

Business Valuation Notes

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Appraisal of Intangible Assets

PATENT CASE TESTS APPEAL COURT

Changes occurring in Patent Law

There will be a full court hearing in appeal based on a request from the Patent Board for determining the scope of patentability early in 2008. The United States Congress may also pass the first revision on patents

The appeal is in regard to a solicited CAFC opinion on patent claims for intellectual property given to the Patent Board of Appeals (BPAI). A significant element the court must consider is "obviousness" of the claim. Another contentious area has been what, if any, "business methods" are patentable. Determination of claims is a critical aspect of assessing if intellectual property can be protected and thus is an important element of its value.

The Court of Appeals for the Federal Circuit (CAFC) issued an order in February 2008 to rehear *Bilski* (In Re Bernard L. Bilski and Rand A. Warsaw) by the entire court (US Court of Appeals for the Federal Circuit, 2007-1130, Serial No. 08/833,892).

The appeal pushed by the BPAI coincides with some apparent disagreements with the US Supreme Court to CAFC decisions and with a push by the US Congress to overhaul patent legislation with the Patent Reform Act of 2007 (H.R. 1998, S. 1145).

Bilski Appeal

The appeal arose from the United States Patent and Trademark Office (USPTO), Patent Board of Appeals, and Interferences. The *Bilski* appeal request was argued before a CAFC panel on October 1, 2007, and resulted in a poll of the judges to determine if the appeal should

be heard 'en banc'; the judges have decided to hold such a hearing. The rehearing is scheduled for May 8; supplemental briefs are to be filed March 6. Amicus briefs are to be filed by April 7.



Schostag

Patentability, or the right to secure legal protection for intellectual assets, is important as one valuation factor: registration enables an entity to more easily defend against others who may seek to duplicate an idea without the innovator's permission. A patent enhances the value of an intangible asset which must otherwise be protected by trade secret or by other means.

The Minnesota Business Valuation Group (MBVG) conducts appraisals of intangible assets, including those formally registered as intellectual property, for purchase price allocation, goodwill impairment, licensing, and other applications, and is concerned with the 'risk' of protecting these unique assets. MBVG President Randall Schostag said, "First we try to identify what intangible assets there are in a company. Then we try to assess how risky those assets are. That risk is used to ascertain useful life and also the risk of losing the edge to a competitor."

On February 15, 2008, the CAFC ordered the 'en banc' hearing. Some appellate courts which have a large number of judges and a large caseload divide into divisions or panels for most cases, which

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DAMAGES CASE HIGHLIGHTS EXPERT WEAKNESS

In a 2007 California lost profits damages case, the court found plaintiff's expert used poor comparables for the market approach and was unable to support the income approach, thus rendering the findings speculative.

The dispute was about a very early stage company, reminding business appraisers about the added care which must be exercised when valuing companies without an earnings and operating history.

MBVG President Randall Schostag said the case is pertinent for business appraisers who do business damages litigation support work.

"One method of assessing damages in the case of a breach of contract, for example, is to value the business before the breach and after the breach," Schostag said. "For seasoned companies with a track record, proving damages can be obtained by showing the difference in valuation outcomes."

The California case involved *Parlour Enterprises, Inc. v. The Kirin Group, Inc.*, No. G036525 (Opinion of rehearing, Cal. Ct. App., Fourth App. Dist., Division Three) and the opinion was filed 19, 2007. It was an appeal from a judgment of the Superior Court of Orange County

In the Orange County court a jury had awarded plaintiffs *Parlour Enterprises, Inc.* (Parlour), *Fun Foods 1, LP* (Fun Foods 1), and *Fun Foods Block, LP* (Fun Foods Block) approximately \$6.6 million in damages.

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Patents

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may then heard by three judge panels. According to the Federal Rules of Civil Procedure, however, on the request of the panel or one of the litigants, a case may later be reheard by the full court (en banc).

CAFC

In the US federal court system, each state has at least one US District Court where all trials are held; appeals are made to one of 12 Circuit Courts of Appeal, the one appropriate for that district court. However, to ensure uniform patent law, in 1982 the CAFC was established to hear all patent appeals from the various district courts, rather than having the cases appealed through their normal appeal process to the 12 Circuit Courts of Appeal. All decisions of the CAFC and the other circuit courts of appeal may be further appealed to the US Supreme Court.

