

Problems With Hypothesizing Reasonable Royalty Negotiation

Law360, New York (January 07, 2014, 12:41 PM ET) -- Reasonable royalty damages are the predominant form of relief awarded in patent infringement cases. Of late, they have been a lightning rod for assertions that the patent protection system is out of control.

The primary tool used to assess such damages is the hypothetical negotiation. The construct provides that a reasonable royalty should be determined by hypothesizing an imaginary negotiation between a patent holder and an infringer over the use of a patented invention at the time of first infringement. Use of this construct has become so common that many courts go so far as to define a reasonable royalty as the outcome of a hypothetical negotiation.[1]

Increasingly heavy reliance on the hypothetical negotiation construct may not be appropriate in light of the fundamental purpose of reasonable royalty damages. That purpose is to provide a patent holder with adequate compensation for infringement.[2] Such a determination does not require the construction of a negotiation between the parties. In fact, in many circumstances, efforts to artificially create such a negotiation can introduce unnecessary and irrelevant uncertainties and disputes, such as

- What is the proper goal of a hypothetical negotiation?
- When should the hypothetical negotiation take place and what information should be considered in analyzing such a negotiation?
- What should be the impact of a finding of validity, enforceability, and infringement on the level of damages?
- What role, if any, should the relative bargaining power of the patent holder and the infringer play in the determination of damages?

Focusing attention on negotiation-related questions like these may, and often does, undermine the quality and reliability of the ultimate damages determinations.

Origins of Reasonable Royalty Damages

Reasonable royalty damages were not originally conceived of as the outcome of a hypothetical negotiation. Rather, reasonable royalty damages emerged from a number of cases in which patent holders had established infringement, but were unable to prove damages under prevailing evidentiary standards. The Sixth Circuit wrote in 1914: "It is a travesty to allow property rights to be seized and enjoyed without remedy simply because of the supposed difficulty in establishing their value." [3] To avert such a travesty, the court described an appropriate damages analysis:

This damage or compensation is not, in precise terminology, a royalty at all, but it is frequently spoken of as a “reasonable royalty”; and this phrase is a convenient means of naming this particular kind of damage. It may also be well called “general damage”; that is to say, damage not resting on any of the applicable, exact methods of computation but upon facts and circumstances which permit the jury or the court to estimate in a general, but in a sufficiently accurate, way the injury to plaintiff caused by each infringing sale.[4]

One year later, the U.S. Supreme Court specifically endorsed the use of reasonable royalty damages as compensation for patent infringement in *Dowagiac Manufacturing Company v. Minnesota Moline Plow Co.*[5]

Since then, a reasonable royalty has been described as “a device for retroactively reaching a just result.”[6] In essence, reasonable royalty damages were conceived of as a form of general damages that were intended to ensure that a patent holder is fairly compensated for the unauthorized use of its patent(s).

Emergence of Hypothetical Negotiation Construct

Reliance on the hypothetical negotiation construct as a tool for assessing damages typically is traced to the 1970 district court decision in *Georgia-Pacific Corporation v. United States Plywood Corporation*.^[7] In that decision, the use of the construct was advocated by the plaintiffs and described by the court as “more a statement of approach than a tool of analysis.”^[8] The court noted that the construct “represents an attempt to colligate diverse evidentiary facts of potential relevance”^[9] and was just one of the fifteen “factors *mutatis mutandis* seemingly more pertinent to the issue[s]”^[10] in the case.

Unfortunately, trying to transform this statement of approach, or colligating factor, into a mandatory super-structure for damages analysis requires adoption of a number of critical assumptions. Judgments about these assumptions usually create, rather than resolve, issues and conflicts. Most of these issues and conflicts do not relate to the value generated by the unauthorized use of the patented technology and can distract from a proper focus on determining fair compensation for a patent holder in light of an infringement.

Implementation Issues

A fundamental source of conflict arising from use of the hypothetical negotiation construct concerns the objective of the analysis. Specifically, is the negotiation intended to determine the hypothetical licensing terms that would have been agreed to by the litigating parties^[11] or what the parties should have agreed to if they had been acting rationally?^[12]

The former goal invites consideration of extreme negotiating positions of parties (e.g., plaintiffs demanding full compensation for “lost profits” without satisfying the requirements for lost profits damages or defendants insisting that they would never have paid for use of the infringed patents) that provide little insight into the amount of damages needed to adequately compensate a patent holder for the unauthorized use of its patent.

The latter goal may avoid this problem, but it is not clear how a “negotiation” aids in the determination of appropriate damages. Arguably, because reasonable royalty damages are appropriate only when the patent holder is unable or unwilling to prove entitlement to lost profits, a “reasonable” patent owner should accept any compensation above zero as reasonable royalty damages, because none of its profits

were displaced.

