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REJOINDER: Why It's An Inappropriate Reasonable Royalty Rule

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In their recent rebuttal article,[1] Michael Chapman and John Jarosz argue in favor of the patentee obtaining as reasonable royalty damages the entire incremental profit earned by the alleged infringer on the smallest salable patent practicing unit ("SSPPU"). In arguing for this form of apportionment, they make several arguments that are, not to put too fine a point on it, either incorrect or irrelevant.

First, Chapman and Jarosz state that, "[i]n practice, the determination of true incremental benefits (profits) generated by the SSPPU represents an attempt to quantify the benefits contributed by the patented technology at issue," and "[i]n any given case, it is a factual inquiry as to whether the calculation of incremental benefits (profits) accurately reflects the contribution of the patented technology." So, according to Chapman and Jarosz, a damages expert should always survive a Daubert motion and be permitted to testify to the jury simply because the expert used the SSPPU profits as the royalty base. The principal problem with this "SSPPU safe harbor" argument is that the Federal Circuit already has rejected it.

"[T]he requirement that a patentee identify damages associated with the smallest salable patent-practicing unit is simply a step towards meeting the requirement of apportionment," the Federal Circuit explained in VirnetX Inc. v. Cisco Sys. Inc., and "[w]here the smallest salable unit is, in fact, a multi-component product containing several non-infringing features with no relation to the patented feature ... , the patentee must do more to estimate what portion of the value of that product is attributable to the patented technology."[2] Failure to do so, or to do so in an arbitrary way, is a methodological problem: simply stating that the apportionment analysis is "a factual inquiry" does not shield it from Daubert scrutiny. The Daubert reliability analysis focuses on the expert's analysis itself — that is, whether the analysis is conclusory or misapplies an accepted methodology — and in evaluating the reliability of a proffered expert opinion, courts should scrutinize not only whether the principles, reasoning, or methodology are scientifically valid, but also whether the reasoning or methodology is properly applied to the facts of the case.[3]

Second, Chapman and Jarosz state that "even the Georgia-Pacific case does not suggest that the alleged infringer is entitled to any of the incremental benefits (profits) that are due solely to the efforts of the patent owner" and that "[b]asing a reasonable royalty on the incremental benefits (profits) provided by the patented technology at issue allows the alleged infringer to continue to operate in the business and obtain a reasonable profit." The Georgia-Pacific trial and appellate decisions themselves, however, show the error in this argument.

As explained in our earlier article, despite the Georgia-Pacific trial court identifying the "anticipated amount of net profits that the prospective licensee reasonably thinks he will make" as one of the factors that parties to a hypothetical negotiation may consider, it determined that the patented invention provided all the value of the accused plywood sheets and awarded reasonable royalty damages that the Second Circuit struck down as impermissibly high because the award did not "allow [the supposititious licensee] a reasonable profit after paying the supposititious royalty."[4] The proposed 100 percent rule is directly contrary to the principle that served as the basis for the Georgia-Pacific appellate court's reversal. And, as pointed out in our earlier article, the Federal Circuit repeatedly has endorsed that principle, and has endorsed it since.[5]

Third, Chapman and Jarosz state that "consistency or inconsistency with the precepts of the hypothetical negotiation construct should not be the basis for assessing whether a particular analytical approach to the determination of reasonable royalty damages is permissible," the patent damages statute "does not require the use of a hypothetical negotiation, and the Federal Circuit has acknowledged that other approaches to the determination of reasonable royalty damages are valid." All well and good, but irrelevant. In the case under discussion, the expert undertook his analysis using the "hypothetical negotiation construct," and thus he should be held to the legal requirements that the U.S. Supreme Court and Federal Circuit have developed around this analytical construct, including that set forth in VirnetX.

To be sure, the hypothetical negotiation construct was developed and continues to be applied outside the patent infringement context,[6] and in both patent and other contexts courts have emphasized that the construct is not the sole way to calculate reasonable royalty damages.[7] Valuation professionals estimate the value of property in multiple ways — grouped generally under the cost, income and market approaches[8] — and patent damages experts should consider applying approaches used in other valuation contexts, tailored as necessary for patent infringement cases.[9] Like the hypothetical negotiation construct, however, these other valuation approaches must be applied within the bounds of Federal Rule of Evidence 702, informed by the patent damages statute and its history,[10] the Supreme Court's precedent on patent damages (paying careful attention to the law/equity distinction in the early cases), the Federal Circuit's evolving patent infringement damages jurisprudence, Federal Rules of Evidence 403, 701 and 703, the Supreme Court's opinions in Daubert and Kumho Tire, and the rules governing application of these approaches by valuation professionals. Only by presenting a rigorous analysis complying with these restrictions should a damages expert's opinion pass muster under Daubert.

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[1] Michael J. Chapman & John C. Jarosz, REBUTTAL: It's Not An Inappropriate Reasonable Royalty Rule, Law360 (August 21, 2015).

[2] VirnetX, Inc. v. Cisco Sys., Inc., 767 F.3d 1308, 1327 (Fed. Cir. 2014).

[3] Daubert v. Merrell Dow Pharms., Inc., 509 U.S. 579, 597 (1993) ("[T]he Federal Rules of Evidence . . . —especially Rule 702—do assign to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand.").

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

[5] See Carnegie Mellon University v. Marvell Tech. Group, No. 2014-1492, slip op. at 33 (Fed. Cir. August 4, 2015) ("A key inquiry in the [reasonable royalty] analysis is what it would have been worth to the defendant, as it saw things at the time, to obtain the authority to use the patented technology considering the benefits it would expect to receive from using the technology" and "a 'basic premise of the hypothetical negotiation' is 'the opportunity for making substantial profits if the two sides [are] willing to join forces' by arriving at a license of the technology."); Lindemann Maschinenfabrik GmbH v. American Hoist & Derrick Co., 895 F.2d 1403, 1408 (Fed. Cir. 1990); Hanson v. Alpine Valley Ski Area, Inc., 718 F.2d 1075, 1081 (Fed. Cir. 1983).

[6] Patent lawyers should look to other areas of valuation law to inform hypothetical negotiation analysis, including the Book of Wisdom. See, e.g., Hon. Martha K. Gooding, Reasonable Royalty Patent Damages: A Proper Reading of the Book of Wisdom, 87 Pat. Trademark & Copyright J. 1476 (2014).

[7] See, e.g., United States v. Virginia Electric & Power Co., 365 U.S. 624, 633 (1961) (in the context of taking of property, willing buyer-willing seller "is not an absolute standard nor an exclusive method of valuation")

[8] See generally Weston Anson, Fundamentals of Intellectual Property Valuation: A Primer for Identifying and Determining Value (Am. Bar Ass'n 2005).

[9] See, e.g., William F. Lee & A. Douglas Melamed, Breaking the Vicious Cycle of Patent Damages, 101 Cornell L. Rev. __ (2015) (forthcoming).

[10] 35 U.S.C. §284.
