PATENT DAMAGES UPDATE: 2012 HOT TOPICS

By

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I. Introduction

Given the time allotted, rather than rapidly discussing the Federal Circuit and district court patent damages decisions since the last Fall Institute, we decided to focus on what we think are two of the hottest topics in patent damages: the entire market value rule and settlement licenses. With respect to the entire market value rule, we note much discussion in recent decisions relating to surveys to prove the basis of demand, and approaches to conducting an apportionment (including consideration of the lowest salable unit). With respect to settlement licenses, we note much discussion relating to the extent of discovery of party patent licenses resulting from litigation settlements and, in connection with admissibility, active discussion concerning the comparability of the settlement licenses to the hypothetical license.

This paper does not attempt to go in detail through the several decisions that have led to the current focus on these topics. The following introductory summary is only intended to provide basic background and to set the stage for our discussion of more recent cases that follows. In the Federal Circuit's 2009 *Lucent* decision, the Court reversed a damages verdict in part because the party licenses were not sufficiently comparable to the hypothetical license to support the verdict. In addition, the Court found that the patent represented a small part of a much larger product and that there was insufficient support for a royalty based on entire market value of the accused product (software – initially, the entire computer system, but that approach was rejected by the trial court). Earlier that year, Judge Rader sitting by designation in *Cornell* had rejected damages based on an entire system, requiring reduction of the base to the least salable unit. In early 2010 the Federal Circuit decided *ResQNet*, concluding that the most comparable licenses to the hypothetical negotiation were older settlement licenses, setting aside the longstanding practice of presumptively excluding settlement agreements (and related licenses) under Federal Rule of Evidence 408. In early 2011, the Federal Circuit decided *Uniloc*, reinforcing and presumably clarifying its views on when the entire market value of an accused product can be the royalty base where the patent is only a small part of a larger product (requiring the patented feature be the "basis for demand" contrasted with the language in *Lucent* allowing the patented feature to be "a substantial basis" for demand), as well as license comparability, and ending the use of rules of thumb (specifically the "25% rule") apart from the specific facts of the case.

A number of other cases were decided by the Federal Circuit during this same 2009 to 2011 time frame which we have seen cited and discussed in annual patent damages law updates at this and other conferences, and which touch upon the entire market value rule and comparable settlement license issues. Our failure to reference some those other decisions herein does not suggest their lack of import but, rather, reflects our view that the foregoing should suffice to set the stage for the EMVR and settlement license discussions hereafter.

II. *Lucent II*: A Case Study on the Difficulty of Proving Patent Damages

In 1986, engineers at AT&T filed a patent application directed to entering information on a computer using an on-screen tool, such as a graphical keyboard or a calculator. The Day patent eventually issued and, through restructuring and spin-offs by AT&T, the patent ended up assigned to Lucent. Lucent asserted the patent against the drop-down calendar date-picker tool found in several Microsoft products. At trial in 2008, Lucent sought $562 million in reasonable royalty damages based on an 8% running royalty rate on sales of the accused Microsoft software products. Microsoft proposed a much smaller $6.5 million lump sum. The jury awarded a $358 million lump sum for Microsoft's infringement. Microsoft appealed. The Federal Circuit relied on the lack of comparability between the parties' licenses and the hypothetical license, the misapplication of the entire market value rule in the context of an invention constituting a small part of a much larger product when that feature was not the basis for demand, and the lack of support in the record for the jury's specific verdict of a large lump sum not advocated by either party in overturning the verdict.

During the second trial on damages, several experts testified on licensing, negotiation, and damages. Both parties proposed a lump sum royalty to avoid a potential mismatch between the structure of the royalty sought and the royalty awarded by the jury in the first trial. However, there were both entire market value rule and license comparability issues (though different and more refined), along with new evidence relating to usage of the accused feature and survey information about the importance of the patented feature.

The second jury awarded the $70 million reasonable royalty sought by Lucent, as opposed to the $3 to $5 million proposed by Microsoft. On November 10, 2011, the trial court reduced the verdict to $26 million based on an alternative apportionment of the sales price of Microsoft Office to correspond to an "equal" proportionate value of Outlook relative to the other modules of Office.

By the numbers, a recap of the computation gives some insight into how the parties and trial court tried to address the entire market value rule issue. To simplify the discussion, the numbers at issue have been rounded. Based on the trial court's analysis, the jury could have computed the $70 million award by multiplying undisputed unit sales of Outlook (~110 million units) *by* 43% (the portion of Outlook users who use the drop-down calendar based on internal Microsoft data) *by* 7% (the portion of Outlook purchase-decision makers surveyed that use the drop-down calendar feature that would not have bought Outlook if it lacked the drop-down calendar), or 3.3 million units, *by* $67 (standalone Outlook average sales price), or $221 million, *by* the documented profit margin relevant to Office (76%), discounted back to the hypothetical negotiation date, resulting in a lump sum of $139 million, *by* 50%, the minimum profit split Lucent contends it would have accepted.

In other words (and organized slightly differently, where LSU is lowest salable unit, Outlook):

Units x LSU_ASP$ x Usage% x Demand% x Profit% x Profit Split%

In further support for this approach, Lucent proffered a cost savings estimate from a customer perspective. Using a combination of Microsoft estimates of certain Outlook activity levels over the life of the product, plus Lucent's technical expert's estimates of time that would be saved on those activities due to using the patent, an amount of hours saved per product lifetime was determined. This amount was then multiplied by the date-picker usage-adjusted units (43%), *by* the average wage rate for product users ($12.09/hr.), discounted back, resulting in a lump sum of customer savings totaling $170 million – more than total discounted profits.

