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The Sword and the Shield—How Recent Developments in Patent Damages Law Can Help Your Case as Both a Defendant and a Plaintiff



BY SAMUEL L. WALLING, WILLIAM H. MANNING,
JACOB S. ZIMMERMAN, TONY G. BEASLEY, AND
AARON R. FAHRENKROG

I. Introduction.

The past two years have seen significant evolution in patent damages law. A line of cases beginning with *Cornell University v. Hewlett-Packard Co.*, No. 5:01-cv-01974 (N.D.N.Y. March 30, 2009), and continuing through (most recently) *Uniloc USA Inc. v. Mi-*

Samuel L. Walling, William H. Manning, Jacob S. Zimmerman, Tony G. Beasley, and Aaron R. Fahrenkrog are patent trial lawyers with Robins, Kaplan, Miller & Ciresi, Minneapolis.

crosoft Corp., 632 F.3d 1292, 98 USPQ2d 1203 (Fed. Cir. 2011) (81 PTCJ 275, 1/7/11), has heightened the scrutiny with which courts approach reasonable royalty damages as calculated by the appropriate royalty base (entire market value rule) and royalty rate (comparable licenses, apportionment, or 25 percent rule). The conventional wisdom is that the progression of case law has inured almost exclusively to the benefit of accused infringers, by making it more difficult for patent holders to obtain large damages verdicts. But these cases present opportunities for patent holders as well, by providing patent holders with a framework for constructing a more persuasive damages case.

Thus, the astute litigator can use the current state of damages law as both a shield against unreasonably high damages awards, and as a sword that can drive high-value patent damages recoveries.

II. Summary of Evolution in Patent Damages Law.

The most noticeable progression in patent damages law began at the district court level, where Judge Randall R. Rader, now chief judge of the U.S. Court of Appeals for the Federal Circuit, was sitting by designation. In this role, Rader was able to directly exercise the gatekeeping function that he has since urged district court judges to undertake more rigorously.

The Federal Circuit has amplified this message in a series of landmark decisions scrutinizing the sufficiency of damages evidence. Collectively, these decisions have reframed the patent damages analysis.

Cornell: Entire Market Value Rule

Sitting with the U.S. District Court for the Northern District of New York in March 2009, Rader granted judgment as a matter of law in *Cornell v. Hewlett-Packard* that the reasonable royalty damages awarded by the jury were incorrect. The jury had wrongly premised its award on a royalty base that consisted of the entire market value of defendant Hewlett-Packard's "CPU bricks." The accused feature, however, was contained entirely within the CPU which was itself within those bricks.

Under the entire market value rule, Rader held, a patentee can include the entire price of a product containing an infringing component in the royalty base *only* if that component was the basis for customer demand. Otherwise, the royalty base must be limited to the "smallest saleable unit."

Lucent and ResQNet: Comparable Licenses

In September 2009, the Federal Circuit issued its watershed decision in *Lucent Inc. v. Gateway Inc.*, 580 F.3d 1301, 92 USPQ2d 1555 (Fed. Cir. 2009) (78 PTCJ 583, 9/18/09), striking down a jury's damages award of nearly \$360 million and in doing so addressing several aspects of reasonable royalty damages.

The court of appeals focused most rigorously on the patentee's reliance on four license agreements to support its royalty rate of eight percent for infringement of a patent that read on the "date-picker" function in Microsoft Outlook. These licenses, however, were "radically different" from the hypothetical license between Lucent and Gateway, in terms of both economic circumstances and technological subject matter.

The court criticized Lucent's characterization of the licenses as covering "PC-related patents," "as if personal computer kinship imparts enough comparability to support the damages award," and held that it was the patentee's burden to show that license agreements are "sufficiently comparable" to the circumstances of the case.

The *Lucent* court criticized the lack of evidence regarding several other *Georgia-Pacific* factors, including Factor No. 10, related to the benefits of the invention, Factor No. 11, related to the extent of use of the invention by the accused infringer, and Factor No. 13, related to the portion of profit that should be attributed to the invention as opposed to contributions made by the accused infringer.

The court's remarks with respect to Factor No. 11 were particularly scathing: "[W]e observe that the evidence of record is conspicuously devoid of any data

about how often consumers use the patented date-picker invention."

