

## SURREJOINDER: 3 Problems In 'Clearing Up The Confusion'

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In their most recent response article in this spirited series,[1] seeking to “clear up any confusion [they] may have created,” Michael Chapman and John Jarosz have backpedaled almost to the point of surrender. They valiantly continue to fight on, however, taking refuge in sleight of hand, inapt case law and economic nonsense.

First, the sleight of hand. Chapman and Jarosz engage in a long discussion of “incremental benefits,” but they fail to be consistent in their answer to the question: incremental benefits of what?

They begin by defining “the incremental benefits attributable to a particular patented technology,” but then go on to conflate “the technology at issue,” with the “patented feature,” the “patented invention,” and the “patent.” The patent’s claimed “invention” is not “technology” in any sense of that word. In explaining the “distinction between the [claimed] idea and its application in practice,” the U.S. Supreme Court long ago recognized that “[t]hough the mental concept is embodied or realized in a mechanism or a physical or chemical aggregate, [this] embodiment is not the invention and is not the subject of a patent.”[2]

Even more important than the distinction between the claimed invention and the technology disclosed in the patent’s written description is the distinction between the claimed invention and the alleged implementation of that claimed invention in the accused device. In much of today’s patent infringement litigation, the asserted patent claims are based on a written description that bears little, if any, relation to the accused device. In the ordinary case, the accused infringer developed its product without any input from the inventor, that is, without any transfer of technology. Implementation of a “feature” that is later accused of infringement almost always depends on at least a modicum of the accused infringer’s own technological development.

Further, the accused infringer invariably incurs transaction and opportunity costs, and is saddled with all the risk associated with commercializing a new technology. There is, consequently, an important economic difference between a patented — or more precisely, claimed — invention and an actual product’s feature, even if the feature is covered by the patent claim. The semantic antics of incorrectly assuming that there is no such difference — or using distinct concepts such as “claimed invention” and “technology at issue” as if they were interchangeable — is the basis for the invalid presumption that a patentee should be entitled to 100 percent of the “benefit” from the accused device, the smallest



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salable patent practicing unit, or the infringing feature.[3]

Second, the inapt case law. Chapman and Jarosz rely again on the Second Circuit's opinion in *Georgia-Pacific*,<sup>[4]</sup> which they misinterpret and misapply. They overlook that the *Georgia-Pacific* trial court had found that the claimed invention had contributed "substantially the entire value to the structure represented by the infringing article"<sup>[5]</sup> and still rejected the special master's recommendation to award all of the accused infringer's profits as damages.<sup>[6]</sup> In other words, Chapman and Jarosz overlook that the *Georgia-Pacific* trial court rejected the application of the very 100 percent rule they champion.

Chapman and Jarosz also continue to ignore the point we emphasized in our original article in this series,<sup>[7]</sup> that the principle noted by the *Georgia-Pacific* trial court, relied on by the *Georgia-Pacific* appellate court, and repeatedly recognized by the Federal Circuit (that the hypothetical negotiation's suppositious licensee should be left with some expected profit) conflicts with their 100 percent rule. But wait, there's more. Chapman and Jarosz then state that the *Georgia-Pacific* appellate court subtracted the accused infringer's usual net profit from its anticipated net profit on the infringing sales "to estimate incremental benefits." That statement is flat-out wrong. The *Georgia-Pacific* appellate court affirmed all of the district court's findings except the ultimate finding of reasonable royalty.<sup>[8]</sup> In other words, the *Georgia-Pacific* appellate court did not endeavor to calculate the incremental benefits at all; rather it affirmed the district court's finding that the claimed invention had contributed "substantially the entire value" of the infringing product. The *Georgia-Pacific* appellate court then simply reduced the award by applying a cap to the hypothetically negotiated reasonable royalty, which it held "must be fixed so as to leave the infringer, or suppositious licensee, a reasonable profit."<sup>[9]</sup>