Ultimately the trial court accepted the foregoing analysis, but felt that it stopped short. The Court considered additional data points presented at trial – including the ASP of Office ($98), the difference in the retail price of Office with and without Outlook ($280 vs. $150, or $130), and the MSRP of standalone copies of Outlook, Word, PowerPoint and Excel (all $139). Based on these data points, the trial court concluded that rather than using the Outlook standalone ASP of $67 as the estimate of the portion of the Office ASP ($98) to be apportioned to Outlook for use in computing damages, it would be more reasonable to apportion the $98 Office ASP based on the MSRP relationship of Outlook to the other Office modules (Word, PowerPoint and Excel), or 25%. In other words (adjusting the above where EMV is Office):

Units x EMV_ASP$ x LSU% x Usage% x Demand% x Profit% x Profit Split%

Although the trial court concluded no further micro-apportionment was necessary, the expert's and trial court's approach in this case reflects a highly detailed level of apportionment. Further, it was based in part on a customer survey, which is evidence not frequently presented in patent (as opposed to trademark) case (last seen, at least in a Federal Circuit decision in *i4i* where it was also admitted). And Lucent's position was further supported by what at least appeared from the trial court's description to be a novel and reasonably detailed cost saving analysis integrating product usage, time saving, wage and sales data. There is no getting around it: the expert efforts in this case were uniquely extensive.

In addition to making an alternative apportionment, the trial court also discussed the relevance of certain licenses. Lucent proffered selected non-settlement licenses dated near the hypothetical negotiation date that non-exclusively assigned bundles of patent rights, including the patent in suit, in exchange for a 1% running royalty per patent and certain cross-licensed rights, and Microsoft objected. The Court concluded the licenses were relevant since they included the patent in suit, and sufficiently comparable (coupled with licensing executive testimony) given they reflected a minimum royalty amount (*i.e.*, 1% of the lowest salable unit, which was mathematically consistent with the above computed lump sum) Lucent would accept. Further, the licenses were also responsive to Microsoft's assertion Lucent would have accepted a lower $3 to $5 million lump sum. However, concerning Lucent's effort to admit the Z4/Microsoft settlement license, the trial court determined it should not be admitted since the technology was not comparable (the only similarity was it also involved a minor feature of a larger product). Lucent had sought to admit the license to undermine the credibility of Microsoft's position that a $3 to $5 million royalty was reasonable given that was also Microsoft's position in the *Z4* case which Microsoft later settled for $225 million.

After ten years of litigation, two trials, a trip to the Federal Circuit, and a reduced damages award for Lucent, the parties settled the case this past January. Although we will never know how the Federal Circuit would have handled Microsoft's now moot appeal from the second damages award, the case provides an excellent case study of the difficulties litigants and courts face in applying the Federal Circuit's damages jurisprudence. In *Lucent II*, there was clearly an effort to determine a lowest salable unit, an effort to understand evidence of usage of and demand for the patented feature, and efforts made to apportion between the patented and non-patented components of the accused products.

The basis for claiming (and allowing) the final step in the apportionment, the 50/50 profit split, is not spelled out and appears to simply be a mid-point between an all and none negotiating position. Is this different than a rule of thumb outlawed by *Uniloc*, or the Nash bargaining solution so far rejected by courts that have considered it, or is it simply that acceptable degree of imprecision or estimation that courts may allow similar to that applied in the old *TWM Manufacturing* case cited by the Federal Circuit in *Lucent*?

The trial court's decision also does not address what evidence, if any, was presented to the jury to explain how to compare the bare patent hypothetical lump sum license to Lucent's license of multiple patents and cross-licenses including a running royalty. And, in taking a step back, the complex royalty approach in this case bears little resemblance to the approach used in the vast majority of real world licensing negotiations and no facts discussed by the trial court suggest otherwise in the case of Lucent or Microsoft. Is it possible that the parties normal approaches simply don't matter or are unimportant when compared to assuring you have a well-supported and defensible royalty computation?

III. The Current State of Apportionment and the Entire Market Value Rule

The rule that patentees must either apportion the value of the infringing device between its patented and unpatented parts, or else show that the patented feature is the basis of demand for the infringing device was set out in a succinct Supreme Court opinion in 1884:

> When a patent is for an improvement and not for an entirely new machine or contrivance, the patentee must show in what particulars his improvement has

> added to the usefulness of the machine or contrivance. He must separate its results distinctly from those of the other parts, so that the benefits derived from it may be distinctly seen and appreciated.... *The patentee ... must in every case give evidence tending to separate or apportion the defendant's profits and the patentee's damages between the patented feature and the unpatented features,* and such evidence must be reliable and tangible, and not conjectural or speculative; *or he must show*, by equally reliable and satisfactory evidence, *that the profits and damages are to be calculated on the whole machine, for the reason that the entire value of the whole machine, as a marketable article, is properly and legally attributable to the patented feature***.**

Garretson v. Clark, 111 U.S. 120 (1884) (*emphasis added*).

The common-sense nature of the rule is apparent on its face – a patentee should only be able to recover a royalty on the value that its invention created. However, finding the line beyond which the patentee may not reach is a fact intensive inquiry that can be quite difficult.

In 1995, the Federal Circuit sitting en banc reaffirmed the EMVR test, characterizing it as a test of legal causation or proximate cause. Noting that actual damages might range as broadly as the loss of a business or adverse health impacts, the Federal Circuit set forth what it perhaps considered a practical and ostensibly bright-line rule that would limit the reach of patent damages, stating that "the entire market value rule permits recovery of damages based on the value of a patentee's entire apparatus containing several features when the *patent-related feature is the 'basis for customer demand*.'" *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1549 (Fed. Cir. 1995) (en banc) (*emphasis added*).

Prior to the recent reinvigoration of the entire market value rule that followed after *Lucent*, patentees routinely sought damages based upon the entire value of the commercial embodiment of the patented apparatus. The parties' dispute over damages focused primarily over the form of the royalty – running royalty versus lump sum – and the royalty rate. This practice arguably ran afoul of well-settled damages law, but was not often raised as a question to the courts of whether apportionment or the entire market value rule applied in a particular case.

In *Lucent*, the Federal Circuit did not expressly address the necessity of drawing the line demarking the appropriate royalty base, finding that the EMVR could be used if the royalty sought was sufficiently lowered. The Federal Circuit stated that the royalty rate or the base could be adjusted to account for the value of the non-infringing features of the product:

> [C]ourts must nevertheless be cognizant of a fundamental relationship between the entire market value rule and the calculation of a running royalty damages award. Simply put, *the base used in a running royalty calculation can always be the value of the entire commercial embodiment, as long as the magnitude of the rate is within an acceptable range* (as determined by the evidence).

