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June 30, 2008

The Honorable Patrick Leahy
433 Russell Senate Office Building
United States Senate
Washington, DC 20510

The Honorable Orrin Hatch
104 Hart Senate Office Building
United States Senate
Washington, DC 20510

Re.: Patent Reform Act (S. 1145)

Dear Senators Leahy and Hatch:

When Congress focuses again on patent reform, I urge the Senate not to amend section 284 as provided in the Patent Reform Act, Senate bill 1145 dated January 24, 2008. Section 284 provides damages for patent infringement. Senate Report 110-259 of the Committee on the Judiciary on this bill reflects the considerable effort and thought given to this issue. Since I am urging Congress not to enact these amendments in spite of that work, I should explain my reasons in some detail. This explanation is in the enclosed paper titled "Patent Damages, the Patent Reform Act, and Better Alternatives for the Courts and Congress." This letter is a summary. There are many problems with the law of patent damages.[1] The bill addresses four of them. I discuss three and ignore the fourth, patent marking under section 287.

The Problems with Reasonable Royalty Damages. The main premise of these amendments is that reasonable royalty damage awards frequently exceed the economic value of patented inventions. (sections II and III of the paper) The amendments address two problems with reasonable royalty damage awards.

One is that juries are not given useful guidance on how to apply the so-called *Georgia-Pacific* factors and the entire market value rule. The other problem is that damages are too large in many cases because damages are determined by multiplying an infringer's total revenue from sales of some product by some rate (such as X percent) and the infringed patent did not make available an entirely new product. The invention merely provided some addition or modification to an existing product. A similar issue arises when the revenue from sales of two products is used to measure damages and the infringed patent covers only one of them. The report also

[1] I described the problems with patent damages in Chapter 13 of a book, *Patent Law, Legal and Economic Principles,* West Group (1992, 2d edition 2007). See sections 13:131 – 13:171.

refers to the problem that arises when the infringed patent is merely one of many patents covering inventions used in the same infringing product. The amendments do not appear to address that problem.

The Proposed Solution. In response, the proposed amendments require that a judge pick one of three "methods" or theories by which reasonable royalty damages may be determined. (section IV.A.)

Entire Market Value Method. One "method" is the entire market value rule. S. 1145, section 284(c)(1)(A). The entire market value rule is not and should not be a separate theory of reasonable royalty damages. (section IV.B.) The entire market value rule is and always has been merely one step in the process of determining damages for lost profits (the rule's historical role) or an amount not less than a reasonable royalty (a role the rule has played more recently). If some courts are applying the entire market value rule as a separate damages theory or permitting juries to treat it as one, those courts are making a serious error under existing law. Rather than correcting that error, the amendments may be understood to require it.

There are also several versions of the entire market value rule. The amendments require use of a version ("the basis for consumer demand" test) that is sometimes applied in a way that fails to identify inventions that are responsible for the entire revenue and profits some infringer earns from the sale of some product. Most patents relate to some change to an existing product. Most companies charged with patent infringement could have sold a product without infringing the patent, a product without the patented change. Patents that make available an entirely new type of product are rare. Nonetheless, the courts frequently find that some patented variation of an old product is the basis for an infringing company's entire revenue and profits. The version of the rule the amendments would require contributes to this problem and would likely prevent the courts from employing a better approach.

The Valuation Calculation Method. Another optional theory is what the bill calls the "valuation calculation" rule. S. 1145, section 284(c)(1)(C). This rule may be applied if a judge decides the entire market value theory does not. (section IV.C.) When applicable, the amendments require that "...the court shall conduct an analysis to ensure that a reasonable royalty is applied only to the portion of economic value of the infringing product or process properly attributable to the claimed invention's specific contribution over the prior art." If this language means damages are the portion of the economic value of the infringing product properly attributable to the patented invention, the amendment is sensible in most situations, assuming the courts identify that portion of economic value in the proper way. The bill and the report do not identify the proper way to do so. There is a way well known to the law that I describe in a moment.

For reasons I discuss in the paper, the courts are likely to understand this language to have a different meaning, namely that damages are some portion of an infringer's total revenue attributable to the invention multiplied by a reasonable royalty rate. Again, the bill and the report do not say how to determine a rate that will lead to a sensible award when applied to this portion of revenue. If the rate is less than 100 percent, as the courts are likely to believe, damages will be too low. Given these issues, the ultimate effect of this feature of the amendments on total damages is unclear and, like the entire market value amendment, poses an obstacle to a better approach.

A Better Approach. This is the better approach. The perceived problems may be solved by using a principle the courts have recognized and applied in the context of lost profits, and have applied and perhaps not always recognized in the context of reasonable royalty damages.

(section IV.F.) With some refinements discussed in the paper, reasonable royalty damages should be the difference between the net profits the infringer earned from sales of the infringing product and net profits it could have earned using the next best non-infringing substitute available to it during the period of infringement. The economic value of the invention is this difference in profits. This approach to reasonable royalty damages solves the problem of patents to changes in existing products. This approach is entirely consistent with the origins and purpose of reasonable royalty damages. This approach is one feature of the existing law on reasonable royalty damages and fails to lead to sensible damages awards in all cases because other features of the law obfuscate its significance.

