HAMIL AMERICA, INC. v. GFI

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United States Court of Appeals for the Second Circuit, 1999
193 F.3d 92

OAKES, Senior Circuit Judge.

I. INTRODUCTION

Hamil America, Inc. sued GFI (a Division of Goldtex, Inc.), SGS Studio, Inc. and J.C. Penney Company, Inc. for copyright infringement. According to Hamil America, GFI copied one of Hamil America's floral fabric patterns, SGS manufactured garments using the infringing GFI fabric and sold the garments to J.C. Penney, and J.C. Penney sold the garments in its retail stores. Hamil America prevailed at trial and was awarded damages against all three defendants. GFI, SGS, and J.C. Penney appeal the district court's finding of liability for infringement and its calculation of damages. Hamil America cross-appeals the district court's calculation of damages, arguing that the district court should have awarded damages for profits that Hamil America presumably would have earned had other customers not purchased GFI's infringing pattern. Because the district court erroneously prohibited GFI from deducting any overhead expenses in the calculation of its profits, we reverse in part and remand for recalculation of damages. We affirm on all other issues.

II. BACKGROUND

Hamil America and GFI are companies doing business in the garment industry. Each sells printed fabric to manufacturers that, in turn, create garments for sale to wholesalers or retailers.

In 1993, Tabitha Kim created an original floral design for Hamil America which was designated Pattern No. 96. Kim transferred her copyright rights in the design to Hamil America. Hamil America produced and sold fabric printed with Pattern No. 96 in various color combinations, or "colorways." One of the color combinations, designated colorway 575, featured clusters of small white and yellow flowers with blue centers on a red background.

SGS is a garment manufacturer. J.C. Penney is a retailer that sells, among other things, garments made by SGS. In June 1994, SGS purchased fabric samples of Hamil America Pattern No. 96 in four colorways, including colorway 575. SGS showed the fabric samples to J.C. Penney, along with other fabric samples obtained from other fabric vendors, to allow J.C. Penney to choose fabric patterns to be used for garments that SGS would manufacture for J.C. Penney. J.C. Penney selected six patterns out of the various patterns shown to it by SGS, including Hamil

America Pattern No. 96 in colorway 575 and five GFI patterns.

SGS made sample garments from these six fabric patterns and supplied them to J.C. Penney. J.C. Penney used the sample garments for intra-company marketing and outside advertising. It showed a garment made with Hamil America Pattern No. 96 to buyers in its individual stores and featured a garment made with Hamil America Pattern No. 96 in its newspaper advertising.

SGS then manufactured garments for J.C. Penney. It was more expensive for SGS to use Hamil America fabric than GFI fabric: Hamil America fabric in Pattern No. 96 cost $5 per yard, whereas GFI fabric cost only $3.60 per yard. According to Hamil America, SGS wanted GFI to develop and manufacture a fabric pattern that SGS could substitute for Hamil America Pattern No. 96 in colorway 575, so that SGS could fulfill the J.C. Penney order for garments made from that pattern at a lower cost to SGS.

In October 1994, GFI hired Jae Wang, a freelance artist frequently employed by GFI, to create a fabric pattern that GFI would sell to SGS. In the same month, SGS ordered two yards of Pattern No. 96 in colorway 575 from Hamil America to be shipped to SGS on a rush basis. According to Hamil America, Wang copied, or "knocked-off," Hamil America Pattern No. 96. Wang's design was designated GFI Pattern No. 330. SGS substituted GFI Pattern No. 330 for Hamil America Pattern No. 96 in the garments it manufactured for J.C. Penney.

Hamil America learned of the infringement from Beaver Raymond, one of its Texas manufacturing customers.....

In April 1995, Hamil America registered Pattern No. 96 with the United States Copyright Office and was granted a registration number, VA 642-546. Hamil America sued GFI for copyright infringement, claiming Hamil America Pattern No. 96 was infringed by GFI Pattern No. 330. Hamil America also sued SGS and J.C. Penney because they each sold garments manufactured with GFI's infringing fabric. After a non-jury trial, the district court found that the defendants willfully infringed Hamil America's copyright. In March 1998, the court entered judgment in favor of Hamil America against all defendants, and awarded damages in the amount of $201,049 from GFI, $28,836 from SGS, and $67,106 from J.C. Penney.

GFI, SGS, and J.C. Penney appeal the district court's finding of liability for infringement and its calculation of damages. Hamil America cross-appeals the district court's calculation of damages, arguing that the district court should have awarded damages for profits that Hamil America presumably would have earned had other customers not purchased GFI's infringing pattern.

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III. DISCUSSION

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Because GFI Pattern No. 330 is substantially similar to Hamil America Pattern No. 96, we affirm the district court's holding that the appellants infringed Hamil America's copyright.

