

APPLYING THE ENTIRE MARKET VALUE RULE AFTER LUCENT

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INTRODUCTION: This paper has been created for the Intellectual Property Owners Association Software and Business Methods Committee to provide background to IPO members regarding litigating software and business method patents. It should not be construed as providing legal advice or as representing the views of IPO.

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Some proponents of patent reform have focused on the Entire Market Value rule as contributing to large jury awards disproportionate to the market value of the patented technology. Prior versions of the Senate and House patent reform bills, S. 515¹ and H.R. 1908², would have precluded damages based on the entire market value except upon a showing that the invention's "*specific contribution over the prior art is the predominant basis for market demand.*" While that narrowing provision was ultimately removed, criticism of the Entire Market Value rule persists.

The Entire Market Value rule "permits recovery of damages based on the value of [an] entire apparatus ... when the patent-related feature is the 'basis for customer demand.'"³ Completely eliminating the Entire Market Value rule would "ignore the realities of patent licensing and the flexibility needed in transferring intellectual property rights."⁴ It is not uncommon to find "license agreements that base the value of the patented inventions as a

¹ Patent Reform Act of 2009, S. 515, 111th Cong. (introduced March 3, 2009).

² Patent Reform Act of 2009, H.R. 1260, 111th Cong. (introduced March 3, 2009).

³ *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1549 (Fed. Cir. 1995) (en banc) (citations omitted); *see also Fonar Corp. v. Gen. Elec. Co.*, 107 F.3d 1543, 1552 (Fed. Cir. 1997) ("Under the entire market value rule, it was not improper for the jury to base a reasonable royalty on the value of the entire accused MRI machines.").

⁴ *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1339 (Fed. Cir. 2009).

percentage of the commercial products' sales price.”⁵ In *Lucent*, Judge Michel stated: “There is nothing inherently wrong with using the market value of the entire product, especially when there is no established market value for the infringing component or feature, so long as the [rate] accounts for the proportion of the base represented by the infringing component or feature.”⁶

In *Lucent*, the Federal Circuit panel rejected the jury’s \$358 million damages award based on the entire market value as not supported by “substantial evidence.”⁷ Judge Michel wrote: “The first flaw with any application of the entire market value rule in the present case is the lack of evidence demonstrating the patented method of the Day patent as the basis -- or even a substantial basis -- of the consumer demand for [Microsoft] Outlook.”⁸ Among other things, “the infringing feature contained in Microsoft Outlook [was] but a tiny feature of one part of a much larger software program.”⁹ In addition, “the evidence of record [was] conspicuously devoid of any data about how often consumers use the patented date-picker invention.”¹⁰

Establishing Consumer Demand

Proper application of the Entire Market Value rule requires establishing consumer demand with sales data or other economic proofs. What is key is that the patentee “connect the dots” to show how demand for the patented feature drives demand for the entire product. In software and business method cases, that may mean that “[t]he damages award [is] correlated, in some respect, to the extent the infringing method is used by consumers.”¹¹

⁵ *Lucent Techs.*, 580 F.3d at 1339.

⁶ *Id.*

⁷ *Id.* at 1324.

⁸ *Id.* at 1337.

⁹ *Id.* at 1332.

¹⁰ *Id.* at 1334.

¹¹ *Id.* at 1334.

So what evidence can be used to prove consumer demand? Courts have recognized various types of proofs. Demand can be established with: (a) evidence showing sales of products that practice the patented invention; (b) evidence of an infringer's decision to continue risking infringement liability; and (c) marketing material that promotes the patented features.¹² Relevant sales data includes past and present sales prices and volumes, customer contracts, market share and geographic coverage information. For software and business methods, alternatives to sales price or volume may include number of transactions, number of customers, number of Web site visits, and development or project costs. Evidence of dedicated sales personnel, distribution channels, product launch plans, marketing and promotions also may be relevant. In addition, demand may be shown by consumer demand for the advantages that arise from the claimed feature.¹³ Consumer and industry surveys or reports also may be helpful.¹⁴

The accused infringers' continued sale or use of the patented feature is itself evidence of demand, especially where the infringer has targeted the patentee's actual or potential customers. This may be shown using the infringer's marketing materials promoting the patented feature, including sales proposals, brochures, manuals, user guides, product documentation and websites.¹⁵ Marketing plans and other materials showing that the infringer placed value on the patented feature are also relevant.¹⁶

¹² See, e.g., *Eaton Corp. v. ZF Meritor LLC*, No. 03-74844, 2007 WL 735000, at *4 (E.D. Mich. Mar. 8, 2007).

