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NOTES

DOES THE BAD FAITH REQUIREMENT IN ACCOUNTING OF PROFITS DAMAGES MAKE ECONOMIC SENSE?

I. INTRODUCTION

An accounting of profits damages in trademark infringement actions amounts to the disgorging of the defendant's profits made due to infringement. Although the Lanham Act provides for this remedy, it is far from being awarded as a matter of course upon a finding of infringement. Although a split among the federal circuits currently exists, a majority of the circuits require a finding of bad faith before awarding an accounting of profits. This paper seeks to determine whether the bad faith requirement makes economic sense in light of the policies advanced by the Lanham Act and subsequent legislation.

First, a survey of the legislation and legislative history will establish the policies behind trademark protection. Next, an examination of Supreme Court and federal circuit court opinions will provide a glimpse into the treatment and rationales advanced by the judiciary on this subject. A more in-depth analysis of the components of an accounting will follow in order to clarify and sharpen the economic models which will follow and conclude the note. These models suggest that the bad faith requirement not only may not be necessary to compensate the wronged plaintiff, but also may not be necessary to deter intentional infringers. Rather, the bad faith requirement may act as a proxy for a more important inquiry into the comparative costs facing the infringing and infringed firms.

A. LANHAM ACT AND ITS LEGISLATIVE HISTORY

In 1946 the United States Congress passed the Lanham Act,¹ which placed “all matters relating to trade-marks in one statute.”² In so doing, Congress hoped to protect the public, an investor’s energy, capital and effort, and to provide prompt and effective relief against infringement by “making infringement and piracy unprofitable.”³ As trademark infringement is merely a subsection of unfair competition, the protection afforded is against what Congress deemed “swindling”.⁴

Congress understood the importance of trademark protection, as it has emphasized that trademarks serve public policy by providing the public with a symbol or name to distinguish one product from another.⁵ Furthermore, Congress acknowledged that trademarks insure high quality products “by securing to the producer the benefit of the good reputation which excellence creates.”⁶ As we shall see, without trademark protection these goals would quickly erode as incentives to create and police marks would decrease and public perception of a trademark’s reliability would diminish.

B. RELIEF PROVIDED BY THE LANHAM ACT

Congress provided for injunctive relief to prevent the unauthorized use of a trademark.⁷ A trademark owner can use an injunction to “restrain an infringer from any current or prospective infringing activities.”⁸ The injunctive relief only provides a

¹ Lanham Trademark Act of 1946, ch. 540, 60 Stat. 427.

² S. REP. NO. 79-1333, at 3 (1946), *reprinted in* 1946 U.S.C.C.A.N. 1274.

³ *Id.* at 1275.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ 15 U.S.C. § 1116(a) (1994). The pertinent part of this section follows:

The several courts . . . shall have power to grant injunctions, according to the principles of equity and upon such terms as the court may deem reasonable, to prevent the violation of any right of the registrant of a mark registered . . . or to prevent a violation under section 1125(a) of this title.

Id.

⁸ Keith M. Stolte, *Remedying Judicial Limitations on Trademark Remedies: An Accounting of Profits Should Not Require a Finding of Bad Faith*, 87 TRADEMARK REP. 271, 273 (1997).

sufficient remedy when an infringer "has not yet entered the market in any appreciable manner, or where past sales of infringing articles have not caused significant damage to a trademark owner."⁹

Since injunctions may not be a totally sufficient remedy for the wronged trademark owner,¹⁰ Congress passed Lanham Act section 35.¹¹ This section provides an election of possible remedies for the wronged trademark owner. The owner is entitled, subject to two provisions in the Act and the "principles of equity, to recover (1) defendant's profits, (2) any damages sustained by the plaintiff, and (3) the costs of the action."¹² In assessing profits the plaintiff need

⁹ *Id.* at 273-274.

¹⁰ *Id.* at 274.

¹¹ Act of July 5, 1946, ch. 540, title VI, § 35, 60 Stat. 439 (codified as amended at 15 U.S.C.A. § 1117 (1998)).

¹² 15 U.S.C.A. § 1117. The relevant sections of the statute are:

§ 1117. Recovery for violation of rights; profits, damages and costs; attorney fees; treble damages; election

(a) When a violation of any right of the registrant of a mark registered in the Patent and Trademark Office, or a violation under section 1125(a) of this title, shall have been established in any civil action arising under this chapter, the plaintiff shall be entitled, subject to the provisions of sections 1111 and 1114 of this title, and subject to the principles of equity, to recover (1) defendant's profits, (2) any damages sustained by the plaintiff, and (3) the costs of the action. The court shall assess such profits and damages or cause the same to be assessed under its direction. In assessing profits the plaintiff shall be required to prove defendant's sales only; defendant must prove all elements of cost or deduction claimed. In assessing damages the court may enter judgment, according to the circumstances of the case, for any sum above the amount found as actual damages, not exceeding three times such amount. If the court shall find that the amount of the recovery based on profits is either inadequate or excessive the court may in its discretion enter judgment for such sum as the court shall find to be just, according to the circumstances of the case. Such sum in either of the above circumstances shall constitute compensation and not a penalty. The court in exceptional cases may award reasonable attorney fees to the prevailing party.

...

(c) In a case involving the use of a counterfeit mark (as defined in section 1116(d) of this title) in connection with the sale, offering for sale, or distribution of goods or services, the plaintiff may elect, at any time before final judgment is rendered by the trial court, to recover, instead of actual damages and profits under subsection (a) of this section, an award of statutory damages for any such use in connection with the sale, offering for sale, or distribution of goods or services in the amount of—(1)

only prove the defendant's sales and the defendant is responsible for proving any costs or deductions.¹³ Furthermore, the court may adjust the award of profits if it finds such an award is excessive or inadequate.¹⁴ Congress sought only to provide compensatory and not punitive damages through the Lanham Act's remedies.¹⁵ Thus, through section 35, Congress established a mechanism to insure that offended owners would be assured of some compensation, even if their own damages were difficult to prove.

After several attempts to reform the Act in the 1950's, Congress passed a "housekeeping measure" which made "minimal substantive changes in the trademark law."¹⁶ However, substantive changes were made to the Lanham Act in 1974 when attorney fees were made available to the prevailing party in an infringement action.¹⁷ The Senate Committee stated that the "exceptional cases" where attorney fees are awarded should be times where the infringement is "'malicious', 'fraudulent', 'deliberate', or 'willful.'"¹⁸ The Department of Commerce claimed that the attorneys' fees, along with the possibility of treble damages would serve as a deterrent to trademark infringement.¹⁹ The Department made no mention of defendants' profits as a deterrent to trademark infringement.²⁰ In fact, the Department stated that the measurable damages are nominal even where flagrant infringement has occurred.²¹

not less than \$500 or more than \$100,000 per counterfeit mark per type of goods or services sold, offered for sale, or distributed, as the court considers just; or (2) if the court finds that the use of the counterfeit mark was willful, not more than \$1,000,000 per counterfeit mark per type of goods or services sold, offered for sale, or distributed, as the court considers just.

Id.

¹³ *Id.*

¹⁴ *Id.* These provisions will prove important in the following economic analysis; see *International Star Class Yacht Racing Ass'n v. Tommy Hilfiger U.S.A.*, 146 F.3d 66, 71-72, 46 U.S.P.Q.2d (BNA) 1942, 1946 (2d Cir. 1998) (International II) (stating that a court may use its discretion in awarding a proper amount for an accounting of profits).

¹⁵ 15 U.S.C. § 1117 (1994).

¹⁶ Act of Oct. 9, 1962, Pub. L. No. 87-772, § 19, 76 Stat. 774; S. REP. NO. 87-2107 (1962), reprinted in 1962 U.S.C.C.A.N. 2844, 2845.

¹⁷ Act of Jan. 2, 1975, Pub. L. No. 93-600, § 3, 88 Stat. 1955.

¹⁸ S. REP. NO. 93-1400 (1974), reprinted in 1974 U.S.C.C.A.N. 7132, 7133.

¹⁹ *Id.* at 7136.

²⁰ *Id.*

²¹ *Id.*

Even though the Act was designed to protect the public and the trademark owner's good will from theft, Congress sought enforcement of the Act not through criminal proceedings, but through private actions of trademark owners against infringers. Since trademark owners are the only members of society who enforce the rule,²² they must have an incentive to bring these actions.²³ Without the proper set of incentives, no one will force infringers to cease their practice. This result would cause economic damage, not only to the trademark owner, but also to the public, as consumers' associations with a specific trademark may be deceived.²⁴ Furthermore, repeated infringement could undermine public confidence in trademarks and the good's identification.²⁵

This analysis of trademark legislation and legislative history reveals that Congress sought to advance significant policies. Through trademark legislation, Congress attempted to protect not only the owner's property, but also the public reliance on the mark. In order to protect the mark, Congress set up a system which required: (1) a set of incentives for owners to police their marks; (2) compensation for the wronged owners; and (3) deterrence of future infringement without deterring useful and "good-faith" adoption. Thus, a need exists to balance the importance of protecting property and public reliance on trademarks versus the disincentives to adopt a mark created by potential penalties of infringement.²⁶ This paper will analyze whether the accounting of profits damages strikes this balance and, specifically, whether the bad faith requirement of most circuits is an economically rational way of achieving the goals of trademark legislation.

²² See *Colligan v. Activities Club of New York, Ltd.*, 442 F.2d 686, 687, 170 U.S.P.Q. (BNA) 113, 116-17 (2d Cir. 1971) (holding that consumers have no standing to sue under the Lanham Act).

²³ S. REP. NO. 93-1400, at 5 (1974), reprinted in 1974 U.S.C.C.A.N. 7132, 7136.

²⁴ Roger D. Blair & Thomas F. Cotter, *An Economic Analysis of Damages Rules in Intellectual Property Law*, 39 WM. & MARY L. REV. 1585, 1643-45 (1998).

²⁵ *Id.*

²⁶ A collateral, yet interesting, question arises from an analysis of legislative history and statute structure: Does the inclusion of the bad faith requirement for attorney fees and the absence of the requirement in accounting indicate a Congressional intent not to predicate recovery of accounting of profits on bad faith?

C. TRADEMARK DAMAGES IN GENERAL

Trademark infringement can yield at least five possible types of recovery to the wronged plaintiff:

1. An award to plaintiff measured by defendant's profits, either as a way of measuring plaintiff's loss or under an unjust enrichment theory;
2. An award to plaintiff measured by its actual business damages and losses caused by the wrong;
3. An award to the plaintiff measured by its own loss of profits caused by the wrong;
4. An award to plaintiff of punitive damages in addition to actual damages, for the purpose of punishing defendant; and
5. An award to plaintiff of reasonable attorney's fees incurred in prosecution.²⁷

The courts have often been reluctant to award such monetary relief, balancing several factors including "whether defendant was willful, negligent, or innocent; whether plaintiff suffered losses in any provable amount; whether there is proof of actual confusion of some customers; and whether defendant realized profits from its infringing actions."²⁸ Due to the different importance courts place on these factors, the ability of a trademark attorney to predict recovery of monetary awards is a "dangerous undertaking."²⁹ McCarthy reports that the varying theories and rationales underlying trademark monetary recovery have led "[o]ne commentator . . . [to conclude that these rationales] . . . have received inadequate judicial attention and have remained confused and undefined."³⁰

McCarthy suggests that one reason for the courts' reluctance to award monetary relief is their ability to grant injunctions against use of infringing trademarks.³¹ Courts generally impose injunc-

²⁷ J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARK AND UNFAIR COMPETITION § 30:57, at 30-95, -96 (4th ed. 1996).

²⁸ *Id.* § 30:58, at 30-96.

²⁹ *Id.* § 30:58.

³⁰ *Id.* (citing James M. Koelemay, Jr., *Monetary Relief for Trademark Infringement under the Lanham Act*, 72 TRADEMARK REP. 458, 525 (U.S. Trademark Ass'n) (1982)).

