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DECOSIMO ADVISORY REVIEW

Court Vacates \$1.3 Billion
Damages Verdict in
Oracle v. SAP

Case Study: How
Credible Expert Witness
Testimony Ended
Litigation

Tennessee Appeals Court
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Case Study: How Credible Expert Witness Testimony Ended Litigation

Mike Costello, Principal, and Sharon Hamrick, Director

In February 2006, ABC Healthcare signed a contract to outsource to XYZ Company certain “denial management services” for ABC’s five hospitals. That was the beginning of a five-year saga that involved a failed business relationship, a secret marriage, fabricated financial records, alleged damages of \$30 million, and a dramatic climax at a default judgment hearing.

The Decosimo Advisory Services litigation support team was hired by ABC to assist in clarifying the accounting, business, and financial issues in the case, and our journey from big boxes of documents to credible expert reports is a great example of how our litigation support team works together to develop and report opinions in complex litigation projects.

The Failed Business Relationship - ABC Healthcare was the defendant in a lawsuit filed by revenue cycle management firm XYZ Billing. XYZ Billing was seeking several million dollars in damages from ABC Healthcare for breaching the exclusivity clause and other aspects of its three-year contract to provide denial management services for ABC’s hospitals.

A Secret Marriage - Central to this case was the internally inconsistent and grammatically incomplete contract provision that read, “Termination. Either Party may terminate this Agreement upon one-hundred twenty (180) days’ prior written notice to the other Party. Should [ABC] terminate this agreement within the initial term, then a lump sum payment of \$50,000 and associated software license fee paid by [XYZ] to a third party.”

Most important to the litigation was the phrase regarding the “associated software license fee paid by XYZ to a third party.” The third-party to whom XYZ allegedly paid such fees turned out to be a related company owned by the husband of XYZ’s CEO, and the amount of the fee was far from clear.

Fabricated Financial Records - Subsequent to ABC’s notice of termination of the contract, XYZ billed ABC for \$137,500 in license fees paid to a third party. Forensic accountants from Decosimo Advisory Services examined the financial records of XYZ, and there was no evidence supporting the actual payment of

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DECOSIMO EVENTS

February 22, 2012 7:45 AM - 11:00 AM
2012 EMERGING BUSINESS SYMPOSIUM
 Find out what every business owner and CEO should know about utilizing social media, conducting interviews and making offers, and improving cash flow.
Please visit www.decosimo.com/2012symposium to learn more.
 Tallan Financial Center, Suite 216 Chattanooga, TN

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February 8, 2012 7:00 AM - 7:00 PM
2012 ATLANTA ACG CAPITAL CONNECTION
 Association for Corporate Growth Atlanta Atlanta, GA

February 23, 2012 5:15 PM - 8:00 PM
7TH ANNUAL CWLI LEADERSHIP ADDRESS
 Chattanooga Women’s Leadership Institute Chattanooga, TN

March 21, 2012 9:30 AM - 5:00 PM
2012 CHATTANOOGA BUSINESS EXPO
 Chattanooga Chamber of Commerce Chattanooga, TN

April 3-4, 2012 2-Day Conference
4TH ANNUAL MASTERING DUE DILIGENCE FOR ALTERNATIVE INVESTMENTS
 Financial Research Associates New York, NY

SPEAKER’S BUREAU

February 23, 2012 3:00 PM - 4:00 PM
CASE STUDIES: HOW HEALTHCARE FRAUD OCCURS AND HOW TO PREVENT AND DETECT IT
Mike Costello
 Dixie Institute 2012, Georgia Chapter of HFMA Greensboro, GA

March 9, 2012 9:15 AM - 10:15 AM
CASH FLOW AND FINANCING: DETERMINING RESERVES FOR BAD DEBTS
Mike Costello and Tom Decosimo
 Annual Conference, Community Financial Services Association Nassau, Bahamas

these fees. Later, XYZ alleged damages in excess of \$1 million for software license fees paid to a third party. Again, analysis of XYZ's financial records by forensic accountants from the DAS litigation team found no evidence that \$1 million in fees had been paid.

In an interesting twist, deposition testimony revealed that at least a portion of the payments to the "third party" were payments on a \$600,000 note owed by XYZ that was not recorded on the balance sheet of XYZ. The deponent testified that XYZ did not want to show such a large liability because its bank might stop making loans if the true financial condition of XYZ were known. We agreed with that part of the plaintiff's testimony.

