

**INTELLECTUAL PROPERTY VALUATION UNDER U.S. GAAP AND THE  
IMPACT ON INTELLECTUAL PROPERTY LITIGATION**

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## I. INTRODUCTION

The importance of intellectual property (“IP”) litigation to companies is increasing as IP has become a critical tool for the creation of new products and services and a key differentiator among existing products and services.<sup>1</sup> Accounting standards that require IP valuation are potentially useful tools for litigation in which the complaining party has acquired the allegedly infringed IP. Counsel should not only be cognizant of relevant accounting standards as they relate to the United States Generally Accepted Accounting Principles (“GAAP”), but also be prepared to utilize or defend against a prior valuation of IP that is subject to infringement litigation.

There is often limited published information related to a company’s IP. Moreover, the more well-known sources, such as patent filings, do not address the value of the IP. Since the issuance of Statement of Financial Accounting Standards No. 141, *Business Combinations* (“FAS 141”) in 2001 by the Financial Accounting Standards Board (“FASB”),<sup>2</sup> GAAP has required that acquired intangible assets—including IP, such as patents—be recognized and valued upon acquisition.<sup>3</sup> Companies that need to account for acquisitions under FAS 141 may report limited detailed data on acquired IP in their financial statements. For example, companies may aggregate, for presentation purposes, data on various types of intangible assets under one or more fairly nondescript line items on the balance sheet and provide little additional detail in the notes to the financial statements. However, even if the financial statements do not disclose significant details, other documentation, including third-party or internally-prepared

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<sup>1</sup> See Amy L. Landers, *Let the Games Begin: Incentives to Innovation in the New Economy of Intellectual Property Law*, 46 SANTA CLARA L. REV. 307, 308 (2006).

<sup>2</sup> BUS. COMBINATIONS, Statement of Fin. Accounting Standards No. 141 (Fin. Accounting Standards Bd. 2001).

<sup>3</sup> Statement of Fin. Accounting Standards No. 141, ¶ 39. FAS 141 applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001 or later. 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 that may include a fair value aspect. The value of internally developed intangible assets is not recognized in financial statements. The term “intangible assets” is defined in Appendix F of FAS 141 as “[a]ssets (not including financial assets) that lack physical substance.” Statement of Fin. Accounting Standards No. 141, app. F.

valuation reports and analyses and auditor work paper files, typically provide significant detail related to any acquired IP. This type of documentation necessarily includes detailed assumptions used in identifying and valuing the IP. Moreover, such valuation reports and work papers also include IP that was not valued, effectively valuing those assets at \$0.

Since the issuance of FAS 141, FASB has continued to increase the prevalence of fair value-based measurements under GAAP. In terms of IP-relevant standards, a revised FAS 141 (“FAS 141R”), effective for financial statements issued for fiscal years beginning after December 15, 2008, expanded the scope of fair value<sup>4</sup> measurements and the requirements related to such IP-intensive items as “in-process research and development” projects.<sup>5</sup> In addition, FAS 157, effective for financial statements issued for fiscal years beginning after November 15, 2007, provides a formalized fair value framework that impacts the definition of fair value and describes important factors for measuring fair value under GAAP.<sup>6</sup> To complicate matters, FASB’s new Accounting Standards Codification (“ASC”) revised the references for applicable accounting standards and other guidance.<sup>7</sup> However, due to the relatively recent nature of the above-mentioned developments and the familiarity of the FAS 141 reference among management, valuation specialists, and auditors, this Article mostly refers to the original FAS 141. In addition, neither FAS 141R nor ASC are believed to alter the

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<sup>4</sup> The standard of value under GAAP is “fair value,” which was previously defined in Appendix F of FAS 141 as “[t]he amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.” Statement of Fin. Accounting Standards No. 141, app. F. By contrast, under FAS 157, fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157, ¶ 5 (Fin. Accounting Standards Bd. 2006).

<sup>5</sup> Statement of Fin. Accounting Standards No. 141, ¶¶ B151–B153.

<sup>6</sup> Statement of Fin. Accounting Standards No. 157, ¶¶ 5–17.

<sup>7</sup> Effective for reporting periods ending after September 15, 2009, ASC is the single source of authoritative nongovernmental GAAP. THE FASB ACCOUNTING STANDARDS CODIFICATION™ AND THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Statement of Fin. Accounting Standards No. 168 (Fin. Accounting Standards Bd. 2009). FAS 141 references are contained within ASC 805. *Id.* at ¶ 13.

substance of the procedures and requirements related to valuing intellectual property under FAS 141.

This Article provides an overview of the requirements related to FAS 141, offers statistics related to the frequency of FAS 141-related fair value measurements, discusses the valuation and audit process related to FAS 141, and, finally, explains the legal ramifications of IP valuations in the context of post-valuation litigation. Although the focus of this Article relates to patents, the discussion is applicable to litigation involving other forms of IP, including trade secrets, trademarks, and copyrights.

## II. FREQUENCY OF PATENT RECOGNITION UNDER FAS 141

As a result of FAS 141, which became effective for acquisitions occurring on or after July 1, 2001, mergers and acquisitions require a fair value analysis of any acquired intangible assets, including IP.<sup>8</sup> Before discussing the finer details of FAS 141 and the potential legal ramifications to IP litigation, it is informative to consider the frequency of such valuations. Based upon our review of Standard & Poor's 500 ("S&P 500") companies' filings through December 2007, thirty-two percent of the S&P 500 companies reported owning patents that they valued for financial reporting purposes.<sup>9</sup> In addition to the aggregate statistics, companies often disclose the individual intangible assets (including patents) recognized from specific acquisitions in notes to the financial statements. The notes may also include the fair value and useful life concluded for each of these assets.<sup>10</sup> A

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<sup>8</sup> Statement of Fin. Accounting Standards No. 141, ¶ 59(b).

