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VALUATION Trends
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Can a Reasonable Royalty Ever Exceed Lost Profits?

***Powell v. The Home Depot U.S.A. Inc.*, 2011 U.S. App. LEXIS 22838 (Nov. 14, 2011)**

Ten years ago, The Home Depot—one of the largest, most profitable home improvement retailers—noticed an alarming trend: Every year, its employees were getting badly injured, including losing their fingers, while operating the in-store radial saws used to cut large pieces of lumber for customers. After receiving a directive from the chief executive officer (CEO) to solve the problem, the company began testing a prototype developed by Michael Powell, who'd long provided installation and repair services for the in-store radial saws. The tested units proved effective, and he applied for a patent.

In the meantime, however, The Home Depot invited another, larger company (Industriaplex) to build a design that was cheaper than what it had paid for the prototype ($2,000). By 2006, Powell had his patent, but The Home Depot had already ordered nearly 2,000 saw guards from Industriaplex and Powell sued for patent infringement. Ultimately, a jury awarded $15 million in damages, or approximately $7,736 per infringing unit. After the court added $3 million for enhanced damages plus another $2.8 million in attorneys' fees, The Home Depot appealed to the U.S. Court of Appeals for the Federal Circuit.

Damages measured at the time of infringement. After confirming the findings of willful infringement and related liability issues, the Federal Circuit turned to the damages award. Had the plaintiff successfully negotiated a deal with The Home Depot after his creation of the prototype in 2004, a "conservative" estimate of his expected profits would have been $2,180 per unit. However, a reasonable royalty must be calculated at the time infringement began, the court held, in this case, when the plaintiff received his patent in 2006. By this time, "Home Depot had the luxury of nearly two additional years…to observe the effectiveness of the saw guard solution created by [the infringing design]," the court said. As a result, an expected profit of $2,180 per unit in 2004 was not a "reliable approximation of the upper limit that the parties would have reached during a hypothetical negotiation in 2006."

As a second matter, Home Depot argued that damages should have been limited by what it paid for the Industriaplex design, or $1,295 per unit, which was equivalent to a 3% to 5% royalty on infringing sales.

Injury rate fell to zero. In contrast, at trial, the plaintiff's expert presented a range of damages, bounded on one end by the $2,180 per-unit price during the 2004 negotiations and on the other by the roughly $8,500 per unit that The Home Depot spent to replace the radial saws with the infringing design in 2005. The expert also testified that after the CEO mandated the installation of saw guards, the injury rate among The Home Depot's employees dropped to zero, saving the company over $1 million in annual costs. In addition, while its major competitor (Lowe's) chose to remove radial saws from their stores, The Home Depot was able to continue to provide custom-cut lumber, protecting these profits as well as those from related sales of hinges, nails, etc. He also presented the amount that The Home Depot spent on replacing any saw guards that were incompatible with the infringing design.

"Reliance upon estimated cost savings from use of the infringing product is a well-settled method of determining a reasonable royalty," the Federal Circuit pointed out. At base, the "paucity" of evidence

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presented by The Home Depot represented "nothing more than what it might have preferred to pay, which is not the test for damages," the court held, in affirming that the jury's $15 million compensatory award was based on sufficient if not "extensive" evidence. Based on evidence of willfulness and litigation misconduct, the court also confirmed the award of enhanced damages and attorneys' fees. A brief dissent would have reversed the findings of willfulness only.

Latest 'Bad Facts' FLP Case Emphasizes Poor Planning, Operations

***Estate of Liljestrand v. Commissioner*, T.C. Memo 2011-259; 2011 Tax Ct. Memo LEXIS 251 (Nov. 2, 2011)**

After retiring in 1978, a doctor exchanged his interest in a Hawaiian hospital for several real property holdings, including condominiums and a shopping center in California, a warehouse in Oregon, a Florida strip mall, and a medical building in Arizona. Just about six years later, the doctor formed a revocable trust to hold the real property, naming his eldest son as trustee and also paying him to manage the property.

FLP to ensure son's employment. By 1996, the doctor wanted to plan his estate on behalf of all his four children, but also wanted to make sure that his eldest son kept his position managing the real estate businesses, in which none of his siblings showed an interest. In addition, he was concerned that if he gifted the property while it remained in trust, then local (Hawaiian) law would allow his other children, as beneficiaries, to seek judicial partition of the property and oust him as manager.

To alleviate these concerns, an estate planning attorney suggested that the father form a family limited partnership (FLP) funded with the trust-owned properties. In 1997, the FLP was formed, naming the father as the 99.8% general partner and giving the son a small Class A limited partnership (LP) interest. Within six months, the father transferred all his real property investments, appraised at roughly $6 million, to the FLP.

