

Intellectual Property Litigation Insights

www.willamette.com

SUMMARY OF THE FACTORS COURTS HAVE CONSIDERED IMPORTANT WHEN DETERMINING A REASONABLE ROYALTY RATE IN PATENT INFRINGEMENT LITIGATION

Anna Kamenova

Two seminal cases in the patent infringement area are Georgia-Pacific Corp. v. US Plywood Corp. and Honeywell v. Minolta. Both of these cases highlight the factors the respective courts considered relevant in estimating a reasonable royalty rate in the determination of economic damages. This discussion (1) summarizes these various reasonable royalty rate factors and (2) explains how these factors affect the reasonable royalty rate selection.

INTRODUCTION

The determination of the patentholder's lost profits due to a patent infringement depends on the facts and circumstances of each individual case. In this discussion, we will review the use of the reasonable royalty rate factors described in two federal court cases:

1. *Georgia-Pacific Corp. v. U.S. Plywood Corp.* (318 F. Supp. 116 (S.D.N.Y. 1970)) (the "Georgia-Pacific case") and
2. *Honeywell v. Minolta* (Civil Nos. 87-4847, 88-1624 (N.D.N.J. 1992)) (the "Honeywell case").

In these two cases, the courts concluded those factors that are important in determining a reasonable royalty rate for the estimation of damages related to patent infringement.

These reasonable royalty rate factors are closely followed by valuation analysts in providing economic damages analyses, particularly in the area of intellectual property infringement litigation.

PATENT INFRINGEMENT DAMAGES

Damages adequate to compensate for patent infringement are awarded under the U.S. Patent Act, Title 35 of the U.S. Code Section 284:

Upon finding for the claimant the court shall award the claimant 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, together with interest and costs as fixed by the court.

When the damages are not found by a jury, the court shall assess them. In either event the court may increase the damages up to three times the amount found or assessed.

The court may receive expert testimony as an aid to the determination of damages or of what royalty would be reasonable under the circumstances.

The specifics of this concept can be troublesome to some intellectual property analysts. This is because:

1. the patent statute contains no further guidelines and
2. the case law is not entirely consistent in this area.

A fundamental problem that immediately arises is the existence, in reality, of two different definitions of the term "reasonable royalty."

REASONABLE ROYALTY RATE

The first definition of the term "reasonable royalty" is the actual licensing rate to which the patent owner and a licensee would have negotiated and agreed entirely apart from any litigation or damages question. As stated by

the Federal Circuit, this negotiated reasonable royalty is “merely the floor below which damages shall not fall.”

The second definition of the term “reasonable royalty” is the amount of damages adequate to compensate the patent owner, when the later cannot prove actual damages because no royalty has been set.

In the vast majority of patent litigation damages cases today, this meaning of “reasonable royalty” has rarely been the “floor” represented by a negotiated royalty.¹

Reasonable royalty damages have historically been much higher than—and bear very little relationship to—any royalty that the parties would have ever agreed upon. Reasonable royalty damages can even exceed what could be obtained by a lost profits analysis.

What the courts generally attempt to award is “damages adequate to compensate” the patent owner for the economic effects of the patent infringement.²

In both cases, there is a multiplicity of interpreting factors bearing on the amount of reasonable royalty. However, there is no formula by which:

1. these factors can be rated precisely in the order of their relative importance or
2. by which their economic significance can be automatically translated into their monetary equivalent.

The courts—in the *Georgia-Pacific* case and in the *Honeywell* case—provided jury instructions including all relevant factors that had to be addressed in order to determine the damages award in relation to the patent infringement.

