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Use of License Agreements to Determine Reasonable Royalties

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Recent case law has shown that courts are more closely scrutinizing damages analyses. One area of damages analysis that has received particular attention concerns the use of license agreements to calculate reasonable royalties. Specifically, courts have considered various issues related to the admissibility of settlement agreements and comparability of license agreements. Below is a discussion of issues that are surfacing in the case law regarding these topics.

I. Admissibility of Settlement Agreements

Use of settlement agreements, one type of license agreement, in a reasonable royalty analysis has been the subject of sharp debate. For many years, the prevailing – but not universal – view was that settlement agreements were inappropriate to use in a royalty analysis. In 2010, the Federal Circuit overturned a damages award that was based on license agreements that were entered into outside of the litigation context.[1] The majority stated that "the most reliable license in this record arose out of litigation."[2] Relying on that statement, a number of courts have held that settlement agreements and the underlying negotiations are discoverable and relevant to the royalty determination.

A. The "Century-Old Rule"

Courts that have precluded the use of settlement agreements in the royalty analysis often have pointed to the Supreme Court's decision in *Rude v. Wescott*[3], as the first articulation of the rule prohibiting use of such agreements. In *Rude*, the court stated:

> [S]ettlement of a claim for an alleged infringement cannot be taken as a standard to measure the value of the improvements patented, in determining the damages sustained by the owners of the patent in other cases of infringement. Many considerations other than the value of the improvements patented may induce the payment in such cases. The avoidance of the risk and expense of litigation will always be a potential motive for a settlement.[4]

The Federal Circuit's decision in *Hanson v. Alpine Valley Ski Area, Inc.*,[5] also has been understood to support the preclusion of settlement agreements. In *Hanson*, the court held that the terms of a license agreement was not evidence of an established royalty because "license fees negotiated in the face of a threat of high litigation costs may be strongly influenced by a desire to avoid full litigation costs."[6]

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[1] *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860 (Fed. Cir. 2010).
[2] *Id.* at 872.
[3] *Rude v. Wescott*, 130 U.S. 152 (1889).
[4] *Id.* at 164.
[5] *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075 (Fed. Cir. 1983).
[6] *Id*. at 1078-79.

As a result, courts generally have applied "a century-old rule that royalties paid to avoid litigation are not a reliable indicator of the value of a patent, and should therefore be disregarded when determining reasonable royalty rates."[7]

This rule was not recognized by all courts even before the Federal Circuit's decision in *ResQNet*. A number of courts allowed discovery or use at trial of settlement agreements.[8] And, even after *ResQNet*, courts have disagreed as to whether *Rude* and *Hanson* precluded use of settlement agreements.[9]

B. The *ResQNet* Decision

In *ResQNet*, the patentee offered evidence of seven licenses to support a royalty rate of 12.5 percent. Five of these licenses were described as "re-bundling" licenses because they provided for "finished software products and source code, as well as services such as training, maintenance, marketing, and upgrades."[10] The re-bundling licenses had royalty rates ranging from 25 to 40 percent.[11] The majority held that the district court improperly relied on these higher rates in arriving at its damages award because "none of these licenses even mentioned the patents in suit or showed any other discernible link to the claimed technology."[12] In other words, "[t]he re-bundling licenses simply have no place in this case."[13]

The majority indicated that the district court should have placed much greater weight on another license in which the parties agreed to a substantially lower royalty rate. But, that license "arose out of litigation over the patents in suit."[14] Nevertheless, the

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[7] *Wang Labs., Inc. v. Mitsubishi Elecs. Am., Inc.*, 860 F. Supp. 1448, 1452 (C.D. Cal. 1993). *See also General Elec. Co. v. DR Sys., Inc.*, No. 06-5581(LDW)(ARL), 2007 WL 1791677, at *2 (E.D.N.Y. June 20, 2007) (holding that "settlement agreements reached to resolve litigation or threatened litigation are generally not relevant to the issue of what may constitute a reasonable royalty."); *Donnelly Corp. v. Gentex Corp.*, 918 F. Supp. 1126, 1133-34 (W.D. Mich. 1996) ("[S]ettlement agreements should be precluded under Federal Rule of Evidence 403 [because they] do not accurately reflect what a willing licensee would pay a willing licensor in an arm's length negotiation.").

