

KEY IDEAS:

Reasonable Royalty Basics1

Recent “Comparable License”
Decisions2

Standards on Admissibility
of Settlements3

Licenses Admissible3

Licenses Not Admissible3

Discovery of Settlement Negotiations
Allowed4

Discovery of Negotiations
Not Allowed4

Conclusions4

“WHO’D A THUNK IT”
SETTLEMENT LICENSES PUT THE SQUEEZE ON NPE’S

For years, licenses settling a patent infringement lawsuit were not viewed as an “established royalty” in a patent damages calculation.¹ This “rule” frequently allowed non-practicing entities (NPEs) to ignore early “low ball” settlements used to build their license “portfolio” when later seeking big bucks from recalcitrant “infringers.”

Recent Federal Circuit decisions have, however, upended this approach.² Settlement licenses are now in the mix. This is potentially good news for alleged infringers. In addition, over the last year the Federal Circuit has looked with growing skepticism at “comparable licenses.”³ These cases put the squeeze on patentees who want to prove royalty rates with less than truly “comparable” licenses. Finally, the Federal Circuit’s very recent decision in *Uniloc USA, Inc. v. Microsoft Corp.*,⁴ flatly rejected the controversial but often used 25 percent rule of thumb. As a result, patentees will have to work harder to get a starting point for their reasonable royalty rate analysis. This change further upped the pressure on patentees trying to recover reasonable royalty damages and will focus even more attention on damages proof based on either “comparable” or “established” licenses. Undoubtedly, these cases reflect the Federal Circuit’s previously expressed intention to update the law of patent damages without the need for reform legislation.

Faced with this new dynamic, parties (sometimes patentees and sometimes alleged infringers) are trying to introduce evidence of rates in settlement licenses as part of a “reasonable royalty” analysis. Increasingly, the courts are allowing the admission of settlement licenses and, in some instances, allowing discovery and admission of settlement negotiations. Wise patent litigators will enhance their IP IQ by understanding and considering the interplay of strategic options regarding the admissibility and use of settlement licenses in calculating reasonable royalty damages and develop their case strategies accordingly.

Reasonable Royalty Basics

Reasonable royalty damages are authorized by 35 U.S.C. § 284, which provides for “damages adequate to compensate for the infringement, but in no event less than a reasonable royalty.” While lost profits may provide a larger recovery, a reasonable royalty is, “the floor below which damages shall not fall.”⁵

The burden of proving reasonable royalty damages always falls on the patentee.⁶ Although some approximation is permitted when calculating the reasonable royalty, the Federal Circuit requires “sound economic and factual predicates” for that analysis.⁷

Prepared by:



PETER STRAND
Washington, D.C.
(202) 783-8400
pstrand@shb.com

Peter is a partner in the Firm’s Intellectual Property & Technology Litigation Practice. He holds an LLM in intellectual property law from the University of Houston School of Law.

1 See, e.g., *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1078-79 (Fed. Cir.1983).
 2 See *ResQNet.Com, Inc. v. Lansa, Inc.*, 594 F.3d 860 (Fed. Cir. 2010).
 3 See *id.*; *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1324 (Fed. Cir. 2009).
 4 *Uniloc USA, Inc. v. Microsoft Corp.*, No. 2010-1035, -1055, slip op. at 41 (Fed. Cir. January 4, 2011).
 5 *Lucent Techs., Inc.*, 580 F.3d at 1324 (Fed. Cir. 2009) (citing *Bandag, Inc. v. Gerard Tire Co.*, 704 F.2d 1578, 1583 (Fed. Cir. 1983)).
 6 *Lucent Techs., Inc.*, 580 F.3d at 1324 (citing *Dow Chem. Co. v. Mee Indus., Inc.*, 341 F.3d 1370, 1381 (Fed. Cir. 2003)).
 7 *Riles v. Shell Exploration & Prod. Co.*, 298 F.3d 1302, 1311 (Fed. Cir. 2002).

As the patentees' ability to identify "comparable licenses" or establish a base rate that passes Federal Circuit muster is called into question, a royalty rate established through a settlement license becomes increasingly important.

The most common formula for calculating reasonable royalty damages, called the hypothetical negotiation or the "willing licensor-willing licensee" approach, tries to predict the royalty the parties *would* have agreed to if they negotiated an agreement just before infringement began.⁸ This royalty calculation requires evidence of a royalty base and a royalty rate.⁹ The "royalty base" is the portion of sales (price or volume) of the infringing product to which the royalty rate will apply. The "royalty rate" is the amount paid on the royalty base for use of the patented technology. Frequently, the royalty rate is a "running royalty" described as a percentage of the royalty base.

In calculating the reasonable royalty, litigants and courts have long relied on the 15 *Georgia-Pacific* factors pertinent to determining reasonable royalty damages.¹⁰ For our purposes, two *Georgia-Pacific* factors are relevant.

