

DISGORGEMENT OF PROFITS AS A CALIFORNIA BREACH OF CONTRACT REMEDY: INTELLECTUAL PROPERTY AND OTHER GUIDEPOSTS

ANDREW F. HALABY AND PATRICK W. KELLY*

ABSTRACT

Disgorgement of profits has long been available as a remedy for certain property-related torts, including multiple varieties of intellectual property infringement. But until recently, conventional breach of contract theory has excluded disgorgement of the breacher's profits from the monetary remedies available to the breach victim. Moreover, the California Civil Code generally limits the monetary remedy for breach of contract to damages sufficient to compensate the victim for "detriment" caused by the breach, capped at the equivalent of full contract performance by the breacher — all of which would seem at first blush to foreclose disgorgement of the breacher's profits to the extent those profits exceed the victim's loss.

Here, we examine the history of, and limitations on, the new disgorgement-of-profits remedy for breach of contract under Restatement (Third) of Restitution and Unjust Enrichment § 39. We suggest that up to the "cost of modification" — the figure the breacher hypothetically would have had to pay to "buy out" its remaining performance obligation under the contract but, choosing instead to breach, did not — disgorgement-of-profits is not inconsistent with the Civil Code's limitations on monetary recovery for breach of contract. We also identify intellectual property infringement analogs — chiefly focusing on the "reasonable royalty" calculation from patent law — that may guide California businesses and courts in applying disgorgement-of-profits in future breach of contract disputes and cases.

* Andy Halaby and Pat Kelly are partners in Snell & Wilmer L.L.P., both practicing out of the firm's Los Angeles office. Andy can be reached at 213-929-2546 or ahalaby@swlaw.com, and followed at @andyhalaby. Pat can be reached at 213-929-2533 and pkelly@swlaw.com. Thanks to Barry Halpern, Todd Lundell, and Sam Halabi for their comments on an earlier draft.

TABLE OF CONTENTS

INTRODUCTION	152
I. BACKGROUND	155
II. COST-OF-MODIFICATION	159
III. INTELLECTUAL PROPERTY ANALOGS	160
IV. COURT OR JURY?	165
V. HYPOTHETICALS	167
CONCLUSION	169

INTRODUCTION

In classic breach of contract analysis, a contract obligor earns little opprobrium by breaching in order to earn greater profit by diverting performance resources elsewhere. The “efficient breacher” (obligor) can take those profits, use some of them to pay the victim its lost expectation interest, and keep the remainder, with the two transactions, viewed as a whole, reflecting a more efficient outcome than the breacher’s keeping the original contract.¹

So we, members of the practicing bar, were taught in our introductory contracts course. So we have been taught since at least the days of Oliver Wendell Holmes, who asserted, “The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, — and nothing else.”² “Damages” means just that: the amount by which the breach victim has been *damaged*, with the breacher free to keep or dispose of remaining performance resources as the breacher sees fit. And if we were jarred by the corresponding implication that a promise breached somehow is less wrongful than a tort,³ we soon got used to the idea and moved on.

California contracts are governed not by the common law (except in a limited and remote way⁴), but by the California Civil Code. The Civil Code

¹ See, e.g., E. ALLAN FARNSWORTH, CONTRACTS § 12.3, at 763 (3d ed. 1999); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 133 (5th ed. 1998).

² Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

³ Consider, for example, that punitive damages are available for torts, not contract breaches. E.g., RESTATEMENT (SECOND) OF CONTRACTS § 355 (AM. LAW INST. 1981); CAL. CIV. CODE § 3294(a) (2019).

⁴ See CIV. § 22.2 (2019) (enacted 1951) (“The common law of England, so far as it is not repugnant to or inconsistent with the Constitution of the United States, or the Constitution or laws of this State, is the rule of decision in all the courts of [California].”); *id.* § 5 (enacted 1872) (“The provisions of this Code, so far as they are substantially the same as existing statutes or the common law, must be construed as continuations thereof, not as new enactments.”); *id.* § 20 (enacted 1872) (“No statute, law, or rule is continued in force because it is consistent with the provisions of this Code on the same subject; but in all cases provided for by this Code, all statutes, laws, and rules

identifies the monetary remedy for breach of contract as “damages”⁵ sufficient to “compensate the party aggrieved for all the detriment”⁶ — i.e., “loss or harm suffered in person or property”⁷ — “proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.”⁸ Except as otherwise provided by statute, the breach victim may not “recover a greater amount in damages for . . . breach . . . than he could have gained by the full performance thereof on both sides.”⁹ Thus, consistent with the common law, the Civil Code limits the monetary breach of contract remedy to harm suffered by the breach victim, without regard to the profits gained by the breacher from the breach.¹⁰

In 2011, the American Law Institute propounded Section 39 of the Restatement (Third) of Restitution and Unjust Enrichment:

Profit from Opportunistic Breach

- (1) If a deliberate breach of contract results in profit to the defaulting promisor and the available damage remedy affords inadequate protection to the promisee’s contractual entitlement, the promisee has a claim to restitution of the *profit realized by the promisor* as a result of the breach. Restitution by the rule of this section is an alternative to a remedy in damages.

heretofore in force in this State, whether consistent or not with the provisions of this Code, unless expressly continued in force by it, are repealed or abrogated. This repeal or abrogation does not revive any former law heretofore repealed, nor does it affect any right already existing or accrued, or any action or proceeding already taken, except as in this Code provided.”); *see also* *Ajaxo Inc. v. E*Trade Group Inc.*, 187 Cal. App. 4th 1295, 1310–11 (2010) (noting that California’s Uniform Trade Secrets Act “was intended to codify the common law”); Maurice E. Harrison, *The First Half-Century of the California Civil Code*, 10 CAL. L. REV. 185, 185 (1922) (describing Civil Code’s adoption as an “attempt . . . to codify comprehensively the substantive common law”).

