

MAY/JUNE 2010

The

# Value Examiner®

A PROFESSIONAL DEVELOPMENT JOURNAL *for the* CONSULTING DISCIPLINES



# Economic Damages Analysis for Intangible Assets

*By Robert F. Reilly, MBA, CPA/ABV, CVA, CFA, ASA*

**I**ntangible asset economic damages analyses are typically performed for the purpose of resolving or litigating disputes. The intangible asset owner/operator believes that it was damaged as a result of the wrongful actions of a damaging party, and so the owner/operator pursues legal remedies against that damaging party through litigation in the civil court system (related to commercial or other legal claims) or alternative dispute resolution such as arbitration. By taking such action, the asset owner/operator expects to receive compensation for the amount of damages caused by the damaging party.

There are also non-litigation reasons to quantify the commercial intangible asset economic damages, including: (a) substantiating an owner/operator's insurance claim, or (b) measuring the intangible asset loss for financial accounting and reporting.

A variety of commercial intangible assets, including intellectual property, can be the subject of economic damages analysis in a dispute or legal action. Such an analysis may relate to a breach of contract, or torts between parties that have no contractual relationship.

## **BREACH OF CONTRACT**

When one party to a contract fails to perform its contractual obligations, that

failure is called a breach of the contract. The primary objective of the legal remedy is to compensate the injured party for the loss resulting from the breach.

Examples of contracts that may be breached, causing intangible asset economic damages, include: employment agreements, noncompetition agreements, nonsolicitation agreements, advertising and other promotion agreements, product placement agreements, supply agreements, customer/client purchase contracts, loan indentures, leases, IP use licenses and other IP licenses, franchise agreements, construction contracts, IP commercialization or development agreements, joint venture agreements, procurement contracts, entire-output contracts, marine or other shipping contracts, take-or-pay contracts, marketing contracts, contracts to sell, and others.

There are several legal remedies that a court might award to the plaintiff in a breach-of-contract dispute, including:

- Monetary damages—payment of damages to reimburse the plaintiff for its loss
- Rescission—cancellation of contract
- Reformation—modification of contract terms
- Specific performance—requiring defendant to perform exactly as specified in the contract

## TORTS

A tort is a private or civil wrong for which a remedy can be obtained, usually in the form of damages. In a tort, there is no contractual relationship between the parties. A tort relates to the breach of a duty that the law imposes on the wrongdoer (or tortfeasor) against the injured party. A property tort is a tort involving damage to property, i.e., the intangible asset owner/operator's property rights were violated by the wrongful party.

There are three common elements to every tort damages claim:

- The defendant had a legal duty to the plaintiff.
- The defendant breached that duty.
- The damages are the proximate result of the breach.

Some of the common types of torts that can result in intangible asset damages include: defamation, appropriation, interference with contractual rights, interference with business, disparagement, fraudulent misrepresentation, breach of fiduciary duty, breach of agency duty, and others.

Arguably, the most common type of tort leading to intangible asset damages is an intellectual property infringement. Infringement claims typically relate to the four types of intellectual property: patents, copyrights, trademarks, and trade secrets.

## ECONOMIC DAMAGES ANALYSIS

In legal terms, damages are the amount of money sought by the plaintiff as a remedy for either a breach of contract or a tortious action. Typically, forensic analysts are asked to estimate the amount of the actual damages suffered by the intangible asset owner. The actual damages represent compensation

for the actual and real loss or injury suffered by the claimant.

The court may award other types of judicial damages as well, such as exemplary and punitive damages. However, exemplary and punitive damages are typically not included in the analyst's intangible asset economic damages analysis.

In the law, actual damages are sometimes referred to as compensatory damages, because the damages award is intended to compensate the claimant for the actual injury or loss suffered. Analysts should consider this legal objective in the economic damages analysis. The intangible asset economic damages objective is somewhat different from the objective of the typical intangible asset valuation analysis.

## MEASURES OF DAMAGES

There are many methods that may be used to measure intangible asset economic damages. The most common methods may be grouped into the following categories:

- Lost profits methods
- Lost value methods
- Royalty rate methods

**Lost profits.** The first of the three types of methods estimates the amount of lost profits that the intangible asset owner/operator experienced as a result of the damages event. Lost profits methods apply whether the damages event was (a) a breach of an intangible-asset-related contract or (b) a tort (such as an infringement) against the intangible asset. The objective of the various lost profits methods is to measure the amount of lost income that would make the intangible asset owner/operator whole, i.e., as if the damaging event had not occurred. Most (and, arguably, all) lost profits methods estimate the

amount of income that the owner/operator would have earned "but for" the effects of the damages event.

