Can A Reasonable Royalty Ever Be Zero?

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The complexities associated with industry standards in the world of high-technology products and services provide a good backdrop for examining questions around reasonable royalty. Consider the following:

Since 2000, MakeIt, Inc. has been manufacturing and selling laptops and peripheral devices under its own brand. It also supplies finished products to original equipment manufacturers. MakeIt has sued BigCo for patent infringement. In response, BigCo has sued MakeIt for infringing one of its patents covering laptop technology. MakeIt discovers that the patent-at-issue relates to an industry standard that was adopted more than 10 years ago. In addition, BigCo owns several patents relating to laptop standards, though historically it has never licensed nor affirmatively enforced any of those patents. BigCo's only use of the patent at-issue has been in counterclaims against those bringing suit against it for infringement of other patents.

MakeIt feels quite comfortable about its affirmative suit against BigCo. But it must also evaluate the risk exposure and the likely trial and reasonable royalty outcome of BigCo's counterclaims. In particular, the laptop technology covered by the patent-at-issue is an industry standard that is intertwined with other laptop standards. Because the industry expects that all laptops comply with that standard, switching to an alternate solution likely would be difficult and costly, if not impossible, for any individual entity such as MakeIt. On initial examination, the risk exposure appears substantial.

In assessing patent infringement damages, patent law calls for damages "not less than a reasonable royalty." In particular, if the technology at issue is part of a "must use" industry standard, defense lawyers are typically faced with managing damages analyses where the lack of an acceptable non-infringing alternative may be *prima facie* evidence of a high "reasonable" royalty. However, in certain circumstances a reasonable royalty of zero may be the appropriate and reasonable outcome under the framework of 15 factors established in *Georgia-Pacific v. U.S. Plywood* (1970) for assessing damages, even if infringement is found.

Some recent patent infringement cases involving Internet technologies support the proposition that, given certain facts, the outcome of a hypothetical negotiation may in fact be a royalty-free license. No one individual factor would necessarily impel the trier of fact to conclude that a reasonable royalty would be zero. But, depending on the facts of the case, the collective evidence may point to a royalty-free license as the reasonable and appropriate outcome of a hypothetical negotiation.

In thinking about the hypothetical royalty negotiation, it is important to remember that the negotiation is presumed to take place at the date of first infringement. That date is often many years before trial, and may even be before the patented technology was adopted as an industry standard. Circumstances at the time of the hypothetical negotiation have a powerful influence on the reasonable royalty rate.

We raise some of the possible issues:

1) **If the patented technology had been adopted as an industry standard, should the hypothetical negotiation be between only the patent holder and the accused infringer, or implicitly with other collective users as well?**

A hypothetical negotiation is generally understood to be between the patent holder and the accused infringer. However, when the patented technology is an industry standard or has been widely adopted, that may not be a realistic expectation – especially if collectively the users of the patented technology can effect a change to an alternative solution. Therefore, when using an industry standard, a negotiation with one user may be the same as negotiations with all potential users. For example, the reasonable royalty outcome of a hypothetical negotiation would be very different for a single accused infringer without an acceptable alternative than it would for a collective group of accused infringers with the option; to switch to another solution, perhaps by redefining the industry standard. Even if the negotiation is presumed to be between the patent holder and the infringer, the negotiating parties must understand that their negotiating positions and conclusions would become known and would influence the patent holder's relationships with other potential patent licensees.

Related questions might investigate how the patented technology came to be an industry standard or so widely adopted by the users. For example, did the patent holder "induce" adoption of the patented technology by affirming a zero-royalty position or by remaining silent on the issue of licensing in the face of implicit or explicit obligations to disclose its policies, potentially giving the impression that it would not be seeking a royalty? Or did the patent holder articulate a clear position about providing limited royalty-free licensing for certain circumstances but retaining non-zero licensing rights for other uses?

2) **Does the patent holder have a history of advocating for royalty-free licensing (as in the case of open source software) when patented technologies belong to other entities?**

If the patent holder has a history of advocating royalty-free licensing for technologies belonging to other entities, it may be reasonable to expect that the patent holder similarly would offer its technology royalty-free. It would be unreasonable for the patent holder to grant its technology special status while demanding that other innovators offer their patented technologies for free.

3) Does the patent holder have a history of not seeking a royalty for its patented technologies, either through lack of prior licensing activities or lack of litigation in the face of widespread use (and presumed infringement)?

If the patent holder has a demonstrated history of not seeking a royalty for its patented technologies, *Georgia-Pacific* Factor 4 (as well as *Georgia-Pacific* Factor 1 if the patent holder did not take any action when the technology at issue became adopted as a standard) would point to a royalty-free license.[1]

The users of the patent holder's other technologies would expect that the patent holder would not seek a royalty for the technology at issue. Therefore, a sudden change in licensing policy that is applicable only to the hypothetical negotiation may seem unreasonable and be inconsistent with the expectations surrounding the hypothetical negotiation. This point becomes even stronger if the patent holder shows a history of advocating for royalty-free licensing in the case of others' patented technologies. The patent holder expects to neither pay nor receive a royalty for a patented technology used in the industry.

4) Was the patent holder a participant or contributor in standards-setting organizations, in which it may be required to disclose the patent-in-suit and its licensing policies?

Many standards-setting organizations such as the Institute of Electrical and Electronics Engineers and the Internet Engineering Task Force, strongly encourage or even require participants to disclose patents that may be relevant to Standards-setting organizations often require that patent holders, if they intend to seek a royalty, either offer licensing under reasonable and nondiscriminatory terms or disclose the terms under which licensing would be granted. Often, such a disclosure is implicitly or explicitly taken into account by the organization's participants in deciding which of several possible standards will be adopted.

