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Infringers' profits: lessons from trademark valuation

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Infringers' profits: lessons from trademark valuation

By **Scott D Phillips**, CRA International Inc

Trademark infringement and related causes of action in the United States sometimes include plaintiffs' claims seeking infringers' profits. In some instances such claims have been described as excessive or disproportionate in the context of the defendant's business or other facts. This article briefly describes some of the reasons why this occurs and outlines potential approaches to apportionment of infringers' profits which may help to solve the problem. In particular, it is proposed that generally accepted methods used by professional appraisers to conduct trademark valuation and similar projects may provide solutions.

Background

Plaintiffs in trademark infringement and related litigation generally seek injunctive relief and often also seek monetary awards in the form of plaintiffs' damages and/or infringers' profits. When seeking profits of the infringer, the Lanham Act provides that it is the plaintiff's burden to prove the amount of the defendant's sales, and that it is the defendant's burden to prove its costs and other deductions. Consequently, the initial claims for infringers' profits are often based on the defendant's total revenues. Hence, infringers bear the burden of defending against a plaintiff's claim that may exceed the defendant's total profits by several orders of magnitude.

Often the first effort expended is to call the accounting department to gather necessary information about costs of goods sold and other expenses. While such efforts are necessary, defendants sometimes overlook the more fundamental issue of the amount of their revenues that were impacted by the infringing mark or related action.

Both business and legal professionals generally acknowledge that while trademarks and brands are important, they do not frequently account for all profits that a brand owner earns from the manufacture, distribution and marketing of products or services. For example, in addition to one or more brands, companies may invest significantly in property, plant, equipment, working capital, supply contracts and technology, among many other types of assets.

Figure 1 provides an illustration of the relative value of brands to the total value of companies in a range of industries. It is apparent that brands are more or less valuable depending on the type of industry in which they are used. Further, within industry groups, brands are not all equally effective in generating profits and firm value. An extreme example of this may be the marketing of private label or generic products, where the brand is of much more limited value compared to its branded competitors. In such instances, factors other than brand feature more predominantly in consumer purchasing criteria and decisions.

When confronted with a plaintiff's monetary claim based on all of the defendant's revenues, a primary issue the defendant might address is the portion of those revenues impacted by its use of the infringing trademark. This is one of the challenges involved in proving apportionment of the defendant's profits. In the absence of evidence that the defendant's sales were attributable to factors other than the infringing mark, it may be inferred or posited that such sales were entirely caused by use of the infringing mark.

Valuation and apportionment techniques

The valuation of trademarks is most commonly thought of in the context of determining a fair market value for a sale or purchase. However, there are a number of other contexts in which trademark valuation techniques have been useful. These include benchmarking for internal management, licensing and inter-company transfer pricing, among others.

Both trademark valuation and accountings of defendant's profits are conducted in the context of specific facts and circumstances which are unique to each project. For any given purpose, a valuation project typically involves a unique set of circumstances including the trademark itself, parties involved, geographic area, time period, product market, financial performance and other factors.

Notwithstanding the uniqueness of each project, there are a number of valuation and apportionment techniques that can be considered.

Standards and premises of value

One of the determinants of brand valuation results is the "premise of value". Standards and premises of value inform the appraiser about the conditions under which the property is to be valued and the scope of rights conveyed in the transaction. The most frequently cited standard of value is "fair market value". Fair market value is defined as the amount at which an asset would change hands between a willing buyer and a willing seller within a commercially reasonable period of time, each having reasonable knowledge of the relevant facts, neither being under any compulsion to act and with equity to both. Other market conditions may also form the basis of the premise of value. These include going concern, liquidation, investment, replacement and other forms of value.

