Valuing Trademarks in Domain Names

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1. Introduction

The essay outlines the various approaches to valuing trademarks, pointing out the approaches' different strengths and weaknesses, with emphasis on domain names. Using court cases, the essay points out that there is no one right way to value intangible assets but there are wrong ways.

2. Valuation Components

The valuation of a trademark[1] has four components: the appraisal's purpose/context, its time frame, its scope (that is, whether a single trademark is being considered or a portfolio of assets), and, after the first three components have been decided, the selection of the best valuation method.

2.1. Purpose/context:

The purpose of an appraisal is one of the factors determining the most appropriate valuation approach. In selecting the "best" method, you should act in the best legal interest of your client. If the client is buying a domain name, then the method that gives the lowest value should be used. But if the aim is to determine how much your client should pay in taxes, you would want to use the highest value: legally decreasing a client's tax liability is OK, but tax evasion is not. In either case, you must be able to use reasoning to justify the methodology used. Purposes include:

- Tax
- Sale and Leasing
- Acquisitions
- Mergers
- Management information and reporting
- Special circumstances:
    - Under bankruptcy, a trademark's value will drop by 90% to 95%. [2]
    - Under an imminent acquisition of a recognized brand, the value of the trademark goes up substantially.[3]
    - A study[4] by Bhagat and Umesh of companies involved in lawsuits suggests that both a lawsuit's filing and the eventual court verdict have an

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[1] An in-depth discussion of intellectual property valuation can be found by Gordon V. Smtih at Trademark Valuation.
[2] Weston Anson, Trademark Valuation: The How, When and Why, p. 3.
[3] Ibid.

impact on the stock market value of defendant and plaintiff firms. Shareholders of a company that infringed on a trademark suffered a negative return to its shareholders after the trademark holder filed suit. The returns to the plaintiff firms were mixed and of marginal magnitude due to offsetting factors, although large firms experienced positive returns.

2.2. Date of valuation and the time frame in which the trademark is being valued.

2.3. **Scope:** Whether a single domain name or a portfolio of domain names is being valued. The distinction is important as portfolio risk is typically less than the sum of the risk of individual components.

2.4. Valuation Approach

3. Valuation Approaches

There are three well-recognized quantitative approaches: cost, market, and income. Whenever possible and reasonable, one or a combination should be used. However, when none of these methods is feasible, you can use a qualitative approach.

3.1. Cost Replacement/Reproduction Approach

With intangible assets, the value is less related to the creation cost than to the income that can be generated through the use. In general, cost does not equal value. Thus, this approach is mainly used for internally generated intangible assets that have no identifiable income stream, such as software.

3.2. Market Approach

"Value" in this essay refers to fair market value (FMV), which reflects the highest price that would prevail in an open and unrestricted market between a willing and informed buyer and a willing and informed seller, each acting at arm's length and under no compulsion to transact.

This method reflects the value obtained when marketplace supply and demand drive prices to an equilibrium level. The approach uses the market price of comparable assets to estimate the value of an asset of interest. In order for there to be comparables, an active public market must exist.

You should keep in mind the distinction between comparables and substitutes. All substitutes are comparables, but not all comparables are substitutes. This is especially true for trademarked and brand domain names. Thus, comparables have similar predefined characteristics. On the other hand, for domain names composed of generic words that are used to generate traffic, comparables can also serve as substitutes.

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[4] S. Bhagat and U. N. Umesh. 1997. "Do Trademark Infringement Lawsuits Affect Brand Value: A Stock Market Perspective." *Journal of Market-Focused Management* 2: 127–48.

Nevertheless, the approach places constraints on the pool of available comparables due to the following factors:

- Intellectual property (IP) is not scalable. When appraising real estate, you don't necessarily have to know sales prices for the exact size of the home being considered; instead you can compare price per square foot. But try doing the same with IP.

- The market value of a domain name is a bundle of rights, each of which needs to be estimated separately. Although the market for domain names is growing, there is no active market for trademarks.

