

# valuation & litigation briefing

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I've got  
a **secret!**

Calculating damages in  
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# I've got a secret!

## Calculating damages in trade secret cases

Intellectual property rights typically allow owners to distribute their products, inventions, designs and other work freely with exclusive rights to enjoy the economic fruits of their labor, at least for a specified period. But what rights are associated with trade secrets? Although classified as “intellectual property,” they’re conceptually and legally different from other types of intangible assets.

While patents, copyrights and trademarks are, by definition, intended to protect creations that are shared with the public, trade secrets — as their name suggests — aren’t intended for public consumption. They include a broad range of intellectual capital, including customer lists, formulas, designs, manufacturing processes, recipes, computer programs and even marketing plans.

### Keeping a lid on trade secrets

The keys to trade secret protection for owners are 1) recognizing that the protected information has economic value, and 2) making a reasonable effort to keep it confidential and prevent unauthorized use.

Owners are protected for an unlimited time against parties who acquire their trade secrets unlawfully — through industrial espionage or breach of a confidentiality agreement, for example. But they have no rights against someone who discovers their secrets through legitimate means, such as reverse engineering.

A patent or copyright, on the other hand, has a limited duration but offers the owner greater protection. It prevents others from using the owner’s creation regardless of how they learn about it.

Trade secret damages also are conceptually different from damages arising from other types of intellectual property infringement, though the damages measure is often similar. For instance, the rights and remedies associated with patents and copyrights are designed to encourage and reward creativity. Those who contribute their ideas to the body of public knowledge are

rewarded with exclusive rights to profit from their work for a limited period of time.

But trade secret damages focus on the economic value of the competitive advantage those secrets provide. Thus, trade secret damages are usually limited in duration to the time it would have taken the defendant to duplicate the trade secret through legitimate means.

### Assessing the damage

Damage calculations in trade secret cases are similar in many ways to those in other types of intellectual property infringement cases. Common measures of damages include the plaintiff’s lost profits, the defendant’s unjust gains or a reasonable royalty.

One challenge specific to trade secret cases is that, while patents, copyrights and trademarks are subject to federal law, trade secrets are subject to state law. Most states have adopted the Uniform Trade Secrets Act in some form, but statutory and case law can still vary significantly from state to state. It’s critical, therefore, to determine which state law applies and make sure your damages experts are familiar with it.

*Trade secret damages focus on the economic value of the competitive advantage those secrets provide.*

Some — but not all — states allow plaintiffs to recover punitive damages, prejudgment interest and attorneys’ fees. Further, state laws can vary dramatically on the combination of compensatory damages available.

For example, the plaintiff’s lost profits, the defendant’s gained profits and reasonable royalty damages are often treated as mutually exclusive alternatives. But in some states, circumstances may arise in which a plaintiff can recover under more than one theory.

Also, misappropriation of a trade secret often involves breach of a contract or an implied duty of confidentiality, which in some cases may result in higher damages than a trade secrets claim alone.

### Factoring in the difficulties

One factor that makes calculating trade secret damages difficult is the frequently amorphous nature of trade secrets. Patents and copyrights generally involve a discrete product or invention. An infringer gains an unfair economic advantage by claiming the plaintiff's product as its own or by incorporating the plaintiff's work into its own products. But what if the defendant wrongfully obtains the plaintiff's customer list or marketing plan?

If a defendant uses the plaintiff's customer list to compete directly with the plaintiff, it would seem appropriate to measure damages based on the plaintiff's lost profits or the defendant's profits.

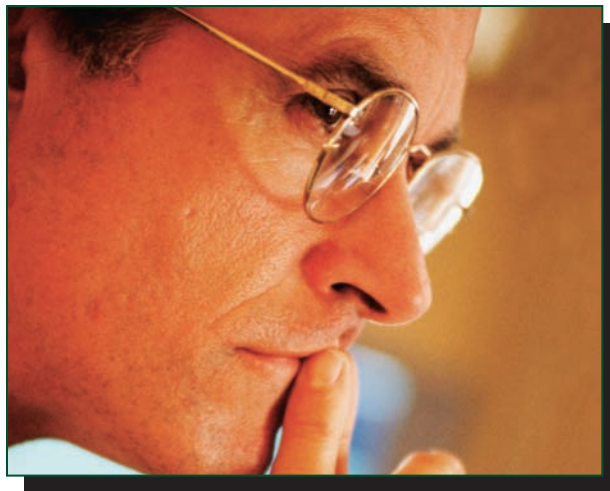
Now suppose the defendant steals the plaintiff's customer list — but uses it to promote a noncompetitive product. In this case, the plaintiff might not lose any profits at all as a result of the infringement. This would weaken the argument that the defendant's profits came at the plaintiff's expense. Under these circumstances, a reasonable royalty might be a more appropriate measure of damages.