<sup>9</sup> Based upon a study of the Securities and Exchange Commission ("SEC") filings of 345 companies comprising the S&P 500 through December 2007 (excluding utility, financial, and insurance companies based upon our expectation of less frequent recognition of IP). This data reflects the aggregate of any patents recognized for any acquisitions made preceding the date of the observed SEC filing. Importantly, the frequency of patent valuation is likely significantly higher than we found in our review, as some companies report patent valuations under more generalized labels, such as developed technology, core technology, or IP, which we did not include in our frequency calculation.

<sup>10</sup> "The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life is amortized; an intangible asset with an indefinite useful life is not amortized. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows

recent Ernst & Young study found that technology assets, including patents, were only recognized in twenty percent of FAS 141 engagements.<sup>11</sup> However, the study found that technology asset recognition in acquisitions varied by industry: pharmaceutical (51%), biotechnology (40%), media and entertainment (21%), and automotive (18%).<sup>12</sup>

### III. FAS 141 OVERVIEW

FAS 141 applies to all business combinations initiated after June 30, 2001.<sup>13</sup> FAS 141 and related standards were widely referred to as part of an “appraiser full-employment act” due to the significant increase in required fair value-based measurements.<sup>14</sup> Prior to the issuance of FAS 141, certain acquisitions qualified for an accounting method that resulted in acquired intangible assets not being recognized or valued under GAAP.<sup>15</sup> Additionally, for certain acquisitions prior to FAS 141, it was not uncommon for companies to

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of that entity.” GOODWILL AND OTHER INTANGIBLE ASSETS, Statement of Fin. Accounting Standards No. 142, ¶ 11 (Fin. Accounting Standards Bd. 2001).

<sup>11</sup> *Acquisition Accounting—What’s Next for You?: A Global Survey of Purchase Price Allocation Practices*, ERNST & YOUNG 1 (Feb. 2009), [http://www.ey.com/Publication/vwLUAssets/Acquisitions/\\$FILE/Acquisitions.pdf](http://www.ey.com/Publication/vwLUAssets/Acquisitions/$FILE/Acquisitions.pdf).

<sup>12</sup> *Id.* at 6.

<sup>13</sup> Statement of Fin. Accounting Standards No. 141, ¶ 59(a).

<sup>14</sup> See Paula Moore, *Rules Are Changing for Mergers, Acquisitions*, DENVER BUS. J. (Oct. 12, 2001), <http://www.bizjournals.com/denver/stories/2001/10/15/newscolumn2.html> (noting that FAS 142 has been referred to as the Appraiser Employment Act); see generally Statement of Fin. Accounting Standards No. 141, ¶ 1 (increasing required measurements, thus enhancing demand for appraisers). FAS 142 was issued at the same time as FAS 141 and includes impairment testing requirements related to recognized goodwill and intangible assets. Statement of Fin. Accounting Standards No. 142, ¶ 1.

<sup>15</sup> FAS 141 supersedes Accounting Principles Board (“APB”) Opinion No. 16. Statement of Fin. Accounting Standards No. 141, ¶ 1. Under APB Opinion No. 16, acquisitions qualifying for “pooling-of-interests method” accounting resulted in no recognition of intangible asset values. BUS. COMBINATIONS, Accounting Principles Bd. Opinion No. 16, ¶ 39 (Fin. Accounting Standards Bd. 1970). FAS 141 mandated the application of the “purchase method” accounting discussed under APB Opinion No. 16 for all acquisitions and eliminated “pooling-of-interests method” accounting. Statement of Fin. Accounting Standards No. 141, ¶¶ 13, 59(a).

record all acquired intangible asset value within a catchall goodwill account, rather than recognize and value intangible assets separately.<sup>16</sup>

### A. *Criteria for Recording Intangible Assets*

FAS 141 provides detailed guidance related to the criteria for determining whether a company must *recognize*, or record in its financial statements, the value of acquired intangible assets. These criteria provide a broad basis for recognition and valuation in IP acquisitions. Specifically, paragraph thirty-nine of FAS 141 addresses the recognition of intangible assets:

An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired entity or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).<sup>17</sup>

In addition, “an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability.”<sup>18</sup> Therefore, there are two potential criteria triggering recognition of acquired IP: the contractual-legal criterion and the separability criterion.

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<sup>16</sup> Acquisitions qualifying for “purchase method” accounting under APB Opinion No. 16 also resulted in companies accounting for intangible assets under APB Opinion No. 17. *See* INTANGIBLE ASSETS, Accounting Principles Bd. Opinion No. 17 (Fin. Accounting Standards Bd. 1970). Under APB Opinion No. 17, all intangible assets were amortized over a period not to exceed forty years. *Id.* ¶ 29. Therefore, to minimize amortization expenses, companies would often establish one goodwill account encompassing all intangible assets, which was amortized over forty years.

<sup>17</sup> Statement of Fin. Accounting Standards No. 141, ¶ 39.

<sup>18</sup> *Id.*

The contractual-legal criterion provides that acquired intangible assets are recognized apart from goodwill if they arise from contractual or other legal rights even if an asset is not transferable or separable from the acquired entity or from other rights and obligations.<sup>19</sup> By illustration, paragraph A10 of FAS 141 explains that an exclusive patent licensing agreement of an acquired entity still meets the contractual-legal criterion apart from goodwill even if it would not be practical to sell or exchange the patent and the related license agreement apart from one another.<sup>20</sup>

Only an acquired intangible asset that is capable of being separated or divided from the acquired entity to be sold, transferred, licensed, rented, or exchanged meets the separability criterion and may be recognized as an asset apart from goodwill.<sup>21</sup> In addition, paragraph A12 of FAS 141 provides that “[a]n intangible asset that meets the separability criterion shall be recognized apart from goodwill even if the acquiring entity does *not* intend to sell, lease, or otherwise exchange that asset.”<sup>22</sup> Lastly, the separability criterion includes intangible assets that are not separable from the acquired entity individually, but are separable in combination with a related contract, asset, or liability.<sup>23</sup>

The language of the contractual-legal and separability criteria broadly define intangible assets that should be recognized and valued under FAS 141.