THE GEORGIA-PACIFIC REASONABLE ROYALTY RATE FACTORS

The factors for estimating a reasonable royalty rate considered in the *Georgia-Pacific* case are as follows:

1. The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty.
2. The rates paid by the licensee for the use of other patents comparable to the patent in suit.
3. The nature and scope of the license, as exclusive or non-exclusive; or as restricted or non-restricted in terms of territory or with respect to whom the manufactured product may be sold.
4. The licensor’s established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention of
5. The commercial relationship between the licensor and licensee, such as, whether they are competitors in the same territory in the same line of business; or whether they are inventor and promoter.
6. The effect of selling the patented specialty in promoting sales of other products of the licensee; the existing value of the invention to the licensor as a generator of sales of his non-patented items; and the extent of such derivative or conveyed sales.
7. The duration of the patent and the term of the license.
8. The established profitability of the product made under the patent; its commercial success, and its current popularity.
9. The utility and advantages of patent property over the old modes or devices, if any, that have been used for working out similar results.
10. The nature of the patented invention; the character of commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention.
11. The extent to which the infringer has made use of the invention; and any evidence probative of the value of that use.
12. The portion of the profit or of the selling price that may be customary in the particular business or in comparable business to allow for the use of the invention or analogous inventions.
13. The portion of the realizable profit that should be credited to the invention as distinguished from non-patented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer.
14. The opinion testimony of qualified experts.
15. The amount that a licensor (such as the patentee) and a licensee (such as the infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement; that is, the amount which a prudent licensee—who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention—would have been willing to pay as a royalty and yet be able to make a reasonable profit and which the amount would have been accepted by a prudent patentee who was willing to grant a license.³

THE HONEYWELL REASONABLE ROYALTY RATE FACTORS

The *Honeywell* case adopted virtually verbatim 11 of the 15 *Georgia-Pacific* case factors.

The *Honeywell* case omits the first two *Georgia-Pacific* case factors relating to established royalties and other “comparables.” Three additional factors were added by the court in the *Honeywell* case, specifically:

1. the extent to which the infringement prevented Honeywell from using or selling the invention;
2. the relative bargaining positions of Honeywell and Minolta;
3. the market to be tapped.⁴

OTHER JUDICIAL PRECEDENT

In previous cases,⁵ the Supreme Court said that, where a patentee could not prove lost profits, infringer’s profits, or an established royalty, the patentee could show the value by providing what would have been a reasonable royalty.

That reasonable royalty rate should consider the nature of the invention, its utility and advantages, and the extent of the use involved. The parties could rely upon the traditional array of facts probative of a reasonable royalty.

But in the *Georgia-Pacific* case, a heavy reliance is placed upon a later formulation called “the willing buyer willing seller” rule. This rule is more a statement of approach than a tool of analysis.

This approach defines the estimated royalty rate not only:

1. as the amount a willing licensee would have paid but also as
2. the amount a willing licensor would have accepted if negotiated at the time the infringement began.

In a litigation context, both parties would present different scenarios and give different weight to relevant factors in a hypothetical negotiation of a royalty rate for the subject patent. The majority of the hypothesized facts—such as anticipated profit rates, probable volume of sales, normal economic motivations, and prevailing business outlook—should be premised on the direct and circumstantial record evidence.

The hypothetical situations to which the reasonable royalty factors are applicable should be supported by direct or circumstantial evidence in order for the court to accept their validity.

ANALYSIS OF THE GEORGIA-PACIFIC REASONABLE ROYALTY FACTORS

Factors 1 and 2

Often in estimating a reasonable royalty rate, the analyst cannot rely on factors 1 and 2. This is because either:

1. the patentee has not previously licensed the patent or
2. the patent in the instant case differs significantly from any other licensed patents by the infringer.

Factor 3

The geographic or sublicense limitations of an actual or hypothetically negotiated licensing agreement would typically warrant a selection of a lower royalty rate.

Factor 4

The policy of a hypothetical licensor to maintain patent monopoly on sales would justify the selection of a higher royalty rate to compensate the licensor for the impaired market position. The reluctance of the patentee to grant licenses would indicate a higher royalty rate selection in hypothetical licensing negotiations.