Over the next two years, he gifted Class B LP units to four trusts established for each of his grown children. Since the father had contributed all but his personal residence to the FLP, the FLP made disproportionate distributions, larger than those provided by the partnership agreement, to pay his living expenses and debts as well as gifts to his grandchildren. Then in 2008, the IRS assessed a $2.6 million deficiency, based on including the entire fair market value of the father's real estate holdings in his estate pursuant to IRC Section 2036(a), and the taxpayer petitioned the court for a determination of liability.

FLP asserts three business purposes, which the court rejected. The court also found several "bad facts" that indicated the FLP transfers were not bona fide sales. For example, the FLP failed to follow "even the most basic of partnership formalities," including keeping regular books and meetings, making proportionate distributions, and refraining from paying the father's personal expenses and the son's debts. The father also stood on "both sides of the transaction" in funding and forming the FLP, without any evidence that he held "arm's-length" negotiations with the other partners or created the FLP to fulfill anything but his own objectives. Based on the totality of these facts, the court concluded that the father did not have a legitimate, nontax reason for transferring his assets to the FLP, which were thus were not "bona fide" sales.

The court also considered the estate's claims that the father did not retain possession of the FLP assets during his lifetime—but the bad facts of its formation, funding, and operations undermined these arguments as well. Although the father retained some assets outside of the partnership, they were not enough to maintain his lifestyle or satisfy his future obligations, including payment of his estate taxes.

Lastly, the "partnership served primarily as a testamentary device through which [the father] would provide for his children at his death," the court held. Taking this feature in light of all the other factors in the case, the court included the full, fair market value of the FLP assets in the father's gross estate, pursuant to Section 2036, and denied the estate's petition to not pay the $2.6 million in tax deficiencies.

Despite 'Egregious' Theft of Trade Secrets, Damages Hard to Prove

***Pure Power Boot Camp v. Warrior Fitness Boot Camp*, 2011 WL 4035751 (S.D. N.Y.) (Sept. 12, 2011)**

While working as a Wall Street trader, the plaintiff got inspired to start her own physical fitness studio, based on a military boot camp. She opened the first Pure Power Boot Camp in New York City in 2003. The studio used military camouflage colors and obstacles fitted to the smaller, indoor facility, with flooring made of crushed rubber tires, separated by sand bags, and a running track overhead. Unlike other personal gymnasiums, the Boot Camp did not charge a membership fee but enlisted clients as "recruits" who signed up for returning "tours of duty," outfitting each in camouflage pants and a Pure Power t-shirt. The owner hired former marines as "drill instructors," including two who became her most trusted and sought-after employees.

The studio was an immediate success, and the owner planned to franchise the operations. She had each instructor sign an employment agreement, which contained nondisclosure, noncompete, and nonsolicitation provisions. She also registered the Pure Power trade dress, receiving a service mark consisting of drawings for an "exercise facility styled to look like a military boot camp training course."

The owner also opened a second studio just outside Manhattan. She offered one of her top two instructors the option to become a partner in this second studio—but he declined, saying he didn't have the money. In reality, he was planning his own military-themed gym with the other instructor. Backed by investments from their girlfriends, the two instructors leased a space just 15 blocks away from the Pure Power studio. They also stole documents from the owner's office and personal computer, including Pure Power's business plan, its startup and operations manuals, and its client list. They also destroyed a folder full of employment agreements—including their own.

The instructors used the stolen materials to launch their Warrior Fitness Boot Camp. They sent e-mails to Pure Power clients, providing detailed descriptions of Warrior Fitness and its classes that closely mirrored Pure Power's promotional materials. They also disparaged the owner of Pure Power to potential clients. In the spring of 2008, one of the instructors engaged in a "heated exchange" with the owner, prompting her to fire him; within two weeks, the second instructor quit, leaving the studio understaffed.

Three weeks later, the owner discovered the theft of her confidential materials and the plans to open Warrior Fitness by reading her former employees' personal e-mails, stored on the company's computer. In May 2008, she sued both instructors in state court, seeking a temporary restraining order against opening their competing business. The court denied the request, finding that the noncompetition agreement was unenforceable, but nevertheless ordered the defendants to return the stolen materials and alter the Warrior Fitness décor to remedy some of the trade dress issues.

The defendants then removed the action to federal court and sought to preclude the plaintiff from using their personal e-mails. The court agreed that the plaintiff's access of the employees' personal e-mail accounts, without their permission, violated the federal Stored Communications Act (18 U.S.C. § 2701 et. seq.) and ordered $4,000 in damages.

The parties subsequently agreed to a bench trial, at which the court considered the plaintiff's claims that the defendants breached their employment contracts and their common law duties of loyalty, infringed the plaintiff's trade dress, and committed torts of interfering with her prospective economic advantages and contracts.