In the context of litigation, a potential premise of value may be the "but-for" or "should-have-been" world, based on what would have occurred assuming that the alleged unlawful actions had not taken place. Thus, the challenge is to quantify the amount of income that would be impacted assuming that the defendant did not infringe a trademark or similar right. In the context of a defendant's profits calculation, the premise of value will likely focus on the subject product line of the defendant's business during the relevant time period. If impacted, the relevant income stream will be the amounts by which total income has changed. This change may be due to fewer units being sold, lower per unit price being received or higher costs incurred.

In addition, the premise of value may include a description of the scope of rights conveyed in a transaction or, in the context of litigation, the scope of the infringing trademark in relation to other elements. Figure 2 illustrates the manner in which the scope of rights might impact on the valuation analysis.

For example, if the premise of value is global ownership *and* use of the trademark, the appraiser may capture 100% of a value pool. The value pool is an economic measure of the benefits realised by the user of a trademark (or other intellectual property). Alternatively, if the scope of rights conveyed in a transaction is, for example, a non-exclusive regional licence, the appraiser may attribute a smaller share of the total value pool to the licence. This reflects that the owner is retaining ownership rights that are not conveyed in the licence.

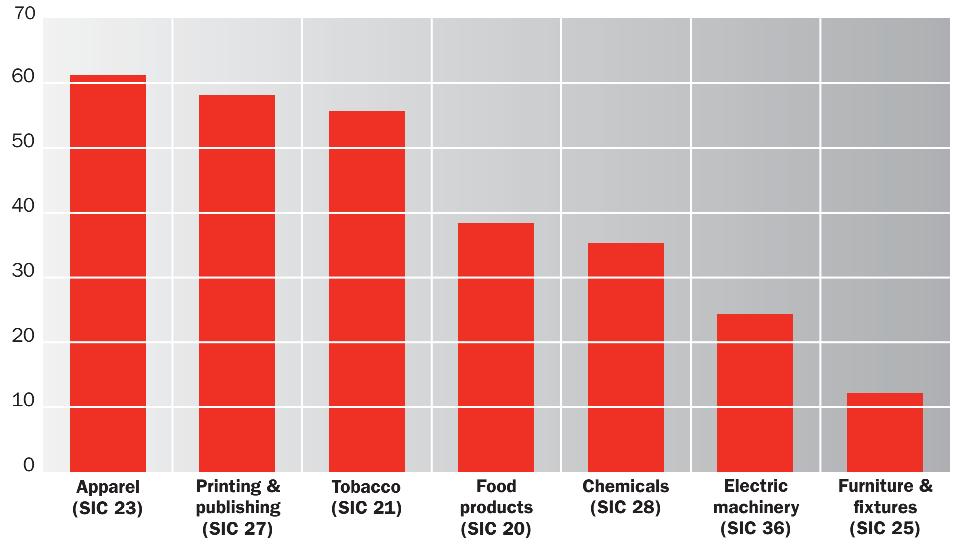
Valuation methods

As previously mentioned, a value pool is an economic measure of the benefits associated with the use of trademarks (or other intellectual property). A variety of techniques exist to measure the value pool and the ultimate valuation results. In the context of calculating infringers' profits, these techniques may be useful in apportioning the economic impact of unlawful from otherwise unrelated actions. Described below are commonly used techniques.

Cost approach

The cost approach values assets based on the cost to create and develop the assets under consideration. Values determined using this approach are also viewed as the anticipated cost to replace an asset already owned should one lose use of it today. This

Figure 1. **Brand equity as a percentage of firm replacement value**



Source: "The Measurement and Determination of Brand Equity: A Financial Approach", Marketing Science, Winter, 1993