As a simple illustration, let's say the owner/operator would have earned \$300 over a three-year period if the damages event had not occurred. But the owner/operator actually earned only \$200 over the three-year damages period. So the intangible asset lost income measurement over the three-year damages period is \$100 (\$300 "but-for" income minus \$200 actual income). In an economic damages analysis, lost profits (or lost income) are typically measured on a contribution margin basis, that is, as revenue less variable costs only; fixed costs are typically ignored in the intangible asset economic damages analysis.

The intangible asset owner/operator would have earned this \$100 of income "but for" the impact of the defendant's wrongful action. So the judicial award of \$100 of damages would make the injured owner/operator whole, that is, in the same economic position it would have been in if the damages event had not occurred.

There are three common lost profits measurement methods: the projections method, the yardstick method, and the before-and-after method. A detailed explanation of those three methods is beyond the scope of this discussion. All three have the same objective: to estimate the amount of lost income the intangible asset owner/operator would have earned "but for" the wrongful actions of the defendant. And each of the three of those lost profits methods are based on a different measurement of the but-for scenario.

**Lost value.** The second category of economic damages methods estimates the decrease in the value of the subject

intangible asset as a result of the damages event, whether a breach of contract or a tort. The objective of the various lost value methods is to measure the amount of intangible asset value that would make the owner/operator whole. In this case, “whole” is defined as the value of the subject intangible asset value but for the impact of the damages event.

To illustrate, let’s say the value of the intangible asset would have been \$5 million but for the impact of the damages event. This but-for value is often measured just before the time when the damages event occurred. After the impact of the damages event, the value of the intangible asset is estimated at \$2 million. Thus the lost value measurement is \$3 million.

In this simple illustration, the judicial award of \$3 million would make the owner/operator whole. After receiving the \$3 million judicial award, the intangible asset owner/operator should be in the same economic position it would have been in if the damages event had not occurred.

The three common intangible asset valuation approaches—cost, income, and market—may be used to achieve the same objective: to estimate the decrement (or loss) in the intangible asset’s value due to the wrongful actions of the defendant. However, each of the three valuation approaches should be applied on a comparative basis.

The lost income measurement methods are applied in a “but for” scenario, i.e., to quantify lost income but for the impact of the defendant’s wrongful action. Likewise, the lost value measurement methods are applied in a “with and without” scenario, i.e., to quantify the intangible asset value difference with versus without the impact of the defendant’s wrongful action.

Owner value is the standard of value that is often used in the lost value measurement methods analysis. Owner value is the value of the subject intangible asset to the current owner. This standard of value is commonly used in an economic damages analysis, and derives from the objective of such an analysis: to make the individual damaged party whole from the impact of the defendant’s wrongful action. However, depending on the statutory provisions or the judicial precedent of the particular jurisdiction, the client’s attorney may direct the damages analyst to estimate fair market value, fair value, investment value, or some other defined standard of value. Regardless of the selected standard of value, the intangible asset lost value analysis should be applied on a comparative (i.e., with-and-without) basis.

**Royalty rate.** The third category of economic damages methods estimates the royalty rate (or other transfer price) that an arm’s-length licensee would be willing to pay to an arm’s-length licensor for the continued use of the subject intangible asset. The legal premise of this damages analysis is to replicate what would have hypothetically occurred if the defendant fairly negotiated a license with the plaintiff before the damage event occurred. In such a hypothetical negotiation, the defendant would not intend to commit the wrongful action (i.e., the contract breach or the tort). Rather, the plaintiff and defendant would negotiate at arm’s-length until they agree on a license royalty rate.

As a result of the hypothetical negotiation, the defendant would sign a license with the owner/operator for the lawful use of the subject intangible asset. The licensee (defendant) would pay the licensor (plaintiff) a royalty-

based license fee that would make the licensor whole.

The court may order a royalty rate award if it decides to allow the continuation of the breach or the tort damages event. If the damages event continues for an indefinite period in the future, it may be difficult to measure lost profits or lost value. In such an instance, the court may order the defendant to pay the plaintiff a royalty payment for each time that the defendant used (in the past) and will (in the future) use the intangible asset.

