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Patent Damages In A World Without Injunctions: Enter The Economists

Friday, October 27, 2006 --- In eBay v. MercExchange, the Supreme Court struck down the iron precedent that had previously awarded a permanent injunction to every successful patent plaintiff, thereby permanently changing the balance of power in patent litigation – even if most parties do not realize it yet. No longer can a patent holder count on the in terroram effect of a threatened injunction to force a settlement. No longer need a patent defendant fear the inevitable shutdown of its operations if it rolls the dice on going to trial and losing.

Now the battle shifts to damages – and to the economists.

Large verdicts seem to be the rule in recent patent cases. Ask Echostar, who was hit with a $74 million verdict by TiVo. Ask Microsoft, who was suffered a $521 million loss at the hands of Eolas Technologies. Ask Medtronic, who was slapped by a Memphis jury with a $570 million verdict, later settling for $1.35 billion.

Without the guaranteed sledgehammer of an injunction, patent plaintiffs now need to turn to threatening an overwhelming damages award as a tool to advance settlement or, if trial cannot be avoided, as the most they may be able to get. Patent defendants, while they may not have to worry about a court order closing their factories, may now be more concerned about actually paying a judgment, which may amount to tens or even hundreds of millions of dollars.

Inevitably, the focus of patent litigants -- and their lawyers – will fall even more sharply on the theories and practice underlying the determination of damages in patent cases. And, their focus will fall more and more heavily on the economist.

For those unfamiliar with this area, it is important to note that damages for patent infringement are not calculated, so much as they are the product of an economic model. Such damages, designed to place the patentholder in the position he would have been in had there been no infringement, are almost entirely hypothetical and depend on an often complicated historical market reconstruction. .

Damages in patent case are of two (or perhaps two and one-half) sorts: Lost profits and “reasonable royalty” – the minimum the patent act permits. Yet another type of damages – price erosion, where a plaintiff claims that an infringement caused it to decrease his prices, rather than costing it sales – is sometimes thrown in for good measure.

For a patent plaintiff to recover its lost profits, it must show what its profits would have been if the defendant had not infringed. While, on first blush, this might seem simple – just add the defendant's sales to the plaintiff's and figure the plaintiff's profits on those lost sales – the situation is rarely that uncomplicated. Indeed, determining lost profits often requires a market study rarely used, in U.S. court, outside of an antitrust case.

Often, there are multiple players in the market in which the plaintiff and defendant compete –the infringer may very well have taken sales from one, or all, of them, for quite different reasons. Moreover, it may not be clear why the patent owner "lost" sales to the defendant – was it because of the patented feature or for some other, less nefarious reason? And, what if the defendant could have replaced the infringing feature with a non-infringing substitute – should the plaintiff be able to collect his profits on all of the sales made by the defendant? And, all of this analysis requires the jury to go back up to six years, pretend the infringer did not sell the infringing product, redistribute its sales and determine what profits the plaintiff would have made if the infringer had not infringed.

The calculation of a "reasonable royalty" is even more theoretical. It posits a "hypothetical negotiation" (which, obviously, never occurred) between the plaintiff and the defendant on the day the defendant started infringing. Although the jury is not supposed to take into account events that took place after this hypothetical negotiation, the courts often allow both parties to submit such evidence anyway. The jury, taking into account no fewer than 15 factors, is required to decide what rate the parties would have agreed on if they had been forced to negotiate with each other and required to reach an agreement.

Obviously, this analysis is not for the faint-hearted and requires much more than a simple examination of the defendant's financial statements. In fact, these determinations require a robust economic analysis of the supply and demand for not only the intellectual property involved, but for products that may only use that intellectual property as a feature. This is a complicated economic analysis, comparable to that required in antitrust cases, of defining a market, determining the actual and potential players, analyzing demand elasticity and the capabilities of the actual and potential market participants to serve that market.

Indeed, the Federal Circuit in Grain Processing v. American Maize-Products, held that, in lost profits cases, "[r]econstructing the market, by definition a hypothetical enterprise, requires the patentee to project economic results that did not occur. To prevent the hypothetical from lapsing into pure speculation, this court requires sound economic proof of the nature of the market and likely outcomes with infringement factored out of the economic picture." No less a complicated analysis is required in reasonable royalty cases – at least, if the advocate is presenting a robust analysis, rather than simply "running the numbers" from an income statement.

What does all this mean for the harried patent litigator, consumed with worries about prior art, Markman hearings and Festo limitations on the doctrine of equivalence? It means your job got even harder.

Without the dramatic, but certain, finality of an injunction, parties need to focus more attention than ever on analyzing – and litigating – the complex economic issues involved in preparing and presenting an effective damages case. Hiring the right economic expert and assigning attorneys experienced in economic litigation can turn a plaintiff's case into a windfall and even a defense loss into a defeat the client can handle.

--By Richard F. Cauley

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