Other potential damages, depending on applicable state law, include the plaintiff's costs of developing the trade secret, damage to the value of the plaintiff's business and "head start" damages — that is, the time and costs the defendant saved by not having to develop the trade secret on its own.

### Using defensive tactics

Defending against trade secret damages can also be a challenge. Assuming that the plaintiff has established liability, the defendant can attempt to minimize its exposure by offering evidence that the plaintiff's damages were caused by factors other than the defendant's conduct.

These may include economic conditions or the plaintiff's failure to exploit the trade secret effectively. In other words, the plaintiff would have suffered the same



losses whether the defendant misappropriated its trade secrets or not.

The defendant also may be able to reduce its damages by the amount of expenses it incurred in making use of an allegedly misappropriated trade secret.

A potential defense strategy when the plaintiff seeks to recover the defendant's profits is to demonstrate that a portion of those profits is attributable to the defendant's own efforts or to the noninfringing qualities of its product, rather than to the trade secret.

Distinguishing between recoverable and nonrecoverable profits can be a difficult task requiring sophisticated economic analysis. In some cases, defendants may be better served by focusing their efforts on limiting the damages accounting period.

For example, they may demonstrate the amount of time it would have taken to reverse engineer a product or otherwise develop the trade secret through legitimate means. But keep in mind that some state laws permit plaintiffs to recover damages extending beyond this period.

### Formulating a winning strategy

Calculating damages in trade secret cases is similar to calculating damages in other cases involving intellectual property infringement. But the process is complicated by state law requirements and the nature of some types of trade secrets. By working closely with damages experts, business owners and attorneys can formulate winning strategies. □

# Rules of engagement

## How CPA ethics rules affect your experts

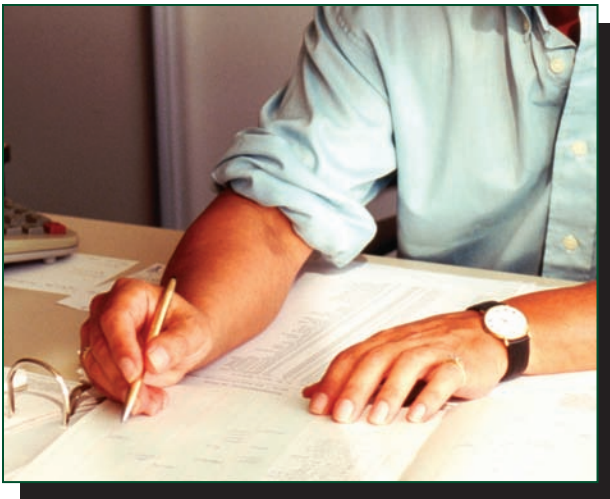
**R**ule 101 of the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct requires CPAs to “be independent in the performance of professional services.” AICPA Interpretation 101-3, *Performance of Nonattest Services*, describes several nonattest services that, if performed for an attest client, impair a CPA’s independence.

From a litigation perspective, the most relevant nonattest services are valuation and forensic accounting. It’s important to note that the Sarbanes-Oxley Act already prohibits a registered public accounting firm from providing a public audit client with certain nonaudit services, including legal and expert services unrelated to the audit and valuation services. Interpretation 101-3 extends some of Sarbanes-Oxley’s restrictions to private companies.

### Valuation services

Interpretation 101-3 states that, when a CPA performs an appraisal, valuation or actuarial service for an attest client, his or her independence is impaired if the results would be material to the client’s financial statements and the services involve a significant degree of subjectivity.

Examples of services that typically involve a significant degree of subjectivity include valuations of assets and liabilities and valuations performed in connection with



employee stock ownership plans or business combinations. An actuarial valuation of a client’s pension benefit liabilities, on the other hand, is an example of an engagement that doesn’t involve a significant degree of subjectivity.

