

Meeting The New Standard For Reasonable Royalties

Law360, New York (February 3, 2011) -- U.S. district courts and the Court of Appeals for the Federal Circuit over the last few years have applied greater scrutiny to evidence presented in patent infringement cases. While the courts have provided some clear examples of the types of evidence and testimony they are likely to reject, patent holders and alleged infringers are without specific guidelines as to the precise evidence needed.

The courts have, however, emphasized that reasonable royalties should be consistent with “accepted economic principles” (IP Innovation v. Red Hat). This article describes the types of evidence upon which plaintiffs or defendants might rely that are consistent with recent rulings.

The Courts Require Better Evidence

Recent court decisions reveal a common theme: evidence and testimony presented in an analysis of a reasonable royalty must be developed using reliable and relevant methodologies and data.

This higher standard is clearly articulated in the recent *Uniloc v. Microsoft* decision, which forcefully rejected the 25 Percent Rule as a methodology for determining a reasonable royalty because “it fails to tie a reasonable royalty base to the facts of the case at issue.” This ruling is consistent with the conclusion that other rules of thumb or analyses without solid evidentiary foundations are excludable under *Daubert*.

The requirement in the *Uniloc* decision, that reasonable royalty expert testimony be tied to the facts of the case, echoes the courts’ criticism of the types of evidence presented in other cases.

For example, in *Cornell v. Hewlett Packard*, the district court faulted Cornell for the use of “generic consumer demand evidence ... because it does not account for the unique motivating factors that led HP customers to purchase HP servers and workstations.”

Similarly, in the first *Lucent v. Gateway* case (related to MP3 patents), the district court denied the use of the entire market value rule because there was “...insufficient evidence to establish the required nexus between the patented features and the value of the entire computer.”

The courts have also questioned the use of purportedly comparable licenses. In *ResQNet v. Lansa*, the CAFC vacated a damages award because the expert “used licenses with no relationship to the claimed invention to drive the royalty rate up to unjustified double-digit levels.”

Similarly, in *Fenner Investments v. Hewlett-Packard*, the district court excluded expert testimony related to purportedly comparable licenses because the expert had “failed to explain whether the license agreements pertained to patented inventions that were essential to or only a small feature or component of the overall product.”

What types of evidence are courts likely to accept? *IP Innovation v. Red Hat* provides some guidance, as the district court warns: “[t]he parties are reminded that expert testimony on the topic of damages will not be allowed absent a firm basis in accepted economic principles.”

The economic framework for determining a reasonable royalty generally begins by modeling a hypothetical negotiation of a royalty between the patent holder and the licensee infringer. The upper bound of the negotiation, the highest amount that the infringer would pay, is defined to be the incremental profit that the patented technology generates for the infringer relative to its next-best alternative.

A rational licensee would never pay a royalty above this amount. Similarly, a rational licensor would never accept a royalty below the incremental profit it would place at risk, if any, from granting the license. In this way, a reasonable royalty calculated within an economic framework is consistent with Georgia-Pacific Factor 15 (the hypothetical negotiation) and Georgia-Pacific Factor 13, which seeks to identify the “portion of the realizable profit that should be credited to the invention.”

The courts already appear to be moving toward this economic framework that seeks to isolate the incremental contribution of the patent, focusing on the “relative significance” or “relative importance” of the patented feature. In *Fenner Investments v. Hewlett-Packard*, the expert’s report was deemed “inadequate ... for failing to identify and support an appropriate ‘multiplier’ that takes into account the relative significance of the patented inventions and their contribution to the overall value of the accused products.”

And in *IP Innovation v. Red Hat*, the district court noted that “[t]he workspace switching feature’s small role in the overall product is further confirmed when one considers the relative importance of certain other features such as security, interoperability, and virtualization.” Or, as summarized in the CAFC’s decision in *ResQNet v. Lansa*, “the trial court must carefully tie proof of damages to the claimed invention’s footprint in the market place.”

Economic Evidence for Assessing the Incremental Value of a Patent

What types of economic evidence are relevant for assessing the specific value of the patent at issue in a reasonable royalty case? At the root of this inquiry is the impact that the patented technology has on the licensee’s profit. If the patent relates to a feature of a product, then we can ask to what extent did the patented feature influence demand for the infringing products?

In particular, how many additional sales did the licensee make and at what price, compared to the sales the infringer would have obtained with its next-best alternative technology? Alternatively, a patented technology might reduce the infringer's costs. In both situations, determining the value of the patent requires assessing the incremental profit that patent generates for the infringer.

