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Spotlight on patent infringement

Recent Federal Circuit case offers guidance on the EMVR

In general, a patent holder seeking infringement damages must apportion profits or royalties between the patented feature and any unpatented features of the infringing product. Apportionment ensures that damages reflect the value attributable to the infringing features without allowing the patent holder to benefit unfairly from the value of the product's unpatented features.

There's an important exception to apportionment known as the "entire market value rule" (EMVR). It allows a patent holder to recover damages based on the full value of the infringing product, even if it contains multiple features, provided the patent holder can establish that the patented feature constitutes the basis for consumer demand for the product. In other words, if the patented feature drives demand for the product, the value attributable to that feature is the product's entire value.

The U.S. Court of Appeals for the Federal Circuit has exclusive jurisdiction over patent appeals. In *Power Integrations*, the court provided guidance on what a patent holder must prove to take advantage of the EMVR and avoid apportionment.

The EMVR is available only when the patented feature drives consumer demand for the infringing product.

Power struggle

Both parties manufactured power supply controller chips that are used to regulate the flow of power in chargers and other devices. In 2009, Power Integrations filed a lawsuit against a competitor, alleging patent infringement. The main patent at issue covers switching regulators used in the chips that enable power supplies to run more quietly and efficiently.

After a 16-day jury trial in early 2014, the jury found that the defendant had indeed infringed several of Power Integrations' patents and awarded $105 million in reasonable royalty damages. Six months later, while the case was still pending in the federal district court, the Federal Circuit decided a similar case, *VirnetX*, that had important implications for apportionment cases.

Previously, in cases involving products with both patented and unpatented features, some courts allowed apportionment based on

the "smallest salable patent-practicing unit." But in *VirnetX*, the Federal Circuit found that practice insufficient to satisfy a patent holder's apportionment obligation. Because Power Integrations didn't apportion royalties beyond the smallest salable unit (and had disclaimed reliance on the EMVR), the district court ordered a new trial.

In the second trial, held in late 2015, the court granted a *Daubert* motion excluding Power Integrations' expert testimony on apportionment, but allowed its expert to testify based on the EMVR. This time, the jury awarded Power Integrations nearly $140 million in damages, relying on the infringing products' entire market value as the royalty base.

Appeals court ruling

The EMVR is available only when the patented feature drives consumer demand for the infringing product. On appeal, the Federal Circuit found that the evidence Power Integrations presented was insufficient as a matter of law to invoke the EMVR, vacating the judgment and remanding the case to the district court.

The court ruled that the EMVR may be appropriate if the patented feature accounts for virtually all the product's value. This may be the case if, for example, the product's other features are generic or conventional, and thus "of little distinguishing character."

Power Integrations offered the following evidence to prove that the patented feature was essential:

- The patented feature enabled the products to meet the requirements of the federal Energy Star program.
- Some customers specifically asked for the patented feature.
- Products with the patented feature outsold other products.
- The defendant's marketing materials promoted the patented feature.

Is the EMVR bar too high?

Power Integrations creates some uncertainty about the future of the entire market value rule (EMVR). (See main article.) Some commentators believe that the Federal Circuit set the bar too high by requiring patent holders to prove a negative — that the unpatented features did *not* drive demand. Others suggest that the court's decision may have been based simply on Power Integrations' failure to prove that the patented feature drove demand, and that the bar isn't as high as it seems.

In February 2019, the U.S. Supreme Court denied Power's petition to review the case. So, the future of the EMVR may depend on additional guidance from the Federal Circuit.

The parties agreed that the infringing products contained other valuable features. But the court found that Power Integrations had "presented no evidence about the effect of those features on consumer demand or the extent to which those features were responsible for the products' value."

The court explained that it isn't enough to demonstrate that the patented feature is valuable or important to the infringing product. Rather, the EMVR is available only "when the patented feature is the sole driver of customer demand or substantially creates the value of the component parts."

