

Intellectual Property Litigation

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GUEST ARTICLE

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Expert Accounting Assistance in Intellectual Property Litigation

As the stakes in intellectual property litigation have increased, so have the role and significance of the expert accountant. The analysis and trial testimony of a certified public accountant ("CPA") on liability and damage issues is often central to sustaining or rebutting a claim. This article discusses ways in which attorneys can make the most effective use of the services of an accounting expert in intellectual property litigation.

Document Requests

One of the most useful and cost-effective contributions of the CPA early in the litigation is to assist in the preparation of document requests. First, the CPA should obtain a preliminary understanding of the case through discussions with the attorney and a review of existing documents. The CPA can then assist by listing specific documents needed using correct nomenclature. This may require no more than a few hours of effort, yet the potential benefits can be dramatic. This is particularly the case in intellectual

properties litigation, in which financial and accounting evidence is central.

CPA assistance in preparing requests for financial and accounting documents reduces the likelihood that the opposing party will take advantage of loopholes in the wording of a request to avoid turning over documents. For example, the request may specify that *audited* financial statements be produced when only *reviewed* or *compiled* financial statements exist. The CPA can also assist by preparing affidavits explaining why particular documents are needed.

Attorneys should call upon the CPA to clarify vaguely worded document requests. An example would be a request to produce "all financial records from 1982 to the present." Such poorly worded requests often result in one of two undesirable outcomes. First, the opposition may object to the request as vague, overbroad, unduly burdensome and lacking in reasonable particularity. Expensive and time-consuming motions and hearings often ensue. Alternatively, the opposition may produce voluminous documents, most of which are uninteresting, but which force the attorney and expert to expend valuable time to extract the necessary information. Both unpleasant outcomes can be avoided or their effects minimized by using the CPA to assist in developing document requests.

The Judicial Conference Advisory Committee on Civil Rules has proposed amendments to the Federal Rules of Civil Procedure and to the Federal Rules of Evidence which affect discovery procedures, in particular document requests.² The proposed rules seek to shift discovery from its traditional adversarial mode by requiring parties voluntarily to disclose relevant documents.

Damage Analysis

Litigators most commonly think of CPAs in the context of damage analysis. Indeed, this is the most common task for accounting experts in intellectual property disputes.

Sales Trend Analysis

The first step in intellectual property damage analysis typically is to determine sales trends of infringed, infringing and collateral products. Sales trend analysis frequently is important in the liability phase as well. The plaintiff will attempt to blame sales

declines on the infringer's actions, while a defendant will attempt to correlate changes in sales trends to other economic or business factors.

The expert should get beneath the sales figures provided in accounting statements. For example, a perceived variation in sales trends may be the result of a change in accounting treatment rather than the impact of an alleged infringer's actions. In one case an economist retained by the defendant testified that there were no damages because the plaintiff's financial statements showed an increase in sales. In fact, the perceived sales increase was the result of a change in accounting policy to record revenue on the accrual rather than the installment basis. The plaintiff's CPA discovered this fact while interviewing the company chief financial officer and used it to discredit the defendant's expert's analysis.

Attorneys should schedule meetings with the client's accounting and financial personnel to assist the CPA in obtaining this type of significant information. The CPA should prepare questions for and attend the depositions of financial and accounting personnel of the opposing party. The CPA should also prepare clear, graphic exhibits of sales trends. Figure 1 provides an example of actual and projected sales as well as lost sales.³

Marginal and Average Profit

The appropriate measure of damages in intellectual property disputes usually is *marginal* profit (the profit earned by selling additional units) rather than *average* profit. In most businesses, fixed expenses (e.g., rents, officer salaries) do not increase with an increase in sales. As a result, the marginal profit earned by selling extra units typically is greater than the average profit of all units sold.

To calculate marginal profit, the CPA undertakes an analysis in which expenses are segregated into fixed and variable components. Only expenses which vary with changes in sales are included in calculating marginal profit. Determining whether expense items are variable or fixed is not a mechanical process. It requires judgment and an understanding of the workings of the business. Interviews with client personnel and depositions of opposing party witnesses and experts are valuable sources to obtain this understanding. The attorney should work with the CPA to facilitate this process. Figure 2 provides an example of a marginal profit analysis.

