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Assessing Damages Recoverable in Patent Infringement Cases

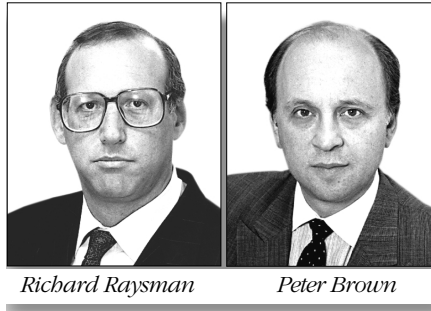
CALCULATING AND proving damages in a patent infringement case is a complex, fact-intensive exercise that often eclipses the task of proving the infringement itself. The proliferation of business method patents over the last five years in the wake of the U.S. Court of Appeals for the Federal Circuit's *State Street* decision¹ has not altered the basic rules for assessing damages recoverable in patent infringement cases, but it has added new wrinkles that will need to be confronted by courts and litigants in years to come.

So far, only a handful of business method patent disputes have resulted in important decisions, and guidance pertaining specifically to damages is nonexistent. As a result, practitioners and prospective litigants must look to the generally applicable law of patent infringement remedies in order to gauge ongoing or potential infringement damages, with an eye toward issues that may be particular to the business method context.

Where to Begin?

The starting point for assessing patent infringement damages is 35 USC §284,

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which provides that a patentee who proves infringement is entitled to recover damages "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." The focus of damages is on the patentee's lost profits. However, if lost profits cannot be determined, the patentee is entitled to a reasonable royalty, a measure that is intended as "a floor below which the courts are not authorized to go." *Del Mar Avionics, Inc. v. Quinton Instrument Co.*, 836 F2d 1320, 1326 (Fed. Cir. 1987).

Thus, "lost profits" recovery and "reasonable royalty" recovery are the recognized measures of damages for patent infringement. On a simple level, a patent owner might be thought of as losing a sale on each sale made by an infringer. But lost profits analysis is rarely as simple as adding up the patentee's lost profit margins from these sales. Factors such as differences in production costs between the parties, the availability of adequate substitutes on the market and lost sales of unpatented component parts make calculations of both lost profits and a reasonable royalty

extremely complicated in most cases. It is not uncommon for patentees to offer testimony from economists, industry analysts, engineers and even consumers to support their damages claims.

Despite the fact-intensive nature and complexity of the calculations, important legal standards for measuring damages have developed. Understanding these general principles is crucial well before the damages phase of litigation, as the size and availability of a potential damages award might well influence the decisions of patent owners and their competitors to commence litigation, settle litigation, bring new technologies to the market or license existing technology.

Lost Profits

Patentees will usually attempt to show that lost profits is the proper measure of damages, as lost profits often comprises a greater damages award than reasonable royalty damages. To recover lost profits, a patentee must show that "but for" the infringement, the patentee reasonably would have made additional profits.

A patentee may use any method to show the "but for" connection, but this argument usually involves a fairly sophisticated market reconstruction. As the Federal Circuit explained, "[t]o show 'but for' causation and entitlement to lost profits, a patentee must reconstruct the market to show, hypothetically, likely outcomes with infringement factored out of the economic picture." *Crystal Semiconductor Corp. v. Tritech*

Microelectronics Int'l, Inc., 246 F3d 1336, 1355 (Fed. Cir. 2001). Even though this market reconstruction is hypothetical, courts have held that it must be based on “sound economic proof,” usually involving expert testimony. Despite this practice, courts have permitted plaintiffs to prove damages with their own “non-expert” testimony about the economics of their own businesses and the fields in which they operate, see, e.g., *Korszun v. Public Technologies, Inc.*, No. 3-00-cv-327 (D. Conn. Aug. 30, 2002), but reliance on the testimony of a plaintiff’s officers or other employees requires careful and detailed preparation with counsel because of their likely lack of experience in dealing with litigation.

The U.S. Court of Appeals for the Sixth Circuit’s *Panduit* test has emerged as a recognized method for showing that “but for” the infringement, a patentee would have made additional profits, and a discussion of this test illustrates many of the concepts involved in any methodology used to show lost profits. To prove entitlement to lost profits damages using the *Panduit* test, the patentee must show: 1) a demand for the patented product, 2) the manufacturing and marketing capacity to meet the demand, 3) the absence of acceptable noninfringing alternatives that offer the advantages of the patented device, and 4) the amount of profit the patentee would have made. *Panduit Corp. v. Stahl Bros. Fibre Works, Inc.*, 575 F2d 1152, 1156 (6th Cir. 1978).

