

## **Article:** Financial compensation – damages or account of profits?

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Intellectual property (“IP”) assets provide protection from the effect of competition. Depending on the type of asset it can provide either the ability to differentiate the IP owner’s products from its competitors, cost savings that are not available to competitors, or both. When companies invest in IP assets they are seeking to benefit from these advantages. Ultimately they are seeking an incremental improvement in profitability. This is shown by the fact that the project appraisal methods that companies use to assess their investments are incremental. For example, net present value calculations focus on the future incremental cash flows of a project (such as an investment in new technology) rather than accounting measures of profits.

When a company’s IP asset is infringed, the infringer deprives the IP owner of those incremental benefits and/or takes the incremental benefits for themselves. The infringer may also diminish the size of the total incremental benefit available from the IP (for example, by increasing competition in the provision of the IP-protected product).

The specific consequences of an infringement depend on the type of IP involved, the nature of the infringement and the businesses of the IP owner and the infringer. An infringement may divert sales from the IP owner to the infringer; alternatively the IP owner may have lost the opportunity to charge licence fees. The infringer may have profited from its use of the IP. The financial remedies available to an IP owner address these consequences of an infringement. The IP owner can elect between either damages or an account of profits. In this article, we consider the key characteristics of these two remedies and the issues to consider when choosing between them.

Damages are based on the compensatory principle. This remedy is intended to return the IP owner to the position it would have been in absent the infringement. Consistent with this principle and the nature of the benefits conferred by IP, it is concerned with the IP owner’s incremental loss. In the case of patents and copyright, the IP owner’s loss can either be its lost profits from sales that it would have made absent the infringement or a reasonable royalty (reflecting the actual or notional licensing income that it could have earned from licensing the IP). In the case of trade marks, IP owners may not have the option of seeking a royalty on the defendants infringing sales that were not diverted from the IP owner (see *Dormeuil Frères v Feraglow* [1990] RPC 449 and *Reed Executive v Reed Business Information* [2004] RPC 767 CA).

At a high level, an account of profits may be seen as the other side of the coin to a damages enquiry. It seeks to take from the infringer the profits that it has made from its misuse of the IP and hand them to the IP owner. In general, the English courts have not interpreted this as the incremental gain of the infringer; they have taken a different approach. An account of profits normally looks at the infringer’s total profits from infringing sales, and apportions these profits between the infringing and non-infringing drivers. This apportionment can involve infringing and non-infringing elements of the end product (for example, an infringing house incorporating a non-infringing kitchen in *Potton v Yorkclose* [1990] FSR 11) and/or infringing and non-infringing assets or processes that contribute to the end product (for

example, the use of the infringing process and non-infringing processes in the production of acetic acid in *Celanese International v BP Chemicals* [1999] RPC 203).

## Damages

When sales of the IP owner have been diverted by the infringement, there are a number of key characteristics of the calculation of lost profits:

- (1) The IP owner's loss is based on the actual sales diverted by the infringement. Therefore, it is not assumed that all the infringing sales would have been made instead by the IP owner. In fact, there are a number of reasons why all the infringing sales may not have been made by the IP owner such as where the total market has been expanded by the pricing strategy or marketing activities or additional distribution channels of the infringer or where there are other non-infringing competitors in the market who would have made some of the infringing sales.
- (2) The infringer cannot say that it would have used alternative non-infringing means to compete with the IP owner if this is not what it actually did. This is a potential departure from true counterfactual analysis since it will often be the case that an infringer could, and would, have competed without using the infringed IP. However, this assumption does not fundamentally change the nature of the damages calculation; it just increases the incremental loss that is calculated.
- (3) Lost revenue of the IP owner incorporates the impact of any price depression due to the infringement. In most cases this is likely to be a loss that has been suffered both on its lost sales and its actual sales.
- (4) As held in *Gerber Garment Technology v Lectra Systems* [1995] RPC 383 (affirmed by the Court of Appeal at [1997] RPC 443 CA), lost revenue can also include products and services that are not protected by the IP but are sold together with the IP-protected article.
- (5) Lost profits are calculated by taking the lost revenue and subtracting any additional costs that the IP owner would have incurred if it had made the sales that were diverted by the infringement. Only those costs that vary within the range of unit increases underpinning the estimate of additional revenue should be included. These additional costs are likely to be quite different to the types of costs included when calculating common accounting metrics such as operating profit and net profit (such as allocations of costs such as rent). Even certain labour costs that are normally considered to be variable may not change absent the infringement. This means that the incremental profit margin appropriate for the damages calculation may be higher than the gross profit margin of the IP owner's business.
- (6) In some circumstances, such as where the IP owner would have been capacity constrained at the higher level of output commensurate with the estimate of lost sales, some costs that are typically treated as fixed would in fact have been higher absent the infringement. These costs can be substantial.