Chapman and Jarosz compound their mistaken interpretation of *Georgia-Pacific* by retreating to the refuge of what is perhaps the nadir in Federal Circuit patent damages law, *TWM Manufacturing Co. v. Dura Corp.*<sup>[10]</sup> We have analyzed the history and fundamental flaws with that opinion at length elsewhere,<sup>[11]</sup> and will not burden this surrejoinder with the details. Instead, we pause to note only that *TWM* was — like *Georgia-Pacific* — one of those rare cases in which the infringing feature created the customer demand for the entire device,<sup>[12]</sup> and *TWM* is irrelevant in that it applied an "analytical method" distinct from, and without the trappings of, the "hypothetical negotiation" reasonable royalty analysis to which this series of articles is devoted.<sup>[13]</sup> Therein lies the ultimate problem with Chapman and Jarosz's analysis: Dropping the hypothetical negotiation construct, which identifies the relative bargaining position, precludes reasoned determination of a profit split. Their selection of 100 percent of incremental profits, just like the rejected 25 percent rule or 50 percent split resulting from *Nash* bargaining, "fails to tie a reasonable royalty base to the facts of the case at issue"<sup>[14]</sup> and fails to "carefully tie the proof of damages to the claimed invention's footprint in the market place."<sup>[15]</sup>

Finally, the economic nonsense. Chapman and Jarosz defend the prospect of parties to a hypothetical negotiation agreeing "to an allocation in which 100 percent of the benefits are received by the patent holder" on the basis that, "[i]n theory, the user would be indifferent between this allocation and not using the patented technology because, even under this allocation, the user would retain all of the benefits generated by factors other than the infringement (i.e., it would receive its 'normal' returns)."<sup>[16]</sup> The error in this argument lies in the semantic antics identified in the first section above.

As we explained above, incorporating into a product a "feature" that is later accused of infringement often depends on the accused infringer's own technological development, and the accused infringer invariably incurs transaction and opportunity costs as well as risk associated with commercializing a new technology. While Chapman and Jarosz properly dismiss certain discounts that would reduce the royalty rate in the real world as irrelevant to the hypothetical negotiation — discounts for uncertainty about

validity, enforceability and infringement, to encourage adoption, or “about the patent’s incremental benefits” — the transaction costs, opportunity costs and risks that the alleged infringer incurs are not mere discounts to be dismissed. They are vitally important to the negotiation construct. No rational manufacturer, as the suppositious licensee is presumed to be, would ever willingly incorporate into its product a feature that would provide it with no benefit, yet entail costs. For that reason, the courts have long recognized that the hypothetical negotiation should fix the reasonable royalty “so as to leave the infringer, or suppositious licensee, a reasonable profit.”[17] By violating this precept, a damages expert would commit a methodological error that would justify exclusion under Rule 702,[18] Daubert,[19] and its progeny.

As an analogous illustration that such an error is methodological and the resulting testimony is subject to exclusion, consider the very recent opinion in *Labyrinth Optical Techs. LLC v. Alcatel-Lucent USA Inc.*[20] In *Labyrinth*, a damages expert testified that in a hypothetical negotiation the accused infringer would have agreed to pay to the patentee “all of the revenues attributable to” the claimed invention’s contribution to the accused device.[21] Judge Andrew Guilford excluded this testimony as “too attenuated to be reliable,” failing “to establish a quantitative connection between the asserted facts and his ultimate conclusion,” and based on “no facts or data demonstrating that anyone has ever agreed to pay 100% of its revenues from a patent process under similar circumstances.”[22] “There is no evidence that [the accused infringer] or anyone else has ever agreed to pay 100% or even 25% royalty, nor evidence that [the patentee] ever received such a royalty,” Judge Guildford explained, and “[w]ithout such evidence, [the expert’s] opinion is inadmissible because it is ‘untethered from the patented technology at issue and the many licenses thereto and, as such, [is] arbitrary and speculative.’”[23] We could not have said it better.

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[1] Michael J. Chapman & John C. Jarosz, RESPONSE TO REJOINDER: Clearing Up The Confusion, *Law360* (Sept. 3, 2015).

[2] *United States v. Dubilier Condensor Corp.*, 289 U.S. 178, 188 (1933).

