Trade Mark Valuation in Australia

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Introduction

The consumer who chooses to pay $1.00 extra for a trade marked product over a generic product has "valued" the trade mark. The consumer who buys the generic product has also "valued" the trade mark. Trade mark valuation occurs all of the time, all over the world. However, only a fraction of trade mark analysis and valuation is delivered in the form of professional valuers reports. Every potential transaction, every opportunity pursued, and every opportunity not pursued, inherently involves a valuation of a trade mark.

Like other forms of property, you can buy, sell and license a trade mark. It is important you understand the value of your clients trade mark.

Overview

Businesses generally take years and spend a fortune developing each new product or service, before marketing it under its own trade mark to win and maintain widespread demand.

Pavri says that, "conventional wisdom has it that in the United States it costs, on average, about $50 million to research, develop and market a new product. After all this, does a trademark have any value? And if it does, what is the value should it change hands?"[1]

[1] Pavri, Z, *Where the Value In A Trademark Lies*, Price Waterhouse, edited by Richard Wise, FCA, Richard Wise & Associates, CA Magazine, February 1987 page 1

In Australia, a trade mark is defined in section 17 of the ***Trade Marks Act 1995*** (Cth) as being:

> "a sign used, or intended to be used, to distinguish goods or services dealt with or provided in the course of trade by a person from goods or services so dealt with or provided by any other person."

Section 6 of the ***Trade Marks Act 1995*** (Cth) defines "sign" as including the following or any combination of the following, namely, any letter, word, name, signature, numeral, device, brand, heading, label, ticket, aspect of packaging, shape, colour, sound or scent.

Simplistically, a trade mark is a badge of recognition that distinguishes a businesses products or services from its competitors. In this sense it is an economic tool to help consumers in making a purchase decision based on the reputation of the business.

Your clients trade mark could be as valuable as their plant, premises or stock. It could even be their single most valuable asset which you could use to secure finance for company growth. In 2015 Forbes magazine listed Google's trade mark to be valued at US$44 billion.

Not all trade marks are valuable. Unless a trade mark helps to create, maintain or increase cash flow they "may" have no financial value.

For the purposes of this paper we are distinguishing trade marks from the concept of brand. As John Elmore put it:

> "A trademark, at its essence, serves as but one identifier of a brand — it does not reflect the entirety of the brand itself. Think of it this way: a business with a good reputation can enjoy an advantage over a competitor even if it employs no trademark.

> Customers, for example, may distinguish the business by its location or owner, or the business may simply employ names or symbols for which it possesses no trademark rights. It follows that the value of a trademark ordinarily is something less than the value of a brand."[2]

In Australia, as for other countries, there is an Australian Accounting Standard AASB 138 dealing with the accounting treatment for intangible assets, such as trade marks. For AASB 138 to apply the trade mark must be identifiable as being:

"... if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations."

Concept of Value

Much has been written about the concept of value in the literature of economics, finance and law. Value is a question of perception. What is value for one person may not necessarily be value for another. Value depends on what is being valued, when the valuation takes place, the method chosen and the quality and quantity of the asset being valued.

[2] Elmore, JE, The Valuation of Trademark – Related Intangible Property, Insights Winter 2015, www.willamette.com pp 66-67

However, for assets (such as trade marks) to be traded, a value must be determined between buyers and sellers. The larger the market for a trade mark and the more efficient the market, the more one can rely on the market- determined value.

The purpose of a valuation will affect and determine the method chosen.[3] One method of valuation is not necessarily better than any other. Each has its own special purpose where it has a comparative advantage over the others. In determining the value for insurance purposes, for example, the owner is not concerned with the book value of the asset, nor necessarily its market value, nor the liquidation value. What is relevant to the owner is the cost of replacing the asset if destroyed.

Courts are required to determine the value of assets in numerous situations. The reasons courts have been required to determine value are: to resolve questions concerning the sale and purchase of businesses; to determine the financial terms under which an existing partner is bought out or admitted to a practice; as an indication of security when obtaining or advancing finance; to determine the value of assets to be divided in divorce proceedings; to determine whether takeover offers are fair and reasonable; for corporate re-construction and re-organisation; as a basis for the assessment of stamp duty; to determine the value of shares to be sold or purchased pursuant to orders of a court under the ***Corporations Act 2001*** (Cth); to determine whether shares have been issued at a discount or a premium for the purposes of the ***Corporations Act 2001*** (Cth); to divide property in deceased estates; to determine the value of a business being converted into a company; to determine the liability for capital gains tax; to determine adequate compensation following compulsory acquisition of an asset; to determine value of land for the purpose of rating and to value trade marks.

Australian Courts' Views on Value

In determining valuation cases courts determine value given the circumstances of each case. The circumstances of each case are each case's own particular facts

[3] see *Housing Commission of NSW v Falconer* [1981] 1 NSWLR 547 at 570 per Mahoney JA and *Commissioner of Succession Duties (SA) v D Clifford's Executors* (1947) 74 CLR 358 at 373 per Dixon J.

and the evidence of experts on the value of the asset in question.

However value is determined, it is rarely a "fact" in the sense the term is normally used. A fact is a statement of what actually happened: I saw the accused hit the deceased. A valuation is not a factual assertion in this sense. It is an opinion given by a person who holds himself out as having experience in an area over and above that of most people.

Ever since the 16th century, English courts[4] have permitted expert evidence to be admitted. The circumstances in which expert evidence has been admitted arise when matters of science or specialised areas of knowledge and practice are required for the court to rely upon and come to a decision on a particular factual issue.

