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Significant Patent Damages Cases Will Lead To More Rigorous Damages Proof [1]

by Lance E. Gunderson[2], Benjamin A. Keller[3], and Daniel J. Melman[4]

Damages have often been a figurative afterthought in the rough and tumble world of patent litigation. Clients and litigators are so focused on proving infringement and validity that damages can be de-emphasized. The same can be said about court decisions. Of the patent opinions issued by the Court of Appeals for the Federal Circuit from June 2008 through June 2010, only 22 addressed damages. [5] Some would argue that in recent times, this number has increased relative to the number of damages-related opinions issued in the 1980s and 1990s. More recently, however, it is clear that the Federal Circuit has signaled a renewed emphasis on damages proof. This article focuses on two recent Federal Circuit decisions and one District Court decision (in which a Federal Circuit judge wrote the opinion) which suggest that more damages proof will be required, and then offers some practical observations to IP litigators, experts, and clients on preparing and presenting their damages cases.

Cornell University v. Hewlett-Packard Company: Without Economic Evidence of Entire Market Value, the Lowest Salable Unit Should Be Used as the Royalty Base

Many a plaintiff has hoped to get the biggest number possible in front of a jury, realizing that even a small fraction of a significant royalty base would result in a large damages award. Certainly, to the extent the patent has contributed to the sales of a wildly successful product, the patent owner should be compensated for such success. Courts, however, are increasingly acknowledging that unless it can be proven that the patented feature is the basis, or at least a substantial basis, for the demand of the product as a whole, the value of the entire device should not be used as the royalty base. Such analysis has been deemed the Entire Market Value ("EMV").

Generally speaking, under the EMV analysis, the entire value of a device or apparatus is used to calculate lost profits or a royalty base despite the fact that the patent may cover only a portion of said device or apparatus. This means that the damages are usually calculated by multiplying the royalty rate or percentage by the value of the entire product – as opposed to merely the value of the infringing component. For actions involving certain technologies, the application of the EMV can have a substantial impact on the amount of damages awarded. Thus, the Federal Circuit's decision in *Cornell University v. Hewlett-Packard Co.*[6] is important, as it provides insight on how courts may approach the EMV analysis going forward.

Cornell is the owner of U.S. Patent No. 4,807,115 (the "'115 patent") relating to an Instruction Reorder Buffer ("IRB"), which the court described thusly: "[the '115 patent] is a small part of the IRB which is a part of a processor, which is part of a CPU module, which is part of a 'brick,' which is itself only part of the larger server." Though Hewlett-Packard typically sells the larger servers, of which processors are a component, it did sell 31,000 processors "à la carte" during the relevant damages period. The court repeatedly advised Cornell that it would scrutinize its damages proof, for it suspected that Cornell might claim damages using a base well beyond the claimed invention. The court expected "well documented economic evidence closely tied to the scope of the claimed invention."

Cornell's damages expert originally proffered a $36 billion royalty "base" which included all server revenue during the infringement period. Judge Rader of the Federal Circuit, sitting by designation in the Northern District of New York, disagreed with such an all encompassing royalty base and excluded it during a *Daubert* hearing. He then provided Cornell a short time to re-calculate an appropriate base. Cornell's expert returned with a royalty base of $23 billion based upon the value of the CPU "bricks." The jury awarded $184 million based on the $23 billion base and a 0.8% royalty, reduced from the 2.5% royalty requested by the plaintiff.

On JMOL, Judge Rader excluded the $23 billion base and opined that the $8 billion worth of processors was the correct base. The court further reduced the base to $6.7 billion to account for an implied license from the use of already licensed Intel processors. The resultant $6.7 billion multiplied by the 0.8% rate yielded the judgment of $53.5 million.

Judge Rader emphasized that no economic evidence was presented showing that the patented technol-

ogy drove sales of the server or sales of the "brick." He also stated repeatedly that the plaintiff did not provide demand curves or other real world evidence showing that the technology encompassed in the '115 patent was the basis for customer demand or even a partial basis for customer demand for the server or the "brick."

