Published by *Intellectual Property Law360*, *Contract Law360, & Appellate Law360* on June 14, 2011.

Georgia (Pacific) On My Mind

--By Paul Alexander, Arnold & Porter LLP

Law360, New York (June 14, 2011) -- The Federal Circuit has engaged in an extensive revision of the law governing the determination of a “reasonable royalty.” This development began at least with Cornell University v. Hewlett-Packard Company, 609 F. Supp. 2d 279, (N.D.N.Y. 2009). It continued with the decisions in Lucent Technologies Inc. v. Gateway Inc., et al, 580 F.3d 1301 (Fed. Cir. 2009), and Uniloc USA Inc. v. Microsoft Corp., 632 F.3d 1292 (Fed. Cir. 2011), both of which indicated that stronger proof would be necessary to establish a “reasonable royalty” under 35 U.S.C. § 284.

In each case, however, the Federal Circuit accepted the basic framework for determining a “reasonable royalty” — the assumption of a “hypothetical negotiation” that supposedly would have taken place at the time of “first infringement,” using 15 factors originally articulated in 1970 by the court in Georgia Pacific Corp. v. U.S. Plywood Corp., 318 F. Supp. 1116 (S.D.N.Y. 1970), modified, 446 F.2d 295 (2d Cir. 1971).

This “hypothetical negotiation requires the court to envision the terms of a licensing agreement reached as the result of a supposed meeting between the patentee and the infringer at the time infringement began.” Rite-Hite Corp. v. Kelly Co., 56 F.3d 1358, 1554 (Fed Cir. 1995). The doctrine has been aptly described this way:

Determination of a "reasonable royalty" after infringement, like many devices in the law, rests on a legal fiction. Created in an effort to "compensate" when profits are not provable, the "reasonable royalty" device conjures a "willing" licensor and licensee, who, like Ghosts of Christmas Past, are dimly seen as "negotiating" a "license." Panduit Corp. v. Stahlin Bros. Fibre Works Inc., 575 F.2d 1152, 1159 (6th Cir. 1977).

There are good reasons to reevaluate the entire “hypothetical negotiation” doctrine, as well as the factors that make it up. The growth of patents addressed at various aspects of new technology has increased dramatically, as has the amount of litigation over them. And the phenomenon of investing in such patents primarily for the sake of attempting to use the “reasonable royalty” legal structure to earn significant profits has taken hold in a remarkable way.

The growth of so-called “Non-Producing Entities” (NPEs) is now so substantial that they are considered to present major investment opportunities largely because they are able to obtain a “reasonable royalty” through litigation or threats of litigation. The current legal standard is thus seen as producing a significant investment opportunity.

In practice, the “hypothetical negotiation” approach inherently takes post hoc advantage of commercial success. Sophisticated NPEs generally target products that have generated a large sales volume in order to maximize their returns and cover the expense and risk of litigation, and this large revenue base is the lens through which everyone involved must look.

One result has been the large “reasonable royalty” jury verdicts that have required so much judicial resource. It is far from clear that these verdicts actually foster, rather than stifle, innovation and consumer welfare. It is legitimate to ask, therefore, whether the so-called "hypothetical negotiation," which uses the standard 15 factors, really is the best model for determining a "reasonable royalty" today.

The issue has major economic consequence. If, by way of example, as few as 10 percent of the 250,000 patents estimated by JP Morgan to exist in the area of smartphones were held to be valid and infringed, and required even small royalty payments determined according to the Georgia Pacific analysis, the resulting total "reasonable royalties" — and the impact on price — could well be substantial. This phenomenon is not limited to smartphones; it applies in most areas of technology. The trend toward more and better technology at lower costs in many areas could be slowed or reversed, to the detriment of all consumers.

The more exacting evidentiary principles in Cornell, Lucent v. Gateway, and Uniloc constitute one way of addressing this issue. But there are factors imbedded in the Georgia Pacific standard itself that call for it to be reconsidered. The first of these assumptions is the notion that there would have been a negotiation at "the time of first infringement."

In the analysis as it is applied, evidence of the commercial success of a product — which could not have been known at the outset — is admissible. The jury is typically instructed that such evidence "can be considered in evaluating the reasonable royalty only to the extent that the evidence aids in assessing what royalty would have resulted from a hypothetical negotiation." (Instruction 6.6, Federal Circuit Model Jury Instruction.)

Allowing the jury to assume that the parties to the hypothetical negotiation would have known that the product would succeed and generate large revenues risks biasing the damages calculation. It makes success appear certain rather than risky. It makes the patent appear more valuable and more essential to the product's success. And it subjects a jury's decision to psychological processes such as "hindsight bias" (events that have already occurred seem more likely than they would have appeared beforehand) and "anchoring" (telling a subject a number, even an irrelevant one, tends to produce estimates that use that number as a starting point). See Bazerman & Moore, Common Biases, from "Judgment in Managerial Decisionmaking," chapt. 2, p. 31-37.

The success of the allegedly infringing product thus inherently makes a royalty percentage appear more "reasonable" than it might have appeared at the time. The significance and pervasiveness of these biases are so well documented that they cannot legitimately be ignored.