Even if valuation services wouldn’t impair a CPA’s independence, he or she must comply with some general requirements for performing nonattest services for an attest client.

### Forensic accounting services

Under Interpretation 101-3, forensic accounting services consist of litigation services and investigative services. Litigation services include expert witness services; litigation consulting; and acting as an arbitrator, special master or other trier of fact.

In a controversial revision to Interpretation 101-3, last year the AICPA’s Professional Ethics Executive Committee (PEEC) added expert witness services to the list of activities that impair a CPA’s independence. The PEEC found that “expert witness services create the appearance that a [CPA] is advocating or promoting a client’s position.”

Critics commented that expert witnesses, by definition, present an objective interpretation of the facts and that ethics rules prohibit CPA experts from acting as advocates. In addition, expert witnesses are subject to rigorous cross-examination. They can damage their credibility and reputations if they’re found to have engaged in improper advocacy on behalf of *any* client. Nevertheless, the PEEC adopted the revision. (See “2 important exceptions” on page 5.)

Under Interpretation 101-3, CPAs who provide litigation consulting services — that is, those who advise clients on facts, issues and strategies without providing expert testimony — don’t compromise their independence unless they ultimately agree to serve as expert witnesses.

A similar rule applies to investigative services, which involve the application of forensic accounting techniques

## 2 important exceptions

Interpretation 101-3 contains two significant exceptions to the expert witness rule. First, a CPA's independence will not be deemed impaired if he or she provides expert witness services to a large group of plaintiffs or defendants that includes one or more of the CPA's attest clients, provided:

1. Attest clients constitute less than 20% of the group members, the group's voting interests and the claim,
2. No attest client is designated lead plaintiff or defendant, and
3. No attest client has sole decision-making power to select or approve the expert.

The second exception involves CPAs who testify as *fact* witnesses. They are permitted to answer questions regarding their opinions on matters within their area of expertise without compromising their independence.

in the absence of actual or threatened litigation. In either case, Interpretation 101-3 requires the CPA to comply with these general requirements.

Finally, under Interpretation 101-3, a CPA who serves as an arbitrator or other trier of fact in a matter involving an attest client compromises his or her independence. But a CPA can serve as a mediator or in a similar role in which he or she doesn't make any decisions but merely facilitates the matter's resolution.

### Impact on litigation

Failure to comply with Interpretation 101-3 doesn't make a CPA expert's testimony inadmissible, but evidence of an ethical violation or a lack of independence can undermine his or her credibility.

For this reason, attorneys should generally avoid obtaining valuation and litigation services from the CPA firm that provides the client's audit services. And, on a related note, attorneys may want to investigate opposing CPA experts' compliance with Interpretation 101-3 and use any violations to impeach those experts' testimony. □

## Precise estimate needed for human capital value

Ask any business owner about his or her most valuable asset and, more than likely, the answer will be "people." Just about anyone involved in recruiting employees would probably attest to the substantial time and expense involved in attracting, training and retaining quality talent.

Yet, from a valuation perspective, business owners and their attorneys often need a more precise estimate of the value of a company's human capital. And appraisers have a variety of ways to calculate such an estimate.

### Why is this necessary?

A trained and assembled workforce is one component of what is commonly referred to as "human capital

intangible assets." Other examples include employment agreements, noncompete agreements and professional licenses.

Determining the value of a company's assembled workforce might be necessary for many purposes, including:

**Financial reporting.** A company's workforce isn't treated as a separate asset for the purpose of accounting for business combinations, but it may be relevant for certain other financial reporting purposes such as determining appropriate "capital charges" when valuing other intangible assets or supporting the value of goodwill.

**Pricing and structuring a business sale or merger.**

A trained and assembled workforce may be a critical

component of value to a prospective buyer or merger partner, particularly in industries where employees require highly specialized skills.

**Preparing a fairness opinion.** Even though an assembled workforce isn't recognized as a separate asset, it may be important to analyze its value in assessing a transaction's fairness.

**Income taxes.** For federal income tax purposes, an assembled workforce acquired in a taxable transaction is an amortizable intangible asset.

**Property taxes.** In many states, the value of a company's assembled workforce and other intangible assets can be excluded from its property tax base.