Australian Courts' views about value and valuation methods are not (usually) determined from personal knowledge or experience of the tribunal of fact (either the jury or a judge sitting alone), but from expert opinions put before the court by the parties in contested litigation. In theory the role of the expert witness is to assist the court to arrive at its determination of the facts of a case. In practice the evidence of each litigant's expert witness tends to espouse the cause of the party by whom the witness is called. Consequently, the value of expert witnesses' evidence has been doubted. For this reason the courts have jealously guarded their duty to be the final arbiter of determining what is the value of an asset in any dispute.[5]

The classic statement in Australia on the nature and character of "value" was made by Griffith C.J. in ***Spencer v The Commonwealth*** (1907) 5 CLR 418 at page 432:

> "In my judgment the test of value of land is to be determined, not by inquiring what price a man desiring to sell could actually have obtained for it on a given date, i.e., whether there was in fact on that day a willing buyer, but by

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[4] ***Buckley v. Rice Thomas*** (1554) I Pl. 118 at 124-125; 75 E.R. 182 at 192-193 per Saunders J

[5] ***Re Dalkeith*** (1985) 3 A.C.L.C. 74 at 81 per McPherson J.

> inquiring “What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?” It is, no doubt, very difficult to answer such a question, and any answer must be to some extent conjectural. The necessary mental process is to put yourself as far as possible in the position of persons conversant with the subject at the relevant time, and from that point of view to ascertain what, according to the then current opinion of land values, a purchaser would have had to offer for the land to induce such a willing vendor to sell it, or, in other words, to inquire at what point a desirous purchaser and a not unwilling vendor would come together.”

While the asset in the case was a parcel of land, Australian courts use this test for all manner of assets that are the subject of a court valuation.

Value in Finance Theory

In finance theory, purchases and sales in efficient markets are zero sum transactions. If you pay $850 for a bond with a promised yield of 8 per cent, you expect to receive over the life of the bond cash inflows whose present value is exactly $850. Your investment outlay ($850) equals the discounted cash inflows ($850). The buyer does not gain value, the seller does not lose value. The sum of the sale value minus the purchase price is zero.

An efficient market is a market where the buyers all have the same knowledge and information about assets. New information is rapidly disseminated to all buyers. Sales in efficient markets occur at the fair value of an asset. Fair value does not mean ultimate future value. It means an equilibrium price which incorporates all the information available to buyers at the time the transaction occurs.

The consequences of a market being efficient are as follows:

- Given the level of information currently known, purchasers and sellers should trust market prices as setting the fair value of an asset.

- The arrival of new information may change the value of an asset. The change may either increase or decrease the asset's value.

- Since the fair value of an asset reflects all relevant information then known, the value (price) of the asset will change when and only when new information arrives.

- The value of an asset is a function of its risk-return profile. A bond with a return of 10 per cent over 12 months compared with a bond with the same term but a return of 8 per cent will be worth more. The risk of not receiving a return from each bond is the same. This is reflected in a lower value being paid to buy the bond with 8 per cent promised return than the bond promising a 10 per cent return.

- Buyers and sellers are economically rational. As such, the time value of money is impounded in the value of assets. Bonds which pay monthly interest are worth more than bonds which pay interest annually. Why? Because the interest received from bonds paying interest monthly can be reinvested immediately and earn more interest.

- Today's values are the best estimate of future values. Statisticians call the process where the best estimates of the next period's value is the previous period's value a "random walk". The term comes from the example used to explain the process. If you see a drunk walking randomly in a field, and later you wish to find where the drunk is lying in the field, the place to set out to find him is where you last saw him. Similarly, in valuing an asset, if value behaves strictly as a random walk and if the only information you have is the value today, the best estimate of next year's value is its value today.

Methods for valuing IP

Valuing a trade mark is not an easy task. How much is a trade mark worth after years of marketing? Does your clients trade mark protect an existing product or service; or is it redundant?

Intellectual property rights change in value for a variety of reasons. Successfully marketing a product or service can ensure that a trade mark has value. Trade marks generally gain value as they become better known.

In general, the valuation of trade marks is founded directly on earning power. Where little or no income history is available, however, imagination, common sense and experience may be the best guides, in addition to studies of the industry in which the trade mark will be used or the products or services marketed, market surveys of probable sale prices and expected profits, and opinions of industry experts.

There are a number of ways to value trade marks. They all have their limitations and no method is appropriate in every case. The stage of development of a trade mark, the availability of information and the aim of the valuation all have a bearing on the method used. Irrespective of the method used the theoretical position is that the value of a trade mark is the sum of the value of its expected earnings. The question is how to assess the future expected earnings of a trade mark.

Here are 5 useful examples:

The Cost Method

This valuation is based on the costs your client incurred in developing or creating the trade mark. It also values what it might cost to recreate or develop a similar product or service. It doesn't take into consideration the current market value of the product or service.

Costs usually included are:

- labour
- materials and equipment
- research and development
- creating a prototype
- testing and trials
- regulatory approval and certification
- registering the trade mark
- overheads for utilities, accommodation and support staff

- developer's profit[6]
- entrepreneurial incentive[7].

The Cost Method assumes that a potential buyer can avoid these costs by buying the trade mark.

Valuable benefits may be:

Time: by purchasing the trade mark right from your client, the buyer will not waste time researching and developing their own trade mark.

Expenditure: if attempting to recreate their own trade mark, the buyer would spend at least this much.

Success: a buyer may not be successful in developing the reputation that your client established with its trade mark.

"Protection: a buyer may not have been able to protect the trade mark, but can do so by buying the sellers registered trade mark and thereby avoid infringing on others." -

The Cost Method of valuing a trade mark lends itself to an overall assessment when buying a product or service. It also considers trade marks when they are at an early stage in their development. However, the emphasis on costs, rather than profit, can skew the figures so that market potential is not fully recognised. The Cost Method does not take account of future value. It therefore misses out on a standard by which value is traditionally calculated.

