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MEETING OF THE MINDS

The Price of Recklessness: Disgorgement of Profits in a Post-Romag World

Josh Escovedo and Zack Thompson

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The U.S. Supreme Court issued numerous landmark decisions in 2020, among those—for trademark scholars and practitioners—*Romag Fasteners, Inc. v. Fossil, Inc.*[1] The Court, with Justice Gorsuch delivering the majority opinion, held that a plaintiff in a trademark infringement suit is not required to show that a defendant willfully infringed the plaintiff's trademark as a precondition to a profits award. But Justice Gorsuch's opinion and Justice Alito's and Justice Sotomayor's concurrences were clear that mental state is still a highly important consideration in determining whether to award profits. To that end, even with the *Romag* decision clarifying that willfulness is not a precondition for a profits award in a trademark infringement suit, the lower courts are likely to still require plaintiffs to prove that defendants had high levels of culpability before awarding profits for trademark infringement. Practitioners should expect that juries will find that defendants who knew of infringement or were reckless concerning the possibility of such conduct deserve to lose their profits.

Romag solidifies the threat posed to companies that rely on third-party manufacturers. By allowing a profits award when infringement is perpetrated with a mental state less than willfulness, this decision incentivizes companies using Chinese and other foreign manufacturers to innovate in order to mitigate these risks, either by strengthening supply chain oversight or (more likely) by writing contracts to control the risk as much as possible. Considering the importance of Chinese manufacturing to global trade, the Chinese legal system and its evolving trademark enforcement system will likely cause companies to get creative.

Summary of the Supreme Court's Opinions

In *Romag*, the Court examined whether a plaintiff in a trademark infringement action is required to show that a defendant willfully infringed the plaintiff's trademark to obtain a profits award. The issue arose from a dispute between Romag, a manufacturer of magnetic snap fasteners for leather goods, and Fossil, a designer and distributor of a wide range of fashion accessories.[2] Long ago, those parties entered into an agreement permitting Fossil to use Romag's fasteners on Fossil's handbags and other products. All was well until Romag discovered that the Chinese factories where Fossil's products were being manufactured were using counterfeit Romag fasteners, and that Fossil had not instituted protocols to prevent such conduct. When settlement discussions proved fruitless, Romag sued.

After trial, the jury found that Fossil had acted "in callous disregard" of Romag's intellectual property rights.[3] However, because the district court also found that Fossil had not acted willfully, the district court refused Romag's request for a profits award. The district court indicated that it was bound by Second Circuit precedent that requires proof of willfulness as a prerequisite to a profits award. The matter was eventually appealed to the Federal Circuit, which affirmed the district court's ruling. But not all of the circuit courts were in agreement with the Second Circuit precedent, the precedent followed by the district court and affirmed by the Federal Circuit, so the Supreme Court granted certiorari to resolve the circuit split.

At the Supreme Court, Romag argued that requiring willfulness for a profits award "flouts the plain text of section 35(a) and undermines the broader policies of the Lanham Act," and is a "serious misinterpretation of federal law" that should not be allowed to stand.[4] Fossil argued that the Federal Circuit's decision below was correct, on the grounds that common law, and principles of equity, required willfulness for a profits award.[5]

The Supreme Court first looked to the section of the Lanham Act governing remedies for trademark violations, 15 U.S.C. § 1117(a), which says:

> When a violation of any right of the registrant of a mark registered in the Patent and Trademark Office, a violation under section 1125(a) or (d) of this title, or a willful violation under section 1125(c) of this title, shall have been established . . . , the plaintiff shall be entitled, subject to the provisions of section 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.[6]

The Court noted that the statute immediately "spells trouble for Fossil and the circuit precedent on which it relies."[7] While the statute makes willfulness a prerequisite to a profits award for trademark dilution under § 1125(c), it does no such thing for claims for the false and misleading use of trademarks, such as Romag's, under § 1125(a). In fact, the Court acknowledged that the Lanham Act has never required a showing of willfulness to recover profits for § 1125(a) claims.

