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Vectura Ltd. v. GlaxoSmithKline LLC

Reasonable royalty damages reflect built-in apportionment

How are damages measured in patent infringement cases? Valuation experts commonly use a reasonable royalty for the patented technology based on a hypothetical negotiation between the parties at the time of the infringement. When a royalty base is the "entire market value," the expert may need to apportion it among the product's infringing and noninfringing components.

However, when reasonable royalty damages are based on a sufficiently comparable license, apportionment is often unnecessary because it's already built into the expert's model. So said the U.S. Court of Appeals for the Federal Circuit in the recent case of *Vectura Ltd. v. GlaxoSmithKline LLC*.

Trial court ruling

In *Vectura*, the plaintiff successfully sued GlaxoSmithKline (GSK) for infringing its patent for production of "composite active particles" used in dry-powder inhalers. At trial, the jury awarded Vectura a royalty of 3% on a base of $2.99 billion in inhaler sales, for a total of nearly $90 million in damages.

The plaintiff's expert calculated damages based on a comparable license granted by Vectura to GSK in 2010. That license called for a tiered royalty structure: GSK agreed to pay Vectura 3% on its first 300 million British pounds in sales, and 2% on sales between 300 million and 500 million pounds. No royalties were owed on sales above 500 million pounds.

In determining a reasonable royalty for the litigated patent, the expert applied a 3% flat royalty rate to total sales of licensed products. But she didn't adopt a royalty cap similar to the one applied by the 2010 license, citing changed circumstances.

Federal Circuit opinion

On appeal, GSK challenged several aspects of the lower court's verdict, including alleged flaws in the royalty calculations proposed by the plaintiff's expert. Specifically, GSK claimed the expert failed to show that the patented substances drove consumer demand for the inhalers. Absent such a showing, GSK argued, the expert should have apportioned the royalty base to reflect the noninfringing components of the inhalers.

The Federal Circuit disagreed, noting that "when a sufficiently comparable license is used as the basis for determining the appropriate royalty, further apportionment may not necessarily be required." The reason is that damages based on a comparable license or negotiation may in some cases have "built-in apportionment."

The court found that the 2010 license was sufficiently comparable. Indeed, GSK's own expert testified that it was "a very close comparable, much closer than you ever find in a patent case." The evidence showed that the circumstances surrounding the 2010 license and the hypothetical negotiation in 2016 "were highly comparable and

Applying the relief from royalty method to value IP

A common method used to value intellectual property (IP) is the relief from royalty method. This market-based valuation technique assumes that, if the IP owner didn't own the asset being valued, it would have to license the asset from a third party. Thus, the IP's value is equal to the present value of the royalty payments from which the owner is relieved by virtue of owning the asset.

Applying this method is similar to valuing a business using the guideline transaction method (also known as the guideline M&A method). Under the relief from royalty method, the expert analyzes available market data for licenses of similar assets in similar industries, with similar territories and other characteristics. That data is used to derive a royalty rate that's applied to the owner's projected revenue attributable to the IP.

It's important to carefully analyze comparable licenses and adjust the royalty rate for differences between comparables and the hypothetical license of the subject IP. For example, adjustments may be necessary if a comparable license includes:

- Uncommon payment terms,
- Unusually short or long license periods,
- Royalties based on something other than revenue, or
- Several IP assets combined in a single license.

Adjustments may also be needed to reflect changes in economic conditions over time, as well as differing financial circumstances or market positions between the comparables and the subject IP.

The last step in the relief from royalty method is to calculate the present value of the projected royalty payments using an appropriate risk-adjusted discount rate. Higher risk equates with higher discount rates and lower IP values (and vice versa).

that principles of apportionment were effectively baked into the 2010 license."

GSK also challenged the expert's failure to use the 2010 license's royalty cap. However, the expert testified that, between 2010 and the time of the hypothetical negotiation, the company's circumstances had changed. For example, the business now had more leverage because of the success of the inhalers. And the Federal Circuit found that the jury was entitled to accept the expert's explanation as a viable reason to discard the royalty cap.

