The Use of Forensic Accounting Techniques in the Determination of Intellectual Property Damages

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Abstract
Forensic accountants are hired to assist the trier of fact (judge, jury, or arbitration panel) by providing their expert opinions as evidence in a case. The forensic accountant is consulted to determine whether economic damages have been incurred, and, if so, the amount of those damages. Forensic accountants, with their training in financial accounting, evidence presentation, and research skills, are ideally qualified to calculate and provide estimates of economic intellectual property rights (IPR) infringement damages. This article discusses the types of IPR, the statutory scheme, and the typical damages-determination engagement; it also summarizes the major types of damages sought in IPR infringement litigation.

Key Words: financial damages, intellectual property, lost profits, infringement
Significance of Intellectual Property Rights

In order to gain an understanding and perspective of the concepts and techniques used to calculate financial damages for intellectual property rights (IPR) engagements, one must embrace the overall intrinsic value of IPR in today's society. Capitalism is the economic system that allows each person the freedom to profit substantially from his or her own efforts. Developing and demonstrating one's imaginative talents by creating new products, ideas, business processes, and works of art is one of the cornerstones of the United States' capitalistic economy. New products, expressions, formulas, inventions, imaginative ideas, processes, or any other creation of the mind are referred to collectively as IPR. Protection of IPR is very important to the continued success and growth of our capitalistic society.

In the United States, ownership and recognition of IPR are usually attained through a registration process. IPR, just like tangible and real properties, may be bought, sold, or leased. As with other property rights in a capitalistic society, there are specific laws that protect the rights and privileges of the owners of IPR. Federal law governs the protection of patents, copyrights, and trademarks; however, trade secrets are governed exclusively by state law.

Summary of the Most Common Types of Intellectual Property

Patents are legal rights granted through a document issued by the United States Patent and Trademark Office to an inventor to exclude others from making, using, or selling the claimed invention in the United States. A patent is granted for a term of 20 years and is not renewable. The patent statutes are part (Title 35) of the U.S. Code (USC), Title 35 USC, Section 271, addresses infringement (2000). Infringement cases are heard in the U.S. district courts. Appeals from district-court decisions go to the court of appeals for the federal circuit rather than to the respective circuit court of appeals. This change was made as part of the Federal Courts Improvement Act of 1982 to promote greater uniformity in patent enforcement and litigation. While the promotion of uniformity was a worthy goal, it has not yet been achieved because the court of appeals for the federal circuit has reversed approximately 50% of district court patent cases appealed to it (Chu, 2002).

A trademark is any word, name, symbol, or device used to indicate the source of a party's goods or services and distinguish those goods and services from the goods and services of others (trademarks for services are called service marks). Trademarks are sometimes followed by the “Circle R” (®) to indicate that they are federally registered. Trademarks and service marks can last forever as long as they are used in commerce. Infringement occurs when a third party uses a mark that is so similar to a mark already in use that it is likely to cause consumer confusion. The trademark laws (sometimes called the Lanham Act) can be found under Title 15 USC, Section 1051, et seq. (2000). The infringement sections are Title 15 USC, Sections 1114 through 1129. Infringement cases are heard in the U.S. district courts, and appeals from district-court decisions go to the respective circuit court of appeals.

A copyright is the right granted to the creator for an original work of authorship. This right gives the owner the exclusive right to reproduce, prepare derivative works, distribute copies, and display the work publicly. The copyright statutes are found in Title 17 USC, with infringement covered in Sections 501 through 513 (2000). Copyrights are granted for the life of the author plus 70 years. Works made for hire (i.e., authored by an individual but owned by a corporation or other legal entity) are granted for the longer term of 95 years from first publication or 120 years from creation. Infringement cases are heard in the U.S. district courts, and appeals from district-court decisions go to the respective circuit court of appeals.

A trade secret is any confidential information not known to the general public or others in the industry that gives a business an economic or competitive advantage. State law covers the establishment and protection of trade secrets. Trade-secret law attempts to promote commercial ethics by protecting trade secrets from misappropriation. The National Conference of Commissioners on Uniform State Laws drafted the Uniform Trade Secrets Act in 1985, however, the Uniform Act has not been adopted by most states. Currently, the trade secrets laws of each state are different (Pillsbury Winthrop Shaw Pittman LLP, 2004).