For his/her part, the infringer should be willing to pay any amount up to the incremental benefits generated by the infringement (assuming that can be determined). In a damages analysis, these data points are useful to the determination of reasonable royalty damages, but, using a negotiation construct typically provides little guidance for determining what is objectively fair.

Reliance on the construct also invites questions about the timing of the negotiation and the information deemed knowable to the negotiators. Although the construct calls for a negotiation at, or immediately prior to, the date of “first infringement,”[13] the specific date of the negotiation often becomes a point of contention. In *Fromson v. Western Litho*, for example, the Federal Circuit noted that “the parties emphasize either the May 1965 date of first infringement or selected later events, depending on which they see as best serving their interests.”[14]

Moreover, in practice, courts have used a variety of dates as the date of “first infringement,”[15] adding further complication to the evaluation of patent damages under the construct. From the perspective of evaluating patent damages, disputes concerning the date of the hypothetical negotiation may not be productive, as they distract from the main question of the amount of compensation needed to adequately compensate the patent holder.

A related set of concerns relates to the information that is assumed to be available to the “negotiators” during the hypothetical negotiation. At one extreme (i.e., ex ante approach), it is assumed that the only relevant information is that which was or would have been known at the time of the hypothetical negotiation — which includes expectations regarding the “future” that may or may not have been confirmed by actual events by the time the damages analysis is conducted.[16] Accordingly, a damages determination under the ex ante approach could be divorced from actual events that are known when damages are determined. At the other extreme (i.e., ex post approach), the damages analysis considers all relevant information, regardless of when such information may have become known.

Consideration of such information is based on the concept known as the “book of wisdom,” the availability of which was embraced and endorsed by the Federal Circuit in *Fromson*.^[17] In practice, the information that may be considered in a given proceeding is a matter of (sometimes unpredictable) discretion^[18] — which does little to enhance the reliability or predictability of reasonable royalty damages analyses.

In the hypothetical negotiation construct, a fundamental presumption is that the negotiation is over rights to a valid, enforceable, and infringed patent. It is axiomatic that such a patent is more valuable than one for which those facts have not been determined. There are substantial disagreements, however, about how to incorporate such presumptions into a determination of reasonable royalty damages.

In particular, experts often disagree as to the level of enhancement, if any, that should be used to account for uncertainties relating to the strength of a patent. A hypothetical negotiation process does little to resolve that uncertainty and imprecision. In fact, it allows for, and may encourage, the parties to take quite divergent positions in the hope of, perhaps, ultimately obtaining a favorable split-the-difference outcome in litigation.

Consideration of Relative Bargaining Power

An overarching problem created by reliance on a hypothetical negotiation to determine reasonable royalty damages is that consideration of relative bargaining power of the negotiating parties often becomes a key driver of reasonable royalty damages. All else equal, the argument often goes, the greater a party's relative bargaining power, the greater the compensation that that party can expect to garner in a negotiation.

In patent litigation, typical bargaining power imbalances may derive, for example, from differences in perceived party strength (e.g., a large infringer vs. an individual inventor) or from differences in bargaining leverage (e.g., hold-up by a patent owner resulting from infringement-dependent investments by the infringing party). Whatever the source, such bargaining advantages may and often do affect the level of proposed compensation for the damaged party in a hypothetical negotiation analysis.

Consideration of relative bargaining power, however does not seem to be consistent with the purpose of evaluating reasonable royalty damages — such considerations often do not relate to the value of the patented technology itself. A patent holder does not become more injured by unauthorized use of a patent if it enjoys a stronger bargaining position, and it does not become less injured by such use if it enjoys a weaker bargaining position.

Similarly, the benefits realized by the infringer due to infringement do not change with relative bargaining power. Under these circumstances, reliance on the hypothetical negotiation construct introduces and elevates an improper element to the evaluation of reasonable royalty damages that is more likely to distort the outcome of the analysis than to improve its accuracy and reliability.

Conclusion

Reliance on the hypothetical negotiation construct to determine reasonable royalty damages introduces a number of unnecessary and, in some cases, counterproductive complications into patent damages analysis. It does that without providing any assurances that the outcome of such an analysis will necessarily meet the requirement of the patent statute to provide the patent holder with adequate compensation for an infringer's use of patented technology.

Moreover, the construct invites, and even necessitates, consideration of the relative bargaining power of the parties, which may have no bearing on the appropriate level of compensation for the patent holder. Given these circumstances, it may be time to reconsider the widespread heavy, and sometimes sole, reliance on the hypothetical negotiation construct in the determination of reasonable royalty damages.