The Court found the rest of the Lanham Act to be equally troublesome for Fossil and the circuit court precedent. For example, § 1117(b) requires courts to "treble profits or damages and award attorney's fees when a defendant engages in certain acts *intentionally* and with specified *knowledge*."[8] Similarly, § 1117(c) increases the ceiling on statutory damages to $2 million for willful violations, and § 1118 allows courts to order infringing items to be destroyed if a plaintiff proves any violation of § 1125(a) or a willful violation of § 1125(c). Conversely, § 1114 protects innocent infringers and subjects them only to injunctions. A comprehensive reading of the Lanham Act therefore demonstrates that the act doesn't address state-of-mind requirements inferentially. It does so expressly. In light of the care with which the Lanham Act normally treats state-of-mind requirements, the Court found the absence of a state-of-mind requirement for claims under §1125(a) "all the more telling."[9]

The Court next turned to Fossil's argument. Because most of the language in the statute stands contrary to Fossil's position, Fossil focused on the phrase "subject to the principles of equity."[10] According to Fossil, the equity courts historically required plaintiffs to establish willfulness, or its historical equivalent, to obtain a profits award in trademark disputes. Fossil claimed, in trademark law, "a willfulness requirement was so long and universally recognized that today it rises to the level of a 'principle of equity' the Lanham Act carries forward."[11]

The Court found the argument intriguing but problematic. While the argument that "principles of equity" includes a willfulness requirement would not "directly contradict the statute's other, express *mens rea* provisions or render them wholly superfluous[,] . . . it would require us to assume that Congress intended to incorporate a willfulness requirement here obliquely while it prescribed *mens rea* conditions expressly elsewhere throughout the Lanham Act."[12] The Court was also troubled by the argument requiring it to interpret "principles of equity" to refer to "a substantive rule about *mens rea* from a discrete domain like trademark law," instead of a "fundamental rule[] that appl[ies] more systematically across claims and practice areas."[13]

But even if the Court put aside these issues, its own survey of the case law was less convincing than Fossil would have had the Court believe. The Court found cases supporting both positions, some holding that willfulness was a prerequisite for a profits awards, and some expressly rejecting the rule or not addressing it at all, concluding that "it's far from clear whether trademark law historically required a showing of willfulness before allowing a profits remedy."[14]

Because of the case law's inconsistency, the most the Court could conclude was that "[*m*]*ens rea* figured as an important consideration in awarding profits in pre-Lanham Act cases."[15] The Court found that the Lanham Act's text also reflects the importance of mental states to determining the appropriateness of heightened penalties and damages for infringement. The Court therefore concluded that "a trademark defendant's mental state is a highly important consideration in determining whether an award of profits is appropriate," even if willfulness itself was not required.[16] The Court vacated the judgment of the court of appeals, remanding the case for further proceedings consistent with the Court's opinion.

Importance of the Defendant's Mental State to Awarding Profits

But what is the practical effect of the Court's decision? Will it incentivize more trademark litigation since it clearly establishes that a showing of willfulness is not required to obtain a profits award? Will it increase shakedowns carried out by trademark bullies by giving them a more powerful weapon to intimidate their prey? Or will it simply clear up the circuit split on the issue and leave the trademark world mostly as is? We think the latter. However, the decision should emphasize to companies that use third-party manufacturers that avoiding the appearance of willfulness is not enough, and that without the proper contractual or operational safeguards, a company with deep pockets or in a jurisdiction in which it is easier to bring suit could end up on the hook for infringement committed by partners.

The Court's opinion and both concurrences underscore the significance of the infringing party's state of mind in determining the appropriateness of a profits award. Justice Gorsuch concluded the majority opinion by saying that "a trademark defendant's mental state is a *highly important consideration* in determining whether an award of profits is appropriate."[17] Justice Alito's concurrence likewise stated that "[t]he relevant authorities, particularly pre-Lanham Act case law, show that willfulness is a *highly important consideration* in awarding profits under § 1117(a), but not an absolute precondition."[18] Justice Sotomayor went even further when she agreed with the majority's decision, though not its reasoning. In her concurrence, Justice Sotomayor accused the majority of incorrectly declaring that courts of equity awarded profits against innocent infringers as often as they did against willful infringers.[19] According to Justice Sotomayor, courts of equity almost always required "willfulness" for a profits award, but for equity courts, "willfulness" included “a range of culpable mental states—including the equivalent of recklessness, but excluding ‘good faith’ or negligence.”[20] Justice Sotomayor opined that profits could be awarded for less than willfulness, but never for innocent infringement, differentiating her view from the majority, whose opinion she perceived to be leaving the door open to profits awards for innocent infringement.

