



## ENHANCING YOUR IP IQ

Vol.1, No.5

AUGUST 2009



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### CRACKING OPEN THE BOOK OF WISDOM: WHERE THE PAST CAN BECOME THE PRESENT

When arguing for reasonable royalty damages, IP lawyers should consider taking a page from the little-known “book of wisdom” to dramatically affect evidence relevant to such damages. In fact, the U.S. Supreme Court says 20/20 “experiential” hindsight can be brought into play under special circumstances. The “book” should be a part of your IP IQ.

#### The Reasonable Royalty Basics

By statute, patent infringement damages must be “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.”<sup>1</sup> A patentee can prove loss by showing actual damages in the form of its lost profits or a reasonable royalty for the infringer’s use of the patented technology.<sup>2</sup>

Of course, an established royalty is the preferred basis for calculation of a reasonable royalty, but this tack requires clear evidence of multiple, arms-length licensing agreements at the same rate.<sup>3</sup>

In the absence of such evidence, however, a “hypothetical negotiation” can determine reasonable royalty damages.<sup>4</sup> A hypothetical negotiation requires the court to reconstruct events that might have resulted from arms-length bargaining between the parties over a license for the infringed patent.<sup>5</sup> To envision the negotiation, the court presumes each party had access to all relevant information, and the parties were willing to agree to a license on reasonable terms.<sup>6</sup> Of course, this is difficult to imagine when the parties are

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### ABOUT SHB

Shook, Hardy & Bacon offers expert, efficient and innovative representation to our clients. We know that the successful resolution of intellectual property issues requires a comprehensive strategy developed in partnership with our clients.

1 35 U.S.C. § 284.

2 *SmithKline Diagnostics, Inc. v. Helena Labs. Corp.*, 926 F.2d 1161, 1164 (Fed. Cir. 1991). The patentee can also seek a mixed award, obtaining lost profits where it can prove its actual losses caused by the infringer’s sales and a reasonable royalty for the remaining infringement. *Crystal Semiconductor Corp. v. Tritech Microelectronics Int’l, Inc.*, 246 F.3d 1336, 1354 (Fed. Cir. 2001).

3 *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1078 (Fed. Cir. 1983).

4 *Id.* at 1079 (“Since there was no established royalty for licensing the Hanson patent, the magistrate necessarily had to use ‘a willing-buyer/willing-seller concept, in which a supposititious meeting between the patent owner and the prospective [user] of the infringing [method] is held to negotiate a license agreement.” (quoting *Tektronix, Inc. v. United States*, 552 F.2d 343, 349 (Ct. Cl. 1977))).

5 *Hanson*, 718 F.2d at 1078.

6 *Proctor & Gamble Co. v. Paragon Trade Brands, Inc.*, 989 F. Supp. 547, 606 (D. Del. 1997). *But see Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1555 (Fed. Cir. 1995) (“The language of the statute requires ‘damages adequate to compensate; which does not include a royalty that a patentee who does not wish to license its patent would



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at war in a patent infringement case.<sup>7</sup> By law, the court sets the negotiation date as the first alleged infringement.<sup>8</sup> The court's analysis must also be based on "sound economic and factual predicates."<sup>9</sup>

### The Book of Wisdom

Logic would seem to dictate that facts unknown at the time of first infringement could not be relevant to the hypothetical negotiation. This may not, however, be correct.

#### *The Supreme Court Writes the Book of Wisdom*

The "book of wisdom" stems from the U.S. Supreme Court's 1933 decision, *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*<sup>10</sup> Ironically, this was not a patent infringement case. Instead, it addressed breach of contract. When the defendant failed to assign patents on improvements, plaintiff sued for damages arising from the alleged breach.<sup>11</sup> At issue was the value of the patent when the breach occurred.<sup>12</sup> Plaintiff sought discovery about the extent of the defendant's commercial use of the patent.<sup>13</sup> The trial court denied the discovery partly because "the value of the patents has no relation to the sales of the patented device, and evidence of such sales would be inadmissible if offered."<sup>14</sup> The court of appeals reversed, saying "the commercial use that had been made of the patented device" could be relevant in some circumstances.<sup>15</sup> The U.S. Supreme Court agreed, saying that when available, "[e]xperience ... is a book of wisdom that courts may not neglect."<sup>16</sup>

