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Federal Courts Closely Scrutinizing and Slashing Patent Damage Awards[1]

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A series of recent decisions indicates that courts are more rigidly enforcing standards for the reasonable royalty calculation of patent damages awards. In particular, recent Federal Circuit decisions (as well as a district court case with Judge Rader of the Federal Circuit sitting by designation) show that the use of prior licenses of either the patentee or the alleged infringer to support high royalty rates, as well as the application of the entire market value rule to increase the size of the royalty base, will be more carefully scrutinized. These recent decisions promote tighter evidentiary standards that will force damage theories to be more closely tied to the value of the invention as claimed. While legislative reforms in the area of patent damages are still being contemplated in Congress,[3] it appears that, as with the trends in recent case law discussed below, legislative reform efforts will also seek to put the burden on district court judges to act as "gatekeepers" and to closely scrutinize the evidence that is relied upon to prove patent damages.

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[3] On February 25, 2010, Senator Patrick Leahy (D-VT) announced that a "tentative agreement" had been reached on the long-pending patent reform bill. In his public comments, Leahy noted that the compromise will "address" the issues of "runaway damage awards" and patent quality. *See* Dennis Crouch, *Patent Reform Moving Forward*, Patently-O at <http://www.patentlyo.com/patent/2010/02/patent-reform-moving-forward.html> (Feb. 25, 2010); *see also Comment on Patent Reform Legislation*, <http://leahy.senate.gov/press/press_releases/release/?id=971907e8-425c-489a-ab48-b1eb307be795> (Feb. 25, 2010).

Introduction

Background Regarding Calculation of Reasonable Royalty

Section 284 of the Patent Act provides that a prevailing plaintiff in a patent infringement suit shall be entitled to damages "adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer."[4] The most common approach to determining the reasonable royalty that would be "adequate to compensate" the patent owner attempts to determine the royalty that the patentee and infringer would have agreed to had they successfully negotiated a license agreement just before the infringement began. The now-well-known framework for applying this "hypothetical negotiation methodology" is set forth in *Georgia-Pacific Corp. v. U.S. Plywood Corp.*[5] The *Georgia-Pacific* factors are a list of flexible factors that may be applied to the facts at hand in order to calculate the reasonable royalty that the parties would have arrived at in a hypothetical negotiation. These factors include, for example, past and present royalties received by the patentee "for the licensing of the patent in suit, proving or tending to prove an established royalty," "[t]he rates paid by the licensee for the use of other patents comparable to the patent in suit," "[t]he extent to which the infringer has made use of the invention; and any evidence probative of the value of that use."[6] The *Georgia-Pacific* factors are not an exclusive list; the parties may argue any other factor that a reasonable licensee or licensor may take into account in determining the value of a patent.[7]

Calculation of a reasonable royalty requires determination of both (i) a royalty base, i.e., the pool of revenue implicated by the infringement; and (ii) a royalty rate, i.e., the royalty percentage of that royalty base.

Royalties Based on the Entire Matter Value Rule

The general rule is that the royalty base for patent damages is based on the subject matter of the claimed invention. For example, damages for a patent claim directed to an improved car radio system are calculated based on the value of the infringing car radio system, and not the sales price of the entire

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[4] 35 U.S.C. § 284 (2006).

[5] 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).

[6] *Id.*

[7] *Id.* at 1120-21.

car in which the car radio system is installed. One important exception to this rule that has been developed in case law is referred to as the "entire market value rule." This doctrine is a powerful tool for patent owners, and a source of anxiety for would-be infringers. The entire market value rule may be applied "where the patent related feature is the basis for customer demand."[8] In such circumstances, a patent owner may recover damages based upon the value of the entire product that incorporates the claimed invention, even whether the claimed invention only covers a component of that product, and the entire product contains many non-infringing components.[9] The question of whether the entire market value rule will apply in a given case has a great impact on the accused infringer's damages exposure. The arguably more widespread-than-appropriate application of this rule and the resulting large damage awards have, in practice, been controversial.[10]

Reforming The Law of Patent Damages - Through Legislative Reform or the Case Law?

