Guidance for Applying the Relief from Royalty Method to Value Trademarks and Trade Names

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Intellectual property is intangible personal property that enjoys special legal recognition and protection, typically as a result of specific statutory authority (either federal or state). One of the four types of intellectual property, trademarks and trade names, provides explicit protections for brands, slogans, and other similar intangible personal property. As trademarks and trade names can represent a valuable type of intellectual property owned by a business, it is important for the valuation analyst to understand how to estimate an appropriate royalty rate to be used in the valuation analysis of trademarks and trade names when applying the market approach, relief from royalty method. This discussion describes tangible property, intangible property, and the various types of intellectual property. This discussion also provides guidance for the valuation analyst in estimating an appropriate royalty rate to be applied in the valuation analysis of trademark and trade name intellectual property, specifically when applying the market approach, relief from royalty method.

Introduction

In the normal course of business, many companies utilize both tangible property and intangible property to generate revenue and to provide infrastructure for operations. While the distinction between a tangible property and intangible property may be intrinsically simple—many valuation analysts ("analysts") conclude that the distinction is whether you can physically hold or touch an asset (i.e., tangible property) versus an asset that you cannot physically hold or touch (i.e., intangible property)—from a valuation perspective, a more definitive distinction is required.

As presented in the textbook *Guide to Intangible Asset Valuation*:

> The important economic difference between a tangible asset and an intangible asset is this:
>
> - The value of a tangible asset is derived from its tangible nature.
> - The value of an intangible asset is derived from its intangible nature.[1]

Said another way, the physical components of a tangible asset—or value of the physical components of a tangible asset—are the asset. Conversely, the value of intangible property is derived from the legal rights associated with the intangible property and the intellectual property content of the intangible property (i.e., the value of an intangible property does not flow from its physical components).

This discussion focuses on the intellectual property category of intangible personal property, and specifically on the trademark and trade name category of intellectual property.

While there are many reasons to value trademark and trade name intellectual property, it is important that the analyst understands the unique characteristics of trademarks and trade names, as well as generally accepted valuation approaches and

methods, in estimating the value of this particular type of intangible personal property.

This discussion describes tangible property, intangible property, and the types of intellectual property. This discussion also addresses the valuation of intangible property, and, specifically, the estimation of an appropriate trademark or trade name royalty rate when applying the market approach, relief from royalty method.

Tangible Property, General Intangible Property, and Intellectual Property

In order to identify and understand intangible property, it may be helpful to first understand what constitutes tangible property. Tangible property generally can possess all of the legal rights that are associated with intangible property (as further discussed below). However, tangible property possesses one key distinction that intangible property does not: it is tangible.

While this may seem intuitive, there are certain specific attributes that an asset should possess in order for that asset to be identified as a tangible property. As presented in *Guide to Intangible Asset Valuation*, tangible property should possess the following:

1. It should have physical existence and substantial form; it should be corporeal.
2. It should be capable of being touched and seen.
3. It should be perceptible to the touch; it should be tactile.[2]

However, for intangible property as well, there should also be some tangible—or physical—evidence of its existence. This creates a dilemma, as the question now is "If there must exist tangible evidence of both tangible property and an intangible property, then what is the definitive difference between the two?"

The definitive difference between tangible property and intangible property is that (1) the value of tangible property is derived from its tangible nature and (2) the value of intangible property is derived from its intangible nature.

Tangible property value is derived from its physical features and depends solely on those physical features, such as a large commercial printer being able to effectively print thousands of copies of documents with minimal oversight or errors. Conversely, intangible property derives economic benefits, either directly or indirectly, from the legal rights and intellectual property content of the intangible property, including the ability to exploit, license, or transfer/sell the intangible property.

Intangible property typically possesses the following ownership characteristics:

1. It is subject to specific identification and a recognizable description.
2. It is subject to legal existence and protection.
3. It is subject to the rights of private ownership, which should be transferable.
4. It is documented by tangible evidence of its existence (such as a contract, license, etc.).
5. It is created or comes into existence at an identifiable time or as a result of an identifiable event.
6. It is able to be destroyed or terminated at an identifiable time or as a result of an identifiable event.

