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Update To Recent Patent Damages Article

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In our March 3, 2010 article in the Patently-O Law Journal, *Federal Courts Closely Scrutinizing and Slashing Damages Awards*, we discussed recent shifts in the Federal Circuit's reasonable royalty jurisprudence and concluded that the recent *Cornell*, *Lucent*, and *Lansa* cases "indicate an emerging trend to more carefully scrutinize the evidentiary and economic basis of reasonable royalty-based patent damages awards in the setting of the appropriate royalty base, the application of the entire market value rule, and the calculation of the appropriate royalty rate." We also noted that contemplated legislative reforms in the area of patent damages may likewise "seek to put the burden on district court judges to act as 'gatekeepers' and to closely scrutinize the evidence that is relied upon to prove patent damages."

1. Patent Reform Bill

Shortly after our article was published, the U.S. Senate announced a new "compromise" patent reform bill (full text available [here](#)), which includes a section addressing patent damages. Whereas prior versions of the patent reform bill which had been considered over the past years had contemplated introducing more specific statutory limitations on patent damages,¹ the current Senate compromise bill does not.

Rather, the approach taken in the current compromise bill is to statutorily *emphasize* the district court's "gatekeeper" role over damages theories and evidence. While there is nothing new about district court judges acting as gatekeepers by conducting so-called *Daubert* hearings to determine whether to exclude expert testimony under Federal Rule of Evidence 702, including on damages-related issues, the proposed bill essentially makes conducting a thorough *Daubert* hearing on patent damages mandatory. In the section entitled "Procedure For Determining Damages," it requires that "[t]he court shall identify the methodologies and factors that are relevant to the determination of damages, and the court or jury, shall consider only those methodologies and factors relevant to making such a determination." In addition, in a section entitled "Sufficiency of Evidence," it requires that "the court shall consider whether one or more of a party's damages contentions lacks a legally sufficient evidentiary basis" and that "[t]he court shall only permit the introduction of evidence relating to the determination of damages that is relevant to the methodologies and factors that the court determines may be considered in making the damages determination." We expect that this proposed reform bill will not alter the traditional role of the *Georgia-Pacific* factors, which have been used in the reasonable royalty analysis, or other established damages law. Thus, other than providing for a first review of the damages evidence by the judge before a case is sent to a jury, it is unclear whether the Senate's proposal would have the effect of limiting damages. The substantive impact will greatly depend on how strict individual judges are when they conduct their *Daubert* hearings; and this will likely vary from judge to judge. But the recent Federal Circuit case law discussed in our prior article, as well as the additional case discussed below, does signal that the Federal Circuit is providing strong guidance as to the degree of scrutiny of the damages theories and evidence that district courts should undertake.

2. The *IP Innovations* Case

As many of our readers pointed out, Federal Circuit Judge Rader, who sat by designation in the *Cornell* case, also recently sat by designation in *IP Innovation, LLC v. Red Hat, Inc. et al.*, Case No. 2:07-cv-447. (Based on his track record in the *Cornell* case, we are sure that plaintiff was none too pleased that Judge Rader was sitting by designation in their

case, at least with regard to damages). In his March 2, 2010 ruling on post-trial motions in *IP Innovation*, Judge Rader again took the opportunity to illustrate his view of the type of careful scrutiny that district court judges should be giving to damages theories and evidence. The court excluded the testimony of plaintiff's damages expert, because his damages theory on what would be a reasonable royalty, "improperly inflates both the royalty base and the royalty rate by relying on irrelevant or unreliable evidence and by failing to account for the economic realities of this claimed component as part of a larger system." Slip. op. at 6.

In *IP Innovation*, the patents-in-suit related to particular features of the defendants' Linux operating system software, specifically, the "multiple virtual workspaces and workspace switching features." Plaintiffs' expert had propounded a damages theory under the "entire market value rule," in which he sought damages based on defendants' total sales of the entire operating system software. Judge Rader excluded this testimony because the damages methodology did not "show a sound economic connection between the claimed invention and this broad proffered royalty base." *Id.* at 3. Judge Rader first found that "the claimed invention is but one relatively small component of the accused operating systems" particularly in view of "the relative importance of other features such as security, interoperability, and virtualization." *Id.* In addition, the court noted that there was no evidence in the record supported the notion that the claimed feature drove demand - "users do not buy the accused operating systems for their workspace switching feature." *Id.* Indeed, plaintiffs' expert did not make any effort "to even discern the percentage of users" who even used the feature. *Id.* at 4. Accordingly, the court found that "the record cannot support the unfounded conclusion that the often-unused feature drives demand for a royalty base of 100% of the operating systems as a whole." *Id.* As in his decision in the Cornell case, it appears that in order to proceed under an entire market value rule theory, Judge Rader would require that the plaintiff provide specific evidence tying customer demand to the claimed feature, or a survey that addresses whether and to what degree the claimed feature drives demand.

In excluding the damages testimony, Judge Rader also rejected plaintiff's argument that it was difficult to determine the value of the desktop switching feature relative to other features of the products based on the information produced in discovery and that the desktop switching feature "has no separate valuation, no aftermarket, and thus no way to value the accused feature separately." The court found that the burden of proof lay with plaintiff and not with defendant: "IPI must show some plausible economic connection between the invented feature and the accused operating systems before using the market value of the entire product as the royalty base." *Id.* at 4.

Finally, Judge Rader also addressed the evidentiary value of other license agreements. The court faulted plaintiffs' expert for disregarding license agreements from years prior to the hypothetical negotiation date in favor of general industry data that was not at all linked to the specific technology of the patents-in-suit. The court found that "these [older specific] licenses are far more relevant than the general market studies" that plaintiff's expert selected to rely upon.

Judge Rader's recent active gate-keeping decisions, such as *Cornell* and now *IP Innovation*, as well as the Federal Circuit's recent pronouncements in *Lucent* and *Lansa*, are even more significant and instructive when viewed in the context of the currently pending patent reform legislation, which specifically proposes addressing the issue of patent damages by having the courts act as stricter gate-keepers on damages theories and evidence.

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¹ For example, the 2007 Patent Reform Bill proposed limiting the amount of damages recovered as a reasonable royalty based on an attribution of "the economic value properly attributable to the patent's specific contribution over the prior art" and statutorily limits the application of the "entire market value rule" to circumstances where the patentee has established that the claimed feature is "the predominant basis for market demand" of an entire product. doi:10.1093/jiplp/jpp143