Thus, statistical techniques need to be used to identify comparables and measure the trademark component implicit in a domain name.

Application to domain names

The method is similar to the income-based the "Premium Price" estimation approach outlined below. Thus, to estimate the premium, you can use statistical models.

3.2.1. Estimation steps:

Step 1: Estimate a statistical model with trademarks as one of the explanatory variables.

Step 2: When estimating the market value of a specific trademark, use the model estimated in Step 1 to predict two components of domain name value: one that includes the trademark explanatory variable and one with the trademark variable set to zero.

Step 3: The difference between above two value predicted values yields an estimate of the trademark value implicit in the domain name.

3.2.2. Estimation Issues

a. There is no one right statistical technique. We use regression-trees, as described here.

b. The value estimate depends on the length of the period of the sample used in Step 1 above.

c. The data on the explanatory variables must be collected in the same time as the sale price.

d. Relevant data must be available for the key words implicit in the domain name being considered.

3.2.3. Overcoming estimation issues

- To overcome estimation issues (a) and (b) above you should use the data length that provides the "best" predictive model.

- With real estate, for example, adjustments can be to sales data using extrapolation. However, this becomes very tricky with the explanatory variables of a domain name value; therefore, time synchronicity–related adjustments should be avoided and data integrity should be ascertained.

- When there is no data available on a domain name's key words, you can use other methods within the same framework, such as the income approach, or resort to a qualitative framework, as described .

3.3. Income Approach

This approach assesses the present value of future benefits. However, there are different income-based methodologies that can be used. The methodologies are:

3.3.1. Residual Value. The method requires the ability to estimate the value of all related property and to estimate total corporate value. The difference is assumed to be attributed to trademark.

3.3.2. Premium Price or earnings. This approach assesses the additional income generated by comparing sales of the trademarked goods against sales of generic goods.

3.3.3. Relief-from-Royalty. If a company owns a trademark, then it is relieved from paying a royalty. The royalty can be estimated by using market sales/license transaction data or known market license/royalty rates.

3.3.4. Discounted Cash Flow (DCF)

Click here for more details on the application of the DCF methodology to domain names. The advantages are:

- Consistent decision criteria for all projects.
- No dependence on individual risk preferences.
- No vulnerability to accounting manipulations.
- Simple to explain criteria and results:
    - Net Present Value (NPV) measures additional value the project under consideration would create.
    - Accept a project when present value is greater than cost. Thus, NPV would be positive.
- Most extensively used method and is incorporated in the American Society of Appraisers: Business Valuation Standards and IVSC recommendations.
- Risk analysis: Sensitivity analysis is one method to better understand value risk. Another is applying a Monte Carlo simulation to quantify uncertainty in DCF models. The latter

model provides the range and probability that CFs can be above or below predicted levels. However, simulations do not consider the strategic options that management has. ROM models, outlined below, explicitly incorporate such options.

3.3.5. Real Options Models (ROMs)
The approach is based on option pricing theory originally developed to value financial puts and calls.

- ROMs make the asset risk explicit and quantify it to provide more risk transparency to aid decision making. They provide robustness to DCF estimates.

- Real options add value only when a financial model can be built. Management has flexibility and strategic options. Although decision trees can be used to depict future strategic pathways that the firm can take, the use of such models alone requires subjective probabilities and discount rates. Using ROM overcomes such problems.

4. A Qualitative Approach to Value Drivers

There are three groups of variables that influence asset value: competition, useful life, and future strategic options.

4.1. Competition issues include:

- Brand name differentiation, i.e., how unique is the product in a local, regional, and global territory?
- Would others be interested in using the trademark?
- Would a third party pay to lease or use the name in a "similar" product line or via extensions into other product areas?
- Breadth of use of the trademark.
- Profit margins.

4.2. Remaining useful life:

Economic life, which measured useful life, is different from service life of the asset. Economic life ends when

- It is no longer profitable to use the asset, or
- It is more profitable to use another asset.