Factor 5

The commercial relationship between the licensor and licensee if they are same-territory competitors would require a higher royalty rate that

1. the licensee would pay in order to enter the licensor's market and earn profits and
2. would motivate the licensor to forgo profits from decreased sales.

In cases where the two parties operate in different territories and/or different lines of business, the royalty rate would typically be lower. This is due to additional efforts that the licensor and licensee need to make in order to compete for new customers.

Factor 6

In a determination of the royalty base for the use of patents, anticipated and actual sales of items that are not part of the subject product may be considered. To determine whether such sales are relevant to the royalty rate, it may be considered if the infringer used or anticipated using its infringing product lines to promote the sale of other noninfringing product lines.

Factor 7

The duration of the infringed patent, and hence term of the hypothetical license, is a factor that is possibly deceptive. A long remaining term does not necessarily point to a higher royalty rate, and vice versa. As with most concepts relating to licensing, it should be examined in the specific context of each case.

If many years remain on the infringed patent, and if it happens to be in a scientific discipline being rapidly advanced such that the patent is likely to become obsolete long before its expiration, then a relatively modest royalty rate could be logical. In addition, a long remaining patent term could help create a larger overall royalty base, which could decrease the applicable royalty rate.

If an infringer is actively marketing products covered by a patent scheduled to expire in a year or two, such an infringer might be willing to pay a very high royalty rate for a short duration to avoid a hiatus from the market.

Factor 8

The level of patent significance in the created product popularity, profitability, and achieved commercial success would lead to the selection of a higher reasonable royalty rate. If the patent in suit has no substantial bearing on the product desirability, this factor would be considered irrelevant.

In the *Georgia-Pacific* case, the product made under the patent had a substantial market share during the last nine years prior to infringement. The patentee had no reason to believe that the demand for the product would decline significantly in the foreseeable future. This factor was heavily weighted in the *Honeywell* case, as well.

Factors 9 and 10

The infringer in the *Georgia-Pacific* case argued that the relevant product was only a type within a whole class of products experiencing substantial competition—during the time the infringement began. The infringer argued that, therefore, the selection of a minimal royalty rate is justified.

Despite the allegedly fierce competition between the subject product and other generally similar products, the Georgia-Pacific company deliberately decided to duplicate the product notwithstanding the caveat of the Georgia-Pacific legal counsel that an expensive infringement suit was inevitable.

The Georgia-Pacific company willful infringement of the subject patent is an admission by conduct that it regarded the product as occupying a uniquely favorable position in the market.

In order to determine the competitive position for a given patent, an analysis of current market technologies—their popularity, life cycle, and customer preferences—is needed to assess the patent exclusivity. A determination to what extent various similar products are competitive with each other can be made by comparing:

1. their respective price ranges and
2. the respective markets that had been developed for them.

Typically, a price stability of the subject product would support a theory of stable competitive position and sufficient product differentiation to sustain other product offerings on the market.

The competitiveness of the subject product and the infringing product is analyzed in conjunction with the degree to which they are competitive to each other and to other products.

In the *Georgia-Pacific* case, the patentee product and the infringing product were competitive to each other to a greater degree than they were competitive with other similar products. This fact provided further support for selecting a high royalty rate.

The competitive situation analysis must address the market conditions as of the time the infringement commenced and hence the time when the reasonable royalty would have been negotiated.

For the patent owner, often the absence of acceptable noninfringing substitutes is the hardest factor to prove. A careful analysis of this factor—sometimes described as whether there is a commercially viable noninfringing alternative to a patented invention—is considered crucial in most situations when determining the appropriate measure of damages.

This issue is directly related to the breadth of the patent being litigated. If the breadth of the patent is insignificant—in that easily available noninfringing alternatives exist—then damages “adequate” to compensate for its infringement should be correspondingly modest.