⁵ CIV. § 3281 (2019) (“Every person who suffers detriment from the unlawful act or omission of another, may recover from the person in fault a compensation therefor in money, which is called damages.”).

⁶ *Id.* § 3300; *see also id.* § 3283 (“Damages may be awarded, in a judicial proceeding, for detriment resulting after the commencement thereof, or certain to result in the future.”).

⁷ *Id.* § 3282.

⁸ *Id.* § 3300; *see generally* 1 WITKIN, SUMMARY OF CAL. LAW § 894 (11th ed. 2017) (“The basic object of damages is compensation, and in the law of contracts the theory is that the party injured by breach should receive as nearly as possible the equivalent of the benefits of performance.”).

⁹ CIV. § 3358; *see also* *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, 7 Cal. 4th 503, 515 (1994) (“Contract damages seek to approximate the agreed-upon performance.”).

¹⁰ *See* CIV. § 3358; *see also id.* § 3274 (“As a general rule, compensation is the relief or remedy provided by the law of this State for the violation of private rights, and the means of securing their observance . . .”).

- (2) A case in which damages afford inadequate protection to the promisee's contractual entitlement is ordinarily one in which damages will not permit the promisee to acquire a full equivalent to the promised performance in a substitute transaction.
- (3) Breach of contract is profitable when it results in gains to the defendant (net of potential liability in damages) greater than the defendant would have realized from performance of the contract. Profits from breach include saved expenditure and consequential gains that the defendant would not have realized but for the breach, as measured by the rules that apply in other cases of disgorgement (§ 51(5)).¹¹

Restatement Section 39 postulates that “[a]n efficient breach of contract . . . is easy to hypothesize but difficult to find in real life,”¹² as well as “the pervasive risk of under-compensation by standard damage measures, not to mention the deadweight loss from the cost of litigation.”¹³ Regardless of those premises, Restatement Section 39 would seem inconsistent with the Civil Code's monetary remedy limitations, since Section 39 allows the victim in limited circumstances to obtain “profit realized by the promisor” as a monetary remedy for the breach.

As we argue below, however, Restatement Section 39 is not inconsistent with the Civil Code up to the limit of the “cost of modification”: the amount of money the breacher hypothetically would have had to pay to “buy out” the victim's entitlement to the breacher's remaining performance due under the contract.¹⁴ At least in the disgorgement-of-profits context, cost-of-modification represents detriment suffered by the breach victim, yet is no greater than “full performance . . . on both sides” would yield, and thus appears to fall within the Civil Code. California courts have not, as yet, had cause to apply this cost-of-modification measure. But disgorgement of profits has a long, broad history as a remedy for intellectual property infringement, including but not limited to the “reasonable royalty” calculation for infringement of patent rights. Courts asked to apply the cost-of-modification measure in contract cases can draw upon this body of law for guidance.

¹¹ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 (AM. LAW INST. 2011).

¹² *Id.* § 39 cmt. h.

¹³ *Id.*

¹⁴ See E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1346 (1985) [hereinafter *Your Loss*].

Below, we present a brief background of Restatement Section 39's disgorgement rule,¹⁵ then demonstrate that application of that section limited by cost-of-modification appears not inconsistent with the Civil Code. We then identify various intellectual property disgorgement remedies for comparison and guidance in applying the cost-of-modification measure, focusing primarily on the "reasonable royalty." After a brief comment on whether disgorgement-of-profits for breach of contract falls to the court or jury for decision, we apply the cost-of-modification remedy to several related hypotheticals.

I. BACKGROUND

It is well understood¹⁶ that the typical monetary remedy for a breach of contract is money damages measured by the breach victim's *expectation interest*.¹⁷ As an alternative, the victim may choose to pursue damages measured by its *reliance interest*, which typically is lower,¹⁸ or, lower still, *restitution*.¹⁹ None of these monetary remedies derives, at the core, from the breacher's gain; all derive from the victim's loss.²⁰

Restatement Section 39 originated with scholars questioning whether and on what terms breachers' profits ought to be subjected to disgorgement notwithstanding contract law's traditional adherence to "efficient breach"

¹⁵ We agree with Professor DeLong that "[t]he term 'disgorgement' is preferable to the more general term 'restitution,' which refers to the *return* of a benefit that has been conferred on the defendant by the plaintiff and the *return* of which is necessary to avoid unjust enrichment." Sidney W. DeLong, *The Efficiency of a Disgorgement as a Remedy for Breach of Contract*, 22 IND. L. REV. 737, 743 n.19 (1989) (emphasis added).

¹⁶ Eric G. Anderson, *The Restoration Interest & Damages for Breach of Contract*, 53 MD. L. REV. 1, 3 (1994) ("Over the course of half a century, the expectation, reliance, and restitution 'interests' have come to determine the way we think about contract remedies."); Jean F. Powers, *Paying for What You Get—Restitution Recovery for Breach of Contract*, 2 PACE L. REV. 501, 501 (2018) (describing "expectation, reliance, and restitution" as "the three contracts measures of recovery" (emphasis added)).

¹⁷ FARNSWORTH, *supra* note 1, § 12.8, at 784.

¹⁸ *Id.* § 12.8, at 785; *see also id.* § 12.16, at 835.

¹⁹ *Id.* § 12.19, at 851; *id.* § 12.20, at 854 ("Restitution as a remedy for breach of contract is limited to benefits that are regarded as having somehow flowed from the injured party, a party that can be said to have 'lost' something that the party in breach is being asked to 'restore.'").

