REPRINT

FINANCIER WORLDWIDE MAGAZINE

SPECIAL REPORT

FORUM: Valuation and damages in IP disputes

REPRINTED FROM
JANUARY 2017 ISSUE

FINANCIER WORLDWIDE corporatefinanceintelligence

FORUM:

Valuation and damages in IP disputes

FW moderates a discussion on valuation and damages in IP disputes between Thomas Vander Veen at Epsilon Economics LLC, John Paul at Finnegan, Henderson, Farabow, Garrett & Dunner LLP, Christopher P. Gerardi at FTI Consulting, and Marti A. Johnson at Skadden, Arps, Slate, Meagher & Flom LLP.

THE PANELLISTS

Thomas Vander Veen
President
Epsilon Economics LLC
T: +1 (312) 637 2960
E: tvanderveen@epsiloneconomics.com

Thomas Vander Veen provides expert economic analysis of intellectual property and international trade, and has served as an economic expert in US courts and international arbitration. Previously, he served as the economic adviser to the chairman of the US International Trade Commission. He teaches economics and finance at Northwestern University and earned his Ph.D. in economics from Brown University.

John Paul
Partner
Finnegan, Henderson, Farabow, Garrett & Dunner LLP
T: +1 (202) 408 4109
E: john.paul@finnegan.com

John Paul has more than 30 years of experience in intellectual property licensing, litigation and prosecution. Focus areas include strategic planning, IP portfolio evaluation and development, complex transactions, due diligence investigations, and licensing and enforcement of IP portfolios to generate revenue. He leads the firm's IP management and transaction section and is designated as a certified licensing professional (CLP).

Christopher P. Gerardi
Senior Managing Director
FTI Consulting
T: +1 (212) 499 3638
E: chris.gerardi@fticonsulting.com

Christopher Gerardi is a senior managing director at FTI Consulting and co-leader of the Dispute Advisory Services practice. He has more than 25 years of experience assisting companies and plaintiffs' and defendants' counsel with complex economic, financial, accounting and litigation issues. As a nationally recognised consultant and expert witness, Mr Gerardi focuses on applied economic and damage analyses as they relate to intellectual property and commercial litigation matters.

Marti A. Johnson
Counsel
Skadden, Arps, Slate, Meagher & Flom LLP
T: +1 (212) 735 3836
E: marti.johnson@skadden.com

Marti A. Johnson concentrates her practice on intellectual property and technology law, with a focus on patent and trade secret litigation. A member of the Skadden group recognised by The National Law Journal as one of the country's leading IP practices in its 2013 'IP Hot List', she also provides guidance to her clients on a variety of issues, including intellectual property transactions, freedom to operate determinations, electronic discovery parameters and damages evaluations.

FW: Could you provide an overview of intellectual property (IP) related disputes in today's market? Are you seeing an increase, and what are some of the common causes?

Vander Veen: One active and growing area of intellectual property disputes is the determination of fair, reasonable and non-discriminatory (FRAND) royalty rates for standard essential patents (SEPs). Standard essential patents describe technology which has been declared essential to comply with technical standards, such as wireless communication standards such as 2G, 3G, 4G/LTE cellular standards, WiFi standards or audio and video compression standards. The scope of this area of disputes is massive. For example, within the wireless communications standards alone, there are tens of thousands of patents which have been declared essential to standards by dozens of entities. On the other side, every smartphone, tablet and electronic device incorporating wireless communications requires rights to use these patents.

Paul: Today's intellectual property (IP) disputes involve all of the various rights that exist and are receiving considerable attention in the media and in appellate courts. Patent disputes and the activities of patent assertion entities continue despite changes in the law that increase the burden of proving liability, the scrutiny of expert reports and damages, the difficulty in sustaining higher damage awards, and the likelihood of losing a patent in validity challenges at the US Patent and Trademark Office. Disputes regarding design patents have grabbed the attention of the public, and the dispute between Apple and Samsung is now before the US Supreme Court to determine whether an award of infringer's profits should be limited to those profits attributable to the infringing component. Copyright is before the US Supreme Court in a dispute between Star Athletica and Varsity Brands to determine whether copyright protection is available for cheerleading uniforms with design features such as stripes and chevrons. The enactment of a recent federal law on trade secret protection also signals increasing interest for protecting and asserting these rights.