One school of thought is that trademark rights have unlimited economic lives since they exist as long as they are used and maintained. For practical DCF valuation purposes, trademark valuations cover a period of 20 years.

4.3. Strategic Options

Such managerial options include the decision to:

- Expand the product scope to other areas. Amazon.com started as an online bookseller and has since expanded into CDs and many other areas, all under the same brand name.

- Reposition an elderly brand through building nostalgic interest. Of course, as WebVan shows us, such retro branding can be costly. You need to shoulder two separate stages: neutralizing customers' negative perceptions and then building the brand.

5. Factors affecting the future value of a trademark

5.1. Mark-specific factors:

- A mark can become generic or nondistinctive (e.g. aspirin, Kleenex).
- It can become obsolete, as with trendy items.
- There can be value attached to it even after abandonment. The Jeeves name and image continue to have favorable associations in the public mind, a likely reason that Ask.com has brought back Jeeves.
- Change in tastes may diminish the value of a brand or trademark, as happened with cigarettes.
- The legality of the trademark can be challenged in court.

5.2. Change in the competitive landscape

- The number and size of the firms in the industry
- Technological changes

5.3. Change in the economic environment

5.4. **Change in the political environment.** Political risk may work against the value of a trademark in a foreign country.

6. Valuation, the IRS and U.S. Courts

There is no single right way to estimate the value of a trademark, but there are wrong ways. I use an example of each from U.S. courts.

6.1. No Right Way

In 1995, the U.S. commissioner of internal revenues (meaning the head of the Internal Revenue Service) notified DHL Corporation (DHL) that the IRS was seeking $194 million in deficiencies and penalties over the taxable value of a 1990–92 sale involving the "DHL" trademark. DHL had valued the trademark at $600 million, but the initially

IRS valued it at $200 million. In 1999, the U.S. Tax Court revised the valuation figure to $100 million. The revised difference is because the Tax Court used a residual value approach, while DHL used the income approach. In 2002, the U.S. Court of Appeals for the Ninth Circuit agreed with DHL that the residual approach had its deficiencies, but the court held that "nonetheless, these shortcomings are debatable and certainly do not warrant reversal in this case." The court cited a 1981 precedent establishing the Tax Court's "broad discretion in determining what method of valuation most fairly represents the market value of the stock in issue." The court added, "DHL may dispute the exact figures used by the tax court in reaching its valuation, but DHL fails to demonstrate clear error, either in the tax court's methodology or in its final result. We therefore affirm the tax court's [sic] valuation of the trademark at $100 million." [Details here]

6.2.Wrong Way

In an action against Nestle Holdings Inc., the U.S. 2nd Circuit Court of Appeals concluded that the Tax Court erred in relying only on the Relief-from-Royalty method in its valuation of a taxpayer's income. The court commented on the use of the method to value trademarks, stating that the method "necessarily undervalues trademarks" and that "royalty modes are generally employed to estimate an infringer's profit from its misuse of a patent or trademark." "However, use of a royalty model in the case of a sale is not appropriate because it is the fair market value of a trademark, not the cost of its use, that is at issue. [The method] fails to capture the value of all of the rights of ownership, such as the power to determine when and where a mark may be used, or moving a mark into or out of product lines. It does not even capture the economic benefit in excess of royalty payments that a licensee generally derives from using a mark. Ownership of a mark is more valuable than a license because ownership carries with it the power and incentive both to put the mark to its most valued use and to increase its value. A licensee cannot put the mark to uses beyond the temporal or other limitations of a license and has no reason to take steps to increase the value of a mark where the increased value will be realized by the owner. The Commissioner's view, therefore, fundamentally misunderstands the nature of trademarks and the reasons why the law provides for exclusive rights of ownership in a mark." The U.S. Tax Court was "instructed to examine alternative methods for determining the fair market value of the trademarks in question." [Details here] ■