## **B. Illustrative List of Intangible Assets**

Paragraph A14 of FAS 141 provides a list of intangible assets that meet the criteria for recognition, which we present below.<sup>24</sup> FAS 141 emphasizes that the list is not exhaustive.<sup>25</sup> Indeed, an acquired intangible asset might meet the recognition criteria of FAS 141 but not be included on the list.<sup>26</sup>

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<sup>19</sup> Statement of Fin. Accounting Standards No. 141, ¶ A10.

<sup>20</sup> *Id.* ¶ A10(c).

<sup>21</sup> *Id.* ¶ A11.

<sup>22</sup> *Id.* ¶ A12 (emphasis added).

<sup>23</sup> *Id.* ¶ A13.

<sup>24</sup> *Id.* ¶ A14.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* Items marked with an “\*” (asterisk) are believed to generally satisfy the contractual-legal criterion while items marked with an “\*\*” (double asterisk) are believed to generally satisfy the separability criterion.

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- a. Marketing-related intangible assets
    - (1) Trademarks, tradenames\*
    - (2) Service marks, collective marks, certification marks\*
    - (3) Trade dress (unique color, shape, or package design)\*
    - (4) Newspaper mastheads\*
    - (5) Internet domain names\*
    - (6) Noncompetition agreements\*
  - b. Customer-related intangible assets
    - (1) Customer lists\*\*
    - (2) Order or production backlog\*
    - (3) Customer contracts and related customer relationships\*
    - (4) Noncontractual customer relationships\*\*
  - c. Artistic-related intangible assets
    - (1) Plays, operas, ballets\*
    - (2) Books, magazines, newspapers, other literary works\*
    - (3) Musical works such as compositions, song lyrics, advertising jingles\*
    - (4) Pictures, photographs\*
    - (5) Video and audiovisual material, including motion pictures, music videos, television programs\*
  - d. Contract-based intangible assets
    - (1) Licensing, royalty, standstill agreements\*

- (2) Advertising, construction, management, service or supply contracts\*
  - (3) Lease agreements\*
  - (4) Construction permits\*
  - (5) Franchise agreements\*
  - (6) Operating and broadcast rights\*
  - (7) Use rights such as drilling, water, air, mineral, timber cutting, and route authorities\*
  - (8) Servicing contracts such as mortgage servicing contracts\*
  - (9) Employment contracts\*
- e. Technology-based intangible assets
- (1) Patented technology\*
  - (2) Computer software and mask works\*
  - (3) Unpatented technology\*\*
  - (4) Databases, including title plants\*\*
  - (5) Trade secrets, such as secret formulas, processes, recipes.\*

FAS 141 also elaborates on each of the general categories of intangible assets as well as some of the specific listed intangible assets.<sup>27</sup> Below are some of the excerpts that specifically address IP:

*Marketing-Related Intangible Assets.* “If registered or otherwise provided legal protection, a trademark or other mark is an intangible asset that meets the contractual-legal criterion for recognition apart from goodwill. Otherwise, a trademark or other mark shall be recognized apart from goodwill only if the

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<sup>27</sup> *Id.* ¶¶ A15–A28.

separability criterion is met, which would normally be the case."<sup>28</sup>

*Artistic-Related Intangible Assets.* "Copyrights can be transferred either in whole through assignments or in part through licensing agreements. In determining the fair value of an intangible asset protected by copyright, consideration shall be given to the existence of any assignments or licenses of the acquired copyrights."<sup>29</sup>

*Technology-Based Intangible Assets.* Technology-based intangible assets relate to innovations or technological advances. As stated in paragraphs A26–A28, the future economic benefits of those assets are often protected through contractual or other legal rights. Thus, many technology-based intangible assets meet the contractual-legal criterion for recognition apart from goodwill.<sup>30</sup>

*Computer software and mask works.* If computer software and program formats are protected legally such as by patent or copyright, they meet the contractual-legal criterion for recognition apart from goodwill. Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may be provided legal protection; for example, in the United States mask works qualify for protection under the Semiconductor Chip Protection Act of 1984. Acquired mask works protected under the provisions of that Act or other similar laws or regulations also meet the contractual-legal criterion for recognition apart from goodwill.<sup>31</sup>

*Databases, including title plants.* An acquired database that includes original works of authorship is entitled to copyright

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<sup>28</sup> *Id.* ¶ A15; BUS. COMBINATIONS, Statement of Fin. Accounting Standards No. 141, ¶ A33 (Fin. Accounting Standards Bd. 2001) (rev. 2007) [hereinafter FAS 141R].

<sup>29</sup> Statement of Fin. Accounting Standards No. 141, ¶ A22; FAS 141R, ¶ A45.

<sup>30</sup> Statement of Fin. Accounting Standards No. 141, ¶ A25; FAS 141R, ¶ A51.

<sup>31</sup> Statement of Fin. Accounting Standards No. 141, ¶ A26; FAS 141R, ¶¶ A52–A53.

protection and, if so protected, meets the contractual-legal criterion for recognition apart from goodwill. However, a database often includes information created as a consequence of an entity's normal operations, such as a customer list or specialized information like a title plant, scientific data, and credit information. Databases that are not protected by copyright can be (and often are) exchanged in their entirety or in part. Alternatively, they can be (and often are) licensed or leased to others. Thus, even if the future economic benefit of a database does not arise from legal rights, it meets the separability criterion for recognition as an asset apart from goodwill.<sup>32</sup>

*Trade secrets, such as secret formulas, processes, recipes.* A trade secret is "information, including a formula, pattern, compilation, program, device, method, technique, or process, that (1) drives independent economic value, actual or potential, from not being generally known . . . and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."<sup>33</sup> If the future economic benefit of an acquired trade secret is protected legally, such as by the Uniform Trade Secrets Act or other laws and regulations, that asset meets the contractual-legal criterion for recognition as an asset apart from goodwill. Otherwise, a trade secret would be recognized as an asset apart from goodwill only if the separability criterion was met, which is likely to be the case.<sup>34</sup>

As illustrated, FAS 141 provides significant detail on the specific categories of acquired IP that would meet the criteria for recognition and valuation.

