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What Will It Cost? - The "Entire Market Value Rule" and How It Affects Companies Today

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Background

In patent litigation, a patent holder is entitled to monetary damages as a remedy for infringement, and, in a typical patent case, damages are calculated by determining a "reasonable royalty." The method of calculating a reasonable royalty where the patent is directed to only one component or feature of a product having many features or components has been in a state of flux recently, and such uncertainty in the law can greatly impact the amount of damages a defendant might be forced to pay. The issue is how to rein in juries from assessing damages on the value of the whole product, known as the "entire market value rule." Both Congress and the Federal Circuit are in a race to control the parameters of this issue. So far, the Federal Circuit is winning and has made the proof necessary to assess damages on the whole product more difficult. Congressional sponsors did address the issue in early versions of their proposed Patent Reform Bill, but they have now retreated and removed the entire market value "apportionment" issue from the pending version of patent reform legislation.

Reasonable Royalty and the Entire Market Value Rule

A reasonable royalty must be calculated by determining the "royalty rate" (typically a percentage) and multiplying that by a "royalty base" (typically the sales revenue for the allegedly infringing product). Disputes arise where the defendant sells a product that contains many different components or features but the patent-in-suit is directed to only one of those components or features. What royalty base should be used in this calculation, the value of the component or the whole product? Conversely, if the entire product value is used, should the royalty rate be smaller?

Imagine that you sell a personal computer, which contains a large number of chips and other hardware components. What happens if you are sued over a patent covering just one of those components, and how will damages be calculated upon a finding of infringement?

While patent holders typically seek to have the royalty base be the sales revenue of the entire product, defendants argue that the royalty base should be the value of the component alone. As you might imagine, the difference in damages calculations could be very large. Returning to the personal computer example, the difference in royalty base might be the difference between the price of a single component (tens of dollars) and the price of the entire computer (a thousand dollars).

To prevail in arguing for the larger royalty base, the patent holder must establish that the "entire market value rule" applies. In essence, this rule states that if the patent holder can prove that the patent-related feature is the basis for consumer demand for the overall product, then the royalty base used in the reasonable royalty calculation will be the value of the entire product, not just the value of the

patented component. The entire market value rule was developed by the courts over a series of cases, in an effort to better approximate the economic loss that a patentee faces in situations where a patent covers just one component of a larger system or product.[1] The entire market value rule in the context of patent royalties requires adequate proof of three conditions, which are additive (not alternative) ways to demonstrate eligibility for its application: (1) the infringing components must be the basis for customer demand for the entire machine, including the parts beyond the claimed invention; (2) the individual infringing and non-infringing components must be sold together so that they constitute a functional unit or are parts of a complete machine or single assembly of parts; and (3) the individual infringing and non-infringing components must be analogous to a single functioning unit.

The key question is — how often is the entire market value rule applied and how, if at all, could it affect the variables in the reasonable royalty calculation?

Recent Activity

In one recent case,[2] the patented feature was a method carried out by a CPU. Because there was no defined market for the CPUs by themselves, the patent holder used the total sales figure for an assembly which included the CPU. A jury initially awarded the patent holder $184 million in damages, using $23 billion, or the total sales of the assemblies, as the royalty base. The judge (a Federal Circuit appellate judge presiding over the trial) reduced the royalty base to $6 billion, which resulted in the damages amount being reduced to $54 million. In so doing, he explained that the patent holder failed to prove that the assembly was the correct product to use in determining the royalty base.

In another case,[3] the appeals court vacated a $357 million damages award against Microsoft that was based on the entire market value rule because of errors in both the royalty rate and royalty base calculations. While the court declined the invitation by the defendant and amicus to abolish the entire market value rule, the court did suggest that applications of the rule would be scrutinized. The court ordered a new trial on damages and noted that, if the patent holder sought a larger royalty base under the entire market value rule, then the royalty rate for the patented feature (a single feature in a complex software program) might be much lower than the typical rate. This inverse relationship might lead to lower damages than typically have been awarded thus far by juries applying the "entire market value rule."

Prior to these recent developments in the case law, Congress made attempts to step into the fray. In the past several years, both the House and the Senate have proposed patent reform bills that have tried to rein in extraordinarily high patent damage awards by including provisions that would impact the entire market value rule. However, perhaps in response to the recent case law activity, Congress' most recent version of the patent reform bill does not address the entire market value rule.

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1 *See generally King Instrument Corp. v. Otari Corp.*, 767 F.2d 853 (Fed. Cir. 1985); *TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895 (Fed. Cir. 1986).

2 *Cornell v. Hewlett-Packard Co.*, 609 F.Supp.2d 279 (N.D.N.Y. 2009)

3 *Lucent Tech., Inc. v. Gateway Inc.,* 580 F.3d 1301 (Fed. Cir. 2009) (Microsoft was one of the co-defendants.)

Only time will tell whether the courts will continue to reform patent damages through judicial decisions or whether Congress will attempt to reform patent damages with even newer versions of the patent reform bill.

In Sum

If you find yourself in a patent suit, the method of calculation of damages can have a significant impact on any adverse verdict. A company that sells a product with numerous components should advocate that the "entire market value rule" does not apply or, if it does, that the royalty rate should be much lower than the typical rates for just the patented component. Otherwise, a small component could have a very big effect on your bottom line.

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