²⁰ *See* RESTATEMENT (SECOND) OF CONTRACTS § 344 (AM. LAW INST. 1981); *see also* Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 TEX. L. REV. 2021, 2035–38 (2001) (citing, *inter alia*, RESTATEMENT (SECOND) OF CONTRACTS § 344, in describing grounding of restitution interest); *cf.* Ajaxo Inc. v. E*Trade Group Inc., 135 Cal. App. 4th 21, 56 (2005) ("When the remedy given for breach of contract is money damages, the amount awarded is determined with the purpose of putting the injured party in as good a position as he would have occupied had the contract been performed. In granting restitution as a remedy for the breach, however, the purpose to be attained may be no more than the restoration of the injured party to as good a position as that occupied by him before the contract was made.") (citing 11 CORBIN ON CONTRACTS (Interim Edition) § 996).

principles.²¹ Debate touched each of the limitations one now sees in Restatement Section 39, which include, but are not limited to,

- its limitation to “deliberate” breaches;
- the disgorgement remedy’s limitation to circumstances in which damages are “inadequate” to protect the victim’s “contractual entitlement”;
- its causal limitation of “profit realized by the promisor as a result of the breach”; and
- measures of “profits from breach,” which include but are not limited to “saved expenditure.”²²

To address each of these limitations would exceed our space constraints, but a few observations are in order.

First, Restatement Section 39’s disgorgement-of-profits remedy for breach of contract is new. It “has no counterpart in either the first or second Restatement of Contracts.”²³ It thus is subject to criticism as an assertion of what the law ought to be (according to the academics, at least) rather than an inductive “restatement” of what the law is, as developed in individual cases.²⁴ As of this

²¹ See Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 MICH. L. REV. 559, 578 (2006) (“Although the assumption that contract law does not protect the disgorgement interest has been widely accepted, since the 1950s there have been periodic expressions of support for disgorgement in the secondary literature.”).

²² See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 reporter’s note (AM. LAW INST. 2011); see also, e.g., Eisenberg, *supra* note 21; *Your Loss*, *supra* note 14; Daniel Friedmann, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 COLUM. L. REV. 504, 508 (1980); Caprice L. Roberts, *Restitutory Disgorgement for Opportunistic Breach of Contract and Mitigation of Damages*, 42 LOY. L.A. L. REV. 131 (2008).

²³ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST § 39 cmt. a (AM. LAW INST. 2011); see also Eisenberg, *supra* note 21, at 561 (“[A]t the time the Restatement Second [of Contracts] was published, it was widely assumed by commentators that the disgorgement interest was not protected in contract law.”); Powers, *supra* note 16, at 502 (“The Restatement [(third) of Restitution & Unjust Enrichment] could, if followed in contracts cases, rewrite contracts casebooks and change the approach to measuring contracts damages.”); Roberts, *supra* note 22, at 132 (referring to then work-in-progress section 39 as “potentially groundbreaking because traditional American contract law does not have a rule encapsulating cases where disgorgement is the proper remedy for breach”); *id.* at 134 (referring to the “disgorgement remedy” embodied in that “novel extension” as “alter[ing] the doctrinal landscape of contract law”).

²⁴ See *Kansas v. Nebraska*, 135 S. Ct. 1042, 1064 (2015) (Scalia, J., dissenting) (“The object of the original Restatements was to present an orderly statement of the general common law. Over time, the Restatements’ authors have abandoned the mission of describing the law, and have

writing, Restatement Section 39 has been cited in only 15 reported decisions — and never, positively or negatively, by any California state court or federal court sitting in California. That said, one of the 15 citing decisions, the water rights case *Kansas v. Nebraska*,²⁵ comes from the United States Supreme Court. So Restatement Section 39 cannot, at this point, be regarded merely as an academic flourish.

Second, determining which breaches qualify as “deliberate” presents what may be one of the thorniest problems in applying Restatement Section 39.²⁶ Section 39 itself is elliptical. Its title uses the term “opportunistic.” Its commentary refers variously to the defendant’s “recogni[tion]” that it could get away with performing less than it promised²⁷; “conscious advantage-taking”; “conscious wrongdo[ing]”; “opportunistic calculation”; “intentional and opportunistic”; and “conscious choice not to perform.” Yet, Restatement Section 39 distinguishes, and denies that plaintiff must prove, “the motivation of the breaching party.”²⁸

chosen instead to set forth their aspirations for what the law ought to be. Section 39 of the Third Restatement of Restitution and Unjust Enrichment is illustrative . . .” (internal quotation marks and citation omitted); *see generally* BENJAMIN N. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* 47–48 (1921) (“In law . . . the truths given by induction tend to form the premises for new deductions. . . . A stock of juridical conceptions and formulas is developed, and we take them, so to speak, ready-made. . . . These fundamental conceptions once attained form the starting point from which are derived new consequences, which, at first tentative and groping, gain by reiteration a new permanence and certainty. In the end, they become accepted themselves as fundamental and axiomatic. So it is with the growth from precedent to precedent.”).

²⁵ *Kansas*, 135 S. Ct. at 1058.

²⁶ Contract breach determinations traditionally are indifferent to the defendant’s state of mind. *Applied Equipment v. Litton Saudi Arabia Ltd.*, 7 Cal. 4th 503, 517 (1994) (“A party may breach a contract without any third-party inducement because of personal, racial, or ethnic animus, or for other nefarious or unethical reasons. In contrast, a breach may be the product of naive or innocent misunderstanding or misperception created by the aggressive solicitation of an outsider. In any case, motivation is irrelevant.”). Even determining breach of the implied covenant of good faith and fair dealing inquires whether the defendant impaired the benefits the plaintiff reasonably expected to flow from the agreement; defendant’s state of mind is irrelevant. *See Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 573 (1973) (the implied covenant of good faith and fair dealing ensures that “neither party will do anything which will injure the right of the other to receive benefits of the agreement”).

²⁷ Here, though, comment b is not clear as to whether it refers to defendant’s state of mind at the beginning of the contract, or at the time of the breach. One would think the latter.

