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NAVIGATING BETWEEN THE “HYPOTHETICAL NEGOTIATION” AND REAL WORLD FACTS IN PROVING PATENT DAMAGES



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While there are many differences between patent cases and other complex commercial litigation, one notable distinction is the use of a “hypothetical” transaction to prove patent damages.

As a remedy for infringement of its patent, a patentee is entitled to “damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer.” 35 U.S.C. § 284. A reasonable royalty is generally calculated by multiplying two separate and distinct amounts: (1) the royalty base, or the revenue pool implicated

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ATTORNEY COMPETENCE AND SOCIAL MEDIA IN AID OF JUROR INVESTIGATION AND MONITORING



Justice (Ret.)
J. Gary Hastings

In order to practice competently these days, a trial attorney may be required to use social media sources to investigate prospective jurors and monitor empanelled jurors’ Internet activities during trial. Such investigation and monitoring, however, may alert a prospective juror or a seated juror that the attorney is

reviewing his or her Internet presence. This article explores whether such contact traces constitute prohibited communications with prospective or actual jurors and whether judges should advise all jurors at the outset that such contacts may take place.

Because technology and social media have become essential parts of daily life, investigation into potential jurors’ online presence during jury selection is becoming an increasingly important part of an attorney’s ethical duty of competence. Professional rules of conduct provide that, in order to practice competently, a trial attorney must keep abreast of technological changes. For example, Comment No. 8 of Rule 1.1 of the American Bar Association Model Rules of Professional Conduct (ABA Model Rules) states: “To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology.”

In California, the Digest from Formal Opinion Interim No. 11-0004 from the Standing Committee on Professional Responsibility and Conduct of the State Bar of California states: “An attorney’s obligations under the ethical duty of

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by the infringement; and (2) the royalty rate, or the percentage of that pool adequate to compensate the plaintiff for the infringement. *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 286 (N.D.N.Y. 2009).

Although not the exclusive method for doing so, the commonly used construct for proving a reasonable royalty for the infringer’s use of the invention – a construct that has been endorsed by case law for decades – is a “hypothetical negotiation” in which the parties would have agreed to license the asserted patent just before infringement began.

Case law provides certain rules applicable to the hypothetical negotiation. For example, in the hypothetical negotiation, the asserted patent claims are deemed to be valid, enforceable, and infringed by the product or service that is the subject of the litigation (the “accused product”), and the parties are assumed to be a willing licensor and willing licensee acting reasonably in reaching an agreement. *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1324-1325 (Fed. Cir. 2009); *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).

Complicating the use of a fictitious transaction as the basis for damages is the need to imbue the hypothetical negotiation with real world data grounded in the facts of the case because, in a number of aspects, real world business practices do not match up with the rules applicable to the hypothetical negotiation.

This dichotomy can arise when parties use “comparable licenses” from the real world as evidence of the “hypothetical license” that would have resulted from the hypothetical negotiation. Courts have long recognized that real world licenses of comparable technology – and particularly actual licenses of the patents-in-suit – may provide highly probative evidence of the value of the patented invention. *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 79 (Fed. Cir. 2012); *Georgia-Pacific*, 318 F. Supp. at 1120. In negotiating real world patent licenses, however, parties generally do not act under the same constraints applicable to the hypothetical negotiation. Accordingly, “[p]rior licenses . . . are almost never perfectly analogous to the infringement action.” *Ericsson, Inc. v. D-Link Sys.*, 773 F.3d 1201, 1227 (Fed. Cir. 2014).

The objective of real world and hypothetical licenses is the same: that the patentee be paid for the value contributed by the features covered by the patent, but not any value attributable to other aspects of the product. However, an

example of a common distinction between real world and hypothetical licenses is the treatment of the royalty base to which the royalty rate is applied. Real world licenses often apply a royalty rate to the entire sales price of (or profit from) the licensee’s product. Rather than undertaking the daunting task of determining the amount of revenue directly attributable to the technology covered by the patent to be licensed, for the purposes of applying a royalty rate solely to that portion of the product’s revenue, real world licensing parties usually choose a royalty rate small enough so that the resulting royalty paid reflects only the value perceived to be provided by the patent. *Ericsson*, 773 F.3d at 1228 (“licenses are generally negotiated without consideration of the [entire market value rule]”). Using the sales price of an entire product as the royalty base for a running royalty to be paid over time also has the obvious business advantages of being readily ascertainable and, if necessary, auditable by the licensor.

In the hypothetical negotiation, however, it is generally not permissible to use as the royalty base the whole sales price – or “entire market value” – of the accused product unless the patented feature drives market demand for the product or substantially creates the value of the component parts. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011). Instead, the patentee is expected to present real world evidence that apportions the value that the patented technology contributes to the accused product, separate and apart from the value of features not covered by the patent-in-suit. See *Garretson v. Clark*, 111 U.S. 120, 121 (1884).