The Federal Circuit levied similar criticisms in its February 2010 decision in *ResQNet.com Inc. v. Lansa Inc.*, 594 F.3d 860, 93 USPQ2d 1553 (Fed. Cir. 2010) (79 PTCJ 422, 2/12/10), vacating a damages award of over \$500 million in reasonable royalties. As it did in *Lucent*, the court faulted the patentee's damages expert for using "licenses with no relationship to the claimed invention" to establish a baseline royalty rate of 12.5 percent.

IP Innovation: Exercise of Gatekeeping Function Under Daubert

Sitting by designation in the Eastern District of Texas in March 2010, Rader issued a decision in *IP Innovation LLC v. Red Hat Inc.*, 705 F. Supp. 2d 687 (E.D. Tex., 2010), excluding the testimony of the patentee's damages expert for failure to adhere to *Daubert* standards. In exercising his gatekeeping function, Rader criticized the patentee's damages methodology on two fronts: (1) failure to establish that the patented feature (a work-space switching feature) was the basis for consumer demand for the accused products (copies of Linux, a computer operating system); and (2) failure to establish that relied-upon licenses were comparable in circumstances and technology.

As a result, Rader held that the damages expert's report "improperly inflate[d] both the royalty base and the royalty rate by relying on irrelevant or unreliable evidence and by failing to account for the economic realities of this claimed component as part of a larger system."

Uniloc: 25 Percent Rule and EMV Rule Revisited

Most recently, the Federal Circuit issued a decision in *Uniloc v. Microsoft* that was again critical of a patentee's damages opinion.

This time, however, the flaw related not to use of non-comparable licenses, but from the expert's use of the "25 percent rule of thumb," whereby Uniloc's expert assumed that 25 percent of the infringer's accused product profits should be attributed to the claimed invention. The opinion, authored by Rader, carefully chronicled the history of the 25 percent rule, its use by experts in the field, and its "passive toleration" by courts—including the Federal Circuit—before explaining why the 25 percent rule of thumb is arbitrary and unreliable.

The court held that the 25 percent rule is a "fundamentally flawed tool for determining a baseline royalty in a hypothetical negotiation" and that evidence relying on the 25 percent rule is "inadmissible under *Daubert* and the Federal Rules of Evidence."

Uniloc also endorsed a strict interpretation of the entire market value rule. While the accused product was the entire Windows operating system, the patentee's expert attempted to comply with the entire market value rule by building his royalty base from a unit price related to product activation keys—a subset of the Windows operating system.

Where Uniloc's expert ran afoul of EMV rule, however, was in offering to the jury a "reasonableness check" that compared the proposed award of nearly \$565 million to Microsoft's total Windows-related revenues of over \$19 billion. The \$19 billion represented

the entire value of the Windows operating system. Uniloc, however, did not show that it was entitled to recover against the entire value of the product by first establishing that the invention was the basis for consumer demand of the entire Windows operating system.

Despite a curative instruction, the EMV rule “cat was never put back into the bag,” even through cross-examination.

It is important to note that most of the decisions listed above are not changes to damages law. The Federal Circuit made clear in both *Lucent* and *Uniloc*, for example, that its application of the entire market value rule derives from precedent over a century old. See *Lucent*, 580 F.3d at 1336-37; *Uniloc*, 98 USPQ2d at 1225 (both tracing the origins of the EMV rule to several Supreme Court cases, including *Garretson v. Clark*, 111 U.S. 120 (1884)).

The only decision that can truly be said to be a change in the law is *Uniloc*'s express renouncement of the 25 percent rule as an acceptable methodological tool. Nonetheless, these decisions, which demand closer scrutiny of economic evidence and analysis in determining reasonable royalty damages, have had the effect of changing how patent litigants approach the issue of damages in their cases.

III. Defendants Can Use These Developments as a Shield to Minimize Exposure and Avoid Verdicts That May Not Reflect the Economic Value of the Patented Invention.

The cases that form the backbone of this rapid progression in damages law have an unmistakable common thread in that they challenge patentees to do better in presenting their damages model and provide a roadmap for defendants in preparing their damages rebuttal case. These developments, along with other long-standing damages principles, can thus serve as a “shield” in patent litigation where a reasonable royalty award is demanded. The shield, as it were, has several components that can affect both the royalty base and royalty rate sides of the damages equation.