Observations for Practitioners

IP litigators and damages experts alike should heed the implications from Judge Rader's rulings in *Cornell*. When putting together jury instructions, asking for more detail from the jury rather than a single damages number can be useful in the appeals process (depending on one's point of view). Though the plaintiff had asked for a 2.5% royalty, the jury came back with a 0.8% rate. Making the rate itself part of the instructions allowed the court to focus on the royalty base during post-trial motions and gave more flexibility for the court to make a decision rather than having to re-try the entire damages portion of the case. A jury often arrives at a number somewhere in between what the plaintiff and defendant have proffered. Parsing out royalty rates, royalty bases and various elements of lost profits such as convoyed sales and price erosion will certainly provide post-trial flexibility rather than leaving the court with a single number that would be difficult – if not impossible – to deconvolute.

The focus on "demand" curves as a tool to prove that a particular patented technology is the basis or partial basis for customer demand is potentially troublesome. Although the intent is well meaning and makes theoretical sense, the practical application of gathering sufficient information through the discovery process coupled with the need for sufficiently granular data focusing on the patented element, as opposed to other elements that might drive customer demand, may hinder the ability to present relevant demand curves. On the other hand, the court's request for demand-related proof has been made clear. Experts must do a better job at showing some type of economic, financial and business support tying the technology in question to an entire apparatus. Courts must be presented with proof that the patented technology is the basis or at least a partial basis for customer demand for the entire device. Otherwise, the royalty will likely be based on the lowest salable unit.

Such proof might mean survey evidence is necessary, though such evidence comes with its own issues and problems. The solution may be a more detailed market analysis. Perhaps a plaintiff should provide a more systematic analysis of advertising to pinpoint the touted features and benefits of a device. In some instances, a review of features and benefits from prior products can be compared to features and benefits of the subject technology with a corresponding analysis of prices and volumes. Clearly, a superficial analysis of EMV that may have been sufficient prior to *Cornell* will no longer pass Federal Circuit muster.

ResQNet.com, Inc. v. Lansa, Inc.: The Calculation of Reasonable Royalties Using Licenses That Cover Similar Technologies

Determining a fair and reasonable royalty has been described by the Federal Circuit as "a difficult judicial chore, seeming often to involve more the talents of a conjurer than those of a judge."[7] This view may be due in part to the uncertainty associated with one of the manners in which reasonable royalties are calculated – the hypothetical negotiation paradigm. Under this approach, the "negotiation" is deemed to have taken place just prior to the first infringement, the patent is presumed valid and infringed, and the royalty is to be determined by multiple factors, including those identified in *Georgia-Pacific Corp. v. U.S. Plywood Corp.*[8]

In the 2009 decision in *Lucent Techs. v. Gateway, Inc.*[9], the Federal Circuit vacated a $350 million dollar award to the plaintiff, remanding the case for a new trial solely on the issue of damages. The Court observed that the damages-related evidence that both parties had proffered was neither very powerful nor presented very well. In particular, the Court homed in on the insufficiency of evidence supporting *Georgia-Pacific* factor number 2, the "rates paid by the licensee for the use of other patents comparable to the patent in suit."[10]

Within six months, the Federal Circuit again visited this issue in *ResQNet.com, Inc. v. Lansa, Inc.*[11] There, the Court vacated an award for past damages, citing insufficiency of supporting evidence – this time in relation to *Georgia-Pacific* factor number 1: the "royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty."[12]

The patent at issue in *ResQNet* related to graphical user interfaces for personal computers. After a bench trial, the United States District Court for the Southern District of New York found infringement and awarded $506,305 in past damages based on a hypothetical royalty of 12.5%. ResQNet's expert had used seven licenses to arrive at this figure. Five of the licenses were "re-branding or re-bundling" licenses that furnished finished software products and source code as well as services such as training, maintenance, marketing, and upgrades. The other two licenses were "straight" rate-based licenses that had been entered into as a result of litigation over the patents in suit. On cross-appeal, Lansa challenged the methodology used by ResQNet's damages expert in determining the royalty rate.

The Federal Circuit took issue with two parts of the district court's analysis. First, the re-bundling licenses had exceptionally high royalties – nearly eight times that of the straight rate-based licenses. Second, ResQNet's damages expert did not provide any link between the re-bundling licenses and the first factor of the *Georgia-Pacific* analysis. Simply put, the re-bundling licenses were unrelated to the patent at issue. It was the plaintiff's burden to persuade the Court with legally sufficient evidence regarding an

appropriate reasonable royalty rate, and its expert did not even attempt to show that these agreements embodied, used, or otherwise showed demand for the infringed technology.

