Calculating Damages Arising from Design Patent Infringement

By Mark Gallagher and Kelly Caputo

It is Saturday night at 2:00 A.M., and the last hand of the firm's annual poker tournament is being dealt. Sitting directly across the table from you is the guy who won the big trial six months ago and has not let anyone forget it. Although a fair sum of money is on the table, you recognize that money is not the real ante. The play of this hand will determine who will now have bragging rights as the "big winner." So you ask yourself, do I need in my hand a straight or a flush?

Fast-forward to Tuesday morning. The jury has been seated, and in representing the plaintiff patent holder, you begin to deliver an opening statement on the damages case. So, what would you like in your hand now—a utility patent or a design patent? The answer may surprise you. This article compares and contrasts the calculation of damages for utility patents and design patents.[1]

As one court noted, "[a]lthough the design patent is not as popularly known as its counterparts, the utility patent and the copyright, design patents perform a distinct function in the federal scheme of legal protection for creative works."[2] Indeed, damages resulting from infringement of a design patent are recoverable under § 284 or under § 289.[3] Therefore, having a design patent in hand opens alternative, and possibly more advantageous, avenues to explore when calculating damages.

Damages relating to patent infringement are generally addressed in § 284:

> Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infrin-ger, together with interest and costs as fixed by the court . . . the court may increase the damages up to three times the amount found or assessed.

Damages relating to design patent infringement specifically are addressed in § 289:

> Whoever during the term of a patent for a design, without license of the owner, (1) applies the patented design, or any colorable imitation thereof, to any article of manufacture for the purpose of sale, or (2) sells or exposes for sale any article of manufacture to which such design or colorable imitation has been applied shall be liable to the owner to the extent of his total profit, but not less than $250, recoverable in any United States district court having jurisdiction of the parties.
>
> Nothing in this section shall prevent, lessen, or impeach any other remedy which an owner of an infringed patent has under the provisions of this title, but he shall not twice recover the profit made from the infringement.

With this framework, a court can consider at least three theories when determining the appropriate damages award in connection with design patent infringement: (1) the infringer's profits pursuant to § 284; (2) lost profits pursuant to § 289; and (3) a combination of lost profits and reasonable royalty pursuant to § 284 and § 289.

As a general matter, for patent holders to recover their lost profits, they must prove that it was more likely than not that, but for the infringement, they would have made the infringer's sales. One of the most common standards for making this showing, which will be familiar to those who practice in the intellectual property damages arena, is the "*Panduit* test." Under this test, the patent owner must establish four factors: "(1) demand for the patented product, (2) absence of acceptable noninfringing substitutes, (3) [the patent holder's] manufacturing and marketing capability to exploit the demand, and (4) the amount of the profit [the patent holder] would have made."[4]

When actual damages, such as lost profits, cannot be proven, the patent owner is entitled to at least a reasonable royalty.[5] A reasonable royalty is an amount that a person, desiring to manufacture and sell a patented item, as a business proposition, would be willing to pay as a royalty, and at the same time have the ability to make and sell the patented article in the market to return a reasonable profit. Determination of a "reasonable royalty" after infringement, like many devices in the law, rests on a legal fiction.[6] Created in an effort to "compensate" when profits are not provable, the "reasonable royalty" device conjures a "willing" licensor and licensee who, like the Ghost of Christmas Past, are dimly seen as "negotiating" a "license" at the time the infringement began.[7]

In calculating a reasonable royalty, 15 different factors aid the court in its evaluation: (1) royalty rates received from prior licenses by the licensor; (2) prior rates paid by the licensee; (3) the nature and scope of the license, such as whether it is exclusive or nonexclusive; (4) the licensor's licensing policies; (5) the commercial relationship between the licensor and licensee; (6) the existing value of the invention to the licensor as a generator of sales; (7) the duration of the patent and term of the license; (8) the established profitability of the product made under the patent; (9) the utility and advantages of the patent property over older modes or devices; (10) the benefits to those who have used the patented invention; (11) the extent to which the infringer has used the invention; (12) reasonable royalties within the industry; (14) opinion testimony by experts; and (15) the amount that the licensor and licensee would have agreed upon in voluntary negotiations.[8] Looking at these factors, the court in *Georgia-Pacific* found that, in a hypothetical negotiation, the patent holder would be "reasonable in taking the position that it would not accept a royalty significantly less than the profit it was making."[9]

Looking at damages under § 289, the plaintiff patent holder has the burden of establishing infringing sales made by the defendant as the starting point of damages. From that number, the defendant then has the opportunity and burden to identify and quantify variable costs associated with those sales to mitigate the damages amount. Notably, fixed or indirect costs are not considered.[10] The advantage given by § 289 is removing the need to establish a reasonable probability that, but for the infringement, the patent holder would have made the infringer's sales. This can work to the advantage of a patent holder that is not manufacturing or marketing a product.

In any case, "the measure of damages is an amount which will compensate the patent owner for the pecuniary loss sustained because of the infringement . . . and the award may be split between lost profits as actual damages to the extent they are proven and a reasonable royalty for the remainder."[11] There enters the possibility of fashioning a damages award consisting of lost profits pursuant to § 284 and a reasonable royalty or an equivalent equal to the lost profits as contemplated by § 289.