²⁸ RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 cmt. b (AM. LAW INST. 2011); *see also* Roberts, *supra* note 22, at 138 (observing that “opportunistic breach” may mean “selfish, advantageous, or exploitive behavior resulting in a breach”). Those interested in distinguishing proof of motivation, which is not required to establish entitlement to disgorgement-of-profits, from proof of deliberateness, which is, may find it fruitful to review treatment of the “consumer motivation” genericism controversy from trademark law. *See, e.g.*, A. Samuel Oddi, *Consumer Motivation in Trademark & Unfair Competition Law: On the Importance of Source*, 31 VILL. L. REV. 1, 63–64 (1986) (discussing *Anti-Monopoly, Inc. v. Gen. Mills Fun Grp., Inc.*, 684

On the breacher's state of mind, consider two practicalities from different times in the real-world breach of contract life cycle.

At the beginning of that life cycle, in contract negotiations, one might consider including explicit acknowledgment that, under specified circumstances, breach of particular terms will be deemed "deliberate" for Restatement Section 39 purposes. Contracting parties routinely include comparable terms with respect to injunctive relief, and Restatement Section 39 comment b explicitly likens the circumstances justifying that relief to those justifying disgorgement-of-profits.²⁹

Later on in the breach of contract life cycle, in circumstances where breach is threatened, an appropriately-timed, appropriately-framed demand letter might well resolve any serious question as to the would-be breacher's state of mind in the event the breach materializes.

Finally, breaches satisfying all Restatement Section 39's requirements will occur only rarely.³⁰ The Restatement commentary posits this as true in part because, as just mentioned, not all breaches will qualify as "deliberate,"³¹ and in part because the commentary likens³² (though doesn't limit³³) eligibility for

F.2d 1316 (9th Cir. 1982), and its legislative overruling in the federal Trademark Clarification Act of 1984); *see also* David G. Barker, *Culpable Mental States in Intellectual Property Cases: An Emerging, Common Law-Like Uniformity*, LANDSLIDE, Mar.-Apr., 2012, at 14.

²⁹ § 39 cmt. b ("Not by coincidence, the contractual entitlements that are vulnerable in the manner just described are those for which the promise would most often be entitled to protection by injunction, or to a remedy by specific performance; or in which well-advised parties would most often provide by contract (where permitted to do so) for liquidated damages or specific enforceability. Disgorgement by the rule of this section serves the same contract-reinforcing objectives as the devices just mentioned, at a different stage of contractual performance."); *see also* § 39 cmt. a ("Where a party's contractual entitlement would be inadequately protected by the legal remedy of damages for breach, a court will often reinforce the protection given to the claimant by an order of injunction or specific performance.").

³⁰ § 39 cmt. a, f; *see also, e.g.*, Kull, *supra* note 20, at 2028–29.

³¹ § 39 cmt. f.

³² § 39 cmt. a ("the present section recognizes a claim in unjust enrichment as an alternative remedy for breach, potentially available to an injured party who might otherwise enforce the contract by an action for damages or specific performance"); *id.* ("Where a party's contractual entitlement would be inadequately protected by the legal remedy of damages for breach, a court will often reinforce the protection given to the claimant by an order of injunction or specific performance. Restitution affords comparable protection after the fact . . ."); *id.* at cmt. b ("Not by coincidence, the contractual entitlements that are vulnerable . . . are those for which the promise would most often be entitled to protection by injunction, or to a remedy by specific performance . . ."); *id.* at cmt. c ("In contract cases, questions about the adequacy of legal remedies traditionally arise when the plaintiff asks the court to prevent a threatened breach by injunction or specific performance. Disgorgement yields a remedial equivalent after the fact . . . One way to examine the adequacy of a damage remedy in disgorgement cases is therefore to conduct a hypothetical test for the availability of specific relief. If a court with the benefit of hindsight would have granted a remedy by injunction or specific performance, restitution by the rule of this section is appropriate after the fact.").

disgorgement-of-profits to that for specific performance. We are more persuaded by another point from the commentary: that the breacher's profits rarely will exceed the victim's damages measured conventionally.³⁴

II. COST-OF-MODIFICATION

As noted above, the Civil Code focuses on the "detriment" suffered by the breach victim, limiting the victim's monetary remedy to damages sufficient to compensate for what would have been obtained through "full performance."

Unless the parties are direct competitors — a presumably atypical scenario in the breach of contract setting — the profits earned by the defendant from the breach would not, at first blush, appear to bear any particular relationship to the detriment suffered by the plaintiff.³⁵

Yet, a strong current runs through Restatement Section 39's developmental history³⁶ and is reflected in its comments: that the breacher's profits from an opportunistic breach may well reflect the breacher's simply taking from the victim that which the breacher should have had to pay for. According to comment e, "The purpose of the disgorgement remedy for breach of contract is to eliminate the possibility that an intentional and opportunistic breach will be more profitable to the performing party than negotiation with the party to whom performance is owed." In other words, the breacher's profits presumably exceed what they would have been, had the breacher had to buy its way out of its remaining performance obligation to the breach victim. Comment b explains,

A restitution claim in response to a profitable tort typically operates to protect property from deliberate interference: standard examples include the claim to profits from trespass or infringement. The rule of § 39 extends an analogous protection to contract rights, where what the wrongdoer seeks to acquire is not "property" but the modification or release of his own contractual obligation. The two situations have much in common. Confronted

³³ See § 39 cmt. c ("Disgorgement will be appropriate in many cases where specific performance would not have been available, because specific performance is often denied for reasons having nothing to do with the adequacy of the damage remedy.").

³⁴ § 39 cmt. f.

³⁵ Cf. *Ajaxo v. E*Trade Financial Corp.*, 187 Cal. App. 4th 1295, 1315 (2010) ("Ajaxo was not in competition with E*Trade, so E*Trade's profits would not have reflected profits Ajaxo might have earned instead.").