### C. *Valuation Considerations Under FAS 141*

FAS 141 does not provide significant guidance related to the valuation of acquired assets, including IP. Instead, FAS 141 states that independent appraisals, among other information, may be considered in determining fair

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<sup>32</sup> Statement of Fin. Accounting Standards No. 141, ¶ A27; FAS 141R, ¶¶ A54–A55.

<sup>33</sup> THE NEW ROLE OF INTELLECTUAL PROPERTY IN COMMERCIAL TRANSACTIONS 293 (Melvin Simensky, Lanning G. Bryer & Neil J. Wilkof, eds., Supp. 1998).

<sup>34</sup> Statement of Fin. Accounting Standards No. 141, ¶ A28; FAS 141R, ¶ A56.

value.<sup>35</sup> In addition, as shown below, FAS 141 also addresses the concerns regarding the difficulty of valuing acquired intangible assets, including IP.<sup>36</sup>

FAS 141 notes that “the fair value estimates for some intangible assets that meet the recognition criteria might lack the precision of the fair value measurements for other assets.”<sup>37</sup> However, “sufficient information should exist to reliably measure the fair value of [an intangible] asset if an asset has an underlying contractual or legal basis or if it is capable of being separated from the entity.”<sup>38</sup> The fair value of such an asset can be represented by “the amount for which it could be bought or sold in a current transaction between willing parties.”<sup>39</sup> When estimating “the period and amount of expected cash flows” during the valuation of an intangible asset, “estimates should be consistent with the objective of measuring fair value and, thus, should incorporate assumptions that marketplace participants would use in making estimates of fair value, such as assumptions about future contract renewals and other benefits such as those that might result from acquisition-related synergies.”<sup>40</sup> According to FAS 141, an entity is permitted to use its own assumptions when valuation information cannot be obtained without “undue cost and effort.”<sup>41</sup>

Although FAS 141 does not provide guidance in terms of valuation methodology, FAS 157 discusses the availability of adequate data to value and

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<sup>35</sup> Statement of Fin. Accounting Standards No. 141, ¶ 36.

<sup>36</sup> Before issuing a final standard, the FASB issues exposure drafts for public feedback. Such feedback is considered by the FASB in drafting the requirements of the final standard. BUS. COMBINATIONS, Statement of Fin. Accounting Standards No. 141, ii (Fin. Accounting Standards Bd. 2001).

<sup>37</sup> Statement of Fin. Accounting Standards No. 141, app. B, ¶ B163.

<sup>38</sup> *Id.* ¶ B152.

<sup>39</sup> *Id.* ¶ B172.

<sup>40</sup> *Id.* ¶ B174.

<sup>41</sup> *Id.*

the methods of valuation.<sup>42</sup> This information, among other topics related to fair value measurements, is also covered within the applicable ASC guidance.<sup>43</sup>

#### D. FAS 141 Valuation Process

The FAS 141 valuation process typically entails the following steps: selection of a third-party valuation specialist, analysis by the specialist, identification of acquired intangible assets, and review of the work completed by the valuation specialists by an auditor working for an independent firm.<sup>44</sup>

If a business acquisition falls under FAS 141 rules, a company may use internal personnel to appraise the value of the acquired intangible assets. In most cases, however, a company will hire a third-party valuation specialist to analyze the newly acquired assets. The Sarbanes-Oxley Act of 2002 prohibits a company's independent auditor from providing valuation services to its audit clients.<sup>45</sup> As part of the engagement, scoping, and proposal process, proper identification of the acquired intangible assets is essential.<sup>46</sup> The number and types of intangible assets are important factors in assessing fees related to a FAS 141 valuation.<sup>47</sup>

It is vital to properly identify, analyze, and value intangible assets under a FAS 141 acquisition, although there are several possible ways to conduct such an analysis. In addition to a careful review of the acquiring company's management, the analysis could include input from personnel of the acquired company, the valuation specialist, and the independent audit firm, including

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<sup>42</sup> FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157, ¶ 18 (Fin. Accounting Standards Bd. 2006) (discussing the general valuation approaches (cost, market, and income)).

<sup>43</sup> See FAIR VALUE MEASUREMENTS, Accounting Standards Codification Topic 820-10-35 (Fin. Accounting Standards Bd. 2009).

<sup>44</sup> See Statement of Fin. Accounting Standards No. 141, ¶¶ 35–36.

<sup>45</sup> Sections 201(a) and (g) of the Sarbanes-Oxley Act of 2002 amend Section 10A of the Securities Exchange Act by adding a list of nine categories of prohibited non-audit services, including appraisal or valuation services. See Pub. L. No. 107-204, 116 Stat. 745, 771–72.

<sup>46</sup> See Statement of Fin. Accounting Standards No. 141, ¶ 35.

<sup>47</sup> See *id.* ¶ A8.

both auditors and internal valuation specialists.<sup>48</sup> Subject to the desires of the acquiring company's management, the other parties listed may or may not be included in identifying the acquired intangible assets. Indeed, the appropriate recognition and valuation of intangible assets under FAS 141 is ultimately the responsibility of management.<sup>49</sup> This includes the accounting, reporting, and presentation of any financial statements in accordance with GAAP.<sup>50</sup>

A FAS 141 valuation analysis is typically documented within a report that includes lengthy narratives covering topics such as valuation methodology, company and industry overviews, an analysis of each asset valued (and in some instances not valued), and schedules with detailed calculations.<sup>51</sup> Once the valuation specialist completes the report, valuation specialists from the acquiring company's independent audit firm perform a "SAS 73 review," which is based upon applicable guidance for an auditor using the work of a specialist.<sup>52</sup> An auditor must obtain an understanding of the assumptions and methods used in the valuation and, if the auditor believes that the assumptions, methods, or value conclusions of the valuation specialist are unreasonable, then the auditor may require additional procedures.<sup>53</sup> Therefore, in addition to the analysis performed

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<sup>48</sup> AUDITING STANDARDS BOARD, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDITING FAIR VALUE MEASUREMENTS AND DISCLOSURES, A TOOLKIT FOR AUDITORS, § 8 (2003).

