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Intellectual Property Consulting

CASE STUDY
ECONOMIC DAMAGES AND PROFIT APPORTIONMENT IN TRADEMARK LITIGATION

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INTRODUCTION

In this case, I represented the defendant in a trademark infringement dispute in the Ninth Circuit between competing after-market parts suppliers. The plaintiff was asserting claims of trademark infringement and unfair competition under the Lanham Act section 43(a), and unfair competition and unjust enrichment under state common law. Under the law governing this matter, the plaintiff was seeking damages in three forms: lost profits, disgorgement of the defendant's profits, and loss in business value resulting from the alleged infringement.

The core task was to rebut the plaintiff's two expert reports, which addressed a number of damages theories. The plaintiff alleged that the defendant was infringing on its proprietary parts numbering system by using it as a cross-reference tool for sales to its customers. The cross-reference use stemmed from the fact that insurance carriers had adopted this parts numbering system as the industry standard for billing purposes. Thus, the defendant and other competitors were providing the part numbers to facilitate customer needs. This practice is common in the after-market parts industry.

LOST SALES ANALYSIS

The first expert report under review dealt with the damages issue of lost profits suffered by the plaintiff as a result of the defendant's alleged use of the plaintiff's proprietary part numbering system. It also purported to cover a calculation of defendant's profits. In his report, the expert first set out to identify the alleged infringing sales revenue transacted by the defendant. This is where the plaintiff's expert initially erred in his economic damages assessment.

First, in the area of trademark infringement, damages are typically measured as those sales that would have been made "but for" the infringement. However, in this matter the plaintiff's expert wrongfully categorized all of the defendant's product sales as infringing by including sales from non-competing products, intercompany transactions, and product sales wherein the part numbering system at issue was not used as several major customers required their own numbering systems. Carving out these revenues served to reduce the alleged infringing sales by as much as 60%.

Table 1 clearly illustrates this discrepancy[i]. The only portion of revenue properly in dispute is the Revenue In Dispute (Plaintiff Part #), totaling $26.6 million, which represents sales using the allegedly infringing part-numbering system. The Total Sales of the defendant, including non-infringing sales, totaled $50.6 million. This oversight is a substantial overstatement of revenue, which served as the foundation for the expert's profit determination.

Table 1
Alleged Infringing Revenue

	2000	2001	2002	2003	2004	Total
Sales Revenue Items:						
Revenue In Dispute (Plaintiff Part #)	**$820,000**	**$3,870,000**	**$6,146,000**	**$6,709,000**	**$9,026,000**	**$26,571,000**
Non-Compete Product	42,000	141,000	192,000	240,000	374,000	989,000
Customer Part # No Claim	1,010,000	3,445,000	4,271,000	6,234,000	4,839,000	19,799,000
Subtotal Sales	**$1,872,000**	**$7,456,000**	**$10,609,000**	**$13,183,000**	**$14,239,000**	**$47,359,000**
Intercompany Transactions	112,000	642,000	651,000	780,000	1,059,000	3,244,000
Total Sales	**$1,984,000**	**$8,098,000**	**$11,260,000**	**$13,963,000**	**$15,298,000**	**$50,603,000**

LOST PROFITS ANALYSIS

The next step in the review process was to examine the expert's calculation of defendant's profits earned on the alleged infringing sales. In this particular case, the expert simply calculated a gross margin as damages. In contrast, the Ninth Circuit has validated the deduction of operating expenses when calculating the defendant's profits. Simply stated, the Ninth Circuit allows for the deduction of a portion of the defendant's general expenses, such as overhead, operating expenses, and federal income taxes, so long as they are material to the generation of the revenue. Making this adjustment for the jurisdictional preference led to a substantial reduction in damages, as illustrated in the following table:

Table 2
Calculation of Defendant's Profits

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Plaintiff's Gross Profit Calculation on Alleged Infringing Sales						
Gross Margin	**$840,000**	**$3,162,000**	**$4,053,000**	**$5,269,000**	**$6,249,000**	**$19,573,000**
Net Profit on Corrected Alleged Infringing Sales						
Gross Profit on Corrected Alleged Infringing Sales	$237,000	$1,210,000	$1,764,000	$1,816,000	$3,211,000	$8,238,000
Incremental Operating Expense Ratio	15.7%	15.7%	16.0%	15.6%	19.1%	17.1%
Incremental Operating Expense	(127,000)	(527,000)	(630,000)	(639,000)	(1,165,000)	(3,088,000)
Incremental Profit on Corrected Alleged Infringing Sales	**$ 110,000**	**$ 683,000**	**$1,134,000**	**$1,177,000**	**$2,046,000**	**$ 5,150,000**
Difference						
Plaintiff's Gross Profit Calculation on Alleged Infringing Sales	**$840,000**	**$3,162,000**	**$4,053,000**	**$5,269,000**	**$6,249,000**	**$19,573,000**
Net Profit on Corrected Alleged Infringing Sales	**110,000**	**683,000**	**1,134,000**	**1,177,000**	**2,046,000**	**5,150,000**
Corrected Minus Plaintiff	**($730,000)**	**($2,479,000)**	**($2,919,000)**	**($4,092,000)**	**($4,203,000)**	**($14,423,000)**