Standards-setting organizations intend for the disclosure requirement to provide full information to participants in the standards-setting process. In the event that a holder of a patent applicable to a technology being considered for adoption as a standard intends to seek royalties for that technology, the participants can weigh the patented technology against an alternative solution, possibly one offering more favorable licensing terms. This would entail an implicit or explicit negotiation between the patent holder and the collective users, as represented by the standards-setting participants. The collective members who have the ability to choose an alternative solution would have a stronger bargaining position than would any individual member.

At the time of their initial adoption, many technologies often have several low-cost alternatives. Once they are adopted, users may come to rely on the technology as it is incorporated into industry standard products. This "network effect" makes the technology much more valuable after its adoption than before. Full disclosure before the standard is adopted would prevent opportunistic patent holders from extracting above-market royalties through a "hold-up" from users after the adoption of the standards. At that point, it would become difficult for any individual entity to switch to a non-infringing alternative, even if the alternative would have been low cost before the standard was adopted. In this case, the value of the "unreasonable" royalty stems from the patented technology being adopted as a standard, not necessarily from the intrinsic benefit the technology provides. A patent-holder's failure to disclose a restrictive licensing policy, or its attempts to enforce a patent after it becomes part of an industry standard, may suggest that the patent's success should not be attributed to the inherent advantages of the patent itself. The standards-setting organization was more than likely misled.

This question also is linked to the earlier query about whether the hypothetical negotiation may be viewed as being with all users of the patented technology. If a patent holder was a participant in a standards-setting organization and had an obligation to disclose the patent, then a negotiation would have occurred with members and users at that time.

5) What is the history of users in this industry paying a royalty on patented technologies related to adopted industry standards?

If licenses, and especially royalty-bearing licenses, do not exist, that may suggest that the "customary" amount (as that word is used in *Georgia-Pacific* Factor 12) attributable to a royalty is zero.[2]

Is there a lack of disclosed licenses relating to industry standards (for example, from Securities Exchange Commission filings) from publicly traded companies in the relevant industry? If so, there are two possible reasons why. The first is that the licenses are not material and so are not reported; the second is that companies in the industry do not seek licenses. Both scenarios would suggest a low royalty or royalty-free license.

For example, in examining licenses in the Internet industry for a recent patent infringement matter, we found there were no royalty-bearing licenses relevant to a particular set of technologies. This fact, combined with widespread adoption of the technologies, strongly suggested that both patent holders and technology users expected to use the technology royalty-free. In fact, many attributed the success of the technology in the marketplace to the fact that the technology could be freely adopted by all. The lack of such licenses may suggest that an after-the-fact claim of a non-zero royalty would be inconsistent with historical behavior.

6) Did the accused infringer uniquely benefit from using the patented technology, when compared to its competition?

If the patented technology were used by all or a significant number of the accused infringer's competitors, all competitors would benefit equally, and it is unlikely that the accused infringer could have earned additional profits associated with using the patented technology. Since the accused infringer did not earn additional profits from infringing the patented technology, there is nothing to share with the patent holder.[3]

It is possible that the entire industry may have benefited from the use of the patented technology; however, this issue takes us all the way back to our first question, about whether the hypothetical negotiation implicitly should be between the patent holder and the collective users, rather than merely with the particular accused infringer.

7) Did the patent holder benefit from the adoption of the technology covered by the patent-in-suit?

If the patent holder provides services or products that utilize the patented features, and the adoption of the technology as an industry standard (de facto or otherwise) directly or indirectly promoted the sale of such services or products, then the patent holder has benefited even if it does not receive royalties. The patent holder also may have benefited indirectly from the adoption of the patented technology as a standard, for instance by cultivating a reputation as an industry innovation leader, which may translate into increased sales. Hence, even if the patent holder were to have offered a royalty-free license (which it may have by not disclosing the patent when the technology was adopted as a standard), it has benefited. Therefore, a royalty-free license does not imply that the patent holder received or would receive no benefit from licensing and should not be considered a priori to be unreasonable.

Further, if acceptable royalty-free or low-cost solutions to the patented technology exist, it is unlikely that the patent holder would have been able to seek a substantial royalty and have the technology adopted as a standard. Therefore, the benefit already received by the patent holder from the adoption of the patented technology is consistent with a royalty-free license.

8) Did the accused infringer breach any explicit terms of a royalty-free license such that the license may be revoked?

The answer to this question could counteract other evidence for a royalty-free license. For example, if the patent holder historically has publicly disclosed that it would provided royalty-free licenses for some or all of its technologies, but has set forth terms for such licenses, a violation of those terms by the accused infringer would in effect revoke any implied royalty-free license for the patented technology for the accused infringer alone. In that event, the argument in favor of a royalty-free license would be weaker, even if the other relevant case evidence points to a zero royalty. Moreover, since only the accused infringer is without a license, the hypothetical negotiation with the collective users discussed above no longer applies.

These questions offer a framework by which litigators can cut through the complexity of a reasonable-royalty analysis pertaining to industry standards or widely adopted technologies. Using this framework, the general counsel of MakeIt can assess the reasonable royalty for the patent-in-suit, and specifically whether the outcome of a hypothetical negotiation is likely to be a royalty-free license.

ENDNOTES

1. *Georgia-Pacific* Factor 4: The licensor's established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention or by granting licenses under special conditions designed to preserve that monopoly.

   Georgia-Pacific Factor 1: The royalties received by the patentee for the licensing of the patent-in-suit, proving or tending to prove an established royalty.
2. *Georgia-Pacific* Factor 12: The portion of the profit or of the selling price that may be customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions.
3. Consider *Georgia-Pacific* Factor 13: The 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.