Here, the most reliable licenses in the record were the "straight" licenses that had arisen out of litigation. And, although the Federal Circuit acknowledged that it had previously stated that litigation can skew the results of the hypothetical negotiation, it remanded the issue with the instruction that the district court may consider the "panoply of events and facts that occurred thereafter and that could not have been known to or predicted by the hypothesized negotiators."

Observations for Practitioners

ResQNet serves as an extension of *Lucent,* suggesting that district courts should consider licenses that are commensurate with what the defendant has appropriated – even when the license is one that has arisen as a result of a settlement agreement. This holding certainly impacts the practical aspects of patent litigation. Most obviously, as it relates to *Georgia-Pacific* factor number 1, the parties should attempt to ensure that past damages are calculated using licenses that (a) cover the patent at issue, and (b) are comparable to the technology used without authorization. A license, however, may not fit neatly into either of these categories. *ResQNet* thus also serves as a reminder of the importance of sound and detailed expert reports in anticipation of the court's potential exclusion of a license from the damages analysis. As a practical note, caveats should be included in the analysis where applicable, as they may serve to alleviate some risk associated with relevancy objections.

ResQNet's impact also reaches beyond the manner in which expert reports are drafted. Because prior licensing agreements and the "panoply of events and facts that occurred thereafter and that could not have been known to or predicted by the hypothesized negotiators" may be relied on, parties should consider reviewing all information and documentation that are even tangentially related to settlement-based licenses – especially those relating to the negotiation of the royalty rate. This may be particularly persuasive evidence in arguing for either a higher or lower royalty. And, as a result of *ResQNet,* objections to the discovery of such evidence may no longer be well founded.

Finally, *ResQNet* serves as a cautionary reminder that a plaintiff has the burden of proof to persuade the court with legally sufficient evidence regarding an appropriate reasonable royalty. If the plaintiff does not meet this burden, the defendant need not proffer expert testimony in rebuttal; the court may refuse to sustain a royalty award based on inappropriate or irrelevant licensing evidence.

Uniloc USA, Inc. v. Microsoft Corp.: The 25 Percent Rule – A "Fundamentally Flawed Tool"

In *Uniloc USA, Inc. v. Microsoft Corp.*,[13] the Federal Circuit continued to scrutinize economic constructs for damages awards in patent cases, addressing issues relating to the proper analysis of calculating reasonable royalty damages and vitiating a common and often criticized tool used by patentees for determining a baseline royalty rate in a hypothetical negotiation. In short, the *Uniloc* decision clearly signals that to prevail on its damages claim, a party must lay a clear factual foundation that establishes the relevance of any analytical theory to the specific facts of the case.

Uniloc owns U.S. Patent No. 5,490,216 (the "'216 patent") which is directed to a software registration system to deter unauthorized copying of software. Uniloc sued Microsoft, claiming that its Product Activation feature found in many of the software programs it sells, including its Microsoft Office products, infringed the '216 patent. Microsoft's feature allowed authorized users to register and be issued a license to use the software based on information supplied by the user. Following an eleven-day trial, a jury found the '216 patent valid and infringed, awarding Uniloc damages in the form of a reasonable royalty lump-sum payment of $388 million.

Uniloc's damages expert had relied on an internal Microsoft document to assign a $10 value to the alleged infringing feature in Microsoft's accused products. The expert then applied the so-called 25 percent rule and calculated a baseline royalty rate of $2.50 for each alleged infringing act. "The 25 percent rule of thumb is a tool that has been used to approximate the reasonable royalty rate that the manufacturer of a patented product would be willing to offer to pay the patentee during a hypothetical negotiation."[14] The rule apportions 25 percent of the operating profits of the accused product or feature to the patent holder and the remaining 75 percent to the manufacturer, suggesting that a licensee would pay 25 percent of its expected profits for the product or feature that incorporates the patented technology.[15]

Applying the *Georgia-Pacific* factors, Uniloc's expert then examined whether the 25 percent value should be adjusted, but ultimately concluded that those factors were equally balanced between the parties. Multiplying the $2.50 royalty rate by the number of issued licenses, the expert calculated a lump-sum royalty payment of $565 million. Finally, as a "check" on the reasonableness of his analysis, Uniloc's expert testified that his lump-sum royalty payment amounted to only 2.9% of Microsoft's $19 billion in revenue attributed to its software products.