Next, I had to rebut the expert's calculation of lost profits. Two major flaws were identified in the expert's analysis. First, the expert made the improper assumption that all of the infringing sales would have accrued to the plaintiff, but for the infringement by the defendant. With respect to real world activity, this assumption was incorrect. As the plaintiff only held a 15% market share, one cannot conclude that all of the defendant's sales would have accrued to the plaintiff. A more practical

assessment of the situation would have apportioned the gross infringing sales according to the plaintiff's actual respective market share, thus arriving at a realistic depiction of real market activity. Furthermore, without any investigation, the expert assumed that the plaintiff had idle capacity suitable to absorb a more than 45% increase in production. Analysis of the plaintiff's manufacturing operation revealed that it was operating at near full capacity; therefore, significant investment would be necessary to absorb all of the alleged infringing sales.

Mutually Exclusive Damages

To conclude the discussion on our rebuttal of this expert, we must comment on a subtle, but very important aspect of the analysis. As this expert went through the process of calculating 1) lost profits suffered by the plaintiff and 2) disgorgement of the defendant's profits, the expert made the mistake of opining that these two areas of damages should be additive. While trademark damages law does allow for the calculation of both lost profits and disgorgement, these calculations cannot be based on the same infringing sales. In other words, you don't get to double dip on the profits generated from the same revenue pool. This oversight cost the plaintiff's expert nearly 40% of the estimated damages – not to mention a profound loss in credibility.

Loss of Business Value

The second expert report offered by the plaintiff encompassed the loss in business value resulting from the alleged actions of the defendant. To accomplish this, the expert calculated the current enterprise value of the defendant, along with a "but for" value, which assumed the infringement never occurred. The fundamental error in this analysis stemmed from the expert's usage of the incorrect infringing sales data identified above. The expert adopted this flawed analysis as the basis for projecting revenues and profits into the future for the "but for" value analysis. This element alone accounted for a nearly 10-fold increase in the expert's damages conclusion. Ultimately, the old adage "garbage in – garbage out," is most appropriate here.

In addition to the adjustments to infringing sales data, numerous other adjustments were necessary to correct the expert's analysis. Mistakes were made to simple finance and accounting calculations such as incremental profit margins, revenue and expense growth, working capital needs, and discount rates. While each of these adjustments alone may not significantly impact the analysis, together they can substantially miscalculate the appropriate level of damages. The overall impact of these adjustments is identified below:

Table 3
Calculation of Loss in Business Value

Business Valuation	Plaintiff Value	Corrected Value	Difference
"But For" Value	$42,381,000	$12,892,800	($29,488,200)
Actual Value	$12,165,200	$10,601,200	($1,564,000)
Estimated Damages	***$30,215,800***	***$2,291,600***	***($27,924,200)***

Profit Apportionment

The final step in our rebuttal of these experts was to evaluate the relative contribution of the defendant's parts numbering system to the plaintiff's overall operation. In building its market share, the plaintiff

possessed a number of key assets which were critical to generating sales revenue. These assets included the breadth and quality of products, pricing strategy, skilled sales force, customer relationships, manufacturing capabilities, and, ironically, its own in-house parts numbering system. After analyzing these assets in detail, it was determined that the defendant's parts numbering system contributed no more than 10% to the success of the defendant's operations. Consequently, the above calculated damages were reduced by 90% to arrive at a value commensurate with the relative contribution of the infringed asset. The asset contributions were broken down as follows:

Table 4
Apportionment of Profits

Sales Generating Factor	Relative Contribution
Available Product Mix	25%
Pricing Strategy	25%
Sales Force / Existing Relationships	15%
Quality of Products	15%
Numbering Systems	***10%***
Manufacturing Capability	5%
Other Factors	5%

Ultimately, the plaintiff's $50 million damages claim was successfully reduced down to a more realistic number below $750,000. The $750,000 damages number was based on correcting errors committed by the opposing experts and by relying on the relevant case information, including actual market share information, actual profit margin data, sales mix characteristics, realistic revenue growth rates, manufacturing capacity constraints and the recognition that other assets contributed significantly to the generation of the defendant's revenue.

One final note, the reduced damages conclusion was further supported by the fact that the plaintiff had recently licensed its parts numbering system in an arm's-length transaction for an annual fixed fee of less than $10,000. Thus, any amount awarded in excess of this amount would theoretically have created a windfall for the plaintiff.

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[i] All dollar figures have been altered by an undisclosed factor to preserve confidentiality.