Id. at 1338-39 (emphasis added). But is this statement consistent with *Rite-Hite*?

Last year, Judge Rader said "no" and rejected *Lucent's* "if the rate is low enough" approach in *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011). (And significantly, the Court in *Lucent*, on remand, rejected that approach as well, instead opting for extensive apportionment as described, *supra*, Section II.) Uniloc's patent was directed to a software registration system that limited the software's functionality until the system confirmed that the installation was authorized. Uniloc accused Microsoft's Product Activation feature, which is included in Microsoft Word and Windows XP, of infringing the patent. Based on an internal Microsoft document stating the product key could be worth between $10 and $10,000, Uniloc's expert applied the 25% rule to Microsoft's $10 estimate, to arrive at a baseline royalty of $2.50 per license. He then "checked" the reasonableness of this royalty by comparing the total royalty amount with the total value of the software ($565M / $19.2B = 2.9%).

Over Microsoft's objection to the entire market value "check," the Court allowed the theories to go to the jury as proffered, and the jury returned a verdict of $388M. The trial court then granted a new trial on damages, noting that "Uniloc conceded customers do not buy Office or Windows because of [Product Activation]" and Uniloc had agreed not to use the entire market value of the accused products. *Id.* at 1319. The trial court then instructed the jury not to use the entire market value of the products. *Id.*

On appeal, the Federal Circuit held the trial court did not abuse its discretion ordering a new trial on damages because the patented feature was not shown to be the basis for demand and, thus, the EMVR could not be used as a "check" or as a basis for damages just because the royalty rate was low. *Id.* at 1320 (citing *Garretson* and *Lucent*).

Most recently in *LaserDynamics v. Quanta Computer*, the Federal Circuit in reversing and remanding for a new damages trial, reaffirmed "that in any case involving multi-component products, patentees may not calculate damages based on sales of the entire product, as opposed to the smallest salable patent-practicing unit, without showing that the demand for the entire product is attributable to the patented feature."

IV. Easy Concepts to Understand, Difficult to Apply in Practice

With the clarification provided by *Uniloc*, trial courts are focusing more on identifying potential problems with a patentee's royalty base, and the appropriate standards have been made relatively clear. Applying these standards, however, is a wholly different matter. With increasing frequency, courts are asked to resolve disputes over whether: 1) an expert's use of the accused product's sales price is an improper application of the EMVR or is instead a proper apportionment, 2) the patentee has used the smallest saleable unit available as a suitable royalty base where the EMVR is not applicable, and 3) party or industry licensing practices, or other economic evidence permit the EMVR when the legal test is not otherwise met.

A. Using the Accused Device's Entire Value in the Apportionment Analysis

In connection with the parties' post-trial motions in *Fractus S.A. v. Samsung Electronics, Co., Ltd.*, although the parties agreed the EMVR did not apply, Judge Davis had to address an objection to an expert's use of the entire product value at an earlier stage of the damages analysis. The patent at issue covered an improved multiband internal antenna used by cellular phones. Fractus' expert started his analysis by calculating the average price of the accused phones ($140 per unit), but then attributed (apportioned) only 10% of the value of the phone to the internal antenna. After considering evidence relevant to setting a royalty rate, such as the patentee's profits and various licenses, the expert opined that a royalty rate could be between 3.5% ($0.46) to 10% ($1.40). Using the lower end of the royalty range ($0.40-$0.60), the expert opined that a reasonable royalty for the 65 million accused phones would be in the range of $26 million to $39 million. Samsung suggested a rate of roughly $.01 per unit and, based on the Court's calculation, the jury awarded $0.36 per unit.

While Samsung argued that Fractus' expert violated the entire market value rule because the average sales price of the entire phone was used as the foundation for the royalty base, the Court appeared to be unimpressed with Samsung's argument given that Fractus' expert clearly presented evidence that the value of the accused phones had been apportioned between their patented and unpatented components prior to applying a royalty rate. *Fractus S.A. v. Samsung Electronics, Co., Ltd.*, Case No. 6:09-cv-203, 2012 WL 2505741 (E.D. Tex. June 28, 2012).

Earlier in the Fractus case, the Court excluded plaintiff's survey because it addressed internal antennas generally and not the patented antenna's or the related improvements. *Fractus* (April 29, 2011 order). Similarly, Judge Davis excluded plaintiff's survey in *Mirror Worlds vs. Apple*, 784 F. Supp. 2d 703 (E.D. Tex. 2011) because the survey was incomplete, only addressing some of the accused features and some of the subject operating systems, and not expressly identifying the basis for demand. More recently, Apple's survey evidence was again excluded for only identifying desirable features as opposed to the establishing the basis of demand and other damages opinions were excluded because of the absence of survey evidence. *Apple Inc. v. Motorola, Inc.*, No. 1:11-cv-08540, 2012 WL 1959560 (N.D. Ill. May 22, 2012).

In *Raymond Caluori v. One World Technologies, Inc.*, the patentee's expert used an analytical method to calculate a starting royalty rate for use a *Georgia-Pacific* analysis. The patent at issue covered using a battery powered light source to provide a cutting guide for a saw. The expert calculated that the defendant earned $7.31 in additional profit from including a laser guide with the accused saws. Because it was conceded that the patent did not cover the entire laser guide, the expert attempted to isolate the value of the patented component. First, the expert calculated that it would cost $3.65 to implement a non-infringing alternative design. The expert opined that the profit attributable to the patented invention is the difference between the additional profit earned from selling the infringing product and the cost of implementing the non-infringing alternative, or $3.65 per unit ($7.31 - $3.65).