[8] *See Phoenix Solutions Inc. v. Wells Fargo Bank, N.A.*, 254 F.R.D. 568, 583 (N.D. Cal. 2008) ("[A]t a minimum, discovery of licensing/settlement negotiations is reasonably calculated to lead to relevant, admissible evidence"); *Sunstar, Inc. v. Alberto-Culver Co., Inc.*, Nos. 01C0736, 01C5825, 2004 WL 1899927, at *28-31 (N.D. Ill. Aug. 23, 2004) (holding that settlement agreements were admissible and noting that the "trier of fact may consider the context in which [the settlement agreements] were reached and determine whether the probative value of [each] license should be discounted"); *Medtronic, Inc. v. Catalyst Res. Corp.*, 547 F. Supp. 401, 415 (D. Minn. 1982) (holding that settlement agreements are "highly persuasive evidence" of the terms to which a willing buyer and willing seller would agree).

[9] *Compare Volumetrics Med. Imaging, LLC v. Toshiba Am. Med. Sys., Inc.*, No. 1:05CV955, 2011 WL 2470460, at *7-11 (June 20, 2011) (examining *Rude* and *Hanson* and determining that those cases did not foreclose use of settlement agreements) *with Fenner Invs., Ltd. v. Hewlett-Packard Co.*, No. 6:08CV273, 2010 WL 1727916, at *1-3 (E.D. Tex. Apr. 28, 2010) (examining the pre-*ResQNet* caselaw and concluding that they established a rule against using settlement agreements).

[10] *ResQNet*, 594 F.3d at 870.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 871.

[14] *Id.* at 870.

majority described the license as the "most reliable" in the case.[15] In a nod to prior decisions addressing use of settlement agreements, the majority observed that "[o]n other occasions, this court has acknowledged that the hypothetical reasonable royalty calculation occurs before litigation and that litigation itself can skew the results of the hypothetical negotiation."[16]

C. Using Settlement Agreements Post-*ResQNet*

The court in *ResQNet* "acknowledged" its prior statements on using settlement agreements. It did not purport to – nor could it – expressly overrule a prior decision. Nevertheless, the majority clearly embraced the use of settlement agreements in calculating a reasonable royalty. Since *ResQNet* was decided, numerous district courts have been asked to determine whether settlement agreements and underlying negotiations are discoverable and admissible.

A majority of district courts have permitted the discovery and/or admission of settlement agreements and underlying negotiations.[17] The scope of these decisions has varied. Some courts have made clear that their decisions were limited only to discoverability of settlement agreements and negotiations, and did not find that such documents necessarily are relevant to a royalty analysis.[18] Other courts have emphasized that "the admissibility of litigation licenses —like all evidence— must be assessed on a case-by-case basis, balancing the potential for unfair prejudice and jury confusion against the potential to be a 'reliable license.'"[19]

Settlement negotiations may be treated differently from the agreements themselves. In *Clear with Computers*, the court allowed discovery of settlement negotiations, but indicated that the result reflected "the exception, not the rule, and in most cases discovery of the negotiations will not be warranted."[20] The court explained that "the settlement agreements [arising from the negotiations] will likely be the only licenses of the patents-in-suit, making an accurate understanding of them more important."[21]

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[15] *Id.* at 872.
[16] *Id*. (citing *Hanson*, 718 F.2d at 1078-79).
[17] *See Automated Merchandising Sys. Inc. v. Crane Co.*, No. 3:03-cv-88, 2011 WL 5025907, at *7 (Oct. 21, 2011); *Small v. Nobel Biocare USA, LLC*, No. 06 Civ. 0683, 2011 WL 3055357, at *4-5 (July 19, 2011); *Volumetrics*, 2011 WL 2470460, at *13-15; *Pandora Jewelry, LLC v. Bajul Imports, Inc.*, No. 1:10CV135SNLJ, 2011 WL 976623, at *1; (E.D. Mo. Mar. 17, 2011); *MSTG, Inc. v. AT & T Mobility LLC*, No. 08C7411, 2011 WL 841437, at *3 (N.D. Ill. Mar. 8, 2011); *Clear With Computers, LLC v. Bergdorf Goodman, Inc.*, 753 F. Supp. 2d 662, 663-64 (E.D. Tex. 2010); *ReedHycalog UK, Ltd. v. Diamond Innovations Inc.*, 727 F. Supp. 2d 543, 546-47 (E.D. Tex. 2010); *Datatreasury Corp. v. Wells Fargo & Co.*, No. 2:06CV72DF, 2010 WL 903259, at *1-2 (E.D. Tex. Mar. 4, 2010); *Tyco Healthcare Grp. LP v. E-Z-EM, Inc.*, No. 2:07CV262(TJW), 2010 WL 774878, at *2 (E.D. Tex. Mar. 2, 2010).
[18] *Small*, 2011 WL 3055357, at *5.
[19] *ReedHycalog UK*, 727 F. Supp. 2d at 546; *see also Clear With Computers*, 753 F. Supp. 2d at 663
[20] *Id*. at 664.
[21] *Id.*