³⁶ E.g., *Your Loss*, *supra* note 14, at 1390; see also DeLong, *supra* note 15, at 744 ("A promisor who is presented with an opportunity for efficient breach could negotiate with the promisee to be released from the contractual obligation."); Eisenberg, *supra* note 21, at 580 ("[W]here nonperformance would not be morally excused, a promisor who wishes not to perform owes a moral duty of respect to the promisee to seek a mutual accommodation, rather than to unilaterally breach and thereby convert the promise from a voluntary actor to an involuntary litigant.").

with a situation—in either context—in which the appropriate course of action would be to negotiate regarding legal entitlements, the wrongdoer takes without asking. The opportunistic calculation in either setting is that the wrongdoer’s anticipated liability in damages is less than the anticipated cost of the entitlement, were it to be purchased from the claimant in a voluntary transaction.³⁷

Restatement Section 39’s disgorgement-of-profits principle actually goes further than cost-of-modification, and thus further than the Civil Code’s “detriment” measure, in that it permits recovery of the breacher’s profits beyond “the amount that might have been paid to obtain the necessary contractual modification in a voluntary transaction.” As the Restatement would have it, such a limitation would supply an “inadequate incentive to bargain over the entitlement in question.”³⁸ Be that as it may, at least up to the amount the breacher would have had to pay to buy its way out of its remaining obligation, Restatement Section 39 is not inconsistent with the Civil Code. Such a modification would seem tantamount to “full performance . . . on both sides.”³⁹

III. INTELLECTUAL PROPERTY ANALOGS

Intellectual property infringement being in the nature of a tort,⁴⁰ it should come as no surprise that disgorgement of profits has long featured as a remedy in intellectual property law. This is true in the case of federal trademark and unfair competition law, where the defendant is either (a) in competition with the plaintiff, making defendant’s profits from the infringement a proxy for profits plaintiff would have earned but for that infringement, or (b) a willful infringer, in which case disgorgement of profits is awarded in order to deter others from similar theft.⁴¹ It is true under the related law of Lanham Act false endorsement.⁴² It is true in the case of copyright infringement, where the statute explicitly authorizes an award of the infringer’s profits beyond actual damages suffered by

³⁷ Emphasis added, citation omitted.

³⁸ § 39 cmt. e.

³⁹ See CAL. CIV. CODE § 3358 (2019). There would seem to be no material distinction between performance of the original obligation, and a mutually agreed modified obligation, in this context.

⁴⁰ See, e.g., *Goldberg v. Cameron*, 482 F. Supp. 2d 1136, 1144 (N.D. Cal. 2007) (“A claim for copyright infringement sounds in tort . . .”); see also *Secard Pools, Inc. v. Kinsale Ins. Co.*, 318 F. Supp. 3d 1147, 1149 (C.D. Cal. 2017) (claims for trademark infringement, trade dress infringement, and dilution of trademark are “Intellectual Property torts”).

⁴¹ See *Maier Brewing Co. v. Fleischmann Distilling Corp.*, 390 F.2d 117, 122–24 (9th Cir. 1968); see generally 15 U.S.C. § 1117(a) (2008).

⁴² See *Fifty-Six Hope Rd. Music, Ltd. v. A.V.E.L.A. Inc.*, 778 F.3d 1059, 1073–74 (9th Cir. 2015).

the copyright owner.⁴³ It is true under California's right-of-publicity statute.⁴⁴ And it is true of misappropriation of trade secrets, under both federal and California law.⁴⁵

Given the monetary remedy limitations imposed by the Civil Code, one significant challenge is how to calculate the hypothetical cost-of-modification or buyout price the breacher would have to pay the victim to be released from the breacher's remaining (breached) performance obligation.⁴⁶

Here, intellectual property law supplies a specific analog: the "reasonable royalty" which establishes the floor of compensation for patent infringement under 35 U.S.C. § 284. To calculate this reasonable royalty, courts have widely adopted the "hypothetical agreement framework"⁴⁷ from *Georgia-Pacific Corp. v. U.S. Plywood Corp.*,⁴⁸ a 1970 patent infringement case, including fifteen factors to consider in deriving the "royalty rate the parties might have agreed upon in a hypothetical negotiation".⁴⁹

1. The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty.
2. The rates paid by the licensee for the use of other patents comparable to the patent in suit.
3. The nature and scope of the license, as exclusive or non-exclusive; or as restricted or non-restricted in terms of territory or with respect to whom the manufactured product may be sold.

⁴³ 17 U.S.C. § 504(b) (2010).

⁴⁴ Civ. § 3344(a) (2018).

⁴⁵ 18 U.S.C. § 1836(b)(3)(B)(i)(II) (2016); Civ. § 3426.3(a); *see also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 cmt. d (AM. LAW INST. 2011) ("[A] promise not to disclose or utilize confidential information is the usual form by which trade secrets are protected; allowing restitution for breach of the contract is equivalent to restitution for misappropriation of the trade secret.").

⁴⁶ This figure is not only hypothetical, but counterfactual, if the breacher tried but failed to negotiate a release of its remaining contractual obligation.

⁴⁷ *Microsoft Corp. v. Motorola, Inc.*, 795 F.3d 1024, 1040 (9th Cir. 2015).

⁴⁸ *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970).

⁴⁹ *Microsoft*, 795 F.3d at 1041; *see also* *Ajaxo Inc. v. E*Trade Financial Corp.*, 187 Cal. App. 4th 1295, 1308 (2010) (in trade secret misappropriation context, "a reasonable royalty is an attempt 'to measure a hypothetically agreed value of what the defendant wrongfully obtained from the plaintiff. By means of a "suppositious meeting" between the parties, the court calculates what the parties would have agreed to as a fair licensing price at the time that the misappropriation occurred.'" (quoting *Vt. Microsystems, Inc. v. Autodesk, Inc.*, 138 F.3d 449, 451 (2d Cir. 1998)).

