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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

The Courts Beat Congress To Patent Reform (Again)

Law360, New York (August 31, 2009) -- In a recent district court case, Federal Circuit Judge Randall Rader sent a clear signal that reform on patent damages is coming with or without Congress' intervention.

Sitting by designation, Judge Rader presided over a patent lawsuit brought by Cornell University against Hewlett-Packard Company in the Northern District of New York.

During the course of this litigation, Judge Rader issued two orders that limit a patent holder's ability to recover a royalty on the entire value of product when the patent only covers a component found within the product.[1]

For several years, the trend in patent litigation has been for patent holders to assert their patents against the farthest downstream entity that sells a product containing the invention in dispute.

For example, if the patent covers memory chips, the patent holder would assert the patent against a personal computer manufacturer rather than the chip maker.

After all, why collect a royalty on a chip that costs a few dollars when it is possible to seek a royalty on a personal computer which that sells for $1,000?

Critics of the current system complain that Federal Circuit precedent permits this practice, and results in a reasonable royalty on an insignificant component to exceed not only the profit attributable to that component, but, in some cases, the entire profit on the product.[2]

This is a primary motivation for current efforts at patent reform legislation that are being directed at revising damages law.[3] The Senate and House are considering different proposals for damages patent reform.

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The Senate version does not propose to change the substantive law, but instead adds procedural mechanisms so that judges will more consistently evaluate the evidentiary basis of the parties' damages contentions.

The House version proposes substantive changes and would require the trial court to select one of three different methods set forth in the statute when calculating reasonable royalties.[4]

Regardless of whether this year's efforts at patent reform result in some form of legislation, the courts are not sitting idly by.

In Cornell v. Hewett Packard, Judge Rader signaled his views on damages reform. His decisions suggest that judges acting as the gatekeeper should make sure that a plaintiff's damages theory has a "firm basis in accepted economic principles."

Cornell sued HP for infringing U.S. Patent No. 4,807,115 ("the '115 patent") entitled "Instruction Issuing Mechanism for Processors with Multiple Functional Units."

The '115 patent claims technology that issues multiple and out-of-order computer processor instructions in a single machine clock cycle.[5]

According to Judge Rader, the "the claimed invention is a small part of the IRB [instruction reorder buffer], which is a part of a processor, which is part of a CPU module, which is part of a 'brick,' which is itself only part of the larger server."[6]

Nonetheless, during trial Cornell's damages expert attempted to testify that Cornell should recover a royalty on the sales of HP servers and workstations.

Judge Rader interrupted trial and conducted a Daubert hearing to determine whether Cornell's damages expert testimony was admissible.[7] The court relied on well established criteria for evaluating expert testimony.[8]

Although Judge Rader recognized that there are cases when the "entire market rule" applies and "a patentee can to collect damages on (i.e., include in the royalty base) the unpatented components sold with the patented invention ... rather than simply the portion of sales due to the patented component," he said those cases are limited to instances where the patented-related feature is the basis for customer demand.[9]

Judge Rader found that Cornell's expert could not identify sufficient economic proof that the component in question drove demand for the entire server and workstation products.[10]

"At best, the record shows that purchasers opt for Hewlett-Packard products because of their superior performance. Yet the patented invention is still merely one of several-what [Cornell's expert] calls a 'handful of components'-in the Hewlett-Packard processor 'Performance Formula.'"[11]

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The court stated the fact “that the patented invention comprises one element of the processors that are just one part of Hewlett-Parkard’s server and workstation systems is not sufficient to support application of the entire market value rule.”[12] As a result, the Court excluded Cornell’s expert testimony.[13]

The ruling on the motion to exclude did not end the controversy.

The court was reluctant to leave Cornell without a damages theory and gave Cornell the opportunity to return the next day of trial and offer testimony “on something less that takes into account to some degree ... the fact that the claimed invention is not the entire system but only a component of a component of that system."[14]

Judge Rader cautioned that the admissibility of the testimony hinged on factoring out that Cornell is seeking only compensation for the value of the claimed invention.[15]

Cornell’s expert proceeded to testify that the royalty base should encompass sales of Hewlett Packard CPU bricks. Cornell eventually prevailed at trial and the jury awarded Cornell $184,044,048 by applying a .8% royalty.[16]

Hewlett Packard filed a motion for JMOL[17] that the hypothetical processor revenue amount is the proper royalty base, or, in the alternative, remitter or a new trial on damages.