Under the first prong of the *Panduit* test, demand for the patented product, courts look at actual sales of the products that embody or share the characteristics of the patented invention. A substantial number of sales of the infringing product is one way to show demand, *Gyromat Corp. v. Champion Spark Plug Co.*, 735 F2d 549, 552 (Fed. Cir. 1984), but owners of business method patents may seek to establish demand in other ways if infringement of a business method cannot be quantified by sales figures. For example, a patent holder could submit

expert testimony demonstrating a need for a particular business method in a given market or field, or evidence of an upswing in a company’s business after the introduction of the business method. See *State Industries, Inc. v. Mor-Flo Industries, Inc.*, 883 F2d 1573, 1578-79 (Fed. Cir. 1989), cert. denied 493 US 1022 (1990).

The second prong of the *Panduit* test requires the patentee to show that it had the manufacturing and marketing capacity to meet the demand for the infringer’s products. This standard can be shown with evidence from someone with personal knowledge that the patentee did or did not have the capability to manufacture to meet demand, or a showing that the patentee could have efficiently subcontracted out the

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manufacturing. *Gyromat*, 735 F2d at 554. While the court may consider factors such as a patentee’s manufacturing backlog or the patentee’s failure to commence manufacturing of the patented device as evidence of the patentee’s lack of capacity to meet demand, such factors are not determinative and the patentee may demonstrate business reasons for working off a backlog, or an intention to commence manufacture. *Micro Motion Inc. v. Exac Corp.*, 761 FSupp 1420, 1425 (N.D. Cal. 1991); *Hebert v. Lisle Corp.*, 99 F3d 1109, 1119 (Fed. Cir. 1996).

Because the embodiment of many business method inventions is computer software that is easily copied with minimal production costs — compared to, say, a jet engine — the second prong of the *Panduit* test may be relatively simple to demonstrate.

The third prong of the *Panduit* test requires that there be an absence of acceptable noninfringing alternatives that offer the advantages of the patented device. This aspect of the *Panduit* test is most problematic in the context of business method patents, which are often freely accessible and easily copied, and can often be designed around.

Substitute Way of Business

In addition, even if a noninfringing substitute is not yet on the market, it may preclude lost profits if it can be developed quickly or is ready but is not being used for some reason. *Grain Processing Corp. v. American Maize-Products Co.*, 185 F3d 1341, 1351 (Fed. Cir. 1999). While a product will not be considered “available” if the substitute would require extensive research and development time and effort to obtain, *Micro Chem., Inc. v. Lextron, Inc.*, 318 F3d 1119 (Fed. Cir. 2003), accused infringers of business method patents will often be able to support an argument that a substitute way of doing business was available at the time of the infringement.

Although accused infringers will typically rely on sales figures showing consumer demand to demonstrate that there are acceptable non-infringing alternative products, courts will consider a variety of evidence, including testimony of potential or actual purchasers of the products, *Fiskars, Inc. v. Hunt Mfg. Co.*, 279 F3d 1378, 1382-83 (Fed. Cir. 2002); *Smithkline Diagnostics, Inc. v. Helena Laboratories Corp.*, 926 F2d 1161, 1165 (Fed. Cir. 1991).

Finally, the patentee must prove the amount of profits it would have made in the absence of the infringement. Various methodologies have been employed for this analysis, usually entailing a calculation of lost sales and then subtracting the costs associated with those sales.² Again, due to the often-attenuated connection between a way of doing business

and quantifiable profits, this showing may be difficult for business method patent owners.

Other Theories of Recovery

Several supplemental theories of recovery have developed as well that can bolster a lost-profits claim. Under the "entire market value rule," courts have allowed recovery of lost profits for sales of non-patented component parts where a patented feature is the basis for consumer demand for an entire machine. *Rite-Hite Corp. v. Kelley Co.*, 56 F3d 1538, 1549 (Fed. Cir.), cert. denied 516 US 867 (1995). Thus, a business method patentee may be able to demonstrate lost sales of hardware if sales of the hardware are linked to patented software.