4. The licensor's established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention or by granting licenses under special conditions designed to preserve that monopoly.
5. The commercial relationship between the licensor and licensee, such as, whether they are competitors in the same territory in the same line of business, or whether they are inventor and promoter.
6. The effect of selling the patented specialty in promoting sales of other products of the licensee; the existing value of the invention to the licensor as a generator of sales of his non-patented items; and the extent of such derivative or convoyed sales.
7. The duration of the patent and the term of the license.
8. The established profitability of the product made under the patent; its commercial success; and its current popularity.
9. The utility and advantages of the patent property over the old modes or devices, if any, that had been used for working out similar results.
10. The nature of the patented invention; the character of the commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention.
11. The extent to which the infringer has made use of the invention; and any evidence probative of the value of that use.
12. The portion of the profit or of the selling price that may be customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions.
13. The portion of the realizable profit that should be credited to the invention as distinguished from non-patented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer.

14. The opinion testimony of qualified experts.
15. The amount that a licensor (such as the patentee) and a licensee (such as the infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement; that is, the amount which a prudent licensee — who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention — would have been willing to pay as a royalty and yet be able to make a reasonable profit and which amount would have been acceptable by a prudent patentee who was willing to grant a license.⁵⁰

In the patent law context, the *Georgia-Pacific* factors have received exhaustive commentary.⁵¹ Regardless of that gloss, the *Georgia-Pacific* factors supply guidance in analyzing a hypothetical buyout negotiated between the contract obligee (the breach victim or plaintiff, who might be considered as assigning a right to not provide the promised performance), and the contract obligor (the breach perpetrator/defendant, who might be considered the assignee of that right) in our context. Cross-applying the *Georgia-Pacific* factors to our context, the following might be pertinent to the cost-of-modification determination:

- A. How important, or valuable, is the assigned right (promised performance) in the context of the broader bundle of rights and obligations exchanged by the parties in their contract? More specifically, how much less value would obligee have had to convey to obligor to enter into the same contract lacking the promised performance? Would obligee have been willing to enter into that contract at all?⁵²

⁵⁰ *Georgia-Pacific*, 318 F. Supp. at 1120.

⁵¹ See, e.g., Daralyn J. Durie & Mark A. Lemley, *A Structured Approach to Calculating Reasonable Royalties*, 14 LEWIS & CLARK L. REV. 627 (2010); Michael Risch, *(Un)reasonable Royalties*, 98 B.U. L. REV. 187 (2018); J. Gregory Sidak, *Bargaining Power & Patent Damages*, 19 STAN. TECH. L. REV. 1 (2015); Zelin Yang, *Damaging Royalties: An Overview of Reasonable Royalty Damages*, 29 BERKELEY TECH. L.J. 647 (2014); see also Richard F. Dole, Jr., *Statutory Royalty Damages Under the Uniform Trade Secrets Act and the Federal Patent Code*, 16 VAND. J. ENT. & TECH. L. 223 (2014).

⁵² *Georgia-Pacific*, 318 F. Supp. at 1120 (factors 13 and 15); see also *Ajaxo Inc.*, 187 Cal. App. 4th at 1313 (in trade secrets context, “[e]vidence of the negotiations between the parties pertaining to the licensing of Ajaxo’s software and evidence of the price E*Trade paid for the license it

- B. What is the nature and value of obligor's contractual obligation to obligee, in the broader context of obligee's general business or other activity? Put another way, how central is receiving performance of that obligation to obligee's business or activity?⁵³
- C. What is the nature and value of the assigned right (promised performance) to obligor, in the broader context of obligor's general business or other activity? Put another way, how central is the assigned right (to breach the remaining obligation of promised performance) to obligor's business or activity?⁵⁴
- D. Do any other features of the commercial relationship between obligor and obligee impact the price obligee is likely to require, obligor is likely to be willing to pay, or both?⁵⁵
- E. To what extent was obligor's breach necessary in order to earn obligor's profits, and accomplish any other obligor objectives?⁵⁶
- F. How much profit was available to be earned by obligor from breaching, and how much profit did obligor, in fact, earn? How would these figures have changed were obligor required to secure from obligee by agreement the right to "breach," i.e., not render the promised performance?⁵⁷
- G. What has obligee been paid, or been promised to be paid, by others for conveying the same or similar assignments-to-breach in the past?⁵⁸

obtained from Everypath could have served as a starting point for the trial court's estimate of what the parties would have agreed was a fair licensing price at the time the misappropriation occurred").

⁵³ *Georgia-Pacific*, 318 F. Supp. at 1120 (factors 4-6, 9-10).

⁵⁴ *Id.* at 1120 (factor 3, 5-6, 9-10).

⁵⁵ *Id.* at 1120 (factors 3-6, 9-10).

⁵⁶ *Id.* at 1120 (factor 11).

⁵⁷ *Id.* at 1120 (factor 8).

⁵⁸ *Id.* at 1120 (factor 1).

Ed 2]

Disgorgement Of Profits

165

- H. What has obligor paid, or promised to pay, others for such rights-to-breach?⁵⁹
- I. How long will the promised performance impact obligor's and obligee's respective businesses or other activities if kept, and if released (assigned)?⁶⁰
- J. Do facts external to the business or contractual relationship between obligor and obligee indicate the value of the assigned right (promised performance) in obligor's hands? For example, have third parties in obligor's position bought their way out of it, under what circumstances, and at what price?⁶¹

The factors pertinent to any particular cost-of-modification inquiry would, of course, turn on the particular case. The point is that, in the intellectual property context, courts have long applied the disgorgement remedy, and in the particular context of patent law, have long applied a close analogy to cost-of-modification as a measure of that disgorgement.

