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Reasonable Royalty: Analytic Vs. Hypothetical Approach

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Law360, New York (February 21, 2012, 1:46 PM ET) -- One of the more difficult legal questions presented in patent infringement actions is how best to determine a "reasonable royalty" under 35 U.S.C. § 284. Currently, the primary standard for determining a "reasonable royalty" is the "hypothetical negotiation" approach that arises from 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).

Under this standard, the trier of fact "envision[s] 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). As the court in Panduit Corp. v. Stahlin Bros. Fibre Works Inc., 575 F.2d 1152, 1159, ((6th Cir. 1978), described it, this process is a "legal fiction" that "conjures a 'willing' licensor and licensee, who like Ghosts of Christmas Past, are dimly seen as 'negotiating' a 'license.' There is, of course, no actual willingness on either side, and no license to do anything."

The "hypothetical negotiation" approach has become so engrained in legal thinking about valuing a "reasonable royalty" that the Federal Circuit recently referred to it as the "primary standard" for that purpose. 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). In fact, in Lucent v. Gateway, both parties accepted the standard as applicable in the case without dispute or, so far as the opinion reveals, much in the way of analysis. Lucent, 580 F.3d at 1324-25. Likewise, the "hypothetical negotiation" approach based on the Georgia-Pacific factors is incorporated into many, though not all, model jury instructions for determining a reasonably royalty. (See, e.g., Federal Circuit Bar Association, Model Patent Jury Instructions, Feb., 2010, Instructions 6.6 and 6.7).

While the Georgia-Pacific "hypothetical negotiation" approach may be appropriate in many cases, there is no valid basis to assume it is the correct standard in every case. Given the enormous breadth of technology, the differing nature of patents granted in different areas of technology, and the virtually infinite variety in the significance of that technology to increasingly sophisticated end products, no single standard can possibly be the right one for all cases.

The decision in Georgia-Pacific itself makes clear that the 15-factor test set forth there was never intended to act as a legal standard for all future cases. Describing the factors, the court said: "The following are some of the factors mutatis mutandis seemingly more pertinent to the issue herein." Georgia-Pacific, 318 F. Supp. at 1120. At no point did the court say that the "hypothetical negotiation" approach using 15 factors it identified was intended to be an all-encompassing checklist for determining a reasonable royalty under 35 U.S.C. § 284 in any future case, much less all cases.

Likewise, there is nothing in the subsequent decision in Panduit indicating that the "hypothetical negotiation" approach was intended as a standard for all cases. Though it is often overlooked, the court in Panduit actually pointed out that there is no single method of determining a reasonable royalty in all cases.

The amount of a reasonable royalty after infringement turns on the facts of each case, as best they may be determined. Among the relevant facts are: "what plaintiff's property was, to what extent defendant has taken it, its usefulness and commercial value as shown by its advantages over other things and by the extent of its use," Panduit, 575 F.2d at 1159.

In TWM Manufacturing Co. v Dura Corp., 789 F. 2d 895 (Fed. Cir. 1986), cert. denied, 479 U.S. 852 (1986), the Federal Circuit held that a district court is not required to use the "hypothetical negotiation" Georgia-Pacific approach at all. The Federal Circuit held that "The methodology of assessing and computing damages under 35 U.S.C. Sec. 284 is within the sound discretion of the district court."

In TWM Manufacturing, a special master had determined a reasonable royalty using what the court described as an "analytical approach." Under this approach, the special master considered evidence of the defendant's projected profitability from sales of the infringing product, applied evidence of costs and expenses to project profitability and then analyzed the portion of that profit that should be attributed to the patented technology.

The defendant argued that the special master erred as a matter of law in declining to use the "hypothetical negotiation" approach set forth in Georgia-Pacific. The Federal Circuit specifically rejected this argument:

> Dura has cited nothing which would limit the district court's discretion in choosing the analytical approach to determine a reasonable royalty. Section 284 does not mandate how the district court must compute that figure, only that the figure compensate for the infringement. Aro Manufacturing Co. v. Convertible Top Replacement Co., 377 U.S. 476, 507, 84 S.Ct. 1526, 1543, 12 L.Ed.2d 457, 141 USPQ 681, 694 (1964).

TWM Manufacturing, 789 F. 2d at 899.

The court went on to affirm the finding of the special master using the so-called "analytical approach" to determining a reasonable royalty.