³¹ MCCARTHY, *supra* note 27, § 30:58 at 30-96.

tions as strict liability against both good and bad faith infringers.³² The injunction essentially makes the infringer “forfeit its mark and associated goodwill and start anew . . . [providing] ‘justice’ in many cases” and thereby reducing the need for monetary recovery.³³

D. ACCOUNTING OF PROFITS—HISTORY AND BASIC RATIONALES

An accounting of profits has historically been based on equitable considerations and has required a defendant to disgorge its profits to the plaintiff as a remedy for infringement.³⁴ This remedy, as developed under trademark law in England and in the United States, was used as a proxy for the plaintiff’s lost profits caused by infringement.³⁵ The Restatement states that the award of an accounting developed due to the difficulty of assessing the plaintiff’s lost profits.³⁶ Courts initially held that the profits the defendant earned served as an approximation of what the plaintiff would have earned using the mark.³⁷ Over time, however, courts determined that this rationale only worked in cases where the plaintiff and defendant were in direct competition and had similar profit margins.³⁸ Thus, courts began to abandon this rationale for an accounting where the goods were not in direct competition and began turning to the rationales of deterrence and unjust enrichment to justify an award of accounting.³⁹

³² *Id.* at 30-96.

³³ *Id.* at 30-97.

³⁴ *Id.* at 30-97.

³⁵ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. b (1995).

³⁶ *Id.*

³⁷ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. b (1995); MCCARTHY, *supra* note 27, § 30:59 at 30-97.

³⁸ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. b (1995).

³⁹ See MCCARTHY, *supra* note 27, § 30:59 at 30-98 (stating that courts still “find the accounting of profits remedy attractive and will accept its rough justice in competitive relationships because as between the victim and the wrongdoer, the burden is placed on the wrongdoer to prove, if it can, that some sales were not caused by the infringement, or would not have gone to the plaintiff or that the infringer is more efficient and has lower costs than the plaintiff.”);

see also *infra* note 88 and accompanying text (describing the determination of the amount of an accounting).

The deterrence theory was adopted in cases where plaintiffs could not prove the damages associated with infringement, since deliberate infringement on noncompeting goods could not be discouraged or deterred by the court's only other remedy, the injunction.⁴⁰ Therefore, innocent infringement does not seem to justify an award of accounting on a theory of deterrence.⁴¹

The rationale for the unjust enrichment theory is "that the infringer has taken the plaintiff's property as represented by his trademark and has utilized this property in making a profit, and that if permitted to retain the profit, the infringer would be unjustly enriched."⁴²

These two theories underlie the award of an accounting but are often used inconsistently and in varied ways. The Restatement states that:

[t]he multiple rationales for an award of the defendant's profits complicate analysis of the applicable rules In many cases it is unnecessary to adopt a specific theory since the consequences of the various rationales frequently overlap. In some cases, however, it may be necessary to adjust the terms of the accounting to reflect the specific objective sought by the award and the equities of the particular case.⁴³

⁴⁰ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. b (1995); *see also infra* note 55 and accompanying text (stating that willfulness is required under theories of compensation, unjust enrichment, and deterrence). The deterrence rationale, theory, and examples will be discussed in more detail in Part II.

⁴¹ This point will be examined and explained through economic models to test its validity. *See infra* note 57 and accompanying and following text (discussing the bad faith requirement in relation to the time of infringement).

⁴² *Maier Brewing Co. v. Fleischman Distilling Corp.*, 390 F.2d 117, 121, 157 U.S.P.Q. (BNA) 76, 79 (9th Cir. 1968).

⁴³ RESTATEMENT (THIRD) UNFAIR COMPETITION § 37 cmt. b (1995). This last sentence will be important for an alternative to the bad faith requirement of an accounting which is developed later - i.e., that trebling should be awarded in cases of bad faith or to induce certain behavior such as increased searching. *See infra* text preceding note 148 (discussing how damages interact with the extensiveness of the search).

As indicative of the indecision among the courts, the federal circuits have split over the issue of a bad faith, or willfulness, requirement for accounting of profits.⁴⁴

II. THE JUDICIARY'S TREATMENT OF ACCOUNTING OF PROFITS

A. THE UNITED STATES SUPREME COURT⁴⁵

The United States Supreme Court has not decisively addressed the issue of bad faith or willful infringement in accounting of profits. Earlier this century, the Supreme Court "indicated that an accounting of profits for trademark infringement follows as a matter of course after infringement is found by a competitor."⁴⁶ In *Hamilton-Brown Shoe Co. v. Wolf Bros.*, the Court discussed the award of profits under unjust enrichment theories and mentioned bad faith as a factor,⁴⁷ but in "no way made this factor dispositive."⁴⁸

In 1942, the Court revisited the issue of damages in trademark actions in *Mishawaka Rubber & Woolen Mfg. v. S.S. Kresge Co.*⁴⁹ The Court there admitted that no willful violations existed yet still

⁴⁴ The Seventh Circuit does not require bad faith, but the Second Circuit and a majority of other circuits do. See *infra* note 55 and accompanying text (discussing the two schools of thought on the issue of bad faith in accounting).

⁴⁵ All three of the cases that the Supreme Court ruled on were heard under the Trade-Mark Act of 1905. See Stolte, *supra* note 8, at 278 n.34 (discussing the difference between the 1905 Act and the Lanham Act: the 1905 Act did not require a "showing of bad faith or willful infringement on its face. The most significant differences between the 1905 Act's treatment of the issue of profits and the Lanham Act's treatment is that the latter goes to extraordinary lengths to ensure flexibility and fairness.").

⁴⁶ MCCARTHY, *supra* note 27, § 30:60 at 30-99, -100 (citing *Hamilton-Brown Shoe Co. v. Wolf Bros.*, 240 U.S. 251, 259 (1916)). In addressing the issue of damages, the Court stated: [t]he right to use a trademark is recognized as a kind of property, of which the owner is entitled to the exclusive enjoyment to the extent that it has been actually used The infringer is required in equity to account for and yield up his gains to the true owner, upon a principle analogous to that which charges a trustee with the profits acquired by wrongful use of the property of the cestui que trust.

Hamilton-Brown Shoe Co., 240 U.S. at 259 (citations omitted).

⁴⁷ *Hamilton-Brown Shoe Co.*, 240 U.S. at 259-62.

⁴⁸ Stolte, *supra* note 8, at 280 n.41.

⁴⁹ *Mishawaka Rubber & Woolen Mfg. v. S.S. Kresge Co.*, 316 U.S. 203, 53 U.S.P.Q. (BNA) 323 (1942).

granted the plaintiff a portion of the defendant's profits.⁵⁰ The last case in which the Supreme Court heard the issue of an accounting in trademark damages was *Champion Spark Plug Co. v. Sanders*.⁵¹ McCarthy states that this 1947 opinion "is often cited for the proposition that an accounting of the infringer's profits is not automatically granted upon a showing of infringement."⁵² However, some commentators have found that this holding is not so broad and that the case really stands for the notion that where an injunction will remedy the problem, an accounting is not needed.⁵³

With no definitive Supreme Court pronouncement on the issue of a bad faith or willfulness requirement for an award of an accounting and no explicit guidance from Congress, the lower federal courts have proceeded to form their own rationales and requirements for trademark damages, creating a rift between the circuits on the federal law of trademark damages.

B. THE FEDERAL CIRCUITS

"To put it bluntly," McCarthy states, "courts are not willing to grant an accounting of profits unless the judge 'gets mad' at the defendant."⁵⁴ Two schools of thought have developed in the void of direction on the issue of bad faith in accounting. One school, led by the United States Court of Appeals for the Second Circuit, holds that bad faith or willfulness is required under the theories of compensation, unjust enrichment, and deterrence.⁵⁵ The Seventh Circuit stands at the other side of the debate claiming that bad faith does not need to be shown.⁵⁶

⁵⁰ Stolte, *supra* note 8, at 281-82.

⁵¹ *Champion Spark Plug Co. v. Sanders*, 331 U.S. 125, 73 U.S.P.Q. (BNA) 133 (1947).

⁵² MCCARTHY, *supra* note 27, § 30.61 at 30-100

⁵³ Stolte, *supra* note 8, at 282 (stating that *Champion Spark Plug Co. & Sanders* cannot stand for the proposition that bad faith is needed because the Court applied the *Mishawaka Rubber & Woolen Manufacturing* rule for awarding accounting damages).

⁵⁴ MCCARTHY, *supra* note 27, § 30.62 at 30-104.

⁵⁵ *George Basch Co. v. Blue Coral, Inc.*, 968 F.2d 1532, 1540, 23 U.S.P.Q.2d (BNA) 1351, 1360 (2d Cir. 1992); *International Star Class Yacht Racing Ass'n v. Tommy Hilfiger, U.S.A., Inc.*, 80 F.3d 749, 753-54, 38 U.S.P.Q.2d (BNA) 1369, 1373 (2d Cir. 1996).

⁵⁶ *Roulo v. Russ Berrie & Co.*, 886 F.2d 931, 941, 12 U.S.P.Q.2d (BNA) 1423, 1430 (7th Cir. 1989).

1. *The United States Court of Appeals for the Second Circuit and Bad Faith.* One commentator has suggested that an accounting of profits is “well suited” to strike the balance between deterring infringement and not acting as a penalty:

By depriving infringers of the profits of unauthorized use, an accounting makes infringement unprofitable and takes away any incentive to infringe. Moreover, by limiting an accounting to the gains of unauthorized use, the award leaves the infringer no worse off than if the infringer had not infringed in the first place.⁵⁷

The deterrence rationale does not focus on the injury to the plaintiff, “but upon the wrongful conduct of the infringer.”⁵⁸ Thus the need for an accounting as a deterrent can only occur in a context where there is wrongful conduct.⁵⁹ The need to impose penalties as deterrents only makes sense when there is willful, wrongful conduct. Penalizing someone for something they do not know is wrong, will not prevent them from doing it again.⁶⁰

The Second Circuit requires a finding of bad faith or willful infringement for an awarding of an accounting under a theory of deterrence. This circuit allows for an accounting under three theories: “if the ‘defendant is unjustly enriched, if the plaintiff sustained damages from the infringement, or if the accounting is necessary to deter a willful infringer from doing so again.’”⁶¹ In *Burndy Corp.*, the plaintiff and the defendant competed in making devices that helped the flow of electricity between conductors.⁶²

⁵⁷ Dennis S. Corgill, *Measuring the Gains of Trademark Infringement*, 65 *FORDHAM L. REV.* 1909, 1928 (1997). Based on this quote, punishing a bad faith infringer may be justified if he is made no worse off and the plaintiff is made whole.

⁵⁸ *Id.* at 1929.

⁵⁹ *Id.* at 1929-30.

⁶⁰ *Cf. id.* at 1966 (suggesting that requiring an accounting of profits will act as a deterrent to not doing a complete search; for a more in-depth analysis, see *infra* Section IV.A.2.a.).

⁶¹ *George Basch Co. v. Blue Coral, Inc.*, 968 F.2d 1532, 1537, 23 U.S.P.Q.2d (BNA) 1351, 1356 (2d Cir. 1992) (quoting *Burndy Corp. v. Teledyne Indus., Inc.*, 748 F.2d 767, 772, 224 U.S.P.Q. 106, 110 (2d Cir. 1984)).

⁶² *Burndy Corp. v. Teledyne Indus. Inc.*, 748 F.2d 767, 224 U.S.P.Q. (BNA) 106 (2d Cir. 1984).

Because the mislabeling by the defendant did not undercut the plaintiff's profits, the Second Circuit agreed with the district court that the plaintiff could not get an accounting based on damage sustained by the infringement.⁶³ The Second Circuit then analyzed whether there was bad faith or wilfulness in order to award an accounting on the deterrence theory.⁶⁴ Although some employees may have known that the devices were being made too small, there was no substantial disregard for the necessity of standard labeling (i.e., UL symbol), nor was there continued willful infringement, or willful false representations.⁶⁵ All these factors led the Second Circuit to decide that there was "no need for deterrence."⁶⁶

In cases where the defendant has attempted to capitalize on the goodwill of another's mark, the Second Circuit has also awarded accounting damages under a deterrence theory.⁶⁷ In *Simon & Schuster, Inc.*, the defendant published an audiobook entitled *The Children's Audiobook of Virtues*.⁶⁸ The plaintiffs owned the rights to the mark *The Book of Virtues*.⁶⁹ The district court found that the coincidental timing of the release of the audiobook on the heels of the great success of *The Book of Virtues* and the lack of a "credible innocent explanation" amounted to bad faith.⁷⁰ With this bad faith finding, an accounting was needed to protect "the public at large and 'promote(s) the secondary effect of deterring public fraud regarding the source . . . of consumer goods.'"⁷¹

The Second Circuit made a very strong pronouncement of its bad faith requirement in *International Star Class Yacht Racing Ass'n.*

⁶³ *Id.* at 773 (mislabeling that occurred was not copying the defendant's mark, but rather the placement of a label that indicated certain standards (i.e., 'UL Listed') were met when they were not).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Simon & Schuster, Inc. v. Dove Audio, Inc.*, 970 F. Supp. 279, 301-02 (S.D.N.Y. 1997).