IV. COURT OR JURY?

This thicket is dense enough under California law to warrant treatment all its own, but here are a few observations:

First, in its assertion that “a claim to disgorgement of profits under § 39 permits some *shaping of the remedy to accord with the equities between the parties*, if only in the measurement of the profits ‘realized . . . as a result of the breach,’”⁶² the commentary to Restatement Section 39 suggests that the disgorgement-of-profits remedy is equitable.⁶³ Courts, not juries, shape remedies according to the equities.⁶⁴

⁵⁹ *Id.* at 1120 (factor 2).

⁶⁰ *Id.* at 1120 (factor 7).

⁶¹ *Id.* at 1120 (factor 12). Care should be taken here to avoid undue inferences from past settlements. See Gregory B. Collins & Andrew F. Halaby, *Of “Purposes Not Prohibited”*: *New Federal Rule of Evidence 408(b)*, 40 CREIGHTON L. REV. 679, 680 (2007) (“Even before [Federal] Rule [of Evidence] 408’s adoption, most courts held that offers of compromise were inadmissible . . . Those relying on . . . irrelevance . . . did so because, they maintained, offers of compromise are made ‘merely to secure peace and avoid the incidents of a legal contest,’ not as admissions of strength or weakness of a party’s case.” (quoting *Brown v. Hyslop*, 45 N.W.2d 743, 748 (Neb. 1951)).

⁶² RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 cmt. i (AM. LAW INST. 2011) (emphasis added).

⁶³ See DAN B. DOBBS, *LAW OF REMEDIES* § 2.1(2), at 50 (“One . . . striking characteristic of equity and equitable remedies is a high degree of discretion.”); see also *Kansas v. Nebraska*, 135 S. Ct. 1042, 1058 (2015) (“[D]isgorgement need not be all or nothing. See, e.g., 1 D. DOBBS, *LAW OF*

Second, the California constitutional jury trial right⁶⁵ has been held to extend only to claims triable, or the “gist” of which would have been triable, at common law in 1850, when the California constitution was adopted.⁶⁶ It also has been held that “the legal or equitable nature of a cause of action ordinarily is determined by the mode of relief to be afforded.”⁶⁷ These holdings leave considerable uncertainty where disgorgement-of-profits, which bears some similarity to the equitable accounting,⁶⁸ is sought for breach of contract,⁶⁹ historically an action at law.⁷⁰

Third, though they do so only rarely, California judges have discretion, in actions at equity, to take advisory jury verdicts on contested fact issues.⁷¹ Given

REMEDIES § 2.4(1), p. 92 (2d ed. 1993) (‘Balancing of equities and hardships may lead the court to grant some equitable relief but not’ the full measure requested); Restatement § 39, Comment *i*; *id.*, § 50, Comment *a* In exercising our original jurisdiction, this Court recognizes that ‘flexibility [is] inherent in equitable remedies’ and awards them ‘with reference to the facts of the particular case.’”). *But see id.* § 4 (denying that Restatement’s remedies necessarily are legal or equitable).

⁶⁴ See, e.g., *A-C Co. v. Security Pac. Nat’l Bank*, 173 Cal. App. 3d 462, 473 (1985) (“The tradition and heredity of the flexible equitable powers of the modern trial judge derive from the role of the trained and experienced chancellor and depend upon skills and wisdom acquired through years of study, training and experience which are not susceptible of adequate transmission through instructions to a lay jury.”).

⁶⁵ CAL. CONST. art. I, § 16.

⁶⁶ See *C&K Eng’g Contractors v. Amber Steel Co.*, 23 Cal. 3d 1, 8–9 (1978).

⁶⁷ *Id.* (quoting *Raedeke v. Gibraltar Sav. & Loan Ass’n*, 10 Cal. 3d 665, 672 (1974)); *Martin v. County of Los Angeles*, 51 Cal. App. 4th 688, 695–96 (1997) (“The form of relief sought in the complaint, although not wholly determinative, is a reliable indicator of the ‘gist’ of the action. Thus, ‘Actions at law *usually* seek a money judgment for damages, while equitable actions seek some form of specific relief and equity decrees are *usually* in personam.’” (quoting 3 WITKIN, CAL. PROCEDURE (3d ed. 1985) ACTIONS, § 77 at 105)).

⁶⁸ See *Van de Kamp v. Bank of America*, 204 Cal. App. 3d 819, 865 (1988) (“The amount of defendant’s liability to plaintiffs, if any, was not definite and clear and would have to be established by an accounting. This indicates the action is equitable rather than legal.”); compare *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 478 (1962) (under federal law, characterizing equitable accounting as limited to accounting matters so complicated as to require court of equity to “satisfactorily unravel them”); DOBBS, *supra* note 63, § 4.3(5), at 408–10 (citing *Van de Kamp* and discussing *Wood*).

⁶⁹ See, e.g., *American Master Lease LLC v. Idanta Partners, Ltd.*, 225 Cal. App. 4th 1451, 1483–84 (2014) (noting in *dicta*, regarding claim for disgorgement of profits for aiding and abetting breach of fiduciary duty, that “[w]here liability is definite and damages may be calculated without an accounting, the action is legal”); *Jogani v. Superior Court*, 165 Cal. App. 4th 901, 909–10 (2008) (distinguishing *Van de Kamp* and holding plaintiff entitled to jury trial on *quantum meruit* claim notwithstanding that “restitution can be a legal, as opposed to equitable, remedy” while noting that plaintiff’s prayer for relief “does not seek a disgorgement of profits”); *Van de Kamp*, 204 Cal. App. 3d at 862–65.

⁷⁰ *C&K Eng’g Contractors*, 23 Cal. 3d at 9.