The husband, who owned the "third party" software company, testified that his company did not bill XYZ for services in a timely manner, because sending bills to XYZ would generate payables that would further compromise XYZ's ability to borrow.

Mike Costello, the financial and forensic accounting expert from DAS who led the project team for this engagement, was able to address these and other issues with the financial records of XYZ and successfully explain them in a clear and straightforward manner for the court.

Alleged Damages of \$30 Million - XYZ later presented calculations presenting financial damages of \$30 million resulting from the alleged breach of the contract. This calculation was predicated on the alleged breach of the exclusivity clause for collection efforts of denied claims from non-governmental third party payers as part of supplemental disclosures. The plaintiff's calculations were not the work of a financial expert and were submitted to the court over two months after the close of fact discovery.

David Cranford, DAS Healthcare Consultant, testified that the exclusivity clause was not breached and that the revenue cycle management for ABC was operating effectively based on healthcare industry standards. He stated, "In my expert opinion, the services provided to ABC by other vendors could not reasonably be viewed as improperly competing or overlapping with those provided by XYZ, in light of the customs and practices of the healthcare industry."

Costello testified that the lost profits damage calculation was not plausible. He stated, "In sum, calculation of lost profits is not applicable in this case because the parties agreed to a termination fee of \$50,000 plus reimbursement for software

fees. There are serious issues with the ability to determine the amount, if any, of associated software license fees paid by XYZ to a third party."

Dramatic Ending - ABC refuted XYZ's allegations and refused to cave to the plaintiff's demands for settlement. By the end of the proceedings, ABC was awarded partial summary judgment, and both of the plaintiff's attorneys were referred to the Board of Professional Responsibility. In addition, lead counsel for the plaintiff was referred to the state bar association for a "psychological and competency evaluation." Eventually, the defendant, ABC, was awarded \$1.5 million in fees.

Morals of the Story -

- First and foremost, capable legal counsel is a must in complex commercial litigation.
- If there are sound reasons to have exclusivity clauses in contracts, companies should have processes to routinely review compliance.
- Before entering a contract for a significant length of time and at a significant potential cost with an unfamiliar vendor, a company would be well-advised to investigate that vendor and to have the contract reviewed by its own legal advisor.
- Before filing litigation alleging lost profits or other financial damages, plaintiffs should consider consulting with a financial damages expert to evaluate the evidence available to substantiate those damages.
- It is not enough to believe you've been wronged - Per the judge in this case, "Although your client may have believed...somebody was not being fair to them, it's one thing to believe and another thing to be able to prove it. And there is no proof."
- Complicated financial damages such as lost profits damages are most often best calculated by financial experts with the experience and knowledge to make such calculations.
- The legal team and the financial experts should work closely to ensure that all relevant information is communicated in a timely manner.

Please contact DAS when dealing with complex litigation. DAS litigation support professionals can provide the technical skills necessary for successful financial expert testimony. ■

Quality Evidence is Key in Proving Economic Damages

Uniloc v. Microsoft

Andy Lipscomb, Manager

Federal courts have recently become increasingly strict in the quality of evidence they require to prove economic damages. One recent case that illustrates this point is *Uniloc v. Microsoft*, a patent infringement case. While the case was first filed in 2003, it remains under litigation to this day, and the aspect on which this article will be focusing is a 2011 ruling at the appellate court level.

Background

The patent in question involves product activation, the copy-protection system used in many software programs. Specifically, the software is sold with a key code that the user enters during installation. The program then sends this information to the seller's computer, which applies various computations to it and returns a license key. When the program runs, it applies the same computations to generate its own version of the key, and will only run if they match. This allows the seller to issue only a certain number of licenses per sale. In some cases, ID codes from hardware components are also used in generating the license code; this means that the program will only run on the specific machine where it was activated.

Case Summary

This system was invented by an Australian company (Uniloc) and patented in 1992 (in Australia) and 1996 (in the USA). The dispute centered on whether the version that Microsoft invented for Word 2000 and Windows XP was close enough to what was described in the patent to require a license. This issue has not yet been conclusively answered.

The secondary question, one that has greater potential effects outside of the case at hand, is the question of damages. In other words, if Microsoft did infringe on the patent, how much should they be required to pay? The legal standard is a "reasonable royalty"—in other words, what hypothetical willing parties would have negotiated. Since there was no negotiation involved, this requires various analytical techniques.