Setting a high bar

Power Integrations shows that the EMVR is a strictly limited exception to the apportionment requirement. According to the Federal Circuit, when an accused infringer presents evidence that its product has valuable features in addition to the patented feature, the patent holder must show that those other features are irrelevant to consumer choice in order to invoke the EMVR. ■

How to value “profits interests” in LLCs

Limited liability companies (LLCs) sometimes offer a unique form of equity-based compensation known as “profits interests.” These awards come in varying formats, requiring a thorough understanding of what’s being awarded and a customized approach to determine their value for tax and financial reporting purposes.

Capital vs. profits interests

Private businesses may award various forms of equity-based compensation to employees and independent contractors. These awards can help businesses attract, retain and reward workers for their contributions to the company.

Profits interests may be contingent on the LLC meeting certain performance targets (such as revenue or market share thresholds).

LLCs aren’t allowed to issue traditional corporate forms of equity compensation, such as common and preferred shares, stock options, restricted shares, and phantom stock. Instead, LLCs generally issue two types of ownership interests:

1. Capital interests. Sometimes referred to as “equity units,” capital interests are like common stock in a corporation. They convey the full rights and benefits of ownership in an LLC, including rights to current and future equity value, a share of income and distributions, and full voting rights. However, each capital interest unit may not provide the same percentages of equity and income. In other words, allocations of equity and income may not necessarily be made pro rata based on the number of units owned. Members typically receive capital interests in exchange for a capital contribution of cash or other assets.

2. Profits interests. Also known as “performance units,” profits interests entitle the owner (or member) to a share of income, future appreciation in value, a share of the company’s equity (or residual value) upon meeting certain benchmarks — or a combination of these benefits. These owners don’t have the full rights of capital interest holders. Profits interests are generally awarded to employees or contractors in exchange for providing services to the company. Awards made to employees may be deductible by the LLC as a form of current or deferred compensation. Recipients also may be eligible for favorable tax treatment, if the awards meet certain IRS requirements.

Profits interests are subject to various restrictions. Examples include vesting requirements, expiration

dates and forfeiture provisions. Profits interests also may be contingent on the LLC meeting certain performance targets (such as revenue or market share thresholds).

It's important to review the LLC's operating agreement and other legal contracts between LLC members to determine the rights and conditions associated with each profits interest award. The flexibility in granting different types of profits interests can result in a complex capital structure.

Valuation process

Before an expert can value a profits interest award, he or she must identify all the profits interest units that the company has issued. Essentially, any units that aren't classified as capital interests are considered profits interests.

The next step is to understand what benefits are conveyed to owners of profits interests. For example, LLCs are pass-through entities that are taxed at the level of the individual owners. So, the term "profit" traditionally refers to earnings before tax (EBT). But it also might refer to revenue, operating cash flow, gross profit from a specific business segment, sales proceeds or future appreciation in value.

It's also critical to understand any terms and conditions that apply to profits interest units. In general, if a profits interest member will receive a share of future income, value will be based on the present value of the projected income that the member expects to receive from the units.

Profits interests that provide a share of the company's future appreciation or residual value pay out only when the unit is redeemed. So, these types of profits interest units are generally valued using option-pricing models. These models allow for complex terms, including assumptions regarding volatility, time frame and probabilities.

For more information

Finding skilled workers is one of the top challenges reported by private companies today. Profits interests can help LLCs attract and retain workers, but, before you issue these types of compensation awards, discuss the potential pitfalls with a business valuation professional. ■

Cost approach

Taking the balance sheet to a different level

A company's balance sheet shows its assets and liabilities. So, it's a logical starting point for valuing certain types of businesses. The cost (or asset-based) approach specifically focuses on this part of a company's financial statements. Here's how the approach works and when it might be an appropriate method of valuation.

From book value to fair market value

The amounts reported on a company's balance sheet for its assets and liabilities may not reflect their fair market value to a potential buyer or seller. There are many reasons for discrepancies, including:

Use of historic cost. Under U.S. Generally Accepted Accounting Principles (GAAP), assets are recorded at historic cost. Over time, historic cost may understate market value for appreciable assets, such as marketable securities and real estate.

