Towards an Efficient Market for Innovation

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Summary

Court awarded reasonable royalty determinations provide the backdrop against which all patent settlements and patent licensing activities are measured. Collectively, these settlements and licenses define an IP market in which developers and implementers of IP come together to trade the rights necessary to provide goods and services. This market must function efficiently, minimizing market friction and transaction costs that are ultimately passed along to consumers. Thus, it is paramount that royalties fairly compensate the patentee and fairly charge the licensee. Damages awards that reflect the economic value of an innovation appropriately balance interests and act as essential references for IP market participants, since patentees and licensees are respectively neither overcompensated/overcharged nor under-compensated/undercharged. IBM believes that an efficient IP market is important for promoting innovation, including for the development of complex products incorporating multiple inventions[1] that have become commonplace; and that an efficient IP market rests heavily on the ability to predict with a high degree of certainty the legal remedies available for patent infringement. Damages determinations informed by the economic value of the essential features of an invention as articulated in the Supreme Court's Quanta decision,[2]

[2] Technology industries are evolving towards providing products and services incorporating multiple innovations from multiple sources and are evolving further towards open innovation. Collaborative development may be horizontal -- in which multifunction products such as computer systems incorporate innovative features from multiple sources; or vertical -- in which single function products such as pharmaceuticals reflect inventions from multiple "upstream" and "downstream" participants in the development "chain".

[1] While multi-function products tend to have high visibility in the IT sector, there is a similar issue in biotechnology due to the multiparty nature of research

As technologies have become more complex, it is typically no longer feasible for any one party to be the source of all the innovative aspects and/or components that are integrated into advanced products. Providers are increasingly integrating multiple inventions of multiple parties -- often competitors -- into increasingly complex products. Incorporating innovation from multiple sources is enabled by: (1) open innovation environments, such as the open source software model; (2) technology standards, where innovators work collaboratively to create a common platform for product-level competition; and (3) licensing and cross-licensing of technology to gain access to others' innovations.

The information technology sector is not unique in this regard. Licensing and cross-licensing are of course common in many industries, and collaborative innovation through open platforms and standards has blossomed across numerous industries in recent years. The U.S. economy as a whole will therefore benefit from an efficient IP market where certainty in damages determinations ensures efficient access to innovation, reduces transaction costs, and avoids unwarranted speculation.

IBM's Perspective on Collaborative Innovation and New IP Models

ing fee should be judged since it is the measure for damages if they are forced to litigate. Given the challenging developments in the market and the resulting challenges in licensing, it is of paramount importance that the law of damages provides clear guidance.

C. Proposed Solutions: Emphasis on "Best Practices" for Damages Law Will Support an Efficient IP Market

To facilitate an efficient market in ideas and licensing, IBM supports an increased focus on best practices for determining patent infringement damages. IBM believes that IP market efficiency can be ensured by focusing the damages calculation on the economic value of the essential features of the subject invention. In particular, IBM believes that this focus can be ensured by: (1) incorporating Quanta's "essential features" concept into the damages determination; (2) encouraging District Courts to increase precision in EMVR and Convoyed Sales determinations; and (3) encouraging District Courts to better exercise their gatekeeper powers to cause rigorous expert analysis and review of damages evidence and reasonable royalty determinations. IBM believes these recommendations are representative of best practices that are supported by Federal Circuit law. Both Congress and the Federal Circuit can play helpful roles in effecting the above recommendations. For this reason, IBM supports both careful judicial management as well as enactment of patent reform legislation that addresses reasonable royalty damages.

1. Incorporation of Quanta "Essential Features" Standard into Damages Determination.

Application by analogy of the Quanta Court's formulation of the "essential features" of a patented invention to damages determinations will focus the damages determination on the value of what the inventor actually invented. In the unanimous Quanta decision, the Court held that if a patentee sells (or licenses another to sell) a product that includes all the essential features of a patented invention,[6] then the patent rights are "exhausted" meaning that the patent can no longer be asserted against downstream buyers of that product. The underlying theory behind the patent exhaustion rule is that "in such a transaction, the patentee has bargained for, and received, an amount equal to the full value of the goods."[7] In other words, the patentee received full compensation when the product was sold, and is not entitled to collect an additional royalty.[8] The connection between Quanta and the law of exhaustion on the one hand, and the determination of patent damages on the other, is the Court's renewed focus on the substance of the invention in determining the proper scope of patent protection. Thus, the economic value of the essential features of the invention should correspond to the full value of the invention.