Factor 11

The extent to which the infringer has made use of the subject invention is directly relevant to the size of the royalty base (against which the royalty rate is multiplied to arrive at the total royalty figure). And, the extent to which the infringer has made use of the subject invention is also pertinent to the question whether noninfringing substitutes were readily available.

Evidence as to the value of such use to the infringer could directly influence the royalty rate which could logically be negotiated.

Factor 12

Instead of *Georgia-Pacific* factor 12 relating to standard industry profits, the *Honeywell* judge substituted:

What the parties reasonably anticipated would be their profits or losses as a result of entering into a license agreement.⁶

Under this formula, the lawyer and the damages expert witness could take into account relevant industry practices. However, the lawyer and the damages expert would also have the added flexibility to consider any other pertinent business circumstances in making the analysis.

Factor 13

Reasonable royalties may be based on the sales of entire product systems, even though the infringed patents cover only parts of those systems. The products manufactured using the infringed patent (the “patented item”) are typically sold in conjunction with products that are not claimed in the patents-in-suit.

This occurs when the subject patented item is a key component in a larger apparatus. It also occurs when the sales of other related products are expected as a result of the sales of the patented product (also known as conveyed sales).

When the patented element is the basis for the consumer demand, an entire market value is applied to determine the royalty base—the base against which the royalty is measured. It is, in effect, what is included in computing royalty damages.

Under the entire market value rule, it is not the fiscal joinder or separation of the items that determines whether they are included in the royalty base. Rather, the financial and marketing dependence on the patented item under standard marketing procedures for the product determine whether they are included in the royalty base.

Factor 14

Often, the expertise sought in determining damages for infringement cases is that resulting from experience in actual licensing transactions. Experts furnish opinions as to what would be a royalty that the patentee and infringer would logically have been expected to negotiate at the

point in time just prior to the commencement of the actual infringement.

Within the context of 35 U.S.C. Section 284, this expert opinion should furnish the court with a floor or lower limit of damages to be awarded. If such opinion is accepted, the court can take various factors into account to increase the base figure to the quantum of damages that the infringer should be required to pay to the patentee. Indeed, the statute contemplates that the court can go even further.

Its discretionary powers allow the court the option to:

- award up to treble damages, particularly if infringement is found to be willful;
- award prejudgment interest; and
- require the infringer to pay the patentee’s attorney’s fees.

When acting as an expert, an analyst should adopt the following attitudes and procedures:⁷

- An expert should thoroughly establish independence. This extends well beyond the absence of conflict of interest from past or present involvement.

The expert should elicit from the retaining party a commitment of absolute candor. Any information that could reasonably be relevant to the expert in constructing an opinion, positive or negative, should be made available.

- Questions about preservation of confidentiality should promptly be settled. Frequently, the expert will be required to sign a court-enforced restraining order on the use of commercially sensitive material which is produced by either party to the litigation, via discovery or otherwise.

In addition, the expert should offer to the retaining party to execute the same confidentiality procedures such party requires of its own employees or consultants. Thus, the expert will not be inhibited in performing a background study.

- A general, preliminary opinion by the expert to the retaining party may reasonably be expected. This indicates the basic direction of the expert’s thinking, as well as the methodologies contemplated to be employed.

If this is unacceptable to the retaining party, the expert should be released and paid for past services. If the plan is acceptable, a relatively detailed plan of action should be mutually agreed upon.

- An expert should require the same degree of familiarity with the technology involved in the litigation as the expert would need if charged to negotiate a license of the patent at the time of the hypothetical negotiation.

This usually involves a visit to actual laboratories and production facilities, similar to those where the infringing products were made or processes performed.

- In addition to requesting access from the retaining party to all potentially relevant documentation in their possession, an expert should be free (within practicable limits) to perform individual investigations to elicit or confirm important facts.
- When formulating an opinion, an expert should be as explicit as possible about the information directly relied on, as well as other circumstances taken into account, in reaching his or her conclusions.