⁶⁸ *Id.* at 282.

⁶⁹ *Id.*

⁷⁰ *Id.* at 299.

⁷¹ *Id.* at 302 (quoting *George Basch Co. v. Blue Coral, Inc.*, 968 F.2d 1532, 1539, 23 U.S.P.Q.2d (BNA) 1351, 1358 (2d Cir. 1992)). The district court also found that there was no diversion of profits or evidence of actual confusion so the theories of unjust enrichment and damage could not be invoked to get an accounting.

*v. Tommy Hilfiger, U.S.A., Inc. ("International I").*⁷² In this case, the plaintiff sued Tommy Hilfiger, U.S.A., Inc. ("Hilfiger") for the use of its "Star Class" mark and solid five pointed insignia.⁷³ The plaintiff, a yachting governance and promotion body, used these marks to identify high profile regattas and races.⁷⁴ Hilfiger adopted these marks on its clothes that were marketed as nautical sportswear with designs taken from racing sails.⁷⁵ Hilfiger requested a limited trademark search, ignored advice of its trademark attorney who recommended a complete search, and proceeded with a complete search only after a suit was instituted.⁷⁶ Furthermore, Hilfiger refused to recall the line once suit was instituted and continued to sell the infringing merchandise.⁷⁷ The court said that the limited search and disregard of attorney advice, coupled with the continued sale of goods, were enough to determine that the district court's finding of no bad faith was "clearly erroneous."⁷⁸ Professors Blair and Cotter suggest that this case could stand for either "the broad proposition that an extensive search is henceforth necessary to dispel any suggestion of bad faith, or only for the narrower proposition that the failure to search can be a factor in the bad faith determination[.]"⁷⁹

The Second Circuit has recently provided more guidance on the holding in *International I*. In *International II*, the Second Circuit stated the "failure to conduct a full search therefore must be evaluated not only in light of industry custom, but also in light of its [Hilfiger's] knowledge that 'Star Class' might be a mark in the yachting context, *together with any other factors* that might prove or negate bad faith."⁸⁰ Thus it appears that conducting a proper search is a Second Circuit factor in determining bad faith and a

⁷² *International Star Class Yacht Racing Ass'n v. Tommy Hilfiger, U.S.A., Inc.*, 80 F.3d 749, 38 U.S.P.Q.2d (BNA) 1369 (2d Cir. 1996).

⁷³ *Id.* at 751.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* at 752.

⁷⁷ *Id.* at 754.

⁷⁸ *Id.*

⁷⁹ Blair & Cotter, *supra* note 24, at 1691.

⁸⁰ *International Star Class Yacht Racing Ass'n v. Tommy Hilfiger, U.S.A., Inc.*, 146 F.3d 66, 70 n.2, 46 U.S.P.Q.2d (BNA) 1942, 1945 n.2 (2d Cir. 1998) (emphasis added).

resultant award of an accounting of profits.⁸¹

2. *The United States Courts of Appeals for the Seventh and Eleventh Circuits and Equity.* In awarding an accounting of profits, the United States Court of Appeals for the Seventh Circuit relies heavily on its holding which states that “[t]he trial court’s primary function is to make violations of the Lanham Act unprofitable to the infringing party.”⁸² The United States Court of Appeals for the Eleventh Circuit also has stated that an accounting accomplishes this goal and “is justified because it deprives the defendant of unjust enrichment and provides a deterrent to similar activity in the future.”⁸³ Although the Second and the Eleventh Circuits may both find justification of an award of an accounting in deterrence and unjust enrichment, they disagree on the issue of bad faith.

The Eleventh Circuit has stated that an accounting based on either the theory of unjust enrichment or the theory of deterrence is not “dependent upon a higher showing of culpability on the part of the defendant, who is purposely using the trademark.”⁸⁴ Thus, the Eleventh Circuit may require a purposeful use of the mark, but it does not require a *mens rea* of willful infringement or intent to palm off the owner’s mark.

The Seventh Circuit alludes to the express provision in 15 U.S.C. § 1117(a) that grants discretion to judges to award and adjust damages as equity requires.⁸⁵ In this vein, Judge Richard Posner has stated:

[T]he principles of equity referred to in section 1117(a) do not in our view justify withholding all

⁸¹ Furthermore, in *International II*, the Second Circuit held that the trial judge may award, at his discretion, a partial or full accounting in order to effectuate deterrence. *Id.* at 71-72.

⁸² *Roulo v. Russ Berrie & Co.*, 886 F.2d 931, 941, 12 U.S.P.Q.2d (BNA) 1423, 1430 (7th Cir. 1989) (quoting *Otis Clapp & Son, Inc. v. Filmore Vitamin Co.*, 754 F.2d 738, 744, 225 U.S.P.Q. (BNA) 387, 391 (7th Cir. 1985)).

⁸³ *Burger King Corp. v. Mason*, 855 F.2d 779, 781, 8 U.S.P.Q.2d (BNA) 1263, 1264 (11th Cir. 1988).

⁸⁴ *Id.*

⁸⁵ *Louis Vuitton S.A. v. Lee*, 875 F.2d 584, 588, 10 U.S.P.Q.2d (BNA) 1935, 1938 (7th Cir. 1989); *Roulo*, 886 F.2d at 941; see also *International II*, 146 F.3d at 71-72, 46 U.S.P.Q.2d (BNA) at 1946 (holding that judges in the Second Circuit may use discretion to develop awards which will deter).

monetary relief from the victim of a trademark infringement merely because the infringement was innocent. As between the "innocent" infringer who seeks to get off scot-free, and the innocent infringed . . . the stronger equity is with the innocent infringed.⁸⁶

The Seventh Circuit perhaps most concisely states its view on an accounting in *Roulo v. Russ Berrie & Co.*, in which the court stated: "Other than general equitable considerations, there is no express requirement that the parties be in direct competition or that the infringer wilfully infringe the trade dress to justify an award of profits."⁸⁷

III. DETERMINATION OF THE AMOUNT OF AN ACCOUNTING

In determining if an accounting is a proper incentive and remedy for deterrence, unjust enrichment, and compensation, an understanding of the composition of an accounting of profits is necessary. An accounting, in theory, should only award the wronged plaintiff that portion of the defendant's profits that are attributable to the infringement.⁸⁸ Thus, burdens and deductions must be analyzed to determine costs faced by businesses making rational decisions in adopting and enforcing marks.

The burdens of proof play essential roles in the process of awarding an accounting. According to the Lanham Act, the plaintiff bears the burden of proof to establish the defendant's "sales only."⁸⁹ Thereafter, the defendant must prove "all elements of cost or deduction claimed."⁹⁰ The courts have interpreted this to mean various things including that the plaintiff must establish

⁸⁶ *Louis Vuitton S.A.*, 875 F.2d at 588-89.

⁸⁷ *Roulo*, 886 F.2d at 941.

⁸⁸ Jere M. Webb & Lawrence A. Locke, *Recovery of Damages Under the Lanham Act: A Practitioner's Guide*, 4 J. PROPRIETARY RTS. 2, 6 (1992).

⁸⁹ 15 U.S.C. § 1117(a) (1994).

⁹⁰ *Id.*

the defendant's volume of sales or total profits.⁹¹ In some cases of intentional infringement apportionment has not been allowed and the defendant has had to yield all of his profits under a theory of deterrence.⁹²

Cases involving the deductions made by the defendant in calculating profits have yielded situations that provide "inconsistent treatment of those deductions . . . [making it] clear that this is an area in which courts are entitled to exercise wide discretion, depending on the facts of the case and the conduct of the defendant."⁹³ Some of the deductions "contested" include "losses incurred in separate accounting periods, fixed and variable expenses, employee salaries, and other costs of doing business" and "the costs of 'correcting' or mitigating the effects of the alleged infringement or other wrongful conduct."⁹⁴ Also, infringing sales that result in a loss are usually not deductible.⁹⁵ Where an infringer has lost money on the sale of the goods, the "Seventh Circuit has said that under the Lanham Act's grant of discretion, it is proper to estimate lost profits of plaintiff [so that the plaintiff is not] prejudiced by defendant's inefficiency."⁹⁶ The Restatement

⁹¹ See *Webb & Locke, supra* note 88, at 6 (describing *Plasticolor Molded Products v. Ford Motor Co.*, 698 F. Supp. 199, 7 U.S.P.Q.2d (BNA) 1885 (C.D. Cal. 1988), where plaintiff just needed to show volume of sales of infringer's "FORD" trademarked floor mats); see also *MCCARTHY, supra* note 27, § 30:65, at 30-113-14 (stating that "the United States Supreme Court said that plaintiff carries his burden of proof when he proves the extent of defendant's total profits, but is unable to apportion them . . .").

⁹² *MCCARTHY, supra* note 27, at § 30:65.

⁹³ *Webb & Locke, supra* note 88 at 7; see also *International Star Class Yacht Racing Ass'n v. Tommy Hilfiger U.S.A., Inc.* 146 F.3d 66, 71-72, 46 U.S.P.Q.2d (BNA) 1942, 1946 (2d Cir. 1998) (holding that the trial judge has discretion in determining the amount of an accounting).

⁹⁴ *Webb & Locke, supra* note 88, at 7 (discussing *W.E. Bassett Co. v. Revlon*, 435 F.2d 656, 168 U.S.P.Q. (BNA) 1 (2d Cir. 1970) in which Revlon attempted to deduct (among their deductions of overhead, operating expenses, and relevant federal income tax) the cost of relabeling the infringing goods; the court held that "Revlon should have to bear the cost of correcting its own wrongdoing." *Id.* at 665).

⁹⁵ *Webb & Locke, supra* note 88, at 7; see also *RESTATEMENT (THIRD) OF UNFAIR COMPETITION* § 37 cmt. d (1995) (stating "[t]he plaintiff may thus recover the defendant's profits on profitable transactions without a deduction for losses suffered on unprofitable transactions.").

⁹⁶ *MCCARTHY, supra* note 27, § 30:66, at 30-118. This factors into the marginal cost analysis undertaken under the compensation economic analysis (i.e. that if this court's lead is followed an accounting can be awarded even if the infringer's marginal cost is higher than the owner's), see *infra* note 172 and following text (discussing marginal costs).

suggests that while salaries of sales personnel may be deductible, the "value of a defendant's own labor . . . salaries or wages paid to persons responsible for the tortious conduct . . . [and] distributions of profits to partners or stockholders," are not deductible.⁹⁷

A. TAXES

The Restatement suggests that income taxes paid by the defendant on the profits in question should generally not be deductible in determining the amount of an accounting.⁹⁸ A hypothetical situation used by McCarthy is illustrative:

. . . [I]f an infringer earned a net pre-tax profit of \$100 from an infringing product, paid \$50 in tax and paid the remaining \$50 to the plaintiff, the infringer would have a \$50 tax deduction worth \$25 at the assumed 50 percent tax rate. If the deduction is fully utilized, it represents a \$25 net gain on the infringement. And, of course, the plaintiff must include the \$50 in its gross taxable income, keeping only \$25 of the award. In this hypothetical, the infringer nets as much as his victim. . . . This does not discourage infringement.⁹⁹

The Restatement concludes that "the denial of a deduction for income taxes paid . . . on the profits awarded to the plaintiff best implements the goals of compensating the plaintiff and preventing the unjust enrichment of the defendant."¹⁰⁰

B. OVERHEAD COSTS

There may be more difficulty in apportioning costs than one would first assume. For instance, many companies produce various

⁹⁷ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. g (1995).

