The role of the expert witness in calculating damages

The Federal Circuit Court of Appeals has set aside a US$358 million damages award in *Lucent v Gateway*, finding that the evidence was insufficient to support the jury's verdict. The case provides some useful guidance on the role of expert witnesses in working out damages

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The US Court of Appeals for the Federal Circuit has affirmed a jury's determination of validity and infringement in *Lucent Technologies, Inc v Gateway, Inc*, but set aside a US$358 million damages award (US$511 million with interest) because the evidence, and in particular the testimony of the damages experts at trial, was insufficient to support the jury's verdict. The ruling looks set to have a significant effect on damages awards in US patent infringement litigation.

Background

In December 1986, engineers at AT&T filed a patent application for what later became known as the "Day" patent. This patent is generally directed to a method of entering data into fields on a computer screen without a keyboard by using concurrently displayed, predefined tools that include an on-screen graphical keyboard, a menu and a calculator. The patent was ultimately assigned to Lucent. In 2002, Lucent sued Gateway for infringement and Microsoft intervened. Lucent's damages claims were based on the sales of Microsoft Money, Microsoft Outlook and Windows Mobile. Microsoft argued that the Day patent was invalid because it was anticipated or obvious.

Microsoft, along with Dell Computer, had apparently sold about 110 million units of these three software products for approximately US$8 billion. At trial, Lucent's theory of damages was based on a running royalty of 8% of the infringing products' sales revenue. It asked the jury to award it a total of US$561.9 million, while Microsoft argued that damages should be a lump-sum royalty payment of US$6.5 million. The jury decided in favour of Lucent and on a lump-sum award of almost US$358 million. However, the Federal Circuit vacated the jury's verdict, holding it to be unsupported and against the clear weight of the evidence.

Damages for US patent infringement

US patent law states that upon "finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court" (35 USC §284). US litigants have the option of calculating a reasonable royalty using either the analytical method, which is based on the infringer's projections of profit for the infringing product, or a second method known as the "hypothetical negotiation", which takes place just before infringement began and takes account of the so-called *Georgia-Pacific* factors, set out in *Georgia-Pacific Corp v US Plywood Corp*, 318 F Supp 1116, 1120 (SDNY 1970). The hypothetical negotiation assumes that the asserted patent claims are valid and have been infringed.

Federal Circuit's analysis

Lucent based its claim on a hypothetical negotiation. The company's licensing expert testified that damages should be based

solely on a running royalty instead of a lump-sum payment. On appeal, the Federal Circuit rejected this and found that Lucent had not offered documentary evidence or testimony upon which a jury could reasonably conclude that Microsoft and Lucent would have agreed, at the time of the hypothetical negotiation, that the patented feature would have been so frequently used or valued as to command a lump-sum payment of 8% of the sale price of Outlook.

On appeal, Lucent relied on eight licence agreements as evidence to support the jury's lump-sum damages award. The court noted that some of these were "radically different" from the hypothetical agreement under consideration for the Day patent. It also stated that it could not ascertain the subject matter of the agreements from the evidence presented, and that therefore the jury could not have adequately evaluated the probative value of those agreements. The court also noted that only four of the eight agreements appeared to be lump-sum agreements:

- A 1993 agreement between Dell and IBM for US$290 million.
- A 1996 agreement between Microsoft and Hewlett-Packard for US$80 million.
- A 1997 agreement between Microsoft and Apple Computer for US$93 million.
- A 1999 agreement between Microsoft and Inprise for US$100 million.

The 1993 agreement between IBM and Dell was a modification of their 1988 agreement and related to IBM's licensing of its entire patent portfolio protecting its one-time dominance in the personal computer market. The court noted that at the time, conventional wisdom was that selling IBM clones required a licence to IBM's patent portfolio. Dell's business was built around selling IBM clones. From this information, the court stated, a reasonable juror could only conclude that the IBM-Dell licence agreement for multiple patents to broad, PC-related technologies was directed to a "vastly different" situation from the hypothetical licensing scenario of *Lucent*, which involved only one patent (the Day patent) and was directed to a narrower method of using a graphical user interface tool known as the date-picker.