In addition to JMOL motions attacking the jury's verdict regarding infringement, validity, and willfulness, Microsoft sought a new trial on damages based on Uniloc's improper reliance on the 25 percent and the entire market value rules. The district court denied JMOL of invalidity and granted JMOL of non-infringement and willfulness. On the issue of damages, the court granted Microsoft's motion for a new trial on the improper use of the entire market value

rule, but rejected Microsoft's arguments regarding the 25 percent rule.

On appeal, the Federal Circuit issued a comprehensive decision dealing with various aspects of infringement, willfulness, invalidity and damages. On the issue of damages, the Court affirmed the district court's grant of Microsoft's motion for a new trial, rejected the 25 percent rule as a matter of law, and further refined its entire market value rule jurisprudence.

The Federal Circuit viewed the question of the proper use of the 25 percent rule as one of first impression, but acknowledged "passively tolerat[ing] its use where its acceptability has not been the focus of the case."[16] The Court also noted that district courts "invariably admitted evidence based on the 25% rule, largely in reliance on its widespread acceptance or because its admissibility was uncontested."[17] Deciding the issue in this case, the Court held that "as a matter of Federal Circuit law . . . the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation. Evidence relying on the 25 percent rule of thumb is thus inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue."[18]

Analyzing relevant Supreme Court case law, the Federal Circuit explained that critical to assessing the admissibility of expert testimony is whether the expert "has justified the application of a general theory to the facts of the case." The Court continued that in the context of calculating patent damages, "there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case." By contrast, "the 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement. The rule does not say anything about a particular hypothetical negotiation or reasonable royalty involving any particular technology, industry, or party."[19] The Court also observed that the rule is essentially arbitrary because it does not account for the actual profits of the products sold, the availability of close substitutes, or the relationships of the parties and the relative risks assumed by the purported licensee and licensor.

The Federal Circuit was also not willing to sanction use of the 25 percent rule as a baseline analytical tool: "It is of no moment that the 25 percent rule of thumb is offered merely as a starting point to which the *Georgia-Pacific* factors are then applied to bring the rate up or down."[20] Notably, the Court stated that examination of the *Georgia-Pacific* factors as an analytical framework for calculating reasonable royalty damages remains a valid exercise – particularly those factors that look at "royalties paid or received in licenses for the patent in suit or in comparable licenses" and "the portion of profit that may be customarily allowed in the particular business for use of the invention or similar inventions" – but cautioned that "evidence purporting to apply to these, and any other factors, must be tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time."[21] Accordingly, the Federal Circuit held that the $2.50 royalty rate calculated by Uniloc's expert using the 25 percent rule "had no relation to the facts of the case, and as such, was arbitrary, unreliable, and irrelevant" and, moreover, a post-application of the *Georgia-Pacific* factors could not remedy such a "fundamentally flawed premise." [22]

The Court also rejected Uniloc's use of the entire market value rule as a "check" on the reasonableness of its damages claim. The Federal Circuit concluded that Uniloc failed to demonstrate that Microsoft's Product Activation feature created the basis for customer demand or that the entire market value of the accused products was derived from the patented contribution. Indeed, the Court noted that "[t]his case provides a good example of the danger of admitting consideration of the entire market value of the accused where the patented component does not create the basis for customer demand."[23] Notably, the *Uniloc* decision also clarified dicta in *Lucent Techs. v. Gateway, Inc.,* which had indicated that an entire accused product may be used as a royalty base if the rate is sufficiently low. As the Court stated in *Uniloc:* "The Supreme Court and this court's precedents do not allow consideration of the entire market value of accused products for minor patent improvements simply by asserting a low enough royalty rate."[24]

Observations for Practitioners

The clear implication of the *Uniloc* decision is the importance of both relevance and specificity in presenting a party's damages case. The Federal Circuit has signaled that it expects district courts to act as gatekeepers, requiring parties to support their damages claims with economic proof and case-specific factual evidence closely tied to the particular patents, technologies, industries, products, and parties at issue.

Going forward, parties may need to devote more resources to damages related discovery and formulate their damages theories as part of their early case assessments, engaging economists and damages related fact witnesses at earlier stages in litigation and in pre-litigation counseling. In addition, litigants should stress targeted discovery of business planning records and financial metrics relating to the accused products and to the specific patented technology, developing solid evidentiary support for their damages analyses. In addition to the overall profitability of an accused product, relevant discovery should focus on the motivation for, and economic impact of, incorporating a patented feature into an accused product, such as cost saving, price increase, differential profitability, and increased demand. Furthermore, attention should be given to relevant industry licensing

and practice, and to specific market research and trends, as guides to assessing the reasonableness of the results of a hypothetical negotiation simulation and license royalty calculations. These considerations likely will increase the pressures – already exacerbated in the current world of electronic discovery – to locate, manage, and analyze vast amounts of damages related data.