When sales of the IP owner have not been diverted by the infringement, or it is difficult to prove, or assess the diversion, then, in the case of patents and copyright, the IP owner can claim for a reasonable royalty. The calculation of the reasonable royalty has the following key characteristics:

- (1) The calculation includes all infringing sales (except to the extent that those sales have been included in a calculation of lost profits).
- (2) Where, in the courts' view, there is a going rate then this rate tends to be applied even though it may reflect the availability of non-infringing alternatives (see for example, *General Tire v Firestone Tyre* [1975] 1 WLR 819 HL).
- (3) The court will award a reasonable royalty even in circumstances where the parties would never have agreed on the amount payable (or to license the IP at all). The reasonable royalty is therefore often described as hypothetical royalty, which may differ from that found in practice. Commercial licensing transactions involve a collaborative agreement between the licensor and licensee as how to best commercialise the IP. A deal is struck at some point between the minimum that the licensor is willing to accept and the maximum that the licensee is willing to pay, based ultimately on the incremental profits that can be generated by using the IP. However, when calculating a reasonable royalty in respect of IP infringement, the courts have sometimes awarded more than the maximum that the licensee would have been willing to pay; for example, where there is evidence that the minimum that the licensor would have been willing to accept is higher than this maximum (*Irvine v Talksport* [2003] EWCA Civ 423).

### **Account of profits**

There are two key steps in the courts' approach to account of profits. These are:

- (1) identifying the total profits made through the infringing sales; and
- (2) apportioning these profits (if necessary) between the infringed IP and non-infringing drivers.

The IP owner is awarded the profits apportioned to the infringed IP, which cannot be greater than the actual profits made by the infringer (that is, the IP owner cannot argue that the infringer ought to have been more successful).

### *Total profits*

As we have noted, an account of profits starts from total profits rather than incremental profits. To calculate the incremental gain that the infringer has made would involve comparing the profits the infringer actually made with the profits that it would have made absent the infringement. The calculation of total profits in an account of profits differs from the calculation of incremental gain in two ways. First, in common with a damages enquiry, the infringer cannot argue that it could have made the sales by using a non-infringing alternative. Second, in contrast to a damages enquiry, costs in the calculation of total profits may include allocations of fixed costs as well as the incremental costs incurred by the infringer in making the infringing sales (these fixed costs are typically allocated using standard accounting principles and can be substantial). This means that it is not clear whether total profits calculated in an account of profits are higher or lower than the actual incremental gain of the infringer; it also means that the incremental profit per unit in a damages enquiry is likely to be significantly greater than the incremental profit per unit in an account of profits.

## *Apportionment*

In a damages enquiry the scope of lost profits is broad. For example, it includes sales of products and services that are not protected by the IP that are sold together with the IP-protected article.

Apportionment in an account of profits goes in the opposite direction. It narrows the scope of profits gained by apportioning profits from infringing sales between infringing and non-infringing drivers.

The underlying motivation for apportionment is that the purpose of an account of profits is not to punish the infringer, but to ensure that the infringer did not unjustly enrich itself. Therefore, profits that were not caused by use of the infringed IP should be excluded. The focus on causation suggests an incremental approach would be appropriate, but in some cases an incremental approach has been explicitly rejected.

Below we focus on the approach to apportionment in two cases where it was discussed in detail: *Celanese International*; and *Hotel Cipriani v Cipriani (Grosvenor Street Ltd)* [2010] EWHC 628 (Ch).

In *Celanese International*, Laddie J explicitly rejected a solely incremental approach. He split apportionment into two parts. The two parts are what he called “base allocated profit” and “differential profit”. Base allocated profit is an apportionment of profit before considering whether the IP has had an incremental impact on profitability. Differential profit is any incremental impact on profitability due to the infringer’s use of the IP.