After a review of the facts and evidence, the court found that the defendants clearly breached the nondisclosure provisions in their employment agreements. However, the court did not agree with the experts' valuations.

Misapplication of the law for breach of loyalty. The facts of the case clearly established the defendants breached their common law duty of loyalty to the plaintiff, for which she claimed a disgorgement of their profits during the damages period, or close to $2.4 million. Although New York law permitted the plaintiff to recover "an accounting of the disloyal employee's gain" through a profit disgorgement, the court said, it also required that she show the breach took place during the time of employment and was a "substantial factor" that contributed to the defendants' gain.

In this case, the defendants opened up their competing gym after the plaintiff terminated them, the court emphasized. Further, it also held that the documents stolen by the defendants were not a "substantial factor" enabling them to open Warrior Fitness, the court said. Instead, "it was the knowledge [they] gained as trainers at Pure Power that was key." Accordingly, it denied the plaintiff's requests for damages for breaches of loyalty.

At the same time, the court found the defendants liable under the New York "faithless servant" doctrine. This entitled the plaintiff to recover the compensation that she paid the defendants while they still worked for her and acted adversely to her business interests, which began in August 2007 with their theft of documents, the court found, and continued until approximately April 2008, when they were terminated. Accordingly, it ordered the defendants to forfeit a total of roughly $96,000 in salary between them. In addition, it ordered the defendants to pay an additional $150,000 in punitive damages for their "egregious" betrayals of the plaintiff's trust. The case is currently under appeal.

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COURT CASE UPDATES

Lost Profits Expert Relied Solely on New Business Plan

***Beijing Tong Ren Tang (USA) Corp. v. TRT USA Corp.*, 2011 U.S. Dist. LEXIS 135471 (Nov. 23, 2011)**

In 2005, the parties agreed that the defendant, an American corporation, would be the sole U.S. distributor for all products provided by the plaintiff, a recently formed subsidiary of a worldwide distributor of Chinese medicine located in Beijing. In addition, the distributor agreed to distribute "Gummy Bear" vitamins in China through an affiliate. Within two years the relationship soured, resulting in claims of unfair competition by the Beijing subsidiary and claims of fraud, breach of fiduciary duty, and trade secret violations by the American distributor.

After trial in 2010, a jury found in favor of the distributor, awarding $1.32 million for fraud and roughly $740,000 for breach of fiduciary duty, plus lesser amounts for the remaining counts. The jury also awarded just over $800,000 in punitive damages, and the Beijing company appealed.

Lost profits based on 'grandiose' projections. The court found a sufficient factual basis to support the jury's findings of fraud, but found that "evidentiary support for a lost profits claim was totally lacking." As a startup venture, the American distributor had no financial track record and thus no "concrete" foundation on which its expert could project lost profits with reasonable certainty.

In fact, "the projection of lost profits was made on the basis of a speculative, grandiose business plan that made assumptions that were totally unrealistic and unreasonably optimistic," the court held.

"While in some circumstances, projected profits in a business plan may provide enough certainty regarding damages to overcome the absence of a proven track record," the court said, "in this case, the profits projected by the [distributor's] business plan are too speculative to meet the legal standard of reasonable certainty." The distributor's expert did show roughly $141,000 in "unjust enrichment" damages, relating to payments for undelivered or unusable product, plus consulting and design fees. Since the factual evidence was sufficient to support these amounts, the court reduced the $1.32 million lost profits damages award to just over $141,000.

Plan to distribute vitamins is also flawed. At trial, the distributor's expert also tried to show lost profits damages relating to the parties' vitamin distribution agreement. But once again, he relied solely on a business plan by the distributor's affiliate, which forecast profits ranging from $13 million in Year 1 to over $22 million in Year 3. Since the American distributor owned 50% of its affiliate, the expert assumed it would be entitled to 50% of the projected profits. Further, since the vitamins were just one out of 50 products involved in the business plan, the expert assumed their products would comprise 1/50 of the total, or approximately $360,000 in lost profits.

However, like the distributor, the affiliate was an "unestablished company" without any financial track record, the court found. "In fact, it never executed its plan to sell Gummy Bear vitamins or any other products in China." The distributor's expert failed to explain how the business plan calculated the projected profits or why those figures were reliable. "He was not a credible witness," the court stated. As a result, it vacated most of the $740,000 award for breach of fiduciary duty, finding only $180,000 supported by "some evidence."

The court also found evidence that executives of the Beijing subsidiary had acted "reprehensibly" in their dealings with the American distributor. Without any evidence of the subsidiary's financial condition, let alone evidence of its parent company's net worth, the court found most of the punitive damages award unconstitutional, vacating all but $30,000 related to the wrongful conduct.