The defendant moved to strike the opinion on the grounds that the expert failed to identify any evidence that apportioned the value of the accused products between their patented and unpatented components. The Court acknowledged that while it was "true that the first step in [the expert's] analysis involved a determination of [the infringer's] profits due to the addition of a complete laser guide rather than that due to the addition of plaintiff's patented feature," the Court overruled the objection and accepted the expert's "analytic" apportionment analysis. The Court also noted that "[t]he Federal Circuit has approved of precisely such an 'analytic approach . . . .'" *Raymond Caluori v. One World Technologies, Inc.*, Case No. CV 07-20350, 2012 WL 630246, at *6 (C.D. Cal. Feb. 27, 2012), *citing TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895, 899 (Fed. Cir. 1986).

Most recently, Apple prevailed against Samsung on design patent claims without doing an apportionment based on the Court's pre-trial ruling finding that apportionment was not required for disgorgement claims. *Apple, Inc. v. Samsung Electronics Co.*, 2012 U.S. Dist. LEXIS 90877 (June, 28 2012)

B. Smallest Saleable Unit and the Lowest Unit Price

A defendant may object to a patentee's proposed royalty base on the grounds that there is a smaller saleable unit (or component) of the infringing device that should be the limit of the royalty base. The basis for the objection is illustrated by the approach to apportionment taken by Judge Rader sitting by designation in *Cornell University v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279 (N.D.N.Y. 2009). In *Cornell*, the patent read on an improved component within a computer processor, which improved the throughput of a multi-processor computing system. The processor was a component of a CPU brick, which in turn was a component of a server, *i.e.*, the processor was the smallest salable unit incorporating the invention. The experts estimated HP revenues by each component: $36 billion for servers; $23 billion for CPU bricks; and $8 billion for processors.

Cornell's expert planned to opine that the appropriate royalty base was the server revenue. Judge Rader stopped the trial to conduct a *Daubert* hearing, resulting in the exclusion of this testimony because there was no credible evidence that the invention drove demand for HP's servers. Judge Rader allowed Cornell a second chance, allowing its expert to testify to damages based "on something less that takes into account to some degree, based on his expertise, the fact that the claimed invention is not the entire system but only a component of a component of that system." But instead of heeding this advice, Cornell's expert testified that the royalty base included HP's revenue from the CPU bricks. The jury applied a 0.8% royalty to the CPU brick revenue, and awarded Cornell $184 million.

HP sought judgment as a matter of law that the royalty base should be reduced, or the award remitted. In addressing the issue, Judge Rader made clear that the EMVR rule requires that the infringing components must be the basis for customer demand for the entire machine (the entire base for which damages are sought). While certain evidence supported the importance of the invention (*e.g.*, increased sales, HP documents noted the infringing feature would be necessary to competition), Cornell's own expert admitted that the performance improvement was not solely attributable to the patented technology, conceding that HP's reputation for reliability and service impacted sales.

Without proof that the invention was the basis for customer demand of the CPU bricks, the jury's award could not stand as a matter of law and the lowest saleable unit into which the infringing feature was incorporated, the processor, was the appropriate base.

It is not completely clear whether *Cornell* is really an application of the EMVR as opposed to an implementation of the apportionment framework the Supreme Court articulated so long ago. To some extent, this case suggests a bright-line rule that prevents patentees from simply putting out a big number and hoping they can prove up the "basis for customer demand." In cases where direct proof that an invention contained within a smaller saleable component actually does drive consumer demand for a larger product, apportionment may effectively replace the EMVR as the sole test.

Later district court cases suggest the test remains unclear, with parties and courts picking and choosing arguments based on the Federal Circuit's (and Judge Rader's) differing opinions. In *Lucent II*, discussed *supra*, the Court took apportionment to heart, resulting in a complicated (and somewhat artificial) exercise to isolate patent value. So, too, in *Oracle America, Inc. v. Google, Inc.*, No. C 10-03561 (N.D. Cal. Jan. 9, 2012), where the Court initially went so far as to find that damages should be apportioned even on a claim-by-claim basis because individual claims within a patent may have different values, design-around possibilities, and the like (the Court later abandoned this position and, despite a handful of party experts plus an independent expert, damages were moot since the jury found no infringement). And, of course, after the Court appointed a Rule 706 expert, each party had at least one testifying damages expert along with one or more consulting or licensing experts, ultimately the trier of fact did not find liability and the damages issues were not even reached.

In *Versata Software, Inc. v. SAP America, Inc.*, No. 2:07-CV-153 (E.D. Tex. Jan. 6, 2011), Versata was awarded $138 million based on a reasonable royalty model. SAP complained that the damages base was not properly limited to the lowest saleable unit per Judge Rader's opinion in *Cornell*. Unfortunately for SAP, on retrial Versata presented evidence under lost profits and reasonable royalty theories and obtained a jury verdict of $435 million, $260 million of which was lost profits, effectively mooting any EMVR issues with the royalty base.

In *Man Machine Interface Technologies v. Vizio, Inc.*, No. SACV 10-0634 AG (C.D. Cal. Feb. 27, 2012), the patent covered a remote control with a thumb-operated switch. The accused remotes varied in price with the more expensive remotes including additional features such as Bluetooth and full keyboards. Some of the remotes were sold as standalone products, while others were bundled with televisions. For the standalone remotes, the patentee's expert used the entire value of the remotes for the royalty base, and applied a running royalty rate. The trial court overruled the defendant's objection to use of the EMVR. The Court found that patent did not merely claim a thumb-switch for use in a remote, but instead claimed a remote with the thumb-switch.

The thumb-switch was such a prominent feature of the remotes, the Court concluded that a reasonable juror could find that the thumb-switch was the primary driver of consumer demand for the remotes. However, the Court was not convinced that the same could be said for the pricier remotes, so the patentee was limited to using a royalty rate based on the value of the standalone remote with the lowest unit price. For the bundled remotes, the patentee was similarly limited to using the value of the bundled remote with the lowest unit price.

The trial court's lowest unit price approach may be an attractive option to a court facing a similar problem. By capping the value of the royalty base to the lowest value unit, the court may be able to convert a problematic running royalty rate into a fixed per-unit running royalty, without the need for the patentee to submit a revised expert opinion and report. On the other hand, it may be disasterous for a patentee if the royalty rate was set relatively low because the majority of accused units sell at prices much higher than the lowest priced unit. It is also unclear from the decision exactly what evidence was available to be presented to a jury from which it could conclude that the patented feature was the basis for demand; there does not appear to have been a survey.