Instances where courts have denied discovery or held that settlement agreements or negotiations were inadmissible are much more limited.[22] In one case, *MSTG, Inc. v. AT & T Mobility LLC*,[23] the court denied a motion to produce settlement negotiations. The court subsequently granted a motion for reconsideration and ordered production of the negotiations after reviewing the damages report of the plaintiff's expert.[24] The expert report contained analysis of six license agreements. The court accepted the defendant's argument that the underlying negotiations may permit the defendant to prove that some or all of the expert's conclusions concerning the license agreements "are incorrect."[25] Accordingly, discovery of settlement negotiations after *ResQNet* stands on less certain ground than does discovery of the agreements arising from those negotiations.

II. Comparability of License Agreements

A number of recent cases have emphasized that parties must show a relationship between purportedly comparable licenses and the facts and technology at issue in the case. In general, courts have increasingly challenged the analyses offered by parties who identify license agreements as "comparable" for purposes of determining reasonable royalty damages.

A. The *Lucent* Decision

One case that highlights many of the issues regarding comparability of license agreements is *Lucent v. Gateway*.[26] In *Lucent*, the Federal Circuit vacated a $358 million damages award after finding, among other reasons, that the patentee, Lucent, had failed to establish that purportedly "comparable" license agreements supported the jury's award. The court identified several areas where more particularized analysis had been required.

The court distinguished between a running royalty license and a lump-sum license, explaining that "certain fundamental differences exist between lump-sum agreements and running-royalty agreements."[27] Although running royalty agreements can be relevant in a lump-sum context and vice versa, there must be "some basis for comparison"[28] in the evidence. In this case, the jury awarded lump sum damages.

The court found that Lucent failed to show a basis for comparison between certain running royalty license agreements and the hypothetical agreement. Lucent did not offer testimony explaining how the patented feature related to the technology licensed in the

[22] *See Software Tree, LLC v. Red Hat, Inc.*, No. 6:09CV097, 2010 WL 2788202, at *3 (E.D. Tex. June 24, 2010); *Fenner*, 2010 WL 1727916, at *3 (E.D. Tex. Apr. 28, 2010).
[23] *MSTG, Inc. v. AT & T Mobility LLC*, No. 08C7411, 2011 WL 221771, at *13 (N.D. Ill. Jan. 20, 2011).
[24] *MSTG*, 2011 WL 841437, at *3.
[25] *Id*. at *2.
[26] *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009).
[27] *Id*. at 1330.
[28] *Id*.

running royalty agreements, how valuable the technology in the past licenses was, or how essential it was to the overall product.

While the court noted that lump sum licenses can be more useful than running royalty licenses for proving a hypothetical lump sum payment, in this case the court found that the past lump-sum licenses were not sufficiently analogous. Lucent did not demonstrate the lump sum agreements involved comparable technology. The court stated, "Lucent's brief characterizes the four [lump-sum] agreements as covering 'PC-related patents,' as if personal computer kinship imparts enough comparability to support the damages award."[29]

Furthermore, one of the lump sum licenses was an agreement for a large patent portfolio. The court found that this was "directed to a vastly different situation than the hypothetical licensing scenario of the present case involving only one patent."[30]

Several other cases have addressed issues similar to those in *Lucent.* The cases show the courts working through questions of whether the litigants and their experts have sufficiently demonstrated a relationship between purportedly comparable license agreements and the hypothetical agreement.

B. Lump Sum versus Running Royalty

As in *Lucent*, the structure of a royalty as a running royalty or lump sum has been an issue where parties are attempting to demonstrate comparability of license agreements. In *Wordtech Sys. v. Integrated Networks*,[31] the Federal Circuit rejected a jury's lump sum damages award, finding that it was not supported by the evidence. Like the *Lucent* opinion, the court distinguished between lump sum and running royalty agreements.