C. Damages

We next turn to the issue of damages. Under the current Copyright Act, a copyright owner can elect to recover either "actual damages and profits" under 17 U.S.C. §504(b), or "statutory damages" under 17 U.S.C. §504(c). 17 U.S.C. §504(c)(1). At Hamil America's request, the district court awarded damages under 17 U.S.C. §504(b). Hamil America could recover "the actual damages suffered by [it] as a result of the infringement, *and* any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages." 17 U.S.C. §504(b) (emphasis added). These two methods of recovery available under §504(b) serve two distinct purposes: "[d]amages are awarded to compensate the copyright owner for losses from the infringement, and profits are awarded to prevent the infringer from unfairly benefitting from a wrongful act." H.R. Rep. No. 94-1476, at 161 (1976), reprinted in 17 U.S.C.A. §504 at 146 (West 1996).

The parties contend that the district court erred with respect to both damages calculations permitted under §504(b). The appellants argue that the court erred by disallowing deductions for overhead and other fixed expenses from the profits generated from the sales of the infringing fabric. Hamil America cross-appeals the calculation of its own actual damages, arguing that it was entitled to recover profits that it presumably would have earned had other customers not purchased GFI's infringing pattern. We address each issue in turn.

1. Calculation of the Infringers' Profits

Section 504(b) of the Copyright Act authorizes a copyright owner to recover the infringer's profits. That section expressly provides that "[i]n establishing the infringer's profits, the copyright owner is required to present proof only of the infringer's gross revenue, and the infringer is required to prove his or her deductible expenses and the elements of profit attributable to factors other than the copyrighted work." 17 U.S.C. §504(b). Put another way, the infringer's profits are calculated as the gross sales of infringing goods minus the costs that the infringer proves are attributable to the production and sale of those goods.

In compliance with this statutory procedure, Hamil America submitted proof of GFI's gross revenue from the sale of the infringing dress patterns, and GFI submitted a schedule of its deductible expenses that included both the actual costs of production of the infringing pattern as well as its general, or "fixed," overhead expenses. The district court rejected GFI's submission to the extent that it sought deductions for overhead expenses, stating that GFI "would have had general administrative expenses of 'X' amount whether [it] sold [the infringing] goods or not." The court also rejected certain specific expenses, such as country club dues, on the ground that they were not "incremental costs of producing [the infringing] fabric." The court asked GFI to adduce the "actual cost of the goods, what it actually cost [GFI] to manufacture [the] specific items." The district court accepted GFI's amended cost schedule, which showed only the variable costs of producing and selling the infringing pattern, and which excluded general overhead items such as rent, insurance, and depreciation.

GFI argues that the district court erred in excluding an allocation of general overhead expenses in its calculation of GFI's profits and that we must remand for recalculation of damages. We agree.

Our analysis begins with *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45 (2d Cir. 1939) (L. Hand, J.), in which a motion picture studio infringed the copyright on a certain play. The district court allowed a deduction for overhead expenses based on the ratio that the cost of producing the infringing movie bore to the total costs of the movie studio. On appeal, the copyright holder argued that the infringers should not have been permitted any deduction for overhead expenses absent a showing that the overhead had been increased by the production of the infringing movie, which was only one of forty produced by the studio. This court affirmed, noting generally that, " '[o]verhead' which does not assist in the production of the infringement should not be credited to the infringer; that which does, should be; it is a question of fact in all cases." *Id.* at 54.

Turning to the specific facts of the *Sheldon* case, the court applied its general rule as follows:

> In the case at bar the infringing picture was one of over forty made by the defendants, using the same supervising staff and organization, which had to be maintained if the business was to go on at all. Without them no picture could have been produced; they were as much a condition upon the production of the infringing picture as the scenery, or the plaintiffs' play itself.

Id. The court thus concluded that certain categories of general overhead expenses — in this case, those relating to creating and maintaining a "supervising staff and organization" — were appropriately deducted from gross revenue. The court then considered various methods of allocating those overhead expenses to the production of the infringing movie, and selected the method that was most fair, accurate, and practical in light of the infringing company's structure and products. Given the impossibility of determining the overhead costs that were directly related to the production of the infringing motion picture, the court permitted a deduction of a portion of overhead expenses based on the cost of production of the motion picture:

> [T]o make a perfect allocation one would have to examine what part of the time of all the employees whose pay went into the "overhead," was given to each picture; and so of the other expenses. That was obviously impossible. It is on the whole more likely that a given picture required that proportion of the general services represented by its cost of production, than that each picture shared those services equally. . . . The [cost of production] solution appears to us as nearly right as was practically possible.

