

The Latest Inappropriate Reasonable Royalty Rule Of Thumb

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In a July 10 order denying a Daubert motion seeking to exclude the testimony of a patentee's damages expert, the court in *Good Technology Corporation v. MobileIron Inc.*[1] rejected a fundamental premise of the willing-buyer/willing-seller hypothetical negotiation form of reasonable royalty analysis: that the parties would have negotiated a royalty that allows the suppositious licensee to make a profit on sales of the accused device. Essentially, the court allowed the patentee's expert to present to the jury a hypothetical negotiation in which the suppositious licensee would have agreed to pay the patentee all of the expected incremental profit. In doing so, the court also allowed the patentee to employ a new "rule of thumb" that is just as arbitrary as the "25 percent rule" or the "50 percent rule," which were both recently rejected — let's call this newest version the "100 percent rule."



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The entirety of the court's analysis occupies a single paragraph:

As to whether [the patentee's expert] puts forth adequate support to sustain an allocation of 100 percent of [expected] incremental profits to [the patentee], while the court is skeptical of [his] conclusion, this is not a problem of methodology. Rather, it is a question of fact properly left for the jury. On the one hand, [the accused infringer] argues that there is no evidence that [it] would ever have agreed to an arrangement that would have left it with no profits whatsoever. But [the patentee] counters that [its expert] allocates 100 percent of [the accused patent infringer]'s incremental operating profit to [the patentee] because the [accused product] is the SSPPU, which is closely related to the claimed functionality of the [asserted] patent. Whatever its ultimate merit, as gatekeeper, the court cannot say that [the patentee's expert]'s allocation methodology is unsound.[2]

Despite expressing skepticism about the expert's conclusion, the court emphasized that it "must be cautious not to overstep [the court's] gatekeeping role," and that this is "particularly essential in the context of patent damages." [3] It is just as essential, however, that courts perform their gatekeeping role of excluding testimony based on unsound methodology. This is crucial given the complexity of patent damages issues and the deference that damages experts receive from the trier of fact.

The Good court characterized the defects in the expert's methodology as factual in nature.[4] It is clear,

however, that a methodology that gives the patentee 100 percent of the supposititious licensee's expected profits as damages is impermissible as a matter of law, both because the methodology rejects a fundamental premise of the hypothetical negotiation analysis, and because it constitutes an impermissible rule of thumb.

The Hypothetical Negotiation Presumes Leaving Profit for the Supposititious Licensee

A fundamental premise of the hypothetical negotiation form of reasonable royalty analysis is that the supposititious licensee would be left with some incremental profit after paying the royalty. In the landmark *Georgia-Pacific* opinion, the trial court identified the "anticipated amount of net profits that the prospective licensee reasonably thinks he will make" as one of the infamous factors that parties to a hypothetical negotiation may consider.[5] On appeal, however, the Second Circuit made clear that the supposititious licensee's expected profit should be seen as a limitation on the reasonable royalty — a royalty should always be fixed "so as to leave the infringer, or supposititious licensee, a reasonable profit." [6] The Second Circuit explicitly rejected as "basic error" the computation of a royalty rate that "did not allow [the supposititious licensee] a reasonable profit after paying the supposititious royalty." [7]

The Federal Circuit has similarly recognized that "[an expert]'s opinion that [a supposititious licensee] would agree to pay a royalty in excess of what it expected to make in profit was ... absurd." [8] Courts must ensure that expert methodologies respect the fundamental principles of reasonable royalty analysis — one of which is that there must always be some expected profit left over for the supposititious licensee.

In allowing the expert to allocate 100 percent of expected profits to the patentee, the *Good* court has essentially endorsed as legally sound an allocation methodology that "gobbles up all of [the alleged infringer]'s expected profit," [9] an outcome that the Second Circuit in *Georgia-Pacific*, [10] and the Federal Circuit in *Lindemann* [11] and *Hansen* [12] have rejected.