Further, the four categories of intangible property are as follows:

1. Intangible financial assets
2. General commercial intangible assets
3. Intellectual property intangible assets
4. Goodwill intangible value

While an analyst may not initially think of financial assets as intangible property, the cash, accounts and notes receivable, and stocks and bonds presented on a company's balance sheet represent financial intangible property. This is because the value of this property does not come from the actual tangible nature of the assets, but rather the value of this property is derived from the fact that an owner has the legal right to exchange this property for goods and services.

General intangible property is typically created in the normal course of business operations. Company executives do not have to make special efforts to create the general intangible property; rather they naturally develop as company executives manage the day-to-day operations of the business.

Examples of general intangible property include customer contracts and relationships, supplier contracts and relationships, a trained and assembled workforce, certain licenses and permits, proprietary operating systems and procedures, and company books and records.

In contrast, intellectual property is typically created by specific and conscious intellectual activity of the intellectual property developer. The creativity involved in developing an intellectual property can typically be identified and attributed to a specific individual (or group of individuals). Once created, intellectual property is a new and unique invention that can be either artistic, such as a book or a photographic image, or technological, such as a chemical process or computer software code.

As presented in *Guide to Intangible Asset Valuation*, there are four generally accepted types of intellectual property:

- Trademarks and trade names
- Patents
- Copyrights
- Trade secrets[3]

Each of these four intellectual property types is briefly summarized below.

Patents

A patent grants the patent holder the right to exclude others from making, using, or selling the patented invention or product for a specific duration of time. For example, a company that develops computer software may register a patent on each new program that it creates.

While the patent is in effect, no other computer software company can develop a software product using the patented program without permission of the patent owner. Once the patent expires, other computer software developers can produce identical software, generally in the form of generic programs.

Trademarks

A trademark identifies goods as coming from a particular manufacturer. A trademark can be a product brand name (such as Nike or GE) or a logo (such as the Nike "Swoosh" or the Apple "Apple"). Related to trademarks, service marks identify services as coming from a particular service provider.

For example, the "Golden Arches" of McDonald's is an example of a well-known service mark. A trademark also grants the owner the ability to prevent anyone else from using the trademark.

Copyright

A copyright is an exclusive right to reproduce, publish, or sell an original work of authorship. Similar to a patent, the legal protection related to a copyright lasts for a limited period of time. An author of any original work owns a copyright on that original work the moment it is completed.

Typically, in order to have assurance of intellectual property legal protection, the author will register the copyright. Copyright law covers many forms of an author's expression, including books, movies, paintings, and songs.

Trade Secret

A trade secret can be any commercial information that has value due to the fact that it is kept confidential and is not publicly known. For intellectual property to qualify as a trade secret, the commercial information (1) is required to be kept secret from the public and (2) should provide a commercial advantage to the owner/operator of the business.

A trade secret is often a secret process, method, or formula for producing a certain product or service, such as the secret formula for Coca-Cola or the secret recipe for KFC fried chicken.

Definition of Trademarks and Trade Names

A trademark includes any word, name, symbol, or device, or any combination, used, or intended to be used, in commerce to identify and distinguish the goods of one manufacturer or seller from goods manufactured or sold by others, and to indicate the source of the goods. Generally, a trademark lets a consumer know that a good is produced by a specific producer.

A service mark is the same as a trademark, except that it identifies and distinguishes the source of a service rather than a product. The terms "trademark" and "mark" are commonly used to refer to both trademarks and service marks.

Trademark rights may be used to prevent others from using a confusingly similar mark, but not to prevent others from making the same goods or from selling the same goods or services under a clearly different mark. Trademarks may be registered with the United States Patent and Trademark Office. The Lanham Act protects trademarks and defines a trademark as "any word, name, symbol, or device, or any combination thereof."[4]

A trade name is the name used by a company in its business activities. A trade name cannot be federally registered unless it also functions as a trademark or service mark, but otherwise is treated the same as a trademark or service mark for protection and infringement purposes. A registered corporate name can be used on legal documents, but if it infringes on another's trade name, trademark, or service mark, it cannot be used in ordinary trade.

