

# Patent damage pitfalls await the unprepared

Failing to consider and analyse damages early on in patent infringement actions is a big risk, say **David J Ball** and **Chad Ennis**



**P**roving damages for patent infringement is no easy feat. The main reason: patent damages are calculated based on entirely hypothetical circumstances. Unlike other actions, where courts and juries can look to medical bills, property records, or detailed contracts, a patent case rarely offers such easy evidence of damages.

The US Patent Act allows a patent holder to seek damages for patent infringement as either a reasonable royalty or lost profits. To calculate a reasonable royalty rate, the factfinder must determine what the two parties would have *hypothetically* negotiated. And to determine the amount of lost profits suffered, the factfinder often must sift through opaque evidence and inconsistent expert reports to determine the impact on lost sales where the patented invention may be only a small component of the overall product's sale price. While the courts have developed intricate damages tests with a myriad of factors to aid in determining damages awards, the inherently speculative nature of patent damages offers numerous opportunities for opposing counsel to discredit damages theories.

Plaintiffs must build, assess, and re-evaluate their damages theories as early as possible, and ideally before even filing suit, or immediately thereafter. And defendants are wise to do the same in order to assess settlement options. Working with consulting experts to identify the strengths and weaknesses of the parties' positions and arrive at optimistic and conservative estimates is crucial. Unfortunately, the court decisions striking evidence and appellate decisions overturning damage awards remains all too common because parties wait too long, often until after discovery closes, to plan their damages strategies.

## Lost profit pitfalls

The Patent Act permits patent owners to obtain damages for lost profits. At a high level, the lost profit analysis seems straightforward: a plaintiff claims it would have sold more product or received a higher sale price if the defendant was not offering an infringing alternative. Yet, determining how much more product would have been sold or how much more profit would have been earned is the opposite of straightforward.

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Lost profits are only available where a plaintiff makes a product using the patented invention and a defendant offers a competing product. While this may seem like an obvious and easy distinction to draw, in practice it can be anything but simple. For example, complex issues quickly develop where the plaintiff owns the patent but seeks to rely on its subsidiaries' sales or where the subsidiary plaintiff entity that is the defendant's direct competitor only recently received a transfer of patent ownership. Plaintiffs must consider the nature

of corporate structures, patent assignment timing, and licensing terms in order to assess the ability to collect lost profits.

Further, it is the rare case where a patent covers the *entire*, allegedly infringing product or where the product cannot be made without the patented invention. In that rare instance, lost profit damages require, essentially, taking all of the infringer's profit and awarding it to the plaintiff. It is far more common, however, for the patent to apply to only a single product *feature*, rather than the entire product. In such instances, establishing lost profit damages requires convincing the court or jury that the defendant's sales are attributed to the patented feature and not the result of clever marketing and unique, unrelated features that are actually driving demand for the defendant's product. Of course, marketing effects are hard to quantify and often require picking apart market share information and customer surveys to determine customer demand rationales. For example, there are countless situations where a particular feature is nice to have, but it does not drive consumers to buy the product. And there are innumerable examples where inferior products outsell better ones because of better marketing. Properly assessing these issues not only takes time – both for sufficient evidence of customer preference and reasoning to develop over time, as well as for counsel and experts to analyse the information – but also may depend on evidence that simply does not exist.

One additional issue that frequently arises in lost profit calculations relates to so-called “convoyed” sales. Convoyed sales are sales of products or services related to the patented product, but not covered by the patent. Using the ubiquitous smartphone as an example, a convoyed sale could be the two-year service

agreement or the headphones or case that might be sold with the phone. Plaintiffs must determine how such conveyed sales will impact the ultimate damages calculation. Whether those conveyed items will be treated along with the patented invention as a single product or functional unit or separately can have a drastic impact on damages.

Finally, plaintiffs must also consider the ramifications of non-infringing alternatives. If a non-infringing product exists as an alternative to the patented feature or process, the damages will be limited. But perhaps even more importantly, the cost of litigating such non-infringing alternatives can be significant because it can lead to disputes over whether the alternative is really non-infringing and whether the alternative is truly an acceptable substitute.

