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Taking Control Of The Patent Damages Debate

Law360, New York (September 14, 2009) -- Everyone agrees that the way that juries have been awarding damages in patent damages cases has become just about unworkable. Patent holders complain that they are being shortchanged for the value of their innovation. Defendants argue that the "entire market rule" results in unfair windfalls to plaintiffs.

Congress has proposed legislation to solve this problem three times since 2004 — with no success whatever. Parties involved in patent litigation and licensing have been left with virtually no direction from either the courts or Congress as to how patent damages should be awarded.

Someone had to be the grown-up. And the Federal Circuit finally stepped in and took control.

In throwing out the $358 million jury award to Lucent, the Federal Circuit not only eviscerated the evidence presented by both sides in support of their respective damages cases, it set forth a commonsense structure for economic analysis which can, and should, be applied in every case and which defuses the pointless political wrangling which has tied up patent reform for years.

The damages dispute here arose from a Lucent patent on a "date picker" feature that Lucent claimed was used in Microsoft Outlook (as well as in other Microsoft programs).

For the purpose of the damages analysis, there was no dispute that this feature was actually included in the accused Microsoft software (although the court noted that there was "little, if any," direct evidence of infringement) but there was no showing as to how valuable the feature was to the individual user or how often the feature was used. Indeed, neither party seemed to think this fact was particularly relevant to the damages inquiry.

Instead, each party relied almost exclusively on other licenses between Microsoft and other parties, each arguing that the “hypothetical license” between Lucent and Microsoft determining the reasonable royalty was similar to the ones it had selected.

On appeal, Lucent’s task was further complicated by having to justify the jury’s verdict, which was based on a “lump sum: license (i.e., a set amount paid up front no matter how many products were sold) even though, at trial, it had relied on quite different licenses with a “running royalty” (i.e. where the licensee has to pay royalties only on the products it sells).

On appeal, the Federal Circuit more or less threw up its hands and told the parties to start over, noting that the evidence presented by both parties had little or no relationship to the actual economic principles underlying patent damages law.

In the process, however, the court set out self-evident economic principles that, hopefully, should guide counsel and the courts — and hopefully silence those in Congress who had hoped to legislate basic economic in the courts.

The Federal Circuit concentrated its analysis on two issues — the use of licenses in determining a reasonable royalty and the viability — and proper use — of the “entire market value rule.”

The court noted that, if a party is going to use a royalty contained in an existing license to show what the parties would have agreed to in the “hypothetical negotiation” setting a reasonable royalty, the actual licenses must be for a technology which bears at least some relationship to the technology involved in the litigation.

If the technologies are not comparable, the licenses are of little value in determining what the parties would have agreed to in determining the royalty for the technology involved in the lawsuit.

More importantly, the “real world” licenses must be of the same type as the license on which the reasonable royalty will be based or the parties must provide some basis on which the two types of licenses can be compared.

The court noted that the parties variously presented lump sum licenses to justify running royalty rates and used running royalty licenses to justify lump sum verdicts — all without any explanation of how to “convert” from one to the other, or apparently any indication that any such conversion was even necessary.

The court explained, however, that there is no problem with a party presenting various types of license agreements to support its damages case — as long as the party explains the how that license agreement values the technology at issue and how to apply that value to the patent involved in the litigation.

The much more important ruling, however, was on the much-maligned “entire market value rule.” This rule is, on its face, fairly simple — if the patented technology is the sole reason consumers buy a certain product, royalties may be awarded based on sales of the entire product.

For example, if I had a patent on technology that made bicycles fly, it would be reasonable to assume that the only reason consumers would buy flying bicycles was because of my patented technology (i.e., the “entire market value” of the product would be my patent).

If, however, I had a patent on a bell that was used on a flying bicycle, damages should be based on the value of that particular component to the consumer.

For example, if the bell only enabled the seller to raise his price 1 percent or only 3 percent of the consumers bought the product because of the bell, the royalty should be adjusted accordingly.

The problem with the “entire market value rule,” however, has been its misapplication by parties, juries and courts and the misunderstanding of the rule by Congress and many commentators.

It is thought by some to be “unfair” for a jury to base its royalty on a percentage of an entire product’s sales where the patent only applies to a small component and it is thought by others to be a “ripoff” of the inventor class to do anything else.

However, the Federal Circuit made the common sense observation that the actual royalty amount is the percentage royalty as applied to the royalty base and that there may be good and proper reasons that the parties may want to use the revenues for an overall product to compute royalties under a license for a patent on a component — such as ease of obtaining revenue figures and ease of auditing.

The issue of “allocation” of the value of a component can be handled, as the court noted, by simply adjusting the royalty percentage to reflect the value of the patented technology.

It reflected that, for all of Microsoft’s complaints about the size of the royalty base (the price of the computer vs. the price of Windows), it would have had little issue with the result if the base had been left alone but the royalty percentage was 0.1 percent instead of 8 percent.

So, perhaps the controversy over “allocation” can now come to an end and the courts can simply handle awarding damages based on the value of a technology in the economically common sense way suggested by the Federal Circuit.

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