Trade names can function as trademarks. Many companies use all or part of their business names as trademarks on their products, or in connection with their services. Consequently, one is not necessarily separable from the other. Therefore, for purposes of this discussion, we will include trademarks and trade names in our definition of the term trademarks.

Trademarks are valuable because they "may represent investment made in advertising and quality assurance testing."[5] For example, companies that develop a quality product (or service) and invest in the production of a quality product (or service) typically want consumers to identify and associate the product trademark with quality. The trademark associated with this quality product allows the owner to achieve that exact objective, which can be valuable.

Trademarks can also be licensed. As presented in *Guide to Intangible Asset Valuation*:

> A trademark can be licensed. Restaurant franchises often function using the license of the franchisor's trademark.[6] For example, restaurant franchisor Burger King licenses out its name and logo to individual franchisees. These franchisees independently operate their own Burger King restaurants. When a consumer sees the restaurant with the Burger King name and logo, the consumer has established expectations as to what food products will be on the menu and how those food products will taste.[7]

Intangible Property Valuation Approaches and Methods

There are many methods and procedures that may be used in the valuation of intangible property. When one considers the fundamental similarities and differences of these methods, they may all be grouped into three generally accepted property valuation approaches: the income approach, the market approach, and the cost approach.

The income approach is based on the economic principle of anticipation (also called the principle of expectation). In this approach, the intangible property value is the present value of the expected income to be earned from the operation or the ownership of the intangible property.

As the name of this principle implies, the investor anticipates the expected income to be earned from the intangible property. This expectation of prospective income is converted to present value, that is, the indicated value of the intangible property.

The market approach is based on the related economic principles of competition and equilibrium. These economic principles conclude that, in a free and unrestricted market, supply and demand factors will drive the price of an intangible property to a point of equilibrium.

The principle of substitution also directly influences the market approach. This is because the identification and analysis of equilibrium prices for substitute assets provide important evidence with regard to the value for an intangible property.

The cost approach is based on the economic principle of substitution. This economic principle indicates that an investor will pay no more for fungible intangible property than the cost to obtain (i.e., either purchase or construct) an intangible property of equal utility.

For purposes of this economic principle, utility can be measured in many ways, including functionality, desirability, and so on. The availability (and the cost) of substitute assets is directly affected by shifts in the supply and demand functions with regard to the universe of substitute investments.

For purposes of this discussion, we will focus on the market approach, and specifically the selection of an appropriate royalty rate to be used in the application of the market approach, relief from royalty method.

Generally, the relief from royalty method is one common valuation method used to estimate the value of trademarks.

Market Approach Valuation Methods

There are fewer market approach valuation methods available to estimate the value of a trademark as compared to either the cost approach or the income approach. Nonetheless, the practical application of a

market approach method is a complex and rigorous analytical process.

There is a systematic process to the application of market approach methods to trademark valuation. The basic procedures of this process are summarized as follows:

1. Research the appropriate exchange market to obtain information on sale/license transactions, listings, and offers to purchase/license guideline (i.e., generally similar) or comparable (i.e., almost identical) trademark assets that are similar to the subject trademark, in terms of characteristics such as trademark age, rights and restrictions, type, functional use, industry in which the trademark functions, date of sale, and so on.
2. Verify the information by confirming that the transaction data obtained are factually accurate and that the sale or license transactions reflect arm's-length market considerations. (If the guideline transactions were not at arm's-length market conditions, then adjustments to the transactional data may be necessary.) This verification procedure may also elicit additional information about the current market conditions for the sale or license of the subject trademark.
3. Select relevant units of comparison (e.g., income multipliers or dollars per unit such as "per drawing," "per customer," or "per location") and develop a comparative analysis for each unit of comparison.
4. Compare the selected sale/license transactions with the subject trademark using the elements of comparison, adjust the sale or license price of each guideline transaction appropriately to the subject trademark, or eliminate the sale or license transaction as a guideline for future consideration.
5. Reconcile the various value indications produced from the analysis of the guideline sale/license transactions into a single value indication or a range of values. In an imprecise market—subject to varying economics—a range of values may sometimes be a better conclusion for the trademark than a single value estimate.

