

# **CALCULATING AN INFRINGER'S PROFITS: TO DEDUCT OR NOT TO DEDUCT, THAT IS THE QUESTION**

By Tim Warnock

The Copyright Act provides two measures of damage to plaintiffs alleging copyright infringement in civil actions.<sup>1</sup> A successful plaintiff may elect between recovering (1) the actual damages suffered plus the profits of the infringer or (2) statutory damages.<sup>2</sup>

This article primarily addresses the method of calculating the profits of an infringer. Whether to elect to pursue the infringer's profits or statutory damage, however, necessarily requires understanding both measures of damage.

The framework for statutory damages establishes three ranges. Statutory damages for copyright infringement may be awarded within a range from \$750 to \$30,000 per infringement.<sup>3</sup> If the defendant proves that the infringement was "innocent," the award may be reduced to \$200 per infringement.<sup>4</sup> If the plaintiff establishes that the infringement was willful, the award may be increased to \$150,000 per infringement.<sup>5</sup>

If the plaintiff elects to pursue actual damages plus the profits of the infringer rather than statutory damages, the plaintiff may attempt to prove two different categories of damage. First, the plaintiff may have suffered actual damage. For example, in a case involving the alleged infringement of a musical composition — the words and music that comprise a song — the plaintiff may claim as actual damage its failure to collect a license fee if the alleged infringer had obtained a license to exploit the composition from the plaintiff.<sup>6</sup>

The infringer's profits reflect the sum that the defendant actually earned from the infringement as opposed to the sum that the plaintiff would have earned. In order to recover an infringer's profits, the plaintiff must only prove the infringer's gross revenue.<sup>7</sup> Proving gross revenue might involve proving revenue from sales of a compact disc or discs in the case of an alleged infringement of a musical composition, revenue from on-line sales, revenue from performing rights societies, revenue from the infringer's having licensed the infringing work to others and revenue from synchronization licenses if the infringing work has been used in a television or radio commercial, television show or movie.

The defendant may then prove "his or her deductible expenses and the elements of profit attributable to factors other than the copyrighted work."<sup>8</sup> The defendant bears the burden of proving the expenses, and "reasonable approximations constitute satisfactory evidence."<sup>9</sup> Uncertainty based on a defendant's inadequate record-keeping practices, however, will be resolved in favor of the plaintiff.<sup>10</sup>

So, exactly which expenses are deductible?

An infringer incurs certain expenses as part of creating and exploiting the infringing work. Is the defendant entitled to deduct the costs of manufacturing the infringing work? Are shipping costs deductible? May the defendant deduct the value of returned goods? Is the defendant entitled to deduct the cost of legal fees defending the infringement action?

The infringer may incur other expenses regardless of the infringing exploitation. Is the defendant entitled to deduct the monthly rent payment for the warehouse where the infringing goods are stored? May the defendant deduct some or all of the costs of the

company's bookkeeper who creates the financial statements reflecting the income earned from sales of the infringing goods? May a corporate defendant deduct the cost of the CEO's salary? What about deducting part of the cost of the corporate jet?

The Sixth Circuit does not have clear answers to each of these questions. In fact, some of these questions have not been answered in any circuit in cases construing the Copyright Act. Analogous cases decided under either the Patent Act or the Trademark Act can provide helpful guidance in a copyright case. The answers to some of these questions are inconsistent, often turning on whether the infringement was willful.

### **Income Tax**

The Sixth Circuit has held, in a case involving patent infringement, that a plaintiff may recover pretax profits.<sup>11</sup> In *Schnadig Corp. v. Gaines Manufacturing Co., Inc.*, the court reasoned that forbidding the deduction of income tax would ensure that the plaintiff was treated as if the plaintiff had earned the profit.<sup>12</sup>

The United States District Court for the Southern District of New York has held that a nonwillful infringer may deduct income tax costs, but a willful infringer may not.<sup>13</sup> The United States Court of Appeals for the Ninth Circuit has held that non-willful infringers may deduct income taxes actually paid relating to the infringing work.<sup>14</sup>

### **Fixed, or Indirect, Costs**

The Sixth Circuit has upheld a district court's decision to allow a defendant to deduct "two-thirds of the fixed costs allocable to the infringing production."<sup>15</sup> Permitting the deduction of all overhead expense for the organization would be unfair to a plaintiff. On the other hand, some overhead expense is necessary to the generation of each dollar of revenue. The court in *Schnadig* recognized that the infringing goods could not have

been manufactured without expenses for “utilities, administrative salaries, building space and the like.”<sup>16</sup> The “guiding principle,” the court reasoned, was that the plaintiff recover “every dollar of advantage realized by the infringer from the infringement.”<sup>17</sup>

A defendant may also attempt to identify the specific overhead-expense categories that are implicated by the infringing activity and propose a fair and reasonable formula for assigning those expenses to the infringing work.<sup>18</sup> “An infringer need not prove overhead expenses and their relationship to the infringing production in minute detail, but must explain at least in general terms how claimed overhead actually contributed to the production of the infringing work.”<sup>19</sup>

If a defendant cannot establish that the overhead costs bear some relation to the infringing work, the court may not deduct those expenses in calculating damages. For instance, replacement of framing damaged during shipping, general advertising of the defendant’s business, bad-debt expense, charitable contributions, internet expenses, training expenses and subscriptions to publications are all expenses that a court refused to deduct in a case involving infringing artwork.<sup>20</sup>