[3] The confusion is most clearly revealed in the language used in the discussion of the discounts available in “real-world” licensing negotiations. Chapman and Jarosz distinguish real-world “discounts to encourage licensee adoption of their technology” on policy grounds, ignoring that the hypothetical negotiation is about a patent license and has nothing to do with “technology.” Similarly, they discuss “uncertainty about the patent’s incremental benefits” separate from “uncertainties about the validity, enforceability and infringement of the patent,” as if there were any value inherent in the patent’s technology separate from the right to exclude.

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

[5] *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1132-37 (S.D.N.Y. 1970), rev’d in part,

446 F.2d 295 (2d Cir. 1971).

[6] *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 243 F. Supp. 500, 505 (S.D.N.Y. 1965).

[7] William C. Rooklidge & Andrew T. Brown, *The Latest Inappropriate Reasonable Royalty Rule of Thumb*, Law360 (July 28, 2015).

[8] 446 F.2d at 299.

[9] *Id.* at 299-300 (“Thus, although we affirm the other findings, we feel that despite the trial court’s professed intention to do so, it did not allow [the suppositious licensee] a reasonable profit after paying the suppositious royalty.”)

[10] 789 F.2d 895 (Fed. Cir. 1986).

[11] William C. Rooklidge, *Infringer’s Profits Redux: The Analytical Method of Determining Patent Infringement Reasonable Royalty Damages*, 89 *Pat., Copyright & Trademark J.* 33 (Nov. 7, 2014).

[12] 789 F.2d at 901.

[13] As to the analytical method, we explained in *Infringer’s Profits Redux*, *supra* note 11, that “[t]he opinions that have applied the ‘analytical method’ as a stand-alone alternative to the hypothetical negotiation damages calculation have misused the infringer’s anticipated profits attributable to the patented feature in three ways, by: (1) ignoring that the infringer’s anticipated profits properly serve only to cap the hypothetical negotiation reasonable royalty; (2) failing to apply anything approaching rigorous apportionment, the requirement of which led to Congress’ rejection of the profits remedy in the first place; and (3) when using actual, instead of anticipated, profits under the Book of Wisdom, awarding those infringer’s apportioned profits or a proxy even though that remedy long ago was rejected by Congress.”

[14] *Uniloc USA Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1313-15 (Fed. Cir. 2011); see also *VirnetX Inc. v. Cisco Sys. Inc.*, 767 F.3d 1308, 1331-32 (Fed. Cir. 2014).

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

[16] In the hypothetical negotiation context, Chapman and Jarosz’s statement that “[a]n allocation of all of the incremental benefits to the patent owner is not improbable in the real world” presumes that “incremental benefits” means “anticipated incremental benefits.” And if that is what Chapman and Jarosz are asserting, the authors would be eager to see their evidence, or even a single real-world example in which a licensee has been willing to enter into an agreement and commercialize a technology with the upfront understanding that it would receive no economic benefit.

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

[18] Fed. R. Evid. 702.

[19] *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 597 (1993).

[20] Order re Defendant’s Motion In Limine #1 Regarding Damages, No. 15-cv-472, Dkt No. 122 (C.D. Cal. Sept. 2, 2015).

[21] The claimed invention related to the function of chromatic dispersion compensation, and the expert allocated 11% of the value of the accused “line card” to its digital signal processor or “DSP,” allocated 25% of the value of the DSP to chromatic dispersion compensation, and awarded all the apportioned revenue to the patentee, reasoning that “all of the economic value of [the accused infringer’s] use of the patented method (25% of the total revenue attributable to the DSP) should be paid to [the patentee] in royalties.” *Id.*, slip op. at 1-2.

[22] *Id.*, slip op. at 5. The patentee pointed to other unquantified benefits from use of the claimed invention, an argument that Judge Guildford rejected, as did the appellate court in *Georgia-Pacific*, 446 F.2d at 299 n.2 (“While we recognize the trial court’s dilemma, its failure to quantify leaves us no recourse but to ignore profits on collateral sales or assume that such profits were taken into account in arriving at the . . . reasonably expected profits.”).

[23] Order, *supra* note 17, slip op. at 6, quoting *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 81 (Fed. Cir. 2012).