⁹⁸ *Id.*

⁹⁹ MCCARTHY, *supra* note 27, § 30:67, at 30-119-20 (citing Schnadig Corp. v. Gaines Mfg. Co., 620 F.2d 1166, 1168-71, 206 U.S.P.Q. (BNA) 202 (6th Cir. 1980) as the source for the hypothetical).

¹⁰⁰ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. g (1995).

goods. As the defendant who is guilty of infringement produces other non-infringing goods, how should costs central to the production of all the goods (both infringing and non-infringing) count as a deduction?¹⁰¹ Courts apportion costs in two ways: "the 'incremental approach,' under which only direct costs of production are deducted, and the so-called 'full absorption approach,' under which overhead costs are apportioned to production of the infringing item."¹⁰² The Restatement suggests that total costs are not to be deductible, since some fixed costs would have been the same and the infringement caused no increase in these costs.¹⁰³ However, where the infringement increased variable or fixed costs, these costs are deductible.¹⁰⁴ The Restatement also suggests that where costs cannot be precisely estimated, a proportional allocation "based on total production or total sales" may be used to determine an acceptable deduction.¹⁰⁵ McCarthy reports that the Second Circuit requires that the defendant show a sufficient nexus between the cost and the production of the infringing good to receive a deduction.¹⁰⁶

C. ACCOUNTING PERIOD

An accounting period for a federally registered mark lasts for the time of infringement, which starts when the defendant receives "actual notice of the registration, unless the plaintiff used the statutory notice ®."¹⁰⁷ If this is the case, then perhaps the bad faith requirement is unnecessary as the damages that would be awarded only start from the notice of infringement. Thus a bad

¹⁰¹ MCCARTHY, *supra* note 27, § 30:68, at 30-120 (suggesting such central costs as "rent, utility costs, and central management expenses [are] deductible as costs . . .").

¹⁰² *Id.*

¹⁰³ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt h (1995). This is an important consideration for the marginal cost analysis that follows; see *infra* note 168 and accompanying text (discussing marginal cost analysis).

¹⁰⁴ *Id.*

¹⁰⁵ RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 37 cmt. h (1995).

¹⁰⁶ MCCARTHY, *supra* note 27, § 30:68, at 30-120; see also James M. Koelemay, Jr., *A Practical Guide to Monetary Relief in Trademark Infringement Cases*, 85 TRADEMARK REP. 263, 290-93 (1995) (listing 18 types of costs courts have allowed or not allowed as deductions).

¹⁰⁷ MCCARTHY, *supra* note 27, § 30:70, at 30-122.

faith infringer who knowingly “palms off” the owner’s mark, could lose all profits attributable to the infringement, since knowledge of the infringement started with the sale of the first “palmed-off” good. However, the good-faith infringer who only finds out about the infringement after suit is filed, or when contacted about the infringing activity, would not be responsible for any profits unless he/she continued to sell after being informed.

D. IMPORTANCE OF COSTS AND DEDUCTIONS

The costs, deductions, and overall method of determining an accounting have been explained because they will play a role in the economic model that will be developed. These costs are what a bad faith infringer can look at to see if a profit or even a salary can be made by deliberately infringing, and what a good faith company looks at in determining the potential for damages it could face if its new mark happens to infringe even after conducting a proper search. Bad faith may play a part in adjusting the costs available for deductions. For instance, if the economic model shows that an accounting of profits should be awarded regardless of bad or good faith in order to effectuate the rationales explained above, perhaps the deductions can be tinkered with in order to change the marginal, variable, and total cost curves for the bad faith infringer in hopes of deterring future infringement. Furthermore, maybe the deductions can be altered to provide the good faith potential infringer enough incentive (i.e., reduce his cost curves) so that there is not over-deterrence in establishing marks. Perhaps these adjustments are where the discretion of the court should matter and not in the overall grant or denial of an accounting based on good faith or bad faith.¹⁰⁸

¹⁰⁸ 15 U.S.C. § 1117(a) (1994) (stating that “[i]f the court shall find that the amount of the recovery based on profits is either inadequate or excessive the court may in its discretion enter judgment for such sum as the court shall find to be just, according to the circumstances of the case.”). Again, this is not a penalty, but is compensation. *Id.*

IV. THE ECONOMIC MODEL - INCENTIVE TO INVEST - DOES THE ACCOUNTING PROTECT A FIRM'S INCENTIVE TO INVEST

Commentators have suggested that an optimal set of intellectual property damage rules should "award the prevailing plaintiff the greater of either a compensatory or restitutionary recovery, suitably enhanced or diminished in light of the competing interests in deterring infringements that otherwise may go undetected, and in discouraging would-be users from overcomplying with their legal obligations."¹⁰⁹

For reasons discussed above, there is some uncertainty about investing in trademarks due to potential infringement, costs greater than returns on the investment, etc. Blair and Cotter develop a model starting with the formula:

$$E[R] = P\pi + (1 - P)(0) - C; \quad (1)$$

where:

$E[R]$ = expected return of the investment in the trademark

P = probability of success, which is between zero and one

$(1 - P)$ = probability of failure, which is between zero and one

C = cost of creating the intellectual property

π = profit that will result if the creative effort is successful

0 = zero; the returns to the creator/adopter of the trademark if it fails.

$(1-P)(0)$ always equals zero, so the equation can be rewritten as:

$$E[R] = P\pi - C. \quad (2)$$

As discussed above, the equation must also reflect some uncertainty that (a) the mark might infringe on other trademarks or (b) others may infringe and reduce the profits of the original adopter. The former situation, (a), will be discussed later in the search costs section. In the latter situation, (b), the potential for infringement on the mark will represent itself as a deterioration in the profits,

¹⁰⁹ Blair & Cotter, *supra* note 24, at 1591.

¹¹⁰ *Id.* at 1618.

π , in equation (2). Thus the potential for infringement will decrease $P\pi$ and thus decrease $E(R)$, the overall incentive to invest in trademarked goods. The incentive to create trademarked goods represented by equation (2), above, shows that as $P\pi$ decreases, if the costs stay the same, the incentive to invest in the mark will decrease.¹¹¹

Part of the purpose of intellectual property law is to encourage investment in useful activities, such as the development of trademarked goods.¹¹² Thus, as equation (2) and the erosion of profits from potentially, unchecked infringement demonstrate, a mechanism must be developed to protect profits so that the incentive to create trademarked goods is unchanged.¹¹³ Blair and Cotter suggest two ways to accomplish this goal, deterrence and compensation.¹¹⁴ Deterrence and compensation protect the plaintiff or investor's expected profits so that the incentive to develop marks remains uninfluenced by the potential for infringement.

A model can be developed for deterrence. One must look at the model from the perspective of the potential infringer. There are two types of potential infringers—those who infringe intentionally or infringe in bad faith, and those who infringe inadvertently. This is an important distinction not only for the thrust of this paper (analysis of the bad faith requirement), but also for developing the incentive structures that present themselves to the two groups.

A. DETERRENCE OF BAD FAITH INFRINGERS

An intentional infringer will look to the profits that can be made through the use of the trademark minus costs and some rough estimate of the probability that he/she will be caught multiplied by the potential damages. So the intentional or bad faith infringer's incentive structure may be expressed as:

¹¹¹ *Id.* at 1618-19.

¹¹² See *supra* note 3 and accompanying text (discussing Lanham Act's legislative history and purpose to protect consumers and provide incentive to create higher quality goods through the establishment of goodwill/reputation through trademarks).

¹¹³ Blair & Cotter, *supra* note 24, at 1618-19.

¹¹⁴ *Id.* at 1619.

$$E[R] = (1 - x)\pi - xD,^{115} \quad (3)$$

where:

$E[R]$ = expected return from infringement

π = profits attributable to use of the infringing mark

$1 - x$ = probability of no infringement (i.e., probability of not getting caught) where $0 \leq x \leq 1$.

x = probability of infringement (i.e., getting caught, and losing at trial)

D = profit minus the damages that the infringer will have to pay if found guilty of infringement¹¹⁶

A rational, risk neutral person will thus infringe if the $E[R]$ is positive, or possibly even if negative, if the profit or π incorporates some salary that the infringer can deduct.¹¹⁷

Thus to deter infringement, there are two possible ways a court can change the incentive structure up front for the potential bad faith infringer: change either (1) the damages or (2) the probability of infringement (x) and correspondingly of no infringement ($1 - x$) so that it creates a sufficient deterrent to intentional infringement. For instance, if a risk neutral, economically rational person was faced with a set of variables where the damages were \$100, the probability of getting caught was .90, and the profit was \$910, the person would infringe, as he/she would expect to make \$1:

$$E[R] = ((1 - .90)(\$910)) - (.90)(\$100),$$

$$E[R] = .10(\$910) - (.90),$$

$$E[R] = \$91 - \$90 = \$1.$$

However, if we increase either the chance of getting caught or the damages, then the incentive to infringe comes out differently. For instance if the probability of getting caught, x , is increased to .95 the calculation yields a negative result:

¹¹⁵ *Id.* at 1619-20.

¹¹⁶ This is where the deductions and the factors of an accounting become very important to the analysis.

¹¹⁷ If this is the case, the infringer will infringe when $E[R]$ is negative and its absolute value is equal to, or greater than, the salary.

$$E[R] = ((1 - .95)(\$910)) - (.95)(\$100),$$

$$E[R] = (.05)(\$910) - \$95,$$

$$E[R] = \$45.50 - \$95 = - \$49.50.$$

Here, the $E[R]$, or the expected return on the infringement, equals a negative dollar amount. Thus, the potential infringer will not infringe when the probability of infringement is at this level. In fact, the infringer will not invest when the probability of getting caught is at or above .9009901 with this set of profit and potential damage figures before him.¹¹⁸ Thus if we know the damages and the expected profits, we could set the probability for infringement to such a level to deter infringement. However this is much harder than it appears, as the probability of infringement is a function of the policing of marks and success of the plaintiff at trial. As Blair and Cotter state "[o]ne . . . cannot accurately calculate the probability of detection[]"—it could be a function of the number of times caught divided by the total number of infringements, but undetected infringements necessarily invalidate this measure.¹¹⁹ However, every potential intentional infringer probably has some general approximation of the chances of getting caught. In fact, Heald suggests that the chance of getting away with trademark infringement is near zero because of the public nature of infringement.¹²⁰ With this in mind we next proceed to look at the increase in damages to deter intentional infringement.

The damage figure could also be changed, or increased, so that bad faith infringement would be unprofitable.¹²¹ For instance, if we take the probability and the profits from the second example, we can determine at what level damages need to be set in order to counter the potential for infringement. With an x , or general probability of infringement, equal to .95 and a π , or profits equal to

¹¹⁸ As the equation is $E[R] = (1-x)\pi - xD$, if $\pi = \$910$ and $D = \$100$, then we can substitute for the variables: $E[R] = (1 - x)910 - 100x$. The expanded equation equals: $E[R] = 910 - 910x - 100x$. Assuming a risk neutral, economically rational person would not infringe when $E[R] \leq 0$, set $E[R] = 0$, thus the equation reads $0 = 910 - 910x - 100x$; which simplifies to $1010x = 910$, so $x = 0.9009901$.

¹¹⁹ Blair & Cotter, *supra* note 24, at 1621-22.

¹²⁰ Paul Heald, Comment, *Money Damages and Corrective Advertising: An Economic Analysis*, 55 U. CHI. L. REV. 629, 646 (1988).

¹²¹ Blair & Cotter, *supra* note 24, at 1620.

\$910, damages (D) have to be at, or above, \$47.89 to be a sufficient deterrent to intentional or bad faith infringement. With an $x = .25$ and a $\pi = \$910$, the damages would have to be \$2730 to deter the bad faith infringer. Thus we can see that the damages needed to deter are driven by the probability of getting caught—the lower the probability, the higher the damages must be and vice versa. Here, two extreme examples are used to show that a significantly larger amount of damages in proportion to potential profits is needed when the probability of infringement is low and a relatively small amount of damages is needed when the probability of infringement is high to effectuate a deterrent to intentional infringement. The only time that the needed damages would equal an accounting of profits would be when the probability of getting caught equaled 50% or more. Only in the case of a 50% chance of infringement ($x = 0.5$) would the accounting act as a deterrent to intentional infringement of trademarks and not as a penalty. Above 50%, an accounting would deter intentional infringement (but could be considered a penalty); however below 50%, a larger damage award would be needed to effectuate deterrence.