Regarding the other lump-sum agreements, the court noted that Lucent's expert gave the jury no explanation about the subject matter or patents covered by those agreements, and that the jury had heard similar testimony about the licence agreement between Microsoft and Hewlett-Packard. Lucent's expert apparently testified only that, under the cross-licence, Hewlett-Packard received "a royalty-free worldwide fully paid up license under the Microsoft patents" and Microsoft "agreed in return for a license under Hewlett Packard's patents to pay Hewlett Packard the sum of...$80,000,000". The court stated that the proffered expert testimony provided no analysis of those licence agreements, simply noting that the agreement was a cross-licence of a large patent portfolio and the amount paid.

Lucent also offered as evidence four running royalty licence agreements which, it argued, supported the jury's lump-sum damages award. However, the court disagreed, holding that the jury had almost no testimony with which to recalculate in a meaningful way the value of any of the running royalty agreements to arrive at the lump-sum damages award, and that the running royalty agreements differed substantially from the hypothetical negotiation scenario involving the Day patent. The court stated that with respect to one agreement, Lucent's expert never explained to the jury whether the patented technology was essential to the licensed product being sold or whether the patented invention was only a small component or feature of the licensed product. In addition, the jury was given no information about the price of the patented technology and thus was unable to assess the magnitude of the royalty rate. The court noted that the testimony of Lucent's expert relating to this agreement was confined to the fact that it was a cross-licensing agreement in which the rights granted to Lucent were royalty free, and that the royalty rate was structured as a commuted rate.

Another agreement offered by Lucent covered two Lucent patents directed to DVD player products, and was a hybrid lump-sum/running royalty cross-licence agreement in which the licensee agreed to pay Lucent an upfront payment along with a per-unit royalty. Lucent's expert apparently told the jury that the agreement was a cross-licence, conveying rights to Lucent to practise the licensee's patents, but the jury never learned anything about those patent rights and how valuable or essential they were. The court noted that even applying the royalty per unit of this agreement to the number of alleged infringing units resulted in only about US$165 million in damages, substantially less than the US$358 million awarded by the jury.

The third agreement offered involved eight patents and various commercial products. According to the court, the trial

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testimony by Lucent's expert focused almost exclusively on its per-unit royalty rate and lump-sum payment, but again the jury did not hear any explanation of the types of product covered by the agreement or the various royalty rates set out in the agreement. In addition, Lucent failed to explain the following:

- How the agreement, involving eight patents, was probative of the Microsoft-Lucent hypothetical negotiation over one patent.
- How similar or dissimilar the patented technology of the agreement was to the invention of using the Outlook date-picker.
- How the per-unit rate corresponded to a percentage of the cost of the products sold under the licence agreement.

The court noted that, even assuming that the average price of computers subject to this agreement was close to the product price used by Lucent's expert to calculate damages, that would equate to about one-thirtieth of the jury's constructive rate awarded to Lucent.

The court noted that the fourth agreement supported a higher royalty rate per unit, but that the jury had little to no testimony before it explaining how its complexity (numerous provisions covering various related products and different product royalty rates) would have affected the hypothetical negotiation analysis.

Microsoft argued that the hypothetical negotiation would have resulted in a lump-sum licensing agreement for US$6.5 million and asked the jury to accept its theory based on a proffer of a single licence that Microsoft had executed for a graphical user interface technology. The court noted that based on this evidence, a reasonable jury could have awarded US$6.5 million or some larger amount as permitted by the evidence, but that there was little evidentiary basis under *Georgia-Pacific* for awarding US$358 million – three to four times the average amount in the lump-sum agreements in evidence (ie, US$80 million, US$93 million, US$100 million and US$290 million).

The Federal Circuit considered *Georgia-Pacific* Factors 10 ("[t]he nature of the patented invention; the character of the commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention", *Georgia-Pacific*, 318 F Supp at 1120) and 13 ("[t]he portion of the realizable profit that should be credited to the invention as distinguished from non-patented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer", *id*) in its analysis. Regarding these issues, the court found that the evidence supported only a finding that:

- The infringing feature contained in Microsoft Outlook was a small part of a much larger software program.
- The parties had presented little evidence relating to Factor 13.
- The only reasonable conclusion was that most of the realisable profit must be credited to non-patented elements.
- "[T]he glaring imbalance between infringing and non-infringing features must impact the analysis of how much profit can properly be attributed to the use of the date-picker compared to non-patented elements and other features of Outlook."
- "[N]umerous features other than the date-picker appear to account for the overwhelming majority of the consumer demand and therefore significant profit."