Johnson: The number of patent litigations filed has continued to decline since its peak in 2013, although the rate of decline seems to have slowed. This decline could be attributed to a number of factors, but the Supreme Court's 2014 decision in *Alice Corp. v CLS Bank* is certainly an important one. The *Alice* decision, which addressed what constitutes an unpatentable abstract idea in the context of software-related inventions, made it more challenging for plaintiffs to successfully assert software patents. By contrast, I think the general expectation is that trade secret litigations will be on the rise, particularly given the passage of the Defend Trade Secrets Act in 2016, which provides a federal cause of action for trade secret cases.

Gerardi: We continue to see an increase in trade secret litigation and even more arbitrations given changes to US patent laws and the Defend Trade Secrets Act (DTSA), which was recently signed into law. The Supreme Court has ruled on several patent-related matters, such as *Alice Corp vs. CLS Bank, Octane Fitness vs. Icon Health & Fitness* and *Limelight vs. Akamai*, which have impacted the level of patent litigation. Further, the America Invents Act, which was signed into law in September 2011, provides for tougher patent review proceedings. These changes to patent law have made it more difficult to enforce patents. The value of intellectual property, however, continues to increase and we see more clients actively debating whether to try to protect their IP through patents, or whether they should keep the information secret and protect it under trade secrets law. The passage of the DTSA will reinforce the inclination to keep some IP as a trade secret. Clients' desire for secrecy is also why we are seeing an increase in the number of private arbitrations, which can be kept out of the public eye, compared to litigation, in a public forum.

FW: When an IP-related dispute arises, what key factors need to be considered when valuing these intangible assets and calculating related damages?

Paul: Key factors to be considered when valuing intangible assets and calculating related damages include: the value of comparable assets in other transactions; changes in the marketplace since those transactions that would affect that value, for example changes in supply and demand, as well as market shifts and any new competing technologies; the relative value of the protected feature relative to other features; the current views of the courts and the patent offices in determining whether such assets are eligible for protection, are sufficiently inventive to be patentable, whether injunctive relief is available, and the evidence required for proving damages; expectations of the parties and terms of agreements when licences or contracts are involved; and the likelihood and cost of litigation.

Johnson: In patent and trade secrets cases, apportionment must be considered carefully when calculating damages. As technology grows more complex, ensuring that the damages sought bear a sufficient connection to the infringing technology, or misappropriated information, becomes more complicated. Often, an IP dispute centres on but one portion of a larger, more complicated item or process. In patent cases, where a reasonable royalty is a common measure of damages, this means that the choice of an appropriate royalty base is critical. Even if a very small royalty rate could, theoretically, offset a large royalty base, the Federal Circuit has made clear that the royalty base itself must be appropriately tailored to the accused technology. Approaches to apportioning the value of accused technology within a larger product vary and can consider such things as the relative cost of the component feature or customer surveys about the value of different product features. Care must be taken, however, because courts have often taken a critical eye to the objective support underlying any given approach.

Gerardi: A number of key factors need to be considered at the onset of a case. First, the facts and circumstances that impact the type of damages that may be claimed – for example, can the patentee meet the burden necessary to establish lost profits or is a reasonable royalty calculation more appropriate? Second, the value of the patented feature relative to non-patented features – for example, is the patented feature one of many non-infringing features contained in an infringing product? Does the patented feature drive demand for the infringing product? What evidence has been produced to support such a claim? Third, how can a damages expert credibly support a reasonable royalty rate – for example, are there prior licence agreements for the patents-in-suit or comparable technology? Does either party have a standard licensing policy? Each of these factors can have a significant impact on the type and magnitude of damages appropriately claimed.

Vander Veen: The key factor in determining the value of intangible assets is calculating the economic value of the technology or patent separate from any other technologies or value-generating components in the product incorporating the intangible asset at issue. For example, a smartphone can practice several thousand patents. The patents declared essential to 4G/LTE cellular standards alone number in the tens of thousands. Thus, determining the value of the intellectual property asset requires determining the portion of the value of a product generated by the intellectual property at issue alone. Apportioning the value to the patented technology is further complicated in the case of standard essential patents because a FRAND rate should reflect the incremental value of the technology separate from any value associated with the incorporation of the patented technology into the standard.

FW: Have any recent, high-profile IP disputes grabbed your attention in so far as they demonstrate the difficulties involved in assessing IP value and calculating damages? What lessons can we draw from the resolution of such cases and their impact on the IP landscape?