The Market Value method

Understanding the value of your client's product or service based on its recent track record in the market place may be a more reliable way of establishing what people

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[6] The developer's profit reflects the reasonable profit expected on the development costs incurred in the creation of the trade mark.

[7] The entrepreneurial profit reflects the economic benefit required to motivate the trade mark creator into the development process, which is often viewed as an opportunity cost.

might pay for your clients trade mark. Assessing the sale or licensing of similar products in the market may also provide a useful benchmark.

The problem with the Market Value method is that it can be very hard to find published data on trade mark transactions as they are often confidential or if known as part of a larger sale and their apportioned value is not known. Trade mark sales and licensing arrangements are hard to generalise. There are sources of data for various sectors, but they tend to provide a wide range of figures for sales and licences which are only broadly comparable.

Few transactions allow a valid comparison and arrangements may differ in terms of:

- exclusivity
- payment structure
- any technical/other support provided
- territory, economic climate and market conditions.

No two deals are the same.

The Market Value method is objective and it can provide a realistic analysis of value based on your clients trade mark's worth as perceived by both owners and their consumers. The Market Value method can be useful for researching the high, low and average royalty rates paid in any given market sector. In negotiating a licence agreement for example, an agreed industry range may form the basis of a discussion.

The Income (or Economic) Benefit method

There are three forms of capitalised earnings based valuations. Discounted cash flow analysis is a refinement of the more conventional techniques of capitalising earnings in the form of maintainable profits, dividends or net royalty payments. Conventional capitalised earnings-based techniques involve the following considerations:

- Identifying the assets that are necessary to provide the normal business income.

- The assumption that assets surplus to requirements are sold.

- The earnings capacity of the necessary assets are determined and referred to as "maintainable" earnings, accounting profit, dividends or rentals (as is appropriate). The maintainable earnings figure provides a benchmark income stream that is capitalised in perpetuity to determine value.

- The time value of money is implicitly taken account of by capitalising the benchmark income stream.

- The method takes account of the future income potential of the going concern by capitalising the benchmark.

- A perpetuity formula is used because in the case of a trade mark it is assumed the trade mark will continue in perpetuity, accordingly, there is no reason to look at earning capacity of the asset over any shorter period.[8]

In employing capitalised earning methods, it is necessary for the valuer to exercise their judgment in selecting the appropriate capitalisation rate in the light of the trade mark's history, the degree of risk of the income flow of the trade mark, general trends in the industry, the general structure of rates applying to various classes of listed companies products and services of a similar nature and other relevant factors.

The capitalisation rate, as for discounted cash flow analysis, is a rate derived from the analysis of sales evidenced in the market.

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[8] See Adamson, op. cit., n. 13, p. 52 and W.A. Leach, "Conveyancing and Valuation" (1959) 23 *The Conveyancer* 204-219

A review of the leading valuation texts and cases reveals[9] that the capitalisation of future maintainable earnings is the most common methodology used in practice to determine the value of trade marks with a potential to create value where there is little or no readily available sales data to use a comparable sales method.

The main criticism concerning other earnings based valuation methods is that they do not take account of economic reality as well as discounted cash flow analysis does. The proponents of discounted cash flow analysis argue that, just as the valuer must exercise their judgment in selecting the appropriate capitalisation rate in the light of such factors as a company's history, the degree of risk of the business that uses the trade mark, general trends in the industry and the general structure of interest rates applying to various classes of listed companies, the valuer if allowed the freedom to exercise their judgment on these issues should also exercise their judgment to answer such questions as:

- How large is the market in which sales growth is forecast?
- Will the market grow or will it decline as substitute products enter?
- What are competitors doing, or likely to do?

By answering such questions the valuer should, in light of the probability of the likely outcomes, forecast the expected future cash flows of the asset being evaluated. As Haney and Jackson state:

[9] see Brown, SJ Investment Decisions: DCF and other valuation methods in Litigation, ***Journal of Banking and Finance Law and Practice***, (1991) March pp 4 – 28.

> "Too many earnings based valuations employ historic earnings as a proxy for future earnings with insufficient critical examination."[10]

The Discounted Cash Flow method focuses on the revenue that the trade mark generates for your client's business in the future. It considers both the future income, which a right may generate during its economic life, and the costs of generating that income. Risk and financial costs are factored into the equation. The end result is described as the 'Net Present Value' or NPV.

The Income Benefit method allows a buyer to consider investment based on whether the NPV is positive or negative.

Although the NPV is a useful, easy-to-use tool. It should be remembered that the Income Benefit method of valuation is based on an assessment of likely future events based upon known past performance.

Difficulties with the Income Benefit method include:

- it is difficult to estimate the economic life of the product or service associated with the trade mark
- it is difficult to estimate the income over several years; while the past is known looking into the future even with the past as a guide is always a less than perfect solution
- the strength of the trade mark
- the size of the potential market
- the nature of the competition
- changes in the economic climate
- the cost of registering, enforcing and defending the trade mark need to be taken into account.

[10] Haney, T. Y. and Jackson, D., "Cash Flow Valuations - A Step Ahead" (1988) 65 *Companies* & *Securities Bulletin* 2 n. 21 at 3

The way in which the trade mark is exploited, the costs involved, the time it will take to get to market and the risks involved along the way will vary from business to business. Other things to consider are income which may be generated from other factors e.g. the skill of the business' staff in generating earnings from the exploitation of the trade mark.

Uncertainties about the future mean that it is unrealistic to project income for more than 4 or 5 years. Trying to estimate the income for early stage technology is very difficult.