Reaching this conclusion, the Court said that, while market value, based on contemporaneous sales, is always not available to value an object of damages,<sup>17</sup> "the absence of market value does not mean that the offender shall go quit of liability."<sup>18</sup> Instead, "[t]he law will make the best appraisal that it can, summoning to its service whatever aids it can command."<sup>19</sup>

When a trial occurs soon after the issuance of a patent, expert witness testimony may be the only evidence available to value the patent.<sup>20</sup> But, when time has passed, experience may "correct uncertain prophecy" by experts.<sup>21</sup> In this circumstance, courts should not ignore the lessons of experience.<sup>22</sup>

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find unreasonable").

7 *Fromson v. Western Litho Plate & Supply Co*, 853 F.2d 1568, 1575 (Fed. Cir. 1988).

8 *Applied Med. Res. Corp. v. U.S. Surgical Corp.*, 435 F.3d 1356, 1361 (Fed. Cir. 2006).

9 *Riles v. Shell Exploration & Prod. Co.*, 298 F.3d 1302, 1311 (Fed. Cir. 2002).

10 289 U.S. 689 (1933).

11 *Id.* at 690-91.

12 *Id.* at 692.

13 *Id.* at 691.

14 *Id.* at 691-92.

15 *Id.* at 692.

16 *Id.* at 698.

17 *Id.* at 697.

18 *Id.*

19 *Id.*

20 *Id.* at 698.

21 *Id.*

22 *Id.*

The Court acknowledged that information may be “scanty” at the time of “the bargain.”<sup>23</sup> Thus, the object of the bargain may be undervalued.<sup>24</sup> But, the Court reasoned, the liable party should not benefit from this dearth of information: “The law is not so tender to sellers in default.”<sup>25</sup> Therefore, the court must endeavor to make as full an appraisal as possible of the object of the bargain (the patent).<sup>26</sup> This appraisal includes “values inherent in the thing itself,” including exchange and use value.<sup>27</sup> The Court explained that its purpose in considering later use of a patent “is not to charge the offender with elements of value nonexistent at the time of his offense,” but “to bring out and expose to light the elements of value that were there from the beginning.”<sup>28</sup>

#### *The Federal Circuit Reads from the Book of Wisdom in Patent Cases*

More than 50 years later, the Federal Circuit applied “book of wisdom” thinking to patent infringement damages in *Fromson v. Western Litho Plate & Supply Co.*<sup>29</sup> Doing so, the Federal Circuit expanded *Sinclair*. The court noted that the use of the hypothetical negotiation to determine a reasonable royalty is a “difficult judicial chore, seeming often to involve more the talents of a conjurer than those of a judge.”<sup>30</sup> Following the U.S. Supreme Court’s rationale, however, the court declared that an infringer should not be rewarded by uncertainty because the methodology of hypothetical negotiation “risks creation of the perception that blatant, blind appropriation of inventions ... is the profitable, can’t lose course.”<sup>31</sup>

Therefore, the court must carefully consider “all the circumstances,” including the infringer’s use of the invention, so that the royalty assigned is “reasonable.”<sup>32</sup> The Federal Circuit emphasized the importance of “full compensation,” quoting the Supreme Court’s analysis of Congress’s intent: “Congress sought to ensure that the patent owner would in fact receive full compensation for ‘any damages’ he suffered as a result of the infringement.”<sup>33</sup>

#### **Living with the Book of Wisdom**

Living with the “book of wisdom” after *Fromson* hasn’t been a model of clarity, and there are few clear guidelines for its use. In *Interactive Pictures Corp. v. Infinite Pictures, Inc.*,<sup>34</sup> plain-

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<sup>23</sup> *Id.* at 699.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 698.

<sup>27</sup> *Id.* at 699.

<sup>28</sup> *Id.* at 698.

<sup>29</sup> 853 F.2d at 1575. Two earlier U.S. Court of Claims decisions previously applied the Book of Wisdom concept to patent infringement damages under 28 U.S.C. § 1498. See *Amerace Esna Corp. v. United States*, 462 F.2d 1377 (Ct. Cl. 1972); *Jamesbury Corp. v. United States*, 207 U.S.P.Q. (BNA) 131 (Ct. Cl. 1980).