<sup>49</sup> *Id.* § 7.

<sup>50</sup> *Id.* ("Management is responsible for making the fair value measurements and disclosures included in the financial statements. In connection with that responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.").

<sup>51</sup> Although there are organizations that publish report guidelines, including the AICPA, valuation specialists still exercise significant discretion in the amount of detail included in FAS 141 reports.

<sup>52</sup> USING THE WORK OF A SPECIALIST, Statement on Auditing Standards No. 73, ¶ 7 (Am. Inst. of Certified Pub. Accountants 1994). For ease, "Statement on Auditing Standards" will generally be referred to in this article as "SAS."

<sup>53</sup> AUDITING FAIR VALUE MEASUREMENTS AND DISCLOSURES, Statement on Auditing Standards No. 101, ¶¶ 12, 22 (Am. Inst. of Certified Pub. Accountants 1994).

by the valuation specialist, a FAS 141 valuation is subject to significant scrutiny by an independent auditing firm before the valuation is permitted to be used as audit evidence.<sup>54</sup> Ultimately, the procedures and findings of the independent review are documented for the audit file, which varies significantly in length and detail depending on issues related to the transaction (i.e. size, complexity, etc.) and the policies of the independent audit firm.<sup>55</sup>

#### **E. *Patent Valuation in FAS 141 and Estimating Patent Infringement Damages***

From 1990 to 2004 over seventy-five percent of all damage awards in patent cases were based solely or in part upon a reasonable royalty.<sup>56</sup> Hence, reasonable royalty awards are the most common form of damages awarded in patent infringement litigation. When valuing patents under FAS 141, one frequently-used methodology, referred to as the “relief from royalty method,”<sup>57</sup> is based on the premise that the only value a patent purchaser receives is the exemption from paying a royalty for its use.<sup>58</sup> Application of the relief from royalty method typically involves “estimating the fair market value of an intangible asset by quantifying the present value of the stream of market-derived royalty payments” that an asset owner is “relieved” from paying.<sup>59</sup>

Other methods considered when valuing patents include the “profit split income method” and a form of discounted cash flow analysis referred to as the “discounted multi-year excess earnings method,” which quantifies the economic earnings attributable to the patent.<sup>60</sup> Even if one of these two other methods is used to estimate the value of a patent, it is not uncommon to conduct a “sanity

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<sup>54</sup> Statement on Auditing Standards No. 73, ¶ 12.

<sup>55</sup> See, e.g., Statement on Auditing Standards No. 101, ¶ 23.

<sup>56</sup> William O. Kerr, Christopher P. Loza & Michele M. Riley, *Trends in Patent Damages: Statistics & Trends, 1990–2004*, Chart III–9 (IPRA, Inc., 2004). During 1990–2004, sixty percent of patent damage awards were based solely on a reasonable royalty and over fifteen percent were based upon both a reasonable royalty and lost profits. *Id.*

<sup>57</sup> STATEMENT ON STANDARDS FOR VALUATION SERVICES 1, 18–19 (Am. Inst. of Certified Pub. Accountants 2007).

<sup>58</sup> *Id.* at 53.

<sup>59</sup> *Id.* at 53–54.

<sup>60</sup> *Id.* at 17–18.

check” for purposes of corroboration using a method such as the relief from royalty method.<sup>61</sup>

Whether valuing a patent under FAS 141 or calculating a reasonable royalty for a patent infringement claim, the primary inputs are the same: royalty base and royalty rate. “Two factors are central to the reasonable royalty calculation—the royalty base (the product sales which would be subject to the reasonable royalty), and the royalty rate. Once these amounts have been set, calculation of the reasonable royalty is a straightforward multiplication exercise.”<sup>62</sup>

Because a reasonable royalty is compensatory in nature, the royalty selected could potentially be higher than that used in a FAS 141 valuation of a patent, which is based upon a different standard of value. A prevailing claimant is entitled to damages “adequate to compensate for the infringement,” but no less than a “reasonable royalty for the use of the invention by the infringer.”<sup>63</sup> Under certain circumstances the reasonable royalty determined may far exceed the profit margins generated by the infringer as “[t]here is no rule that a royalty be no higher than the infringer’s net profit margin.”<sup>64</sup> For example, in *TWM Manufacturing Co. v. Dura Corp.*, the court based damages upon a reasonable royalty of thirty percent of the infringer’s revenues, while the industry’s standard profit margin was between six and twelve percent.<sup>65</sup> By contrast, it would be unusual for a FAS 141 patent valuation to be based upon a royalty in excess of profit margins.

When calculating a reasonable royalty, the first step is to determine the date on which the hypothetical negotiation—in advance of infringement—would

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<sup>61</sup> See generally Zareer Pavri, *Variation of IP Assets: The Foundation for Risk Management & Financing*, PRICEWATERHOUSECOOPERS 10 (1999) (discussing the use of certain valuation methods as “sanity checks”).

<sup>62</sup> *Cornell Univ. v. Hewlett-Packard Co.*, No. 01-CV-1974, 2008 WL 2222189 at \*1 (N.D.N.Y. 2008).

<sup>63</sup> 35 U.S.C. § 284 (2006).

<sup>64</sup> *State Indus., Inc. v. Mor-Flo Indus., Inc.*, 883 F.2d 1573, 1580, 12 U.S.P.Q.2d (BNA) 1026, 1031 (Fed. Cir. 1989).