The court held that the only reasonable conclusion that could be drawn from this evidence was that:

- The infringing use of Outlook's date-picker feature was a minor aspect of a much larger software program.
- The portion of the profit that could be credited to the infringing use of the date-picker tool was exceedingly small.
- Factors 10 and 13 of *Georgia-Pacific* provided little support for the jury's lump-sum damages award in the amount of US$358 million

The Federal Circuit noted that *Georgia-Pacific Factor* 11 ("[t]he extent to which the infringer has made use of the invention; and any evidence probative of the value of that use", *Georgia-Pacific*, 318 F Supp at 1120), as with Factors 10 and 13, informs the court and jury about how the parties would have valued the patented feature during the hypothetical negotiation. In doing so, Factor 11 relies on evidence about how much the patented invention has been used. Implicit in this factor is the premise that an invention used frequently is generally more valuable than a comparable invention used infrequently. Regarding this factor, the Federal Circuit observed that the evidence offered by Lucent was "conspicuously devoid" of any data about how often consumers use the patented date-picker invention.

Microsoft also argued that the damages award had to be reversed because the jury erroneously applied the entire market value rule. The court stated that the first flaw

with any application of the entire market value rule in this case was the lack of evidence demonstrating the patented method of the Day patent as the basis of the consumer demand for Outlook. It again noted that the only reasonable conclusion supported by the evidence was that the infringing use of the date-picker tool in Outlook was a very small component of a much larger software program, and that Lucent failed to meet its evidentiary burden and prove that anyone purchased Outlook because of the patented method. Regarding this issue, the court pointed to the testimony of Lucent's damages expert, who apparently conceded that there was no "evidence that anybody anywhere at any time ever bought Outlook, be it an equipment manufacturer or an individual consumer...because it had a date picker".

The court then stated that the second flaw with any application of the entire market value rule in this case was in the approach adopted by Lucent's licensing expert. At trial, Lucent's expert changed his opinion, contending that the royalty base should be the price of the software (and not the entire computer), but also that the royalty rate should be increased to 8% (from 1%). This opinion contrasted significantly with the rates he proposed for the other patents in suit, which were in the 1% range. In choosing 8%, he reasoned that, "in a typical situation, if one applied a royalty to a smaller patented portion in a computer as opposed to the entire computer using typically infringed patents, 8-percent...of the fair market value of the patented portion would equate to 1-percent of the fair market value of the entire computer".

The court noted that what Lucent's licensing expert proposed to do did not comport with the purpose of damages law or the entire market value rule. Lucent's expert apparently tried to reach the damages number he would have obtained had he used the price of the entire computer as a royalty base; but because the district court had precluded him from using the computer as the royalty base, he used the price of the software but inflated the royalty rate accordingly. Lucent's expert apparently also admitted that there was no evidence that Microsoft had ever agreed to pay an 8% royalty on an analogous patent.

Conclusions

What are some of the lessons to be learned from the Federal Circuit's analysis of the *Lucent* damages award and the expert testimony at trial?

Fundamentally, the patentee and testifying experts must offer documentary evidence and testimony upon which a jury can reasonably conclude that the parties to the hypothetical negotiation would have analysed the relevant factors and considerations in a way that would lead to the agreement argued to be the basis for a damages claim.

Experts must also:

- Explain to the jury whether the patented technology in licence agreements that are being relied upon was essential to the licensed product being sold.
- Explain to the jury whether the patented invention was only a small component or feature of the licensed product.
- Discuss the price of the patented technology so the jury can assess the magnitude of the agreement's royalty rate.

An explanation of the types of product covered by the licence agreements, the various royalty rates that may be set forth in the agreements and how the agreements are probative of the hypothetical negotiation is essential.

Also, if the entire market value rule is relied on to support a damages award, experts must offer evidence demonstrating that the patented features are the basis for consumer demand for the products incorporating those features. ■

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