The Federal Circuit was correct in its conclusion that there is nothing in 35 U.S.C. § 284 that requires a court to use the "hypothetical negotiation" approach to determine a reasonable royalty, much less an approach limited to the fifteen factors set forth in Georgia-Pacific. Nothing in the statute or its legislative history gives rise to such a conclusion.

Moreover, the "hypothetical negotiation" has limitations that make its use in every case dubious. In Lucent v. Gateway, 580 F.3d at 1325, for example, the court held that licenses used in an attempt to re-create the "hypothetical negotiation" must be shown to have a "sufficiently comparable" relationship to the patented technology in order to form a basis for a damage claim using the "hypothetical negotiation" approach.

The Federal Circuit made this point again in ResQNet, 594 F.3d 860, 872 (Fed. Cir. 2010) and Wordtech Systems Inc. v. Integrated Networks Solutions Inc., 609 F.3d 1308, 1319 (Fed. Cir. 2010). Later, in Uniloc USA Inc. et al v. Microsoft Corp., 632 F.3d 1292, 1317 (Fed. Cir. 2011), the court explained:

> The meaning of these cases is clear: there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case.

Thus, the practice of attempting to use licenses for “similar” but different technology, or to use “general” royalty rates that are found in a particular industry as the basis for a “hypothetical negotiation” is not permitted. While certain of the factors that the court in Georgia-Pacific identified may still be pertinent to determining the value of infringed technology, where no license for the claimed technology exists, the attempt to use 15 factors in order to conjure up a “hypothetical negotiation” that has never and will never take place is of limited utility.

In cases in which the value of an invention has never been determined in the marketplace, therefore, the attempt to prove a reasonable royalty based on a “hypothetical negotiation” will be inherently speculative. In such cases, there is no credible evidence of actual licenses of the patent-in-suit. Nor is there a reliable way to recreate how parties would have bargained or what they would have regarded as significant in a supposed negotiation many years before.

Without clear evidence of how actual parties in fact negotiated the value of the exact same technology, the entire exercise is shrouded in speculation. It is not a reasonable way to go about determining millions of dollars in claimed damages. To the contrary, it is rife with speculation. Virtually every damage model in every area of the law, including patent law, precludes speculative damages. Rude v. Wescott, 130 U.S. 152, 167 (1889) (“[A] settled rule of law was violated, that actual, not speculative, damages must be shown, and by clear and definite proof, to warrant recovery for the infringement of a patent.”); ResQNet, 594 F.3d at 873 (finding that a reasonable royalty based on “speculative evidence” is improper); System Fuels Inc. v. U.S., 2012 at *4 (Fed. Cir. 2012) (noting that speculative damages are unavailable for a breach of contract claim); Aronowitz v. Health-Chem Corp., 513 F.3d 1229, 1239 (11th Cir. 2008) (reversing a district court’s grant of speculative damages for lost profits).

Additionally, there is an important public policy objection to applying the hypothetical negotiation in many cases that arises from the attempt to place that negotiation at the date of first infringement. Many patent claims asserted today were granted years after the accused products and technology standards were designed and developed. Likewise, many such claims are asserted years after the standards were implemented and the accused products put on the market.

In these cases, placing the hypothetical negotiation at the date the patent claims were issued awards the patentee “hold up” damages that bear no real relationship to the value of the incremental improvement in the art reflected in the patent claims. See The Evolving IP Marketplace, Aligning Notice and Patent Remedies With Competition, Federal Trade Commission, p. 191 et seq., March, 2011.
(www.ftc.gov/os/2011/03/110307/patentreport.pdf)

The measure of a reasonable royalty necessarily depends upon the economic value of the invention in the pertinent field of art, and on the actual use of that invention by the defendant. That, after all, is what the statutory language of 35 U.S.C. § 284 requires. Where the value of the technology has not been determined in the marketplace through actual licenses of the claimed technology itself, entered into at a time before the accused infringer has invested substantial costs into a design choice that implements the patented technology, the more direct — and therefore appropriate — approach to determining that economic value will often be through a methodology that implements the analytic approach.

The analytic approach has the advantage of focusing the attention — and the evidence — squarely on the economic value of the patented technology. Properly applied, it does not attempt to conjure up what might have happened many years ago in a nonexistent negotiation for a license that no one desires, or award "hold-up" damages to a patentee, particularly one who may have drafted claims to read on innovations reduced to practice by others.