And, the Court's decision suggests a question as to the extent a patentee can draft around the entire market value rule based on the way it drafts the claims of the patent. In other words, can broadly drafted claims covering an entire product but including a relatively small incremental invention nonetheless define the royalty base as the entire product? That does not seem consistent with the aforementioned Supreme Court precendent.

C. Economic Evidence Permitting Use of the Entire Market Value Rule

Several courts have permitted the use of the EMVR without a showing that the patented feature is the basis for demand of the accused products when the industry practice was to use the EMV of the licensed products to set royalties. The courts in *ActiveVideo Networks, Inc. v. Verizon Communication, Inc.*, No. 2:10-cv-248 DF (E.D. Va. Aug., 2011), *Lighting Ballast Control LLC v. Philips Electronics North America*, No. 7:09-CV-29-O (W.D. Tex. June 10, 2011), and *Mondis Technology, Ltd. v. LG Electronics, Inc.*, No. 2:07-CV-565 (E.D. Tex. June 4, 2011) identify alternative rationales for allowing use of the entire value of a product where the patentee acknowledges or the evidence shows the patented feature does not drive demand. In *ActiveVideo*, the Court found that use of the entire subscription base was justified under *Lucent* because the rate was economically justified given the industry.

In *Lighting*, the Court allowed use of entire product sales because comparable licenses did the same but then disallowed discussions of the profit margin as a whole, finding it would contravene *Uniloc*. And, in *Mondis*, the Court found that it was "economically justified" to use the entire value of the accused products for the royalty base because 13 comparable licenses in evidence used the entire value of the licensed products to set the royalty.

Perhaps less persuasive is *DataQuill Ltd. v. High Tech Computer Corp.*, No. 08cv543 (S.D. Cal. Dec. 1, 2011), where the Court denied a motion to exclude the patentee's damages expert, finding that the patented feature was "vital" to the competitive position of the defendant's smartphones in the marketplace even if numerous other key features were incorporated (or indeed more fundamental than the accused technology). It is unclear on what basis the Court determined the vital nature of the patented technology and whether the patented features were even a substantial basis, much less the basis of demand.

In *LaserDynamics*, the Federal Circuit recognized limits on the use of "practical and economic necessity" to justify using the entire market value rule. The defendant manufacturer and sold finished laptop computers that included a patented optical disk drive. However, the defendant did not sell the patented optical disk drives separately, and it purchased the optical disk drives from its customers at a nominal price in a buy/sell arrangement, which the district court found amounted to an "accounting fiction." Because the defendant's records could not be used to determine the market value of the patented optical disk drive itself, the plaintiff sought to use the value of the finished laptops for the royalty base. The Federal Circuit rejected this rationale and noted that the value of the optical disk drives could be calculated from third party data, or using other methods.

V. Settlement Licenses

Historically, under Federal Rule of Evidence 408 and the case law progeny descending from *Panduit*, settlement discussions and agreements in patent cases have not been considered probative of an established *rate* and were generally not discoverable or admissible. *See, e.g., Fenner Investments v. Hewlett-Packard*, No. 6:08-CV-273 (E.D. Tex. April 28, 2010) (Judge Love discusses in detail the longstanding case law precluding settlements). However, the Federal Circuit's decision in *ResQNet* opened (or more widely opened) the door to potential discovery and admissibility of licenses entered into as part of a settlement of litigation. Since *ResQNet* courts have taken a variety of approaches to settlement agreements. While by no means an exhaustive list of decisions on this subject, approaches through 2011 had ranged from:

- Finding settlement licenses were more probative than non-settlement licenses (*DataTreasury*, E.D. Tex. Aug. 2, 2011, post-verdict royalty, Judge Folsom),

- where co-defendant settlement was after the hypothetical negotiation and lump sum but defendant sought running royalty, settlement license was still admissible as issues went to weight not admissibility where plaintiff's expert accounted for differences in date and litigation context (*Cardsoft*, E.D. Tex. June 4, 2012),

- allowing discovery but only admitting settlement license for a limited purpose (to show defendant might have a license to a non-infringing alternative) (*Tyco Healthcare*, E.D. Tex. 2010, Judge Ward),

- initially holding settlement licenses were inadmissible but, later, admitting them when defendants opened the door (*DataTreasury*, E.D. Tex. 2010, Judge Folsom), and

- applying the historical approach presuming settlement licenses were not discoverable or admissible, but allowing that on a case by case, facts and circumstances basis such agreements may be discoverable and admissible (*Reed Hycalog*, E.D. Tex. 2010, *Clear With Computers*, E.D. Tex. 2010, Judge Davis, *Fenner*, E.D. Tex. 2010, *Software Tree*, E.D. Tex. 2010, Judge Love).

A. Discoverability

The Federal Circuit has addressed (affirmatively) the discoverability and admissibility of settlement licenses in *ResQNet*, finding that some older settlement licenses were more probative of the reasonable royalty than other available evidence, and in its recent decision in response to a petition for writ of mandamus, *In Re MSTG*, Misc. Dkt. 996 (April 9, 2012), wherein it affirmed a trial court's order instructing a plaintiff to produce documents and communications behind a settlement license.

Obviously, a significant concern is that settling plaintiffs may craft agreements with self-serving language in an effort to make a settlement appear more or less comparable to the hypothetical negotiation depending on whether the plaintiff wants to use the agreement in litigation against non-settling defendants. Defendants will, of course, want to peek behind the curtain to understand the true substance of these agreements. This may include depositions of settling party representatives to understand what information was exchanged and considered. In *Ceats v. Continental* (E.D. Tex. Jan. 2012), Judge Davis was not willing to allow that discovery:

> Defendants have not demonstrated that the settlement agreements are inconsistent to a degree that discovery of the actual settlement negotiations is necessary to determine how the patented technology was previously valued. [Plaintiff's] former settlement agreements establish a rational and consistent royalty rate. Whether [plaintiff's damages expert's] opinion regarding the royalty rate is the proper measure of the value of the patent is question to be answered by a jury at trial.