The Role of Forensic Accountants in IPR Infringement Litigation

While capitalism allows people to flourish based on their own merits, these labors are fueled by one fundamental consideration—profit. Profit is the purpose and reward for producing goods more efficiently, distributing products to a wider market, and doing things better, faster, and smarter than ever before. The profit or economic benefit is the fundamental right and privilege for the owner of IPR in a capitalistic economy. Someone else's profit also provides a high level of motivation for the willful violator of IPR and for individuals who will illegally take advantage of the opportunities afforded by a capitalistic society.

Profit comes from an increase in the production of wealth. The measurement, calculation, and insight into notions of profit are most often relegated to the financial and economic community. Therefore, when there is a question regarding a determination of lost profits or economic damages resulting from the infringement or theft of IPR assets, the expert hired should be skilled in forensic accounting. The skill set of the forensic accountant is ideal for calculating damages from IPR infringement. Skills typically possessed by forensic accountants include the following:

• Understanding of financial accounting in general.
• Understanding of practical microeconomics.
• Understanding of corporate departmental and cost-center accounting systems.
• Experience in drawing and defending logical conclusions from incomplete data.
Intellectual Property Litigation Process

The forensic accounting damages expert can work for either the plaintiff or the defense. The litigation process begins at an initial meeting with the retaining attorney to discuss background elements, legal pleadings, case progress, preliminary damages theories, timetables, and budgets. Ideally, the forensic accounting damages expert should be retained prior to the end of document production and discovery. If retained early enough, the expert can advise the retaining attorney on specific documents that will likely be needed and can usually identify particular employees who would likely have access to them.

For example, legal counsel may request a manufacturer's production reports by facility and may request product sales reports by region rather than placing a simple request for sales information. This information likely exists for a public company because the segment information is reported in the company's annual Form 10-K. Federal Rule of Civil Procedure 34 provides that "[t]he request shall set forth, either by individual item or by category, the items to be inspected, and describe each with reasonable particularity" (2004). The more particularity specified, the more likely it is that produced financial documents will be useful to the retaining attorney's forensic accounting damages expert.

Quite often it is more advantageous for the expert to initially be retained as a consultant rather than being hired directly as an expert. It is not necessary to identify non-testifying consultants to opposing counsel during the period that the forensic accounting damages expert is retained as a consultant, the retaining attorney needs to decide whether the expert's opinions are helpful to his or her case as he or she wants to present it. If so, the retaining attorney can identify the forensic accountant as a testifying expert.

The expert needs to review the document production from both sides of the case in order to adequately prepare his or her report. In most IPR engagements, document production will result in an immense amount of data. Very often, much of this data may not immediately appear to be pertinent. However, it is imperative that the expert become cognizant of the various data and that he or she does not easily dismiss the data as being irrelevant. While counsel may furnish copies of documents to the forensic accounting damages expert, it is important that he or she also survey the entire document production and read key depositions to determine if there are other relevant documents that the forensic accountant has not considered. Failure to conduct some independent inquiry will subject the forensic accountant to the opposing side's claim that his or her report and testimony are based solely on what the retaining attorney wanted him or her to see.

Through data research and case analysis, the forensic accountant damages expert will begin to develop his or her opinion of economic damages. The basis of the opinion will be predicated upon the current and potential product market, relevant cost, profit structures of the germane product for both sides, financial results surrounding the infringement period, and the financial models developed by the expert. The expert must research the background of specific cases to be sure his or her economic damages model is allowable and has not been dismissed in cases as being speculative.

Ultimately, the expert must convey his or her opinions; this is most often accomplished through a formal written report that supports the expert's findings. Rule 26 of the Federal Rules of Civil Procedure (2004) governs the reports of experts. In summary, that rule states that reports of experts must include a complete statement of all opinions to be expressed, the data or other information considered, and any exhibits and qualifications of the witness (including publications and other testimony) and the reports must be signed by the witness. Reports for cases docketed in state courts follow the civil procedure rules of that state.

