

# HEALTH

# news

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## Changes in the Patent Landscape: Legislative Bills and Judicial Decisions—How They Affect Life Sciences and Other Industries

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**After several years attempting to pass legislation that would reform the patent system, it appears that Congress will soon succeed. The pending reforms are interesting, both for what is included and for what was removed from prior versions. For instance, provisions related to calculating damages in patent infringement matters are no longer being considered, although recent judicial decisions have changed the landscape regardless. In this article, we examine the effects of some of those recent judicial decisions on damage calculations in complex patent litigation, as well as the potential effects of the proposed change from a “first-to-invent” to a “first-to-file” system on the life sciences industry in particular.**

On March 8, 2011, the Senate voted 95–5 in favor of a bill supporting patent reform, known as the America Invents Act<sup>1</sup> and a similar bill has been introduced in the House of Representatives.<sup>2</sup> Some of the provisions included in both versions of the bill include:

1. Changing the system to grant a patent to the first inventor who files for a patent, rather than the first to invent it
2. Granting the Patent and Trademark Office (PTO) fee-setting authority

<sup>1</sup> <http://www.gpo.gov/fdsys/pkg/BILLS-112s23es/pdf/BILLS-112s23es.pdf>.

<sup>2</sup> <http://www.gpo.gov/fdsys/pkg/BILLS-112hr1249ih/pdf/BILLS-112hr1249ih.pdf>.  
On April 13, the U.S. House of Representatives' Judiciary Committee voted 32–3 in favor of the bill. It will now go to the full House.

3. Allowing the PTO to keep the proceeds it collects
4. Reducing the ability to file false marking claims
5. Providing for additional and expanded means by which a third party can challenge a patent or patent application.

Provisions that would have governed the way damages could be calculated in patent infringement cases were removed from the bill that was approved by the Senate, and the one introduced in the House. While discussion of these provisions was contentious during the debate over previous versions of patent reform bills, several recent court decisions have changed the landscape without Congressional action.

## First-to-File

The transition to a first-to-file system is considered by many to be the most significant provision of the pending legislation. While the first-to-file system will bring the U.S. patenting process more into line with practices in many other countries, it has received mixed responses from members of the life sciences (pharmaceutical and medical device) industries. The Biotechnology Industry Organization (BIO) issued a statement in which they opine that this provision would improve the patent system and enhance patent quality.<sup>3,4</sup> AdvaMed also supports the transition to a first-to-file system, because “it will promote international harmonization and generate efficiencies.”<sup>5</sup> However, in sharp contrast, nine groups representing U.S. small businesses, startup entrepreneurs, independent inventors, and technical professionals sent letters to their representatives opposing the first-to-file system, because it “impedes the important process of incubating and vetting inventions.”<sup>6</sup>

The current first-to-invent practice is often touted as providing small inventors a more equal opportunity of being granted a patent as big companies that are typically better equipped to file applications. The pre-filing grace period permits inventors to share innovative ideas without fear of leaks or piracy, to raise capital, to refine those ideas, and to discard the ones that prove worthless before requiring that a patent application be filed. With a change to a first-to-file system, inventors may have to consider how to strategically shorten the time from conceiving an invention to applying for a patent, such that they can be the first to file with an invention that is reasonably mature. Assistance from

technical experts in the subject matter of the invention can help accelerate the technology assessment process and shorten the time to arrive at adequate proof of concepts, thus allowing the inventor to file first. This consultation may come with additional costs that may pose additional challenges to start-ups as they raise capital.

In addition, if inventors file their applications sooner, the effective filing date will be earlier, thereby shortening the period during which prior art can be considered for a patent invalidity allegation. Technical experts can assist in evaluating prior art from the perspectives of anticipation and obviousness, to assess the validity of the patent.

## Calculating a Reasonable Royalty Rate and the 25 Percent Rule

In *Microsoft v. Uniloc* (“*Uniloc*”), the court essentially did away with the so-called “25 percent rule of thumb” which proposes that a licensee pay a licensor a royalty rate equivalent to 25 percent of its expected profits for the product that embodies the intellectual property at issue.<sup>7</sup> The establishment of the 25 percent rule is largely accredited to Robert Goldscheider, who published an article in 1994 in which he examined 18 licenses that one of his clients, a Swiss subsidiary of an American company, had entered into for a portfolio of patents, know-how, trademarks, and copyrighted marketing materials. The licensees were located around the world and were contracted for three-year, renewable periods.<sup>8</sup> It has been argued that this small sample of specific licenses is not sufficiently broad to establish any general pattern or “rule.” Later, in 2002, Goldscheider, with co-authors John Jarosz and Carla Mulhern, published an article in the journal of Licensing Executives Society International, *les Nouvelles*, concluding that “[t]he [25 Percent] Rule continues to have a fair degree

3 BIO press release “BIO commends launch of house patent reform process” at: [http://www.bio.org/news/pressreleases/newsitem.asp?id=2011\\_0331\\_02](http://www.bio.org/news/pressreleases/newsitem.asp?id=2011_0331_02).

4 Even though BIO commends the inclusion of the first-to-file provision, they object to the bill being considered on the House floor due to the inclusion of a supplemental examination provision. See: <http://ipwatchdog.com/2011/04/15/house-patent-reform-bill-is-in-need-of-reform-bio-to-oppose/id=16474/>.