Shortly thereafter, Judge Gilstrap addressed a similar issue in *Charles E. Hill & Associates v. ABT Electronics*. The Court had previously ordered Hill to produce all settlements and licenses involving the patents-in-suit. Defendants then sought to obtain discovery "behind the licenses" reflecting negotiations and settling party communications. Hill objected based on privilege and that such information would not be probative of value. The Court rejected the suggestion that *ResQNet* superseded long-standing precedent generally excluding settlements (like *Goodyear*), but acknowledged that it created an exception to it in certain circumstances. Thus, determinations would be made on a case by case basis.

In this case, the Court concluded that while signed licenses were generally accepted as a valuable source of information in calculating reasonable royalty, negotiations behind those licenses were generally less probative and more prejudicial given negotiators' propensity for taking an end justifies the means approach where truth is often sacrificed for the desired result at the negotiating table. In sum, such discovery would likely often add unneeded heat but not the much needed light to the royalty determination process.

Citing *Clear with Computers* the Court determined that where the licenses were settlements in the subject case and involved the patents-in-suit, the negotiation information may be more probative if they reflect whether the settlements related to the value of the patents-in-suit or a parties strong desire to avoid further litigation. The Court noted this rationale may be further reinforced where the plaintiff's only licenses are settlement licenses. Finding significant similarities between the relevant circumstances of *Clear with Computers* and *Hill* the Court determined that the "exception" applied in the present case and the discovery would be granted.

There are a number of other decisions from other districts since *ResQNet* that have wrestled with discovery of settlement licenses, with results ranging from non-discovery to discovery and admissibility. In addition to the cases listed and discussed above, a non-exclusive list of cases from outside Texas which are representative of the range of decisions include *Bascom* (E.D.N.Y. September 8, 2011) and *Big Baboon* (C.D. Cal. Oct. 2010) (not discoverable), *Pfizer* (N.D. Ill. August 4, 2010) and *High Point* (D. Kan. April 30, 2012) (allowing discovery of the agreements but not behind the agreements), *Small* (S.D.N.Y. July 19, 2011) and *VolumeMetrics* (D.N.C. 2011) (settlements involving the patents-in-suit and similar technology generally discoverable and potentially admissible), *ePlus* (E.D. Va. 2011) (discoverable, admissible, but of limited probative value), and Implicit Networks (N.D. Cal. July 23, 2012) (court allowed discovery behind the agreements where the proponent put facts underlying the negotiations into play).

Taking these cases together with the decisions from the Eastern District of Texas, it appears that most courts are allowing discovery of plaintiff's settlement licenses involving the patent-in-suit (including some third-party discovery), and many are allowing discovery from defendants of settlement licenses relating to the same accused products as well as similar technology. Fewer have allowed discovery "behind the licenses" though demands for this information are increasing and the most recent decisions reflect an increase in instances where such discovery has been allowed.

B. Admissibility

In addition to *ResQNet* and some the district court cases discussed above which addressed discovery and admissibility, there have been numerous other decisions determining the admissibility of settlement licenses at trial, though most have been rulings on motions in limine and are unpublished. Thus, we recap the admissibility holdings from the above decisions and discuss a few more cases to help set the landscape.

ResQNet and the district court decisions listed above generally reflect a greater likelihood of admissibility of settlement licenses that include the patents-in-suit where the other licensing evidence available to determine a reasonable royalty is limited and comparability differences (i.e., subject matter, date, litigation context) can be and are addressed by the experts. But, generally, such admissibility is case by case based on the facts and circumstances and the general presumption remains against admissibility.

This is illustrated most recently by the Federal Circuit's decision in *LaserDynamics v. Quanta Computer*, where the court determined that a settlement license should not have been admitted. In doing so the court put its *ResQNet* decision in perspective: "[d]espite the longstanding disapproval of relying on settlement agreements to establish reasonable royalty damages, we recently permitted such reliance under certain limited circumstances. *See ResQNet*, 594 F.3d at 870-72 (explaining that a settlement license to the patents-in-suit in a running royalty form was "the most reliable license in [the] record" when compared with other licenses that did not "even mention[] the patents-in-suit or show[] any other discernable link to the claimed tech-nology"). We permitted consideration of the settlement license on remand, but we cautioned the district court to consider the license in its proper context within the hypothetical negotiation framework to ensure that the reasonable royalty rate reflects "the economic demand for the claimed technology.""

Distinguishing the circumstances in ResQNet from the present case, the court note that, unlike "the license in *ResQNet*, the BenQ settlement agreement is far from being the "most reliable license in [the] record." 594 F.3d at 872. Indeed, the BenQ settlement agreement appears to be the least reliable license by a wide margin….The $6 million lump sum license fee is six times larger than the next highest amount paid for a license to the patent-in-suit, and ostensibly reflects not the value of the claimed invention but the strong desire *[by the licensee]* to avoid further litigation under the circumstances. LaserDynamics executed twenty-nine licenses for the patent-in-suit in total, the vast majority of which are not settlements of active litigation and do not involve the unique coercive circumstances of the BenQ settlement agreement, and which are therefore far more reliable indicators of what willing parties would agree to in a hypothetical negotiation *(the insert and emphasis are ours)*."

Other district court decisions limiting admissibility include *Lighting Ballast* (N.D. Tex. June 10, 2011) (where the settlement license was insufficiently comparable due to differences in licensed subject matter and the litigation context that were not sufficiently addressed by the experts), and *Tyco/Applied Medical* (E.D. Tex. Sept. 23, 2011) and *Saffran II* (E.D. Tex. Jan. 2011) where the parties had other relevant non-settlement licenses. In contrast, the few settlements produced by the parties were broadly admitted in *Colorquick* (E.D. Tex. June 2011), *Duhn Oil* (E.D. Cal. Jan. 2011) and *Raymond Caluori* (C.D. Cal. Feb. 2012) where the parties had no other licenses.

