Evaluating Lost Profits Damages During Early Stages of Litigation

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In intellectual property infringement cases, both parties and their counsel are wise to consider early in the litigation process whether or not a damages award might include lost profits. Beyond just the legal framework, several practical and accounting considerations are relevant. Damages experts are invaluable at quickly pinpointing the critical issues for a particular set of circumstances, but clients can start thinking through the issues even before an expert has been retained. This article is intended to help both plaintiffs and defendants, as well as their counsel, do just that.

Introduction

In the early stages of every intellectual property infringement suit, both plaintiff and defendant should be asking what amount of damages may be at issue. Often, a sufficiently narrow range of reasonable royalties can be estimated, based on an estimate of the infringing sales and a royalty rate. However, lost profits damages can be multiples higher, so both plaintiffs and defendants should consider whether or not the circumstances may result in a lost profits award and its likely magnitude. By giving proper attention early in the litigation, plaintiffs can direct discovery accordingly. Similarly, defendants can better prepare appropriate responses and can assess their exposure.

Fed. R. Civ. P. 26(a)(1)(a) indeed requires in the initial disclosure "a computation of each category of damages claimed by the disclosing party" plus the supporting documents. IP cases typically follow this requirement only loosely. Yet the rule remains, so defendants can use it to press for damages claims early, and likewise plaintiffs should realize that they may need to get their house in order early.

Following Rule 26(a)(1)(a), the Northern District of California revised its patent local rules in 2017 to mandate an early exchange of damages contentions and documents, plus damages estimates in the initial case management statement.[1] Parties now must focus on damages at the outset of litigation, often with assistance of a damages expert, instead of deferring until much later. Other districts have been known to borrow heavily from the Northern District's rules, so these requirements may be replicated.

Legal Basis for Lost Profits

In patent cases, damages are awarded under 35 U.S.C. § 284, which states:

> *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 infringer, together with interest and costs as fixed by the court.*

Compensatory damages includes lost profits caused by the infringement. When lost profits are not proven, a reasonable royalty serves as a floor on damages.

Plaintiffs may be awarded a mix of lost profits and reasonable royalties. For example, sales in certain territories might be assigned a royalty instead of being included as lost sales. Or lost sales may be claimed on only a portion of the infringing sales because of feature differences, with the remainder subject to a reasonable royalty.

The patent owner may be able to obtain lost profits despite not selling a product covered by the patent-in-suit. If, for example, the patentee sells an (unpatented) product that competes with the infringing product, then lost profits may be available.[2] Even where the patentee does not sell a competing product, it can prove lost profits if it would have made and sold a competing product but for the infringement.[3]

Lost profits commonly consists of (1) lost profits from lost sales, and/or (2) lost profits from price erosion. Although other forms of lost profits are relatively uncommon, plaintiffs have used other theories when supported by the evidence:

- Damage to reputation and goodwill. Although a common concern among plaintiffs, this can be difficult to prove and accurately quantify.
- Future lost profits. These are generally not considered where they relate to ongoing infringement, since (a) the infringement causing the lost sale has not yet occurred, and (b) it is generally assumed that infringement would end after a finding for the plaintiff.[4]
- Miscellaneous business losses. Lost business value or reduced stock price, for example, may be sought if sufficiently supported by the facts. Often, such losses may be insufficiently related to the infringement. The Federal Circuit ruled in *Rite-Hite*[5] that remote consequences of infringement are not compensable, citing as examples a heart attack of the inventor or loss in stock value of the patentee's corporation caused indirectly by infringement.

Approximately 40% of patent damages awards include lost profits, with the remaining 60% being reasonable royalty awards.[6] Price erosion awards have become exceedingly rare—on the order of 2% of all awards.[7] Of course, neither of these percentages suggest a probability of success, since they do not measure the awards against the number of instances they were sought.