¹³ *Funai Elec. Co. v. Daewoo Electronics Corp.*, 593 F.Supp.2d 1088, 1104 (N.D. Cal. 2009) ("Funai presented substantial evidence that demand for the accused products was based on the reduction in depth of the video cassette deck, which is one of the objects of the invention").

¹⁴ *i4i Ltd. Partnership v. Microsoft Corp.*, 589 F.3d 1246, 1272 (Fed. Cir. 2009) (district court did not abuse its discretion in admitting survey estimating the extent of infringing usage by Word users).

¹⁵ See, e.g., *Bose Corp. v. JBL, Inc.*, 274 F.3d 1354, 1361 (Fed. Cir. 2001) (Bose's "efforts to market the benefits of its loudspeakers using the invention of the [asserted] patent ... [is evidence supporting] an award of a reasonable royalty based upon the entire value of the loudspeakers."); *Fonar Corp.*, 107 F.3d at 1552 ("GE's own technical

Connecting The Dots

Evidence of general demand is not enough.¹⁷ There must be “direct evidence that [the infringing] sales are attributed to demand for the [asserted] patent as opposed to any other feature” of the accused product.¹⁸ This is best shown with demand curves and other economic evidence.¹⁹ Evidence linking demand to the patented feature also may include license agreements where the royalty is a percentage of the commercial products’ sales price. Here again, it is the key that the license is tied to the patented feature.

Additionally, courts may require the patentee to show a functional relationship between the patented and unpatented features.²⁰ In *Cornell*, Judge Rader stated that the “individual infringing and non-infringing components must be sold together so that they constitute a functional unit.”²¹ The combined components “must be analogous to a single

literature of record emphasized the [accused] feature. ... There was thus substantial evidence to support an award of reasonable royalty based upon the cost of the entire accused machines.”)

See also Lucent Techs., Inc. v. Microsoft Corp., 544 F.Supp.2d 1080, 1106 (S.D. Cal. 2008) (“Microsoft has used [patented] features in its marketing, including promotions of the home theater capabilities of Vista and the benefits of Vista’s media playback capabilities compared to the competing Apple Macintosh OS X operating system.”).

¹⁶ *Cf. Eolas Techs. Inc. v. Microsoft Corp.*, No. 99 C 0626, 2004 WL 170334, at *2 (N.D. Ill. Jan. 15, 2004) (“[Microsoft] bundles together all of its Windows functionality as seamlessly as it can. ... [T]he bundling makes it very difficult for either party to assess the value of each individual component. Since Microsoft has created this difficulty for itself, it must bear the legal risks attendant to its way of business.”) (denying motion for new trial).

¹⁷ *See, e.g., Eaton Corp.*, 2007 WL 735000, at *5 (General statements in press release “do not provide evidence of demand” and “marketing material connected to the improvement of the ‘350 patent [was] not specifically tied to the [patented feature]”).

¹⁸ *Id.*

¹⁹ *See Cornell Univ. v. Hewlett-Packard Co.*, 609 F.Supp.2d 279, 284 (N.D.N.Y. 2009) (Circuit Judge Rader, sitting by designation, wrote “Cornell did not offer a single demand curve or attempt in any way to link consumer demand for servers and workstations to the claimed invention.”) (granting JMOL that hypothetical processor revenue of \$6,686,785,273 is the appropriate royalty base, and reducing damages award to \$53,494,282).

²⁰ *See Lucent Techs.*, 544 F. Supp. 2d at 1105 (“The Federal Circuit has consistently upheld awards based on entire market value where [the following two elements] were present: (1) sufficient consumer demand based on the patented feature, and (2) integration of the patented and unpatented components into a single functioning unit.”); *Cornell Univ.*, 609 F.Supp.2d at 286-287 (“Notably, these requirements are additive, not alternative ways to demonstrate eligibility for application of the entire market value rule.”).