However in *Acqis v. IBM* (E.D. Tex. Feb. 2011), settlement licenses were numerous, complex and inconsistent, and their admissibility was uncertain until the week before trial. In that case, Acqis had also sued HP, Dell, Sun, NCR and several non-U.S. blade server product market participants. The non-U.S defendants, while large companies, were small volume market participants (as a group, less than 10% of the market) and settled relatively early in the litigation. Generally, the settlements were lump sums for paid up licenses well beyond the date of trial, (thereby covering future infringement). Nonetheless, most of the settlements included a stated effective running royalty rate which Acqis used to support the running royalty sought against IBM. All the "Big 4" market participants except IBM later settled after expert reports and the close of discovery, ranging from a few weeks to a couple months before trial. All of those licenses were also paid-up lump sums, contained portfolio and/or cross-licenses, some involved equity interests, but none contained a stated royalty rate.

Acqis had relied upon the stated rates in the early licenses, performed constructive royalty rate estimates for the few early licenses without stated rates, and supplemented its original damages report with a constructive royalty rate computation for one of the later licenses. IBM had consistently taken the position that the settlements were non-comparable and that Acqis had not made adjustments necessary to allow for comparison. Ultimately, the Court determined the settlement licenses were admissible but also allowed defendant's damages expert to offer rebuttal opinions concerning the terms and economics of the licenses to minimize the prejudice.

In connection with the *Mondis* decision previously discussed, in addition to allowing testimony about the 25% rule where plaintiff had executed licenses based on that rule, the Court also admitted settlement licenses involving the patent in suit. *Mondis* (E.D. Tex. June 14, 2011). Defendant sought to use them to show plaintiff's royalty rate demand was unreasonable and plaintiff sought to triple them to account the fact that the settling parties necessarily compromised disputes about validity and infringement whereas the hypothetical license would not have that uncertainty. The Court allowed the testimony noting that *ResQNet* recognized there could be a difference between royalties compelled through trial and those voluntarily entered into outside of Court.

In sum, this area of law continues to evolve and decisions largely appear to be facts and circumstances as to whether the settlements will be allowed into evidence at trial, primarily depending on whether subject matter and litigation context issues can be properly adjusted for.

C. Comparability

While a general discussion of comparability of actual licenses to the hypothetical license is beyond the scope of the issues we discuss in this paper (and the foregoing discussions highlight comparability issues specific to settlement licenses), decisions concerning comparable and non-comparable licenses in *Convolve v. Dell* (E.D. Tex. July 2011), *Oracle v. Google* (N.D. Cal. July 2011), and *Apple v. Motorola* (N.D. Ill. May 2012) provide representative examples of how courts are addressing the issue. In sum, these courts generally found licenses non-comparable where they involved different subject matter (i.e., patents other than the patent-in-suit, bundles of IP rights as opposed to just the patent-in-suit, different accused products) and the parties had not sufficiently linked and compared, through technical expert opinion or otherwise, the significance and value of the actually licensed technology and the patented technology. This result is consistent with similar decisions out of the Federal Circuit including *Lucent*, *ResQNet*, *Wordtech*, and *Uniloc*, all of which found the proffered party licenses insufficiently comparable to support the verdicts.

A recent law review article discusses more exhaustively the broader issues relating to discovery and admission of settlement agreements. See Keele, "ResQing Patent Infringement Damages After *ResQNet*: The Dangers of Litigation Licenses as Evidence of a Reasonable Royalty," 20 **Texas Intellectual Property Law Journal** 181 (Spring 2012).

D. Strategic Considerations

When it comes to settlement licenses then, the potential party positions can be presented in a simple two by two matrix:

Party / Stage	**Discoverable**	**Admissible**
Plaintiff	**Y/N**	**Y/N**
Defendant	**Y/N**	**Y/N**

The matrix can become multi-dimensional if we differentiate between plaintiff's settlements in the subject case and settlements in other cases that are arguably relevant under *Georgia-Pacific* factors 2 or 12, as well as settlements where the current plaintiff was a defendant, along with a defendant's settlements in other matters involving the same accused products or similar technology, again, whether as a plaintiff or defendant. The simple matrix can quickly triple or more in size. In any event, following is a non-exhaustive discussion of potentially relevant considerations by parties in deciding whether to seek or resist the discovery and admission of settlement licenses.

1. Plaintiff's Perspective

Continuing the simplicity theme, generally, a plaintiff will want to use settlement licenses in the same and future litigations where it has negotiated an arrangement that is within the targeted range it seeks. Unique arrangements with "first" and smaller defendants (e.g., a low nuisance or no value arrangements, reduced value arrangements in order to secure an initial license and/or provide litigation funding), as well as complex agreements with larger or difficult defendants (e.g., cross-licenses, IP bundles, resolving multiple disputes, extra covenants, contingent future payments, etc.) are generally less useful.

Also, since settlements generally involve a single payment through the date of settlement and, most are paid up licenses based on a lump sum (though some involve a continuing royalty), the structure may complicate use against other defendants and future litigants where a running royalty may be sought in litigation or used to determine the historical infringement royalty portion of any lump sum. As noted in the case law discussion, the key is being able to equate the lump sum to a running royalty which experts have been unsuccessful in doing in many cases. Stating an effective running royalty rate is a good start but having verifiable support for it is even better. This may risk, however, opening up discovery "behind the license" or third-party discovery. Attaching accused sales data and computations to the settlement may cut off additional discovery. It also serves to document the date back to which the royalty applies which can be useful in arguing the relevance of the settlement to determining the royalty for other defendants who began infringing around the same time.

The plaintiff should be careful to address how estimated future royalties were determined if a paid up lump sum license is granted since significant future expected accused sales may suggest that only a small portion of the lump sum was for past infringement since that is the relevant royalty period for remaining litigants. Understandably settling defendants with want waivers and releases and those are a common arrangement. Noting that the settling parties dispute validity and infringement are useful support for the argument that the arrangement reached was below the royalty that would apply where patent validity and infringement were not in dispute, which are the assumptions that must be made for damages purposes.