There are 10 basic elements of comparison that should be considered when selecting and analyzing guideline sale or license transactions in the market approach. These 10 basic elements of comparison are summarized below:

1. The legal rights of trademark ownership that were conveyed in the guideline sale/license transaction
2. The existence of any special financing terms or arrangements (e.g., between the buyer and the seller)
3. Whether the elements of arm's-length sale/license conditions existed
4. The economic conditions that existed in the relevant secondary market at the time of the sale/license transaction
5. The industry in which the trademark asset was—or will be—used
6. The physical characteristics of the guideline sale/license assets, as compared to the subject trademark
7. The functional characteristics of the guideline sale/license assets, as compared to the subject trademark
8. The technological characteristics of the guideline sale/license assets, as compared to the subject trademark
9. The economic characteristics of the guideline sale/license assets, as compared to the subject trademark
10. The inclusion of other (nonintangible) assets in the guideline sale/license transaction; this may include the sale of a bundle—or a portfolio—of assets which could include tangible personal property and/or real estate, as well as the trademark

The guideline sale/license transactions are commonly referred to as comparable uncontrolled transactions or "CUTs". Further, in conducting the search, some of the more popular sources that the analyst may rely on include the following:

1. RoyaltySource Intellectual Property Database, a service of AUS Consultants
2. KtMINE database, available through Business Valuation Resources and others

Considerations in the Selection of an Appropriate Royalty Rate When Applying the Market Approach Relief from Royalty Method

In estimating an appropriate royalty rate to be used in the application of the market approach, relief from royalty method, there are numerous attributes or factors to be considered by the analyst. These attributes or factors may be either quantitative or qualitative in nature.

Exhibit 1 presents a nonexhaustive list of some of the qualitative attributes that the valuation analyst should consider when analyzing trademark CUT

data within the market approach, relief from royalty method.

It is important for the analyst to understand that the above-listed qualitative factors are nonexhaustive, as each trademark is unique and there may be other qualitative attributes not listed above that would affect the selection of an appropriate royalty rate to be used in the valuation analysis of a subject trademark (when applying the market approach, relief from royalty method).

The above considerations will assist the analyst in estimating an appropriate royalty rate that an independent party would be willing to pay to license the trademark. This is because the relief from royalty method is based on the principle that the trademark owner would be willing to pay a reasonable royalty rate to license the trademark if it was not already owned. License royalty rates can be estimated from an analysis of market-derived empirical data with respect to the license of guideline trademarks.

In order to estimate an appropriate, fair royalty rate to be used in the relief from royalty method, the analyst should analyze publicly available data related to arm's-length royalty and/or license agreements. From these data, the analyst can conclude an actual arm's-length royalty and/or license payment range for the trademark based on the guideline royalty and/or license agreement data.

This estimated royalty rate can then be applied to a relevant subject royalty income measure such as (1) total royalty dollar payments per period, (2) royalty rate as a percentage of revenue, (3) royalty rate as a percentage of profits, (4) royalty dollar amount per unit sold, or (5) royalty dollar amount per unit allocated, in order to estimate the fair market value of the trademark.

