, these companies pay relatively small amounts for their patents and have no self-developed IP. Under GAAP, such entities would need to recognize the fair value of any acquired IP assets.[9] However, many of these entities are relatively small and may not be required to prepare financial statements in accordance with GAAP. Entities involved in litigation with patent trolls should nonetheless inquire as to whether the plaintiff acquired its asserted assets and, if so, whether the plaintiff performed a FAS 141 valuation. The implications of the answers to those queries will necessarily depend upon regulatory or other obligations requiring FAS 141 treatment for acquired assets.

Conclusion

Although this article focuses on patents, other forms of IP, such as trade secrets, trademarks, and copyrights are also included within the scope of FAS 141, and a reasonable royalty is a measure for estimating damages in non-patent litigation. In addition, case law related to reasonable royalty for non-patent IP suits has been influenced by the more developed body of case law from patent infringement cases.

Discovery related to FAS 141 valuations should become a standard tool for IP litigation attorneys. As a result, corporate counsel, management, valuation specialists, and auditors should be aware of the potential legal consequences of FAS 141 valuations. Existing and future case law may help guide companies as to best practices in performing such IP valuations to reconcile compliance with GAAP with minimizing the potential negative impact that may arise if the acquired IP should later become the subject of infringement litigation.

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8 See Landers, *supra* note 1, at 308.

9 The acquired assets may not encompass a "business" as defined in accounting literature and, therefore, assets acquired under something other than a "business combination" would be valued under other applicable accounting guidance. FAS 141R, §§ D2-D7.