Figure 2. **Illustrative composition of value pool**

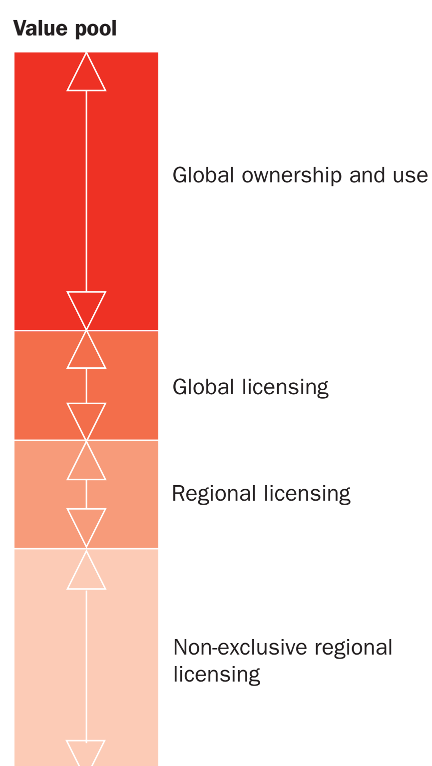


Figure 3. **Illustrative calculation of excess earnings**

	Branded	Unbranded	Premium
Average unit price	$100	$70	
Incremental cost/unit	$80	$60	
Incremental earnings/unit	$20	$10	
Excess earnings/unit			$10

valuation method is based on the premise that no party involved in an arm's-length transaction would be willing to pay more to use the property than the cost to replace the property.

The cost approach is often used to value new or relatively new property, or when information needed for other approaches is not available. However, the cost approach may involve several drawbacks for the valuation of trademarks and other intellectual property. The main limitation of this approach is its lack of consideration for all elements of income and/or profit streams, market conditions, useful life and the risk associated with receiving future economic benefits.

Market approach

The market approach values assets based on comparable transactions between unrelated parties. When considering potentially relevant transactions, it is necessary to evaluate the comparability of the market transactions. Factors which may be considered include company structure; relative balance of power between the parties; industry; market size; market share of the parties involved; profitability (both gross and net); any economic, legal, regulatory, political or other barriers to entry; new product introductions; and the growth outlook for the asset at issue. The time at which the comparable agreement took place may affect all of these factors and should be considered when analysing comparability. In addition, there may be other factors specific to a particular agreement that could significantly influence the value of the property.

If exact comparables are available, the market approach may provide an indication of an asset's value. By their very nature, trademarks and other intellectual property tend to be unique and therefore it is unusual to find exact comparables in this arena. However, inexact comparables might serve as a guide or indicator of value. Adjustments may be made to inexact comparables to compensate for differences in various factors.

Income approach

The income approach values assets based on the present value of income streams expected from the asset under consideration. It is one of the most widely used methods for determining values of intangible assets and intellectual property, including patents and trademarks. Three parameters are quantified in this method:

- The income stream from the asset;
- The duration of the income stream (ie, the remaining useful life of the asset); and
- The risk associated with the realisation of the income stream.

The duration of the income stream is determined by forecasting the useful life of the property or, in the context of litigation, the relevant damages period.

The risk associated with the realisation of the income stream is addressed through the use of a discount rate. In the context of calculating historical profits, such discounting may not be necessary. However, when future profits are analysed, the risk of achieving future benefits may be considered.

The income stream from the asset - usually a series of periodic amounts - may be quantified using a variety of approaches, depending on the specific circumstances of each case. The following is a discussion of some of the possible approaches to the quantification of income streams.

Residual income approach: Economic benefits are rarely generated by intangible assets alone. Instead, working capital and tangible assets, such as property, plant and equipment, are usually combined to form a business enterprise. This collection of assets, when effectively managed, produces economic returns. By allocating the amount of return that is attributable to each of the business assets, it is possible to isolate the amount of return that is attributable to the intangible assets.

The residual income approach deducts the income associated with all other assets in the business from total income to determine the amount of residual income attributable to the asset under consideration (eg, a trademark right or a patent right).

Excess earnings approach: The excess earnings approach is based on the following premise: a property's value can be measured by the incremental earnings achieved by a "branded" product relative to an essentially identical but "unbranded" product (ie, a "generic" version of the same product). The excess earnings may result from the "branded" product commanding a price premium, delivering certain manufacturing cost savings or achieving larger sales quantities. Figure 3 provides an example of an excess earnings calculation.