It is strictly imprecise to speak of trade mark values as following a random walk. The value of trade marks are a wandering series with shifts (or expected changes) in each period but with a constant variability over time." Such a series is called a submartingale. Although future values cannot be forecast ahead of time, a trend of increased growth in earns from a trade mark can be expected. The reason for this is because the expected changes per period have a constant variability; as such it is a safe bet to expect the trend to continue in the next period. Consequently, in looking at trade marks in an appreciating market the random walk analogy is not strictly accurate. To continue with the analogy, if the drunk behaved as a submartingale we would expect to find him in the same direction we last saw him but more likely than not some distance ahead of where we last saw him, rather than in any other direction. By considering the consequences of efficient markets, a theoretically sustainable method of valuation has been developed. Initially, discounted cash flow analysis was used only to assess the value of proposed investment decisions. Today the technique is being used as a method of valuation. The reason for discounted cash flow analysis being a theoretically sustainable method of valuation is because the empirical evidence supports the validity of the efficient market hypothesis.[11]

Accordingly, if the real world has efficient markets, then people value assets in a rational manner consistent with the methodology employed in discounted cash flow analysis.

[11] Weston and Copeland, op. cit., p. 454 and see R.R. Officer, "Profit Forecasts in Published Reports" (1985) 25 (May) *Companies and Securities Bulletin* 2-8.

Relief from Royalty method

While the Income Benefit method recognizes that a trade marks earning power is essential in establishing value, it does not enable a valuer to segregate value between identifiable and unidentifiable intangibles. This segregation is often required because identifiable intangibles are often purchased, sold or assigned independently of the business enterprise owning them.

Having regard to this limitation, an approach used commonly to value a trade mark is the Relief from Royalty method. The principle is that, by owning a trade mark, a business is relieved of the necessity of having to pay someone else a royalty for its use. Consequently, anyone wanting to obtain the right to this trade mark would have to enter into a business arrangement with the original owner. Such licensing arrangements, akin to the licensing of patents, usually entail a royalty payment, generally a percentage of sales. The percentage will vary depending on a trade mark's strength and visibility and, more specifically, on:

- The product or services opportunities in the market.
- The product or services reputation: Are the claims justified?
- The security, if any, afforded by a patent, recognizing that most products in the development stage or in a yet-to-be established market have patents to guard against their unauthorized use by competitors.
- The security of supply of raw materials.

Furthermore, the royalty rate depends on the frequency with which new, acceptable products or services enter the market. Generally, the less frequent the entry, the more a market is considered to be a licensor's market. Ultimately, the selection of an appropriate royalty rate will take all of the characteristics mentioned into account, since the trademark's user is expected to benefit immediately from a competitive standpoint.

According to experts in trade mark valuations, trade marks closely identified with consumer products or services will generally command high royalty rates - much higher than those for goods and services in the industrial sector.

Under the Relief from Royalty method, trade mark valuation computations generally include consideration of the present value of the annual after-tax stream of revenues - the result of not having to pay royalties - and of the present value of future income tax savings resulting from claiming capital cost allowances on a specified portion of a trademark's cost; that is, the tax shield.

To determine the present value of this after-tax stream of future revenues, certain assumptions are generally made regarding the annual estimates of revenues associated with the trade mark product or service, the royalty rate, the company's tax rate and a reasonable rate of return, normally based on the risk involved in realizing the projected revenues when considered in relation to the type of trade mark product or service being acquired.

The Relief from Royalty method assesses trade mark royalties. It is based on an assessment of what royalty costs a company is avoiding by virtue of owning the trade mark out right.

Even after identifying reasonably comparable trade mark licenses, some dissimilarity can remain. So the selected royalty rate may be adjusted to fit the particular facts and circumstances surrounding the subject trademark. Some factors that analysts often consider in the adjustment of the royalty rate are presented in Table 1[12].

Table 1 Factors Considered in the Adjustment of the Royalty Rate

[12] Table from Elmore, JE, The Valuation of Trademark – Related Intangible Property, Insights Winter 2015, www.willamette.com p 70

Item	Factor	Consideration
1	Age, absolute	Long established or newly created trademark
2	Age, relative	Older or newer than competing trademarks
3	Use, consistency	Used consistently on related products or inconsistently on unrelated products
4	Use, specificity	Used on a broad range of products and services vs. narrow range
5	Use, geography	Has wide appeal (e.g., can be used internationally) vs. narrow or local appeal
6	Potential for expansion	Unrestricted vs. restricted ability for use on new and different products
7	Potential for exploitation	Unrestricted vs. restricted ability for licensing in new industries and uses
8	Associations	Trademark associated with positive vs. negative person, event, or location
9	Connotations	Name has positive vs. negative connotations and reputation among consumers
10	Timeliness	Trademark is perceived as modern vs. old-fashioned
11	Quality	Trademark is perceived as respectable vs. less respectable
12	Profitability, absolute	Profit margins on associated products is higher vs. lower than industry average

Table 1 Factors Considered in the Adjustment of the Royalty Rate		
Item	Factor	Consideration
13	Profitability, relative	Profit margins on associated products is higher vs. lower than competitor(s)
14	Expense of promoting	Low vs. high cost of advertising and marketing of trademark
15	Means of promoting	Numerous vs. few means to promote the trademark
16	Market share, absolute	Associated product has high vs. low market share
17	Market share, relative	Associated product has higher vs. lower market share than competitor(s)
18	Market potential, absolute	Products are in an expanding vs. contracting market
19	Market potential, relative	Market for products expanding faster vs. slower than competitor(s)
20	Name recognition	Trademark has high vs. low recognition among consumers

Gross Profit Margin Differential method

The Gross Profit Margin Differential method compares the gross profit margins of a product or service with an established trade mark to a similar "no-name" or generic product or service.

The Gross Profit Margin Differential method is a function of a trade mark's reliability and public acceptance, which depends in turn on the reputation of the product or service associated with the trade mark. In simple terms, the greater the public acceptance, the larger the differential. Since the advent of generic products, particularly in the food and pharmaceutical markets, consumers have shown strong resistance to the often substantial costs associated with maintaining trade marks (through promotions, advertising and so on).