It has been said that "[d]etermining a fair and reasonable royalty is often . . . a difficult judicial chore, seeming often to involve more the talents of a conjurer than those of a judge."[11] Indeed, Federal Circuit Chief Judge Michel has himself noted that "[t]here still seems to be massive unclarity about how reasonable royalty damages are to be calculated."[12] For this reason, patent damages reform, including proposals to more strictly limit the application of the entire market value rule, has been included in the Patent Reform bills that have been considered by Congress over the past years. These reform proposals also seek to limit the *Georgia-Pacific* factors by limiting damages to the inventor's "specific contribution over the prior art" to determine damages.[13] According to Senator Patrick Leahy, the Senate bill would, in a

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[8] *Imonex Servs. v. W.H. Munzprufer Dietmar Trenner G.m.b.H.*, 408 F.3d 1374, 1379-80 (Fed. Cir. 2005).

[9] *See Id*.

[10] *See, e.g.*, Brian J. Love, Note, *Patentee Overcompensation and the Entire Market Value Rule*, 60 STAN. L. REV. 263 (2007); Amy L. Landers, *Let the Games Begin: Incentives to Innovation in the New Economy of Intellectual Property Law*, 46 SANTA CLARA L. REV. 307 (2006).

[11] *Fromson v. W. Litho Plate & Supply Co.*, 853 F.2d 1568, 1574 (Fed. Cir. 1988).

[12] Oral argument recording from Lucent v. Gateway, No. 2008-1485, available at http://oralarguments.cafc.uscourts.gov/mp3/2008-1485.mp3 (time index = 27:10).

[13] Patent Reform Act of 2009, H.R. 1260, 111th Cong. § 284(c)(1)(A).

manner similar to the cases discussed in this article, place a "gatekeeper" role on district court judges.[14] But even with the recently announced progress in reviving the legislative patent law reform bills, it remains unclear whether a harmonized version of the Patent Reform Act will be passed by Congress. In the meantime, courts have responded to slow legislative efforts by preemptively issuing rulings that have changed other aspects of patent law that Congress had considered reforming, such as in the areas of willful infringement (*In re Seagate Tech. L.L.C.*[15]) and venue (*In re Volkswagon A.G.*[16]).

The cases discussed below indicate a trend toward making it more difficult to prove and obtain large reasonable royalty-based damage awards. Courts are focusing both on the royalty base and the royalty rate aspects of the reasonable royalty analysis. As to the royalty base, these cases show that courts are setting a higher bar for patentees that seek to apply the entire market value rule by requiring specific evidence that consumer demand for the overall product is driven by the patented feature or component. Courts are also engaging in a closer and more demanding scrutiny of the evidence that is often relied upon by patentees to establish a particular royalty rate, the prior license agreements of both the patentee and the infringer. This more rigorous evidentiary review may alleviate the need for legislative reform in the area of damages by preserving a patent owner's ability to make reasonable arguments regarding the value of their invention, provided that they can meet careful scrutiny of the evidence in support of their arguments. However, whether such steps are enough remains to be seen.

***Cornell* - Setting the Proper Royalty Base and Limiting the Application Entire Market Value Rule**

In *Cornell University v. Hewlett-Packard Co.*[17], the New York District Court (with Judge Rader of the Federal Circuit sitting by designation), drastically reduced a jury's award for HP's infringement of a Cornell University microprocessor patent from \$184 million to \$54 million. The *Cornell* decision

[14] *See* Reuters, "Judges to have role in deeming patents crucial," (February 25, 2010)("[T]he bill would require judges hearing patent infringement cases to play a gatekeeper role in helping identify appropriate damages.").

[15] 497 F.3d 1360 (Fed. Cir. 2007).

[16] 545 F.3d 304 (5th Cir. 2008).

[17] 609 F. Supp. 2d 279 (N.D.N.Y. 2009) ("*Cornell*").

addressed the appropriate royalty base to be used in a calculation of a reasonable royalty, as well as the use of the entire market value rule.