I believe it is likely this approach is what the amendments attempted to require when applying the "valuation calculation" rule. Section 284(c)(1)(C)("...the court shall conduct an analysis to ensure that a reasonable royalty is applied only to the portion of economic value of the infringing product or process properly attributable to the claimed invention's specific contribution over the prior art.") Properly understood, the "economic value of the infringing product or process properly attributable to the claimed invention's specific contribution over the prior art" is this difference in profits. Damages should be the amount of the difference.

This approach to reasonable royalty damages would also solve the problem with the "basis for consumer demand" version of the entire market value rule. By asking the same question, the law sensibly identifies patented inventions providing a patent infringer with its entire profits. Whether applied to patents on changes in existing products or patents on entirely new products, if there was no substitute, the invention is responsible for all the net profits. This approach is how the Supreme Court has applied the entire market value rule for well over 100 years. This approach makes a separate entire market value rule unnecessary and misleading.

An Invention's Contribution over the Prior Art. There is one feature of the bill's definitions of the entire market value rule and the valuation calculation rule that requires an additional comment. Those definitions focus on the "claimed invention's specific contribution over the prior art." (section IV.D.) This language creates a significant risk that damages will be too large in many and probably most cases. This will happen if the courts interpret those rules to require measuring the economic value of some invention by comparing the value of products employing that invention with the value of products employing only prior art inventions (as the valuation calculation rule says and the entire market value rule could be read to say). Damages should be measured by the economic value of an invention at the time of infringement, not its value on the date an application for a patent was filed. This is the law and should remain the law. While the report indicates to me that the amendments do not intend to change the law in this way, history has shown that the words in the Patent Act take on a life of their own, because most people who apply the law do not know the purpose of the words and those who do know frequently forget.

Established Royalty. The third optional damages theory is the established royalty rule. S. 1145, section 284(c)(1)(B). The law now permits damages to be measured in that way. (section IV.E.) The amendments change the law by requiring that this theory take precedence over the valuation calculation rule. Damage awards should seldom be based on an established royalty. Damages measured in that way are usually too low. As importantly, if an established royalty is a preferred method for determining damages (as the amendments would require), there will be less licensing and more litigation in the future. For those two reasons, damages based on an established royalty should be the last resort and used only where it is clear the invention has some economic value and there is no other way to determine the amount of that value.

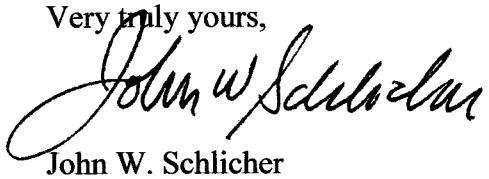
The Procedural Changes. The amendments also change the procedures for determining damages in the district courts. Judges would be required to select one of these three permissible damage theories for a particular case and to identify the "factors" the judge or a jury may consider in reaching an award. (section IV.G.) Even if I agreed with the three theories, I would not require a judge rather than a jury to select the one that is appropriate to some case or to select the right "factors" for determining damages. These requirements will simply add to the burdens of patent litigation for federal judges and the parties, and will not necessarily lead to better awards or to less time-consuming and expensive processes for deciding damages. While I agree with the report that the instructions given to juries on patent damages permit an extraordinarily wide range of awards and too often fail to point in an understandable way to a sensible award, I do not believe that problem is solved by requiring judges to select "factors" to consider. The multiple "factors" approach to reasonable royalty damages is a large part of the problem and not the solution.

The Problem of Increased Damages. The amendments also address the problem of increased damages. (section V.) Over the past twenty-five years, damages have been increased more often than they should have been. Since the early 1980s, the law has permitted damages to be increased if an infringer, after learning of a patent, failed to exercise reasonable care to avoid infringement liability. As understood and applied, this is not an appropriate standard for increasing damages. The amendments do not seem to correct that standard. Hence, they fail to address the basic problem. In late 2007, the Court of Appeals for the Federal Circuit attempted to correct the standard. I understand Senator Leahy proposed in March 2008 to replace this provision of the amendments with some language from the Court of Appeals' decision. While the Court of Appeals' decision is a step in the right direction, I would not amend the Patent Act to include language from this decision, because it is unclear to me that the Court of Appeals' new standard is the best solution to this problem.

Other Problems with Patent Damages. The law has several other features that make it difficult for damage awards to approximate the economic value of patented inventions consistently. Some of them tend to make awards too large and others too small. The net effect is that damages may approximate the economic value of patented inventions in some instances and not come close in others. The amendments do not address these other problems. (section VI.)

The Desirability and Substance of Legislation. Having criticized this bill, I should offer a better alternative. It is difficult to write an amendment to section 284 having clear concise language that would correct the major defects and leave alone the sensible features of current law. I have attempted to write such an amendment and a brief explanation of what that amendment is intended to do. (section VII.) However, at present, I would leave the problems to the federal courts. The courts have the power to correct the problems within the spacious charter of section 284. If the courts prove unable to do so after Congress has indicated its concern, Congress should act.

Very truly yours,



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Encl.