⁷¹ *Hoopes v. Dolan*, 168 Cal. App. 4th 146, 156 (2008); WEGNER ET AL., CALIFORNIA PRACTICE GUIDE CIVIL TRIALS & EVIDENCE § 2:171 (Oct. 2018 Update).

the uncertainty over whether disgorgement-of-profits for breach of contract would require a jury trial, the Rutter Guide's commentary resonates:

When [advisory juries] are used, it is often where there is a doubt whether a particular cause of action (among many) is legal or equitable. Using an advisory jury, but not informing the jury that its verdict is only advisory, allows the judge to avoid the automatic reversal that would follow if the judge was wrong about the right to a jury trial. (This does not work, however, where the judge disagrees with the verdict . . . in which case, the court must "bite the bullet" regarding jury entitlement.)⁷²

"Bullet-biting" occasions may arise, since the court sitting in equity must conduct its own independent evaluation and decide fact issues for itself.⁷³

V. HYPOTHETICALS

Unsurprisingly, Restatement Section 39 itself supplies a number of illustrations of its broader disgorgement principle, and these are worth reading. Here, we supply a few other hypotheticals illustrating its application with the cost-of-modification limitation.

Hypothetical 1: Alpha Corporation, which sells widgets, agrees to let Beta join its independent contractor sales network. Alpha competes vigorously with other widget companies not only in selling widgets to consumers, but in securing the services of skilled widget salespersons. Alpha agrees to compensate Beta handsomely for Beta's sales efforts (and success) but obtains Beta's agreement that Beta will not recruit other members of Alpha's salesforce to any other widget seller. Assume that such agreements are standard in the industry, do not unduly restrain competition, and are lawful in California.⁷⁴ Moreover, the other members of Alpha's salesforce have agreed to, and expect all members to comply with, this non-solicitation term, and given its importance to Alpha's salesforce and business model, Alpha would not have entered into a contract with Beta absent Beta's agreement to the term. Beta breaches this obligation by joining Gamma Corp's salesforce and recruiting his former colleagues at Alpha to join him at Gamma, knowing how critical his non-solicitation obligation was to Alpha yet also knowing it is unlikely Alpha can prove damages directly flowing from breach of that obligation with reasonable certainty. Had Beta asked Alpha before

⁷² WEGNER ET AL., *supra* note 71 at § 2:171.

⁷³ A-C Co. v. Security Pac. Nat'l Bank, 173 Cal. App. 3d 462, 474 (1985).

⁷⁴ In AMN Healthcare, Inc. v. Aya Healthcare Servs., Inc., 239 Cal. Rptr. 3d 577 (2018), the Court of Appeal held invalid under California Business & Professions Code § 16600 a non-solicitation clause applying to travel nurse recruiters. At this writing, *AMN Healthcare* has yet to be applied beyond its specific facts.

joining Gamma for a release from the non-solicitation term, Alpha would have demanded $\$X$, which is less than the $\$Y$ in profits Beta earned from breaching. Under the *Georgia-Pacific*-based cost-of-modification factors, above, Beta would have paid $\$X$ for the desired release.

Under Restatement Section 39 and the Civil Code, Beta is liable to Alpha for $\$X$ — the cost-of-modification Beta would have (and should have) paid, but did not.

This is a good point to acknowledge one potential critique of the cost-of-modification limitation proffered here: *Any* breach victim — not just the victim of a breach profitable to the breacher — could assert that the victim has suffered “detriment” in the form of $\$X$, the amount the victim would have required to release the breacher from liability, yet no one would seriously consider viable such an *ipse dixit*-based remedy. One response is that the breacher was able to earn profits shows that the breacher did in fact take something real from the victim: the value of the victim’s (uncompensated) right to performance which evidently (or there would be no causation) was indispensable to the breacher’s successful pursuit of profit. Without the “detriment” suffered by the victim, in other words, the breacher could not have profited.

Hypothetical 2: Same as Hypothetical 1, but Beta made no profits from Beta’s breach of the non-solicitation term. In other words, $\$Y$ equals zero. Because Beta has no profits to disgorge, Alpha is entitled to no remedy under Restatement Section 39. Alpha must resort to other means to prove entitlement to a monetary remedy.

Hypothetical 3: Same as Hypothetical 1, but Alpha would have demanded $\$Z$, an amount greater than Beta’s profits from the breach ($\$Y$), to release Beta from Beta’s non-solicitation obligation.

Here, because the cost-of-modification Alpha would have demanded exceeds Beta’s profits from the breach, Restatement Section 39’s limitation of Alpha’s remedy to Beta’s profits operates as a cap on Alpha’s monetary remedy. An interesting question is whether, applying the cost-of-modification factors — particularly F — allows Alpha to recover *all* of Beta’s profits $\$Y$. It is true that such an award would nullify Beta’s gain from the breach entirely, creating an arguable anomaly in the cost-of-modification calculus since Beta presumably would walk away from the hypothetical negotiation if the price of buying out Alpha made acquiring the right to “breach” pointless. But that anomaly exists only by applying hindsight. It is possible that, confronted with a demand by Alpha to be paid $\$Z$, Beta could have extracted still greater revenue from Gamma so as to preserve Beta’s profit $\$Y$ or some portion of it. In patent infringement, the reasonable royalty a patentee may be awarded is not necessarily limited to the infringer’s profits from the infringement.⁷⁵ In any event, as noted above, the court

⁷⁵ See, e.g., *Golight, Inc. v. Wal-Mart Stores, Inc.*, 355 F.3d 1327, 1338 (Fed. Cir. 2004).

Ed 2]

Disgorgement Of Profits

169

has flexibility to take not only Factor F, but all the cost-of-modification factors, into account in determining the amount to award to Alpha.

CONCLUSION

Restatement Section 39's disgorgement-of-profits remedy for breach of contract is relatively new. Applied to the limit of the hypothetical cost to the obligor/breacher to modify the parties' contract to permit what otherwise was a breach, however, the disgorgement-of-profits remedy does not appear inconsistent with longstanding provisions of the California Civil Code. The law of intellectual property may inform disgorgement principles in the breach of contract context, with the foregoing cost-of-modification factors derived from patent law supplying particular guidance as California breach-of-contract litigants, their counsel, and courts consider this new prospective remedy.