Furthermore, litigants should ensure that the *Georgia-Pacific* factors are thoroughly analyzed and insist that both the license royalty rate and base properly reflect the incremental contribution of the patented technology. Damages experts must rely on relevant and specific facts and provide a link showing how those facts and their theories or economic principles simulate a hypothetical negotiation between the parties, and with respect to the patented technology at issue. Conversely, practitioners should carefully scrutinize adversaries' damages analyses and claims, and challenge improper use of irrelevant facts and flawed economic theories.

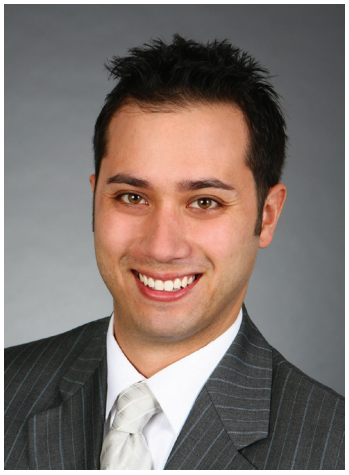
Conclusion

Rather than waiting until the end of discovery to engage an expert and gather damages proof, litigators need to address damages earlier in the case. Technical experts can be utilized to tie the patented elements to features and benefits of the accused products or devices. Technical experts may also assist with technical comparisons of the patents in suit relative to patents in existing license agreements. Damages experts may need to develop more in-depth analyses of relevant markets, customer preferences, purchase-drivers, and non-infringing alternatives whether by surveys or other means. Consideration may be given to analyzing price and volume changes over time for the products in suit compared to previous or comparable products.

As the cases discussed above demonstrate, the Federal Circuit has signaled that it demands greater attention to detail in the context of patent damages. In the absence of broad and early damages based planning and discovery, parties and their attorneys will be challenged to establish sufficient support for their damages claims and experts will strain to bolster their opinions.

[1] The views expressed herein are those of the authors specifically identified, and they do not necessarily represent the views of the authors' firm or clients. All authors are members of the New York Intellectual Property Law Association's Patent Litigation Committee.
[2] Senior Managing Director at FTI Consulting, Inc.
[3] Intellectual Property Associate at Goodwin Procter LLP
[4] Senior Intellectual Property Attorney at Cadwalader, Wickersham & Taft LLP
[5] Statistics based on an analysis of Federal Circuit decisions performed by FTI Consulting, Inc.
[6] 609 F.Supp.2d 279 (N.D.N.Y. 2009).
[7] *Fromson v. Western Litho Plate & Supply Co.*, 853 F.2d 1568, 1574 (Fed. Cir. 1988).
[8] 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).
[9] 580 F.3d 1301 (Fed. Cir. 2009), *cert. denied*, 130 S. Ct. 3324 (2010)
[10] *Id.*, at 1325-7.
[11] 594 F.3d 860 (Fed. Cir. 2010).
[12] *Georgia-Pacific*, 318 F. Supp. at 1120.
[13] 632 F.3d 1292 (Fed. Cir. 2011).
[14] The Federal Circuit noted that the 25 percent rule has "met its share of criticism" by experts in the field. *Id.* at 1313.
[15] Robert Goldscheider *et al.*, *Use Of The 25 Per Cent Rule in Valuing IP*, 37 les Nouvelles 123, 123 (Dec. 2002) ("Valuing IP").
[16] 632 F.3d at 1314.
[17] *Id.*
[18] *Id.*, at 1315.
[19] *Id.*, at 1317.
[20] *Id.*
[21] *Id.*, at 1317-8.
[22] *Id.*, at 1318.
[23] *Id.*, at 1320.
[24] *Id.*

Lance E. Gunderson is Senior Managing Director at FTI Consulting, Inc.He can be contacted at *lance.gunderson@FTIConsulting.com*



Benjamin A. Keller is an Intellectual Property Associate at Goodwin Procter LLP. He can be contacted at *bkeller@goodwinprocter.com*

Daniel J. Melman is Senior Intellectual Property Attorney at Cadwalader, Wickersham & Taft LLP. He can be contacted at *djmelman@yahoo.com*