--By John C. Jarosz and Michael J. Chapman, Analysis Group Inc.

John Jarosz is managing principal and Michael Chapman is vice president of Analysis Group in Washington, D.C.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See, e.g., *Fujifilm Corp. v. Benun*, 605 F.3d 1366, 1372 (Fed. Cir. 2010); *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1554 (Fed. Cir. 1995) (en banc); *State Indus., Inc. v. Mor-Flo Indus., Inc.*, 883 F.2d 1573,

1580 (Fed. Cir. 1989).

[2] The issues discussed in this article are treated in greater depth in John C. Jarosz & Michael J. Chapman, "The Hypothetical Negotiation and Reasonable Royalty Damages: The Tail Wagging the Dog," 16 STAN. TECH. L. REV. 769 (2013) <http://stlr.stanford.edu/pdf/royaltydamages.pdf>.

[3] *United States Frumentum Co. v. Lauhoff*, 216 F. 610, 616-17 (6th Cir. 1914).

[4] *Id.* at 617 (emphasis added).

[5] *Dowagiac Mfg. Co. v. Minnesota Moline Plow Co.*, 235 U.S. 641 (1915).

[6] *Georgia-Pacific Corp. v. U.S. Plywood-Champion Papers, Inc.*, 446 F.2d 295, 299 (2d Cir. 1971) (emphasis added).

[7] *Georgia-Pacific Corp. v. United States Plywood Corp.* (Georgia-Pacific 1970), 318 F. Supp. 1116 (S.D.N.Y. 1970).

[8] *Id.* at 1121.

[9] *Id.* at 1122.

[10] *Id.* at 1120.

[11] See, e.g., *Lucent Techs., Inc. v. Gateway, Inc.* (Lucent), 580 F.3d 1301, 1325 (Fed. Cir. 2009). ("[We] must decide whether substantial evidence supports the jury's implicit finding [as to what the infringer] would have agreed to, at the time of the hypothetical negotiation.").

[12] *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F. Supp. 2d 147, 150 (D.R.I. 2009) (describing the negotiating parties as "perfectly reasonable avatars" for the litigating parties).

[13] *Integra Lifesciences I, Ltd. v. Merck KGaA*, 331 F.3d 860, 870 (Fed. Cir. 2003). See also *Riles v. Shell Exploration & Prod. Co.*, 298 F.3d 1302, 1311 (Fed. Cir. 2002); *Panduit Corp. v. Stahl Bros. Fibre Works, Inc.*, 575 F.2d 1152, 1158 (6th Cir. 1978).

[14] *Fromson v. W. Lito Plate & Supply Co.* (Fromson), 853 F.2d 1568, 1577 (Fed. Cir. 1988).

[15] See, e.g., *Oracle Am., Inc. v. Google Inc.*, 798 F. Supp. 2d 1111, 1116 (N.D. Cal. 2011) (using point of first use (i.e., development and testing) as the date of the negotiation); *Georgia-Pacific* 1970, 318 F. Supp. 1116, 1123 (S.D.N.Y. 1970) (using the date of first manufacture); *Medtronic Sofamor Danek USA, Inc. v. Globus Med., Inc.*, 637 F. Supp. 2d 290, 310 n.26 (E.D. Penn. 2009) (using the date that the relevant product was first available for use). The FTC has advocated, as a matter of policy, for a hypothetical negotiation associated with contemplated infringement. Federal Trade Commission, *The Evolving IP Marketplace: Aligning Patent Notice And Remedies With Competition* (2011), available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf>, at 22.

[16] See, e.g., *Lucent*, 580 F.3d 1301, 1325 (Fed. Cir. 2009).

[17] *Fromson*, 853 F.2d 1568, 1575-76 (Fed. Cir. 1988). See also, *Honeywell Int'l, Inc. v. Hamilton*

Sundstrand Corp., 378 F. Supp. 2d 459, 464 (D. Del. 2005). (“[A]scertainment of [the hypothetical negotiation] date does not rigidly foreclose the factfinder from considering subsequent events. To enforce such rigidity would be to ignore a limitation inherent to the hypothetical negotiation method.”).

[18] For example, in the ActiveVideo opinion issued in 2012, the Federal Circuit noted that the Eastern District of Virginia did not allow for the infringer’s expert to rely upon a particular agreement because it post-dated the hypothetical negotiation by four years. *ActiveVideo Networks, Inc. v. Verizon Commc’ns, Inc.*, 694 F.3d 1312, 1332 (Fed. Cir. 2012). Yet, the plaintiff’s expert was allowed to rely upon an agreement that post-dated the negotiation by two years. *Id.* The Federal Circuit found there to be no abuse of discretion. *Id.*