This equation seems to present a neat formula which courts could use to effectuate systematic deterrence that would be fair and evenhanded and not result in a penalty as the Lanham Act instructs. However, Blair and Cotter point out that the problem here rests in determining the probability of detection, the measurement of the profit attributable to the infringement and the risk adversity of the infringer.¹²² All of these uncertainties could lend themselves to impossibility of calculation or the lack of precision necessary for optimal use of the equation.¹²³

We can, however, deduce from the above model that at a 50% detection rate or better, an accounting will act as a sufficient deterrent to intentional, or bad faith infringement. However, as we depart further from 50%, the accounting seems to work a penalty upon the infringer. Given the inability to precisely measure the probability and the correct threshold of damages, the accounting may serve as a proxy for a precisely accurate amount which would

¹²² Blair & Cotter, *supra* note 24, at 1620-22.

¹²³ See *id.* at 1620-22 (discussing the ramifications in changes to the model and the effects of a lack of precision in measurement).

compensate the trademark owner or leave the wronged person some relief at least in an attempt to further deter infringement.¹²⁴

The above analysis shows that, as long as we can assure ourselves that the system of enforcement will find and award an accounting damage against one intentional infringer for every other infringer not found (i.e., a 1/2 detection rate), the accounting of profits acts as a sufficient deterrent to the intentional, or bad faith infringer.¹²⁵ The concern with some courts though is not that the accounting will act as a deterrent to the bad faith infringer, but that the accounting will over-deter, in that the potential loss of all of their profits will cause some firms not to develop trademarked goods.

B. THE UNINTENTIONAL INFRINGERS AND THEIR INCENTIVE TO INVEST IN TRADEMARKS - DOES AN ACCOUNTING AGAINST GOOD FAITH INFRINGERS MAKE SENSE OR DOES IT OVER-DETER?

The concern about over-deterrence arises most acutely in the realm of product configurations and descriptive word marks.¹²⁶ To illustrate this, consider a company that adopts a mark that contains a borderline descriptive word. The concern is that an accounting could possibly deter the next developer of goods in this market from using this same word to describe his/her product, even if this word is essential to the marketing of the good. If over-deterrence occurs, the results could lead to the potentially unattractive reality that trademark owners can receive "back door" patents on product configurations. Furthermore, over-deterrence could reduce the supply of essential words by allowing the owner of a descriptive mark a shelter, which is never challenged for fear of accounting damages.

Unlike the above intentional or bad faith infringer, a company or person who seeks to adopt a mark for legitimate business purposes without purposefully intending to "palm off" or intentionally infringe on another's mark is not faced with the sole decision

¹²⁴ See *id.* at 1681 (discussing how an accounting may approximate a license agreement the parties would have agreed to *ex ante*).

¹²⁵ This rate of enforcement seems fairly likely in light of Heald's observation that the chances of "escaping detection are low." Heald, *supra* note 120, at 646.

¹²⁶ Blair & Cotter, *supra* note 24, at 1679.

between getting caught and not getting caught. Rather, the potential adopter ("adopter" hereinafter) will normally conduct a trademark search before adopting or using the mark on its goods. The adopter's search serves the purposes of (1) reducing the probability of infringement and (2) potentially factoring into a determination of bad faith.¹²⁷

1. *Search Overview.* Throughout the process of adopting a mark, a firm will have to deal with some probability of infringement. It is important to see how this probability is minimized and dealt with throughout the adoption process. A company attempting to develop a mark for its goods or services usually goes through a multi-phase process in order to register the mark. First, the company decides on a mark. The company either develops the mark through the use of its own labor and time or contracts the development out to a designing firm. Thus, the development of the mark either costs the firm labor, capital, or both. Conversely, a bad faith adopter can save on costs by adopting another's already developed mark and thereby eliminating the costs of production, development, and good will.¹²⁸

After the development of the mark, the company will usually go to a lawyer. The lawyer will set into motion a series of searches to determine if the mark in question is likely to infringe on any other marks registered or in use. First, many lawyers choose to do what some call a "knockout" search through on-line databases, such as LEXIS. Through a "knockout" search, a lawyer can try different variations of a mark to test whether a simple, cost effective search will come up with any conflicting marks. Costs of these searches depend on the on-line package costs and the cost of labor for the search. Paralegals and lawyers can effectively do this search, and the company will have to pay for their time spent searching and the cost of the on-line time or search costs.

If a "knockout" search comes up with what appears to be a low chance of a conflicting mark, then the lawyer suggests that the client order a trademark search report. Companies generate these trademark searches and there are different levels of trademark

¹²⁷ See *supra* notes 72-81 and accompanying text.

¹²⁸ See Corgill, *supra* note 57, at 1940-51 (discussing the costs and benefits faced by the intentional infringer).

search reports. Levels are based upon the breadth of the search: federal registration, state registration in all fifty states, and a common law search.¹²⁹ A federal registration search will look for variations of the mark in question in the federal registry. State searches will do the same through the fifty states. One risk with both the federal and the state searches is that the database can be behind the actual registration. There is no practical (i.e., cost-effective) way to compensate for this time lag. Therefore, newly registered marks that could be infringed upon may be missed by even the most thorough search.¹³⁰

Common law searches present an even greater risk. In a common law search, the search company looks for variations of the mark in many databases. Databases are gathered through news reports, directories of industries, yellow pages, and similar publications. When a company relies on a common law search, they take the risk that a conflicting mark may not appear in one of these databases, either because the trademark search company does not include the database in which they appear, the mark does not actually appear in any database, or because of time lags in reporting.

Within these three types of searches, inquiries can be limited to a class of goods. Goods and products are broken down into a number of categories. Each category represents a certain type of product. For instance, category thirty-two includes marks from the aircraft industry, and class twenty-five is a clothing classification.¹³¹ These categories help to focus the search on areas where

¹²⁹ The differences between these types of protection are as follows: a federally registered trademark gives the owner a nationwide right to protection, state registration gives protection to a mark within the state, and common law protection does not require registration, just use, and limits protection to the "geographical area of actual product market penetration." *Minnesota Pet Breeders, Inc. v. Schell & Kampeter, Inc.*, 41 F.3d 1242, 1245, 33 U.S.P.Q.2d (BNA) 1140, 1143 (8th Cir. 1994) (quoting *Truck Equip. Serv. Co. v. Fruehauf Corp.*, 536 F.2d 1210, 1221-23, 191 U.S.P.Q. (BNA) 79, 88 (8th Cir. 1976)).

¹³⁰ One could go through all of the *Official Gazette* volumes to see new marks that are federally registered, but basically this means that there will always be some probability of infringement existing that is systemic and unable to be eliminated. This concept will be important when the search costs are modeled.

¹³¹ See, e.g., *International Star Class Yacht Racing Ass'n v. Tommy Hilfiger, U.S.A., Inc.*, 80 F.3d 749, 752, 38 U.S.P.Q.2d (BNA) 1369 (2d Cir. 1996) (explaining how defendant asked attorney to search only in class 25, a clothing classification, and ignored its attorney's advice to do a full trademark search; this factored into a determination of bad faith); *International*

there may be a likelihood of confusion and thus trademark infringement. However, simply searching through the class in which the mark in question will be used may not be sufficient,¹³² and many attorneys advise a full trademark search through all classes of goods.

Of course, the possibility for human error and oversight exists in all types of trademark searches. In both these types of searches, the database or the search company employs people to look through the database and print all types of marks that may look like, or are similar to, the mark in question. These searchers then forward the list of potentially infringing marks to the attorney and the attorney filters through them, attempting to discern which marks could be infringed upon and what is likely to be confused with the mark in question. The attorney then usually presents the most closely resembling or confusing mark(s) to the client with his/her advice as to adoption or rejection of the mark. The client, ultimately, after receiving the remnants (or the marks filtered out by the searcher and attorney), makes the final decision to adopt or reject the mark.

One can see that in both stages, where the searcher and the attorney view the marks and test each one independently for likelihood of confusion, error can exist. One person's determination of a lack of confusion may be what a court sees as confusing. Thus, a responsible business, that (1) either developed the mark on its own, or paid to have it developed; (2) conducted and spent money on a thorough search in all areas; and (3) heeded the advice of

Star Class Yacht Racing Ass'n v. Tommy Hilfiger, U.S.A., Inc., 146 F.3d 66, 70 n.2, 46 U.S.P.Q.2d (BNA) 1942, 1945 n.2 (2d Cir. 1998) (stating that the failure to search properly is a factor in the bad faith determination); *see also supra* notes 71-80 and accompanying text.

¹³² *See International Star Class Yacht Racing Ass'n*, 80 F.3d at 753-54 (stating defendant could be liable for bad faith infringement due to ignoring attorney's advice to conduct a full trademark search). The court criticized the defendant's ostrich-like behavior:

Hilfiger's choice not to perform a full search under these circumstances reminds us of two of the famous trio of monkeys who, by covering their eyes and ears, neither saw nor heard any evil. Such willful ignorance should not provide a means by which Hilfiger can evade its obligations under trademark law.

Id. Conversely, the same court stated that "[o]ther courts have found that an infringer who 'acts in reasonable reliance on the advice of counsel' generally cannot be said to have acted in bad faith . . . the failure to follow the advice of counsel given before the infringement must factor into an assessment of an infringer's bad faith." *Id.* (citations omitted).

counsel, can still be an infringer because of the inherent problems in the search process.¹³³ The company in this situation would probably be determined to be a good faith infringer and therefore not have to disgorge profits in the Second Circuit and in courts that follow their lead. However, such an infringer may have to give up profits in the Seventh and Eleventh Circuits.¹³⁴

2. *The Search Model.*¹³⁵ Blair and Cotter explain that the optimal search in trademarks will not result in an exhaustive look through all of the federal and common law records as the cost of information is positive, "and it will seldom be optimal, or even possible, to acquire complete information concerning earlier use."¹³⁶ In the following model, the extent of the search can be determined by setting damages at certain levels.¹³⁷ Thus, a system of damages could force a firm to search too far and over-deter them from adopting a mark due to the cost prohibitiveness of a search that still yields some probability of infringement. Blair and Cotter developed the following model for assessing the optimal level to search.

First, the cost of the search is represented by the linear equation:

$$C=cS \quad (4)$$

where:

C = total cost of the search

c = cost per unit searched

S = search activity.¹³⁸

The benefit of the search is the reduction in the probability that there will be infringing activity by the adopter. As the adopter continues to search, the probability of infringement presumably decreases. So,

¹³³ Again, this shows a systemic existence of some probability or expected probability of infringement.

¹³⁴ See *supra* notes 57 & 82 and accompanying text (discussing circuits' bad faith requirements).

¹³⁵ The following model is taken from Blair & Cotter, *supra* note 24, at 1677-79.

¹³⁶ *Id.* at 1677.

¹³⁷ *Id.* at 1678-79.