First, defendants, where appropriate, should always seek to establish the smallest saleable unit in accused product sales and carefully analyze what evidence either supports or contradicts a claim that the patented feature serves as the basis for customer demand of a larger product. Defendants might also consider targeted discovery directed to the patentee's contention that its invention is the basis for consumer demand.

It is the patentee's burden to establish entitlement to a royalty on the entire value of an accused product. It is the defendant's job to hold the patentee to that burden.

Second, defendants can use these changes and clarifications to push for a damages model that carefully considers the concept of apportionment between patented and unpatented features as discussed in *Uniloc*. This apportionment can be done on either the royalty base or royalty rate, depending on the technology at issue and the facts of the case.

The apportionment should always be done with an eye to the economic realities of the accused product, the marketplace for that product, and how the accused feature affects (or does not affect) the product's performance in the marketplace. When evaluating the rate, recognize that the option for a patentee's expert to sim-

ply commandeer 25 percent of the accused infringer's profits to establish a baseline royalty is gone.

Defendants should take advantage of the stricter scrutiny with which courts must now approach royalty rate opinions, especially where the invention relates to a “minor” component or feature of a sophisticated product that might encompass hundreds or thousands of potentially patented inventions.

Third, defendants should carefully consider what license agreements the patentee will likely rely on to support at a substantial royalty rate and evaluate whether those licenses would be considered “sufficiently comparable” under *Lucent* and *ResQNet.com*. These cases encourage a narrower focus on what licenses may fairly be compared to the hypothetical negotiation, which could either go for or against the defendant's favor, depending of course on the particulars of the licenses at issue.

Where possible, particular attention should be paid to the claims of the patents in licenses alleged to be for similar technology. Technical expert testimony on similarity or dissimilarity between licensed patent claims and asserted claim(s) of the patent(s)-in-suit might be powerful evidence, especially where the other side has not taken care to undergo a similar analysis.

Fourth, defendants should always consider the availability of any arguments that they could have designed around the patent, or, in other words, adopted the closest noninfringing alternative, at the time of the hypothetical negotiation. While the availability of design-arounds has long been a central issue in patent cases involving lost profits damages, district courts have more recently applied the design-around framework expressly in reasonable royalty cases. See *LaserDynamics Inc. v. Quanta Computer Inc.*, No. 2:06-cv-348-TJW (E.D. Tex. Jun. 9, 2010) (79 PTCJ 327, 1/22/10).

Defendants should be prepared, however, to do more than simply state that a design-around would have been available. Just as in a lost profits case, a defendant should be prepared to present evidence that the defendant possessed all of the necessary know-how, equipment and experience to implement that design-around at the time of the hypothetical negotiation.

Fifth, defendants would be well advised to take a cue from *Lucent*'s admonishment of the patentee for its failure to put forth evidence of extent of use. Although it is the patentee's burden to make such a showing, defendants should consider well in advance of expert disclosures what evidence the patentee may offer regarding extent of use and how to counter that evidence. Market research data and consumer surveys may be potentially valuable sources of evidence showing that the invention is not used very often.

Finally, and perhaps most importantly, defendants should always keep in mind that it is the patentee's burden to put forth evidence and support its reasonable royalty damages model. There are several pitfalls, some of which are identified above, that the patentee's damages expert can step into and thus, several areas for defendants to attack in rebuttal reports, *Daubert* motions, motions in limine, or on cross-examination. On the other hand, it is critical for defendants to employ a damages expert that appreciates the changes in law, keeps apprised of the law, and can correctly and flexibly apply the concepts urged by the courts in his or her analysis.

IV. Plaintiffs Can Use These Developments as a Sword to Crystallize and Showcase the Benefit of the Invention.

The silver lining to the enhanced scrutiny mandated by *Cornell*, *Lucent*, *Uniloc*, etc., is that the cases can serve as a roadmap for building a damages theory that will both persuade a jury and withstand appellate review.