Georgia-Pacific Factor No. 1: "The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty."¹¹ This factor focuses on licenses to the patent in suit and actual claims in litigation.¹² This factor recognizes that, "An established royalty is usually the best measure of a 'reasonable' royalty for a given use of an invention because it removes the need to guess at the terms to which parties would hypothetically agree."¹³

Georgia-Pacific Factor No. 2: "The rates paid by the licensee for the use of other patents comparable to the patent in suit."¹⁴ This factor examines whether the licenses the patentee relied on to prove damages are sufficiently *comparable* to the hypothetical license at issue in suit.¹⁵ The Federal Circuit requires district courts to exercise vigilance when considering licenses to technologies *other* than the patent in suit.¹⁶ It is the notion of "comparable licenses" that has recently garnered the Federal Circuit's close attention.

As the patentees' ability to identify "comparable licenses" or establish a base rate that passes Federal Circuit muster is called into question, a royalty rate established through a settlement license becomes increasingly important.

Recent "Comparable License" Decisions

The law began to change in *Lucent Technologies, Inc. v. Gateway, Inc.*¹⁷ In that case, the jury returned a verdict against the defendant awarding a lump-sum royalty based, in part, on eight "comparable" license agreements introduced by the patentee.¹⁸ Concluding that the verdict was not supported by substantial evidence, the Federal Circuit rejected the proffered license agreements, saying (1) some were "radically different" from the patent in suit, and (2) there was insufficient evidence regarding the others to allow the jury to evaluate the probative value of those agreements.¹⁹ The Federal Circuit said that a reasonable royalty "cannot stand solely on evidence which amounts to little more than a recitation of royalty numbers, one of which is arguably in the ballpark of the jury's award, particularly when it is doubtful that the technology of those license agreements is in any way similar to the technology being litigated here."²⁰

8 *Lucent Techs.*, 580 F.3d at 1324.

9 *IP Innovation L.L.C. v. Red Hat, Inc.*, 705 F. Supp. 2d 687, 689 (E.D. Tex. 2010).

10 *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970), *modified*, 446 F.2d 295 (2d Cir.), *cert. denied*, 404 U.S. 870 (1971).

11 *Id.* at 1120.

12 *ResQNet.Com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010).

13 *IP Innovation L.L.C.*, 705 F. Supp. 2d at 691 (citing *Monsanto Co. v. McFarling*, 488 F.3d 973, 978-79 (Fed. Cir. 2007)) (citation omitted).

14 *Georgia-Pacific Corp.*, 318 F. Supp. at 1120.

15 *Lucent Techs.*, 580 F.3d at 1325.

16 *ResQNet.Com*, 594 F.3d at 869; *see Lucent Techs.*, 580 F.3d at 1329.

17 580 F.3d 1301, 1324 (Fed. Cir. 2009).

18 *Id.* at 1327.

19 *Id.* at 1327-28.

20 *Id.* at 1329.

But, the *ResQNet* opinion went even further to state, “This court observes as well that **the most reliable license in this record arose out of litigation.**” It is this “throw away” comment that has spawned the recent intense focus on settlement licenses.

In *ResQNet.Com, Inc. v. Lansa, Inc.*,²¹ the Federal Circuit clarified the new, more stringent rules when it again considered “comparable licenses” offered by the patentee. The outcome was a foregone conclusion when the court said that the licenses introduced by the patentee had “no relationship to the claimed invention,” that “none of these licenses even mentioned the patents in suit or showed any other discernible link to the claimed technology,” that the patentee’s expert has used the licenses merely to “drive up the royalty rate to unjustified double-digit levels,” and that the district court “made no effort to link certain licenses to the infringed patent.”²²

But, the *ResQNet* opinion went even further to state, “This court observes as well that **the most reliable license in this record arose out of litigation.**”²³ It is this “throw away” comment that has spawned the recent intense focus on settlement licenses.

Standards on Admissibility of Settlements

Federal Rule of Evidence 408 provides that offers or acceptance of offers of compromise, including settlement agreements and statements made in settlement negotiations, are not admissible to prove, *inter alia*, liability or the amount of a claim.. They may, however, be admissible for other purposes. One often cited appellate court opinion, *Goodyear Tire & Rubber Co., v. Chile-Power Supply, Inc.*,²⁴ flatly concluded that “any communications made in furtherance of settlement are privileged.”

Against this backdrop, courts considering the calculation of reasonable royalty damages have taken a variety of approaches to discovery and admissibility of settlement licenses and related settlement negotiations.

