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Reasonable Royalties After EBay

Monday, Sep 24, 2007 --- The Supreme Court, in its decision in eBay Inc. et al. v. MercExchange LLC ("eBay"), clarified the legal standard for granting injunctive relief to a plaintiff in a patent infringement lawsuit.[1]

Rather than granting an automatic injunction in the event the patent in dispute is found to be valid and infringed, as was the past practice, courts must apply the traditional four-factor test to determine whether an injunction is appropriate.[2]

While this decision should directly affect parties' expectations of relief in a patent matter, it could also potentially affect the calculation of damages, particularly the reasonable royalty component. eBay raises a number of important and complex issues in areas other than the determination of royalties, including the terms of compulsory licenses, when and how the terms of such a license would be determined, and, perhaps, even about the extent to which the broader goals of the patent system are served.

In this paper, we focus on the impact of eBay on the bargaining position of the parties in the hypothetical negotiation in which reasonable royalties are determined.

The practical impact of eBay is that certain patent holders are less likely than previously to be granted injunctions, even after the patent is upheld and infringement is found.

Justice Kennedy, in his concurring opinion, noted that an injunction may not be appropriate "when the patented invention is but a small component of the product the companies seek to produce and the threat of an injunction is employed simply for undue leverage in negotiations."[3]

He singles out a particular type of firm that may use the threat of injunction as a bargaining tool, namely "firms [that] use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees."[4]

Recent case law indicates that this characterization is consistent with the types of plaintiffs who are denied injunctive relief, despite their patent being upheld and found to have been infringed by the defendants.[5]

eBay may have important implications for determining damages in a patent infringement lawsuit, particularly in a case in which the plaintiff and defendant are not competitors and thus a damage award based on lost profits from sales is inappropriate.

In such a situation, the appropriate damage award is a reasonable royalty, determined as the outcome of a hypothetical negotiation between the two parties that takes place just before the date of first infringement.[6]

In assessing what a reasonable royalty would be, an expert should consider all relevant economic factors, including factors enumerated by the courts in the well-known Georgia-Pacific decision.[7]

In constructing this hypothetical negotiation, the expert should determine how much the prospective licensee would be willing to pay, how little the prospective licensor would be willing to accept, and the relative bargaining strengths of the two parties, among other factors. The reasonable royalty should be a rate that reflects the economic incentives and positions of each of the negotiating parties.

The hypothetical negotiation should represent, as closely as possible, the bargaining environment that would have existed had the plaintiff and the defendant negotiated a license just prior to infringement.

Post-eBay, the patent holder is now faced with at least the possibility that he would not be able to force the infringer out of the market, even if he prevails in every aspect of the litigation. Therefore, his bargaining power—derived, in part, from a threat not to license—may be diminished.[8]

Thus, eBay may change the relative bargaining positions of the two parties. Any such change should be represented in the hypothetical negotiation as well.[9]

Furthermore, the most that the potential licensee would be willing to pay for the technology has likewise decreased.[10] Even if the potential licensee were to lose in a patent infringement lawsuit, the patent holder may not be able to force the infringer to stop selling the product embodying the patent.

The profits at risk to the potential licensee in the event that it would lose in the lawsuit are no longer necessarily the entire incremental profit stream flowing from the patented invention (i.e., relative to the profits that might have been earned on sales of a product that embody the next-best available noninfringing alternative).

Rather, the profits at risk might be restricted to some royalty amount that the infringer would be obligated to pay to the patent holder in the event that an injunction is not granted.[11]

This potential reduction in the willingness of the potential licensee to pay for the technology and the diminution in the bargaining power of the potential licensor should—other things equal—result in lower royalty rates for patent holders who, by virtue of eBay, are faced with an increased probability of not being able to enjoin the alleged infringer, even if the patent were upheld and infringement found.

This means that as a damages expert considers what royalty rate the parties would likely have agreed to in a hypothetical negotiation, the expert perhaps may also consider the likelihood that the plaintiff would prevail at the injunction hearing.

If the hypothetical negotiation is to represent accurately the bargaining environment that would have existed in an actual negotiation, these changes may need to be incorporated in damage evaluations.

Notably, however, the current framework for determining a reasonable royalty has laid out one critical exception to creating an "historical" bargaining outcome: the patent is assumed by both parties to be valid and infringed.

Had there been an actual negotiation on the eve of first infringement, the parties would still have had doubt as to the validity and applicability of the patent.

In the damages context of the hypothetical negotiation, this uncertainty is removed. However, when first infringement has occurred post-eBay, the parties to the hypothetical negotiation will remain uncertain about whether the patent owner could force the putative licensee to stop using the patented technology.

Put differently, the magnitude of the threat facing the putative licensee has likely been reduced and now depends on the probability that an injunction would issue at some point in the future.

Moreover, eBay may necessitate a new round of legal guidance regarding the hypothetical negotiation. For example, one of the basic tenets of the hypothetical negotiation has been that the parties, quite counterfactually, were a willing licensor and a willing licensee.[12]

However, eBay implies that a potential infringer, facing a non-producing patent owner, may not be willing to pay a substantial amount for a license because it would recognize that, in the end, the patent owner may not be able to exclude it from the market.