²¹ *Cornell Univ.*, 609 F.Supp.2d at 286.

functioning unit.”²² In other words, it is not enough that they are sold together for mere business advantage.²³

Evidence of a functional relationship may include whether and how product functionality or components are bundled²⁴; the number of product functions attributable or related to the patented features²⁵; whether the accused functionality is enabled by default or is an optional or add-on function; and whether the overall performance of the accused product is improved by the patented feature.²⁶

Calculating the Rate

In calculating a reasonable royalty, the base “can always be the value of the entire commercial embodiment, as long as the magnitude of the rate is within an acceptable range.”²⁷ In the *Lucent* case, however, the Court found that Lucent’s expert, having been precluded from using the price of the entire computer as the royalty base, instead used the price of the software and inflated the rate to arrive at the same damages number that he would have obtained had he used the entire computer price. Judge Michel stated: “This cannot be an acceptable way to conduct an analysis of what the parties would have agreed to in the hypothetical licensing

²² *Id.* at 286-87.

²³ *Cornell Univ.*, 609 F.Supp.2d at 287.

²⁴ *See, e.g., Spreadsheet Automation Corp. v. Microsoft Corp.*, 587 F. Supp. 2d 794, 803 (E.D. Tex. 2007) (“To the extent Defendant bundles products incorporating the accused functionality of PivotTables with other non-accused functionalities and products, the finder of fact may consider such evidence in calculating damages.”).

²⁵ *Lucent Techs.*, 580 F.3d at 1332 (“[T]he infringing feature contained in Microsoft Outlook is but a tiny feature of one part of a much larger software program.”).

²⁶ *See, e.g., Tec Air, Inc. v. Denso Mfg. Michigan Inc.*, 192 F.3d 1353, 1362 (Fed. Cir. 1999) (“[T]he evidence shows that customers wanted fans that were balanced to a certain specification and once Denso abandoned the patented method, it could not meet the 2.0 gm-cm balance specification. ... From this evidence, the jury could have reasonably concluded that the demand for the entire assembly depended on the patented invention.”).

²⁷ *Lucent Techs.*, 580 F.3d at 1338-39.

context.”²⁸ If the entire market value is used, the rate must be proportional to the value of the patented technology.

In *i4i Ltd. Partnership v. Microsoft Corp.*, the patentee used a third party “benchmark” product to value Microsoft’s use of the patented XML functionality.²⁹ The Federal Circuit affirmed the \$290 million jury award – in its words, “because of the procedural posture.”³⁰ The benchmark, a custom XML editor called XMetal, had a retail price \$499, as compared to \$97 for the accused Word products in certain retail settings. To calculate a royalty, the patentee’s expert multiplied the \$499 price of XMetal by Microsoft’s profit margin and applied the 25-percent rule to arrive at a “baseline royalty rate” of \$96 per copy of Word.³¹ The expert then increased that rate to \$98 based on certain *Georgia-Pacific* factors.³² The jury’s verdict was based on this \$98 rate even though it exceeded the price of Word in some instances.

The *i4i* Court affirmed the district court’s decision to admit the damages expert’s opinion.³³ The patentee’s expert testified that he chose XMetal as a benchmark “because it was the product Microsoft bought and used before developing its own custom XML editor, it was the cheapest of the custom XML editors available on the market at the time, and it was one of three principal competitors Microsoft identified in the custom XML market.”³⁴ In other words, he linked demand for the XML functionality to Microsoft’s accused product.³⁵

²⁸ *Id.* at 1338.

²⁹ *i4i*, 589 F.3d at 1273.

³⁰ *Id.* at 1272.

³¹ *Id.* at 1268.

³² *Id.* at 1266.

³³ *Id.* at 1270.

³⁴ *Id.*

³⁵ *Cf. Uniloc USA, Inc. v. Microsoft Corp.*, 640 F.Supp.2d 150, 184 (D.R.I. 2009) (expert testimony comparing “reasonableness” of \$564 million royalty against the \$19 billion total dollar volume of sales of the accused products “runs afoul of the entire market value rule.”).

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The *Lucent* decision cautions patentees that applying the Entire Market Value rule requires marshalling “substantial evidence” of demand and carefully linking it to the patented features. *Daubert* challenges can (and will) succeed in the absence of such linking evidence.³⁶ In software and business method cases, establishing this demand may require inquiry into non-traditional revenue models, usage surveys and third-party benchmarks to identify the relevant indicators of demand.

³⁶ See, e.g., *Imonex Servs., Inc. v. W.H. Munzprufer Dietmar Trenner GmbH*, 408 F.3d 1374, 1380 (Fed. Cir. 2005) (“Without any evident record that the patented features were the basis for customer demand for the laundry machines as a whole, the trial court properly foreclosed further evidence on this unsupported theory.”) (affirming Judge Ward’s decision to exclude testimony on the entire market value rule).