It can be erroneous to compare the reported gross profit margin of a generic product with that of a trade mark product, since costs associated with maintaining the trade mark are generally excluded in computing the gross profit and resulting margins. The gross profit margins of trade mark products would necessarily have to be substantially higher than those for generic products to cover these costs; therefore, it is only by deducting them from the gross profits of trade mark products that a realistic, comparable differential can be derived.

The adjusted gross profit margin differential, when capitalised using appropriate multiples, would likely approximate the trade mark's value. The multiples in such situations would obviously be lower than normal earnings multiples and would reflect the pre-tax nature of the differential and the product's expected life. The latter, in turn, would normally be a function of the risk of a new and more acceptable product entering the market, resulting in the possible erosion of public acceptance and the significance of the old trade mark.

Often the Gross Profit Margin Differential method is used to support the conclusions arrived at using the Market method, Income Benefit method or the Relief from Royalty method.

Which method do you use?

Each valuation method emphasizes a different attribute of a trade mark.

Using all applicable methods may increase the confidence level of value conclusions. Nevertheless, poorly supported valuations result from the naïve use of the methods. Ultimately, the information that is available for valuation will or should determine the method used.

The Market Value method examines the comparative characteristics of reasonably competitive properties. When there are sufficient market driven transactional data from which to estimate comparable trade marks, this method is appropriate. If the selected comparable trade marks are not, indeed, comparable to the subject trade mark, the Market Value method is weakened.

The Income Benefit method relies on the cash flow that the trade mark is expected to generate over its life. Accordingly, if the real world has efficient markets, then people value assets in a rational manner consistent with the methodology employed in discounted cash flow analysis.

As such, this method requires a reasonable estimate of future cash flows and their risk. Thus, quality of valuation depends on the accuracy of the estimates used in the valuation model.

The Cost method looks at the cost to reproduce or replace a trade mark. This method is not the most appropriate for trade marks, since the cost to replace such a trade mark is seldom reflective of its value, except at the inception of its life.

The Relief from Royalties method is a valid valuation method provided there is evidence of what royalties would be paid in the real world. However, obtaining such information is often difficult if not impossible.

Getting the best deal

In a typical scenario, a seller of a trade mark usually has a more optimistic view of the future earnings of from the trade mark, characterized by a conviction that their investment and labour is about to bear an abundance of fruit. The buyer may understand the basis for the seller’s optimism, but is not convinced that results will materialize and doesn’t want to pay cash for what is a riskier tranche of projected

earnings from the trade mark. The different views become the basis for uncertainty which then causes issues with determining the value of the trade mark being acquired (the "Acquired Trade Mark").

Earnout clauses can be structured to bridge the value gap and to allow the buyer and seller to reach a meeting of the minds thereby facilitating an otherwise willing buyer and seller to bridge the gap in their respective valuation concepts for the Acquired Trade Mark in order to complete a sale.

Under typical trade mark earnout arrangement, there is a payment of a lump sum amount and the buyer or seller receives the entitlement to additional payments depending on the subsequent performance of the Acquired Trade Mark.

Example 1 – a simple standard earnout:

Joe Bloggs buys a trade mark "X" from Mary Jane.

Due to the uncertainty of the value of the trade mark, Joe Bloggs agrees to pay Mary Jane $200,000 for the trade mark, with a further $20,000 payable in 12 months time if the earnings from the use of the trade mark generates a certain level of profitability.

A "reverse earnout" is a variation on the concept. In a "reverse earnout", the buyer is paid an agreed upon amount or percentage of the performance target. The payment is reduced if the performance target is missed.

Example 2 – a simple reverse earnout arrangement:

As detailed in Example 1 above, in a standard earnout arrangement, Joe Bloggs agrees to pay Mary Jane $200,000 for trade mark "X", with a further $20,000 payable in 12 months time if the earnings from the trade mark reaches a certain level of profitability.

In contrast, a reverse earnout arrangement would be that Joe Bloggs agrees to pay

Mary Jane $200,000, on the condition that Mary Jane pay him $40,000 in 12 months time if the trade mark does not achieve a certain level of profitability.

From a psychological perspective, in a reverse earnout, a seller is working to “keep” the earnout amount by achieving the performance target and will be “penalised” for missing the goal. In a normal earnout, the seller is working toward a target so that they will “be in the money.” It is human nature to work harder to keep what we have rather than achieve something we don’t.

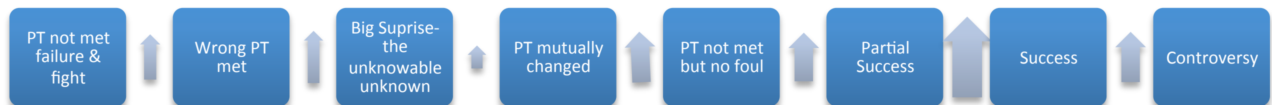
Earnout clauses are to be used as incentives to encourage the seller who remains with the business after the sale to achieve the mutually agreed upon performance targets. Since the earnout payment is only paid upon attainment of the performance target, the advantages to a buyer include:

- Conservation of cash.
- Reduction of leverage (which is helpful in a tight credit market with typically lower advance rates).
- An incentive for the seller to make the transition in ownership a success.
- An overall reduction of risk.

From the seller’s vantage point, an earnout represents an opportunity. If performance targets are hit, the seller receives additional value from the sale of their trade mark. If the trade mark exceeds the performance targets, the seller may actually net more dollars in the long run.

