

RESPONSE TO REJOINDER:

Clearing Up The Confusion

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On Aug. 28, William Rooklidge and Andrew Brown published a response¹ to a recent Law360 guest article of ours². In their response, Rooklidge and Brown wrote that we “argue in favor of the patentee obtaining as reasonable royalty damages the entire incremental profit earned by the alleged infringer on the smallest salable patent practicing unit (‘SSPPU’)³.” They went on to write, “according to Chapman and Jarosz, a damages expert should always survive a Daubert motion and be permitted to testify to the jury simply because the expert used the SSPPU profits as the royalty base⁴.”

We wish to clear up any confusion we may have created about our position on (1) the meaning of “incremental benefits” (profits); (2) the relevance of incremental benefits for the determination of reasonable royalty damages; and (3) the wisdom of using Daubert challenges to exclude damages assessments based on an incremental benefits analysis.

The Meaning of Incremental Benefits

The “incremental benefits” attributable to a particular patented technology refer to the additional benefits attributable to the use of the patent above and beyond those contributed by a host of other value drivers⁵. If such benefits can be calculated perfectly, these benefits “represent the value of the contribution of the patent, and nothing else⁶.” As a general matter, depending on the coverage of the patent, incremental benefits rarely

correspond to all of the alleged infringer's expected profits on accused products, or even to the expected profits associated with the SSPPU. Properly calculated incremental benefits often are much narrower than either of these measures of benefit and are tied specifically to the use of the technology at issue.

Incremental benefits flow from higher prices, lower costs, or increased volumes that would not have been achieved in the absence of infringement. By way of example, assume that a smartphone (GEN1) sells for \$200. Further, assume that a next-generation smartphone (GEN2) is identical, except for the inclusion of one new patented feature. If that next-generation smartphone sells for \$202, and the volumes shipped of the two phones are identical, the incremental revenues are likely to be calculated as the difference between the \$202 GEN2 price and the \$200 GEN1 price. Factoring in incremental (additional) costs associated with the patented invention, the incremental benefits (profits) of the patent are some fraction of \$2. The incremental benefits are not simply (or necessarily) the profits associated with the \$202 GEN2 product or some component of that product, regardless of whether the profits are ultimately calculated on a gross, variable, incremental, or fully loaded basis. They are the enhanced profits (some fraction of the \$2 price premium) that were driven by the patent.

In practice, the isolation of incremental benefits usually is very challenging. The challenges are often due to inadequate data and/or the complexity of the interactions between infringing and noninfringing contributors of product value. If the isolation can be done, however, the patent owner likely is entitled to a return associated with that contribution, but certainly is not entitled to a return associated with the contributions of other product (or component) value drivers. This conclusion appears to be consistent with Federal Circuit law⁷.

Interestingly, the Georgia-Pacific example described by Rooklidge and Brown provides an illustration of a useful analysis that sought to capture the incremental benefits of the patented technology in question. In that example, the Second Circuit struck down as impermissibly high the original award because it did not allow the alleged infringer "a reasonable profit after paying the supposititious royalty⁸." There, the Second Circuit adjusted the award to subtract out Georgia-Pacific's "normal" profit rate to allow it compensation for its own (normal) contributions⁹. The "normal" profit rate was used as the baseline against which to estimate "incremental" benefits. The above-"normal" return was deemed to be a proper measure of the "incremental benefits," of the patented invention and was awarded to the patent holder as reasonable royalty damages.

In *TWM Manufacturing Co, Inc. v. Dura Corp*¹⁰, the Federal Circuit affirmed a damages determination in which the reasonable royalty was determined by "subtract[ing] the infringer's usual or acceptable net profit from its anticipated net profit realized from sales of infringing devices¹¹" and in which the entire incremental benefit was awarded to the patent holder as reasonable royalty damages¹². In reaching its decision, the court noted that the infringing party "ha[d] not persuaded this court that [such a] royalty does not reflect what a willing licensor and licensee would have agreed to [at the time], based on the present record¹³."

The Use of Incremental Benefits in Determining Reasonable Royalty Damages

In reality, some number of real-world licenses do not provide for the patent owner to receive 100 percent of the expected incremental profits generated by a particular patent. For several reasons, however, that does not mean that a damages award (using a hypothetical negotiation construct) cannot provide for such an allocation.

First, in real-world licenses, discounts often are granted by the patent owner because of uncertainties about the validity, enforceability, and infringement of the patent. In a damages setting, no such uncertainties are presumed to exist.

Second, in real-world licenses, patent owners can and do grant discounts to encourage licensee adoption of their technology. A damages award, however, is not explicitly intended to incent behavior. It is intended to grant fair compensation associated with infringing use. Granting a discount in a damages award would encourage infringement¹⁴.

Third, in real-world license negotiations, there often is uncertainty about the patent's incremental benefits. In fact, extensive real-world bargaining often occurs because of such uncertainties. That uncertainty, however, is a measurement problem, not an allocation problem. A "discount" is not needed for this reason in a damages award if the incremental benefits can be calculated properly.