The significant takeaway is that, under § 284, it seems the infringer is permitted to argue that some portion of the sales and profit results from factors other than the patented feature, while under § 289, the patented design itself is, in fact, driving the sales, and an apportionment is not appropriate.

To illustrate this point, we look at some figures from an actual design patent damages case. Of course, to reach damages for purposes of this example, it is assumed that the patent at issue has been determined valid and infringed.

The plaintiff patent holder is a small company operating from a simple office, and its owner is the principal sales representative. The company purchases products that incorporate the patented design from an overseas company, and sales of the products have consistently yielded a profit. To increase profitability, the company prefers to have the manufacturer ship products directly to the customer. Because it is unable to use this arrangement for all product sales, the plaintiff maintains a small warehouse and incurs some warehousing and shipping-related costs.

The defendant infringer is a much larger corporation, and the product at issue rounds out one of its product lines. The defendant sells its products through an internal sales force that earns a small commission on the sales. The defendant also purchases its products overseas and endeavors to ship them directly to its customers. It cannot do this in all cases and stores some product in a warehouse.

The plaintiff has several products that incorporate the patented design, and selling prices range from $67 to $126 per unit. The weighted average selling price calculates to $88.70 per unit. The plaintiff's weighted average gross margin (calculated as sales minus cost of goods sold) is $41.57 per unit. Gross margin as a percentage of sales is 46.86 percent.

The defendant's selling price ranges from $31 to $84 per unit, and its weighted average selling price calculates to $47.06 per unit. The defendant's weighted average gross margin is $16.45, or 34.96 percent, per unit. For purposes of this discussion, it is assumed that the defendant sold 10,000 units that infringe the plaintiff's patent.

Using the figures above, had the plaintiff sold the defendant's 10,000 units, the plaintiff would have generated sales of $887,200 and earned a gross profit of $415,742. Instead, the defendant had sales of $470,574 and a gross profit of $164,513. Notably, the plaintiff does not have any expenses below the gross profit line, whereas the defendant can claim selling and warehousing-related costs associated with the sales of the infringing product in an amount of, let's say, $25,000.

Unfamiliar with design patents, the defendant's damages expert agrees the defendant earned a profit of $139,513. However, the defendant's expert posits that the patented design did not drive sales, and lost profits were therefore not an option. Instead, a royalty of 5 percent of the defendant's sales, or $20,787, is reasonable, or as an alternative calculation and a maximum damages amount, the expert applies the 5 percent to the plaintiff's sales, resulting in a damages figure of $44,350.

In response, the plaintiff's expert comments, "Why would the plaintiff accept a royalty of 5 percent using either company's sales figures under § 284 when, under § 289, the plaintiff would be entitled to a lost profits figure of $139,513 or, calculated on a percentage basis, a royalty of 29.65 percent?" Based on plaintiff's expert's calculation, the royalty floor is now 29.65 percent. Further, the plaintiff's expert comments that his client is entitled to a royalty figure closer to the gross margin percentage it would have earned had it made the sales, or 46.86 percent.[12]

A hypothetical negotiation envisions a figure acceptable to both parties. In this case, if we assume the parties split the difference, the defendant's 29.65 percent and the plaintiff's 46.86 percent suggest a "reasonably agreed upon" royalty of 38.25 percent. However, multiplying 38.25 percent by the defendant's sales results in a royalty payment of $192,512. A figure in excess of the defendant's profit is certainly not an amount the defendant will swallow.

So, what are the defendant's options? Well, any option clearly hinges upon defining what "profit" really means and how it is calculated. Is profit under design patent law comparable to accounting net profit before tax, net profit after tax, or incremental profit (calculated as selling price minus variable expenses)? Each can provide a very different figure.

First, consider net profit after tax. The Supreme Court in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.* said:

> The Court of Appeals evidently felt that since only after-tax profits can be reinvested or distributed to shareholders, [plaintiff] was damaged only to the extent of the after tax profits that it failed to receive. The view of the Court of Appeals is sound in theory, but it overlooks the fact that in practice the Internal Revenue Service has taxed recoveries for tortious deprivation of profits at the time the recoveries are made.[13]

Citing *Hanover Shoe*, the plaintiff in *Nike, Inc. v. Wal-Mart Stores, Inc.* asserted that a damages award should be based on pretax profits, and the court agreed:

> [An] award of only the infringers' post-tax profits would leave the appellants in possession of their tax refunds, and that if the appellants still enjoy a profit the award can not be their "total profits" as mandated by the statute. . . . The statute requires the disgorgement of the infringers' profits to the patent holder, such that the infringers retain no profit from their wrong.[14]

The court in *Schnadig* was more direct in holding that § 289 is "an 'additional remedy'" for design patentees, describing the section's purpose as follows:

> [I]ts apparent purpose is to place the patentee in the shoes of the infringer. By recovering an infringer's pre-tax

> profits, the patentee will in fact be treated as though he had gained the profits from the exploitation of his patent. We find this to be the result intended by the statute, and accordingly, we reverse the district court's ruling that only after-tax profits can be recovered under 35 U.S.C. § 289.[15]

Next, consider the fact that classification of a certain expense as fixed or variable can vary upon the facts and circumstances of the case. In one case, the court reviewed a trial court's determination that labor as a component of manufacturing costs was a fixed cost based upon "the business practice of [the company] to pay its employees for an eight hour . . . day, five days a week . . . . and [company]'s cost of labor [having] been steady with respect to sales over the period in question."[16] In practice, ask whether the facts and circumstances of the case call into question the classification of direct labor as variable or fixed. The determination can, of course, have an impact on any damages calculation.