<sup>65</sup> *TWM Mfg. Co., Inc. v. Dura Corp.*, 789 F.2d 895, 899, 229 U.S.P.Q. 525, 527 (Fed. Cir. 1986).

have occurred.<sup>66</sup> Under a more restricted view of the information considered during the hypothetical negotiation, the analysis would be limited to information available before commercial success of the patent, actual profitability, and customer acceptance could be determined.<sup>67</sup> Therefore, reasonable royalty estimates may be limited to such information as budgets, forecasts, and pricing estimates.<sup>68</sup> However, these are merely estimates, so when actual evidence can be offered the courts may choose to utilize that evidence to correct the estimates.<sup>69</sup>

In *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, the court developed a list of fifteen factors to consider in determining a reasonable royalty for a patent license.<sup>70</sup> This test is useful for calculating patent damage claims<sup>71</sup> and FAS 141 valuations.<sup>72</sup> The factors in the *Georgia-Pacific* test fall into two main groups: licensing activities and factors related to the value of the patent.<sup>73</sup> The “value of the patent” group, which is more relevant to the present discussion, includes: the patent’s profitability (eighth factor), benefits of the invention (tenth factor), value of the invention (sixth and thirteenth factor), available non-infringing alternatives (ninth factor), and the duration of the patent (seventh factor).<sup>74</sup>

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<sup>66</sup> *Integra LifeSciences I, Ltd. v. Merck KGaA*, 331 F.3d 860, 870, 66 U.S.P.Q.2d (BNA) 1865, 1872 (Fed. Cir. 2003), *vacated*, 545 U.S. 193, 74 U.S.P.Q.2d (BNA) 1801 (2005).

<sup>67</sup> DANIEL L. JACKSON, CALCULATING INTELLECTUAL PROPERTY INFRINGEMENT DAMAGES, PRACTICE AID 06-1, 55 (Am. Inst. of Certified Pub. Accountants 2006).

<sup>68</sup> *Id.*

<sup>69</sup> *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, 289 U.S. 689, 698, 17 U.S.P.Q. (BNA) 522, 525 (1933) (referring to this type of evidence as a “book of wisdom”).

<sup>70</sup> *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120, 166 U.S.P.Q. (BNA) 235, 238 (S.D.N.Y.), *modified*, 446 F.2d 295, 170 U.S.P.Q. 369 (2d Cir. 1970).

<sup>71</sup> *Id.*

<sup>72</sup> See BUS. COMBINATIONS, Statement of Fin. Accounting Standards No. 141, ¶ 39 (Fin. Accounting Standards Bd. 2001).

<sup>73</sup> TERENCE P. ROSS, INTELLECTUAL PROPERTY LAW: DAMAGES AND REMEDIES 3-64 (Rel. 18, Law Journal Press 2010).

<sup>74</sup> *Id.*

In determining the profits related to a patent, it is important to consider sales generated from products or services that benefit from demand arising from the patent, but are not encompassed by the patent.<sup>75</sup> The sixth *Georgia-Pacific* factor addresses such derivative or convoyed sales arising from a patent.<sup>76</sup> A reasonable royalty rate accounts for derivative sales because a hypothetical licensee expecting a patent to generate such sales would pay a higher royalty.<sup>77</sup> A FAS 141 patent valuation also accounts for derivative sales.<sup>78</sup>

The significance of the patent's effect on the related product or service's sales is another important consideration in both reasonable royalty calculations and the FAS 141 analysis. This consideration accounts for both the ninth *Georgia-Pacific* factor addressing the advantages of the patent property over old modes<sup>79</sup> and the thirteenth *Georgia-Pacific* factor addressing the portion of the realizable profit allocated to the patent as opposed to other enabling assets.<sup>80</sup> For example, if the patented invention's contribution is significant, a higher royalty would result from the hypothetical negotiations as "a large portion of the realizable profit should be attributed to the uniqueness of the invented patent."<sup>81</sup> An analysis of the patent's effect on a related product or service's sales would also account for the impact, if any, of royalty stacking.<sup>82</sup>

#### IV. THE ROLE OF FAS 141 VALUATIONS IN IP LITIGATION

The seasoned trial lawyer will immediately understand that 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

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<sup>75</sup> *Id.* at 3-59, 3-63(b).

<sup>76</sup> *Georgia-Pacific*, 318 F. Supp. at 1120, 166 U.S.P.Q. (BNA) at 238.

<sup>77</sup> *A & L Tech. v. Resound Corp.*, No. C 93-00107 CW, 1995 WL 415146, at \*1 (N.D. Cal. 1995).

<sup>78</sup> *See* BUS. COMBINATIONS, Statement of Fin. Accounting Standards No. 141, ¶ 39 (Fin. Accounting Standards Bd. 2001).

<sup>79</sup> *Georgia-Pacific*, 318 F. Supp. at 1120, 166 U.S.P.Q. (BNA) at 238.

<sup>80</sup> *Id.*

<sup>81</sup> *Golight, Inc. v. Wal-Mart Stores, Inc.*, 216 F. Supp. 2d 1175, 1184 (D. Colo. 2002), *aff'd*, 355 F.3d 1327, 69 U.S.P.Q.2d 1481 (Fed. Cir. 2004).

<sup>82</sup> *See generally* Raju Adhikari *Patents, Royalty Stacking and Management* (2005), [http://www.worldpharmaceuticals.net/pefs/025\\_wpf008.pdf](http://www.worldpharmaceuticals.net/pefs/025_wpf008.pdf).

to provide the patentee proper economic return in the acquisition of the patent.<sup>83</sup> 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.<sup>84</sup> FAS 141 valuations may be particularly useful to a defendant if the plaintiff previously allocated only nominal value to the infringed IP.<sup>85</sup> Moreover, a difficult fact pattern would likely develop if the plaintiff failed to list or value the acquired IP at all.<sup>86</sup> Conversely, a plaintiff who properly valued—or even overvalued—the now-infringed asset when it was acquired may reap a benefit in litigation.<sup>87</sup>

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<sup>83</sup> See *King Instruments Corp. v. Perego*, 65 F.3d 941, 950, 36 U.S.P.Q.2d (BNA) 1129, 1135 (Fed. Cir. 1995).