As with any case, the plaintiff has the burden of proving damages with reasonable certainty. Lucent v. Gateway,580 F.3d at 1329, supra. Using the analytical approach, the plaintiff could establish the value of a reasonable royalty by proof of the amount of incremental profit earned by the defendant that can be attributed to the patented technology and what portion of that additional profit should reasonably be paid to the patentee. The concept of reasonable certainty determining a reasonable royalty demands proof of both, using evidence that is directed to the value of the technology in terms of its ability to produce an amount of profit beyond what had gone before.

While there may be a variety of ways to apply the analytical approach, depending upon the nature of the technology, the invention, and its commercial utility, in most cases the analytical approach would require proof of: (1) the nature of the technology and the degree to which the claimed patent represents an actual advance in the art; (2) the degree to which the improvement claimed in the patent in suit has generated either an incremental profit or some discernable portion of the profit that the defendant has earned, taking into account pre-the totality of patents and existing technology in the field; and (3) the actual use of the patented technology by the defendant.

Applying this standard would require the parties to focus attention — and admissible evidence — on the actual economic value of the claimed invention itself, not upon mechanical application of a series of factors, most of which are inapplicable.

Applying this standard to Lucent v. Gateway case, by way of illustration, the admissible evidence would most likely not be the percentages in royalties paid under different licenses for different, even if superficially similar, technology. Rather, the evidence would focus first on the invention itself and the extent to which it represented a valuable improvement over prior art.

In this connection, proof of the prior art — that is the scope of the art in the field and the place that the patented invention occupies in that field — would be important. The value of "datepicker" technology in the art would be determined based upon its place in field, not on licenses for different technology. Next, the extent to which "datepicker" technology in fact contributed to any profit by Microsoft earned on the software that incorporated would be essential.

Some inventions are of extraordinary value, and that should be recognized. Others, however, represent small incremental variations of steps claimed in many other patents, and thus should be accorded very little actual economic value. Proof of the actual value of the technology — articulated in terms of how it has in fact contributed to the creation of economic profit — should be a requirement in order to recover damages for the use of that technology.

General notions of "value" that are not tied to the ability to produce actual economic gain are generally speculative and therefore insufficient to support a "reasonable royalty." Last, proof of the actual use of this "datepicker" technology would also be essential evidence. The simple fact that code for "datepicker" is present in Outlook when it is sold is, without more, not sufficient to show that this technology contributed to additional profit and therefore produced economic value.

Evidence of actual user adoption of this technology would be highly probative if not essential in order to prove actual use of the patented invention. There would be no need to presume a hypothetical negotiation or to consider the application of inapplicable "factors."

Using this approach would make evidence concerning the actual use of the patented technology during the period after the claimed "date of first infringement" not only admissible but highly relevant. Of course, this information may well have been unknown to both the patent holder and the infringer prior to the "date of first infringement," when the supposed "hypothetical negotiation" would have occurred.

This, however, cannot be a valid objection to its admissibility. Evidence of actual sales of the allegedly infringing product is admissible, even though this could not have been known years before. E.g., Innogenetics NV v. Abbott Labs., 512 F.3d 1363, 1380 (finding that a jury award must have included an ongoing royalty because the lump sum award was too high relative to the actual sales prior to the date of the judgment to have been reasonable as a royalty for past infringement only).

And courts have had no difficulty admitting evidence of events subsequent to the "date of first infringement" when deemed desirable. This is accomplished through reference to the "book of knowledge," which is little more than a metaphor for evidence of subsequent conduct that court decides it would like to consider. Lucent, 580 F.3d at 1333 ("[T]he hypothetical negotiation analysis 'permits and often requires a court to look to events and facts that occurred thereafter and that could not have been known to or predicted by the hypothesized negotiators.'"); Standard Mfg. Co. Inc. v. United States, 42 Fed. Cl. 748, 762 (Ct. Cl. 1999) ("Consideration of later-occurring events may be necessary to approximate a fair royalty to which negotiators with access to such knowledge would have agreed.").

Finally, in reasonable royalty cases, strong consideration should be given to determining the correct legal standard early in the litigation, not as a virtual afterthought at the end. The correct legal standard by which the value of the patent-in-suit should be decided is often as significant to the outcome of the case as the correct determination of the meaning of the terms used in the patent claims required under Markman v. Westview Instruments, 517 U.S. 370 (1996). In many cases, if judicial attention is focused early in the case on the proper measure of value, it is reasonable to conclude that it would have a positive impact on the prompt resolution of the entire case.

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