Uniloc's expert used what the court described as a traditional "rule of thumb" known as the 25% rule. This rule suggests that 25% of the revenue from a

product may be attributed to its intellectual property. The expert valued a key (on a standalone basis, considering the lowest value of any product on which it was used) at \$10, thus setting the royalty at \$2.50 and the total damages at \$565 million. As a test of reasonableness, he compared that figure to the total revenue from all sales of the infringing products, and found it to be 2.9% (which he deemed reasonable).

Appellate Court Ruling

The appellate court (the Federal Circuit, which hears all appeals of patent cases) ruled all of that evidence to be useless. Specifically, the court described the 25% rule as "fundamentally flawed" in that it does not take into account any of the unique negotiating factors that may exist in a particular case. The court also pointed out that the entire market rule only makes sense when the feature covered by the patent contributes to demand for the product, which it ruled was not the case here.

It is important to note that the jury did not actually award the value the expert proposed as a reasonable royalty, but the appeals court ruled that even allowing them to hear that testimony was enough to throw out their verdict altogether.

This verdict throws a great deal of uncertainty into the field of patent infringement damages. While the court clearly wants to see an analysis more closely tied to the specific case, its decision gave no guidance on how to do so. We can expect continued controversy in this area for some time. ■



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Rick Stooksbury

Tennessee Appeals Court Addresses Lost Profits Damages

Sharon Hamrick, Director, Paul Henry, Analyst, and Brent McDade, Managing Director

In a 2004 opinion on *Waggoner Motors v. Waverly Church of Christ*, the Tennessee Appeals Court included a lengthy discussion on the concept of lost profits damages, the calculation of such damages and the use of experts to make those calculations.

Background

In the summer of 1997, Waverly Church of Christ (the Church), acting as its own general contractor, was constructing a 9,000-square-foot general purpose building located behind the existing church building. The Church hired a painter to spray paint the steel beams supporting the roof. The painter testified that despite his concerns that overspray would reach the cars on the nearby lot, the Church instructed him to proceed. At some point that afternoon, an employee of Waggoner Motors, Inc. (Waggoner), the car dealership located next door to the Church, informed the Church that the cars at the dealership were being covered by fine droplets of paint.

Approximately one month after receiving assurance from the Church's insurance company that the affected cars would be cleaned and detailed, Mr. Waggoner received permission from both Chrysler Insurance and Cincinnati Insurance to have the automobiles cleaned and detailed (which was successful to varying degrees) in order to sell them. All of the affected automobiles were sold by the end of 1997.

Immediately after the overspray incident occurred, Mr. Waggoner informed Chrysler's Dealer Relations Manager that paint overspray had damaged the lot's entire fleet of vehicles. An unintended consequence of this telephone call was the triggering of a review by Chrysler of the dealership's finances. Chrysler concluded that the level of floor plan financing in place at Waggoner Motors was not supported by the dealership's level of sales. Chrysler reduced the amount of floor plan financing available to the dealership, in turn reducing the number of cars the dealership was able to purchase using Chrysler's low cost dealer financing. This resulted in the owners of the dealership having to borrow at higher rates from other capital providers in order to purchase cars at auction.

Waggoner filed suit against the Church, claiming its negligence regarding the spray painting resulted in financial damages to the dealership, including lost profits.

Case Summary (Primary Issues Raised)

A portion of Waggoner's case was predicated on the contention that the damage sustained to the dealership's vehicles caused Chrysler to reduce the dealership's floor plan financing. Waggoner asserted that the reduction in financing had "devastating, long-term effects" on the dealership's ability to buy and sell new and used vehicles and, thus, to make a profit.

The Church argued that an employer of an independent contractor was not liable for damages caused by the contractor's negligence. In addition, it argued that Waggoner had "serious financial problems" prior to the overspray incident and implied that any reduction in financing by Chrysler was the direct result of these past financial issues. Additionally, the Church claimed the financial impact of the damage caused by the overspray to the dealership's profits was both minor and brief.

During the trial, the plaintiff's expert (an economist) claimed that Waggoner had suffered approximately \$718,000 in damages as a result of the paint overspray (\$509,000 in lost profits and \$209,000 in other damages). By comparing Waggoner's financial performance following the incident with its performance during the three full calendar years preceding the incident, the plaintiff's expert testified that the dealership had experienced lost profits with a present value of \$509,000. The expert also testified that Waggoner would continue to be damaged by the overspray incident until profits returned to their three-year baseline average and the dealership's floor plan financing was restored to levels consistent with those experienced prior to the incident.