The patent at issue in *Cornell* covered a method for issuing instructions in a component that resides within a computer processor. Even though the claimed invention covered "a component of a component within the processors used in Hewlett-Packard's servers and workstations," Cornell originally sought damages on the revenue from HP's entire server and workstation systems.[18] In particular, Cornell's expert "sought to testify that the jury should compute damages using a royalty base encompassing Hewlett-Packard's earnings from its sales revenue from its entire servers and workstations."[19] At a *Daubert* hearing, the court excluded Cornell's expert's testimony that "the entire market value of Hewlett-Packard's servers and workstations should be used as the royalty base," because "neither Cornell nor [its expert] offered credible and sufficient economic proof that the patented invention drove demand for Hewlett-Packard's entire server and workstation market."[20] In response, Cornell modified the damages theory that it presented at trial. Cornell, however, did not seek royalties merely on sales of processors; HP's sales of stand-alone processors were relatively small, particularly when compared to HP's sales of servers and workstations. Rather, Cornell chose to seek royalties on HP's sales of so-called "CPU bricks." CPU bricks are a component of HP's servers, and are made up of CPU modules (containing the allegedly infringing processors), as well as a temperature controller, memory, and a power converter. The court again found Cornell's damages theory to be inappropriate, due to use of this over-inflated royalty base.

In particular, the court stated that while the entire market value rule does permit damages on technology beyond the scope of the claimed invention, it only does so "upon proof that damages on the unpatented components or technology is necessary to fully compensate for infringement of the patented invention."[21] In order for the entire market value rule to apply, Judge Rader required "credible and economic proof that damages on the unpatented portions of this technology was necessary to compensate for the infringement."[22] Here, because "Cornell did not offer a single demand curve

[18] *Id.* at 283-84.

[19] *Id.* at 284.

[20] *Id.*

[21] *Id.* at 285.

[22] *Id.*

or any market evidence indicating that Cornell's invention drove demand for bricks,"[23] or any evidence that shows a connection between consumer demand for the CPU bricks and the claimed invention, the use of CPU bricks as the royalty base was found to be inappropriate.

The *Cornell* decision strictly limits the application of the entire market value rule to those circumstances in which the patentee is able to provide specific economic evidence that consumer demand for the entire product (rather than the component containing the accused technology) is clearly linked to the claimed invention. The Cornell decision also illustrates that a district court can take an active role as a vigorous "gate keeper" of what damages theories and evidence are allowed before the jury. However, it cannot be expected that the typical district court judge will act as aggressively as Judge Rader did in the *Cornell* case. Judge Rader actually stopped the trial in progress to conduct a *Daubert* hearing to determine whether a theory being given by a damages expert testimony on the entire market value rule comports with a strict interpretation of the rule.

Lucent **– Close Scrutiny of Reliance on Other Licenses of Accused Infringer to Set Appropriate Royalty Rate; Limiting Application of the Entire Market Value Rule**

In *Lucent Technologies v. Gateway, Inc.*[24], the Federal Circuit vacated the jury's $358 million damages award against defendant-intervener Microsoft Corporation. The court found that the damages award was not supported by substantial evidence, and remanded the case for a new trial on damages.

The patent at issue in *Lucent* was directed to a method of entering information on a computer screen in which the user selects information from a graphical pre-defined on-screen object. The accused software products, Microsoft Outlook, Microsoft Money, and Windows Mobile, include a graphical calendar tool that allows the user to select and enter dates from a graphical object that is formatted as a calendar, i.e., the so-called date-picker feature.

The jury's $358 million damages award for infringement of the date-picker feature amounted to approximately 8% of the sales price of Microsoft Outlook. The court found that "Lucent submitted no evidence upon which a jury could reasonably conclude that Microsoft and Lucent would have

[23] *Id.* at 288.

[24] 580 F.3d 1301 (Fed. Cir. 2009) ("*Lucent*").

estimated, at the time of [a hypothetical] negotiation, that the patented date-picker feature would have been so frequently used or valued as to command" such a payment.[25] In so finding, the *Lucent* decision addressed two aspects of the reasonable royalty analysis and the supporting evidence. First, the court addressed the methodology for arriving at the royalty rate. Second, the court, like the *Cornell* court, addressed the appropriateness of the application of the entire market value rule, i.e., the methodology for arriving at the royalty base.