Once the expert has reached his or her conclusions and completed the report, opposing counsel will have the opportunity to depose the expert under oath. Opposing counsel can have as many as 10 goals in mind in deposing the expert (Babitsky, 1999), which includes evaluating the expert's credibility in front of a jury. The transcript is evidence and may be used at the trial if the expert is not available due to death, disability, or any other acceptable reason. Deposition testimony is a double-edged sword. It likely will include an explanation of the expert's theory of damages, but it will also lock down the expert to the opinions stated. Often the retaining attorney will request the forensic accounting damages expert to attend the deposition of the opposing expert in order to suggest questions and evaluate the opposing expert's answers.

Damage Remedies

Most IPR plaintiffs request an injunction against the alleged infringer. The injunction could be temporary or permanent. Beyond an injunction, the IPR plaintiff may request financial remedies. The following list describes some of the usual financial remedies requested by IPR plaintiffs:

- Lost profits are the difference between the profits that the IPR owner would have realized but for the alleged actions of the infringer, and the IPR owner's actual profits over the appropriate damages period.
- The infringer's profits can be awarded to the IPR owner, except in patent cases in which the award of the infringer's profits is not provided for in the statute.
- A reasonable royalty is the monetary amount the infringer would have paid the IPR owner as the result of a hypothetical license negotiation occurring at the time the infringement began. Reasonable royalties are most often seen in patent cases, where 35 USC Section 284 provides that the damages awarded be adequate to compensate for the infringement but in no event be less than a reasonable royalty for the use made of the invention by the infringer (2004).
- Statutory royalties are provided for copy-
right law violations. The statutory royalty can be increased up to $150,000 by aggravating factors, such as willful violation.

- Lost profits on convoyed sales are the profits on items usually sold along with the infringed patented or trademarked product.
- Price erosion is the reduction in profits suffered by the IPR owner due to having to compete with the alleged infringer.
- Corrective advertising costs are the cost incurred by the IPR owner in providing accurate information to consumers after advertising or market activity by the alleged infringer.

Experts and Helpfulness to the Trier of Facts

The expert's testimony must be relevant to the issue and helpful to the court in understanding the issue. In order to be helpful, the witness must be qualified as an expert, the expert must have a reasonable factual basis for the testimony, the testimony must be based upon reliable methods, and the testimony must be relevant to the facts of the dispute.

Daubert and Kumho Cases and Challenges to Experts

In Daubert (Daubert v. Merrell Dow Pharmaceuticals, 509 U.S. 579 (1993)), the Supreme Court ordered the trial judge to be the “gatekeeper” for scientific testimony, allowing only expert testimony that meets the following four requirements:

- The theory can be (and has been) tested.
- The theory or techniques have been analyzed through peer review or publication.
- The theory or techniques have been tested for potential rate of error.
- The theory or techniques have been accepted within the scientific or technical community.

Daubert (1993) was extended to non-scientific experts, such as financial damages experts, by Kumho Tire Co. v. Carmichael, 526 U.S. 137 (1999). These standards have been adopted as Section 702 of the Federal Rules of Evidence (2004). Opposing counsel may make a Daubert challenge, called a motion in limine, seeking to exclude the forensic accountant's report and testimony. It is important that the forensic accountant does not overreach in his or her report or deposition and provide ammunition for a Daubert challenge. The importance cannot be overstressed. Loss of a Daubert challenge and exclusion of the expert's report usually means that the financial damages portion of the case is over.

With the financial damages at stake, it is imperative that the forensic accounting damages expert consider not only the reliability of the testimonial evidence, but also his or her own level of expertise. For this reason, the expert should associate with other knowledgeable colleagues from the inception of the engagement. An association or collaboration with an economist is advisable if the forensic accountant's report will likely include technical economic issues. If advanced economic issues are identified, the economist may prepare his or her own report. In the event of a Daubert challenge, the court will likely examine both the methodology and the applicability of the expert's approach.