Key takeaways

Calculating damages in patent infringement cases can be challenging — particularly when the product contains noninfringing components. This decision illustrates the importance, when calculating reasonable royalty damages, of carefully analyzing comparable licenses or negotiations used to support the royalty rate and royalty base. By showing that apportionment was "baked into" its damages model, a plaintiff can avoid further apportionment and enhance its recovery. ■

Use a multifaceted approach to tackle postacquisition disputes

Mergers and acquisitions (M&As) sometimes fail to meet the parties' expectations. Examples of potential sticking points include contractual purchase price adjustments, representations and warranties, earnout provisions, and alleged misrepresentations by the seller. Determining liability and calculating damages in these disputes may involve a combination of business valuation, forensic accounting and economic analysis techniques.

Scrutinize seller representations

Some of the most challenging disputes involve "benefit of the bargain" claims. Essentially, this is when the buyer argues that the value of the business is less than what the seller represented it to be.

To illustrate, suppose ABC Co. acquires XYZ Co. for five times earnings before interest, taxes, depreciation and amortization (EBITDA). XYZ's EBITDA for the 12-month period ending on the closing date is $10 million, so the purchase price is $50 million (5 times $10 million).

After closing, ABC alleges that XYZ's financial statements contained material misrepresentations under U.S. Generally Accepted Accounting Principles (GAAP). ABC alleges that XYZ overstated its EBITDA by $1.5 million (or 15%). As a result, it bargained for a business worth $50 million but received a business worth only $42.5 million (5 times $8.5 million). If the allegations in this hypothetical example are proven true, it seems clear that the buyer was damaged to the tune of $7.5 million by XYZ's inaccurate financial statements.

A forensic accountant can serve as an expert on whether the company's financial statements complied with GAAP. If the statements don't comply, the expert can also identify where the errors, omissions or manipulation happened — and how they would have affected EBITDA and the purchase price.

Consider confounding factors

Many postacquisition disputes are less clear-cut, however. Suppose, for example, that XYZ's financial statements are accurate, but it loses a major customer that contributes $1.5 million to the company's annual EBITDA just before closing and fails to disclose this development to the buyer. On the one hand, ABC might argue that the customer loss reduces the company's EBITDA to $8.5 million and, therefore, reduces its value to $42.5 million.

On the other hand, XYZ might argue that this type of customer turnover is an ordinary part of its business and, as of the closing date, management was in negotiations with prospective new customers intended to replace the lost revenue. XYZ's damages expert might present forecasts and other evidence

showing that normal customer attrition isn't expected to hurt the company's future financial performance or market value.

Often, the company's actual performance is relevant. If XYZ can show that the company's postacquisition performance was in line with ABC's expectations, it's arguable that the buyer received the benefit of its bargain, despite the loss of a major customer.

Evaluate causation

Another important issue is causation. Even if XYZ is shown to have made misrepresentations or breached the purchase agreement, it may be able to rebut ABC's causation arguments with evidence that the diminution in the company's value was caused by external factors, rather than the alleged wrongdoing by the seller. Examples of outside conditions that may depress a company's value postacquisition include unanticipated adverse economic conditions, changes in government regulations, new competitors or technology, or the loss of a key employee.

In fact, if XYZ can convince the court that ABC failed to meet its burden of proving causation, ABC may not have a case for damages at all. Such evidence may require analysis and testimony by an industry expert or economist, in addition to the work of a business valuation specialist.

Assemble your team

In postacquisition disputes, it's critical to enlist a team of financial experts to analyze issues of liability, causation and damages. Whether you represent the buyer or the seller, these experts can provide objective, market-based estimates of postacquisition damages. ■

Financial experts play a key role in employment discrimination cases

Employment discrimination claims continue to be a major concern for employers today. These claims may be based on race, color, national origin, sex (including pregnancy, gender identity and sexual orientation), religion, disability or genetic information. Financial experts can not only help the parties calculate and evaluate damages, but also play a key role in proving or disproving discrimination.

Possible remedies

The remedies available for employment discrimination depend on the relevant statute under which the claim is brought. However, they generally include:

- Back pay,
- Promotion,
- Reinstatement,
- Front pay,
- Reasonable accommodation, and/or
- Other relief designed to make the claimant "whole" again.

Financial experts are often used to determine front-pay damages. This estimates a victim's lost compensation and benefits from the date of the claim through a future date when the victim will reach, or is expected to reach, the compensation level that would have been achieved absent the wrongful termination or other discriminatory act. Damages are based on various factors, such as age, race, education, wages, tenure and industry.