<sup>30</sup> *Fromson*, 853 F.2d at 1574 (Fed. Cir. 1988).

<sup>31</sup> *Id.* at 1575; accord *Lam, Inc. v. Johns-Manville Corp.*, 718 F.2d 1056, 1065 (Fed. Cir. 1983) (“Where the tort itself is of such a nature as to preclude the ascertainment of the amount of damages with certainty, it would be a perversion of fundamental principles of justice to deny all relief to the injured person, and thereby relieve the wrongdoer from making any amend for his acts.”) (quoting *Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U.S. 555, 563 (1931)).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 1574 (quoting *GM v. Devex Corp.*, 461 U.S. 648, 654-55 (1983)).

<sup>34</sup> 274 F.3d 1371 (Fed. Cir. 2001).

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tiff presented evidence at trial of defendant's sales projections prepared just two months before the hypothetical negotiation for use in the royalty calculation.<sup>35</sup> Defendant objected, calling the projection "speculative" and based on an "outdated" business plan.<sup>36</sup>

Siding with plaintiff, the Federal Circuit allowed the projections.<sup>37</sup> Then, apparently erecting a barrier between pre-negotiation and post-negotiation information, the court observed that projections prepared before the negotiation could be "used as a basis for a royalty base, as opposed to an after-the-fact counting of actual sales."<sup>38</sup>

Later, in *Riles v. Shell Exploration and Prod. Co.*,<sup>39</sup> the Federal Circuit appeared to affirm the barrier between pre- and post-negotiation information when it said, "a reasonable royalty determination for purposes of making a damages evaluation must relate to the time infringement occurred, and not be an after-the-fact assessment."<sup>40</sup> An even later case, *Integra Lifesciences I, Ltd., v. Merck KGaA*,<sup>41</sup> "appears to erect a much more solid wall between pre-negotiation information and post-negotiation information."<sup>42</sup>

Finally, a helpful case to review before turning to the book of wisdom is *Honeywell Int'l, Inc. v. Hamilton Sundstrand Corp.*<sup>43</sup> There, defendant sought to preclude plaintiff from basing its reasonable royalty calculation on sales projections that did not exist at the time of the hypothetical negotiation.<sup>44</sup> When defendant's early projections for sales increased dramatically in the wake of the September 11, 2001, events, plaintiff sought to use the later projection in seeking damages 60 percent larger than those based on pre-negotiation projections.<sup>45</sup> In its opinion, the court analyzes the case law from *Sinclair* through *Integra* in detail and ultimately concludes that, based on *Fromson*, post-negotiation sales projections can be used as the basis for the royalty calculation.<sup>46</sup>

In the end, the book of wisdom must be "read" on a case-by-case basis. It should be part of your damages-calculation arsenal, but it may not always apply to the case. As several cases have shown, outside pressures might impinge on whether post-negotiation facts are relevant. It is worth the time, however, to consider the "book of wisdom" if your case is filed several years post-award of the patent, and where projection and sales history exist.

*Mr. Strand wishes to thank Joshua Brown with the law firm of Saliwanchik, Lloyd & Saliwanchik, Gainesville, Florida, for his invaluable work on earlier versions of this article.*

<sup>35</sup> *Id.* at 1384.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 1385.

<sup>38</sup> *Id.* (emphasis added); See *Honeywell Int'l, Inc. v. Hamilton Sundstrand Corp.*, 378 F. Supp. 2d 459, 466 (D. Del. 2005).

<sup>39</sup> 298 F.3d 1302 (Fed. Cir. 2002).

<sup>40</sup> *Id.* at 1313; See *Honeywell Int'l, Inc.*, 378 F. Supp. 2d at 467.

<sup>41</sup> 331 F.3d 860 (Fed. Cir. 2003).

<sup>42</sup> *Honeywell Int'l, Inc.*, 378 F. Supp. 2d at 468.

<sup>43</sup> 378 F. Supp. 2d 459 (D. Del. 2005).

<sup>44</sup> *Id.* at 462.

<sup>45</sup> *Id.* at 462-63.

<sup>46</sup> *Id.* at 462-70.