There are various types of economic evidence that may be used to assess the incremental value generated by the patented feature. In some cases, this would involve an assessment of ordinary course of business documents produced in the case combined with industry analysis. If the benefit of the technology is tied closely to a specific feature (i.e., it is essential to that feature), company documents may provide some indication of the value of the patented feature.

Such documents may include internal marketing studies or surveys that the company performed in the course of regular business. Third-party analysis may also be available, including evidence of the importance of the feature in trade press or industry market research reports.

In many cases, additional evidence and analysis may be needed to develop reliable estimates of a reasonable royalty. Here, we discuss two types of analysis that could be performed; a quantitative analysis of existing sales and price data and an analysis of original data, typically gathered through surveys.

It should be noted that these types of analyses cannot necessarily be applied in every patent infringement case; the availability of data, appropriateness of surveys and other case-specific issues need to be considered to determine the best method for demonstrating incremental value.

Quantitative Analysis of Sales Data

With respect to the quantitative analysis of sales and price data, we provide some examples of methodologies that can assist in assessing the incremental profit associated with the patented feature. The first is sometimes referred to as a "before-after" approach.

Here, the value of the patent can be assessed by comparing the infringer's sales (and prices obtained) of a product before and after the patented feature was incorporated into the product. This approach may help identify the specific demand for the patented feature by testing the extent to which the introduction of the patented feature resulted in an increase in the infringer's sales or allowed the infringer to charge a higher price and earn a higher margin. As with all economic analyses, other factors that might have affected sales or prices should, to the extent possible, be taken into consideration and controlled for.

Another type of analysis available in some cases is a price comparison analysis. This analysis may assist in determining one aspect of the incremental profit associated with the patented feature: the additional price the infringer was able to charge due to the patented feature.

For example, if the infringer sold products with the patented feature and otherwise identical products without the patented feature, the difference in prices charged may be assessed (again, controlling for other factors that might have affected the price difference).

Note, however, such an analysis only relates to the price charged and therefore provides only a partial assessment of the incremental profit that the infringer earned. In some cases, the higher price may be due, in part, to higher costs associated with the patented technology. On the other hand, a price comparison analysis does not take into account the potential change in the infringer's sales due to incorporating the patented technology into its product.

To simultaneously evaluate the overall impact of changes in price and quantity, in some cases it may be possible to model and estimate the structural demand for the product as a function of product attributes. If the patented technology improves an attribute, the demand for the patented product can be estimated and indeed the whole market outcome may be simulated. Again, any incremental cost associated with the patented technology also should be taken into account.

Surveys

Surveys present another type of analysis that may assist in assessing the incremental value associated with the patented feature. While the design and implementation of a survey may present certain challenges, one of the main benefits of this approach is that, unlike many analyses of existing sales data, a well-designed survey can be designed to address the specific issues in the litigation. In particular, surveys may be used to 1) show awareness and use of patented feature; 2) show demand for the patented feature; and 3) quantify incremental demand created by the patented feature.

One question that may arise in determining the incremental profit associated with a patent is the extent to which consumers are aware of or use the allegedly infringing feature. On the surface, an "awareness" or "use" survey is simple and straightforward, but the survey still should be designed with care. In addition, the selection of survey participants should be designed such that the results can reliably be used to represent the total relevant population.

Defining the appropriate population and sampling from that population is important; for example the answers of product designers who included a particular patented feature within a larger product may differ greatly from the answers of consumers who actually purchase and use the product in question.

Surveys may also be designed to assist with determining the extent to which there is demand for the patented feature and the strength of such demand, if any. "Demand" surveys may use a variety of question strategies, including open-ended questions about the valued attributes of the product or drivers of demand, or rank-order or rating questions asking respondents to evaluate a list of attributes or product choices.

Finally, surveys may be used to help quantify the incremental demand created by a particular feature. For example, choice-modeling survey methods may help experts quantify the value of particular features to consumers. Generally, choice surveys present respondents with a set of product choices each with a set of particular attributes; included among the attributes of some products in the choice set is the patented feature.

With each set, the respondent is asked, given the set of products shown (with the particular set of attributes identified), which product would be the first choice (second choice and so on). A statistical analysis of all respondents' choices — that allows the expert to take into account the ranking, the products' price points, and the presence or absence of the feature at issue — may determine the specific value consumers place on the patented feature.

While this type of survey can provide insight into consumers' willingness to pay for the patented feature, other factors, such as how cost changed or the impact of supply-side competitive effects, may need to be taken into account to determine the overall incremental profit created by the feature at issue.

In conclusion, while the appropriate analysis will vary from case to case, the guiding principle remains the same: because courts are unlikely to permit "rule of thumb" or any analyses not rooted in economic evidence, reasonable royalty evidence must be consistent with economic methods for determining the incremental value of the patent.

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