Using essentially the same analysis that he did in ruling on the motion to exclude, Judge Rader granted Hewlett-Packard’s motion.

He stated that once again, “Cornell proffered a royalty base that incorporated much more than the claimed invention without providing any additional evidence demonstrating entitlement to the entire market value of any Hewlett-Packard product.”[18]

Specifically, Cornell failed to “offer evidence that the claimed invention drove demand for Hewlett-Packard’s CPU bricks.”[19]

The Judge went on to provide additional detail on when a patentee could assert the entire market rule.

He said that there needed to be proof of three conditions: “(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 noninfringing 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.”[20]

Judge Rader went on to note that “Cornell chose this hypothetical royalty base in favor of another alternative more clearly relevant to the value of the patented invention—the

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revenue Hewlett-Packard would have earned had it sold each infringing processor as just that, a processor, without any additional non-infringing components."

He reduced the damages award to $53,494,282, in part, by using the hypothetical value (the processors were never actually sold alone) of Hewlett Packard's processor sales as the royalty base.[21]

Since an appeal in Cornell v. Hewlett Packard pending before the Federal Circuit, nothing is certain. Nonetheless, this decision is more noteworthy than your typical district court case.

Judge Rader normally sits on the Federal Circuit Court of Appeals, and a panel of Federal Circuit Judges recently suggested that the Federal Circuit has not had an opportunity to rule on apportionment[22] issues and that they were eager do to so because they believed that their precedent had been unfairly criticized.[23]

In Cornell v. Hewlett Packard, Judge Rader appears to be illustrating that very point.

In sum, Judge Rader has signaled that at least one Federal Circuit Judge believes that one form of damages reform is already here.

Assuming that he is not alone, and public statements from the Federal Circuit panel presentation in Silicon Valley suggest that he is not, patent defendants should consider filing Daubert motions, motion for summary judgment and JMOLs when a plaintiff seeks to apply the entire market value rule (i.e. seeks to define the royalty base on an entire product as opposed to the component containing the accused technology).

Similarly, patent holders that wish to apply the entire market value rule should develop evidence showing that the patented invention drives demand for the product as a whole.

--By Bernard Chao, Chao Hadidi Stark & Barker LLP

Bernard Chao is a partner with Chao Hadidi Stark & Barker in the firm's Menlo Park, Calif., office. The firm has represented Hewlett Packard, but not in the case discussed here.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Cornell Univ. v. Hewlett Packard Co., No. 01-CV-1974, 2008 WL 2222189 at *2 (N.D.N.Y. May 27, 2008) ("Cornell I"), Cornell Univ. v. Hewlett Packard Co., 609 F.Supp.2d 279 (N.D.N.Y. March 30, 2009) ("Cornell II").

[2] See, e.g. Bensen and White, Using Apportionment to Rein in the Georgia-Pacific Factors, 9 Colum. Sci. & Tech. L. Rev. 1 (2008).

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[3] Condon, Senate Panel Approves Patent Reform Bill, CNET News (April 2, 2009).

[4] H.R. 1260, Patent Reform Act of 2009, introduced March 3, 2009.

[5] Cornell II, 609 F.Supp.2d at 283.

[6] Id.

[7] Id. at 283-84.

[8] Cornell I at *1 citing to Daubert v. Merrell Dow Pharmaceuticals Inc., 509 U.S. 579 (1993), Kumho Tire Co. Ltd. V. Carmichael, 526 U.S. 137 (1999) and Fed. R. of Evid. 702.

[9] Id. at *2 citing to Rite-Hite Corp. v. Kelley Co. Inc., 56 F.3d 1538, 1549 (Fed.Cir.1995).

[10] Id. at *3.

[11] Id. at *3.

[12] Id. at *3.

[13] Id. at *4.

[14] Cornell II, 609 F.Supp.2d at 284.

[15] Id.

[16] Id. at 282.

[17] See, Fed. R. Civ. P. Rule 50.

[18] Cornell II, 609 F.Supp.2d at 284.

[19] Id. at 289.

[20] Id. 292-93.

[21] Id. at 292.

[22] One commentator has defined apportionment to refer to the requirement that a patentee's recovery be based on the economic value contributed by the patent. Bensen and White, 9 Colum. Sci. & Tech. L. Rev. at 3.

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[23] The Federal Circuit Visits the Valley, Four Seasons in East Palo Alto, Nov. 5, 2008. The author attended this event and is providing his best recollection of the Judges' statements.

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