MBVG President Randall Schostag said that the CAFC has been criticized for creating law, rather than enforcing it, and that at times the CAFC seems to have disregarded US Supreme Court decisions. "In early 2007 the US Supreme Court decided more patent cases in a few months than it usually decides in a decade," Schostag said. "While the CAFC curbed some of the problems associated with how the court evaluated 'obviousness' in the past, the Supreme Court and the Patent Office have become determined to roll back some of CAFC's decisions."

Patents

Patents are important for valuation because they grant a monopoly for new inventions for a specified time period. This monopoly is recognized in the US Constitution in Article I, Section 8. Patents are governed by the Patent Act (35 US Code), which also established the USPTO.

First, there must be an identifiable inventor, a constitutional requirement. (35 USC 102(f)) Generally, patents must also be statutory, novel, useful, and non-obvious. Because the United States statute is very broad, most innovations are patentable except data struc-

tures or programs, nonfunctional descriptive material such as literary works, or electro magnetic signals, which are considered forms of energy.

Utility patents are the most common type and which have a time life of 20 years. Design patents protect ornamental designs, and plant patents protect new varieties of asexually reproducing plants.

Business Method Patents

Business Method Patents are contentious and vary in acceptance from legal jurisdiction to jurisdiction. A business method may be defined as "a method of operating any aspect of an economic enterprise". The United States has been one of a few (include Australia, Japan, and Singapore) which have been considered a "safe haven" for business method patents. This class of patents discloses and claims new methods of doing business, such as in e-commerce, insurance, banking, and tax compliance.

The USPTO until about 20 years ago did not consider business methods patentable. But with the advent of internet and computer methods of doing commerce, the USPTO relented, finding it difficult to ascertain if an innovation was a technological invention or a business invention. In 1998 a test case, *State Street Bank v. Signature Financial Group, Inc.* (47 USPQ 2nd 1596 (CAFC 1998)) affirmed this position and rejected that such innovations were excluded subject matter. The State Street decision was affirmed in the case of *AT&T Corporation v. Excel Communications, Inc.* (50 USPQ 2d 1447 (Fed. Cir 1999)). Although in early adoption of this decision the USPTO required the use or advancement of "technological arts", this was subsequently overruled in 2005 by the BPAI. On an interim basis BPAI has said only that the claimed invention must be a process, manufacture, or composition of matter or machine, and that a process must produce a concrete, useful, and tangible result. In 2006 US Supreme Court Justice Kennedy commented that some of the business methods were potentially vague and of suspect validity.

Non-obvious

If an invention differs from prior products or processes (prior art), then it is novel. But to be patentable, the invention must also create an improvement over prior art which is not obvious. The test is whether a person having ordinary skill in the type of technology used in the invention would consider such an improvement as obvious.

Schostag said, "Determining if an invention is non-obvious is one of the most difficult jobs for examiners. It's apparent that a change in size or a simple substitution of materials is not sufficient to overcome the non-obvious requirement. But making the decision in many instances must be very difficult."

Procedures for reviewing patent claims are enumerated in the Manual of Patent Examining Procedure (MPEP) (last updated in July 2007). But the CAFC and US Supreme Court have had differences of opinion about what is obvious.

When examiners in the patent office review new invention applications, they will, for example, review prior art (MPEP Section 2141.01(a) – Analogous and Nonanalogous Art) to determine if a combination of existing inventions could produce the innovation applied for, and if so, then the application would likely be rejected (35 USC 103 rejection).

The CAFC's critical determination has been if there is something in prior art to point to, the desirability or obvious nature, of the combination of previously known elements, the application would fail. This CAFC test is often called "Teaching – Suggestion- Motivation" or TSM. This test was intended to prevent hindsight bias (*In re Kahn*, (Fed. Cir., 2006). But in applying the test, some have believed that the evidence required explicit teaching or suggestion to make a modification to prior art and thus has been too narrow in practice.

The US Supreme Court in *KSR International v. Teleflex, Inc., et al* (No. 04-1350, April 30, 2007) rejected "...the rigid approach of the Court of Appeals (CAFC)..." noting that "...our cases have set forth an expansive and flexible approach..." which has not been adopted by the appeals court.

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Patents

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The Supreme Court said, “The combination of familiar elements according to known methods is likely to be obvious when it does no more than yield predictable results.”

Instead the court placed emphasis on prior decisions rendered in connection with *Graham v. John Deere Co. of Kansas City*, (U.S. 1 (1966)) which was based on *Hotchkiss v. Greenwood*, (11 How. 248 (1851)) and which included “...such secondary considerations as commercial success, long felt but unsolved needs, failure of others...to give light to the circumstances surrounding the origin of the subject matter sought to be patented.”