### The (un)reasonableness of reasonable royalties

Given the unavailability of lost profits in non-competitor situations and the difficulty of proving lost profits, many plaintiffs seek “reasonable royalty” damages. The Patent Act permits an award of damages that is “adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention.” The difficulty in determining the reasonable royalty rate lies in the inherently hypothetical nature of the “reasonable” rate. The reasonable royalty rate is calculated by assessing the rate that would have resulted from a *hypothetical negotiation* between the patent holder and the infringer had they, in reality, negotiated an agreement before the infringement began. Indeed, the seminal case on calculating a reasonable royalty, *Georgia-Pacific Corp v US Plywood Corp*, contains 15 factors to consider in determining the appropriate reasonable royalty rate.

A primary consideration in assessing the hypothetical negotiation result is with so-called “comparable licences”. This requires an examination of licences that the patent holder has granted for the relevant patents or, if they are the infringer’s patents, licences to similar patents. On the surface, this seems like a simple approach to determine a reasonable royalty. Unfortunately, that is not the common case because typically the “comparable” licences are anything but comparable. And litigants, recognising the impact that comparable licence evidence could have on future damage awards, try to game the system.

One tactic is for a patent holder to obtain a licence for the same patents from a small player in the market for a low dollar amount but pegged to a seemingly high royalty rate. For example, if a licensee has \$500,000 in

sales and the licence is for \$50,000, that yields a 10% effective royalty rate. A smart patent holder may enter into licences with multiple small players for this amount. Now, when the patent holder sues an infringer with \$1bn in sales and argues for a comparable 10% royalty rate, that translates into \$100m in potential damages. The smart patent holder, then, can use that evidence so that any resulting finding of a lower reasonable royalty rate will still result in damages far in excess of what may have resulted from a truly fair market-influenced negotiation.

## “Another frequently overlooked mistake is failing to appreciate the hypothetical nature of the examination.”

Where the alleged infringer’s licences are used as the basis of the comparable licence, the hypothetical negotiation determination can be even more dangerous for both parties. Using the alleged infringer’s licences as evidence of an appropriate rate necessarily means that the licences are not for the same patents at issue in the infringement action. Indeed, they may not even be related to the same invention or same field of technology. This means that technical expert testimony may be needed to establish that a significant enough relationship exists between the licence patent rights and the patents at issue in the litigation just to link the reasonableness of the licence royalty rate. While this may seem obvious, the case law is replete with instances where the parties overlook this technical step in the analysis and simply have damages experts opine on the reasonableness of the rate without showing any actual comparability.

Another frequently overlooked mistake is failing to appreciate the hypothetical nature of the examination. It is hypothetical, not real, and therefore governed by the rules for the hypothetical. All too often, parties attempt to redefine the hypothetical to arrive at a more preferable outcome. But that evidence is not applicable. For example, in *Samsung Electronics Co v NVIDIA Corp*, NVIDIA argued that because it did not produce the particular components that went into the larger devices, the suppliers of those particular components would have joined the hypothetical negotiation to arrive at a proper reasonable

royalty. While this position makes logical sense and may have been how a negotiation played out in the real, business world, it is at odds with the hypothetical negotiation rules applied in the legal world: the legal standard for the hypothetical negotiation demands assessing a hypothetical negotiation *between the patent holder and the infringer* without resorting to third party influences. NVIDIA’s damages expert testimony was tossed out as a result of trying to rewrite the hypothetical.

### Summary

This article presents just some of the highly nuanced considerations that impact damages awards in patent infringement actions. There are countless more where courts (and juries) continue to labour under the myriad of factors and difficult to comprehend standards that apply. Early preparation and attention to damages issues by both plaintiffs and defendants is crucial. Yet, the burden of collecting and analysing damages evidence, which can often be one of the most disruptive aspects of patent infringement litigation for the business personnel, is all too often postponed by pending issues related to infringement and patent validity. This is all the more true following the America Invents Act and the proliferation of challenges to patent validity before the US Patent & Trademark Office, where both plaintiffs and defendants focus their efforts on these apparent threshold issues. Failing to consider and analyse damages earlier, and constantly reassessing those damages as the case develops, is arguably one of the biggest risks associated with patent infringement actions.

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