Johnson: This year the Supreme Court decided *Halo Electronics v. Pulse Electronics*, loosening the framework for awarding enhanced damages in a patent case. The Court rejected the prior test, which allowed enhanced damages for wilful infringement only where it had been shown by clear and convincing evidence that there was an objectively high likelihood that defendant's acts were infringing and where the defendant knew or should have known of the risk. This was considered a difficult test to meet because it required that defendant's non-infringement and invalidity defences be 'objectively baseless'. The Supreme Court rejected this approach as overly rigid and further held that

> "AS TECHNOLOGY GROWS MORE COMPLEX, ENSURING THAT THE DAMAGES SOUGHT BEAR A SUFFICIENT CONNECTION TO THE INFRINGING TECHNOLOGY, OR MISAPPROPRIATED INFORMATION, BECOMES MORE COMPLICATED."
>
> MARTI A. JOHNSON
> Skadden, Arps, Slate, Meagher & Flom LLP

wilfulness should be decided based on a preponderance of the evidence standard, not the heightened clear and convincing standard applied previously. This has opened up the possibility that enhanced damages will be more readily obtainable, which will significantly impact valuation of potential damages in patent cases going forward.

> THERE HAVE BEEN A NUMBER OF HIGH-PROFILE DECISIONS THAT DEMONSTRATE THE CONTINUING NEED FOR AN ECONOMIC EXPERT TO TIE A DAMAGES CALCULATION TO THE VALUE OF THE PATENTED FEATURE AND TO THE FACTS AND CIRCUMSTANCES.
>
> CHRISTOPHER P. GERARDI
> FTI Consulting

Gerardi: There have been a number of high-profile decisions that demonstrate the continuing need for an economic expert to tie a damages calculation to the value of the patented feature and to the facts and circumstances of a particular matter. For example, the Federal Circuit's decision in *VirnetX, Inc., v. Cisco Systems, Inc.* provided additional guidance regarding the calculation of reasonable royalty damages based on the smallest salable patent practicing unit (SSPPU) and the need to further apportion when the SSPPU contains multiple non-infringing features. Additionally, in *Uniloc USA, Inc. v. Microsoft Corp*., the Federal Circuit found the 25 percent rule of thumb to be inadmissible, as it did not tie the reasonable royalty rate to the particular facts of the case. These decisions continue to highlight the need for economic experts to provide a refined and well-supported calculation that meets the enhanced requirements of the courts.

Vander Veen: One significant matter is a 2015 decision by the US Court of Appeals for the Federal Circuit in *Commonwealth Scientific and Industrial Research Organization v. Cisco Systems, Inc*. This case highlights that damages must be based on the incremental value of the patented technology separate from other drivers of value in the products incorporating the patented technology. The Federal Circuit indicated that the value of the patented technology must be apportioned from the value of standardisation. This is consistent with the fundamental principal that damages for patent infringement must be based on the value of the patented technology and not on the value of the unpatented features. The Federal Circuit also stated that one method to apportion value to the subject patents is to evaluate the value of the SSPPU within the product.

Paul: Cases in recent years that have addressed apportionment of damages have grabbed my attention, including *Uniloc USA, Inc. v. Microsoft Corp., LaserDynamics, Inc. v. Quanta Computer, Inc., VirnetX, Inc v. Cisco Systems, Inc.*, and *ResQNet, Inc. v. Lansa, Inc*. Apportioning damages to reflect the value attributable to the patented features contained in the accused product and excluding value attributable to unpatented features can depend on the subjective perspective and experience and relative priorities of the various entities involved: the patent owner, the implementer, the consumer and the government.

FW: In your experience, what benefits can expert witnesses bring to case analysis, including initial calculations of IP value and damages? Indeed, how might the appointment of an expert witness impact the damages ultimately awarded?

Paul: Expert witnesses bring the experience they have collected through valuing intangible assets, as well as the insight gained from working with many rights holders and implementers in various industries and in various contexts and situations, that a party would not otherwise have. They also give a perspective on how rights holders and implementers assess value, initial calculations of IP value and damages to set the expectations of the parties, factual support for negotiations to resolve disputes, and reports and testimony in litigation to support a party's position and critique the position of opposing parties.

Vander Veen: Expert witness analysis and testimony is essential for a dispute which is litigated at trial. However, economic expert analysis can be extremely valuable well before any litigation dispute begins. For example, in the context of FRAND disputes, a licensor or licensee often needs to establish that the licensor had been offering royalty rates to the licensee which are fair and reasonable. An economic expert can be engaged before a licensor or licensee makes royalty rate offers to a potential licensee to provide advice on the 'offer rates'. The expert can also provide an opinion as to whether these rates are fair, reasonable and non-discriminatory. In the event any subsequent litigation occurs, it can be valuable to be able show that an independent third party had evaluated the offer rates and determined the offers to be fair, reasonable and non-discriminatory.