Finally, there is no evidence or reason to believe that patent owners never seek, or obtain, a payment that corresponds with all of the incremental benefits of the patent. From an economic perspective, the incremental benefits flowing from a patent can be and are shared between the parties in an infinite number of ways – each representing a different "share" of benefits assigned to the parties. At one end of this spectrum, the parties could agree to an allocation in which 100 percent of the benefits are retained by the user. In theory, a patent holder would be indifferent between this allocation and receiving nothing because, in a world without use, the patent holder would receive nothing for its efforts. At the other end of this spectrum, the parties could agree to an allocation in which 100 percent of the benefits are received by the patent holder. In theory, the user would be indifferent between this allocation and not using the patented technology because, even under this allocation, the user would retain all of the benefits generated by factors other than the infringement (i.e., it would receive its "normal" returns). An allocation of all of the incremental benefits to the patent owner is not improbable in the real-world, and need not be made impossible in the damages world.

Using a properly constructed hypothetical negotiation framework to calculate reasonable royalty damages, it is a factual question as to how the two parties would have allocated the patented benefits. Granting 100 percent of the incremental profits to the patent owner is neither theoretically nor empirically wrong. We believe that the court was correct in *Good Technology Corporation v. MobileIron Inc.* in holding that "as gatekeeper, the court cannot say that [the patent holder's expert's] allocation methodology is unsound¹⁵."

The Use of Daubert

We may have unintentionally given Rooklidge and Brown the impression that we think that expert testimony should never be excluded under Daubert when the expert uses the SSPPU profits as the royalty base or that we have created a “safe harbor” for royalty testimony. In fact, that is not our view.

We believe, however, that the issue addressed by the court in *Good Technology* – i.e., whether the patent holder is entitled to 100 percent of the estimated incremental profits – is the kind of question that a jury is qualified to evaluate, such that the court need not exercise its gatekeeper role to shield the fact-finder from this information.

In fact, that case seemed to pose two expert testimony questions. First, did the expert properly calculate the incremental benefits generated by the patented technology? On this question, the expert appears to have focused his analysis on the SSPPU and estimated the incremental benefits attributable to the patented technology to the value of the SSPPU. Whether this analysis was done correctly is unclear. This issue, however, can be addressed by the alleged infringer in opposing economic testimony challenging whether the SSPPU has been properly determined and whether the benefits identified by the patent holder are solely attributable to the patent, rather than other potential contributors of value. Furthermore, this testimony can be probed in detail on cross-examination. The resolution of this dispute involves analysis that is inherently case- and fact-specific and is within the scope of issues that juries commonly resolve.

Second, should all of the calculated incremental benefits be awarded to the patent holder as reasonable royalty damages? Once again, this conclusion is a judgment that can be challenged both with opposing economic testimony and through cross-examination. Though we have an opinion on that matter that is based on the assumption that incremental profits are properly isolated, there does not appear to be any definitive economic or legal reason that such a conclusion is inherently wrong. The resolution of this dispute involves analysis that is likely to be case- and fact-specific and is within the scope of issues that juries commonly resolve.

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Endnotes

- 1 William Rooklidge and Andrew Brown, “REJOINDER: Why It’s An Inappropriate Reasonable Royalty Rule,” *Law360* (Aug. 28, 2015).
- 2 Michael J. Chapman and John C. Jarosz, REBUTTAL: It’s Not An Inappropriate Reasonable Royalty Rule, *Law360* (Aug. 21, 2015).
- 3 William Rooklidge and Andrew Brown, “REJOINDER: Why It’s An Inappropriate Reasonable Royalty Rule,” *Law360* (Aug. 28, 2015).
- 4 William Rooklidge and Andrew Brown, “REJOINDER: Why It’s An Inappropriate Reasonable Royalty Rule,” *Law360* (August 28, 2015).
- 5 John C. Jarosz and Michael J. Chapman, “The Hypothetical Negotiation And Reasonable Royalty Damages: The Tail Wagging The Dog,” 16 *Stan. Tech. L. Rev.* 769, 813 (2013).

- 6 Michael J. Chapman and John C. Jarosz, REBUTTAL: It's Not An Inappropriate Reasonable Royalty Rule, Law360 (August 21, 2015).
- 7 Michael J. Chapman and John C. Jarosz, REBUTTAL: It's Not An Inappropriate Reasonable Royalty Rule, Law360 (August 21, 2015) (citing *Uniloc USA Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011); *ResQNet.com Inc. v. Lansa Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010); *VirnetX Inc. v. Cisco Sys. Inc.*, 767 F.3d 1308, 1326-28 (Fed. Cir. 2014); and *LaserDynamics Inc. v. Quanta Computers*, 694 F.3d 51, 67 (Fed. Cir. 2012)).
- 8 William Rooklidge and Andrew Brown, "REJOINER: Why It's An Inappropriate Reasonable Royalty Rule," Law360 (August 28, 2015) (citing *Georgia-Pacific Corp. v. U.S. Plywood-Champion Papers, Inc.*, 446 F.2d 295, 299 (2d Cir. 1971)).
- 9 *Georgia-Pacific Corp. v. U.S. Plywood-Champion Papers, Inc.*, 446 F.2d 295, 299-300 (2d Cir. 1971).
- 10 *TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895 (Fed. Cir. 1986).
- 11 *Id.*, at 898.
- 12 *Id.*
- 13 *Id.*, at 899.
- 14 Michael J. Chapman and John C. Jarosz, REBUTTAL: It's Not An Inappropriate Reasonable Royalty Rule, Law360 (Aug. 21, 2015).
- 15 No. 5:12-cv-5826-PSG (N.D. Cal. 2015), Order Granting-In-Part Motion to Exclude Testimony, No. 296, slip op. at 8 (July 10, 2015).

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