<sup>84</sup> Consideration of patent acquisition costs can be found outside the civil litigation context. For example, under compulsory patent licensing statutes, the Atomic Energy Commission is instructed to appoint a “Patent Compensation Board,” which determines a reasonable royalty to pay a patent owner whose patent is licensed. 42 U.S.C. §§ 2187(a)–(b)(1) (2006). In establishing the reasonable royalty, the Board is permitted to “consider the cost to the owner of the patent of developing such invention or discovery or acquiring such patent.” *Id.* § 2187(c)(1)(D) (emphasis added).

<sup>85</sup> 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). See Brian Andreoli & Ed Dembitz, *Valuation of Intangibles for Financial and Tax Purposes . . . or EPS v. The IRS*, 55 TAX EXEC. 218, 219 (2003).

<sup>86</sup> 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. Cf. *In re Simon Transp. Servs. Inc.*, 292 B.R. 207, 215, 217 (Bankr. D. Utah 2003) (relying 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).

<sup>87</sup> See *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) (finding over-valued assets in license agreement initially resulted in questionable \$15,000,000 award), *vacated and remanded on other grounds*, 545 U.S. 193, 74 U.S.P.Q.2d (BNA) 1801 (2005).

### A. *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.<sup>88</sup> 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, Ltd. v. Merck KGaA*, the Federal Circuit vacated a jury's damages award because it was not supported by sufficient evidence, particularly in regard to the overall value of assets at issue in the suit.<sup>89</sup> The Federal Circuit 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.<sup>90</sup> 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' patents.<sup>91</sup>

On remand, the District Court for the Southern District of California reduced the royalty-based damage award to \$6,375,000.<sup>92</sup> 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.<sup>93</sup> The district court found that the patent in question represented a large percentage of Telios' value, reduced the jury's original award by nearly two-thirds, and determined

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<sup>88</sup> See *id.* at 870-71, 66 U.S.P.Q.2d (BNA) at 1872-73; *Fresenius Med. Care Holding Inc. v. Baxter Int'l., Inc.*, 224 F.R.D. 644, 653 (N.D. Cal. 2004).

<sup>89</sup> See *Integra*, 331 F.3d at 871-72, 66 U.S.P.Q.2d (BNA) at 1873.

<sup>90</sup> *Id.* at 871, 66 U.S.P.Q.2d at 1872-73. The court discussed the purchase price in its entirety, not the prices allocated to individual parts of the company. *Id.* (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 FAS 141. *Id.* at 862 n.1, 66 U.S.P.Q.2d (BNA) at 1866 n.1.

<sup>91</sup> See *id.* at 871, 66 U.S.P.Q.2d at 1872-73.

<sup>92</sup> *Integra Lifesciences I, Ltd. v. Merck KGaA*, No. CV 1307-B(AJB), 2004 WL 2284001, at \*1 (S.D. Cal. Sept. 7, 2004).

<sup>93</sup> *Id.* at \*11.

that the now-reduced damage award was “not unbalanced in comparison to the purchase price.”<sup>94</sup>

The United States 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.<sup>95</sup> In *Spectrallytics, Inc. v. Cordis Corp.*, the jury awarded plaintiff Spectrallytics, Inc. royalty-based damages of \$22,350,000, which defendants Cordis Corporation and Norman Noble, Inc. challenged as excessive in a post-trial motion for judgment as a matter of law.<sup>96</sup> Defendants argued that the jury’s damage award was unbalanced and clearly excessive because it greatly exceeded the proposed net worth of Spectrallytics, 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 Spectrallytics, Inc. was acquired by Preco Industries after the infringing activity (\$4,000,000).<sup>97</sup> In denying defendant’s motion, the *Spectrallytics* court dismissed the impact of the proposed sale as “weak evidence” because it took place before the patent-in-suit issued.<sup>98</sup> 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.<sup>99</sup> The court concluded that, even though the patent’s value was “unknown and not individually specified in 2003” it was nonetheless not “worthless,”<sup>100</sup> and a reasonable jury

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<sup>94</sup> *Id.*

<sup>95</sup> *Spectrallytics, Inc. v. Cordis Corp.*, 650 F. Supp. 2d 900, 914–15 (D. Minn. 2003).

<sup>96</sup> *Id.* at 903–04.

<sup>97</sup> *Id.* at 913–14. 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 twenty-five percent of any proceeds realized from the subject patent litigation. Regardless, in its post-trial submission, the defendant argued that the plaintiff attributed no value to the patent in the acquisition. *Id.* at 915. It is not stated in the decision whether Preco performed a valuation pursuant to FAS 141.

<sup>98</sup> *Id.* at 914–15.

<sup>99</sup> *Id.* at 915.

<sup>100</sup> *Id.* (emphasis in original).

could have given such evidence little value in reaching its determination of damages.<sup>101</sup>

### B. *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 in 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.<sup>102</sup> It is well settled that a plaintiff's financial records are relevant for purposes of calculating damages in an action for patent infringement.<sup>103</sup> 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,<sup>104</sup> at least one court 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.<sup>105</sup>

In *Fresenius Medical Care Holding Inc. v. Baxter International, Inc.*, at least one of the patents-in-suit was acquired when the cross-plaintiff, Baxter

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<sup>101</sup> *Id.* at 916.

<sup>102</sup> FED. R. CIV. P. 26(b).

<sup>103</sup> *See, e.g.,* Phase Four Indus., Inc. v. Marathon Coach, Inc., No. 04-4801 JW, 2006 WL 1465313, at \*11 (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); 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) (ruling that the financial statements of the plaintiff were "clearly relevant to a determination of damages" and therefore discoverable).

<sup>104</sup> One court has ruled that financial documents produced pursuant to Statement of Financial Accounting Standards ("FAS") Nos. 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. *Ferko v. Nat'l Ass'n for Stock Car Auto Racing*, 218 F.R.D. 125, 139-40 (E.D. Tex. 2003).