To be sure, one can find some dicta to support the *Good* court's ruling. In *Powell v. Home Depot*, [13] the Federal Circuit properly rejected the infringer's argument that the reasonable royalty could not exceed the patentee's expected profits, but went on to also reject in dicta the infringer's profit expectation as a limit on the reasonable royalty. [14] For this dicta, *Powell* relied solely on *Stickle v. Heublien Inc.*, [15] which it characterized as "rejecting the accused infringer's argument that the reasonable royalty is capped by the sales prices of the patented product." [16]

The post-hypothetical negotiation sales price of a product, however, is not the same as the supposititious licensee's profit expectations during the hypothetical negotiation. Based on this inapposite authority, the *Powell* panel purported to eliminate from the reasonable royalty analysis the proper role of the supposititious licensee's expected profit as a limitation on the reasonable royalty. Because *Powell*'s dicta conflicts with several earlier Federal Circuit rulings on the issue, including *Lindemann* [17] and *Hansen*, [18] the extent to which the infringer's profit expectation still serves to limit the reasonable royalty analysis remains for future panels, the court en banc, or the U.S. Supreme Court to resolve. Absent clarity on this issue, some courts — such as the trial court in *Good* — may still occasionally reach the conclusion that a supposititious licensee during a hypothetical negotiation would be willing to fork over its entire expected profit to the patentee — an outcome that the Federal Circuit has accurately labeled "absurd." [19]

A New Rule of Thumb

Not only is the Good expert's allocation methodology contrary to a basic tenet of reasonable royalty analysis, but it is also "essentially arbitrary" — just as arbitrary as allocating 25 percent of the profits from an infringing product to the patentee as a "rule of thumb." [20] Just like the rule of thumb in *Uniloc*, the Good expert's methodology "fails to tie a reasonable royalty base to the facts of the case at issue." [21] The methodology thus also fails to "carefully tie the proof of damages to the claimed invention's footprint in the market place." [22]

The purpose of using the infringer's expected — instead of actual — profits in a reasonable royalty analysis is to comport with the hypothetical negotiation construct, where it is important to value the license before the infringement began, and to take into account the risk that each party assumes. Allocating the entirety of expected profits as damages ignores this risk allocation and serves to compound the arbitrariness of the rule of thumb methodology. Because the Good expert's methodology essentially constitutes a new 100 percent rule of thumb, it should have been rejected.

Conclusion

In denying the Daubert motion to exclude the expert's testimony that allocated 100 percent of expected incremental profit to the patentee, the Good court overlooked a fundamental premise underlying the hypothetical negotiation form of reasonable royalty analysis. Further, despite its expressed skepticism, the Good court gave somewhat of an imprimatur to the newest iteration of an inappropriate patent infringement damages rule of thumb: the 100 percent rule. The Federal Circuit should restore the fundamental premise, reject the *Powell* dicta, and ban the use of the 100 percent rule.

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[1] No. 5:12-cv-5826-PSG (N.D. Cal. 2015).

[2] *Id.*, Order Granting-In-Part Motion to Exclude Testimony, No. 296, slip op. at 7 (July 10, 2015).

[3] *Id.* at 5–6.

[4] *Id.* at 8.

[5] *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1121 (S.D.N.Y. 1970).

[6] *Georgia-Pacific Corp. v. U.S. Plywood-Champion Papers, Inc.*, 446 F.2d 295, 299 (2d Cir. 1971).

[7] *Id.*

[8] *Lindemann Maschinenfabrik GmbH v. American Hoist & Derrick Co.*, 895 F.2d 1403, 1408 (Fed. Cir. 1990); see also *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1081 (Fed. Cir. 1983) ("[T]hat a

reasonable royalty would leave an infringer with a reasonable profit ... is implicit.”).

[9] *Georgia-Pacific*, 446 F.2d at 299.

[10] *Id.*

[11] 895 F.2d at 1408.

[12] 718 F.2d at 1081.

[13] 663 F.3d 1221, 1238–39 (Fed. Cir. 2011).

[14] *Id.*

[15] 716 F.2d 1550, 1563 (Fed. Cir. 1983).

[16] *Powell*, 663 F.3d at 1239.

[17] 895 F.2d at 1408.

[18] 718 F.2d at 1081.

[19] *Lindemann*, 895 F.2d at 1408.

[20] See *Uniloc USA Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1313–15 (Fed. Cir. 2011) (rejecting a rule of thumb analysis as “fundamentally flawed”).

[21] *Id.*; see also *VirnetX Inc. v. Cisco Sys. Inc.*, 767 F.3d 1308, 1331–32 (Fed. Cir. 2014) (rejecting the application of a 50% rule cloaked in “Nash Bargaining Theory”).

[22] *ResQNet.com Inc. v. Lansa Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010).