Lost Profits

The plaintiff, as the owner of intellectual property rights, may seek recovery for lost profits from a variety of causes, including:

Diverted Sales. These are sales the plaintiff lost to the infringer. Diverted sales may be calculated as a fraction of the infringer's sales. The attorney should work with the CPA, other experts and fact witnesses to identify and quantify factors which affect the infringer's and the plaintiff's sales.

Reduced Selling Price. Often the owner of an infringed product must lower the selling price to compete with the lower prices at which infringing items are sold. This reduces the profits on all sales of the infringed item. The CPA often can substantiate or rebut claims for lost profits due to reduced selling price by analyzing industry average prices and the prices of analogous, non-infringed products sold by the owner. The CPA may research market factors other than the infringer's actions which affect prices and communicate the findings to the attorney.

Diminished Market. Inferior quality infringing products can reduce overall demand. A consumer disappointed by the quality of an infringing item may not choose to purchase a second (either from the owner or the infringer) or recommend the product to friends. Contrasting the market sales trend of the infringed item to comparable products is a frequently-used approach to substantiate or refute a claim for lost profits due to diminished market.

Damage Models

In preparing a damage model the CPA must be able to adapt the analysis rapidly to a constantly changing litigation environment. Claims for individual elements of lost profits may be stronger or weaker depending on the facts and circumstances of the case. The litigator may decide to modify the damage claim presented at trial based on court rulings, the flow of evidence, jury reactions, time constraints or other factors. When liability and damages are bifurcated and multiple liability claims are presented (e.g., trademark infringement, antitrust and unfair competition), prior to the conclusion of the liability trial the combination of damage claims sustained will be unpredictable.

To maintain the necessary flexibility, the CPA should calculate each damage element separately and be prepared to testify to the appropriate damages as

the exigencies of trial dictate. This can be facilitated by computerized damage models in which individual damage elements are calculated and stored separately so that the elements can be aggregated or deleted as needed. Figure 3 illustrates an example of such a model.

Damage to Goodwill

Attorneys in intellectual property disputes at times fail to seek to recover for damage to a company's reputation, also known as damage to goodwill. Perhaps the attorney does not see a way to quantify the impact an inferior quality infringing product has on the reputation of a firm. It may not be immediately apparent to the attorney how a CPA can assist in such a calculation.

The role of the CPA in calculating damage to goodwill becomes clear once it is understood that the economic impact of damage to a company's reputation is its reduced ability to earn future profits. The CPA can calculate damage to goodwill as the discounted present value of future lost profits.

Damage to goodwill can be presented to the trier of fact either as a separate damage element or as part of the lost profits damage calculation. Each approach has advantages and disadvantages. "Future lost profits" may be deemed speculative while "lost value of the business" may appear concrete, even though the actual calculations may be identical. On the other hand, lost future cash flow may be more compelling to a jury than a "value" placed on reputation. The litigator must work closely with the CPA to incorporate these considerations in the expert's analysis and the litigator's pleadings and arguments.

Reasonable Royalty

CPAs assist in reasonable royalty analysis by determining the profitability of infringing and related products. This is an essential element of the "analytical approach," in which a reasonable royalty is calculated as the excess profit -- above the profit the infringer ordinarily would have accepted -- resulting from the desirable but infringing characteristics of the object. This is often estimated by comparing the profit earned on sales of the infringing object to the infringer's "normal" profit on other, non-infringing items. Often the expert will use the analytical approach as a starting point for conducting a hypothetical negotiation between willing licensor and willing licensee, a second method to determine a reasonable royalty.

Summary

CPAs are an essential part of a successful intellectual property claim or defense. Although, current practice favors bringing in CPAs at the last minute, the full benefits of expert assistance can be better achieved if CPAs are brought in early to deal with discovery issues. This often can reduce the total cost of expert assistance. CPAs can be utilized in determining damages, calculating reasonable royalties and analyzing liability issues.