So, while the majority and concurrences unanimously agree that the Lanham Act does not require willfulness to award profits under § 1117(a), the justices emphasized the importance of the infringer’s state of mind to determining the appropriate remedy, and in our opinion, the lower courts will continue to award profits mostly in instances where the infringement was willful. Lower courts may continue to require willfulness both based on general notions of fairness and due to the weight of case law. Although, after an explicit opinion from the Supreme Court that willfulness is not required, lower courts may be more willing to find profits awards appropriate where the infringer knowingly or recklessly violated the rights of the plaintiff.

Whether courts award profits where infringement is less than willful will be highly fact-dependent, although the dispute between Romag and Fossil outlines one archetypal situation where a jury might award profits for less than willful conduct. The jury in *Romag* found that Fossil’s infringement wasn’t willful, yet found Fossil acted with “callous disregard” of Romag’s rights. The jury was apparently bothered by Fossil’s awareness of the infringement and failure to either rectify the issue or put reasonably prudent safeguards in place to prevent such conduct. Had the *Romag* jury not been instructed that willfulness is required for awarding profits, they may have awarded profits on the facts they had. Future juries will face no such limitation, which should worry companies like Fossil that rely on third-party manufacturers.

But we believe the decision is unlikely to have much of a practical effect on trademark litigation other than in situations substantially similar to *Romag*. It will obviously make the profits remedy available to parties even in the absence of willfulness. But the majority and concurring opinions’ directive that mental state is a “highly important consideration” should mean that losing the willfulness requirement will not make it easier for spurious filings aimed at extracting a quick settlement. Trademark litigants will still need to show that the infringing party had a highly culpable state of mind to warrant disgorgement of profits—which is difficult to prove and is a remedy the courts do not impose lightly. Showing a highly culpable mental state requires extensive discovery and isn’t likely to be considered a grave threat in most pre-litigation contexts. It follows that the trademark landscape will remain mostly unaffected by *Romag*.

Still, *Romag* changes the law in the circuits that formerly required a showing of willfulness to obtain a profits award, potentially opening companies that entrust their manufacturing to third parties to significant liability if they fail to police the conduct of their business partners. *Romag* enables juries to punish such parties by requiring them to disgorge profits, and it seems unlikely that juries will spare parties who have knowingly or recklessly permitted such infringement. The Supreme Court's explicit clarification—that a profits award does not require willfulness—could be wielded as a sword against practitioners and companies unfamiliar with the fine details of the *Romag* decision's discussion of mental states. Expect more cease and desist letters referencing the Supreme Court's explicit clarification in *Romag* when threatening to seek profits against merely knowing, reckless, or even innocent infringers.

U.S. Companies Using Chinese Manufacturers Will Need to Adapt to Risks

Given the threat of increased penalties for non-willful trademark infringement, U.S. companies that contract with foreign manufacturers need to take steps to protect themselves against liability for a profits award arising out of infringement committed through a foreign manufacturer. Companies with manufacturers in China, and other countries where infringement has been a constant threat, may need to be especially alert. Unfortunately for these U.S. companies, like Fossil, they were already easy targets compared to their Chinese manufacturer partners. Remember, it was Fossil's Chinese manufacturer that replaced Romag's fasteners with counterfeits. Fossil was the easier target for Romag, however, given the impediments to a U.S. company obtaining or enforcing a judgment against a Chinese company. All Romag needed to do was prove that Fossil sold the infringing goods with knowledge of or recklessness toward potential infringement in their manufacture. Romag's path to judgment was smoothed by the ability to use U.S. courts and not worry about hometown bias for Chinese companies in Chinese courts. And sooner or later, Romag can collect any judgment from Fossil's U.S. assets.

