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Determining Your Royalty Base Under Section 271

Law360, New York (November 05, 2010) -- Patent damages jurisprudence is evolving at a rapid pace, both through U.S. Court of Appeals for the Federal Circuit opinions such as Lucent v. Gateway and ResQNet.com v. Lansa, and federal district case law like Cornell v. Hewlett-Packard Co. and IP Innovation v. Red Hat.

Courts have challenged patentees, attorneys and damages experts to more thoroughly support opinions as to the royalty rate through more sound economic proof, evidence of extent of use and precise apportionment of an infringer's profits. Courts are also looking closely at the royalty base, through rigorous analysis of the entire market value rule and inquiry into the smallest saleable unit.

As a patentee, these analyses may require extensive discovery and expert costs in litigation, and so it is important to identify components of a potential royalty base that offer the highest relative predictability in the early stages of a monetization strategy. One such factor is the extent of infringement that can be attributed to the U.S. under the territorial limits proscribed by 35 U.S.C. § 271.

Patentees and potential litigants should attempt early in the forensic stage to ascertain the true extent of infringement — in other words, the extent of use made of the invention for which recovery can be had — and the true measure of harm that is attributable to sale, offer for sale and manufacture or importation within the U.S. Ideally, this exercise will yield a potential royalty base that, when applied against a conservative royalty rate, results in a recovery that far outweighs the cost of litigation and justifies initiating suit on behalf of one or several patents.

The geographical limitations imposed by 35 U.S.C. § 271 can play a critical factor in the size of a potential royalty base, especially where alleged infringers conduct global activities. The relevant text of this statute provides the following:

“Except as otherwise provided in this title, whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefore, infringes the patent."

While making, using, offering to sell, selling or importing infringing products into the U.S. seem like straightforward concepts, it often will not be clear how the practical details of where accused activities take place relate to the statute. This is especially so where defendants are global conglomerates, or even just domestic companies with certain overseas operations or customers.

And in today's global, Internet-driven economy, this includes just about everyone who would be a patent litigation target.

Ultimately, § 271 circumscribes the scope of the royalty base, and it can establish a large gap between a foreign or multinational corporation's prosperous annual reports and the amount of revenue on which the patentee can actually collect.

As a hypothetical example, consider a patent with asserted apparatus and method claims. The defendant is believed to be both selling products that infringe the apparatus claims and performing processes that infringe the method claims.

The defendant has manufacturing facilities both in the U.S. and overseas, sells products manufactured in the U.S. to overseas customers, sells products manufactured overseas to U.S. customers, and does so interchangeably with both overseas and domestic-based subsidiaries through offices and sales channels located throughout the world.

Not only is this example not far fetched, but it probably covers the bulk of large-scale patent litigation currently docketed, and as patent litigators, we have our work cut out for us to categorize these various activities as either falling within some ambit of 35 U.S.C. § 271 or falling outside the scope of the statute altogether.

Case law offers limited guidance beyond the statute itself, but, importantly, the limited precedent on determining the situs of an infringing sale or activity under § 271 leaves plenty of room for interpretation.

Litecubes v. Northern Lights Prods (Fed. Cir. 2008) involved an American plaintiff with rights to artificially illuminated, novelty ice cubes. The Canadian-based defendant sold allegedly infringing ice cubes to American customers. The defendants moved for judgment as a matter of law that its products did not infringe under section 271 because they were shipped "f.o.b." (or "free on board," meaning that the buyer bears all costs and risk of loss or damage) with legal title changing hands in Canada before being physically moved across the border.

The district court denied JMOL and the Federal Circuit affirmed, holding that there was substantial evidence supporting the finding that sales took place within the U.S. Customers in the U.S. contracted for the accused ice cubes, and the ice cubes were delivered directly to these U.S. customers.

The Litecubes court relied somewhat on MEMC Elec. Materials v. Mitsubishi Materials Silicon (Fed. Cir. 2005), where sales were found not to have taken place in the U.S. under § 271 because, in part, "there was no evidence that 'contracting and performance' took place in the United States."

On the contrary, "all of the essential activities" of the allegedly infringing sales took place in Japan. Litecubes found the circumstances of the sales of accused ice cubes to be in contrast to those in MEMC, and this in part aided its decision to uphold the denial of JMOL.

The Federal Circuit recently revisited this area of law in Transocean Offshore Deepwater Drilling Inc. v. Maersk Contractors USA Inc. That case involved patents related to an apparatus for conducting offshore drilling. While much of the infringing activity took place through contracts signed overseas, the accused product was to be delivered and used in the U.S.

The Federal Circuit thoroughly discussed liability for both an "offer to sell" and a "sale" in the U.S., and its analysis was couched in both the language of § 271(a) and its previous holding in Lightcubes.

Importantly, the Federal Circuit held that an offer made overseas by a U.S. company to another U.S. company to sell a product in the U.S. for delivery and use in the U.S. constituted an offer to sell under § 271(a).

