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KEY IDEAS:

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STUFF THAT GENIE BACK IN THE BOTTLE: STOP WISHFUL THINKING ABOUT ROYALTY BASE, RATE AND THE EMVR

Unlike a mythical genie who grants three wishes, there is no such windfall when attempting to tie a rate to a royalty base to capture the entire market value of an infringing product. In fact, just this sort of wishful thinking can seriously undermine your damages case.

In a 2009 opinion, then-Chief Judge Paul Michel of the Federal Circuit Court of Appeals casually observed, "There is nothing wrong with using the market value of the entire product, especially when there is no established market value for the infringing component or feature, so long as the multiplier [rate] account for the proportion of the base [is] represented by the infringing component or feature."[1]

Chief Judge Michel was starting to look like a "genie" ready to grant three wishes for patentees seeking to conjure big dollar damage awards. While mathematically and logically correct, his aside threatened more than 100 years of established case law and foreshadowed another spate of mega-dollar "reasonable" royalty verdicts.

Quick corrective action by the courts, however, remedied the problem and firmly put the cork back in the bottle. Understanding this seductive problem and how to avoid it will save you much wasted effort chasing genies.

Apportionment and the EMVR

For more than 125 years, the law was clear: "The patentee . . . must in every case give evidence tending to separate or apportion the defendant's profits and the patentee's damages between the patented feature and the unpatented features, and such evidence must be reliable and tangible, and not conjectural or speculative . . ."[2]

The logic behind this rule is obvious. Calculating a reasonable royalty,[3] requires determination of two distinct elements: (1) a royalty base (measured by the volume of infringing sales, either in dollars or units); and (2) a royalty rate (measured either as a percent of sales, or an amount per unit). The base and rate are then multiplied together to determine the statutory reasonable royalty.

But the mathematical relationship between the royalty base and rate can give rise to mischief. If the royalty base is large enough, a ridiculously huge damage award can be generated by a seemingly innocuous royalty rate. For example, a modest 1 percent rate for a minor patent on a very small part of a product with a sales base of $10 billion would result in a "reasonable" royalty of $100 million.[4]

1 *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1339 (Fed. Cir. 2009), *cert. denied,* 130 S. Ct. 3324 (2010).

2 *Garretson v. Clark*, 111 U.S. 120, 121 (1884); *Lucent Techs., Inc.*, 580 F.3d at 1337; *see Seymour v. McCormick,* 57 U.S. 480, 491 (1853) (a "very grave error" to have same rule for measuring damages for a patent covering a mere improvement on a machine as for a patent on the entire machine.)

3 35 U.S.C. § 284 (2006) provides that infringement damages must be "adequate to compensate for the infringement, but in no event less than a reasonable royalty."

4 *See, e.g., Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279 (N.D.N.Y. 2009) (Fed. Cir. Judge

Shook, Hardy & Bacon L.L.P.

ENHANCING YOUR IP IQ

Vol. III, No.7 JULY 2011

Recognizing the need for essential fairness and the potential for abuse, courts adopted and evolved the entire market value rule (EMVR). The EMVR "allows a patentee to assess damages based on the entire market value of the accused product *only* where the patented feature creates the 'basis for customer demand' or 'substantially create[s] the value of the component parts.'"[5]

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Failure to adhere to the EMVR will result in the offending damage calculation being tossed out. For example:

- Judge Randall Rader, sitting as the trial judge, refused to allow an expert to testify when the expert invoked the EMVR and included 100 percent of the revenues of an accused system. He found, "The evidence shows that the [patented] workspace switching feature represents only one of over a thousand components included in the accused products."[6]
- The Federal Circuit rejected as "improper under the entire market value rule" an expert's attempt to use the total $19.28 billion of sales of the accused products as a "check" to justify his $564,946,803 royalty figure, claiming that it was only 2.9 percent of revenue.[7]
- Judge T. John Ward in the Eastern District of Texas found "there was no basis for the 'entire market value rule,'" and ordered remittitur in the absence of evidence that the patented method drove the demand for the accused product.[8]