Licenses Admissible

Shortly after *ResQNet*, the alleged infringer in *Datatresury Corp. v. Wells Fargo & Co.*,²⁵ moved *in limine* to stop the patentee from offering evidence of litigation-induced licensing agreements as part of a reasonable royalty analysis. Initially noting that “*ResQNet* may have changed the legal landscape regarding admissibility of litigation-related licenses,” the trial court ultimately decided that litigation-related licenses to the patents in suit can be the most appropriate means of evaluating a reasonable royalty and should **not** be excluded from the trial.²⁶ The court also allowed discovery of negotiations relating to the settlement licenses it deemed admissible.²⁷

In *Reedhycalog UK, Ltd. v. Diamond Innovations Inc.*,²⁸ the court also faced a challenge to the admissibility of settlement licenses relating to the patent in suit. The court said that admissibility of litigation settlement licenses must be assessed on a case-by-case basis.²⁹ Based on the plaintiff’s avowed intention to identify the licenses, the licensees, the rates of the licenses, the total royalties that have been received, and the royalties received per year, but **not** the fact that licenses resulted from litigation, the court held that the litigation licenses were admissible.³⁰

Licenses Not Admissible

In *Fenner Investments, Ltd. v. Hewlett-Packard Co.*,³¹ the district court considered plaintiff’s motion to block evidence related to settlement licenses with unrelated third parties. After reviewing more than a century of precedent, the court concluded, “*ResQNet* is distinguishable and does not compel

21 594 F.3d 860 (Fed. Cir. 2010).

22 *Id.* at 870-71.

23 *Id.* at 872 (emphasis added).

24 332 F.3d 976, 983 (6th Cir. 2003).

25 2010 WL 903259 (E.D. Tex., March 4, 2010).

26 *Id.* at *1, *2.

27 *Id.*

28 2010 WL 3021550 (E.D. Tex., Aug. 2, 2010).

29 *Id.* at *3 (internal citations omitted).

30 *Id.*

31 2010 WL 1727916, *1 (E.D. Tex., April 28, 2010).

ENHANCING YOUR IP IQ

Vol. III, No.1

JANUARY 2011

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.



OFFICE LOCATIONS

Geneva, Switzerland

+41-22-787-2000

Houston, Texas

+1-713-227-8008

Irvine, California

+1-949-475-1500

Kansas City, Missouri

+1-816-474-6550

London, England

+44-207-332-4500

Miami, Florida

+1-305-358-5171

San Francisco, California

+1-415-544-1900

Tampa, Florida

+1-813-202-7100

Washington, D.C.

+1-202-783-8400

the admission of evidence and testimony relating to settlement agreements in prior litigation.³² The court ultimately **granted** the motion to exclude the evidence, concluding that “the potential for prejudice and jury confusion substantially outweigh whatever probative value the agreements may have.”³³

Discovery of Settlement Negotiations Allowed

Some courts have gone even further. In *Tyco Healthcare Group LP v. E-Z-Em, Inc.*,³⁴ the court allowed discovery of settlement negotiations, notwithstanding the purported “settlement negotiations” privilege, after it found, “The *Goodyear* privilege does not apply in light of the Federal Circuit’s ruling in *ResQNet*.” In *Clear with Computers, LLC v. Bergdorf Goodman, Inc.*,³⁵ the court reached a similar result.

Discovery of Negotiations Not Allowed

In *Software Tree, LLC v. Red Hat, Inc.*,³⁶ the court denied defendant’s motion to compel production of documents regarding plaintiff’s negotiations of settlement licenses relating to the patent in suit. Relying on the holding in *Fenner*, the court found that “*ResQNet* has not upset this district’s case law regarding discoverability of settlement negotiations.”³⁷ The court did, however, allow discovery on negotiations relating to agreements not entered into in the context of litigation.³⁸

Conclusions

Practitioners must pragmatically answer the following 10 strategic questions when considering reasonable royalty damages:

1. Are there existing settlement licenses relating to the patents in suit? Have I requested those licenses in discovery? Have I asked for a Rule 30(b)(6) deposition to understand those licenses?
2. Do the terms of those settlement licenses help or hurt my damages case? Specifically, do I want those license rates in the case or not? Will they drive a higher or lower royalty rate?
3. Can the effect of the litigation be factored out of the royalty rate in any settlement licenses?
4. Are the settlement licenses truly “comparable,” or do extraneous factors rule them out? What was actually licensed as a part of the settlement? Is what was licensed the same as what would be licensed in my case?
5. Do other truly “comparable” licenses exist? If not, in the absence of the 25 percent rule of thumb, where is proof of a base royalty rate going to come from?
6. Were there settlement negotiations leading up to the settlement license? What was said? Have I asked for a Rule 30(b)(6) deposition to get to the bottom of this issue?
7. What was said in settlement negotiations about patent value vs. litigation risk? Can this be factored out?
8. How will the balance of the probative value vs. risk of prejudice and confusion play out if the settlement licenses are offered? How do I overcome problems with that balance?
9. Are the experts using “comparable” licenses merely to inflate/deflate royalty rates? If so, how do I eliminate that problem for my expert or attack that issue with the opposing expert?
10. How can I credibly position the reasonable royalty inquiry?

32 *Id.* at *3.

33 *Id.* at *2.

34 2010 WL 774878, *2 (E.D. Tex., March 2, 2010).

35 2010 WL 4881801 (E.D. Tex., Nov. 29, 2010).

36 2010 WL 2788202, *1 (E.D. Tex., June 24, 2010).

37 *Id.* at *4.

38 *Id.*