Regarding the royalty rate, at trial, Lucent and its damages expert relied on a number of Microsoft and Dell license agreements to attempt to establish the rates or amounts paid by defendant for use of patents that were allegedly similar to the patent-in-suit (the second *Georgia-Pacific* factor). The *Lucent* court did not rule on whether "any of the evidence relevant to damages was improperly before the jury" because no objection to the evidence presented was made below.[26] Rather, the Federal Circuit's analysis was premised on the fact that they "must accept that the license agreements and other evidence were properly before the jury."

Four of the license agreements related to the PC field, and were characterized by Lucent as "PC-related patents."[27] The Federal Circuit, however, flatly found that the mere "personal computer kinship" does not "impart[] enough comparability to support the damages award."[28] For example, one license agreement upon which Lucent relied was a 1993 agreement between Dell and IBM for $290 million. However, while the single patent-in-suit was directed to "a narrower method of using a graphical user interface tool known as the date-picker," this license agreement was for multiple patents that related to broad PC-related technologies.[29] Thus, the court found, there was no reasonable evidence that Dell/IBM Agreement was at all probative of the reasonable royalty amount that would be applicable for the patent-at-issue. For certain other license agreements, Lucent introduced the agreements into evidence and elicited testimony from its damages expert regarding only the structure and amount of the licenses. The court found that this "superficial testimony" which "provides no analysis of [the] license agreements" does not satisfy Lucent's "burden to prove that licenses were

[25] *Id.* at 1327.

[26] *Id*. at 1325.

[27] *Id.* at 1328.

[28] *Id.*

[29] *Id.*

sufficiently comparable to support" the damages award it sought.[30] In particular, "Lucent's expert never explained to the jury whether the patented technology is essential to the licensed product being sold, or whether the patented invention is only a small component or feature of the licensed product (as is the case here)," and "Lucent did not explain how the fact that [certain of the license agreements it relied on] involved eight patents affects how probative it is of the Microsoft-Lucent hypothetical negotiation over one patent. Nor is there any document or testimony upon which the jury could have considered how similar or dissimilar the patented technology of the [other license] agreement is to the invention of using the date-picker."[31] Here, there simply was no evidence that Microsoft had ever agreed to pay an 8% royalty on an analogous patent, and the Court concluded there was no basis to arrive at an 8% royalty rate.

Furthermore, in consideration of the *Georgia-Pacific* factors that address the overall value of the patented feature, the Federal Circuit concluded that "[t]he evidence only can support a finding that the infringing feature contained in Microsoft Outlook [the date-picker within the calendar] is but a tiny feature of one part of a much larger software program," and "numerous features other than the date-picker appear to account for the overwhelming majority of the consumer demand and therefore significant profit."[32] Therefore, the court concluded that "no reasonable jury could have found that Lucent carried its burden of proving that the evidence" supported the $358 million damage award.[33]

The Federal Circuit in *Lucent* also separately addressed the entire market value rule. As a separate ground for seeking reversal of the damages award, Microsoft argued that only way the jury could have arrived at a $358 million damage award was to apply the entire market value rule. Microsoft argued that the entire market value rule was inappropriate in this case. The Federal Circuit agreed.

While the Federal Circuit indicated that the legal standard for determining the applicability of the entire market value rule is "[i]n one sense . . . quite

[30] *Id.* at 1329.

[31] *Id.* at 1330, 1331.

[32] *Id.* at 1332, 1333.

[33] *Id.* at 1335.

clear," it also acknowledged that translating the court's guidance into "a precise, contemporary, economic paradigm presents a challenge."[34] The starting point for the court's analysis is the requirement that for the entire market value rule to apply the patentee must prove that "the patent-related feature is the basis for customer demand."[35] Thus, when the patented invention is a part or feature among many in the accused product royalty base, the damages analysis must first determine the value of the patented invention and then ascertain what the parties would have agreed to in terms of compensation in the hypothetical reasonable royalty negotiation.