Patent Reform Act of 2007

During April 2007, Congressman Howard Berman introduced H.R. 1908, patent legislation which would reform patent law statutes. The bill was subsequently passed by the House in early September 2007. A similar bill was introduced in April by Senator Patrick Leahy; it remains under consideration.

The United States’ first patent statute was the Patent Act of 1790. It was entitled “An Act” to promote the progress of useful Arts and passed on April 10, 1790.

- Patent Act of 1790
- Patent Act of 1793
- Patent Act of 1836
- Patent Act of 1952
- Patent & Trademark Law Amendments Act of 1980

The revised patent legislation proposes many of the changes which had been recommended for the Patent Reform Act of 2005 by a 2003 report by the Federal Trade Commission and a 2004 report by the National Academy of Sciences. Among other things, the legislation would make US patent law more consistent with the patent laws of many other countries.

From a valuation perspective, the Act includes changes that may effect how patents are litigated. To reduce damage awards, for example, Section 5 requires

that courts use specific valuation methods listed in the Act to determine “reasonable royalty awards” and that it is applied only to the economic value attributable to the patent’s specific contribution over the prior art, and not to the total. The court determines which valuation method to use and relevant factors to be considered.

Damages

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The award consisted of lost profits, lost franchise fees, and consequential expenses sustained by plaintiffs when defendants unilaterally terminated a franchise agreement to develop subfranchises.

Defendants Herman Chan and his corporation, The Kirin Group, Inc. (Kirin), appealed the decision, contending the damages awarded were improper because the evidence was unreliable.

The appeals court agreed, with the exception of \$62,907 awardable to Parlour as lost franchise fees and \$67,348 in extra expenses incurred by Parlour to develop the subfranchises.

The appeals court also reversed the judgment in favor of Fun Foods 1 and Fun Foods Block for intentional interference with prospective economic advantage, and remanded to the trial court with directions to reduce the award of damages to Parlour to \$130,255.

Schostag said, “At times the trial court’s decision, when reviewed by a superior court, is going to be found lacking. The lower court bench may not be as skilled in valuation methods.

“We’ve had cases where the trial court seemed more motivated by local politics and personalities which on appeal were remanded for failure to follow established valuation precedents.”

From 1963 to 1972, Bob Farrell opened 55 Farrell’s Ice Cream Parlours (Farrell’s) around the United States. In 1972, he sold all of them to Marriott Corporation, which opened an additional 85 restaurants. Around 1980, Marriott sold the ice cream parlors only

to take them back three years later. Marriott shut down all Farrell’s operations in the mid-1980s, except for a single Farrell’s operating in San Diego.

Chan, who had worked at a Farrell’s Ice Cream Parlour as a teenager, formed Kirin and in 1996 bought the Farrell’s trademarks and trade names. In November 1999 he opened a Farrell’s in Temecula but closed it in early 2002 because it was not profitable.

Before closing that Farrell’s, Kirin entered into a series of written agreements with Parlour in 2000 to develop Farrell’s subfranchises in California.

The agreements consisted of an Area Development Agreement (ADA) and a rider to the ADA. The ADA gave Parlour certain exclusive rights to subfranchise Farrell’s in California. Under the subfranchise agreements, Parlour was to receive an up-front fee and royalties in the form of a percentage of the net sales.

The ADA required Parlour to open a minimum number of restaurants within a certain time period. Parlour ultimately opened only one store within the required time. The limited partnership that owned the center provided the funds. Before then Parlour had been unable to find any investors.

Parlour was unsuccessful in obtaining investors for additional restaurants. Accordingly, Parlour set up the limited partnerships of Fun Foods Block and Fun Foods 1 to fund the building of two Farrell’s. For both partnerships, the limited partners contributed all of the funds.

In December 2002, Kirin and Parlour executed a Settlement and Mutual Release Agreement, which extended Parlour’s time to open the second restaurant to December 2003 and gave it an additional year to open the other restaurants. Kirin terminated the ADA in October 2003 for Parlour’s refusal to pay attorney fees relating to the Amendment.

Parlour, Fun Foods 1, and Fun Foods Block sued defendants. Parlour alleged causes of action for breach of contract, intentional fraud, negligent misrepresentation, and defamation.

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Damages

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Fun Foods 1 and Fun Foods Block brought a claim for interference with prospective business advantage.

At trial, plaintiffs' expert testified to the amount of damages caused by defendants' conduct, referencing eight locations in his analysis.