The *Wordtech* court acknowledged that running-royalty agreements can be relevant to lump-sum damages, but it explained that some basis for comparison must exist in the evidence that is presented to the jury. The court found that the plaintiff provided no such basis for the eleven running-royalty agreements in evidence. Each of the eleven license agreements had royalty rates that were lower than the effective royalty rate awarded by the jury.

As for the lump sum license agreements in evidence, the court rejected them as well. The court explained that the agreements "provide[d] no basis for comparison with [the] infringing sales"[32] -- none of the licenses described how the parties calculated each lump sum, the licensees' intended products or expected sales. The lump sum damages award, which was the average of these two prior lump sum licenses for the same patents, was therefore rejected.

[29] *Id*. at 1328.
[30] *Id*.
[31] *Wordtech Sys., Inc. v. Integrated Network Solutions, Inc.*, 609 F.3d 1308 (Fed. Cir. 2010).
[32] *Id*. at 1320.

A slightly different issue was considered in the case of *Convolve, Inc. v. Dell Inc*.[33] The defendant's damages expert used third party license agreements to show that the industry preferred lump sum agreements. A district court allowed the expert's report and testimony to stand. The court found that the expert "gave adequate consideration to the comparability of the commercial circumstances and the technology at issue, particularly in light of the fact that [his] use of [those] licenses is limited to showing the existence of an industry preference for a lump-sum royalty – i.e., he made no attempt to incorporate the royalty rates underlying [those] licenses into his opinion."[34]

The court indicated that the analysis required from the expert would have been different if the expert wanted to present the royalty rates from the third party licenses to the jury. The court stated, "It is not sufficient to state that both the [patent-in-suit] and the patents underlying the [third party] licenses cover hard disk drive technology. Rather, [defendant] must establish the functionality enabled by the [patent-in-suit], as well as the functionality purportedly covered by the licensed patent, and compare their economic importance."[35]

C. Similarity of Technology

The *Lucent* court indicated that the technology covered by a license should be similar to the technology contemplated by the hypothetical negotiation. Other courts have also considered similarity of technology in analyzing comparability of license agreements.

As discussed previously, the *ResQNet*[36] court found five license agreements were not comparables for determining a reasonable royalty where, unlike the hypothetical agreement, they provided software, source code, and services (training, maintenance, marketing, upgrades) and allowed the licensees to re-brand products before resale or to bundle the product into a broader suite of software products. The court stated, "[N]one of these licenses even mentioned the patents in suit or showed any other discernible link to the claimed technology."[37] ResQNet's expert did not link the re-bundling licenses to the infringed patent. No factual finding was offered to account for the technological and economic differences between the licenses and the patent in suit.

In *Anvik Corporation v. Samsung Electronics America, Inc., et. al.*,[38] a district court sustained defendants' objections to producing certain license agreements after the court reviewed the agreements *in camera*. The court explained that "[t]he documents in question consist of certain cross-license agreements, involving multiple patents, and so-called 'know-how' agreements, and to certain modifications and extensions of those agreements. These agreements are vastly different from any potential licensing agreement that might have been entered into with regard to the patent which is the subject of these

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[33] *Convolve, Inc. v. Dell Inc., et. al.*, No. 08 Civ. 0244 (E.D. Tex. July 7, 2011)
[34] *Id*. at 1.
[35] *Id*. at 2.
[36] *ResQNet v. Lansa*, 594 F.3d 860 (Fed. Cir. 2010).
[37] *Id*. at 870.
[38] *Anvik Corp. v. Samsung Elecs. America, Inc.*, No. 07 Civ. 818 (S.D.N.Y. Sept. 30, 2011).

cases. It is difficult for the Court to ascertain any relevance that such agreements could potentially have, either to the discovery process or as evidence at trial."[39]

D. Relative Size of Patent Portfolio

The *Lucent* court rejected one license agreement that covered an entire patent portfolio when the hypothetical negotiation concerned one patent. Other cases have also involved license agreements that differed in scope from the hypothetical agreement. These cases indicate that parties must demonstrate how a license to multiple patents is probative of the hypothetical agreement.