5 AdvaMed letter to Leader Reid and McConnell dated February 25, 2011; accessed at: [http://www.patentmatter.com/issue/pdfs/20110228\\_other\\_letters\\_of\\_support.pdf](http://www.patentmatter.com/issue/pdfs/20110228_other_letters_of_support.pdf).

6 Letter by American Innovators for Patent Reform et al. to U.S. House of Representatives, dated 3/29/11 accessed at: <http://www.patentdocs.org/2011/04/reaction-to-house-patent-reform-bill.html>.

7 Robert Goldscheider, John Jarosz, and Carla Mulhern, “Use of the 25 Per Cent Rule in Valuing IP,” 37 *les Nouvelles* 123 (December 2002), pp. 123–133.

8 Robert Goldscheider, John Jarosz and Carla Mulhern, “Use of the 25 Per Cent Rule in Valuing IP,” 37 *les Nouvelles* 123 (December 2002), pp. 123–133.

of both ‘positive’ and ‘normative’ strength.” The article itself, however, seems to belie this statement, because it is based on a finding that, on average, over certain selected industries, royalties as a percent of operating profit are in the range of 25 percent. However, the distribution of the values over which that average is calculated (i.e., the variance) is so large that blind application of the 25 percent rule could be considered unfounded. Indeed, in one of the examples given by the authors, application of the 25% rule would actually leave the licensor in a worse position, all else equal, than it would have been if it did not use that patent at all.

### Calculating a Royalty Base and the Entire Market Value Concept

In another recent case, *IP Innovation LLC v. Red Hat* (“*Red Hat*”), the court issued an order to exclude the testimony of a damages expert. The order did not mention the 25 percent rule of thumb specifically, but it rejected a damages analysis in part because the royalty rate used by the expert as a starting point was derived from studies of industry averages and did not consider licenses or information specific to the patents at issue.<sup>9</sup> The 25 percent rule, which was shown in the article discussed above to be a rule only as it related to industry averages, has also been rejected as it is not specific to any given patent being litigated.

Despite foreshadowing the royalty rate discussion in *Uniloc*, the order in *Red Hat* is better known for its criticism of the plaintiff’s expert’s calculation of the royalty base (which is the revenue against which a royalty rate is applied). The expert used the defendants’ total revenues from sales of subscriptions to the accused operating systems in his proposed royalty base, or what is known as the “entire market value” of the final product. The expert then applied the royalty rate he derived to this royalty base to arrive at his calculation of damages. The court determined that his methodology

was unsound on both counts—the royalty rate, for reasons discussed above, and the royalty base because the feature was only a small part of the product and was not shown to drive demand for the entire product.<sup>10</sup>

Economically most important is whether the royalty rate and the base are not only correct, but also consistent with one another. The value of the patent is the incremental value it creates—often calculated as the difference between the profits generated by the product without the patented feature (with the next-best alternative) and the profits with the patented feature.<sup>11</sup> Whether that difference is calculated based on a royalty rate applied to the entire market value of the product, or one applied at the level of a component part, at least in the short run, is simply a matter of math. The royalty rate is not determined in a vacuum; it depends on the royalty base to which it is being applied. It is not economically rational to determine one without considering the other. Nonetheless, the decision in *Red Hat*, combined with similar decisions in the matters of *Lucent Technologies v. Gateway*,<sup>12</sup> *Cornell University v. Hewlett-Packard*,<sup>13</sup> and *Uniloc* (which, in addition to rejecting the royalty rate, also rejected the royalty base as being too broad) should make experts very cautious if they choose to use all revenue from sales of a product that contains the patented element as only one component of a larger good.

### Conclusion

The Patent Reform Bill that is currently in front of the House, and the version that has already been passed in the Senate would bring about important changes in patent law. In particular, the change from a first-to-invent to a first-to-file system may require companies to file more quickly and engage additional assistance in

<sup>9</sup> *IP Innovation LLC v. Red Hat Inc.*, No. 2:07-CV-447 (RRR), 2010 WL 986620 (E.D. Tex. Mar. 2, 2010).

<sup>10</sup> *IP Innovation LLC v. Red Hat Inc.*

<sup>11</sup> It is common to think of an increase in profits being associated with a higher price or additional sales; however, a technology that lowers costs, for instance, is also likely to result in higher profits.

<sup>12</sup> *Lucent Techs. Inc. v. Gateway Inc.*, 580 F.3d 1301 (Fed. Cir. 2009).

<sup>13</sup> *Cornell University v. Hewlett Packard Company*, 609 F. Supp. 2d 279 (NDNY), 2009.

the form of technical experts familiar with the patent field. In addition to the legislative changes that appear imminent, the courts have handed down several decisions that are having an impact on patent damage calculations. The economic value of a patent, and any damages associated with its infringement, must be tied to the incremental value that the specific patent creates. In recent decisions, the courts have rejected analyses that do not ultimately reflect that reality. While those decisions have been discussed extensively, they primarily affirm the method by which patent damages are calculated by some experts already. Damages experts will have to continue ensuring that their analyses are consistent with the economic reality with which they are faced.

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### Recent Exponent Publications

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