The value of an assembled workforce also may be relevant in a litigation setting, particularly when it's necessary to calculate damages an employee or former employee has caused by breaching an employment or noncompete agreement.

### Which method is best?

Like most assets, whether tangible or intangible, an assembled workforce may be valued using one or more of the three basic valuation approaches:

**1. The market approach.** Here an appraiser examines actual market transactions involving comparable companies. But the usefulness of the market approach in valuing an assembled workforce may be limited. Why? Transactions specifically involving the transfer of a company's workforce are unusual — thus, data may be hard to come by.

**2. The income approach.** Under this approach, the appraiser measures the present value of future economic benefits, such as cash flows or earnings. The income approach may be particularly suitable for professional firms and other service businesses where it's possible to measure the income specific employees or groups of employees generate. By the same token, this approach may be less appropriate for manufacturers or other capital-intensive businesses.

**3. The cost approach.** This is probably the most common approach appraisers use to estimate the value



of an assembled workforce. The appraiser calculates the recruiting, hiring and training costs associated with the subject company's workforce and estimates the investment that would be required to duplicate it.

The valuator may estimate the "reproduction cost," which is the cost of creating an exact duplicate of the existing workforce. Alternatively, he or she may measure the "replacement cost," which is the cost of creating a workforce capable of matching the existing workforce's output.

Replacement cost may hypothesize a workforce that looks different from the current one. For instance, it may posit a smaller number of employees with superior skills. Under this method, the valuator makes adjustments to reflect differences in labor costs and other factors.

When using the cost approach, appraisers carefully consider characteristics of the existing workforce that affect value. For example, if the current workforce includes many highly compensated, long-time employees, it may be appropriate to reduce its value to reflect the possibility of re-creating the workforce with younger employees who are equally skilled but lower paid.

### How much are people worth?

A company's workforce is instrumental in determining its ultimate viability — and profitability. Although appraising a company's workforce is similar in many respects to valuing other intangible assets, applying traditional valuation approaches to human capital also poses some distinct — and fascinating — challenges. □

## Taking a WACC at the cost of capital

The “cost of capital” can be an important component of an income-based business valuation. And like many valuation terms, its precise meaning depends on the context.

### Common methods

The income approach involves estimating the net present value of a future economic benefit stream, such as cash flows. To convert projected cash flows or other benefits to present value, the valuator uses a discount rate that reflects the time value of money and the degree of risk associated with an investment in the business. Essentially, the discount rate is the rate of return a hypothetical investor would require given the degree of risk associated with an investment. It is also known as the cost of capital.

A common method used to derive a discount rate is the weighted average cost of capital (WACC), which is the average of the subject company’s cost of equity and cost of debt, weighted according to the relative percentages of each. Because the discount rate is based on the expected cost of *new* capital, valuers typically measure equity and debt by their market values, not their book values.

There are several methods for calculating the cost of equity, including the capital asset pricing model (CAPM) and the build-up method. The cost of debt is usually based on the company’s actual borrowing costs. The WACC formula also takes into account the company’s effective tax rate to reflect the tax deductibility of interest expenses.

### The right “capital structure”

Determining the right “capital structure” — that is, the relative percentages of debt and equity — is key. The most appropriate structure is the mix of debt and equity likely to occur in the future.

When valuing a minority interest in a company, appraisers often use the company’s actual capital structure. But when a controlling interest is being valued, it may be more appropriate to use an *optimal* capital structure, because a controlling owner has the power to change the company’s capital structure.

There’s a common misconception that the optimal capital structure means no debt at all. For most companies, the ideal capital structure involves a manageable amount of debt that allows owners to leverage their investment and boost their returns.

There are several methods for determining a company’s optimal capital structure, including industry averages, capital structures of guideline companies and debt-to-equity criteria used by lenders.



## Proven expertise. Personalized service.

For more than 20 years, Hooper Cornell's team of CPAs, economists, Certified Fraud Examiners, Accredited Senior Appraisers, MBAs and Chartered Financial Analysts has helped legal professionals throughout Idaho and around the country analyze and understand cases involving many types of economic disputes, including commercial litigation, business valuation, personal injury, health care litigation, divorce and fraud. We provide focused evaluations, sound conclusions and expert testimony that translate complex concepts into language that clients, juries and judges can easily understand.



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