Faced with a proffer of expert scientific testimony, the trial judge must determine at the outset whether the expert is proposing to testify to scientific knowledge that will assist the trier of fact to understand or determine a fact in issue. This entails a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology can be applied to the facts in issue (Daubert, 1993, p. 592-93).

A proper damages analysis requires an understanding of the IPR owner's and the infringer's financial reports, books, and records. A background in accounting principles is a basic requirement to accurately identify the financial information necessary for translating abstract economic theories into factually supported positions. A forensic accountant can provide a detailed accounting analysis that is suitable to the courts and often will assist the trier of fact and form the foundation for argument, debate, and ultimately dispute resolution. Beyond basic accounting, forensic accountants utilize various investigative skills necessary to sift through documentary evidence, financial records, and economic data to communicate financial information clearly and concisely in a courtroom setting.

Damages Quantified

It is one matter for the IPR owner to claim that some sort of harm or financial damage occurred as a result of an alleged IPR infringement; it is an entirely different matter to quantify the financial damages into categories without double-counting. The core principle of compensatory damages requires awarding the smallest monetary amount required to put the plaintiff in the pecuniary position he or she would have been had the alleged “bad act” not occurred” (Glick, 2003, p. 34). To satisfy this requirement, the expert must understand the IPR owner's current economic and financial condition. A hypothetical “but for” economic model must be constructed as if the IPR infringement had not occurred.

While this may seem straightforward,
there are restrictions and guidelines in creating the hypothetical “but for” economic position. Federal Rule of Evidence 703 provides guiding principles for information used in the construction of the “but for” model (2004). The failure to adhere to these principles risks the expert’s exclusion under a Daubert challenge. Aside from an injunction, one of the initial decisions a damages expert or lawyer must decide is which of the above primary financial remedies should be used to calculate the economic damages incurred. In many cases, a combination of theories should be used if allowable under the statute and case law.

Application of Forensic Accounting in Determining Trademark Infringement Damages

In the case of the infringement of a registered trademark, 15 USC 1117 (2000) provides in pertinent part:

[T]he plaintiff shall be entitled…to recover (1) defendant’s profits, (2) any damages sustained by the plaintiff, and (3) the costs of the action. The court shall assess such profits and damages or cause the same to be assessed under its direction. In assessing profits the plaintiff shall be required to prove defendant’s sales only; defendant must prove all elements of cost or deduction claimed.

In preparing his Rule 26 report, the forensic accounting damages expert for the plaintiff should use the above as his or her outline of damages sustained. However, it is unwise to wait for the defendant’s expert to prove all of the elements of cost and deduction from the defendant’s infringing gross receipts (assuming that the infringing gross receipts are properly reported) because discovery might have closed and documents to refute the defendant’s computations might not be available.

Accordingly, it is important that the plaintiff’s forensic accountant review the documents produced and prepare preliminary estimates of the elements of the defendant’s costs and deductions. The general standard is that variable costs are the only ones allowed. In other words, fixed costs such as rent and executive compensation are not an allowed element of cost or deduction. Some sources of this variable cost information include the following:

- Defendant’s financial statements, product and departmental budgets, and sales reports.
- Defendant’s tax returns (including Section 263A cost allocations) and detail of cost of goods sold.
- Reports to regulatory agencies.
- Accountant’s working papers and trial balances.
- Industry information and statement studies from the Risk Management Association (formerly known as RMA or Robert Morris Associates, an association of bankers and credit executives).

Using the variable cost information, the forensic accountant for the plaintiff can estimate the defendant’s claimed costs and deductions. He or she can also work with the retaining attorney to request additional documents.

Summary

Litigation of intellectual property rights requires financial damages analysis. This analysis requires accounting, economics, and forensic techniques. The role of the financial damages expert in the resolution of the case is defined in the federal rules of evidence for most IPR cases, although state law applies to trade secrets and other IPR under certain fact patterns. As the financial damages expert, the forensic accountant must consider the applicable statutes and case law in preparing his or her opinion of damages incurred and defending it.

References


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