With the clarification that willfulness is not required for a profits award, plaintiffs may find it easier to obtain such awards against U.S. companies using foreign manufacturers. Companies already struggle to police foreign partners' operations and infringement. Companies like Fossil, to protect themselves while using a Chinese or another foreign manufacturer, need to maintain strict oversight over their global supply chain or prepare contractually to seek remedies from manufacturers.

Infringement has long been part of the business landscape for foreign businesses operating in China.[21] In a 2011 survey conducted by the U.S. International Trade Commission, 30 percent of firms reported material sales or profit losses due to trademark infringement in China.[22] More than 90 percent of consumer goods manufacturers, including 99.7 percent of apparel manufacturers, like Fossil, reported such problems.[23] Ninety percent of survey respondents expressed dissatisfaction with enforcement options in China, offering criticisms ranging from weak remedies that are absorbed as a cost of doing business to local protectionism and corruption.[24] Unless the Chinese company has sufficient assets in the U.S., litigation in U.S. courts is likely useless, given that observers can easily track (and count on one hand) the number of times Chinese courts have enforced U.S. judgments—and none so far have enforced a judgment in favor of a U.S. company against a Chinese company.[25] Others note that lack of insurance among Chinese manufacturers often makes indemnification more difficult.[26] And, at least in the recent past, U.S. companies and their lawyers have considered tort litigation in China pointless.[27]

There are some signs that recent reforms to the Chinese intellectual property right enforcement system are improving results for foreign rights holders. A survey conducted in late 2019 by the American Chamber of Commerce in the People's Republic of China reported that more than two-thirds of its members who responded thought China's enforcement of intellectual property rights had improved in 2019, up from 59 percent in 2018.[28] Others have noted local judicial protectionism decreasing in provincial appellate courts,[29] improving evidentiary procedures,[30] and rising damage awards.[31] Such improvements may give U.S. companies greater leverage against Chinese manufacturers, but the first line of defense for a U.S. company contracting with Chinese manufacturers, after insurance,[32] will be contracts. Potential remedies against Chinese companies are going to be less predictable for U.S. companies than they would be in U.S. courts. U.S. companies should contract with their Chinese manufacturer partners and intellectual property rights holders to take advantage of potential contract, tort, and property remedies.

The exact contractual solutions may vary based on the parties' respective leverage, although recent reforms like the 2010 Tort Liability Law of the People's Republic of China offer sufficient reasons for U.S. companies to preserve all their potential remedies.[33] This means seeking an express representation that no counterfeit components will be used to facilitate a fraud claim. To support an indemnity provision, requiring insurance, and even requiring that the U.S. company be an additional insured on the policy, can help ensure recovery.[34] Finally, when contracting with intellectual property rights holders, as Fossil did with Romag, U.S. companies should consider subrogation and cooperation clauses that will enable them to seek recovery in administrative or civil forums in China, or in arbitration,[35] without having to surmount standing issues or prove indirect harm.

Conclusion

Depending on how the lower courts apply the *Romag* decision, U.S. companies that contract with Chinese manufacturers to produce goods that contain licensed components could be facing an increased need for protection from infringement by their Chinese partners. Disgorgement of profits is much easier to prove than lost sales and, depending on the scale of the infringement, could result in a large judgment. Such a judgment would also, by its nature, prevent the company from offsetting its damages through its ill-gained profits. In order to lessen the risk and afford as much relief as possible in this difficult position, such companies should avail themselves of as many avenues to relief as they can negotiate in their contracts with Chinese manufacturers. Otherwise, those companies may experience the full ramifications of the *Romag* decision.

Endnotes

1. 140 S. Ct. 1492 (2020) (Gorsuch, J.).

2. *Id.* at 1494.