ENDNOTES

[1] Thomas Neches is Senior Partner and Sabrina Thomas is an associate of Simpson & Company, a firm of certified public accountants providing litigation services, including expert witness testimony, damage claims and investigative accounting. Mr. Neches specializes in intellectual property and antitrust litigation. The authors gratefully acknowledge the contributions to this article of Cindy A. Holdorff, CPA and Matthew R. Graczyk.

[2] Preliminary Draft of Proposed Amendments to the Federal Rules of Civil Procedure and the Federal Rules of Evidence, Committee of Rules of Practice and Procedure of the Judicial Conference of the United States, Administrative Office of the United States Courts, August 1991. Proposed Rule 26 states:

"Each party shall, without awaiting a discovery request, provide to every other party a copy of, or a description by category and location of, all documents, data compilations, and tangible things in the possession, custody, or control of the party that are likely to bear significantly on any claim or defense.... These disclosures shall be made (i) by a plaintiff within 30 days after service of an answer to its complaint; (ii) by a defendant within 30 days after serving its answer to the complaint.... The disclosure should describe and categorize the nature and types of documents, including computerized data, "sufficiently to enable opposing parties (1) to make an informed decision concerning which documents should be examined, at least initially, and (2) to frame their document requests in a manner likely to avoid squabbles resulting from the wording of the requests."

The proposed amendments have not been submitted to or considered by the Judicial Conference of the United States or the Supreme Court. If adopted they would be effective December 1, 1993.

[3] See pages 8, 9 and 10 for Figures 1, 2 and 3 respectively. All names and values used in Figures 1, 2 and 3 are fictitious and for use only in this article.

Johnson Lasers, Inc.
Actual and Projected Laser Sales By Quarter
Quarters Ended 3/31/88 through 12/31/91