[6] The "essential features" exclude "common processes" or "standard parts," even if included in the claims. *See* Quanta, 128 S.Ct. at 2120. Determining what constitutes the "invention" is of course fundamental to the determination of damages under the patent statute, which requires that damages are no "less than a reasonable royalty for the use made of the invention by the infringer." 35 U.S.C. Sec. 284.

[7] B. Braun Med., Inc. v. Abbott Labs., 124 F.3d 1419, 1426 (Fed. Cir. 1997); *see also* Adams v. Burke, 84 U.S. (17 Wall.) 453, 456-57 (1874); Keeler v. Standard Folding Bed Co., 157 U.S. 659, 663-64 (1895).

[8] *See* PSC v. Symbol Techs., 26 F. Supp. 2d 505, 510 (W.D.N.Y. 1998) ("The purpose of the exhaustion doctrine is to 'prevent[] patentees from extracting double recoveries for an invention . . . .' Cyrix Corp v. Intel Corp., 846 F. Supp. 522, 539 (E.D. Tex.), aff'd 42 F.3d 1411 (Fed. Cir. 1994).")

Judge Rader sitting by designation recognized the significant burden of proof that application of the EMVR should require:

> "Moreover, neither Cornell nor Dr. Stewart has offered sufficient economic proof that the component of a component of a part of the server and workstation systems drove demand for the entire server and workstation products and entitles Cornell to damages on sales of Hewlett-Packard's entire servers and workstations".[13]

It is important to encourage widespread and vigorous application of this evidentiary threshold so that the "reach" of patent protection afforded an invention does not extend beyond the actual invention and onto unrelated components or features of a product incorporating the invention unless the invention is in fact "**the** basis for customer demand" for the entire product that nevertheless includes other functions or features.

Finally, as IBM understands application of the EMVR it may be based on demand driven by the claimed invention as expressed by all of its respective limitations.[14] IBM suggests that in an environment characterized by the proliferation of complex products incorporating multiple inventions, the fairest application of the law would require evaluating whether the demand is driven by the invention itself – i.e. by the essential features of the patented invention. This avoids giving weight to claim elements that may be unrelated to the invention, in applying the EMVR.

3. Judicial Gatekeeping

In the Cornell case mentioned above, the court also excluded damages expert testimony because the purported expert failed to "show a sound economic connection" between the claimed invention and the proffered royalty base.[15] IBM believes that such strong gatekeeping is highly supportive of an efficient market in IP, and should be encouraged by the Federal Circuit. District Courts that provide clear articulation of the logic and factors relied upon in their damages decisions provide a better foundation for review, and equally importantly provide the clear guidance for negotiators that is critical for commercial entities and the public. Rigorous requirements for damages experts, coupled with clear articulations of the bases for damages determinations, creates certainty for licensors and licensees alike, improving the efficiency of IP markets.

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[13] *Id.* at *7.

[14] Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538 (Fed. Cir. 1995) ("Subsequently, our predecessor court held that damages for component parts used with a patented apparatus were recoverable under the entire market value rule if the patented apparatus 'was of such paramount importance that it substantially created the value of the component parts.' Marconi Wireless Telegraph Co. v. United States, 99 Ct. Cl. 1, 53 U.S.P.Q. (BNA) 246, 250 (Ct. Cl. 1942), aff'd in part and vacated in part, 320 U.S. 1 (1943). We have held that the entire market value rule permits recovery of damages based on the value of a patentee's entire apparatus containing several features when the patent-related feature is the 'basis for customer demand.' State Indus., 883 F.2d at 1580, 12 U.S.P.Q.2D (BNA) at 1031; TWM Mfg. Co. v. Dura Corp., 789 F.2d 895, 900-01, 229 U.S.P.Q. (BNA) 525, 528 (Fed. Cir.), cert. denied, 479 U.S. 852, 93 L. Ed. 2d 117, 107 S. Ct. 183 (1986)."). In Rite-Hite, the court declined to apply the Entire Market Value Rule to the dock levelers since they did not function together with the patented vehicle restraint to achieve one result, but could have been

Conclusion

IBM believes an efficient IP market will benefit innovators/licensors, producers/licensees, and most importantly the public. The jurisprudence of the Federal Circuit supports the best practices that will facilitate an efficient IP market and fair licensing results for all participants in the IP marketplace. IBM supports both careful judicial management and enactment of patent reform legislation addressing reasonable royalty damages to achieve consistent and predictable application of these best practices. This will focus damages analysis around essential features of the patented invention, engender precise application of the Entire Market Value Rule and Convoyed Sales doctrine, and encourage district courts to perform a careful gatekeeping role, and thus will ensure efficient functioning of the IP marketplace in an era characterized by a wide array of innovation and a wide array of products and services delivering that innovation to the public.