The defense expert (a CPA employed by a firm experienced in calculating economic damages) testified that the automobile dealership's financial performance had steadily declined in the two years immediately preceding the overspray incident and that the rate of loss during the six months leading up to the incident was greater than the rate of loss over the previous two full calendar years. The expert further testified that the financial records of the company did not show any loss of income attributable to the overspray incident after November 1997. Ultimately, the defense expert asserted that Waggoner's lost profits did not exceed \$44,000.

Trial Court Ruling

The trial court found that the Church violated its duty to properly supervise the painting of the new building and that this violation directly resulted in damage to the dealership's vehicles. Moreover, the court found that it was possible that

Court Vacates \$1.3 Billion Damages Verdict in Oracle v. SAP

Andrew Gardner, Senior Analyst

The 9th Circuit recently vacated a \$1.3 billion award to Oracle for SAP's patent infringement on Oracle's software. Judge Phyllis Hamilton replaced one of the largest-ever awards based on patent infringement with a much smaller award of \$272 million. Judge Hamilton found issue with the jury's original decision, saying

that it was based on speculative hypotheses of the plaintiff's expert that did not rely on objective analysis.

Background

Prior to the November 2010 jury trial, both parties agreed that SAP infringed on Oracle's patent, so the trial focused on the amount of damages. Oracle's expert estimated damages were

between \$881 million and \$2.7 billion. (The expert based this range on what he believed to be the "negotiation perspectives" of the parties assuming they entered into a licensing agreement for the software. Damages were based on the decline in the value of the patent resulting from the loss of the ability to derive revenue through licensing fee.) The defendant's expert based his damages opinion on the lost profits of Oracle and the profits gained by SAP that resulted from customers who left Oracle's applications and services and/or purchased SAP's infringing applications and services. The jury awarded \$1.3 billion to Oracle, based on the testimony of the plaintiff's expert.

New Trial

SAP moved for a new bench trial, claiming that the damages awarded by the jury were "grossly excessive," "unduly speculative," and had "no objective foundation."

As evidence for the Oracle expert's damages, various Oracle executives testified as to how they would have approached a licensing agreement with competitor SAP. The court found that Oracle's case for damages was flawed for several reasons, including:

- Oracle's executives testified "that it had never [licensed] the works to third parties...[and] offered no evidence...such as past licensing history or a plaintiff's previous licensing practices."
- Oracle's evidence did not "establish an objective non-speculative license price...An objective, non-speculative license price is established through objective evidence of benchmark transactions, such as licenses previously negotiated for comparable use of the infringed work, and benchmark licenses for comparable uses of comparable works."
- Oracle executives testified "that Oracle has never granted a comparable license that would permit a competitor to use Oracle software to compete for Oracle's customers, and that such a license would be 'unique' and 'unprecedented.' Nor were the Oracle executives aware of any analogous situations in which any other company had licensed software to or from a competitor to provide support services."
- The plaintiff's and defendant's experts "agreed that no benchmark licenses exist, and the evidence Oracle did present proved that the parties would never have agreed to a license."
- The court would have expected the damages analysis presented by the plaintiff's expert to present "objective evidence of what a willing buyer would have reasonably paid, not simply what Oracle would have demanded. However, Oracle failed to present such objective, non-speculative evidence."

The court further stated that:

Absent evidence of benchmarks, Oracle cannot recover a lost license fee award, because any such award would be based on a subjective, not an objective, analysis of fair market value. Objective evidence is necessary to price a hypothetical license because the hypothetical license is simply a construct designed to help calculate actual damages suffered as a result of the infringement (the measure of damages under the copyright statute). The amount of the hypothetical license must be based on the actual use the defendant made of the work, not simply the highest use for which the plaintiff might license.

Thus, the court found that Oracle could not be entitled to damages based upon

Court Vacates \$1.3 Billion Damages Verdict in Oracle v. SAP

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hypothetical license fees (the loss in value of the patent). Consequently, the court granted a new trial where “Oracle must be allowed to recover actual damages in the form of lost profits/infringer’s profits.”

New Expert Opinions

The defendant’s expert opined that the lost profits caused by SAP were \$19.3 million and the infringer’s profits were \$8.7 million (totaling \$28 million). The plaintiff’s expert calculated \$120.7 million in lost profits to Oracle and \$288 million in infringer’s profits for SAP (totaling \$408.7 million). The plaintiff’s expert also calculated under an alternative scenario \$36 million in lost profits and \$236 million in infringer’s profits (totaling \$272 million).