Id. at 52-53.

The court therefore affirmed the district court's use of an estimate of overhead expenses based on the cost of production — notwithstanding the absence of particularized findings as to the use of those expenses for things that specifically contributed to the infringing picture — because of the "extravagant labor" necessary to determine the incremental contribution of individual property to the infringing picture:

> It was better . . . to compute this item by assuming that the infringing picture used that proportion of the whole plant which its cost of production bore to the cost of production of all pictures made that year, than to attempt any allocation of buildings and other property according to their actual use for the picture. The second method would have been incredibly difficult in application, involving as it would a different proportional use of each bit of property concerned.

Id. at 54. In adopting this pragmatic approach, the court implicitly rejected the need for a detailed analysis of an infringer's ledgers.

Sheldon thus contemplates a two-step procedure for deducting overhead expenses from an infringer's profits. The first step is to determine what overhead expense categories (such as rent, business, entertainment, personnel and public relations) are actually implicated by the production of the infringing product. Once a sufficient nexus is shown between a category of overhead and the production or sale of the infringing product, a court need not scrutinize for inclusion or exclusion particular items within the overhead category. For example, if "entertainment expenses" is a category of overhead implicated in the line of business that produced or sold the infringing product, then country club dues included within that category should not be singled out for exclusion, as they were by the district court here. Rather, the court should limit its inquiry to the sufficiency of the nexus between the expense category and production of the infringing product.

The second step is to arrive at a fair, accurate, and practical method of allocating the implicated overhead to the infringement. The infringer has the burden of "offering a fair and acceptable formula for allocating a given portion of overhead to the particular infringing items in issue." 4 Melville B. Nimmer and

David Nimmer, *Nimmer on Copyright* §14.03 [B], at 14-39 (1996). The reasonableness of the proffered overhead allocation formula is a question of fact in all cases.[5]

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Despite the clear precedent on the deduction of overhead expenses established by *Sheldon* . . . , the district court here prohibited GFI from deducting any overhead whatsoever unless GFI could show that its overhead was actually increased by its production of Pattern No. 330. *See* [*Hamil America, Inc. v. SGS Studio, Inc. et al.*, 1998 WL 19991 (S.D.N.Y. Jan. 21, 1998)], at *3 ("[T]he Court must examine the facts to determine those incremental cost[s] of the infringer that were increased as a direct result of the production and sale of the infringing goods . . . and to separate them from those fixed costs that would have been incurred in any event."). The court appears to have based its holding at least in part on the fact that the infringement by GFI was willful, relying on cases from other jurisdictions suggesting that willful or deliberate infringers may not deduct overhead when calculating the profit the plaintiff is entitled to recover.

Unlike the district court, we are not prepared to abandon the teachings of *Sheldon* in favor of a hard and fast rule denying all overhead deductions to willful infringers. But we share the district court's concern that willful infringers should not be permitted to subsidize the sale of legitimate goods with the sale of infringing goods by "passing part of its fixed cost on to the copyright holder." *See id.* at *2. We also recognize that "a rule of liability which merely takes away profits from an infringement would offer little discouragement to infringers." *F.W. Woolworth Co. v. Contemporary Arts*, 344 U.S. 228, 233 (1952). We therefore conclude that *Sheldon*'s two-step approach must be applied with particular rigor in the case of willful infringement.

Every infringer shoulders the burden of demonstrating a "sufficient nexus between each expense claimed and the sales of the unlawful goods," [*Manhattan Indus. v. Sweater Bee by Banff, Ltd.*, 885 F.2d 1, 8 (2d Cir. 1989)], before it may deduct any overhead expenses from its profits. When infringement is found to be willful, the district court should give extra scrutiny to the categories of overhead expenses claimed by the infringer to insure that each category is directly and validly connected to the sale and production of the infringing product. Unless a strong nexus is established, the court should not permit a deduction for the overhead category.

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5. Some methods of allocating overhead to the infringement proffered in previous cases include: the production cost of the infringing product as a percentage of the total production costs, *see Sheldon*, 106 F.2d at 52; the number of infringing products as a percentage of total products, *see Wilkie v. Santly Bros.*, 139 F.2d 264, 265 (2d Cir. 1943); and the dollar sales from the infringing product as a percentage of total dollar sales, *but see Gaste v. Kaiserman*, 863 F.2d 1061, 1071 (2d Cir. 1988) (rejecting the dollar sales method).

An infringer also bears the burden of proposing a fair and acceptable formula for allocating a portion of overhead expenses to the infringing items at issue. The district court must determine that the particular allocation formula is optimal and sound, and all presumptions are drawn against the infringer. The allocation formula of a willful infringer should be held to a particularly high standard of fairness, and the court should not hesitate to reject a formula which allows the willful infringer to deduct more of its overhead than was directly implicated in the manufacture of the infringing product.

