Royalty Bases And Damages Theories: A Fed. Circ. Update

Law360, New York (April 7, 2016, 10:21 AM EDT) --

Patentees frequently attempt to estimate reasonable royalty damages as a percentage of the defendants' sales of an accused product. This approach has lead to outsized jury awards in some cases where the patent covers only a minor feature of a much larger product. In recent years, the Federal Circuit has clamped down on such awards, limiting the situations where royalties may be based on sales of an entire end product, and requiring instead that royalties generally be based on the "smallest salable unit" (or some portion of it) that incorporates the patented feature. This has led some patentees to turn to alternative reasonable royalty approaches, such as royalties based on comparable licenses and license offers, in an attempt to evade the "smallest salable unit" requirement. This article will discuss the evolution of these different approaches in light of recent Federal Circuit precedent.

Restrictions on Use of the Entire Market Value Rule

Under a long-standing principle known as the "entire market value rule," a patentee may in certain circumstances obtain damages "based on the value of an entire apparatus containing several features," when the patented feature is "the basis for customer demand."[1] The entire market value rule, however, can (and sometimes did) result in excessive damages awards in situations if the patented item is only a minor feature of a much larger and more expensive (and popular) end product. Recognizing this possibility, the Federal Circuit began addressing and limiting the use of the "entire market value rule" in a series of cases starting in 2009.

The first of these cases was Lucent Techs. v. Gateway,[2] where the Federal Circuit overturned a jury verdict due to a lack of evidence supporting application of the entire market value rule. In Lucent, the jury awarded over $350 million in damages, calculated by taking a percentage of sales of Microsoft's Outlook software. The patent at issue, however, covered only a minor feature of Outlook — a "date-picker" allowing a user to select a particular date from a calendar.[3] The court found that the award was as an improper application of the entire market value rule, since the patented feature "is but a very small component of a much larger software program," the "vast majority of the features [of Outlook] do not infringe" and the plaintiff "did not carry its evidentiary burden of proving that anyone purchased Outlook because of the patented method."[4]

Lucent, however, left open the question of whether it might sometimes be permissible to use an entire product as a royalty base in such a situation if the rate applied was sufficiently low. The Federal Circuit answered this question in the negative two years later in Uniloc v. Microsoft.[5] It found that 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."[6] The entire market value rule can thus be applied "only where the patented feature creates the basis for customer demand or substantially creates the value of the component parts."[7]

The Federal Circuit in Uniloc also emphasized apportionment as central to the selection of revenue-based royalties. It explained not only that the patentee must "apportion" royalties between patented and unpatented features, but also that "such evidence must be reliable and tangible, and not conjectural or speculative.'"[8]

Limiting the Royalty Base to the "Smallest Salable Patent Practicing Unit"

Although Uniloc stressed the need for apportionment, it did not prescribe how apportionment should be carried out. But further guidance was forthcoming from the Federal Circuit the following year in LaserDynamics v. Quanta Computer.[9] In LaserDynamics, the jury awarded damages based on the sale of an entire computer when the patent related only to the computer's optical disk drive.[10] In finding this award improper, the Federal Circuit clarified that the principle of apportionment required the use of the "smallest salable unit" incorporating the patented feature as the royalty base.[11] In other words, "[w]here small elements of multi-component products are accused of infringement," it is "generally required that royalties be based not on the entire product, but instead on the 'smallest salable patent-practicing unit.'"[12] Allowing damages to be based on the sale of the entire product is merely "a narrow exception to this general rule."[13]

Two years later, in VirnetX v. Cisco Systems,[14] the Federal Circuit took the apportionment principle further, holding that using the "smallest salable patent practicing unit" as the royalty base did not necessarily end the requirement for apportionment. In VirnetX, the jury awarded damages based on sales of entire iOS devices even though the patent related to only one feature concerning Apple Inc.'s FaceTime software.[15] In overturning the jury's verdict, the court rejected the notion that "when the smallest salable unit is used as the royalty base, there is necessarily no further constraint on the selection of the base."[16] To the contrary, the "requirement that a patentee identify damages associated with the smallest salable patent-practicing unit is simply a step toward meeting the requirement of apportionment."[17] "Where the smallest salable unit is, in fact, a multi-component product containing several non-infringing features with no relation to the patented feature … the patentee must do more to estimate what portion of the value of that product is attributable to the patented technology."[18]

Application of the "Smallest Salable Unit" Requirement to Alternative Royalty Approaches Based on Licenses and License Negotiations

Calculating damages as a percentage of sales of an accused product is not the only approach to determining a reasonable royalty. Another approach is to use comparable licenses as a starting point to determine a royalty rate. While the Federal Circuit was tightening up the entire market value rule, it has also reaffirmed the use of comparable licenses as a method of determining royalties in appropriate circumstances.[19]

LaserDynamics and VirnetX, however, left open the question of how the "smallest salable unit" rule might apply to restrict the use of comparable licenses. The Federal Circuit addressed this question in two recent cases, largely limiting its application.