Factor 15

In restating factor 15, the court in the *Honeywell* case affirmed that it intended to cover unexpected facts that actually occurred subsequent to the hypothetical negotiation, stating to the jury:

The amount that Honeywell and Minolta would have agreed upon, if both had been reasonable and had voluntarily tried to reach an agreement, starting at the time the infringement began. In making this determination, you may take into account the events and facts that occurred thereafter, and that could not have been known to or predicted by the hypothesized negotiators.”⁸

While the district court in the *Georgia-Pacific* case spelled out all of the foregoing criteria for fixing reasonable royalties in the context of Section 284, it should be noted that this decision was partially reversed on appeal to the Second Circuit.⁹

Indeed, the Second Circuit did not appear to take into account all of the nuances that could exist in a hypothetical negotiation. Instead, the Second Circuit employed a methodology that has since come to be known as the “analytical approach.”

According to this “analytical approach,” the analyst starts with the net sales of the infringing articles by the infringer and then deducts the infringer’s:

- direct or variable costs in producing the article,
- fixed costs, including allocated overhead to produce the article, and

- “normal” profits to the infringer on similar products.

The remainder is given to the patentee, and is described as “reasonable royalties.” The reason given by the Second Circuit in modifying the lower court decision was that it failed to leave the infringer, *Georgia-Pacific* “a reasonable profit on its sale of striated plywood,” the infringed product. The analytical approach is designed to do just that.

SUMMARY AND CONCLUSION

The methodology for assessing and computing damages in patent infringement cases is a choice within the sound discretion of the district court. The choice and the means of application of a particular methodology will not be disturbed by the Court of Appeals for the Federal Circuit (CAFC). This is true unless an abuse of discretion is found, something which has historically occurred only in a small minority of cases.

The *Georgia-Pacific* case pertinent factors have stood the test of time in that they continue to be cited regularly. An updated version of these factors was utilized in the 1992 charge to the jury by Judge Alfred Wolin, in the *Honeywell* case. This case was subsequently settled by a substantial payment by the defendant, Minolta, to Honeywell, the patentee.

The quality of the economic reasoning in reasonable royalty cases has been improving steadily in the years since the *Georgia-Pacific* case and the *Honeywell* case.

Notes:

1. John Skenyon, Christopher Marchese, John Land, *Patent Damages Law and Practice*, (Egan, MN: Thomson/West), 1999, supplemented 2005), pp. 3:3–4.
2. *Ibid.*
3. *Georgia-Pacific Corp. v. US Plywood Corp.* (318 F. Supp. 1116 (S.D.N.Y. 1970)).
4. Transcript of Court’s Charge, *Honeywell v. Minolta* (Civil Nos. 87-4847, 88-1624 (N.D. N.J. 1992)), p. 78.
5. *Dowagiac Mfg. Co. v. Minnesota MolinePlow Co.*, 235 U.S. 641, 35 S.Ct. 221, 59 L.Ed. 398 (1951) and *United States Frumentum Co. v. Lauhoff*, 216 F. 610 (6th Cir. 1914).
6. *Georgia-Pacific Corp. v. US Plywood Corp.* (318 F. Supp. 1116 (S.D.N.Y. 1970)).
7. Robert Goldscheider, “The Employment of Licensing Expertise in the Arena of Intellectual Property Litigation,” *The Journal of Law and Technology*, 1996.
8. Transcript of Court’s Charge, *Honeywell v. Minolta* (Civil Nos. 87-4847, 88-1624 (N.D. N.J. 1992)), p. 76.
9. *Georgia-Pacific Corp. v. U.S. Plywood-Champion Papers, Inc.*, 446 F.2d 295, 170 U.S.P.Q. (BNA) 369 (2d Cir. 1971).

Anna Kamenova is a senior associate in the Chicago office. Anna can be reached at (773) 399-4312 or avkamenova@willamette.com.