Because the district court erred under *Sheldon* in applying a blanket prohibition of all overhead deductions, we reverse on this issue and remand for a recalculation of GFI's profits. In that proceeding, GFI, as a willful infringer, must demonstrate a direct and valid nexus between each claimed overhead expense category and the production of GFI Pattern No. 330 and propose a fair and acceptable formula for allocating a portion of overhead to the pattern's production. The district court, applying the heightened scrutiny appropriate in cases of willful infringement, will have the latitude to adopt or reject certain categories of overhead, and to accept, reject, or amend GFI's overhead allocation formula. Of course, if the resulting calculation causes the district court to reconsider its finding that Hamil America "will be fully compensated on its claims," *see Hamil America, Inc.*, 1998 WL 19991, at *3, the court could award Hamil America its "actual damages" in lieu of, or in addition to, GFI's recalculated profits. *See* 17 U.S.C. §504(b).

2. Hamil America's Lost Profits

Hamil America raises one issue on cross-appeal: whether the district court erred when it determined that Hamil America could not recover for lost profits that it might have earned from sales to those of its customers who purchased GFI's infringing design. It relies on three facts: (1) Hamil America and GFI had several shared customers; (2) the shared customers bought samples of Hamil America Pattern No. 96 with the probable intention to purchase more Hamil America fabric; and (3) the shared customers did not purchase the fabric from Hamil America after the less expensive version offered by GFI appeared on the market. Hamil America reasons that it is entitled to damages for lost profits, as it would have sold Pattern No. 96 to the shared customers had GFI not made the infringing pattern. It argues that it is entitled to a total judgment against GFI in the amount of $240,782, rather than the $201,049 that was awarded by the district court.

GFI argued below that Hamil America should not recover lost profits, because the shared customers would not have purchased the fabric at Hamil America's above-market prices. GFI also pointed out that those customers purchased GFI's fabric several months after they had purchased Hamil America's samples, and concluded that the commercial failure of Hamil America's pattern "had nothing to do with the availability of [GFI's] pattern."

The district court agreed that the shared customers may well have declined to purchase Hamil America's fabric, due to its higher price, and held that Hamil America could not recover the alleged lost profits. The court further noted that Hamil America could not recover both for its hypothetical sales to the shared customers and for GFI's actual sales to those same customers.[7] The court elected to measure GFI's actual profits from sales to the shared customers, rather than speculate as to what Hamil America might have earned had it sold Pattern No. 96 to the shared customers.

As Nimmer states, "[i]n the absence of convincing evidence as to the volume of sales that plaintiff would have obtained but for the infringement, the measure of lost profits may be rejected as too speculative." *Nimmer on Copyright* §14.02[A], at 14-11 (citing *Odegard, Inc. v. Costikyan Classic Carpets, Inc.*, 963 F. Supp. 1328, 1341 (S.D.N.Y. 1997)). The district court rejected Hamil America's request for lost profits as too speculative. In our view, this conclusion was not clearly erroneous. In the absence of more reliable evidence of Hamil America's lost profits, the district court was entitled to rely on the less abstract calculation of damages from GFI's sales to the shared customers. We therefore affirm on this issue.

IV. CONCLUSION

Because the district court erroneously prohibited GFI from deducting any overhead expenses in the calculation of its profits, we reverse in part and remand for recalculation of damages . . . .

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7. Hamil America properly conceded below that "it may not recover its profit on these alleged sale[s] and defendant[s]' profit on the sale to these companies." *Hamil America, Inc.*, 1998 WL 19991, at *3. A copyright plaintiff may recover its own lost profits, which are part of the plaintiff's "actual damages," as well as the defendant's profits. But a "plaintiff may not recover damages that have already been taken into account in computing its actual damages." *Nimmer on Copyright,* §14.03, at 14-29. Thus, "[a] plaintiff may not recover its full lost profits plus all of the defendant's profits, for this would constitute a forbidden double recovery." *Id.* §14.02[A], at 14-10 (citing *Taylor v. Meirick*, 712 F.2d 1112 (7th Cir. 1983)). Thus, if Hamil America were in fact entitled to recover lost profits, it would have had to set off its recovery for GFI's profits by those profits already taken into account to determine Hamil America's lost profits, because Hamil America could not recover twice. Hamil America properly performed this analysis below, when Hamil America contended that it had lost profits of $149,823, and that GFI's profits not taken in account in computing Hamil America's lost profits were $90,959, for a total judgment against GFI in the amount of $240,782.