Relationship Between Rate and Base

Of course, an obvious and fundamental relationship exists between the EMVR and the calculation of a running royalty damages award.[9] As Chief Judge Michel observed in his *Lucent* opinion, "Simply put, the base used in a running royalty calculation can always be the value of the entire commercial embodiment, as long as the magnitude of the rate is within an acceptable range (as determined by the evidence)."[10] Before appearing to conclude that there was "nothing wrong" with using the entire market value of an accused product, Judge Michel first observed that, "Thus, even when the patented invention is a small component of a much larger commercial product, awarding a reasonable royalty based on either sale price or number of units sold can be *economically justified*."[11]

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But this relationship is one that is easily abused and can be seductive to patentees aiming to "ring the bell" with huge damage verdicts.

Interestingly, Chief Judge Michel's analysis was directly at odds with Judge Rader's conclusion in the *Cornell* case just a few months earlier that "An over-inclusive royalty base including revenues from the sale of non-infringing components is not permissible simply because the royalty rate is adjustable."[12]

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Rader sitting by designation) (rejecting $184,044,048 damage award calculated by applying .8 percent royalty rate to a $23,005,506,034 royalty base).

5 *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011) (citing *Lucent Techs., Inc.*, 580 F.3d at 1336; *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1549-50 (Fed. Cir. 1995)) (emphasis added).

6 *IP Innovation L.L.C. v. Red Hat, Inc.*, 705 F. Supp. 2d 687, 689-90 (E.D. Tex. 2010) (Fed. Cir. Judge Rader sitting by designation).

7 *Uniloc USA, Inc.*, 632 F.3d at 1318-19.

8 *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 2010 WL 2331311, *3 (E.D. Tex. June 9, 2010).

9 *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1338 (Fed. Cir. 2009).

10 *Id.* at 1338-39.

11 *Id.* at 1339.

12 *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 286 (N.D.N.Y. 2009) (citing *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1549 n.9 (Fed. Cir. 1995)).

Shook, Hardy & Bacon L.L.P.

ENHANCING YOUR IP IQ

Vol. III, No.7 JULY 2011

In *Uniloc*, the Federal Circuit pointed out "the danger of admitting consideration of the entire market value of the accused [product] where the patented component does not create the basis for customer demand."

"Apportionment cannot be achieved by the mere downward adjustment of the royalty rate in a purported effort to reflect the relative value of the accused features because doing so fails to remove the revenues associated with the non-accused features from the revenue base."

Dangers of Ignoring the EMVR

In *Uniloc,* the Federal Circuit pointed out "the danger of admitting consideration of the entire market value of the accused [product] where the patented component does not create the basis for customer demand."[13] There, plaintiff's damages expert testified that his calculation of $565 million was a mere 2.9 percent of defendant's total sales of the infringing sales.

As Judge Richard Linn observed, the $19 billion "cat was never put back into the bag," in spite of an instruction that the jury could not award damages based on the defendant's total revenues from the accused products. This was especially obvious when, during cross-examination of defendant's damages expert, counsel used the EMVR to suggest that defendant's proffered damages were a paltry .000035 percent of total sales.[14]

Disconnecting Rate and Base—Again

Since *Lucent,* the Federal Circuit and most district courts have taken pains to cram the EMVR genie back in the bottle.

In *Uniloc,* the plaintiff relied on Chief Judge Michel's observation in *Lucent* to argue that "the entire market value of the products may appropriately be admitted if the royalty rate is low enough."[15] In response, the Federal Circuit noted that plaintiff's argument took the statement out of context.[16] According to the court, "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."[17]

A recent case in the Eastern District of Texas adopted the Federal Circuit's conclusion.[18] There, plaintiff's expert initially used the revenue from the sales of all products that contained the allegedly infringing software, including both software and hardware.[19] Based on that royalty base, the expert calculated damages totaling about $300 million.[20]

After the jury returned a verdict of infringement and awarded $208.5 million in damages, defendant challenged the award asserting that plaintiff had improperly relied on the EMVR. Although plaintiff argued that it had not relied on the EMVR, the court disagreed, observing that plaintiff undisputedly used the entire market value of the accused commercial products in calculating its royalty base.[21]