If eBay implies that the defendant is able to sell the goods in question, even without a license, the infringer would presumably not be considered "willing" and thus the bargaining power may tip extraordinarily in the infringer's favor.

Under such circumstances, a non-producing patent owner may be placed in a compulsory licensing situation, reducing the expected compensation perhaps below the true incremental economic contributions of its inventions.

Furthermore, without guidance from the courts, the elimination of the patent holder's power to exclude may lead to a certain circularity of reasoning that could make it difficult to determine a reasonable royalty.

If the patent holder can not block the incremental profits flowing from use of the patent, then the most a putative licensee would be willing to pay in a hypothetical negotiation would depend not on the incremental profits at risk if it fails to get a license but, instead, on royalties avoided.

But, if the level of the avoided post-infringement royalties is determined by the very hypothetical negotiation at issue, the determination of the reasonable royalty itself is circular.

As the defendant would not be willing to pay any more than it expects to be forced to pay in post-judgment damages—and the plaintiff would not accept any less—any possible royalty that could be expected by the parties would necessarily be the outcome of a negotiation based on that expectation.

Thus, in our view it will be important for the Courts to consider the implications of eBay on the assumptions for determining economically rational damages awards. In the meantime, however, experts should be prepared to account for the fact that negotiated royalties may be affected by eBay, especially in cases similar to those noted in Justice Kennedy's opinion.

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[1] eBay Inc., et al., v. Mercexchange, L.L.C., Opinion of the Court, 547 U.S. No. 05-130 (2006), May 15, 2006.

[2] ibid. As stated by the Court, the plaintiff must demonstrate "(1) that it has suffered an irreparable injury; (2) that remedies available at law are inadequate to compensate for that injury; (3) that considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction."

[3] ibid. From an economic perspective, "small component" must mean that the economic contribution of that component, relative to its next-best non-infringing alternative, is minor in comparison with the total value of the product incorporating the patented technology. A patented component could be a small part of a product or one of a large number of components but still be the key economic contributor to the profits generated by the product.

[4] ibid. It should be noted that the threat of an injunction is part of the patent holder's bargaining position, even if the patent holder does actually produce and sell goods and services.

[5] See, for example, z4 Technologies Inc., v. Microsoft Corporation and Autodesk, Inc., Paice L.L.C., v. Toyota Motor Corp., et al, Jan K. Voda, M.D., v. Cordis Corporation, and Sundance, Inc. and Merlot Tarpaulin and Sidekit Manufacturing Co., Inc., v. DeMonte Fabricating Ltd., and Quick Draw Tarpaulin Systems, Inc. In the z4 and Sundance rulings, the Courts declined to grant injunctive relief in part due to a finding that the patented invention was a “small component” of the product. In the z4, Paice, and Jan Voda cases, the plaintiff’s primary use of the patents was for licensing purposes.

More recently, however, in Commonwealth Scientific and Industrial Research Organization, v. Buffalo Tech., Inc., the court granted CSIRO, Australia’s national science agency, a permanent injunction despite the fact that CSIRO does not actively practice the patent at issue. Thus, Justice Kennedy’s finding that an injunction may not be appropriate when it will grant “undue leverage” to the patent-holder does not simply exclude non-producing firms from receiving an injunction. To understand the economic import of Justice Kennedy’s comments, we must envision certain situations in which the patent owner’s assertion of its rights is somehow unduly increased, perhaps through exercising so-called “submarine” patents in which the patent owner waited to file claims or assert its rights until the infringer had already made substantial investments in the product, until it was already widely adopted by the market (over the prior generation or next-best alternative), or until the patent was adopted as a de facto or de jure standard. In these situations, the granting of a permanent injunction may grant an “undue” amount of hold-up value to the patent holder, above and beyond the intrinsic value of the patented technology.

[6] See, for example, Gregory K. Leonard and Lauren J. Stiroh. “A Practical Guide to Damages.” In Economic Approaches to Intellectual Property. National Economic Research Associates, 2005.

[7] Georgia-Pacific Corp. v. United States Plywood Corp., 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).

[8] Depending on the facts of the case, the threat not to license may not result in substantial bargaining power at all, such as in the case of an infringer who has a readily available non-infringing alternative whose cost, market price, and market acceptance is little different from those of the accused technology.

[9] This may imply that, even in trials occurring post-eBay, if the hypothetical negotiation is assumed to take place prior to the issuance of the eBay ruling, the parties would not have considered the eBay ruling and its implications.

[10] Subject to the condition noted in footnote 7, above.

[11] Reasonable royalty payments are typically less than or equal to the infringer’s incremental profits. That is because royalty terms that result in payments that are larger than the incremental profits earned by the infringer

would lead the infringer, if at all possible, to turn to his next best alternative.

[12] But cf. Rite-Hite Corp. v. Kelley Co., 1995 U.S. App. LEXIS 14681 (Fed. Cir. 1995), at n. 13 [“this is an inaccurate, and even absurd, characterization when, as here, the patentee does not wish to grant a license.”].