The Federal Circuit found two flaws with the application of the entire market value rule in this case. First, Lucent did not meet its burden of proving that any customer purchased Microsoft Outlook <u>because of</u> the patented date-picker feature. Because there was no causal link establishing that customers purchased Outlook <u>because of</u> the patented feature, the court found that the entire market value rule should not apply.

The court also instructed courts to be "cognizant of [the] fundamental relationship between the entire market value rule and the calculation of a running royalty damages award."[36] In other words, the market value of the infringing component or feature may be taken into account either in the analysis of the appropriate royalty rate or in the analysis of the appropriate royalty base. But it must be taken into account in the damages analysis.

Second, the court took issue with Lucent's attempt to seek a higher royalty rate when it was forced to seek damages against a lower royalty base. Here, Lucent's original damages theory and that of its expert was based on a royalty rate of 1% applied against a royalty base consisting of the net sales generated from the sale of personal computers that included the infringing Outlook software. As in the *Cornell* case, the district court granted a motion in limine to exclude this testimony, since there was no basis for seeking damages on a royalty base that included the entire computer. At trial, Lucent's expert revised his damages opinion, opining that the royalty base should be the price of the software (and not the entire computer) but

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[34] *Id.* at 1336, 1337.

[35] *See Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1358, 1549 (Fed. Cir. 1995); *see also TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895, 901 (Fed. Cir. 1986) ("The entire market value rule allows for the recovery of damages based on the value of an entire apparatus containing several features, when the feature patented constitutes the basis for customer demand.").

[36] *Lucent*, 580 F.3d at 1338.

increasing the royalty rate from 1% to 8%. The reason for increasing the royalty rate to 8% was essentially to try and reach the same damages number that he would have reached had he applied the 1% royalty rate to the broader royalty base of the entire computer. The Federal Circuit found this approach to be contrary to both the purpose of damages law and the entire market value rule, and contrary to the district court's correct ruling in its earlier motion in limine.

Lansa – Close Scrutiny of Reliance on Other Licenses of Patentee to Set Appropriate Royalty Rate

Most recently, in *ResQNet.com, Inc. v. Lansa, Inc.*,[37] the Federal Circuit vacated a $500,000 damages award based on a 12.5% royalty rate. The court found the 12.5% royalty rate to be excessive and inadequately supported by the evidence, and therefore remanded the case back to the district court for a recalculation of a reasonable royalty.

The patents at issue in *Lansa* related to remote terminal emulation technologies for computers. The court found that the 12.5% royalty rate was based on evidence of license agreements that had no relationship to a determination of the value of the claimed invention.

The *Lansa* court began its damages analysis by emphasizing the need to "carefully tie proof of damages to the claimed invention's footprint in the market place."[38] The court stressed that the evidence must strictly be tied to the invention of the patent.[39] The *Lansa* court also noted that the Federal Circuit requires "district courts performing reasonable royalty calculations to

[37] Nos. 2008-1365, 2009-1336, 2009-1030, 2010 U.S. App. LEXIS 2453 (Fed. Cir. Feb. 5, 2010) ("*Lansa*").

[38] *Id.* at *19.

[39] *Id.* at *20 ("Any evidence unrelated to the claimed invention does not support compensation for infringement but punishes beyond the reach of the statute."). This strong statement by the Federal Circuit was made without citation to prior cases. It is interesting to juxtapose this standard against the "specific contribution over the prior art" standard proposed in the pending House of Representative's version of the Patent Reform Act of 2009. H.R. 1260, 111th Cong. § 284(c)(1)(A). Likewise, as discussed *supra*, the Senate version of the Patent Reform Act relies on district court judges to act as gatekeepers. Requiring the rejection of evidence not related to the claimed invention may be another way of stating that one must examine the improvement of the invention over the prior art in assessing damages. However, limiting damages based on evidentiary grounds alone may not be adequate to ensure consistent damages awards since this puts a great burden on district court judge as gatekeeper for such evidence.