Gerardi: Retaining a damages expert can be extraordinarily beneficial to clients on both a short- and long-term basis. Initially, economic experts can provide an early case

damages assessment. This analysis can give clients a sense of the magnitude of potential damages and the discovery necessary to support a given claim. Further, an economic expert can assist in formulating document requests, interrogatories and deposition questions regarding financial, industry and technical information potentially relevant to a damages calculation. Experienced damages experts also stay up-to-date on the ever-changing body of case law affecting damages calculations. Ultimately, in the face of mounting challenges to such calculations, retaining a damages expert can lead to a more refined and defensible analysis.

Johnson: In my view, damages experts in particular should be brought on to a case as early as possible. An expert's initial analysis of potential damages can provide valuable insight that will allow a company to take a more reasoned approach to determining settlement value and the potential for early resolution of a case. Moreover, an expert's early involvement can make for a more efficient litigation, allowing counsel to tailor damages-related discovery to the particular information that will be needed for the expert's analysis. Any streamlining of discovery always provides for a more cost-effective and efficient litigation. The choice of a damages expert is particularly key in trade secrets cases, where the law on what constitutes an acceptable measure of recovery is less settled than in patent cases. There are many approaches to valuing damages in trade secrets cases, and it is incredibly important to find an expert who will have the flexibility and creativity to find the most appropriate and economically sound way to calculate such damages given the facts of the case.

FW: How is the issue of apportionment of damages generally handled during an IP dispute? Do limitation periods exist which could impact the decision-making process around calculating IP value and damages?

Vander Veen: Apportionment is the central issue in IP disputes and US courts are acutely focused on ensuring that damages are properly apportioned to the patented technology. However, apportionment is frequently a very complex issue and involves extensive expert analysis. For example, one method to apportion the value of a product to a patent is to survey users of the products incorporating the patent in order to evaluate how consumers value the patented feature in the product. A scientifically valid survey is developed and fielded to specifically assess the value of the patented features of the product. Other methods involve assessing the value of the SSPPU within the product.

Gerardi: From a patent perspective, the issue of apportionment is often of paramount importance in a damages calculation. Notably, courts require damages experts to isolate the value of the patented features, as distinct from non-infringing features, or, alternatively, to prove that the patented feature drives demand of the infringing product, known as the Entire Market Value Rule (EMVR). In my experience, establishing the credibility of the EMVR in a particular situation is not an easy feat. I anticipate that courts will continue to offer guidance on use of the EMVR and apportionment requirements. Further, there are various limitation periods that may impact damages. For example, a patentee can only recover damages for a period beginning six-years prior to the filing of the complaint. Alternatively, in certain instances, damages may be limited to the period in which the infringer received notice of infringement. These limitation periods can have a significant impact on the magnitude of damages.

Johnson: Apportionment is important in patent cases, but it is also critical in trade secrets cases. In cases where the misappropriated information is not embodied in an accused product, but was instead used as a stepping stone to create a different or improved product, determining the value of that stepping stone relative to the ultimate end product can be complicated. One approach is to determine the length of any head start that the defendant received by virtue of the misappropriation. In other words, damages are calculated based on the assumption that the defendant was able to launch its product sooner than it otherwise would have due to the misappropriation. The length of this head start can be calculated by considering such things as the amount of time it took the plaintiff to develop its trade secret, the defendant's development time, or even the development time of third parties that have launched similar products. The amount to which the defendant was enriched due to this earlier entrance into the market may then inform unjust enrichment damages.

> "THE OUTLOOK FOR IP DISPUTES IN OUR INCREASINGLY GLOBAL BUSINESS WORLD CONTINUES TO EVOLVE BASED ON THE AVAILABILITY OF COURTS AND OTHER DISPUTE RESOLUTION ORGANISATIONS IN VARIOUS COUNTRIES."
>
> JOHN PAUL
> Finnegan, Henderson, Farabow, Garrett & Dunner LLP

Paul: Points for dispute include defining an appropriate royalty base, whether the patented feature is the basis for customer demand for the overall product and, therefore, having the overall product as the royalty base, and what is the SSPPU and whether even that unit should be narrowed to discount for significant non-infringing features.

FW: What final piece of advice can you offer to companies in terms of assessing and quantifying the value of their IP assets in the context of an IP dispute?

Gerardi: Involve an economic expert early on, as he or she can assist in a wide range of tasks throughout the litigation lifecycle, from early case assessment to discovery to summary judgment motions. Relatedly, he or she can identify and work through potential damages 'problem areas' with counsel and clients sooner rather than later. Our experience clearly demonstrates that such early involvement may not only help to guide case strategy, but also save on legal and expert fees in the long-run.