<sup>105</sup> *Fresenius Med. Care Holding Inc. v. Baxter Int'l, Inc.*, 224 F.R.D. 644, 653-54 (N.D. Cal. 2004).

International, Inc. (“Baxter”) purchased Althin Medical, Inc. (“Althin”).<sup>106</sup> 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.<sup>107</sup> 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.”<sup>108</sup> 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.<sup>109</sup>

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<sup>106</sup> *Id.* at 653.

<sup>107</sup> *Id.* The court summarized the document requests as follows:

Request No. 40 seeks: “All document[s] relating to Baxter’s evaluation, purchase, and acquisition of Althin Medical, Inc.” Request No. 41 seeks: “All documents relating to Althin Medical’s evaluation, purchase and acquisition of DC Medical’s kidney dialysis machine business.” Request No. 43 seeks: “All agreements or communications between Althin Medical, Inc. and Baxter.” Request No. 59 seeks: “All documents relating to valuations of the patents in suit or any related patent or application that Baxter has sought or considered.” Request No. 60 seeks any documents that relate to Baxter’s decision to acquire Althin, including all minutes of Baxter’s Board of Directors. Request No. 63 seeks all communications to or from Baxter’s accountants, auditors or investment bankers that relate to the decision to acquire Althin. Request No. 68 seeks all documents relating to “any negotiations, agreements, settlements including license agreements, settlement agreements and drafts thereof, granting rights to the technology related to, or incorporate in, covered products and allegedly ancillary products and kidney dialysis machines.” Request No. 69 seeks all documents relating to “payments made by Baxter for technology related to, or incorporate in, covered products and allegedly ancillary products and kidney dialysis machines, including but not limited to, license agreements, accounting documents, receipts, and summaries of such payments.” *Id.*

<sup>108</sup> *Id.* (citing *Integra Lifestyles I, Ltd. v. Merck KGaA*, 331 F.3d 860, 871, 66 U.S.P.Q.2d (BNA) 1865, 1873 (Fed. Cir. 2003)) (emphasis added).

<sup>109</sup> *Id.* at 653–54.

### C. *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 or opposition of expert witness testimony about damage calculations because of the valuations' impact on opinions regarding reasonable royalty determinations.<sup>110</sup> 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,<sup>111</sup> irrelevant,<sup>112</sup> or that its prejudicial effect substantially outweighs the probative value of the information.<sup>113</sup> 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.<sup>114</sup> 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 United States District Court for the District of Colorado addressed the issue in the context of claims of unfair competition.<sup>115</sup> In *Netquote, Inc. v. Byrd*, a federal magistrate judge conducted a hearing on the defendants' motion to exclude the plaintiff's damages expert,<sup>116</sup> when the expert's testimony was based on a financial valuation report on NetQuote's Business (the Quist Report) prepared

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<sup>110</sup> See *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) (listing factors used to determine a reasonable royalty, including expert testimony (the fourteenth factor)).

<sup>111</sup> See FED. R. EVID. 802 (stating that hearsay is not admissible unless provided by other rules of the Supreme Court or Act of Congress).

<sup>112</sup> See FED. R. EVID. 402 (stating that evidence that is not relevant is not admissible).

<sup>113</sup> See FED. R. EVID. 403 (stating that evidence may be excluded if the danger of unfair prejudice outweighs its probative value).

<sup>114</sup> See *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).

<sup>115</sup> *Netquote, Inc. v. Byrd*, No. 07-cv-00630-DME-MEH, 2008 WL 2442048, at \*1 (D. Colo. Apr. 29, 2008).

<sup>116</sup> *Id.*

using the procedures of FAS No. 141.<sup>117</sup> There, the magistrate addressed defendant's hearsay objections, found the Quist Report admissible as a business record,<sup>118</sup> and recommended that the expert's testimony be admitted.<sup>119</sup>

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.<sup>120</sup> 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.<sup>121</sup> In *Spectralytics*, no value had been assigned to the patent-in-suit when it was sold after the infringing activity.<sup>122</sup> 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.<sup>123</sup>

#### D. *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

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<sup>117</sup> *Id.* at \*4.

<sup>118</sup> *Id.* at \*9 (applying FED. R. EVID. 803(6)) (quoting *Paddock v. Dave Christensen, Inc.*, 745 F.2d 1254, 1257 n.3 (9th Cir. 1984) ("Although a financial statement audit is based in part on hearsay, it is generally admissible as a business record of the audited entity under Fed. R. Evid. 803(6)").

<sup>119</sup> *Netquote, Inc.*, 2008 WL 2442048, at \*10.

<sup>120</sup> *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).

<sup>121</sup> *See Spectralytics*, 650 F. Supp. at 914–16.

<sup>122</sup> *Id.* at 915.

<sup>123</sup> *Id.*

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.<sup>124</sup> Other corporations may choose to only prepare financial statements according to GAAP in order to meet lending requirements or for other reasons.<sup>125</sup> 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.<sup>126</sup>

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.<sup>127</sup> In general, these companies pay relatively small amounts for their patents and have no self-developed IP.<sup>128</sup> Under GAAP, such entities would need to recognize the fair value of any acquired IP assets.<sup>129</sup> However, many of these entities are relatively small and may not be required to prepare financial statements in accordance with GAAP.<sup>130</sup> 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.

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<sup>124</sup> *The Thought Process, Acquisitions and Allocations*, VALUE CONCEPTS (Jan. 2003), [http://www.valueconcepts.net/Newsletter\\_01.03.htm](http://www.valueconcepts.net/Newsletter_01.03.htm).

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *See Landers, supra* note 1, at 308.

<sup>128</sup> *Id.*

<sup>129</sup> 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.

<sup>130</sup> *The Thought Process, Acquisitions and Allocations*, VALUE CONCEPTS, *supra* note 124.

## V. 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 royalties 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.