¹³⁸ Blair & Cotter, *supra* note 24, at 1677-78.

$$P = P(S) \text{ and } dP/dS < 0 \quad (5)$$

where:

P = probability of infringement is a function of the search.¹³⁹

With the sanction represented as F, Blair and Cotter develop a model for the expected penalty facing the adopter as the probability of infringing, a negatively sloping function of the extent of the search, times the penalty for infringement:

$$E[\text{Penalty}] = P(S) * F.^{140} \quad (6)$$

So in total, the expected cost for the adopter of adopting a mark is the "sum of the expected penalty, $P(S) * F$, plus the cost of whatever search is done, cS :"

$$E[TC] = (P(S) * F) + cS.^{141} \quad (7)$$

A rational adopter will minimize its total costs when the marginal benefit of the search equals the marginal cost of the search. In this case one can take the first derivative with respect to S of $E[TC]$ and set it equal to zero to find the minimum. This yields:

$$dE[TC]/ds = (F * dP(S))/dS - c = 0.^{142} \quad (8)$$

or

$$c = (F * dP(S)/dS). \quad (9)$$

Thus "the marginal cost of additional search activity is c [a constant (increasing slope)], while the marginal benefit equals the penalty if one infringes, F, times the decrease in the probability of infringing resulting from the additional search activity $dP(S)/dS$."¹⁴³ Blair and Cotter represent this graphically in the following way:

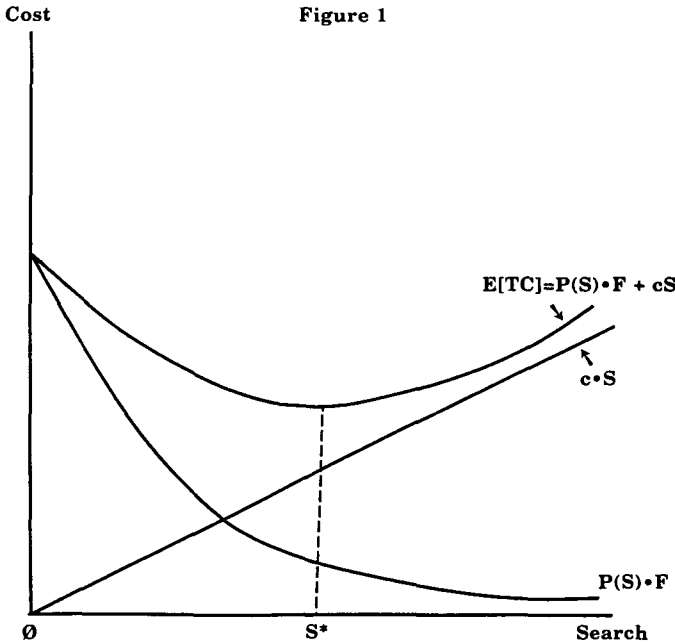
¹³⁹ *Id.* at 1677.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 1678.

¹⁴² *Id.*

¹⁴³ Blair & Cotter, *supra* note 24, at 1678.



Reprinted from Blair & Cotter, *An Economic Analysis of Damages Rules in Intellectual Property Law*, 39 WM. & MARY L. REV. 1585, 1678 (1998).

Thus, a rational, risk-neutral firm or person will stop searching where the expected total cost of the search is at a minimum.¹⁴⁴ There is still some risk of infringing then as the probability of infringement is never at zero.

The courts can control the extent of the searching by changing the amount of the fine. If the fine is larger, then more searching will occur.¹⁴⁵ Regardless of the amount, a rational adopter will now have at least a rough probability of some infringement to weigh into a decision of whether to adopt or reject a mark after doing the search model above (or acting in accord with the search model).

¹⁴⁴ *Id.* A firm that is risk-averse may seek to go past this threshold and conduct a further search. A firm that is a risk-taker may not search as thoroughly. See *International I*, *supra* note 72 and accompanying text (discussing a firm that chose not to search as completely as its attorney advised).

¹⁴⁵ *Id.* at 1678-79.

3. *The Search Model's Results and Potential for Over-Deterrence Caused by an Accounting Imposed on "Innocent" Infringers.* To see if the accounting of profits damages without a bad faith requirement over-deters a good-faith adopter, we must now analyze the search model, its determination of a rough probability of infringement and the weight of this probability on the firm's decision to adopt a mark.

To tie the search equation and the adoption equation together, consider the following hypothetical adopted from Blair and Cotter, where a potential adopter faces the following search constraints:¹⁴⁶

\$50 for an additional search activity;
 .01 decrease in the probability of infringement attributable to that additional search;
 \$1,000 in expected damages if lost profits used; and
 \$2,000 in expected damages if an accounting or restitutionary award is granted.

Blair and Cotter suggest that these constraints will not deter the firm from infringing.¹⁴⁷ However, the search model results may not determine whether the firm will infringe; rather, these constraints will establish the probability from which an adopter will look to see if the investment is worth the still-evident risk of infringing. In other words, this search model will establish the optimal search level, not the decision to adopt or not to adopt. Plugging these numbers into the equation for the optimal level of the search, we return with the following:

$$dE[TC]/dS = (F * dP(S))/dS - c = 0.^{148}$$

or

$$c = (F * dP(S))/dS,$$

$$(\$1,000 * (.01)) + \$50 = \$10 + 50 = \$60.$$

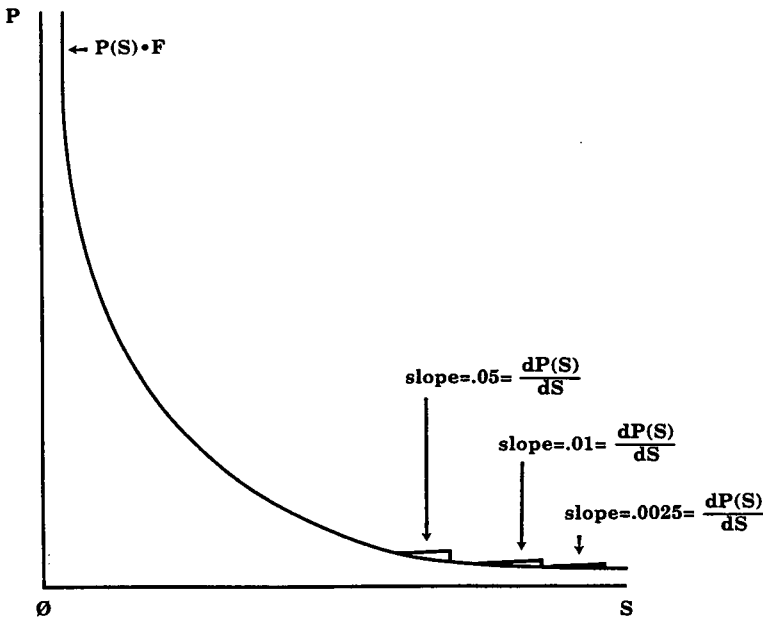
¹⁴⁶ *Id.* at 1680-81.

¹⁴⁷ Blair & Cotter, *supra* note 24, at 1681.

¹⁴⁸ *Id.* at 1678.

Here, they are searching too far. The search in this case should stop when the decrease in probability of infringing resulting from the additional search is equal to .05 if the marginal cost of an additional search is constant and the damages are fixed at \$1,000. Also, assuming that as the search continues the first derivative of $P(S) * F$ (or the marginal benefit of the search) diminishes, .05 would be the optimal level and would occur before .01.

Figure 2



If the damages changed to the accounting amount of \$2,000 the equation would then be:

$$((\$2,000) * (.01)) + 50 = \$70$$

Here it seems that the search in their model would not have gone far enough to get to the optimal level.

The best way to find out when the rational firm will stop the search is to determine what damages the firm will incur and how much the costs of the search are and then figure out where the optimal search will occur. A firm can estimate these factors (i.e.,

costs and damages). A firm can estimate the damages since it is provided with court holdings that say whether there will be an award of an accounting or actual damages and a firm will also know the cost of the additional search. Thus, a firm in a circuit where an accounting is awarded for any infringement may be faced with the following scenario or equation:

$$dE[TC]/dS = (F * dP(S)/dS) - c = 0 \quad (\$2,000 * dP(S)/dS) - \$50 = 0$$

Substituting x for $dP(S)/dS$ for simplicity's sake, the equation can be rewritten as:

$$\begin{aligned} \$2,000x - \$50 &= 0 \\ \text{or} \\ \$2,000x &= 50, \text{ solving for } x, \\ x &= 0.0025 \end{aligned}$$

So the firm should stop searching at a level where the marginal benefit, or marginal reduction in probability of infringement equals 0.0025. Assuming that the accounting of profits is more than the actual damages caused to the owner of the trademark (potential plaintiff), we see that the accounting encourages a more thorough search of the registers and common law than the lost profits would.

Example:

$$\text{lost profits} = \$1000$$

So the firm is faced with the following optimal level of searching:

$$dE[TC]/dS = (F * dP(S)/dS) - c = 0 \quad (\$1,000 * dP(S)/dS) - \$50 = 0,$$

Substituting x for $dP(S)/dS$, the equation becomes:

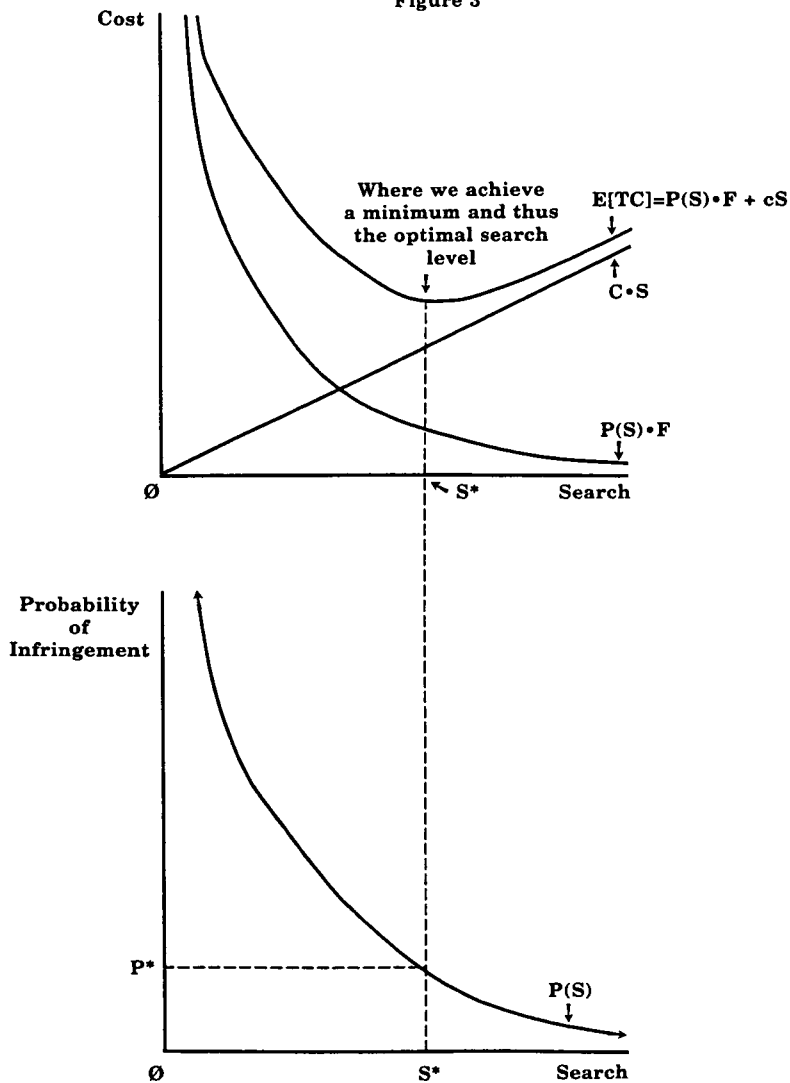
$$\begin{aligned} (\$1,000x) - \$50 &= 0 \\ \$1,000x &= 50 \\ x &= 0.05 \end{aligned}$$

Thus, where lost profits are used, the firm will search for a shorter duration and their optimal search will occur where the marginal decrease in probability of infringement equals 0.05.¹⁴⁹ However, by increasing F , and thereby increasing the level of the search, the accounting may not be operating at an optimal or economically efficient manner for adopters in that it may create too much of a disincentive to invest. So now we must go back to see (1) the level of probability of infringement an adopter takes after the search is terminated at the optimal level and (2) whether the adopter will find that this probability of infringement, determined by the extent of the damages, is prohibitive of adoption.

Taking the search up to the point where the decrease in probability of infringement multiplied by the penalty equals the marginal cost of the search, the adopter now has a rough idea of the probability of infringement upon which it operates.

¹⁴⁹ See *supra* Figure 2.