The Panduit Factors

The *Panduit*[8] decision articulated a four-factor test that has since become the most common (but not the exclusive) way for a patentee to prove entitlement to lost profits damages. The Panduit test requires that a patentee establish: (1) demand for the patented product; (2) absence of acceptable non-infringing substitutes, (3) manufacturing and marketing capability to exploit the demand; and (4) the amount of profit it would have made. Where a patentee satisfies the Panduit test and shows that there was a reasonable probability that it would have made the sales but for the infringement, the burden then shifts to the infringer to show that the inference is unreasonable for some or all of the lost sales.[9]

The framework for analyzing lost profits typically consists of reconstructing the market

as it would have developed absent the infringement; i.e. the "but for" inquiry.[10] The four Panduit factors are then analyzed within this framework.

Factor 1. The first Panduit factor simply asks whether demand existed for the "patented product," i.e. a product that is covered by the patent-in-suit or that directly competes with the infringing device.[11] Hence, this factor is generally straightforward to demonstrate in the market reconstruction. The Federal Circuit has ruled that a showing of demand for the patented *feature* is not required, only demand for the relevant *product*.[12]

Factor 2. Defendants can rebut a lost profits claim by showing that it would have sold an acceptable non-infringing alternative during the damages period. Even if an alternative was not sold during the damages period, defendants can show that it could have, and would have, made and sold such a product. Numerous court rulings address this Panduit factor and especially the question of availability.

Factor 3. Plaintiffs should also demonstrate the manufacturing and marketing capacity to make the claimed sales. Defendants may argue plaintiff lacked marketing capability based on differences in the customer base, geography, etc.

Factor 4. The fourth factor requires plaintiffs to provide a reasonable approximation of its lost profits; the amount "need not be proven with unerring precision."[13]

Deciding to Seek Lost Profits

Early in the process, plaintiffs should consider what evidence will help demonstrate that it lost sales. This can include, for example:

- Testimony from its personnel that it lost sales;
- Internal documents, emails, customer correspondence, etc. evidencing the lost sales; and/or
- Possible documents or testimony from defendants or third parties.

A lost profits award can be multiples greater than a reasonable royalty award, especially where the plaintiff's profitability is high. However, the additional effort to gather information and conduct research and analyses results in added expert and attorney fees. Generally, a damages expert can provide an estimate of the additional fees related to their work.

Plaintiffs should also consider lost profits analyses typically require the production of sensitive business records. While sales and profitability information are often used in reasonable royalty analyses, they are nearly certain to be needed for lost profits. Additionally, lost profits analyses may include customer-level data; for example, in analyses of the extent that the parties sell to the same customers. This information is typically covered by a protective order that limits disclosure.

Quantifying Lost Profits from Lost Sales

Ultimately, a lost profits analysis boils down to multiplying the infringing sales by the plaintiff's profitability. Early in litigation, quantifying lost profits can be challenging since the plaintiff knows its profitability but not the infringing sales. Conversely, the defendant knows its infringing sales but not the plaintiff's profitability.

Interrogatories can be useful at quantifying infringing sales in early stages. Damages experts can also assist with research or analyses to estimate infringing sales.

Once the infringing sales have been identified and estimated, they can be "mapped" into the plaintiff's products by comparing features, prices, market segments, etc. Lost sales can

also include (1) collateral or convoyed sales, consisting of unpatented products that function with and are sold with the patented product, as well as (2) derivative sales, which occur after the initial sale.

If the relevant market consists of only two suppliers (plaintiff and defendant), then the plaintiff may claim 100% of the infringing sales as lost sales. If other firms sell competing products, then the lost sales can be adjusted by using the market share approach.[14] The following table illustrates this approach:

	Market Share, Actual	***Market Share, But-For***
Plaintiff	50%	83%
Defendant	40%	0%
Others	10%	17%
Total	100%	100%

As this example shows, "but for" market shares are calculated by excluding the defendant and redistributing those sales to the plaintiff and others by their market shares. In this example, if infringing sales were $100 million, then plaintiff would claim lost sales of $83 million.

Lost sales are reported as lost revenues or lost units. If the latter, then a selling price is generally identified in order to arrive at lost revenues. Is the appropriate price that of the patent owner, or the price of the infringing sales, or something else? There is no definitive answer, and will depend on the circumstances. Where plaintiff's and defendant's prices differ substantially, the presumed but-for price deserves appropriate justification.