Then, look to determine what expenses can be deducted to arrive at profit. The court in *Schnadig* looked at the lower court's ruling that "a portion of fixed costs may be considered as an expense in computing the total profit which the patentee may recover."[17] The parties had "agreed that the expenses which vary directly with productive activity should be deducted in determining total profits, and have stipulated to the amount of these variable expenses.'"[18] There remained a question as to the classification by the parties of expenses generally categorized as overhead. The court noted:

> Neither case law nor logic provides a clear rule for the proper treatment of fixed expenses in computing an award of profits. Theoretically, a fixed expense is one that does not fluctuate with the volume of business. However, we recognize that the real world of business does not offer pure laboratory conditions which allow a given expense to be so clearly isolated . . . the fixed expenses are as necessary to the infringing production as are the variable expenses, and should be similarly treated. The basic truth that no article of manufacture can be profitable in a real sense if it cannot bear its proportionate share of the fixed costs is hardly new.[19]

Ultimately, the court came up with a benchmark finding, that "approximately two-thirds of the fixed costs allocable to the infringing production may be used to reduce the profit attributable to the infringement is reasonable."[20]

Standing before the jury, ready to make your opening statement in a damages case, you want a design patent in hand, along with an understanding of its advantages, which you can easily convey to the layperson assessing your client's damages. A significant advantage of a design patent in the damages arena is that the design itself is credited with driving the sales, and, as a result, no apportionment of the sales is assignable to other factors. Looking at our case example, the profit recovered under § 289 exceeded the royalty suggested by defendant's expert. So, can the defendant's profits calculated as a percentage of sales be used to effectively set a base royalty? And what costs are ultimately deductable in calculating a profit in a design patent case? These questions remain as open-ended as the facts of each case of infringement. As we await further guidance from the courts, look to the benefits of the design patent and the relevant statutes, and if you are defense counsel, look to your expert to dissect and classify expenses and costs.

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Endnotes

1. For an informative discussion of the background and origins of the design patent, *see* Nike, Inc. v. Wal-Mart Stores, Inc., 138 F.3d 1437 (Fed. Cir. 1998); and Schnadig Corp. v. Gaines Mfg. Co., 620 F.2d 1166, 1167 (6th Cir.1980).
2. *Schnadig*, 620 F.2d at 1167.
3. Catalina Lighting, Inc. v. Lamps Plus, Inc., 295 F.3d 1277, 1290 (Fed. Cir. 2002).
4. Panduit Corp. v. Stahlin Bros. Fibre Works, Inc., 575 F.2d 1152, 1156 (6th Cir. 1978). Although the *Panduit* test is accepted and relied upon heavily by the courts, it is not an exclusive standard for determining lost profits. *See* State Indus. v. Mor-Flo Indus., 883 F.2d 1573, 1577 (Fed. Cir.1989).
5. Georgia-Pacific Corp. v. U.S. Plywood Corp., 318 F. Supp. 1116, 1121 (S.D.N.Y. 1970), *modified*, Georgia-Pacific Corp. v. U.S. Plywood-Champion Papers, Inc., 446 F.2d 295 (2d Cir. 1971).
6. *Panduit Corp.*, 575 F.2d at 1159.
7. *Id.*
8. *See Georgia-Pacific*, 318 F. Supp. at 1120.
9. *Id.* at 1127.
10. *See* John O. Butler Co. v. Block Drug Co., 620 F. Supp. 771, 778 (N.D. Ill. 1985); Schnadig Corp. v. Gaines Mfg. Co., 620 F.2d 1166, 1175 (6th Cir. 1980).
11. State Indus. v. Mor-Flo Indus., 883 F.2d 1573, 1577 (Fed. Cir. 1989).
12. "[T]o refuse to award reasonably foreseeable damages necessary to make [the patent holder] whole would be inconsistent with the meaning of § 284." Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538, 1547 (Fed. Cir. 1995).
13. Hanover Shoe, Inc. v. United Shoe Mach. Corp., 392 U.S. 481, 502–3 (1968).
14. *Nike, Inc.*, 138 F.3d 1437, 1448 (1998).
15. *Schnadig*, 620 F.2d at 1174.
16. Kalman v. Berlyn Corp., 914 F.2d 1473, 1478 (Fed. Cir. 1990) *aff'd*, 988 F.2d 129 (Fed. Cir. 1993).
17. *Schnadig*, 620 F.2d at 1171.
18. *Id.*
19. *Id.* at 1172.
20. *Id.* at 1175.