Figure 3



Graphically this is represented as the optimal search level decided by the top graph in Figure 3, as S^* , which determines the probability of infringement in the bottom graph of Figure 3 as P^* .¹⁵⁰

We know that the lower the marginal decrease in probability is, the more thorough the search, and the lower the probability of actual infringement. We also know that where damages are higher, a more thorough search will be conducted. As the expected damages increase, the more thorough the search and the lower the probability of infringement, or conversely the higher the probability of no infringement. Thus we can say that the fine will determine to some degree the search, unless the costs of the search are not linear and therefore not the constant marginal costs.¹⁵¹

From the above analysis (determination of the optimal search) we see the optimal level of risk (i.e., the "optimal" probability of infringement) that faces the "good-faith", rational adopter. Actually, we see not only the probability of infringement, but also the optimal level of expected damages that face the adopter, $P(S) \cdot F$. Taking this level, we then can determine whether the adopter will adopt the mark. The decision can be represented as:

$$E[\text{return}] = (1 - P(S))\pi - (P(S) \cdot F) \quad (10)$$

where:

$E[\text{return}]$ = expected return of the trademark,
 $(1-P(S))$ = probability of not infringing,
 π = profit derived from the use of the trademark
 $P(S)$ = probability of infringement
 F = penalty for infringement.

$P(S)$ is determined by the economically rational risk-neutral adopter where $E[TC]$ is at a minimum, see equations 8 and 9 above and Figure 3.

This equation can be used to show when an economically rational, risk neutral adopter will adopt the mark. As long as the expected return is above zero, the adopter will use the mark. Thus, when

¹⁵⁰ Blair & Cotter, *supra* note 24, at 1678.

¹⁵¹ *Id.* at 1679.

$E[R] > 0$, the adopter will adopt the mark. We can then rewrite the equation:

$$0 < (1 - P(S))\pi - (P(S) * F), (P(S) * F) < (1 - P(S))\pi. \quad (11)$$

So long as the expected profit is greater than the expected penalty, the adopter will invest. This seems to be a simple concept but it is complicated by (1) the probability determined by the search and the magnitude of the fine and (2) the increasing costs of a search cutting into profits. As we do not want to create a disincentive to adopt useful marks, the fine must not be so high as to dissuade legitimate adopters from using and developing marks, especially when the marks are product configurations or potentially descriptive words.¹⁵² If the fine is high, the search will continue longer and will decrease the probability of infringement, but will also cut into profits by increasing the costs.¹⁵³

Using our hypotheticals above, we will keep the damages of \$1,000 and the expected profits equal to \$2,000 and thus the accounting or restitution damages equal to \$2,000. The adopter's decisions can be represented with the following equations:

PLAINTIFF'S LOST PROFITS AS DAMAGE AMOUNT:

$$E[\text{return}] = (1 - P(S))\pi - (P(S) * F)$$

$\$2,000 * (1 - P(S)) - (P(S) * 1,000) = 0$ (set to zero so any probability bigger than this will suffice—the benefit must outweigh the burden)

$$\$2,000 - \$2,000 * P(S) - \$1,000(P(S)) = 0$$

$$\$2,000 - \$3,000 * P(S) = 0$$

$$\$2,000 = \$3,000 * P(S)$$

$$P(S) = .66667$$

So with lost profits equal to \$1,000, this adopter would adopt if her search yielded a probability of no infringement of 33%. Thus, if the

¹⁵² See *supra* Section IV.B.2. (discussing descriptive word marks).

¹⁵³ Blair & Cotter, *supra* note 24, at 1678-79.

adopter was satisfied that she had searched optimally and gone past the point of a 33% chance of infringement, the adopter would adopt.

ACCOUNTING OF PROFITS AS DAMAGE AMOUNT:

$$\begin{aligned} E[\text{return}] &= (1 - P(S))\pi - (P(S) * F) \\ 0 &= (1 - P(S))\$2,000 - (P(S) * \$2,000) \\ 0 &= (\$2,000 - \$2,000(P(S)) - \$2,000(P(S)) \\ 0 &= \$2,000 - \$4,000(P(S)) \\ \$4,000(P(S)) &= \$2,000 \\ (P(S)) &= .50 \end{aligned}$$

So with an accounting, the adopter will adopt once she is certain that her search's optimal level has surpassed the 50% chance of infringement threshold. Thus we see that with the accounting there is a further incentive to search and there is a greater requirement to invest money and costs in the search, but only to the extent that the adopter avails herself of a 50/50 chance of infringement. If we assume that the optimal level of a search will yield at least a 50% chance of no infringement, we can assume that the threat of an accounting of profits does not dissuade or over-deter in the area of a "good-faith adopter".

There are some problems, however. Since the probability of infringement is dependent upon the level of the search, the probability curve will be a function that is firm specific and defined by such variables as experience, expertise, and knowledge of the searcher.¹⁵⁴ The more of these factors a firm can assume, the faster the probability of infringement will decrease as the search continues (i.e. that the marginal benefit of the decrease in the probability of infringement will be greatest and thus a firm with these increased marginal benefits will be able to more readily overcome or reach a higher level of probability of no infringement before the marginal benefit equals the marginal cost). Thus a firm with these factors in its favor is less deterred by the threat of an

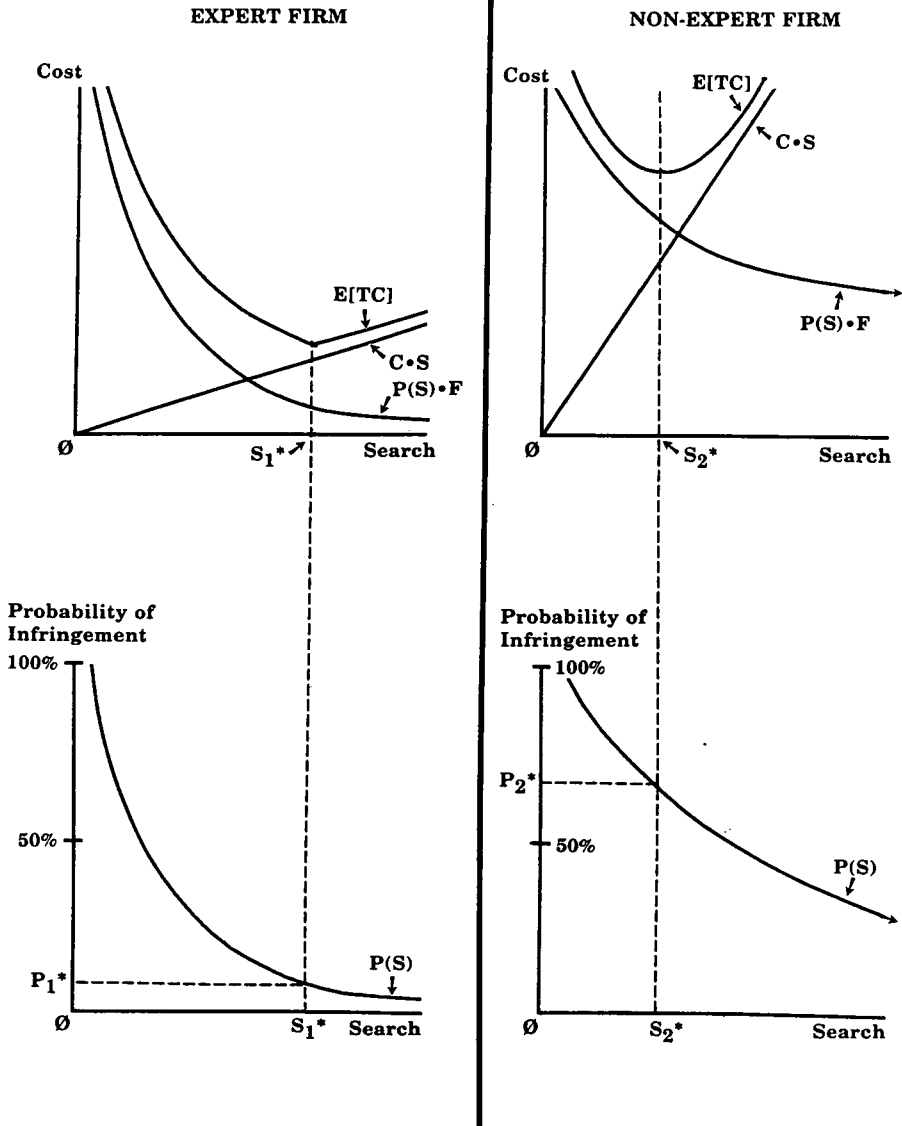
¹⁵⁴ As these factors are found in a firm, its cost curve's slope may diminish also. This may lead to a more thorough search as well since the search will stop when the slope of $P(S)*F = \text{slope of } cS$ which is a constant, c .

accounting as they will probably be able to reach the 50% mark quickly and easily.¹⁵⁵ Conversely, the accounting may deter firms who are not as expert driven and cannot deduce or rule out potential infringing marks from non-infringers. In this case the marginal benefit will not decrease in a steep manner (or the costs of the search will be very steep and prohibitive) and the 50% mark may not be reached by the time the search reaches its optimal level.¹⁵⁶

¹⁵⁵ Unless the mark is, of course, very close to another and is a sketchy choice at best, this could be the area where we are worried about an accounting of profits acting as an over-deterrent to a descriptive mark or potentially useful trade dress. If people adopt these marks, which could be useful and/or descriptive, and then a second comer wishes to use what they believe to be a descriptive mark, the accounting of profits damages may weigh too heavily as a disincentive, thus deterring companies from adopting potentially valid marks; see, Blair & Cotter, *supra* note 24, at 1683-85 (discussing adoption of another's mark in good faith).

¹⁵⁶ This might be in keeping with economic efficiency as we do not want to encourage those that are more inefficient to act in a field; rather, we would want to create systems to promote efficiency and efficient firms.

Figure 4



However, the courts can tinker with the fine amounts to determine which amount of certainty or deterrence they want to achieve. Here with an expert firm, it seems that it would probably search well past the 50% mark as their optimal search would continue past this mark to S_1^* and achieve a probability of infringement that is low at P_1^* , and thus it would not be deterred by the threat of an accounting. However, a firm less experienced could be deterred as their search would end at S_2^* and with a high probability of infringement at P_2^* . If courts want to encourage the most efficient firms to do the searches, then the accounting without a bad faith requirement seems to have a secondary way of achieving this goal.

However, one can see that if the efficient firms knew they only had to be 50% sure to avoid deterrence by an accounting of profits threat, then maybe they would not continue the search and would adopt the mark once they determined that it was more likely than not that they would not infringe. However, the damage system allowed by the Lanham Act allows for trebling of damages, and the threat of this use could also, through case precedent, determine that such action is not good faith and could result in further damages. This could push the firms toward their optimal search levels without the deterrence of an accounting and the potential for abuse this equation shows.

So in total, the accounting of profits is not a deterrent for the good-faith adopter; rather, it sets a level of certainty which the adopter must reach before they adopt. So long as this certainty (probability = 50%) is at or below the probability of infringement determined by the optimal search equation, the firm will not be deterred. If it is above this level, the firm will stop searching and will not adopt the mark for fear of infringement.¹⁵⁷ Thus, the accounting under this theory does not need a bad faith requirement, as it will act as a deterrent to the bad faith adopter and will not over-deter the good-faith adopter. The worries that some circuits have about over-deterrence seem economically unfounded.

¹⁵⁷ The adopter is presumed to be an economically rational, risk neutral person/firm so that they are average or will act as we assume a normal, reasonable person or business should act. In making this assumption the models hope to capture the most accurate representation of capitalistic behavior. Furthermore, in line with the law of torts, punishing the average for reasonable acts seems unfair; thus, all the punishment or damages that can be inferred from these models must be economically driven.

V. DOES AN ACCOUNTING COMPENSATE ENOUGH FOR THE INFRINGED - DOES BAD FAITH MAKE SENSE FOR COMPENSATION?

The other rationale for an accounting of profits is compensation under an unjust enrichment theory. Blair and Cotter suggest that intellectual property rights should vindicate the owner's rights and incentives to develop intellectual property by ensuring that it will get the full benefit of its investment in, and development of, the intellectual property.¹⁵⁸

"With respect to actual damages, the court may award: (1) the plaintiff's lost profits attributable to the infringement; (2) the amount necessary to undertake a corrective advertising campaign; or (3) a reasonable royalty for use of the mark."¹⁵⁹ An accounting, as discussed above, will award the successful plaintiff in a trademark infringement suit with the defendant's profits less the deductions mentioned above.¹⁶⁰ Blair and Cotter suggest that intellectual property rights should be designed "so that the infringer is no better off than he would have been had he been enjoined from using the property *ab initio*."¹⁶¹

Blair and Cotter develop an expectations model for an innovator's incentive to create intellectual property.¹⁶² For the purpose of this note it will be used in analyzing an adopter's incentive to create, develop, and adopt a trademark. The adopter's expectations can be shown as:

$$E[R] = P\pi + (1 - P)(0) - C, \quad (12)$$

where:

$E[R]$ = expected return on the trademark

P = probability of success

π = profit from the trademark

$(1 - P)$ = probability of failure

0 = returns from a trademark that fails

C = costs of creating the intellectual property.¹⁶³

¹⁵⁸ Blair & Cotter, *supra* note 24, at 1618-9.