The Spectrum of Earn-Out Clause Outcomes

An earnout is an opportunity for both buyer and seller to maximize their respective post-acquisition returns on investment, but it doesn’t always play out that way. There are eight possible outcomes when an earnout is included in any acquisition transaction, being:



- **Performance target (PT) not met: failure and a fight**: When there is a controversy that can't be amicably resolved, the conflict can escalate into a legal action. This is the worst outcome and one that will cost the parties a considerable amount of stress, time and money. This risk can be mitigated by building a conflict resolution process into the trade mark acquisition agreement.

- **The Wrong Performance Target Gets Hit**: It is possible that the seller successfully hits all or part of the performance targets and it doesn't create additional cash flow or value for the buyer. This could be due to the selection of the wrong performance targets or a malformed agreement. In this case, the seller is being paid directly out of the buyer's pocket, which is a big disappointment because the buyer was assuming that the seller would only be paid if the deal was successful.

- **The Big Surprise—the Unknowable Unknown**: Life doesn't fit into a projection and it doesn't much pay attention to statistics and bell curves. Unexpected random events can lay waste to the best formed plans. Nassim Taleb's Black Swans (***The Black Swan: The Impact of the Highly***

Improbable is a literary/philosophical book by the epistemologist Nassim Nicholas Taleb. The book focuses on the extreme impact of certain kinds of rare and unpredictable events (outliers) and humans' tendency to find simplistic explanations for these events retrospectively. This theory has since become known as the black swan theory) are in some invisible or ignored corner of our Universe doing push-ups. There are positive surprises and then there are surprises that bring misfortune. As a buyer, it never hurts to spend some time trying to imagine the unimaginable.

- **Performance targets mutually changed**: There are a number of business events that can present themselves during the term of an earnout clause that can create problems. Examples include termination of the seller's employment (if employed), the sale, assignment or transfer of the business unit or company, and termination of the buyer's management team. To the extent that these issues have been diligently addressed in the earnout clause, or by subsequent mutually agreement of the parties the change can be smooth. If not, then we move to the next two possible outcomes, a controversy or a fight.

- **Performance target not met: But No Foul**: The seller misses the performance targets and doesn't receive any payment, but both the buyer and seller believe that the game was played fairly on a level field. There is no cause for celebration. The players feel that they faithfully tried to adhere to the letter and spirit of the agreement and both parties walk away amicably, but disappointed.

- **Partial Success**: The seller can hit a portion of the performance targets and receives a payment that is disappointingly lower, but both buyer and seller believe that the earnout was implemented faithfully and that each party gave an honest best effort. While this is not the optimal outcome, it is still successful.

- **Success**: The seller hits all or most of the performance targets and receives the payment as expected—on-time in accordance with the terms and spirit of

the earnout clause. In addition, the hitting of the performance targets creates additional value and cash flow for the buyer. This is the most desired outcome, one that you can call completely successful.

- **Controversy**: The seller doesn't earn a payment or earns one that is lower than expected and feels that the agreement was implemented in bad faith. The seller may believe that his or her ability to earn the payment was thwarted by the actions of the buyer. It is also possible that the seller earned a payment but it was withheld or used to offset a charge arising from the provisions of another transaction agreement. In this outcome, the earnout results in a controversy that can mushroom into a full-fledged fight. In both instances the buyer and his or her legal team need to get into conflict resolution mode to contain the situation. This is a poor outcome and the only question is: will it be contained?

Buy-Side Considerations

Threshold questions for the buyer include:

- Is an earnout really a good idea?

- How do I measure the success of the acquisition to structure valid performance targets?

When considering an earnout, a buyer should address the following points before getting into the nitty-gritty detail of negotiations:

Clarify the intent and purpose of the earnout. An earnout can be structured to bridge the value gap and/or can also provide an incentive for the seller to hit predefined targets after the transaction closes. Buyers must be clear about what they are trying to accomplish with an earnout because that intention will shape the discussions and negotiations with the seller.

Bridge the value gap: If the earnout is intended to bridge the value gap, then the amount of the earnout is a component of the purchase price. Depending upon the terms of the earnout clause, the earnout amount is a portion of the price that is conditioned upon the attainment of the performance targets. The use of the earnout clause also is a test of the veracity of the sellers estimate of the value of the Acquired Trade Mark and how realistic the seller thinks the Acquired Trade Mark will achieve the performance targets with or without him or her at the helm.

Provide a performance based incentive: If the earnout is intended as an incentive only, then any earnout payments are over and above the purchase price of the Acquired Trade Mark. In this case, earnout payments are much like a bonus or similar incentive plans, and are not a component of the purchase price.

Determine the amount of the value gap. The buyer needs to quantify the value gap before you can begin to bridge it. The value gap is caused by a mismatch between the buyer's and seller's expectations and projections for the future. The value gap is the difference between the buyer's concept of value and buyer's best guess of the price the seller would be inclined to accept in a transaction without an earnout, which is not necessarily the seller's asking price.

Discover the facts and assumptions that account for the value gap. Simply quantifying the value gap does not provide you with sufficient information to craft an earnout that meets the objective of maximizing buyer and seller value.

Dig into the facts and assumptions upon which the seller's projections are based. The buyer will need to fully understand the assumptions behind the projections: the goals, strategies and action-steps that form the seller's future vision and business plan. Understanding the seller's assumptions doesn't imply that the buyer is in agreement with them—it just means the buyer comprehends them.

Determine if the seller's assumptions and projections are "reasonably" achievable. The seller's business plan and projections can be based upon a pipe-dream or can be both realistic and fundamentally sound. If the buyer thinks the facts and logic behind the seller's assumptions are specious or unrealistic, then going any

further with the earnout is an invitation for future conflict. There will need to be a meeting of the minds as to the validity of the assumptions before any meaningful earnout clause can be negotiated let alone drafted.