The Federal Circuit in *Finjan v. Secure Computing*[40] affirmed a jury's $9.18 million damages award for three patents even though the evidence included a license agreement for $8 million covering a much larger technology portfolio. The defendants argued that the jury ignored a license agreement in which a third party, Microsoft, acquired a worldwide license to Finjan's entire patent portfolio for a lump sum of $8 million. Finjan identified several differences between the Finjan-Microsoft licensing scenario and a hypothetical negotiation with the defendants: 1) Finjan did not compete with Microsoft but does compete against Secure; 2) Finjan received significant intangible value from Microsoft's endorsements of Finjan; and 3) the license involved a lump sum instead of a running royalty. The court found that these differences permitted the jury to properly discount the Microsoft license.

In *Ricoh v. Quanta*,[41] the plaintiff's damages expert relied on past licenses involving groups of patents even though there were only two patents involved in the case. In this case, the district court allowed the expert's testimony. The court explained that under *Lucent*, multiple-patent licenses can be "comparable" as long as the plaintiff shows how the multiple-patent licenses are comparable or how the multiple patents impact the analysis. The court stated, "*Lucent* does not stand for the proposition that licensing agreements are not comparable as a matter of law unless they involve the same number of patents as those involved in the lawsuit."[42]

In *DataQuill Limited v. High Tech Computer Corp.*,[43] a district court excluded DataQuill's expert's testimony regarding significant patent agreements even though the expert showed that the agreements were technologically comparable. The court explained that the expert failed to show that "two worldwide licenses between [the defendant] and multiple technology companies covering thousands of patents are economically comparable to the license at issue in this case, a domestic license for two patents."[44]

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[39] *Id*. at 3.
[40] *Finjan v. Secure Computing*, 626 F. 3d 1197 (Fed. Cir. 2010)
[41] *Ricoh Co. Ltd. v. Quanta Computer, Inc.*, No. 06-462, 2010 WL 1233326 (W.D. Wis. Mar. 23, 2010).
[42] *Id*. at 9.
[43] *DataQuill Limited v. High Tech Computer Corp*., No. 08-543, 2011 WL 6013022 (S.D. Cal. Dec. 1, 2011).
[44] *Id*. at *21.

E. Adjustment for Uncertainty

Courts have considered other factors in analyzing comparability of license agreements. In some cases, parties have been permitted to argue that a royalty rate for a hypothetical negotiation should be higher than rates for comparable licenses because comparable licenses have been discounted for uncertainty as to a patent's validity.

In *Spectralytics, Inc. v. Cordis Corp.,*[45] the Federal Circuit stated that a patent may be less valuable at an earlier time (i.e., when it reflects a "deep discount") when there is uncertainty as to its validity or infringement.

Similarly, in *Mondis Technology v. LG Electronics,*[46] a plaintiff was allowed to argue that the royalty rate for the hypothetical negotiation should be higher than the rates negotiated for the comparable licenses. The court explained, "Because Federal Circuit law allows for the fact that real world licenses might be greatly reduced for uncertainty, the Court will allow [Plaintiff's damages expert] to opine that the 'standard royalty rates' would be tripled if infringement and validity were established."[47]

F. Use of Publicly Available Rates

Recent case law has also addressed the use of publicly available royalty rates. In *IP Innovation v. Red Hat*[48] the court excluded plaintiff's damages expert where the expert relied on industry royalty rates from third party studies. The court explained that the unsupported use of general industry rates is not sufficient. Judge Rader, sitting by designation, stated that the expert offered, "no evidence that the alleged industry agreements [were] in any way comparable to the patents-in-suit."[49] Furthermore, the court stated, "Instead of relying on these studies, [the expert] should have at least inaugurated his analysis with references to the existing licenses to the patents-in-suit,"[50] even though they were entered more than 10 years before the hypothetical negotiation. This case again highlights the trend in the case law that litigants need to offer rigorous analysis to demonstrate how the purportedly comparable licenses relate to the specific circumstances in the case.

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[45] *Spectralytics, Inc. v. Cordis Corp.*, 649 F. 3d 1336 (Fed. Cir. 2011).
[46] *Mondis Technology Ltd. v. LG Electronics, Inc. et al.*, No. 07-565, 2011 WL 2417367 (E.D. Tex. June 14, 2011).
[47] *Id*. at *4.
[48] *IP Innovation L.L.C. v. Red Hat, Inc.*, 705 F. Supp. 2d 687 (E.D. Tex. Mar. 2, 2010).
[49] *Id*. at 691.
[50] *Id*.