In particular, the cases compel patent holders to rigorously assess the asserted patent in an effort to definitively identify both the claimed invention and its purported benefits. These determinations are not only essential to establishing the appropriate royalty base and royalty rate, they are also critical to clearly and credibly explaining to the jury what was invented and why it is important.

The first step in this process is to isolate the claimed invention. Is it a complete system? A component of a system? A component of a component of a system?

Resolving these questions is central to identifying the “smallest saleable unit” in the accused product as required by *Cornell*, which will be used for calculating the royalty base. Because overreaching in this area can have harsh consequences, as illustrated by the reduction of the damages award in *Cornell* and the exclusion of expert damages testimony in *IP Innovations*, the bounds of the invention should be precisely drawn.

The second step is to identify the benefits of the invention. Does the invention make something faster? Smaller? Stronger? More efficient? To what are these qualitative measurements being applied?

The answers to these questions will provide a lens for assessing how the marketplace values the purported improvements. This assessment should include an analysis of the non-infringing alternatives available at the time of the hypothetical negotiation, and licenses for comparable technologies according to *Lucent* and *ResQNet*.

With respect to the latter inquiry, it is important to point out that patent holders should not delay analyzing comparable licenses until the last minute. Evaluation of comparable technology is a time-consuming process that involves a careful reading of the claims in the covered patents, and collaboration between the attorneys and the technical and damages experts. Thus, comparable licenses should be obtained and analyzed early in the case.

Although *Lucent* and *ResQNet* are typically cited in the context of limiting patentees’ reliance on licenses, the same analysis can be used by the patentee to eliminate the potential for the infringer to rely on low value licenses to decrease the royalty rate. *Lucent* and *ResQNet.com* require evidence that a license involved similar technology and economic factors whenever such a license is being used as a comparable, not merely when the patentee is doing so.

Identifying the benefits of the invention will help the patentee to ensure that the analysis supporting the damages testimony focuses on the correct measure of damages. For example, a survey expert should focus the survey on an evaluation of the benefits of the claimed invention. By identifying and crystallizing the

benefits early in the process, the patentee can prepare supporting analysis such as regression analysis or survey evidence that is narrowly tied to the benefits of the asserted patent claims.

The marketplace assessment should also examine the extent to which the benefits of the invention drive sales of the accused product as reflected by the accused infringer’s marketing activities. For example, is the purported benefit a feature that the accused infringer heavily promotes, or does not mention at all? This inquiry will inform the portion of the accused infringer’s profits that are attributable to the claimed invention pursuant to *Uniloc*.

Bear in mind that an invention’s benefits may not have been contemplated or appreciated by the inventor(s) at the time of the invention. In other words, when developing the benefits of the invention it is important to look beyond the language of the patent itself, and to look instead to how the claimed invention operates in the real world, especially at or around the time of the hypothetical negotiation.

This is a tremendous opportunity to build value because the greater the benefit that one can credibly attribute to the invention, the higher the royalty rate that one can ultimately assign to the use of invention. Thus, whereas precision is an important aspect of defining the invention, creativity and imagination are important aspects of applying the benefits of the invention.

Although these exercises may seem elementary, they are essential entry points to forming a precisely stated and well supported damages theory. Isolating the invention allows your damages expert to apportion the revenues for the accused products and to build the appropriate royalty base. Defining the benefits of the invention allows your expert to place the invention in the proper marketplace context, to apportion the profits for the accused products, and to determine the proper royalty rate.

Melding these concepts into a “statement of the invention” allows you to clearly and persuasively communicate the essence and value of the invention to the ordinary fact-finders that will be deciding your case.

The end result is a rock-solid damages theory that helps insulate your expert from *Daubert* challenges, and gives you the best shot at obtaining a sustainable jury verdict in your favor. In other words, it gives you significant leverage toward settling the case on favorable terms, with the added benefit of avoiding the risk and expense associated with trial and appeal. In this way patent damages law, when wielded appropriately, can be a sword as well as a shield.

V. Conclusion.

At first glance, the recent evolution in damages law appears to be a boon to defendants. Much of the commentary discussing the decisions that have driven this evolution has only amplified that perception.

But a deeper look shows that the case law is not so one-sided, and provides compelling opportunities for each side of a patent litigation suit. Thus, in its present state damages law can act as a sword or a shield—it just depends on how one chooses to use it.