Johnson: One further idea that must be borne in mind in the context of trade secret disputes is the value attributable to each individual trade secret. In cases where many trade secrets are asserted, it is not uncommon to see parties attach a single valuation to all of the asserted trade secrets. In other words, one damages number is put forward, which is inherently based on the assumption that all asserted trade secrets are misappropriated. In cases where the defendant is found to have misappropriated only a subset of the asserted trade secrets, courts have thrown out damages verdicts where the number put forward by the expert – and adopted by the jury – had been based on the valuation of all of the asserted trade secrets in combination. Companies must take care in identifying each of their trade secrets distinctly and valuing each separately.

Paul: Be informed and realistic about the value of the IP and understand that the perspective of opposing parties may honestly be different based on their experience, their subjective feelings, their business objectives and the alternatives available to them.

> "EVALUATING THE VALUE OF IP ASSETS OR THE POTENTIAL EXPOSURE TO IP LITIGATION WITH SOUND ANALYSIS IS ESSENTIAL TO MAKING INFORMED BUSINESS DECISIONS."
>
> THOMAS VANDER VEEN
> Epsilon Economics LLC

Vander Veen: Engage economic consultants as early as possible. Evaluating the value of IP assets or the potential exposure to IP litigation with sound analysis is essential to making informed business decisions. This is especially true in the context of standard essential patents as it is vital to be able to establish that royalty offers within the negation process have been fair, reasonable and non-discriminatory.

FW: What do you believe is the outlook for IP disputes in our increasingly global business world? What issues do you expect to influence the calculation of IP valuations and related damages going forward?

Johnson: The enactment of the DTSA will have a significant impact on the future of intellectual property disputes, and the number of trade secrets cases will increase as a result. The Act explicitly covers trade secret misappropriation that occurs outside of the United States if the misappropriator is a US corporation or citizen or if an act in furtherance of the misappropriation occurred within the US. This is an important feature of the Act given increasing globalisation as well as concerns about cyber attacks by 'hacktivists' or other foreign entities. The passage of the Act will also likely lead to a more uniform body of case law governing issues like trade secrets damages, allowing companies to better predict potential damages resulting from the theft of a trade secret, which can be a useful tool in valuing a companies' intellectual property.

Vander Veen: IP disputes are increasingly multinational and the trend is likely to continue. Patent holders are increasingly selecting among global venues to file patent infringement litigation in order to facilitate global settlement agreements. For example, patent holders file in multiple international venues, selecting particular venues in which an injunction is more likely. Moreover, the use of international arbitration to settle global patent disputes is increasing. Recently, large licensors and licensees, such as Samsung and Nokia, have turned to international arbitration venues to resolve disputes related to FRAND rates for standard essential patents.

Paul: The outlook for IP disputes in our increasingly global business world continues to evolve based on the availability of courts and other dispute resolution organisations in various countries, and the evolution of law, procedures, timing, costs and results in different countries. Germany has been an attractive forum based on timing, cost and predictability. China's increased focus on patenting and

the high number of court decisions finding for patent owners is attracting interest more recently. And the Unified Patent Court for a single European litigation system may come into being as an attractive forum in the near future in view of the recent ratification announcement by the UK. The greater scrutiny of damages and proofs of infringement in US courts and the success of validity challenges in the patent office has decreased the attractiveness of proceedings in the US for patent owners. The calculation of damages will continue to be affected by the perception of whether the litigation process is being abused by rights holders or implementers, whether the patent office is perceived as invalidating patents that should be upheld, whether the US Supreme Court will change the law created by the Federal Circuit, the perception of royalty stacking, the perception of value to the consumer, whether standards-based licensing and patent pools are viable, and whether patents are becoming less important and therefore less valuable and less asserted in rapidly moving technologies.

Gerardi: From a patent perspective, I expect the number of cases that make it to the damages phase to continue to decline given the many avenues available for settlement beforehand and the costs of the litigation lifecycle. Going forward, I expect a number of issues to continue to influence the calculation of patent damages, including: apportionment requirements; the use of acceptable licence and settlement agreements; requirements for determining FRAND royalties; and extraterritoriality. Additionally, the ability of a patentee to recover the entirety of profits from sales of infringing products in design patent matters will almost certainly make headlines in the near future, as this issue was recently argued before the Supreme Court in *Apple, Inc. v. Samsung Electronics Co., Ltd., et al*. Finally, given the recent federalisation of trade secret law, I expect the courts to offer guidance on and refine the process of calculating damages in trade secret matters, as has been the case in patent matters. ■