3. *Id.*

4. Petition for a Writ of Certiorari at 24, *Romag*, 140 S. Ct. 1492 (2020) (No. 18-1233).

5. Brief for Respondents in Opposition at 3, *Romag*, 140 S. Ct. 1492 (2020) (No. 18-1233).

6. *Romag*, 140 S. Ct. at 1494–95.

7. *Id.* at 1495.

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.* at 1495–96.

13. *Id.* at 1496.

14. *Id.* at 1497.

15. *Id.*

16. *Id.*

17. *Id.* (emphasis added).

18. *Id.* (Alito, J., concurring) (emphasis added).

19. *Id.* at 1498 (Sotomayor, J., concurring).

20. *Id.*

21. *See generally* Peter K. Yu, *A Half-Century of Scholarship on the Chinese Intellectual Property System*, 67 Am. U. L. Rev. 1045 (2018).

22. China: Effects of Intellectual Property Infringement and Indigenous Innovation Policies on the U.S. Economy, Inv. No. 332-519, USITC Pub. 4226, at 3-32 (May 2011), https://www.usitc.gov/publications/332/pub4226.pdf.

23. *Id.* at 3-32 to 3-33.

24. *Id.* at 3-35 to 3-37.

25. *See, e.g.*, Terence Wong, *The Current Status of Enforcing U.S. Judgments in China*, Winston & Strawn LLP (July 30, 2019), https://www.winston.com/en/thought-leadership/the-current-status-of-enforcing-us-judgments-in-china.html.

26. *See, e.g.*, Dan Harris, *Chinese Company Indemnification and Insurance*, China L. Blog (July 5, 2017), https://www.chinalawblog.com/2017/07/chinese-company-indemnification-and-insurance-buyer-beware.html; Peter Masaitis, *Chinese Manufacturers vs. U.S. Distributors: Contractual Indemnity and Insurance Coverage Governing Product Liability*, Bloomberg L. (Sept. 2019), https://www.alston.com/-/media/files/insights/publications/2019/09/uschinaindemnity.pdf.

27. *See, e.g.*, Roger Parloff, *China's Newest Export: Lawsuits*, CNN Money (July 5, 2007), https://money.cnn.com/2007/07/05/news/international/chinese_lawsuits.fortune/index.htm ("No American lawyer interviewed for this article was contemplating suing Chinese entities in Chinese courts, where tiny damage awards and frequently hostile local judges often make litigation pointless.").

28. Am. Chamber of Commerce in the People's Republic of China, 2020 China Business Climate Survey Report 7 (2020). *See generally* William Weightman, *China's Progress on Intellectual Property Rights (Yes, Really)*, Diplomat (Jan. 20, 2018), https://thediplomat.com/2018/01/chinas-progress-on-intellectual-property-rights-yes-really.

29. *See* Cheryl Xiaoning Long & Jun Wang, *Judicial Local Protectionism in China: An Empirical Study of IP Cases*, 42 Int'l Rev. L. & Econ. 48 (2015).

30. Weightman, *supra* note 28.

31. *See, e.g.*, Pei Li, *Chinese Court Awards New Balance $1.5 Million in Trademark Case*, Reuters (Aug. 23, 2017), https://www.reuters.com/article/us-new-balance-china-trademark/chinese-court-awards-new-balance-1-5-million-in-trademark-case-idUSKCN1B317X.

32. The authors do not mean to suggest that obtaining insurance to protect against trademark infringement by a contracted Chinese manufacturer will be easy or cheap, but it is probably worth investigating for contracts of sufficient value involving licensed intellectual property.

33. *See generally* Ellen M. Bublick, *China's New Tort Law: The Promise of Reasonable Care*, 13 Asian-Pacific L. & Pol'y J. 36 (2011).

34. *See* Wong, *supra* note 25.

35. Arbitral decisions are generally much more likely to be enforced in China than judgments from U.S. courts. *See id.*

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Authors

Josh Escovedo

Josh Escovedo is a shareholder at Weintraub Tobin. He specializes in intellectual property and real property litigation.

Zack Thompson

Zack Thompson is an associate at Weintraub Tobin in Sacramento, California. He specializes in labor and employment litigation and has litigated trade secret and trademark cases.