The Federal Circuit hears all appeals in patent infringement cases. Historically, that Court’s position on the challenges presented by the apportionment requirement could be summarized as sympathetic, if not particularly forgiving. The Court has readily acknowledged the difficulty of accomplishing the apportionment task, and the reality that it will typically involve approximation and uncertainty. *Ericsson*, 773 F.3d at 1232, n.9; *VirnetX, Inc. v. Cisco Sys.*, 767 F.3d 1308, 1328 (Fed. Cir. 2014); *LaserDynamics*, 694 F.3d at 66. “Determining a fair and reasonable royalty is often . . . a difficult judicial chore, seeming often to involve more the talents of a conjurer than those of a judge.” *Fromson v. Western Litho Plate & Supply Co.*, 853 F.2d 1568, 1574 (Fed. Cir. 1988). Nevertheless, as to the fine line between the hypothetical negotiation and the real world, the Court has stated that, “a reasonable royalty

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analysis requires a court to hypothesize, not to speculate.” *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010). While founded on a hypothetical negotiation, “[a] damages theory must be based on sound economic and factual predicates.” *LaserDynamics*, 694 F.3d at 67 (internal quotations omitted).

In addition to recognizing the difficulty of apportionment, the Federal Circuit acknowledges that apportioning the royalty base to include only the value of the patented features is not the only way to ensure that a patent damages award provides a reasonable royalty only for the patented technology. The Court concedes that, as a mathematical matter, a reasonable royalty can be accurately calculated using the entire sales price of a product if (like in the real world) it is balanced out by using a small enough royalty rate. *Ericsson*, 2014 U.S. App. LEXIS 22778, at *54.

However, mathematical accuracy is not the sole objective of the entire market value rule. That rule also serves “an important evidentiary principle,” *id.*, i.e., to avoid improperly influencing a jury to wrongly compensate the patentee for non-infringing components of the product by exposing the jury to large revenue figures representing the entire market value of accused products. The Federal Circuit has expressed the concern that using a product’s entire market value as a royalty base “cannot help but skew the damages horizon for the jury,” *Uniloc*, 632 F.3d at 1320, and “make a patentee’s proffered damages amount appear modest by comparison.” *LaserDynamics*, 694 F.3d at 68.

Relying on this rule, some accused infringers have sought to exclude damage testimony that incorporated references to real world licenses that were based on end products rather than the patented features of those products. These defendants have argued that the inclusion of those licenses in the damage analysis violates the entire market value rule.

In December 2014, the Federal Circuit rejected that argument. Instead, the Court found that exclusion of such real world licenses did not strike the appropriate balance between the benefit of real world evidence of the invention’s worth in the marketplace and the evidentiary principle behind the entire market value rule. In so doing, the Court affirmed that real world licenses “in which royalties were set by reference to the value of an end product” are not disqualified from being used as comparable licenses in the

hypothetical negotiation when proper adjustments are explained to the jury. *Ericsson*, 773 F.3d at 1227-1228.

In *Ericsson*, the patentee advanced a per unit royalty rate consistent with comparable licenses that the patentee had entered into with third parties for a group of patents that included the patents-in-suit. The patentee argued that its damages expert’s analysis included steps to isolate the value of the patents-in-suit from any other patents covered by the real world licenses he referenced, and therefore properly apportioned any damages calculations based on those licenses to account for the value of the patents at issue. *Id.* at 1225.

In seeking to exclude the damages testimony, the accused infringers argued that the testimony violated the entire market value rule because the damages calculations were, in part, based on licenses which were themselves tied to the entire value of the licensed products, even though the patents-in-suit related to only portions of those products. *Id.* at 1225.

The Federal Circuit disagreed, concluding that, in light of the steps that the patentee’s expert had taken to isolate the value of the patents-in-suit from the other patents in the comparable licenses, the patentee’s damages testimony violated neither the rule requiring apportionment, nor the evidentiary principle demanding an “appropriate balance between the probative value of admittedly relevant damages evidence and the prejudicial impact of such evidence caused by the potential to mislead the jury into awarding an unduly high royalty.” *Id.* at 1227.

The *Ericsson* decision demonstrates the practical reality that, in navigating between the real world and the hypothetical negotiation, it’s preferable not to let the perfect be the enemy of the good. Where real world licenses predicated on the value of a multi-component product are used to inform the hypothetical negotiation, with appropriate evidence apportioning the revenue from those licenses to the patents-in-suit, they need not be excluded under the entire market value rule because, as the Federal Circuit acknowledged, a contrary rule would often make it impossible for a patentee to utilize real world license-based evidence. *Id.* at 1228.

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