Based on actual, third-party license agreements related to commercial intangible assets, there are many types of royalty rate arrangements that licensees and licensors have actually entered into, including:

- Fixed dollar amount per intangible asset use
- Fixed dollar amount per time period (month or year)
- Percent of profit (gross or net) related to the intangible asset use
- Percent of revenue related to the intangible asset use

Of those four types of license arrangements, the royalty rate arrangement that both courts and litigants prefer is the last one, percent of revenue royalty rate. A damages award based on a percent of revenue royalty rate is easier to administer (and to audit) than royalty rates based on other financial or operational metrics.

There are four common intangible asset royalty rate estimation methods:

- Investment method
- Income method
- Comparable uncontrolled transaction method
- Comparable profit margin method

All of these royalty rate methods may be used to achieve the same objective: to estimate a fair, arm's-length royalty rate that a licensee would pay to a licensor for a license to use the subject intangible asset. The defendant pays royalties to the plaintiff as compensation for any damages to the subject intangible asset.

## WHY MEASURE ECONOMIC DAMAGES

Following are the four most common reasons why a client may retain a damages analyst to measure intangible asset economic damages. The client may be the injured owner/operator, the alleged damaging party, the legal counsel for either party, a property and casualty insurance company, a dispute mediator, or a finder of fact (e.g., a judge or arbitrator).

**1. Damages analysis for the injured party.** Typically, the first party to retain the damages analyst is the intangible asset owner/operator (or the damaged party's legal counsel). The damaged party may want an initial estimate of the actual damages in order to determine if the amount of damages justify the cost and effort of litigation. The damaged party may want an initial estimate to negotiate a settlement with the injuring party before incurring the expense and risk of litigation.

If a settlement cannot be negotiated, legal counsel may request a formal economic damages analysis. The damages analyst may start the engagement as a consulting expert, working for the client's legal counsel. As the litigation proceeds to the expert discovery phase, the damages analyst may be named as a testifying expert. The analyst typically prepares a written report and prepares to testify at deposition and at trial.

The plaintiff's damages analyst may also be asked to rebut the analyses, positions, and expert report of the defendant's damages analyst. This effort may involve consulting with the plaintiff's legal counsel, preparing a rebuttal expert report, and delivering rebuttal expert testimony.

**2. Damages analysis for the alleged injuring party.** Typically, the alleged wrongful party will engage their own damages analyst shortly after that party is approached by the asset owner/operator (or by the injured party's legal counsel). The alleged wrongdoer may want a preliminary analysis of the intangible asset damages claim to determine the exposure to economic damages, if any.

The alleged wrongdoer may also request a preliminary damages estimate to use for settlement negotiation purposes. The accused party may use this estimate to convince the owner/operator that the likely judicial damages award is not worth the expense and effort of a formal litigation proceeding.

In addition to defending his or her report and analysis, the defendant's damages analyst may be asked to rebut the positions and conclusions of the plaintiff's damages analyst. The defendant's analyst may challenge the facts relied on, methods selected, procedures performed, and conclusions reached by the plaintiff's analyst.

**3. Damages analyses as (or for) the finder of fact.** An experienced damages analyst may be retained by both parties as a neutral analyst or as a mediator. When retained by only one party, the analyst must be objective and unbiased. When retained by both parties, the analyst will also try to help them reach an out-of-court settlement position.

The damages analyst may also be re-

tained as an adviser to, or a special master for, the judicial finder of fact in the litigation. In this role, the finder of fact may ask the analyst to reach an independent conclusion of the economic damages. Or the finder of fact may ask the analyst to (a) evaluate the pros and cons of both experts' reports and (b) help the judge reach a judicial determination of damages based on the evidence presented in the case.

Lastly, the analyst may be retained by both parties to act as an arbitrator. In this role, the analyst reviews the evidence presented by both parties in the dispute. Much like a judge, the arbitrator acts as a finder of fact and reaches a final conclusion as to the economic damages, if any.

**4. Damages analyses related to insurance claims.** Some intangible asset damages events are covered by property and casualty insurance, including business interruption insurance. Particularly with regard to an intangible asset damages claim, the owner/operator may need the assistance of the damages analyst. The analyst may or may not need to prepare a written report, but he or she will need to quantify the amount of the intangible asset damages.

With respect to large and complex damages claims, the insurance company may retain its own damages analyst. This is likely to be the case if the owner/operator's insurance company intends to pursue its legal claim against the third party that actually caused the damages event.

## DIFFERENCES BETWEEN DAMAGES ANALYSIS AND VALUATION

As I mentioned above, there are fundamental differences in the purpose and objective of a damages analysis, com-

pared to those of a valuation analysis, for an intangible asset.