The cost of warehouse staff to fill orders of infringing goods may not be deductible absent testimony explaining not only the amount of the cost but also testimony addressing the amount of time spent filling orders with infringing goods as opposed to filling other orders.<sup>21</sup>

### **Variable, or Direct, Costs**

Costs incurred directly related to the infringement, such as the cost of printing and mailing an infringing brochure, are properly deductible from a defendant’s gross

revenue.<sup>22</sup> In connection with an infringing musical performance, deductible expenses included the commission to the booking agent, musician salaries for the infringing shows, and commission to the business manager.<sup>23</sup>

In a case involving the infringement of copyrighted software, the jury was instructed specifically to deduct production and marketing expenses.<sup>24</sup> Framing, printing, freight and sales commissions are properly deductible in connection with a damage calculation in a case involving infringed artwork.<sup>25</sup> A court may deduct royalties, or a portion of the profits, paid to others.<sup>26</sup>

“Remaindered” costs of goods sold may be deducted.<sup>27</sup> These costs are the value of unsold or returned product less the sum received upon liquidation. Similarly, printing costs for unsold copies of the infringing goods are deductible if the unsold goods were destroyed.<sup>28</sup>

The cost of retouching — or altering — photographs falls into two categories. Retouching for the purpose of concealing infringement is not deductible.<sup>29</sup> Retouching for other purposes with the incidental effect of concealing, on the other hand, is deductible.<sup>30</sup>

On occasion, a direct cost is not really a direct cost. In *Burns v. Imagine Films Entertainment, Inc.*, the United States District Court for the Western District of New York held that distribution costs paid directly by a defendant were not deductible because those expenses were paid to companies in which the defendant had an ownership interest.<sup>31</sup>

## Conclusion

The cases addressing the calculation of the profits of the infringer seek to award the plaintiff every dollar of profit earned by the infringer from the infringement. At times, such as calculating the amount of overhead that the defendant may deduct, the calculation is imprecise. In other instances, such as disallowing income-tax payments for willful infringers, the rationale appears simply punitive. With respect to each of the categories of expense, however, a defendant should be well prepared not only with proof of the expense but also a credible explanation for the relationship between the claimed expense and the infringing activity.

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<sup>1</sup> In addition to liability for damages, the Copyright Act also provides for impoundment, destruction of infringing goods, injunctive relief and criminal liability. 17 U.S.C. §§ 502, 503 and 506.

<sup>2</sup> 17 U.S.C. § 504.

<sup>3</sup> *Id.*

<sup>4</sup> 17 U.S.C. § 504(c)(2).

<sup>5</sup> *Id.*

<sup>6</sup> *McRoberts Software, Inc. v. Media 100, Inc.*, 329 F.3d 557, 566 (7<sup>th</sup> Cir. July 22, 2003).

<sup>7</sup> 17 U.S.C. § 504(b).

<sup>8</sup> *Id.*

<sup>9</sup> *Folkens v. Wyland (NFN)*, 2002 U.S. Dist. LEXIS 13519, at\*3 (N.D. Ca. 2002).

<sup>10</sup> *Caffey v. Cook*, 409 F. Supp. 2d 484, 504 (S.D.N.Y. 2006).

<sup>11</sup> *Schnadig Corp. v. Gaines Manufacturing Co., Inc.*, 620 F.2d 1166 (6<sup>th</sup> Cir. 1980).

<sup>12</sup> *Id.* at 1171.

<sup>13</sup> *Caffey*, 409 F. Supp. at 506.

<sup>14</sup> *Folkens*, 2002 U.S. Dist. LEXIS 13519, at \*19.

<sup>15</sup> *Schnadig*, 620 F.2d at 1175.

<sup>16</sup> *Schnadig*, 620 F.2d at 1172.

<sup>17</sup> *Schnadig*, 620 F.2d at 1175.

<sup>18</sup> *Caffey*, 409 F. Supp. at 504.

<sup>19</sup> *Folkens*, 2002 U.S. Dist. LEXIS 13519, \*15.

<sup>20</sup> *Id.* at \*117-18.

<sup>21</sup> *Mendler v. Winterland Concessions Co.*, 2000 U.S. Dist. LEXIS 12966, at \*\*10-11 (N.D. Ca. Sept. 6, 2000).

<sup>22</sup> *Pham v. Jones*, 2006 U.S. Dist. LEXIS 32932 (S.D.Tx. May 13, 2006).

<sup>23</sup> *Caffey*, 409 F. Supp at 504.

<sup>24</sup> *McRoberts Software, Inc.*, 329 F.3d at 568.

<sup>25</sup> *Folkens*, 2002 U.S. Dist. LEXIS 13519, at \*14.

<sup>26</sup> *Gunthy-Renker Corp. v. Bernstein*, 39 Fed. Appx. 584 (9<sup>th</sup> Cir. 2002).

<sup>27</sup> *Mendler*, 2000 U.S. Dist. LEXIS 12966 at \*11-12.

<sup>28</sup> *Sigma Photo News, Inc. v. High Society Mag., Inc.*, 778 F.2d 89, 92 (2d Cir. 1985).

<sup>29</sup> *Id.* at 93.

<sup>30</sup> *Id.*

<sup>31</sup> *Burns v. Imagine Films Entertainment, Inc.*, 2001 U.S. Dist. LEXIS 24653 (W.D.N.Y. Aug. 23, 2001).