¹⁵⁹ *Id.* at 1610 (citing RESTATEMENT (THIRD) OF UNFAIR COMPETITION, *supra* note 35, at § 36); MCCARTHY, *supra* note 27, at §§ 30:79-87.

¹⁶⁰ See *supra* notes 94-108 and accompanying text (discussing the calculation of damages in trademark infringement cases, including potential deductions).

¹⁶¹ Blair and Cotter, *supra* note 24, at 1617.

¹⁶² *Id.* at 1618-19.

¹⁶³ *Id.* at 1618-19.

This can be rewritten as:

$$E[R] = P\pi - C, \quad (13)$$

that is, "expected return equals the expected profit minus the cost of the creative effort."¹⁶⁴ If there is no system of protection for the trademark adopter, the fear of infringement decreases the expected profits, thereby decreasing the incentive to invest in the trademark.¹⁶⁵ Assuming that there is no protection, profits would be decreased in an expectations sense. Infringers could "piggy-back" off the mark and use it on their goods, thereby taking some of the profits that rightfully belong to the adopter. Blair and Cotter represent the uncertainty that the potential adopter faces in determining whether to develop the trademark in the face of unchecked infringement in the following way:

$$E[R] = P * (\pi - I) - C^{166} \quad (14)$$

where:

$E[R]$ = expected returns

P = probability of failure

π = profits from the development and use of the mark

I = lost profits attributable to infringement

C = costs of development of mark.

Blair and Cotter suggest that the intellectual property system should either deter such infringement (discussed above) or compensate in the amount of I , so that the incentive to invest in the trademark is preserved by the courts.¹⁶⁷

The adoption of a trademark will, in most cases, grant the owner an advantage over time. Upon the dissemination and identification of the mark with the producer's goods, the mark will confer a useful and convenient way for consumers to identify the goods and will

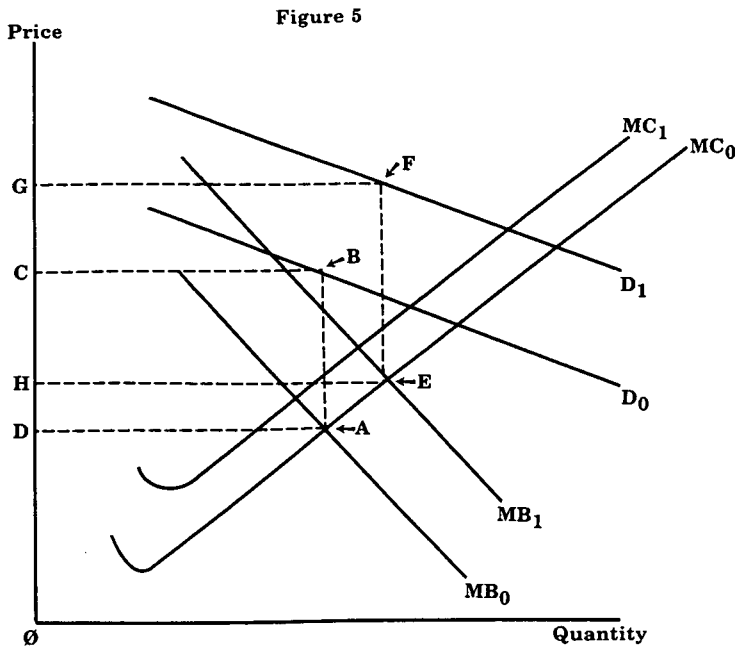
¹⁶⁴ Blair & Cotter, *supra* note 24, at 1618. The above two formulas, (12) and (13), are taken from page 1618.

¹⁶⁵ Blair & Cotter, *supra* note 24, at 1618-19.

¹⁶⁶ *Id.* at 1619-21.

¹⁶⁷ *Id.* at 1619.

confer some advantage on the adopter of the mark.¹⁶⁸ This advantage can be shown graphically as:¹⁶⁹



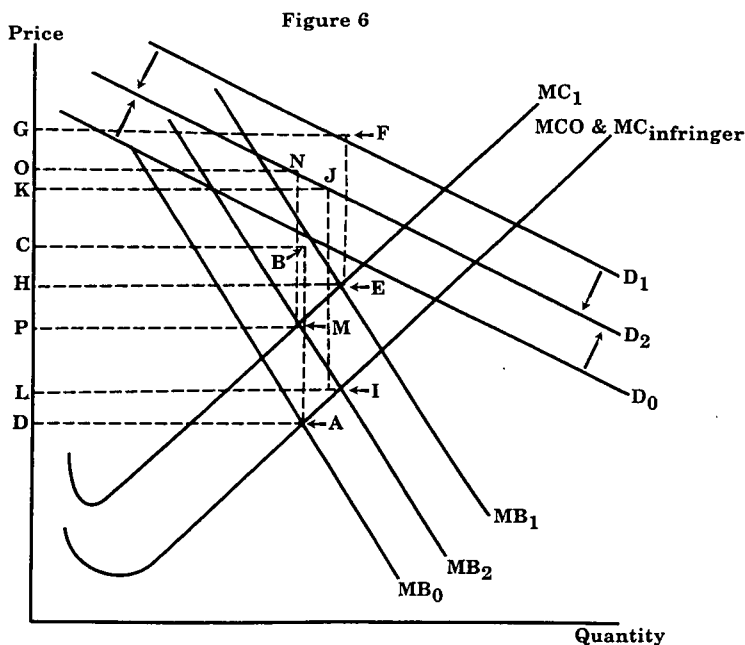
Before a company decides to invest in a trademark, assume that all firms are faced with the same marginal cost curves and that all face the same demand curve. Now with the investment in the trademark, the marginal cost of the investor will probably increase or shift up due to the investment. However, the marginal benefit and the demand curves for *the firm* will probably push out as consumers will now be able to identify the goods more readily, thereby assuring themselves of the known quality of the good. Thus, assuming that the increase in marginal benefit is greater than the increase in marginal cost (otherwise the trademark would

¹⁶⁸ See William M. Landes & Richard A. Posner, *Trademark Law: An Economic Perspective*, 30 J.L. & ECON. 265, 268-70 (1987) (discussing the benefits of using an easily identifiable trademark which allows quick recognition by consumers).

¹⁶⁹ Figure 5 is adapted from Blair & Cotter, *supra* note 24, at 1624.

not be adopted), the owner of the mark can increase profits from the area of ABCD to EFGH shown on Figure 5. The owner of the trademark would thus make (EFGH - ABCD) more in profits due to the addition of the trademark. This difference is the area that trademark law should seek to protect.

When a bad faith infringer infringes on the mark for the same goods intentionally, its marginal cost curve does not shift out as they do not incur research and development costs or search costs associated with the development of the trademark as has the owner.¹⁷⁰ Thus the intentional infringer, assuming that the marginal costs curves would be equal absent the costs of developing the trademark, would be able to gain profits greater than the losses incurred from the infringement.



¹⁷⁰ See Corgill, *supra* note 57, at 1951 (discussing the costs to the intentional infringer: "By using a brandname that is confusingly similar to an established and successful trademark, the infringer avoids costs that do not vary with the quantity of the product that is produced." Corgill also discusses the costs and benefits during the cycles of infringing use throughout his article).

Figure 6 shows that if the infringer cut into half the increased demand of the trademark owner then both the infringer and the owner would, individually, face the demand curve of D2.¹⁷¹ In this situation, the infringer would have increased his profits from area ABCD to area IJKL. The infringement would decrease the infringed profits from area EFGH to area MNOP. The loss to the owner would thus be (area of EFGH - area of MNOP). If the owner was awarded an accounting, it looks as if the infringer's profits, IJKL, would represent more than enough to compensate for the loss. Thus, it appears in a situation of intentional infringement, where the marginal cost of the infringer is lower due to the lack of costs associated with developing a trademark, an accounting of profits is sufficient to compensate the aggrieved party.¹⁷²

When the infringer's marginal costs are higher the profits may not be sufficient as the infringer is less efficient. Consequently, the profits that the infringer attained may not be equal to the profits the more efficient owner could have attained.¹⁷³ In this case the accounting is not an economically rational choice of damages.¹⁷⁴

We can also see that if the marginal costs after the innovation are identical for the infringer and the owner, the infringer's profits will be the same as the lost profits of the owner. Thus, an accounting is an economically rational choice for compensation in this case.

The distinction between good-faith infringers and bad-faith infringers in accounting of profits does not withstand this analysis entirely. In the realm of compensation, the role of an accounting should not be dependent on good-faith or bad-faith, but on a comparison of marginal costs between the infringer and the owner.¹⁷⁵ Having said that, there could still be a role for bad

¹⁷¹ See also Blair & Cotter, *supra* note 24, at 1672 (illustrating their model).

¹⁷² See Blair & Cotter, *supra* note 24, at 1674 (stating that their model "advises courts to award restitutionary damages whenever the defendant is . . . the more efficient user of the property").

¹⁷³ See also, Corgill, *supra* note 57, at 1965 (suggesting that if an infringer does not profit, the accounting of profits does not compensate the mark's owner).

¹⁷⁴ See Blair & Cotter, *supra* note 24, at 1632-33 (discussing patents, but the general thrust of the discussion applies to the analysis of trademarks undertaken here).

¹⁷⁵ See Blair & Cotter, *supra* note 24, at 1674 (stating their "model generally advises courts to award restitutionary damages whenever the defendant is . . . the more efficient user of the property").

faith in the inquiry of whether an accounting compensates properly. Bad faith could be used as an indication of whether the marginal costs are the same or different for the infringer. From a finding of a bad faith adoption, a court can determine that the marginal cost of the infringer could be lower simply due to the fact that the infringer incurred no search, research, or development costs in the trademark.¹⁷⁶ Thus, from the analysis above, the profits of the infringer would be sufficient to compensate the plaintiff. A finding of no bad faith could also be used as a proxy that the marginal costs are similar to the plaintiff's. A court in such a situation may not want to award an accounting for fear of under-compensating the plaintiff.

A court could evaluate the operating costs of the infringer and infringed, and regardless of the good-faith/bad-faith analysis, determine whether an accounting is sufficient to compensate based solely on marginal costs. However, in light of the discussion at the beginning of this paper, it is often difficult for the court to determine not only the plaintiff's lost profits, but also the costs that a defendant attempts to deduct from an accounting determination. Therefore, we cannot assume that a court may be able to determine the plaintiff's and defendant's marginal costs accurately. Furthermore, if they could, this determination may be very burdensome and expensive. The bad-faith/good-faith distinction may then be a viable, useful, and convenient way to make sure that the plaintiff is compensated adequately.

VI. CONCLUSION

Without the express provision of a bad faith requirement existing in the statute, courts have had little guidance in developing rationales for the awarding of an accounting. As discussed, the majority of circuits require a finding of bad faith for an accounting. As the models above show, perhaps a more correct inquiry would examine the costs and benefits of the firms. The bad faith requirement for an accounting of profits may serve some economic role as a proxy for marginal costs in order to compensate a plaintiff.

¹⁷⁶ See Corgill, *supra* note 57, at 1950-1 (suggesting that the marginal costs of the intentional infringer do not increase).

However, a bad faith requirement is not necessary in order to deter bad faith infringers without over-detering those who seek to legitimately adopt a mark. The bad faith requirement does not seem to be a necessity to strike a balance between deterrence and over-deterrence; rather, it seems as if it is a judicial creation, without much guidance from the statute, based on a misguided sense of fairness.

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