In a valuation analysis, the valuator determines a standard of value and a premise of value, and based on that, selects appropriate variables for the subject intangible asset. The value is concluded as of a specific historical, current, or prospective valuation date. The analyst typically considers all information that is known or knowable on the valuation date.

In the damages analysis, on the other hand, the analyst estimates the amount of monetary compensation necessary to make the owner/operator whole after the subject intangible asset experienced a damages event. That amount of compensation should put the owner/operator (injured party) in the same economic position that the party would have been in had the damages event not occurred. The analyst estimates the amount of damages suffered by the subject intangible asset as a result of a specific damages event.

While damages analysts are typically not causation experts, they do have to consider several factors in the damages measurement. For example, the intangible asset damages claim, based on a loss or injury, should be related to a wrongful action by the defendant. This wrongful action is often referred to as the damages event. The amount of the intangible asset damages claim should compensate the specific damaged party claimant—and not some hypothetical party, as would be the case with an estimation of fair market value.

In the valuation of intangible assets for other purposes (other than economic damages), the valuator generally does not have to consider any of the above factors in the intangible asset valuation. The intangible asset valuation analyst

is not usually concerned about who caused the value or what event caused the value. Rather, the valuator is only concerned that the subject intangible asset has a measurable value. The valuator usually does not quantify intangible asset value to the particular owner/operator. More commonly, the analyst quantifies the intangible asset value in the marketplace, to hypothetical transactional participants. And, the valuation analyst is typically not concerned about whether the concluded intangible asset value makes the owner/operator whole or not. However, in an intangible asset economic damages analysis, the damages analyst should consider each of these above-mentioned factors.

#### DATES AND RATES

The damages may be estimated either (a) as of the date of the damages event (typically the beginning of the damages period), or (b) as of the date of the damages analysis or damages report. The former type of damages measurement (as of the damages event date) is called an ex-ante damages analysis. The latter (as of damages analysis date) is called an ex-post damages analysis. In either case, the damages analysis will typically rely on subsequent information—i.e., information that would not have been known or knowable as of the selected analysis date.

Also in the damages analysis, the analyst will consider analytical variables that are appropriate to the specific damaged party, not a hypothetical party. In addition, the damages analyst will typically consider the following factors which may not be considered in an intangible asset valuation:

- Judicial discount rate/capitalization rate

- Convoyed/derivative revenue
- Mitigation
- Income tax consequences of judicial award
- Statutory definitions of damages

Various courts have allowed different measures of discount/capitalization rates for different types of intangible asset damages analyses. In the intangible asset valuation, the discount rate is often a function of (a) the subject ownership interest (e.g., controlling interest versus noncontrolling interest) and (b) the subject standard of value (e.g., fair market value, investment value, etc.).

In the damages analysis, the judge may expect the damages analysis discount rate to be (a) a risk-free rate of return, (b) an owner/operator weighted average cost of capital (WACC), (c) an industry WACC, or (d) some other rate of return measure. The damages analyst should consult with the client's legal counsel regarding what judicial discount rate measure may be appropriate for the type of intangible asset, the type of legal claim, and the jurisdiction.

In the damages analysis, various courts have allowed the inclusion of lost revenue from (a) convoyed products and services and (b) derivative products and services. In the valuation, the analyst typically considers only the revenue from the products or services that are directly related to the subject intangible asset. In the damages analysis, the analyst typically considers the lost revenue from products or services that may be only indirectly related to the subject intangible asset. Convoyed products or services do not use the subject intangible asset, but they are typically sold with products or services that do use the subject intangible asset. Derivative products or services do not use the subject intangible asset,

but they are typically sold as a follow-on to the products or services that use the subject intangible asset.

For example, let's assume that the patent or the trademark on a laptop computer is infringed. The computer is typically sold with a fitted carrying case (which enjoys no patent or trademark protection). The carrying case is a conveyed product. The lost revenue for the conveyed product would typically be included in the intellectual property damages analysis. This procedure is appropriate even though that conveyed product does not use the damaged intellectual property.

Let's now assume that, after the initial purchase of a computer printer, the printer customers typically buy printer-specific ink cartridges and multi-year warranty service contracts. Neither the ink cartridges nor the warranties are covered by the infringed patent or the infringed trademark. The follow-on sales of ink cartridges and warranty service plans are derivative products. The lost revenue from the derivative products would typically be included in the infringement damages analysis.