Once the lost sales are determined, we can turn our attention to profitability. Plaintiffs will typically have an income statement (or "profit and loss statement") similar to the following example:

	$ ('000)	***% of Sales***
Net sales	$100,000	100%
Cost of Sales	(50,000)	
Gross profit	50,000	50%
SG&A	(40,000)	
Operating profit	10,000	10%
Taxes & interest	(4,000)	
Net profit	$6,000	

This income statement shows gross profits of 50% and operating profits (i.e. after selling, general, and administrative costs) of 10%. However, lost profits analyses apply the plaintiff's "incremental" profit margin, which attempts to include only the incremental, or variable, costs. This typically includes Costs of Goods Sold, plus only those SG&A costs that would increase with additional sales of the magnitude at issue. Some components of SG&A might be variable (commissions, credit card fees, etc.) while others may be fixed (rent, advertising, etc.). As such, incremental profitability falls somewhere between gross and operating profits. In the absence of any other information, an incremental profitability near the midpoint might be assumed; in this example, 30%. However, the gap between gross and operating margin can be quite large (as in this example), so this ballpark estimate would accordingly have a large error band. Accurately calculating the incremental profitability typically entails a detailed line-by-line review of each cost sub-category to determine the extent that each is variable.

Quantifying Lost Profits from Price Erosion

Price erosion damages on the patent owner's historical sales can easily exceed lost profits from lost sales, for example where:

- The affected sales greatly outnumber infringing sales;
- Per-unit price erosion is high; and/or

- Little to no additional costs are associated with the lost revenues (which is often the case).

However, price erosion is usually difficult to estimate in early litigation stages, especially since little is typically known about defendant's historical pricing.

The calculation commonly consists of identifying the price erosion on a per-unit basis, then multiplying this by the number of plaintiff's affected sales to arrive at a dollar amount of price erosion. Any costs that would increase due to the additional sales revenue (such as commissions) should be deducted.

Conclusions

Although lost profits claims (and rebuttals) call for rigorous and well-supported analyses by damages experts, plaintiffs and defendants can independently consider such damages early in the litigation process. While one can get absorbed in the quantification step, appropriate attention should also be paid to the market reconstruction, plaintiff's manufacturing and marketing capacity, and acceptable non-infringing alternatives.

Plaintiffs and defendants should also understand that a trend is apparently underway to require early disclosures of damages contentions and estimates. Hence, early attention to damages may become not just good practice, but also mandatory.

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[1] See www.cand.uscourts.gov/localrules/patent
[2] See *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538 (Fed. Cir.) (en banc), cert. denied, 516 U.S. 867 (1995).
[3] *Wechsler v. Macke Int'l Trade, Inc.*, 486 F.3d 1286 (Fed. Cir. 2007).
[4] However, future lost profits that stem from acts that occurred during the period of infringement may be appropriate in some circumstances.
[5] See *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1544-46 (Fed. Cir.) (en banc), cert. denied, 516 U.S. 867 (1995).
[6] PwC 2017 Patent Litigation Study, p. 11.
[7] *Ibid.*, p. 8.
[8] *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152, 197 U.S.P.Q. (BNA) 726 (6th Cir. 1978).
[9] *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152, 197 U.S.P.Q. (BNA) 726 (6th Cir. 1978), citing *Kaufman Co. v. Lantech, Inc.*, 926 F.2d 1136, 1141, 17 U.S.P.Q.2D (BNA) 1828, 1831 (Fed. Cir. 1991).
[10] See *Grain Processing Corp. v. American Maize-Products Co.*, 185 F.3d 1341, 1350 (Fed. Cir. 1999) (citation omitted).
[11] See *DePuy Spine, Inc. v. Medtronic Sofamor Danek, Inc.*, 567 F.3d 1314, 1330 (Fed. Cir. 2009).
[12] *Ibid.*
[13] *Del Mar Avionics, Inc. v. Quinton Instrument Co.*, 836 F.2d 1320, 1327 (Fed. Cir. 1987) (internal quotations and citations omitted).
[14] See *State Industries, Inc. v. Mor-Flo Industries, Inc.*, 883 F.2d 1573 (Fed. Cir. 1989).