exercise vigilance when considering past licenses to technologies other than the patent in suit."[40] Citing to the recently decided *Lucent* case, the court noted it had recently rejected a patentee's reliance on other licenses on the grounds that "some of the license agreements [were] radically different from the hypothetical agreement under consideration,"[41] and/or the evidence presenting regarding the subject matter of the agreements was insufficient to be able to consider whether or not they were comparable to the subject matter of the patent-in-suit. The Federal Circuit found that the majority of the licenses relied upon by the patentee in the *Lansa* case were "problematic for the same reasons that doomed the damage award in Lucent."[42]

In particular, the Federal Circuit criticized ResQNet's analysis under the first *Georgia-Pacific* factor, which examines the past and present royalties received by the patentee "for licensing of the patent in suit, proving or tending to prove an established royalty."[43] ResQNet's damages expert based his damages opinion on seven ResQNet licenses. Five of these licenses were agreements that provided finished software products and source code, maintenance and training services, and the right to re-brand and sell the ResQNet software in exchange for a payment of revenue-based royalties to ResQNet. These so-called re-bundling and re-branding licenses include top rates that range from 25 to 40% of sales, and formed the basis for the 12.5% royalty sought by ResQNet. Notably, however, none of the re-bundling and re-branding licenses "even mentioned the patents-in-suit or showed any other discernible link to the claimed technology."[44] Moreover, the other license agreements of record, which were "straight licenses" that arose from settlements of litigation over the patents-in-suit, indicated a substantially lower royalty rate than 12.5%.

The ResQNet damages expert recommended a 12.5% royalty rate for the patents-in-suit, because this was "'somewhere in the middle' of the re-bundling licenses and the straight rate-based license on the claimed technology."[45] The Federal Circuit took issue with this methodology, since it

[40] *Id.* at *21.

[41] *Id.* at *20.

[42] *Id.*

[43] *Georgia-Pacific*, 318 F. Supp. at 1120.

[44] *Lansa*, 2010 U.S. App. LEXIS 2453, at *22.

[45] *Id.* at *23.

used the higher royalty rates of those license agreements that were unrelated to the claimed invention—which in certain cases had a rate nearly eight times greater than the straight license on the claimed technology in the case—to significantly inflate the overall royalty rate. Because there was no evidence or factual findings that took into account the different technological and economic circumstances between the re-bundling licenses and the patent in suit, the Federal Circuit concluded that "the district court in this case made the same legal error that this court corrected in *Lucent*. This trial court, like the one in *Lucent*, made no effort to link certain licenses to the infringed patent."[46] The outright rejection by the majority of using the licenses at all appears to be done in an attempt to roll back the speculative nature of arguments that could be made under the flexible *Georgia-Pacific* factors.

In contrast, Judge Newman provided a vigorous dissent on the damages issue, which focused on many of the *Georgia-Pacific* factors that supported the damages award. She chastised the majority for holding "that it was legal error to take cognizance of most of the existing licenses introduced at trial" and argued that the majority created a "a new rule whereby no licenses involving the patented technology can be considered, in determining the value of the infringement, if the patents themselves are not directly licensed or if the licenses include subject matter in addition to that which was infringed by the defendant here."[47] Newman also argues that "[n]either *Lucent* nor any other precedent dictates such a blanket exclusion of relevant evidence."[48] Newman appears to favor flexible application of the *Georgia-Pacific* factors over the more rigid standards for evidence adopted by the majority; she would find that, at best, the arguments made by the majority may go to the weight of the evidence but not to whether such evidence is admissible and relevant.[49]

Conclusion

The *Cornell*, *Lucent*, and *Lansa* decisions indicate an emerging trend to more carefully scrutinize the evidentiary and economic basis of reasonable royalty-based patent damages awards in the setting of the appropriate royalty base, the application of the entire market value rule, and the

[46] *Id.* at *25.

[47] *Id.* at 41-42.

[48] *Id.* at *45.

[49] *Id*. at 43.

calculation of the appropriate royalty rate. While existing standards for determining patent damages have not been formally changed, the more rigorous approach to reviewing damage awards revealed in these opinions may impact the scope of and need for any legislative changes to the law governing patent damages.