The court rejected the first calculation presented by the plaintiff’s expert, as it represented Oracle’s lost profits through 2015 (“to reflect the ongoing impact” of the infringement). The second calculation of the plaintiff’s expert, however, ended damages in October 2008 when SAP wound down the infringing operation. The remaining difference between the experts was which customers of SAP were customers as a result of the infringing activities.

Since the court found that the opinion of SAP’s expert was based largely on inadmissible evidence, the court found that the “maximum amount [of damages] sustainable by the proof” was the \$272 million calculated by Oracle’s expert and vacated the jury’s original damages of \$1.3 billion.

Commentary

We find it interesting that the court took issue with the testimony of the plaintiff’s expert due to a failure to consider both the hypothetical buyer and seller in the negotiation. This objection has been raised by judges and other users of business valuation opinions for decades. The need to consider the economics of the hypothetical transaction from both sides (from the point of view of both buyer and seller) has been part of the business valuation body of knowledge since Revenue Ruling 59-60 and before.

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Tennessee Appeals Court Addresses Lost Profits Damages

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the overspray incident led to Chrysler's decision to reduce Waggoner's floor plan financing.

The trial court expressed displeasure with the convoluted testimony given by both experts. After instructing the parties to present additional evidence regarding damages resulting from the reduced level of financing, the trial court awarded Waggoner approximately \$345,000 in damages and \$11,000 in discretionary costs. The Church appealed the trial court's ruling, arguing that the court was incorrect in finding that it was liable for the damages caused by the overspray. The Church and Waggoner both appealed the amount of damages and discretionary costs awarded.

Appellate Court Ruling

The appellate court concluded that the Church was responsible for both the damage inflicted on the vehicles parked in Waggoner's lot and for the business injuries suffered as a result of the overspray.

Regarding the trial court's decision to award damages for lost profits, the Church argued that Waggoner was not entitled to damages for lost profits because it was not a profitable business at the time the incident occurred. The appellate court ruled that even though it did not agree with the amount of damages awarded by the trial court, the Church's argument that non-profitable companies (or firms with no history of profits) are not entitled to lost profit damages is flawed. "To hold otherwise would produce a particularly egregious result in cases like this one in which the injured party is hovering around the break-even point. Were we to follow the Church's logic, Waggoner could recover if the overspray occurred during one of its good years but not if the injury occurred during one of its down years."

The appellate court agreed with the Church that the trial court erred in the amount of damages it awarded Waggoner and adjusted the amount downward to award lost profit damages of approximately \$86,000 and discretionary costs of \$8,500.

The appellate court discussed in considerable detail its reasoning and conclusions regarding the calculation of lost profits damages beyond the question of lost profits for a marginally-profitable or unprofitable company.

Other significant points in its opinion include:

- The standard of reasonable certainty applies chiefly to the evidence regarding the existence of damages, and the amount of damages does not have to be proven with exactness or absolute precision. It states that it is more important that an injured party not be deprived of just compensation merely because

- the extent or amount of damages suffered cannot be proven with certainty.
- Anticipated future profits can reasonably be based upon past performance, taking into consideration other factors which may have affected past performance as well as future profits.
- Damages awards are limited to "net profits", not gross revenues or gross profits. Net profits must take into account the costs of generating the lost revenue.
- Overhead expenses that would have been incurred regardless of the wrongful act should not be deducted from gross revenues.
- The burden is on the plaintiff to prove not only the revenues lost, but also the expenses associated with the lost revenues.
- The opinion addresses the determination of the appropriate past time period to be used for calculating those anticipated future profits.
- Lost profits damages can be established by expert testimony, calculated using both objective facts and data, and established and accepted methodology, applied in a proper manner. A lack of any of these factors will result in flawed results. In its opinion, the appellate court criticized the plaintiff's expert's methodology as so flawed that it resulted in a calculation of lost profits which was speculative and therefore not a satisfactory basis for an award of damages.

Tennessee has not historically had a rich body of case law from which to draw in lost profits damages cases, and this case provides some much-appreciated commentary from the appellate court on how to evaluate lost profits claims. Its conclusions emphasize the importance of knowledgeable experts who use reliable data to apply reasonable and accepted methodologies. Both the trial court and the appeals court were presented with evidence that was in part economically sound and in part flawed. Both courts attempted to distinguish one from the other, and we at DAS are encouraged by the effort the courts made to examine the underlying economics of the claims.

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