In the first, Ericsson v. D-Link Systems,[20] the defendant argued that prior licenses should be excluded from the damages analysis because they were "tied to the entire value of the licensed products, even though the technology being licensed related to only a component of those products."[21] The court rejected this argument.[22] It explained that prior licenses "are almost never perfectly analogous to the infringement action."[23] For example, they may cover additional intellectual property rights or "be calculated as some percentage of the value of a multi-component product."[24] As long as testimony relating to such licenses "account[s] for such distinguishing facts," the court found, the fact that "a license is not perfectly analogous generally goes to the weight of the evidence, not its admissibility."[25] Because "licenses are generally negotiated without consideration of the [entire market value rule]," requiring that they must be tied to the smallest salable unit "would often make it impossible for a patentee to resort to license-based evidence."[26]

Last December, the Federal Circuit expanded upon this analysis in Commonwealth Scientific v. Cisco Systems,[27] finding that “all damages models” need not “begin with the smallest salable patent-practicing unit.”[28] In Commonwealth Scientific, the court upheld a damages model that used the parties’ prior offers during negotiations as the basis for the damages award. Because these discussions “centered on a license rate for the [patent-in-suit], this starting point,” the Federal Circuit found, they “already built in apportionment.”[29] The court also explained that the “choice of royalty base” in this case was “irrelevant” because the rates relied on were “contemplated as cents per end unit” but “could equally have represented cents per wireless chip without affecting the damages calculation.”[30] The Federal Circuit further reaffirmed that a reasonable royalty may be based on comparable licenses, and that such licenses “are not inadmissible solely because they express the royalty rate as a percentage of total revenues, rather than in terms of the smallest salable unit.”[31]

It is important to recognize that these alternative approaches have their own significant evidentiary requirements. In the case of comparable licenses, although the analysis need not start with the smallest salable unit, apportionment must nonetheless be considered. For example, “expert testimony” may be needed to “explain[] to the jury the need to discount reliance on a given license to account only for the value attributed to the licensed technology.[32] The Federal Circuit also directed that “the court should give a cautionary instruction regarding the limited purposes for such testimony” if “the accused infringer requests the instruction.”[33] Court should also “ensure that the [jury] instructions fully explain the need to apportion the ultimate royalty award to the incremental value of the patented feature from the overall product.[34]

These recent admonitions are in addition to the long-standing requirement that a party seeking to rely on a license must prove that it is “sufficiently comparable to the hypothetical license at issue in suit.”[35] “[A]lleging a loose or vague comparability between different technologies or licenses does not suffice.”[36] And, when royalty rates are based on offers by the parties, the fact finder “still may need to adjust the negotiated royalty rates to account for other factors” that are relevant, such as the patents being essential to a standard.[37]

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[1] LaserDynamics, Inc. v. Quanta Computer, Inc., 694 F.3d 51, 67 (Fed. Cir. 2012) (citation omitted).

[2] Lucent Techs., Inc. v. Gateway, Inc., 580 F.3d 1301 (Fed. Cir. 2009).

[3] Id. at 1323, 1337.

[4] Id. at 1337.

[5] Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292 (Fed. Cir. 2011).

[6] Id. at 1320.

[7] Id. at 1318 (internal quotation marks and citation omitted).

[8] Id. (quoting Garretson v. Clark, 111 U.S. 120, 121 (1884)).

[9] LaserDynamics, Inc. v. Quanta Computer, Inc., 694 F.3d 51 (Fed. Cir. 2012).

[10] Id. at 60.

[11] Id. at 67.

[12] Id. at 67 (quoting Cornell Univ. v. Hewlett-Packard Co., 609 F.Supp.2d 279, 283, 287-88 (N.D.N.Y. 2009).

[13] Id.

[14] VirnetX, Inc. v. Cisco Systems, Inc., 767 F.3d 1308 (Fed. Cir. 2014).

[15] Id. at 1325.

[16] Id. at 1327.

[17] Id.

[18] Id.

[19] See ResQNet.com. v. Lansa, 594 F.3d 860 (Fed. Cir. 2010); Apple Inc. v. Motorola, Inc., 757 F.3d 1286, 1325-26 (Fed. Cir. 2014) (overruled on other grounds by Williamson v. Citrix Online, LLC, 792 F.3d 1339, 1349 (Fed. Cir. 2015). Finjan v. Secure Computing Corp., 626 F.3d 1197 (Fed. Cir. 2010).

[20] Ericsson, Inc. v. D-Link Systems, Inc., 773 F.3d 1201 (Fed. Cir. 2014).

[21] Id. at 1225.

[22] Id. at 1226.

[23] Id. at 1227.

[24] Id.

[25] Id.

[26] Id. at 1228.

[27] Commonwealth Scientific and Industrial Research Organisation v. Cisco Systems, Inc., 809 F.3d 1295 (Fed. Cir. 2015).

[28] Id. at 1303.

[29] Id.

[30] Id. at 1303 n.1.

[31] Id. at 1303.

[32] Ericsson, 773 F.3d at 1228.

[33] Id.

[34] Id.

[35] LaserDynamics, 694 F.3d at 79 (citation omitted).

[36] Id.

[37] Commonwealth Scientific, 809 F.3d at 1303-04.