Three of the locations had specific plans for opening a restaurant. For these he calculated franchise fees and lost profits owed to Parlour. For the one location already open and the remaining four locations, the appraiser assessed only franchise fees owed to Parlour. The fees included an up-front charge, plus royalties in the form of a percentage of the gross sales.

Projections provided by Parlour formed the starting point of the appraiser's analysis for both the franchise fees and lost profits. The appraiser did not know who created the projections or the preparer's education, training, or experience.

The appraiser did know the projections were prepared on behalf of Parlour's principals, who he thought were "experienced in these sorts of businesses."

The appraiser also used those company-prepared projections as the primary source to determine expenses. He did not use Parlour's projections for the first two years but rather allowed for a ramp up time to get to where the company projections could be stabilized.

The analyst also used the market approach, obtaining market data for "... a couple of dozen ice cream parlors" and developed publicly available information for one chain of restaurants called Friendly's, a publicly traded company.

According to the appraiser, Friendly's "is a chain of about 300 or so restaurants", which he thought was similar to Farrell's in that it had "... both the ice cream end and the food end." Since the earnings projected by Parlour were lower than the Friendly's chain, he considered the Parlour's projections reasonable.

Although the appraiser also considered two Farrell's which were open, to determine revenues, expenses, and profits, he spoke only to Parlour's principals.

For one location which was part of a center, the profit and loss statement covered the entire center which precluded the appraiser from determining the restaurant's profit and loss from the Farrell's alone. Instead he did "...a rough appraisal" of the net profits by allocating or apportioning expenses.

The sales from the center location were lower than plaintiffs' projections. The appraiser concluded that was because the location did not receive stand-alone business but rather "most of its business tended to be from people already there at the arcade, as opposed to itself being a big attraction.

Based on this information, the appraiser concluded, the center was not as attractive of a location as the others for which they had plans." For that reason, he did not use the actual location numbers as a starting point for his other estimates.

As to the lost franchise fees, the appraiser took a percentage of the gross revenue, and adding a "one-time flat fee," discounted it to present value.

According to the appraiser, "franchise fees are based only on a percentage of revenue[s]o you don't have to consider expenses. You don't even have to consider profitability.

"As long as the stores are open and earning revenue," Parlour would receive franchise fees, according to the appraiser.

The appeals court included the following citations as references for their opinion:

"[I]f the business is a new one or if it is a speculative one . . . , damages may be established with reasonable certainty with the aid of expert testimony, economic and financial data, market surveys and analyses, business records of similar enterprises, and the like.'" (*Kids' Universe, supra*, 95 Cal.App.4th at p. 884.)

"[T]he experience of similar businesses is one way to prove prospective profits. [Citations.] Also relevant is whether the market is an established one. [Citations.]" (*Id.* at p. 885; see *S. Jon Kreedman & Co. v. Meyers Bros. Park-*

ing-Western Corp. (1976) 58 Cal.App.3d 173, 184-185.)

"A plaintiff's [or a third party's] prior experience in the same [or similar] business has been held to be probative [citations]; as has a plaintiff's [or a third party's] experience in the same [or similar] enterprise subsequent to the interference. [Citations.]" (*Kids' Universe, supra*, 95 Cal.App.4th at p. 886.)

"Similarly, prelitigation projections, particularly when prepared by the defendant, have also been approved. [Citation.] The underlying requirement for each of these types of evidence is a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed." [Citation.]" (*Ibid.*)

"[E]xpert testimony alone is a sufficient basis for an award of lost profits in the new business context when the expert opinion is supported by tangible evidence with a 'substantial and sufficient factual basis' rather than by mere 'speculation and hypothetical situations.'" [Citations.]" (*Id.* at p. 885.)

In reviewing the court's findings in this matter, Schostag said, "Lost profits damages for unestablished businesses are difficult to prove, but not impossible. There is a careful choreography which must occur between the expert and legal counsel in proving these cases."

In this California case the court noted that certainty as to the amount of damages was not required, but that the evidence must make it reasonably certain as to their occurrence and extent. The court explained that reasonable certainty as to damages can be built with expert testimony, economic and financial data, market surveys and analyses, business records from similar businesses, and prelitigation projections, particularly those prepared by defendant.

The underlying requirement of each type of evidence cited, according to the court, is "...a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed."

The court observed that expert testimony alone can provide sufficient basis for a lost profits award, but only if supported by tangible evidence supported by facts.

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BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

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