In addition to considering the qualitative factors presented in Exhibit 1, the analyst should also address several issues in order to ensure that the selected royalty rate for the trademark is accurate and appropriate. These issues include the following:

1. Ensuring that the selected arm's-length royalty and/or license agreements are not duplicative
2. Ensuring that the selected arm's-length royalty and/or license agreements are in effect as of the trademark valuation date
3. Ensuring that the selected arm's-length royalty and/or license agreements are within the trademark owner/operator industry
4. Ensuring that the selected arm's-length royalty and/or license agreements are in reasonably close proximity to the trademark valuation date
5. Ensuring that the selected arms'-length royalty and/or license agreements are truly "arm's-length," and not related party transactions

Conclusion

This discussion presented an overview of tangible property and intangible property, including the key differences between the two property categories. This discussion also addressed the four generally accepted types of intellectual property, and specifically trademark and trade name intangible property.

While there are three generally accepted approaches to estimating the value of trademarks, the relief from royalty method is a common market approach trademark valuation method.

In applying the relief from royalty method, one of the procedures is to estimate an appropriate royalty rate to be used in the trademark analysis. This appropriate, royalty rate is typically estimated by considering publicly available data related to arm's-length royalty and/or license transactions of intellectual property generally similar to the subject trademark. This estimated royalty rate can then be applied to a relevant royalty income measure in order to estimate the value of the subject trademark.

Notes:

1. Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation*, Revised ed. (New York: American Institute of Certified Public Accountants, Inc., 2014), 9.
2. Reilly and Schweihs, *Guide to Intangible Asset Valuation*, 9.
3. Ibid., 29.
4. 15 U.S.C. §1127.
5. Patricia S. Rogowski and Craig H. Young, *Bankruptcy and its Impact on Intellectual Property*, 2nd ed. (Alexandria, VA: American Bankruptcy Institute, 2009), 23.
6. Ibid., 27.
7. Reilly and Schweihs, *Guide to Intangible Asset Valuation*, 29.

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Exhibit 1
Nonexhaustive Qualitative Attributes to Consider in Valuing Trademarks

Item	Economic Attribute	Positive Influence on Economic Analysis	Negative Influence on Economic Analysis
1	Age-absolute	long established trademarks	newly created trademarks
2	Age-relative	older than competing trademarks	newer than competing trademarks
3	Use-consistency	used consistently on related products and services	used inconsistently on unrelated products and services
4	Use-specificity	general and can be used on a broad range of products and services	specific and can only be used on a narrow range of products and services
5	Use-geography	wide appeal, e.g., can be used internationally	narrow appeal, e.g., can only be used locally
6	Potential for expansion	unrestricted ability to use trademarks on new or different products and services	restricted ability to use trademarks on new or different products and services
7	Potential for exploitation	unrestricted ability to license trademark into new industries and uses	restricted ability to license trademark into new industries and uses
8	Associations	associated with positive person, event, location	associated with negative person, event, location
9	Connotations	has positive connotations and reputation among consumers	has negative connotations and reputation among consumers
10	Timeliness	perceived as modern	perceived as old-fashioned
11	Quality	perceived as respectable	perceived as less respectable
12	Profitability-absolute	profit margins or investment returns on products and services higher than industry average	profit margins or investment returns on products and services lower than industry average
13	Profitability-relative	profit margins or investment returns on products and services higher than competing trademarks	profit margins or investment returns on products and services lower than competing trademarks
14	Expense of promoting	low cost of advertising, promotion, deals, or other marketing of trademarks	high cost of advertising, promotion, deals, or other marketing of trademarks
15	Means of promoting	numerous means available to promote	few means available to promote
16	Market share-absolute	products and services have high market share	products and services have low market share
17	Market share-relative	products and services have higher market share than competing trademarks	products and services have lower market share than competing trademarks
18	Market potential-absolute	products and services are in an expanding market	products and services are in a contracting market
19	Market potential-relative	market for products and services expanding faster than competing trademarks	market for products and services expanding slower than competing trademarks
20	Name recognition	high recognition, e.g., high aided or unaided recall among consumers	low recognition, e.g., low aided or unaided recall among consumers
21	Industry	industry revenue is increasing	industry revenue is decreasing
22	Stability	historical positive operating performance	lack of historical positive operating performance
23	Leadership	consistent and effective leadership	inconsistent and ineffective leadership