In contrast, where a settlement is below the target range, less is more in the sense that not including provisions that would aid in comparing the settlement license to the hypothetical license potentially limits its relevance. But also more may be more where provisions are added to further distance the settlement license from the hypothetical license including explanations or rationales for the settlement, unique structuring, extra covenants and other considerations, describing limitations on discovery and information, and so forth. But plaintiffs must keep in mind that this license will become part of their body of work concerning licensing practices and policies that may be referenced in future litigations whether as a plaintiff and defendant concerning arrangements plaintiff found acceptable in the past.

Generally, a plaintiff that wants its settlement licenses to be potentially admissible can start by voluntarily producing them in the litigation as part of automatic or mandatory disclosures or, even better, in response to a specific defendant discovery request for licenses. Of course, in negotiating the settlements plaintiff will have to be mindful of provisions that may restrict disclosure of the agreements to others, including in litigation. Provisions are often included requiring the licensed parties to resist disclosure or discovery, to notify one another, and/or to require an objection forcing a motion to compel. Generally, such provisions will only slow down the production as courts will frequently compel production based on the protective order in the case.

Odds of discoverability and admissibility (whether sought by the plaintiff or a defendant that wants plaintiff's settlement licenses discovered and admitted) will be increased where the settlement license involves the patent-in-suit. While comparability is a critical factor in determining whether a settlement license is admissible, the cases suggest that some comparability considerations may come up at the discovery phase. Of course where a plaintiff has produced its own settlement licenses the discovery issue is moot. As to discovering defendant's settlement licenses, the plaintiff should anticipate objections to discovery relating to relevance and comparability so that at least an initial showing can be made of reasons to anticipate the settlements may eventually be admissible. Among other things, technical expert opinions can be used to bridge the gap between settlements involving other patents for relevant technology (e.g., relating to similar products, in the same field and of comparable significance, and so forth). Plaintiffs representing their intention to conduct such analyses may be sufficient at this stage to overcome objections based on relevance and non-comparability. But, parties will have to be mindful of other comparability differences including the relationship between the parties, date, litigation context, and other rights included in the agreement. Practically, it is often difficult to adjust for many of these differences with mathematical precision, requiring some sound economic rationale for the adjustments such that the result is not speculative.

As reflected in the case law, affirmatively addressing and properly adjusting for differences in royalty structures (lump sum vs. running royalty), date differences between the settlement (or relation back date) and the hypothetical negotiation, and subject matter (freedom to operate under the patents-in-suit vs. a bundle of rights, other patents, other considerations and covenants) is critical to ultimate admissibility. Where the license documentation and witness testimony does not address these issues directly, the technical and damages expert will have to work together to perform the analyses and develop the record. For example, where a plaintiff has granted a paid up license in settlement, adjustments will need to be made to determine the equivalent through the date of trial as to remaining defendants. Where a plaintiff has granted a lump sum license in settlement but seeks a running royalty, computations reflecting a reasonable estimate of the effective royalty rate will need to be performed. Or where the settlement license involves different patents or technology but the same products, technical expert opinions concerning the comparative significance of the technology and, potentially, economic analyses of the importance of the features impacted by the other technology to the consumer compared to the patented technology will be needed.

2. Defendant's Perspective

In short, reverse the above. Well, not exactly. Of course, where a plaintiff doesn't produce or rely upon prior settlement licenses, a defendant has to consider whether they want to seek their production. While the plaintiff's failure to produce the prior settlements suggests they are not that useful to plaintiff, seeking their discovery will open the door to defendant's settlement licenses as well. Where defendant's prior settlements are useful to defendant, then it is perhaps worth the risk of seeking plaintiff's settlement licenses as well.

The defendant settlements most likely in issue will be ones involving the same accused products, the same field of invention or otherwise similar technology to the patented technology, both where defendant was the plaintiff and defendant in the prior action. Where defendant doesn't want to produce such agreements, the discussion in the previous section concerning anticipated barriers to admissibility as a threshold argument against discovery (i.e. relevance and comparability) should be raised to demonstrate the discovery exceeds that which is expected to lead to admissible evidence. Parties who are mostly defendants understandably want to fill settlement licenses with provisions that will distance them from the "bare patent license for a running royalty based on a percentage of sales structure" often sought in the hypothetical negotiation. Thus, adding one-sided and cross-exchanges of other rights and considerations, language reflecting the importance of settling and avoiding litigation as opposed to licensing the patents, expressing the limits on information used to reach the settlement, and so forth, may limit comparability. Of course, the plaintiff may seek discovery "behind the license" but, to date, courts have been reluctant to grant that relief meaning most of what can be determined about the licenses will come from the face of the documents and party witnesses presented in connection with them. As noted above, plaintiffs can often overcome objections to discovery based on issues about inadmissibility by explaining the process by which they can make the agreements more comparable. As discussed in the previous section, making appropriate comparability adjustments will most likely dictate admissibility.

Where a defendant wants to use its own settlement licenses, the defendant can simply voluntarily produce them or produce them in response to the plaintiff's specific request for license agreements. The defendant should be careful about criteria applied to determine agreements produced where there are other less favorable agreements not being produced. The existence of the other agreements may be discovered through public records, may be well known by those active in the industry (including counsel who have litigated many other cases involving market participants) or designated representative depositions, and defendant may have to produce those potentially undermining the favorable royalty theory suggested by the agreement voluntarily produced.

For those who find themselves on both sides of the docket, there may be considerations on one side or the other that will dictate the philosophy for the party in all circumstances. In other words, a large software company that gets sued a lot by NPE's and competitors but also asserts patents to block competitors, may decide to take a uniform approach to settlement licensing and terms of settlement which may make its settlements as plaintiff less comparable to its litigation position, but may provide the safest structure for its defendant cases where discovery of the settlement licenses are regularly expected. This approach may also prevent some cases from settling where a counter party desires provisions to which the software company will not agree. The result may include trials involving settlement licenses and verdicts based on them, leading to appeals where those agreements may be further published and scrutinized. It's a tangled web.

CONCLUSION

Ultimately, there is no magic formula but case law developments from 2009 to date on the EMVR and settlement licenses provide an objective framework if not yet predictable outcomes.