Injured intangible asset owner/operators are legally required to mitigate the amount of the damages they suffer. That is, they must make reasonable efforts to correct the damages event and minimize the amount of intangible asset damages suffered. For example, the owner/operator who suffers a breach of contract is required to make reasonable efforts to find another party to provide the contractual goods/services or to replace the contractual sales. The damages analyst typically considers and (directly or indirectly) quantifies the injured party's mitigation efforts as part of the damages analysis. In contrast, mitigation is a concept that typically would not affect a valuation.

### TAXABLE INCOME

In many instances, the judicial award of actual (compensatory) damages is taxable

income for federal income tax purposes. The damages analyst may have to consider that fact if the objective of the damages analysis (and of the judicial award) is to make the injured plaintiff whole.

For example, let's assume that the damages analyst concludes that an intangible asset owner/operator suffered \$1,000 of damages due to the defendant's wrongful actions. The finder of fact agrees with the analyst and awards \$1,000 as compensatory damages. However, if that \$1,000 award is taxable at the rate of 35 percent, the owner/operator will pay \$350 in income taxes and is left with only \$650 as compensation for the \$1,000 in damage. In this example, the damaged plaintiff was not made whole. Accordingly, the damages analyst may have to calculate both (a) the amount of intangible asset damages suffered by the injured party, and (b) the total amount of the judicial award that is necessary to make the injured party whole.

In the intangible asset valuation for other (non-economic damages) purposes, the analyst typically does not have to consider income tax consequences of the value conclusion. A \$1,000 value conclusion is what the willing buyer would pay for the subject intangible asset. The analyst does not have to consider the after-tax sale proceeds for either buyer or seller.

The damages analyst may also be asked to consider damages measurements based on statutory authority or judicial precedent. For example, by statute, a trademark or copyright owner/operator may be entitled to receive damages in the form of the profits actually earned by the intellectual property infringer. These actual profits of the infringer are sometimes referred to as unjust enrichment. In a patent infringement case, however, the patent owner/operator is not entitled to receive economic damages in the form of the profits actually earned by the in-

fringer; the damaged patent owner may receive damages in the form of its lost profits or a reasonable royalty rate.

Accordingly, the damages analyst should consult with the client's attorney about damages measurements that are allowed and prohibited by law. This point illustrates another important difference between a valuation and an intangible asset damages analyses for intangible assets. A valuation is supposed to emulate the expected transactional behavior of identified market participants. A damages analysis is supposed to provide an economic answer to a legal question. The question of whether the intangible asset owner/operator was damaged, the question of whether the defendant is responsible for causing the damages event, and the question of the appropriate judicial award to the injured intangible asset owner/operator are questions of law. The damages analyst can only recommend to the judicial finder of fact (a) the amount of damages that the owner/operator suffered and (b) the amount of the compensatory damages award that would make the owner/operator whole.

### CONCLUSION

This article has discussed (1) the types of wrongful actions that may result in intangible asset economic damages claims, (2) the typical purpose of the intangible asset economic damages analysis, (3) the common methods used to measure intangible economic damages, (4) the common reasons why clients retain a damages expert, and (5) the contrast between intangible asset economic damages analyses with typical valuation analyses.

While some of the approaches and methods are conceptually similar, there are numerous differences, some of them subtle, between an intangible asset valuation and an intangible asset damages analysis.

For example, in an intangible asset valuation for non-economic damages

purposes, the analyst (a) is not concerned about who caused the value or what event caused the value, (b) is typically not concerned about whether the concluded intangible asset value makes the owner/operator whole or not, and (c) typically does not have to consider income tax consequences of the value conclusion.

In contrast, in an intangible damages analysis, the analyst (a) considers the wrongful action by the defendant (the damages event), (b) quantifies the amount of compensation to put the injured party in the same economic position that the party would have been in had the damages event not occurred,

and (c) typically does consider income tax consequences of the damages award in developing the damages estimate.

In addition, the valuation analysis and the value conclusion are principally influenced by market considerations. The economic damages analysis and the damages conclusion are principally influenced by legal considerations. **VE**



**Robert F. Reilly, MBA, CPA/ABV, CVA, CFA, ASA,** is a managing director of Willamette Associates, a national business valuation, economic analysis, and financial advisory services firm. He specializes in the valuation, lost profits/damages analysis, and transfer price estimation of intellectual property for transaction, taxation, financing, bankruptcy, accounting, litigation, and planning purposes. Reilly is a coauthor of *The Handbook of Business Valuation and Intellectual Property Analysis* (McGraw-Hill, 2004). E-mail: [rfreilly@willamette.com](mailto:rfreilly@willamette.com).



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