Rejecting consumer survey evidence which plaintiff offered to support its conclusion that the patented feature was the "basis for customer demand," the district court concluded that the plaintiff failed to apportion the royalty base between the infringing and non-infringing features.[22]

The district court then cited *Uniloc* as "clarifying" *Lucent,* saying "Apportionment cannot be achieved by the mere downward adjustment of the royalty rate in a purported effort to reflect the relative value of the accused features because doing so fails to remove the revenues associated with the non-accused features from the revenue base."[23] For good measure, the district court added that the patentee, "cannot simply apply 'haircuts' adjusting the royalty rate to apportion damages, and thereby justify the jury award, because the entire market value of the accused products has not been shown to be derived from the patented contribution."[24]

13 *Uniloc USA, Inc. v. Microsoft Corp.,* 632 F.3d 1292, 1320 (Fed. Cir. 2011).
14 *Id.* at 1320.
15 *Id.* at 1319.
16 *Id.* at 1320.
17 *Id.* (citations to numerous other cases omitted).
18 *Mirror Worlds, LLC v. Apple, Inc.,* 2011 WL 1304488 (E.D. Tex. April 4, 2011).
19 *Id.* at *13.
20 *Id.*
21 *Id.* at *18.
22 *Id.*
23 *Id.* (citing *Uniloc USA, Inc.,* 632 F.3d at 1319-20).
24 *Id.*

Shook, Hardy & Bacon L.L.P.

ENHANCING YOUR IP IQ

Vol. III, No.7 JULY 2011

ABOUT SHB

Shook, Hardy & Bacon offers expert, efficient and innovative representation to our clients. We know that the successful resolution of intellectual property issues requires a comprehensive strategy developed in partnership with our clients.

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Connecting Rate and Base and End-Running the EMVR

Not every judge deep in the heart of Texas agrees, however. In *Mondis Technology, Ltd. v. LG Electronics, Inc.*,[25] the district court magistrate judge denied defendant's motion to exclude plaintiff's damage expert based on the *Lucent* opinion.[26] Relying on the *Lucent* passage which provides that, "awarding a reasonable royalty based on either sale price or number of units sold can be '*economically justified*,'"[27] the magistrate decided, "This is a case where it is 'economically justified' to base the reasonable royalty on the market value of the entire accused product."[28]

In this lone-ranger opinion, the Texas magistrate concluded that use of the EMVR was economically justified because there was an industry-wide practice of basing the royalty on the EMVR of the licensed products, notwithstanding that those products included both patented and unpatented features.[29]

Conclusion and Practical Advice

Notwithstanding the one-off *Mondis* ruling, attempts to avoid application of the EMVR by decreasing the royalty rate appear to be non-starters. The case law is simply too longstanding and well-reasoned to allow for an exception that could swallow the rule. That being said, it will be interesting to see if the "industry license" exception announced in *Mondis* gains any traction.

Here are four quick rules to follow:

1. If you are the patentee, don't adjust the rate to justify a large base when calculating damages. Don't try to avoid the EMVR by adjusting the rate downward. It simply won't work.

2. If you are the accused infringer, be on the lookout for both obvious and subtle attempts to adjust the royalty rate to avoid the EMVR. The case law provides helpful examples where the indirect use of the entire market value of the accused products was precluded. If you see something that doesn't look right, quickly object and preserve your objections on appeal.[30]

3. Be prepared to challenge the relevance and comparability of industry licensing norms that use the EMVR as the royalty base.

4. Whether you are the patentee or defendant, be safe. Look to or require the "smallest salable unit" for the royalty base.[31]

25 2011 WL 2417367 (E.D. Tex. June 14, 2011) (U.S. Magistrate Judge Charles Everingham).
26 *Id.* at *2-*3.
27 *Id.* at *2 (citing *Lucent Techs., Inc.*, 580 F.3d at 1339) (emphasis by the court).
28 *Id.* at *2.
29 *Id.*
30 *See Finjan, Inc. v. Secure Computing Corp.*, 626 F.3d 1197, 1208 (Fed. Cir. 2011) (where defendant waived EMVR arguments by not raising them in post-trial motions).
31 *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 287, 291-92 (N.D.N.Y. 2009) (suggesting that the smallest salable unit is the point to begin the royalty base analysis.)