Unreported items. Internally generated intangible assets — such as customer lists, brands and goodwill — are excluded from balance sheets

prepared in accordance with GAAP unless they were acquired from other companies. Balance sheets also might not include contingent liabilities, such as pending litigation or an IRS audit.

Cash or tax-basis reporting. Companies that don't follow GAAP may exclude accruals (such as accounts receivable and payable) and rely on accelerated depreciation methods that understate the market value of fixed assets.

Under the cost approach, business valuation experts identify all the company's assets and liabilities, including those that aren't recorded on the balance sheet. Next, they assign a value to each item, based on the appropriate standard of value (typically, fair market value). This process results in the creation of a market-based balance sheet.

Although the cost approach can provide valuable insight, it often requires significant time and effort to identify and revalue everything separately. In addition, revaluing certain assets — such as machinery, equipment and real estate — may require separate appraisals by outside specialists.

When it may be useful

When valuing a business for litigation purposes, the cost approach may be the preferred methodology. That's because it's perceived as straightforward, especially when used for asset holding companies and small manufacturers that rely heavily on their "hard" assets. It may also be useful when the parties present conflicting appraisal evidence.

In some cases, the cost approach provides a useful "floor" for a company's value that serves as a sanity check for the other valuation approaches. After all, reasonable sellers typically won't accept less than net asset value in a business combination unless they're under duress to sell.

In addition, many buyers and sellers turn to the cost approach in M&A, because it assigns a specific value to the individual assets and liabilities that are owned by the business. That's different from either the income or market approach, which may indicate that a business is worth, say, 1.5 times annual revenues, but doesn't assign value to specific assets and liabilities.

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With a cost approach analysis, the buyer and seller can negotiate exactly which assets and liabilities to include (or exclude), allowing them to more effectively negotiate a price. Then, after the deal is closed, a cost approach analysis can be used to allocate the company's purchase price for tax and accounting purposes.

Right for you?

The cost approach isn't necessarily used in every valuation assignment. Discuss the pros and cons of this approach with your valuation expert. He or she can help you understand how it works and whether it's appropriate for your situation. ■

The challenges of valuing promissory notes

Business valuation professionals are sometimes asked to determine the fair market value of a promissory note, typically in connection with gift or estate tax matters involving intrafamily loans or sales. This task is often more complicated than it seems at first blush.

Measuring fair market value

Many people assume the value of a promissory note equals the unpaid principal plus accrued interest as of the valuation date (typically, the date of death or a gift). However, the IRS often will accept a lower value. So, it's important to have promissory notes valued by a qualified professional, rather than estimate the value yourself.

The techniques a valuation pro uses to value a promissory note are like those used to value businesses. For example, the value of a business might be based on future cash flows that are discounted to present value using a discount rate that reflects the risk to a hypothetical buyer. Similarly, the value of a promissory note might be based on future payments of principal and interest that are discounted to present value using a discount rate that reflects the note's risk profile.

To determine an appropriate discount rate, a valuation specialist may research required rates of return for publicly traded bonds. Then he or she will adjust those rates for differences between public debt and the private note being valued.

Factoring in terms and conditions

When valuing a promissory note, it's necessary to examine the factors that affect its perceived risk, including:

Interest rate and duration. Generally, the shorter a note's term, and the higher the interest rate relative to market rates, the greater its value. The longer the term, the greater the risk to a hypothetical investor that market rates will increase. And a below-market interest rate reduces the value of a note.

Value of collateral. If a note is secured by enough collateral, it will reduce the risk of default and increase the note's value.

Financial condition. A borrower's financial condition affects its ability to make payments and, therefore, the risk of default.

Protective covenants and default provisions. These provisions are designed to protect the lender. More restrictive terms lower the note's risk and increase its value.

In addition, there's no active public market for private notes. So, it may be appropriate to apply a discount for lack of marketability, which lowers the note's fair market value.

More than meets the eye

Valuing promissory notes can be deceptively complex. Contact a valuation professional who can incorporate all the relevant factors into his or her analysis and help minimize the taxes due. ■

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