Laddie J concluded that the most appropriate method for calculating the base allocated profit attributable to the IP in the context of the case was to apportion profit by reference to the costs and expenses attributed to the IP (specifically relative capital expenditure on the infringing technology in the case of BP Chemicals’ infringing acetic acid production). The concept of base allocated profit that is distinct from incremental benefit is a challenging one for a financial expert given that the motivation for investing in and using IP is to gain an incremental benefit. In Laddie J’s approach, the incremental benefit is picked up in his concept of differential profit. However, Laddie J concluded that compelling evidence is required to support attributing differential profit to the IP. He found that there was no differential profit attributable to the IP in the case of BP Chemicals’ use of the infringing technology.

In contrast, the judge in *Hotel Cipriani* found that there was evidence that the use of the IP (in that case a trademarked name and logo) gave rise to a differential profit. Briggs J adopted the approach suggested by the two financial experts in the case. The approach used is a standard valuation approach used to isolate the incremental impact of intangible assets. It involved two steps. First, a return was apportioned to functional activities based on a mark-up on their costs with the residual being attributable to all intangibles. Second, this residual was split between the name and logo (the infringed IP) and other intangibles. For this the judge used the approach suggested by the claimant’s expert, which was to look to the ratio between two agreements that the defendant had entered into with a related party, one with respect to the name and logo (at 11.5% of revenue), and the other with respect to management (at 3% of revenue). This approach resulted in 79% (11.5% divided by 14.5%) of the profits attributable to the intangibles being attributed to the name and logo. An approach based purely on costs, that is, the

proportion of the infringer's total costs that related to its use of the name and logo, would have resulted in a significantly lower proportion of profits being allocated to the infringing acts.

The apportionment approach applied in *Hotel Cipriani* shows that where compelling evidence is available on the incremental impact of the IP, IP owners can achieve significantly greater awards than would be possible using a simple cost-based apportionment approach as used in *Celanese International*.

### **Choosing between the remedies**

Where the IP owner can show that significant sales have been diverted by the infringement then damages are nearly always likely to be the preferred option. The primary reasons are:

- (1) the broad scope of revenue included in damages (including all lost revenue not just that which is protected by the IP) compared to the narrow scope of profits in an account of profits due to apportionment;
- (2) the significantly higher profit per unit used in a damages enquiry due to the inclusion of allocations of fixed costs in an account of profits;
- (3) the ability to recover losses due to price depression in a damages enquiry whereas in account of profits any price depression would reduce the profits of the infringer that are available for the IP owner to recover; and (of particular practical importance);
- (4) the greater uncertainty as to what might be recoverable in an account of profits at the time of making the election between damages and an account of profits.

Even when the IP owner would be capacity constrained at the higher level of output commensurate with the estimate of lost sales, the consequential additional costs are still unlikely to make an account of profits more attractive. In the situation where the infringer substantially expanded the market through its marketing activities or distribution strength this would in principle affect both a calculation of lost profits and an account of profits. It is a non-infringing driver of sales that would not be present in the scenario absent the infringement. This issue would normally have a more significant impact on damages making an account of profits more attractive, but in certain circumstances it could make a claim for a reasonable royalty on the infringing sales the most appropriate choice.

The greater strength of protection offered by patents means that it is more likely to be possible to show that an infringement resulted in a diversion of sales than for trade marks or copyright. With respect to trade marks, assuming a claim on a royalty basis is not available then an account of profits is the only option where there is no diversion of sales from the IP owner.

With respect to patents and copyright, where the infringement has not diverted sales or it is difficult to assess, the choice can be more subtle. If the infringer's exploitation of the IP was unsuccessful and it did not generate profits then the IP owner can only sensibly choose a damages enquiry on a reasonable royalty basis. Even where the infringer has made a profit, judgments such as *Celanese International* may have led IP owners to choose a damages enquiry for a reasonable royalty due to a perceived greater

likelihood of a substantial award. However, the apportionment approach in *Hotel Cipriani* shows that where compelling evidence of the differential impact of the defendant's use of the IP is available, an account of profits may provide the IP owner with access to a greater award.

### **Authors' biographies**

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Daniel Ryan has 20 years experience in valuing businesses, shares and intellectual property assets in both contentious and non-contentious matters. He is a chartered accountant and a member of the Society of Share and Business Valuers and the Licensing Executive Society.

#### **Andrew Wynn**

Andrew Wynn specialises in financial analysis involving IP and damages analysis in commercial disputes. In IP matters, his experience includes damages and account of profits following infringement, determination of licence fees, valuation of IP, IP transactions, transfer pricing involving IP assets, and employee compensation awards. He holds an MSc Economics from the University of Warwick.