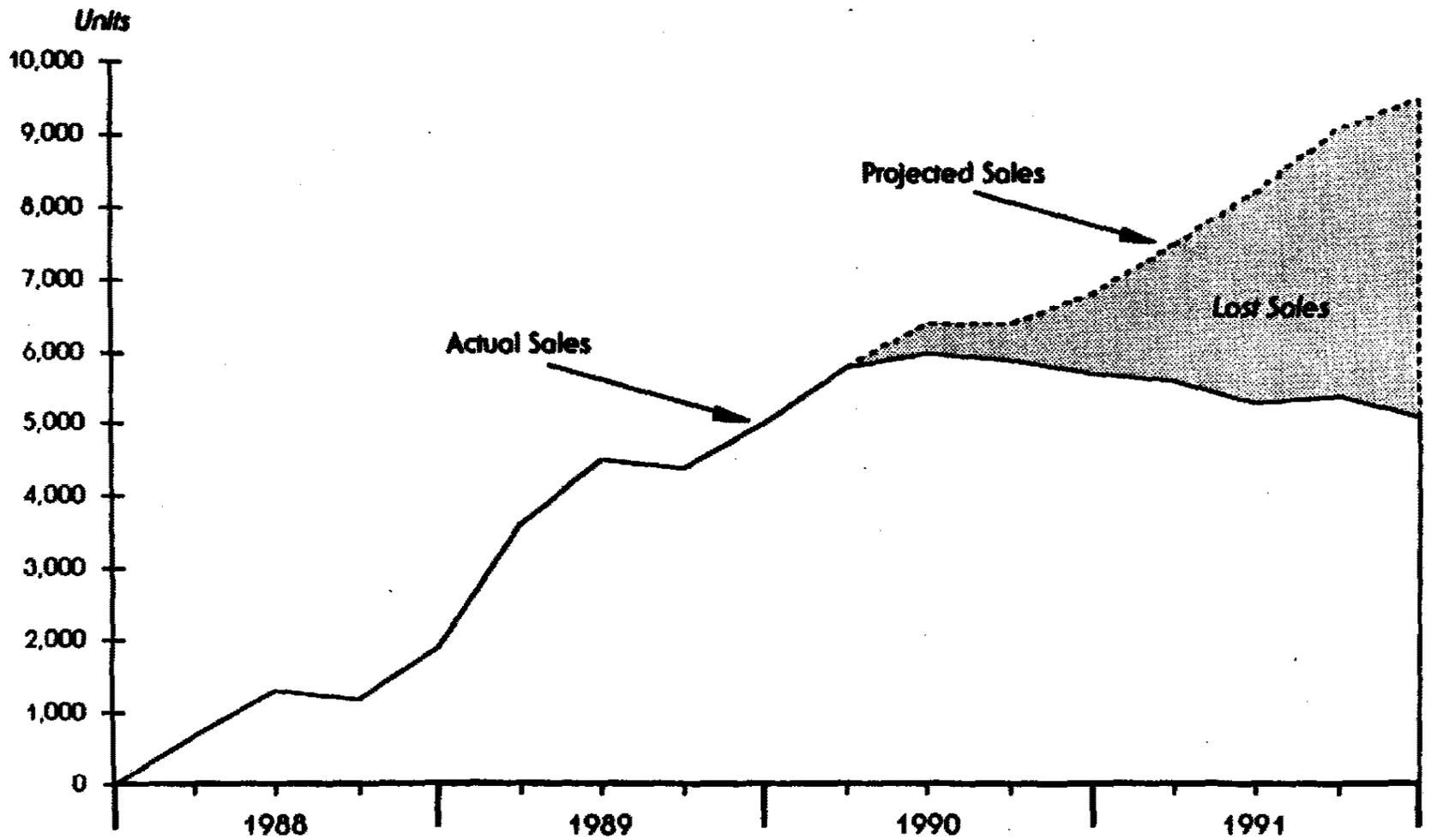


Figure 1

Johnson Lasers, Inc.
Marginal Profit
Fiscal Year Ended March 31, 1990

	<u>Year Ended 3/31/90</u>	<u>Variable Percent</u>	<u>Variable Amount</u>
Sales	<u>\$81,432,760</u>	100%	<u>\$81,432,760</u>
Cost of Sales			
Labor	14,832,984	100%	14,832,984
Materials	18,505,470	100%	18,505,470
Overhead	<u>5,698,374</u>	80%	<u>4,558,699</u>
Subtotal	<u>39,036,828</u>		<u>37,897,153</u>
Gross Profit	<u>42,395,932</u>		<u>43,535,607</u>
Selling, General & Administrative Costs			
Administrative Salaries	3,249,942	0%	0
Commissions	8,247,870	100%	8,247,870
Travel & Entertainment	1,743,184	50%	871,592
Depreciation	2,497,801	0%	0
Rent	1,842,325	0%	0
Utilities	652,870	50%	326,435
Legal & Accounting	397,840	0%	0
Bonuses	1,647,425	100%	1,647,425
Temporary Help	287,392	100%	287,392
Advertising	<u>4,781,952</u>	0%	<u>0</u>
Subtotal	<u>25,348,601</u>		<u>11,380,714</u>
Profit Before Taxes	<u>\$17,047,331</u>		<u>\$32,154,893</u>
Profit Percentage	<u>21%</u>		<u>39%</u>

Average Profit

Marginal Profit

Figure 2

**Johnson Lasers, Inc.
Summary of Lost Profits
Laser and Mini-Laser and Collateral Products**

Category	Lasers Lost Profits	Mini-Lasers Lost Profits	Total Lost Profits
Diversed Sales	\$3,710,476	\$434,687	\$4,145,163
Diminished Market	1,106,268	335,578	1,441,846
Generally Lower Selling Price on Johnson Units	420,247	24,315	444,562
on Diversed Units	120,156	9,044	129,200
on Diminished Market Units	89,355	4,630	93,985
Subtotal	629,758	37,989	667,747
Lost Collateral Sales on Diversed Units	177,874	9,092	186,966
on Diminished Market Units	71,864	6,456	78,320
Subtotal	249,738	15,548	265,286
Total Lost Profits	\$5,696,240	\$823,802	\$6,520,042

**Lost Profits
Presented to Jury ***

\$3,710,476

120,156

177,874

\$4,008,506

* **Note:** In this case it is assumed that at the time of the CPA's testimony, judicial rulings and the "flow of the case" caused the trial attorney to limit the lost profits to only three of the many potential categories.

Figure 3