Consider whether the seller's direction is one that the buyer wants to pursue as the new owner. It is possible that the seller's plans are feasible, but not a direction the buyer wants to take. In this case, pursing an earnout can be a set-up for future conflict and friction.

Determine the additional risks associated with the seller's assumptions and if they increase the enterprise risk. When discounting future earnings or cash flows (income streams), the key variables are the income stream and the discount (risk) rate. The buyer will need to compare the relative risk between the two business plans and, if necessary, work the additional risk into the overall discount rate and value concept.

Consider how much the Acquired Trade Mark would be worth if the buyer used the seller's more optimistic projections (with the same valuation metrics the buyer applied to their projections). By determining the additional earnings and discount rate of the trade mark based upon the seller's projections, the buyer can create a "what if…?" value. By deducting the value based upon the buyer's projections and the seller's "what if…?" projections, the buyer has a number to work with in setting the earnout performance targets and payout rates.

Consider whether the Acquired Trade Mark is for a standalone product or service, closely integrated into an existing business, or to be merged into another business. When negotiating an earnout, it is important to define what product or service the Acquired Trade Mark is used for. Such a definition is clearer when the Acquired Trade Mark will be operated on a standalone basis. However, isolating the various performance targets becomes increasing more difficult when the Acquired Trade Mark is merged, tightly integrated or completely assimilated by a parent entity. It also requires additional accounting and reporting to distill the performance target from the overall entity. Despite the difficulty, if an earnout makes sense, these issues can be addressed during the negotiation process.

The buyer will have to share their vision for the Acquired Trade Marks future and the detail of their business plan with the seller, and determine if the seller is aligned with them. If a transaction settles, the buyer will have an on-going relationship with the seller. The seller is going to be a stakeholder in the Acquired Trade Marks future and might even have an active role in the management and operation of the Acquired Trade Mark. Incongruent visions will result in conflict, especially if the seller is a strong "A" type personality. An entrepreneur who is used to doing things his or her own way, being a strong "A" type personality, may not work well with others. Not being able to work with a team of the buyers people could lead to conflict and in the earnings of the Acquired Trade Mark not reaching its anticipated potential.

As lawyers we must assist our buyer clients to consider the role they want the seller to play in the Acquired Trade Marks future. For example, assuming that the buyer and the seller are congruent with the vision of the future, the next issue is to define the seller's future role, if any, in the future of the Acquired Trade Mark. The seller may or may not want to have a continuing role, and, the buyer may or may not want the seller to be active.

If the seller is going to have an active role in the management of the Acquired Trade Mark, consider whether the seller's management style is consistent with the buyer's. If the seller is not someone the buyer would want on their management team, then the buyer obviously doesn't want to go down that road. If the buyer employs the seller and then feels obliged to terminate employment, there are going to be hard feelings and, depending upon the terms of the agreement, possibly a payment to be made to the seller.

Consider the degree of control and authority the buyer is comfortable giving a seller over operations, accounting and capital budgeting matters. When it comes to the time to negotiate the actual details of the earnout, control is going to be a big issue. The seller is going to want to do everything possible to protect their earnout payment. On the other hand, the buyer, may want to retain all of the rights and authority necessary to protect their investment. This is not necessarily the case but it can be.

Think about the buyer's chances of reaching a clear understanding with the seller on the post-acquisition operational, accounting and fiscal policies. A lack of clarity on these issues is a breeding ground for disagreement. If the buyer can't discuss these issues and reach a good understanding with the seller, during the negotiation phase of the acquisition, what chance is there after completion?

Quantify the financial impact of the seller meeting the performance targets. If project-based targets are to be included in an earnout, the buyer will want to quantify the financial contribution that these projects will add to the bottom line and cash flow. In addition, the buyer will want to thoroughly understand any expenditures and additional investments that might be necessary to complete the project. The buyer will need to factor these items into their projections and discounted cash flow calculations to make sure that the additional risk and amount paid meet your hurdle or threshold rate of return on investment (ROI) on acquiring the Acquired Trade Mark.

The above steps provide a framework for evaluating whether an earnout makes sense in a particular situation and lay a foundation for negotiating one that will maximize value for you and the seller.

In many ways, an earnout negotiation is like an employment interview in which both parties do much better when they focus their discussions and questions on the job's requirements and abilities of the candidate to successfully perform his or her duties. After the parties are comfortable with each other and want to pursue a relationship, then issues like compensation and benefits naturally come into play. Trying to negotiate a "dumb number" without reaching a meeting of the minds about the underlying assumptions is putting the cart before the horse and may not get the parties where they want to go.

Sell-Side Considerations

An earnout is frequently proposed by the buyer, who is concerned about conserving cash, reducing the need for debt, mitigating risk and enticing the seller by making a

portion of the purchase price contingent upon the attainment of pre-defined performance targets.

While the advantages to the buyer are clear, an earnout proposal runs counter to a seller's general financial objectives which are to get the highest possible price, with the most cash up-front and, in many instances, as little future risk as possible. Even if a seller has been active in the management of the business, he or she may have been motivated to sell in order to retire. This tension between a seller's and buyer's objectives, sets the stage for negotiations.

Within the context of the negotiation, it is reasonable to assume that the buyer is evaluating several investment opportunities and uses for its funds (i.e., other acquisitions, candidates, projects providing organic growth or dividend distribution). On the other hand, it's equally likely that the seller is going to be evaluating proposals from several prospective purchasers.

From a sell-side perspective, an offer containing an earnout may be one of several different offers a seller will entertain, and they will possibly be entertained simultaneously. Just like the buyer who decides which investment opportunity among several is the optimal blend of risk, reward and strategic congruence, the seller may have to decide which buyer proposal is ultimately going to be accepted and pursued.