Other recoverable losses

Additionally, a wronged employee may be eligible for attorneys' fees, expert witness fees and court

costs. In cases involving intentional discrimination, claimants may be entitled to compensatory damages, including actual and future monetary losses, as well as nonpecuniary losses, such as emotional distress. Punitive damages may also be available if the claimant demonstrates that the employer acted with malice or reckless indifference to federally protected rights.

Under 42 U.S.C. Section 1981a(b), total compensatory and punitive damages are capped in cases of intentional discrimination. The cap is based on the number of employees the employer had in each of 20 or more calendar weeks in the current or preceding calendar year. It tops out at $300,000 for employers with more than 500 employees.

In cases involving either intentional age- or sex-based wage discrimination, victims can't recover either compensatory or punitive damages. But they may be entitled to liquidated damages that may be equal to the amount of back pay awarded the victim.

Adverse treatment vs. disparate impact

In general, there are two categories of discrimination. First, *adverse treatment* happens when members of a protected class are *intentionally* treated differently than other employees. The classic example is refusing to hire workers of color because the employer feels that they're less capable or that customers won't want to deal with them.

The second category is *disparate impact*. This term refers to *unintentional* discrimination that can result when an ostensibly neutral employment policy or practice disproportionately affects members of a protected group.

Statistical analysis can be particularly helpful in disparate impact cases. For instance, suppose an employer screens applicants using a test that disproportionately excludes older workers. A group of workers subsequently sues for age discrimination based on the test's disparate impact. In response, the employer hires an expert who conducts regression analyses to study the correlations between various factors and hiring rates. Despite finding a positive correlation between age and failing the employment test, the expert finds a *stronger* correlation between test failure and lack of computer skills. The employer uses this information to show that the test had a legitimate, nondiscriminatory business purpose.

> ***In cases involving intentional discrimination, claimants may be entitled to compensatory damages and nonpecuniary losses.***

Involve experts early

Ideally, employers should consult experts before they adopt a particular employment practice or lay off workers. Being proactive helps evaluate an employer's exposure to employment discrimination liability. In the event of litigation, however, an expert can provide critical analysis and testimony to help the parties objectively evaluate the facts of a case. ■

Opinion vs. legal conclusion: Has your expert crossed the line?

The line between *permissible* expert opinion and *impermissible* legal or factual conclusions can sometimes be blurry under the Federal Rules of Evidence (FRE). It's critical for lawyers and their expert witnesses to understand the distinction between an opinion that embraces an ultimate issue and one that offers a legal conclusion.

FRE Rule 704 states, "An opinion is not objectionable just because it embraces an ultimate issue." The committee notes to Rule 704 provide a helpful example: In a proceeding to determine the validity of a will, an expert can express an opinion on whether the will maker had "sufficient mental capacity to know the nature and extent of his property and the natural objects of his bounty and to formulate a rational scheme of distribution." But the expert would impermissibly cross the line by opining whether the will maker had the "capacity to make a will."

Applying the rule in the real world

A recent Delaware Chancery Court decision provides another example of the subtle differences between permissible expert opinions and impermissible legal conclusions. *In re Columbia Pipeline Group, Inc. Merger Litigation* involved claims against an energy company and its officers for alleged breaches of fiduciary duty related to a merger. (Note that the Delaware Rules of Evidence closely track the FRE.)

The defendants submitted a report by a financial expert on merger and acquisition negotiations. But the court disallowed several aspects of his report because they offered conclusions of law or specific factual findings.

In one example, the expert opined on whether fiduciaries' actions were "reasonable and consistent with negotiation best practices." The court explained that the test for measuring a breach of fiduciary duty is whether the officers' conduct "fell outside the range of reasonableness." Here, it was permissible for the expert to opine on whether the actions in question were consistent with negotiation best practices. However, by going beyond that to provide an opinion on their reasonableness, the expert was "expressing a backdoor legal opinion."

The court also suggested that it would be more likely to exclude expert testimony for invading the province of the judge or jury if it isn't supported by data and rigorous analysis. The court seemed skeptical about testimony that simply offers the expert's "views based on his thinking and judgment."

Toeing the line

FRE Rule 702 permits expert opinion testimony when, among other things, the expert's "specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue." However, experts aren't permitted to usurp the court's role by offering legal conclusions or specific factual findings. These tasks are reserved for the judge and jury. ■

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