The Federal Circuit buttressed its holding with policy, stating that "[t]he focus should not be on the location of the offer, but rather the location of the future sale that would occur pursuant to the offer." A company traveling abroad to make offers to sell "would generate interest in its product in the U.S. to the detriment of the U.S. patent owner ... These acts create a real harm in the U.S. to a U.S. patentee."

In line with this policy, and consistent with its holding in Lightcubes, the Federal Circuit held further that a contract between two U.S. companies for the sale of a patented invention where delivery and performance are to occur in the U.S. constitutes a sale under § 271(a) as a matter of law.

In contrast to Transocean, Judge David Folsom in the Eastern District of Texas recently held in Ion Inc. v. Sercel Inc. that there could be no liability for offers for sale that fell within the plaintiff's royalty base. In Ion, the sales at issue were sales of products shipped from Sercel in France to customers in Venezuela, Brazil and Canada.

Although the accused products were manufactured in Europe and shipped directly to the forementioned customers without touching U.S. soil, plaintiff argued that Sercel quoted prices from its offices in Houston, that orders were received in Houston, and that payment was received in Houston in U.S. dollars.

The crux of the dispute, therefore, was whether these activities in Houston, characterized as "domestic offers for foreign sales," fell within the scope of U.S. patent protection. Judge Folsom held, as a matter of law, that they did not, noting that Transocean did not control because that case instead concerned "foreign offers for domestic sales."

Judge Folsom relied on Transocean's holding that "the focus should not be on the location of the offer, but rather the location of the future sales that occur pursuant to the offer." The key difference between Transocean and Ion thus appears to be the eventual intended location of the delivery.

In Transocean, where liability attached to the offer for sale, that location of sale was the U.S., while in Ion, where no liability attached to the alleged offer, those locations of sale were overseas.

Similar to these cases, plaintiffs evaluating a new matter may be aware of a wealth of domestic or foreign contracting for certain sales that might be included in a potential royalty base. It would be wise, however, to seriously evaluate both the language of § 271 and the opinions discussed herein before adding those sales to a potential royalty base to determine the value of a case.

In addition, plaintiffs need to identify who the target's biggest customers are and whether they are U.S.-based. If the potential target is foreign-based, but known to supply large volumes of infringing product to U.S. retailers or U.S. companies incorporating infringing components into other products, this could yield positive results for a royalty base.

On the other hand, the target could be U.S.-based but sell a large amount of infringing product overseas, and, depending on the facts of the matter, you may not be able to capture such sales.

To this end, plaintiffs must also be extremely attuned as to whether potential defendants manufacture or merely sell infringing products in the U.S. A defendant company dealing in smaller volumes and with a smaller market share can nonetheless rival "bigger" firms and contribute more significantly to a potential royalty base if it manufactures domestically.

Even if a target company's biggest customers are overseas, every product coming out of a domestic factory will infringe, and perhaps more importantly, it will be easier for the plaintiff to prove the connection to the U.S. through such manufacturing activity.

Conceptually, the act of infringement is complete when manufacture is complete. Larger companies with greater sale volumes get more attention, but as discussed here, connecting a sale to a situs may not be a straightforward exercise.

Any discovery plan designed to bolster and prove the substance of a potential royalty base should address head-on § 271 and the geographic situs of infringing activity. Some questions you may consider are:

1) Did the defendant company sell the infringing product at a brick-and-mortar storefront in the U.S., or did the defendant company sell infringing product over the Internet?

2) In what country was the revenue for the infringing product recognized? Was it recognized by the defendant's domestic subsidiary or its foreign headquarters?

3) Where was the invoice sent?

4) Were contracts for a large number of infringing products negotiated in the U.S. or overseas?

5) Were telephone orders placed in the U.S. or overseas?

6) How large are defendants' foreign manufacturing facilities as compared to domestic?

7) How are domestically manufactured products distributed to subsidiaries and customers?

8) How are large and small customers dealt with?

These are just some examples. Plaintiffs will need to carefully examine the nature of the defendants' business and product offerrings when drafting their initial round of discovery.

Having thought out these crucial issues from the beginning, you will probably have a significant leg up on your opponent as you develop a discovery plan. Your first round of requests for production and interrogatories can include scores of questions and demands related to the issues above, and your experts can have an early appreciation of the type of information you are seeking and what may eventually end up in a damages report.

Most important, you will be in a position to strategize early about executing your demand for production of the defendant's sales data and assembling the right people to parse and analyze it. The costs of retaining people with such skills should be specifically factored into your litigation cost model.

Armed with the correct personnel, you will need to aggressively push the defendant for explanations about its sales data early and often in the discovery period, and if the opportunity presents itself, to stipulate to legal issues or factual aspects regarding the nature of the sales data or the composition of the base.

The considerations above are numerous and at times painstakingly detailed, but they will allow you to descend from the abstract world that most patentee plaintiffs inhabit when estimating a target royalty base.

Instead, you will have a fleshed-out and highly realistic picture of the use made of your client's invention that is attributable to harm in the U.S. for which recovery can be made. This preparation will benefit your client, your experts, your team during fact discovery, expert discovery, trial and the celebration after victory.

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