Usually, the most significant challenge in attempting to use the excess earnings approach is finding a generic version of the "branded" product such that the only difference between the two is the presence or absence of the property being valued. It is important to consider whether other factors, aside from the property in question, contribute to the excess earnings achieved by the "branded" product. Examples of such factors include differences in the functionality/features of the products; differences in the post-sale and warranty services offered by each of the products; and differences in the costs of components and labour necessary to make each of the products. When such factors are present, the comparison may still be made, as long as adjustments can be made to account for the impact of these differences (ie, provided the appropriate data is available).

Relief from royalty approach: The relief from royalty approach is based on the following premise: a property's value can be measured by what the owner of the property would pay in royalties if it did not own the property and had to license it from a third party.

This method requires the selection of a reasonable royalty. Such royalty rates may be determined by examining licences which provide for the use of similar or comparable trademarks. To the extent such licences are not comparable, adjustments to rates may be considered, or they may not provide a basis to quantify the relevant trademark earnings.

Surveys: Surveys sometimes contain information that provides an understanding of the relative importance of trademarks in the context of consumer decision making. For example, surveys may ask consumers to rank or mention factors that influence their decisions. Such factors may include brand, price, location, quality, service, recommendations and many others. In the context of litigation, surveys which address the likelihood of confusion may be useful in developing an understanding of the "but-for" or "should-have-been" world. This is not to suggest that any particular survey ought or ought not to be used in a mechanical sense, since the capability of surveys to address monetary issues will vary based on their methods, subject matter and particular factual settings. However, such surveys may, to varying degrees, assist the appraiser in developing a better understanding of the economic issues.

Trend analysis: The economic value of intellectual property may be evaluated by analysing sales and other trends. Changes in sales, market share or other economic metrics during one or more periods of time can be examined using trend analysis. Regression analysis is a technique commonly used to understand such trends. In the context of a trademark infringement action, for example, it may be possible to discern the impact of infringement on product performance and the competitive environment by analysing trends in sales or other data prior to, during and/or following infringing actions. Such changes may form a basis to understand economic value associated with a trademark. Of course, it is important to consider factors other than infringement which may potentially have impacted on sales or other aspects of the business.

Conclusion

The calculation of defendant's profits in the context of a trademark infringement or similar action is often thought of as an accounting problem that consists of quantifying total sales and determining the deduction of appropriate costs and expenses. However, apportionment of profits also involves an assessment of the degree to which the defendant's sales or costs have been impacted by having infringed the plaintiff's trademark rights. Appraisal techniques relied on by trademark valuation professionals may also be useful in the context of the apportionment of defendant's profits.

The subjects and techniques in this article are presented for illustrative purposes and are not intended to reflect a comprehensive review of intellectual property valuation issues. Pertinent valuation issues and theories must be assessed on the basis of the particular factual and legal circumstances of each case. It is not meant to provide consulting advice with respect to any specific matter and should not be acted upon without professional advice. This article reflects the views of the author and not necessarily those of CRA International Inc or its employees.

Scott D Phillips is a vice president and leader of the firm's trademark practice, which focuses on the business aspects of trademarks, brand strategy and related areas. He has significant testimony experience in federal, state and tax court matters regarding the valuation of brands, patents, lost profits, reasonable royalties and businesses. Mr Phillips advises companies on valuation and pricing issues in the context of licensing, acquisitions, joint ventures, bankruptcy, restructuring and investment holding companies. He also assists companies and governmental agencies on IP strategy and compliance issues. Mr Phillips is a certified public accountant and received a BS in economics from Northern Michigan University and an MBA in finance from Michigan State University.

Scott D Phillips
Vice President
Email: sphillips@crai.com
Tel: +1 312 357 1000

CRA International Inc
USA
www.crai.com