Moreover, the assumption that the "reasonable royalty" rate should be applied retroactively to the date of first infringement can have the effect of artificially inflating damages by, among other things, depriving the defendant of the opportunity to redesign the product, or otherwise mitigate.

While the "date of first infringement" assumption may have been valid 40 years ago, there is reason to revisit it now in the light of the practice of purchasing patents — many of which have been previously unenforced — to put together a portfolio to monetize through litigation using the Georgia Pacific approach.

If the patent in suit had not previously been asserted and is first asserted after being acquired as part of a portfolio of patents, then there was no opportunity for a real-world negotiation. The alleged infringer would have had no notice that someone would later claim damages covering a period of many years.

Significant opportunities to avoid the claimed infringement may have been lost.

Given the myriad of ways in which patents may be first asserted against products that have been in production for years, the automatic assumption that a “hypothetical negotiation” would have occurred on the “date of first infringement” no longer seems justified. Rather than an assumption built into the analysis, the date on which the parties would have confronted the issue of a reasonable royalty should be a matter of proof rather than an assumption built into a legal fiction. Facts, such as why no actual negotiation occurred earlier, what actually took place and why, should all be a part of the analysis in determining value.

Accompanying the legal fiction of a “hypothetical negotiation” at the “date of first infringement” is the assumption that the “reasonable royalty” that would emerge should be recovered from that date, even if no claim of infringement was advanced until years later. Ironically, if the claim is brought by an entity who actually uses the patented technology, the plaintiff must mark his products or give actual notice of his claim in order to start the damage period running.

But if the patent pertains to a claimed business method or if the plaintiff never produced a product incorporating the claimed invention, no such obligation exists, and the plaintiff can recover back to the date of “first infringement.” Crystal Semiconductor Corp. v. Tritech Microelectronics Int’l Inc., 246 F.3d 1336 (Fed. Cir. 2001).

The result of this legal fiction — which favors those who do nothing over those who actually practice their invention — should be reconsidered. A plaintiff that fails to asserts its invention for years may be statutorily entitled to a “reasonable royalty,” but that reasonable royalty during the period of its own inaction might more appropriately be a nominal one. A more significant royalty might be “reasonable” only after the plaintiff has actually asserted his claim and put the alleged infringer on notice. Whether the royalty should be nominal or large should be the product of proof, not of assumptions imbedded in a legal fiction.

Likewise, there are significant factors bearing upon the value of a technology patent that are arguably at least as important as the 15 Georgia Pacific factors. One such factor is the nature and amount of patented technology in the field. The example cited by JP Morgan — 250,000 patents in the field of smartphones alone — makes it doubtful that the value of a single patent in many areas of technology should be determined in isolation. Where and how the patent fits in relation to other patents is relevant to value, yet afforded no recognition under the Georgia Pacific standard.

Another potentially significant factor is whether others in the field have recognized the patent as a significant contribution to the art. Many scientists publish their contributions to the art in a variety of ways, which is not inconsistent with simultaneously seeking patent protection. This allows members of the community who are involved in the actual practice of the technology claimed in the patent to assess the nature of the contribution. If a patent has been recognized by others in the art as significant, its value may be great. On the other hand, if it is a “stealth patent” that few, if any, regard as making a contribution (other than those attempting to enforce it years later), its value may well be far less.

Further, the manner in which the owner of the patent came into possession of it should be relevant to its valuation. Of course it is possible that the asserted patent is a hidden gem that represents a game-changing but somehow overlooked advance in the art. But the fact that no one regarded it as such until after it was purchased and a cadre of well-trained lawyers began the quest to extract royalty payments might have significant relevance to the overall determination of its worth.

It is beyond the scope of this brief article to propose exactly how the Georgia Pacific analysis should be reconsidered in light of the changes in commerce and patent litigation that have taken place over the past 40 years. The point is simply that a reconsideration of the entire Georgia Pacific analysis, including the "hypothetical negotiation," the "date of first infringement assumption" and the 15 factors, is due. At a minimum, automatic assumptions should be abandoned and replaced by proof tailored to the case at hand.

Changing a model that has been in existence for 40 years is, many will surely say, an invitation to confusion. There is no certainty that a new model would not also have its problems. But simply continuing to accept a model uncritically is far worse. "Georgia" (Pacific) may be an old, sweet song, but the world has changed and there is a need for a different tune.

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[1] For example, JP Morgan has developed a specific investment analysis for Acacia Research Corporation, concluding that it is an attractive investment opportunity. According to JP Morgan's "investment thesis" for Acacia, "We believe patents, as an asset class, and licensing, as a business model, present attractive long-term investment opportunities. We note strong 19% outperformance over the last five years for a select group of IP-centric stocks, relative to the S&P 500, 60% over the last four years, and 36% outperformance over the past year alone …. Companies that generate recurring revenues from royalty payments, such as Dolby, Rovi, and Qualcomm, can command high margins and often high valuation multiples. There are vast licensing opportunities in areas like smart phones (250,000 patents, according to RPX Corp), digital media, semiconductors, medical technology, ecommerce and other growth sectors."

[2] While theoretically, other factors might arguably be considered under the Georgia Pacific rationale, the practical effect of the fifteen factor list is to render anything else far less meaningful, since any other factor is not part of the "standard" analysis.