If a business falls into any of the four groups listed below, it should not surprise a seller if a buyer(s) wants to add the element of an earnout into the deal. That doesn't mean that a seller should necessarily announce that they are seeking an earnout, it just means that the conditions suggest the subject may be raised:

- Acquiring asset in the development or entrepreneurial stage with limited operating history.
- Companies that have introduced (or plan to introduce) a new product line or technology that does not have a track record as of the date of negotiations.
- Turnaround situations in which the future existence of a business is in question. The focus is on survival and the acquiring asset may not be generating positive cash flow.

- Markets or industry sectors that are experiencing growing valuation multiples that may be reaching a peak (and buyers are indicating resistance).

The sellers' objective is to maximize their chances of meeting the earnout performance targets and earning the contingent portion of the purchase price without getting into a head-knocking contest with the buyer. The seller can't reduce the risk to zero, but the seller can minimise it by understanding the implications of an earnout and having experienced lawyers and other professionals assist them to get paid.

Consider the following scenario. Imagine a business is on the market, buyers are *kicking the tyres* and one such buyer is interested enough to introduce the topic of an earnout into the discussions.

The seller can react in several ways:

1. Dismiss the idea and give it no further thought on the grounds that they are "Just not interested in an earnout. I don't want one and talking about one is a sign that we are wobbly on price."

2. Look at the top-side of the number and enthusiastically lock into that number because it is close or possibly exceeds the seller's aspirational price. For example, the owner is looking for a number of $5,000,000 and the buyer offers $5,000,000 to be paid 50% cash and the balance contingent upon the attainment of a financial metric (that was pulled from the seller's own projections).

3. Study the idea with objective detachment to determine if the seller wants to have an earnout relationship with that particular buyer and approach discussions accordingly. A suggested response is to respond with an open response. An open response neither embraces nor rejects the idea. An open response would be something to the effect of: "My client is interested in all serious proposals and will look forward to your proposal."

Threshold Seller Considerations

The following check list is written from a seller's perspective on the threshold issues of whether or not to enter into negotiations over the details of an earnout.

1. Discover the buyer's assumptions that account for the value gap. When the buyer presents an offer with an earnout component, the seller has several important pieces of information:
   - The seller's concept of the value of the asset sought to be sold.
   - The total price of the buyer's offer (all forms of consideration including the earnout component).
   - The portion of the offer that is made up of cash, notes, and shares. The seller will want the buyer to be financially committed to the acquisition. A seller doesn't want to be promised "monopoly money" in exchange for the keys to the Acquired Trade.
   - The portion of the total offer attributable to the earnout. The larger the percentage of earnout, the greater the risk to the seller.

2. Discover the buyer's stated reasons for including an earnout into the deal structure. There are a number of reasons why a buyer would gravitate toward an earnout. As stated earlier, an earnout conserves cash, reduces debt, provides an incentive to the seller and lowers the buyer's risk. A buyer can also be offering an earnout because they are short on cash or debt capacity and that is the only way they can get the deal financed. In either case, it is helpful to understand the buyer's intentions and the implications.

3. Find out how the buyer established the earnout amount and performance targets. The seller needs to understand how the buyer arrived at these conclusions. Is the seller in agreement with the buyer's thinking? Based upon the seller's intimate understanding of the asset being acquired (as it is currently being operated), are these metrics attainable?

4. Determine what, if any, role the seller wants to have or the buyer seeks from the seller to have in the ongoing management of the Acquired Trade Mark? When an earnout is part of the transaction, a potentially significant portion of

the purchase is contingent upon hitting the performance targets. This amount is at risk. Sometimes, a seller was passive before the sale or is selling by being motivated to retire. Provided the seller is willing to remain involved post completion, and the degree of control from the buyer is acceptable to the seller, the seller may feel more comfortable about the risk in achieving the performance targets and receiving the earnout payment; as to a greater or lesser extent the control is in their hands. The management of the operations of the Acquired Trade Mark after completion will determine if the performance targets are hit or missed and whether the seller is paid an earnout or not. The degree that a seller can exert influence over the success of the venture will reduce the seller's risk. The key questions are:

- Does the seller have the ability to meet the earnout targets?
- Does the Acquired Trade Mark have the opportunity to meet the performance targets?
- Is the seller prepared to be involved in the management after the deal?
- Can the seller see himself or herself working for/or with the buyer?

5. The seller must find out as much as possible about the buyer's vision and plans for the future of the Acquired Trade Mark. If the acquisition is completed, the seller will have an entirely new relationship with the former business. Instead of having control of the business as an owner, the seller will become what is effectively an investor in the Acquired Trade Mark. The control over operations, policies and treasury will to the extent agreed to by the earnout clause pass to the buyer. The questions the seller must answer are:

   - Does the buyer have the commitment, financial capacity and/or ability to attain the performance targets?
   - If the seller is to have an active role in post-acquisition management, are the performance targets realistic and, more importantly, what degree of support can the seller expect from the buyer to do what is necessary to meet the performance targets?

6. The degree of integration of the seller's Acquired Trade Mark into the buyer's business. After the acquisition, the Acquired Trade Mark can be operated as a standalone business, provide the buyer with a platform for growth, or rolled-up or merged into another business. It is very important to understand the actual business and the targets upon which the sellers' earnout payment will be dependent.

7. Merging or combining the Acquired Trade Mark with another business can be attractive for the buyer. However, it will require careful negotiation and definition of the earnout formula along with the issues of control, accounting and financial reporting.

Bottom Line

While these are good bases for trade mark valuation, remember there are no generally accepted rules of thumb. As is often the case with intangibles, experience, common sense and reasoned judgment may be the best guides you can have.

Ultimately, the value of a trade mark is what can be obtained in the market place on a given day. If the anticipated value of the seller does not match the value that a buyer is prepared to pay, then the use of earnout clauses could close the gap and result in a successful sale of a trade mark.

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