Another important supplemental theory of recovery is "price erosion," which recognizes lost profits damages due to price reductions that the patentee had to make because of the presence of the infringing products on the market. Lost profits damages based on a theory of price erosion can be quite significant. See *Minnesota Mining & Mfg. Co. v. Johnson & Johnson Orthopaedics, Inc.*, 976 F2d 1559, 1578-79 (Fed. Cir. 1992) (upholding lost profits damages of almost \$30 million due to price erosion).

In addition, an "incremental income approach" is often used when converting lost sales figures into lost profits damages. This theory recognizes that production costs will generally decrease with greater numbers of products being produced, meaning that a patentee may be able to demonstrate higher profit margins for the lost sales than for its actual sales, or the infringer's sales. See *Micro Motion*, 761 FSupp at 1429. This factor may be particularly important in business method and software-related patent cases, where marginal production costs are quite low or nonexistent.

Reasonable Royalties

Where infringing sales are not

captured by the lost profits calculation, or a patentee elects for strategic reasons not to attempt to prove lost profits, the patentee may receive a reasonable royalty for such sales. In some cases, such as where some infringing sales can be shown to result in lost sales for the patentee but other infringing sales do not directly compete in the same market as the patentee, a damages award may be split between lost profits and a reasonable royalty. See, e.g., *Crystal*, 246 F3d at 1356.

Royalty rates may either be calculated by using established royalty rates charged by the patent owner on prior actual licenses of comparable use, or by using a test to determine a "reasonable royalty." To determine a "reasonable royalty" rate, which is a hypothetical royalty that a willing licensee would have paid to use the patent, expert testimony will usually be submitted relating to the 15 "Georgia-Pacific" factors, of which no one single factor is determinative. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 FSupp 1116, 1120 (SDNY 1970), modified and aff'd sub nom., *Georgia-Pacific Corp. v. United States Plywood-Champion Papers*, 446 F2d 295 (2d Cir. 1971), cert. denied, 404 US 870 (1971).

There are no specific limits on how high a royalty rate may be. For example, in affirming an award of one-half of the infringing unit's profits as a royalty, the Federal Circuit in one notable case considered that the "patent was a 'pioneer' patent with manifest commercial success," the patent owner had a pattern of exploiting its own patents (i.e., it did not want to license to anyone), the patent owner would have forgone "a large profit by granting a license to [the infringer] because [it] was a strong competitor," and the patent owner would have made substantial collateral sales. The court also noted that "'there is no rule that a royalty be no higher than the infringer's net profit margin'" and the royalty need not even be less than the price of the infringing

product. *Rite-Hite*, 56 F3d at 1555.

Treble Damages

Finally, a court may award treble damages under §284, in its discretion. While the statute does not set forth criteria for establishing the appropriateness of enhanced damages, courts have generally focused on the following factors: (1) whether the infringer deliberately copied the ideas or design of another, (2) whether the infringer, when he knew of the other's patent protection, investigated the scope of the patent and formed a good-faith belief that it was invalid or that it was not infringed, (3) the infringer's behavior as a party to the litigation, (4) the infringer's size and financial condition, (5) the closeness of the case, (6) the duration of the infringer's misconduct, (7) any remedial action by the infringer, (8) the infringer's motivation for harm, and (9) whether the infringer attempted to conceal its misconduct. See *Johns Hopkins Univ. v. CellPro, Inc.*, 152 F3d 1342, 1352 (Fed. Cir. 1998). While treble damages are the exception, defense counsel must be alert to unusual competitive business behavior or overly aggressive positions during the litigation which might cause the court to impose this extraordinary remedy.

(1) In *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F3d 1368 (Fed. Cir. 1998), cert. denied 525 US 1093 (1999), the Court of Appeals for the Federal Circuit unambiguously eliminated the so-called "business method exception" to patentability, thereby permitting protection for otherwise patentable business models, so long as their intrinsic processes produced a "useful, concrete and tangible result."

(2) See, e.g., *Micro Motion Inc. v. Exac Corp.*, 761 FSupp 1420, 1428 (N.D. Ca. 1991) (setting forth a six-factor test to determine lost sales from infringement of mass flowmeters).