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Article

**RES“Q”ING PATENT INFRINGEMENT DAMAGES AFTER RESQNET: THE DANGERS OF LITIGATION
LICENSES AS EVIDENCE OF A REASONABLE ROYALTY**

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***183 Introduction**

When a patent owner makes and sells a patented invention, it is easy to see how the owner is harmed by another’s infringement. But what happens when the patent owner merely holds the patent with no plans to make or sell the patented invention? In that case, the patent owner loses no sales even when an infringer enters the scene. Unwilling to leave this non-practicing patent owner without an infringement remedy, the patent laws allow the patent owner to recover from the infringer damages in the rather imprecise form of a “reasonable royalty.”¹

To determine the amount of a reasonable royalty, the fact-finder journeys into the land of make-believe: she imagines a hypothetical negotiation that took place between the patentee and the infringer just before the infringing conduct began.² The royalty that would have resulted from that negotiation usually constitutes the reasonable royalty. As the Federal Circuit has lamented, the reasonable royalty measurement involves “more the talents of a conjurer than those of a judge,”³ because it is a difficult, if not impossible, task to determine what royalty two warring parties would have agreed to had they negotiated a license years ago.

The fact-finder does not navigate these difficult waters unaided. She is usually presented with, among other things, previous license agreements for the patent-in-suit. Prior licenses help demonstrate the marketplace’s general perception of the value of

the patent, so they may give the fact-finder a good idea of what royalty the parties would have negotiated. But when the earlier licenses resulted from the settlement of previous litigation, their value as a market indicator becomes questionable--it is hard to determine how much of the settlement value is the result of the patent's value as compared to litigation risk or expenses. For this reason, litigation licenses have a checkered past as evidence of a reasonable royalty.⁴

***184** Courts and scholars have trended toward allowing litigation licenses to be used as evidence of a reasonable royalty.⁵ Their arguments often rely on a recent decision by the Federal Circuit, *ResQNet v. Lansa*.⁶ This Article explores the Federal Circuit's *ResQNet* decision, as well as the practical results of admitting litigation licenses as evidence of a reasonable royalty.

Part 1 of this Article briefly recounts the history of patent damages and the development of the reasonable royalty as a damages standard. Part 2 examines the Federal Circuit's precedent regarding litigation licenses and similar evidence in proving a reasonable royalty. Part 2 also explores the *ResQNet* decision, as well as several other recent Federal Circuit decisions clamping down on the evidence that can be used to prove a reasonable royalty. In addition, Part 2 explains the error that district courts commit when they view *ResQNet* as mandating the admission of litigation licenses and distills the *ResQNet* line of cases into a few paramount principles that the Federal Circuit applies in reviewing the evidence supporting reasonable royalty awards.

Because *ResQNet* does not mandate the admission of litigation licenses in reasonable royalty cases, admission of these licenses hinges largely on an analysis of the three Federal Rules of Evidence traditionally used to exclude litigation licenses--Rules 402 (relevance), 403 (balancing), and 408 (settlement agreements). Part 3 applies these rules to litigation licenses. Part 3 shows that Rule 402 is an improper basis for blanket exclusion, because litigation licenses are relevant to a reasonable royalty determination. For purposes of Rule 403 and Rule 408 (by extension of Rule 703), Part 3 examines the balance between the probative value of litigation licenses and their prejudicial effect. Part 3 also takes issue with the recent argument of one commentator that courts should admit litigation licenses while foreclosing discovery of related negotiations. Part 3 concludes that litigation licenses should be excluded from evidence in most cases.

1) Background

a) The Reasonable Royalty as a Measure of Damages

Three kinds of damages are generally available to a patent holder whose patent has been infringed. The first is lost profits--if the infringer has made sales that otherwise would have gone to the patentee,⁷ the patentee can recover its lost profits. ***185**⁸ For many reasons, most notably the difficulty of proving causation, patentees are often unable to prove lost profits at trial.⁹

The second category of damages is an established royalty. If the patent holder had a track record of licensing the invention to others for a set amount, damages may be imposed at the rate of the established royalty.¹⁰ An established royalty is difficult to prove--it requires prior licenses of the patent-in-suit that were (1) paid or secured before the infringement complained of; (2) paid by enough people to show a general acquiescence in its reasonableness; (3) uniform in their terms; (4) not entered under threat of suit or in settlement of litigation; (5) for comparable rights or activity under the patent.¹¹ The Supreme Court has cautioned against the use of litigation licenses to prove an established royalty, reasoning that the licenses do not necessarily reflect a voluntary royalty value.¹²

The final--and the most common--kind of damages available to the wronged patentee is a reasonable royalty.¹³ This is the statutory floor of a damages award--the patent laws allow the patentee to recover from an infringer "damages adequate to compensate for the infringement but in no event less than a reasonable royalty for the use made of the invention by the infringer."¹⁴ The reasonable royalty may be set as a lump sum or a running royalty, and a running royalty may be unscaled (a set value for every use of the invention) or based on a sliding scale (a sliding value that varies based on how often or extensively the licensee uses the invention).¹⁵

***186 b) Development of the Reasonable Royalty Standard**

The reasonable royalty measure of damages arose as a result of the difficulty many plaintiffs faced in proving damages for patent infringement. Before the advent of the reasonable royalty, the Supreme Court limited damages for patent infringement to either provable lost profits or an established royalty.¹⁶ Where a plaintiff had not previously licensed the patent and was not

an active market participant (and, consequently, incurred no provable lost profits as the result of infringement), the Court often limited the plaintiff to a recovery of nominal damages and, for suits in equity, an injunction against further infringement.¹⁷ In the mid-1800s, the Court began to allow damages awards to patentees who had neither previously licensed the patent-in-suit nor practiced the patent-in-suit in any commercial manner, though the Court was inconsistent in this area.¹⁸

Eventually, lower courts adopted the reasonable royalty standard.¹⁹ The Supreme Court expressly approved--though in dicta--the use of the reasonable royalty standard as compensation for patent infringement for the first time in 1915, in *Dowagiac Manufacturing Co. v. Minnesota Moline Plow Co.*²⁰ The Court noted that, “although the plaintiff was entitled to prove what would have been a reasonable royalty, and thereby show a proper basis for an assessment of damages, no proof upon that subject was presented.”²¹

In 1922, Congress amended the patent laws to allow a patentee to recover “a reasonable sum as profits or general damages” for infringement where the patentee could not prove lost profits or an established royalty.²² The statutory language proved too vague, however, and in 1946, Congress again amended the law, this ***187** time to provide for minimum damages of a “reasonable royalty.”²³ Specifically, the amended language provided that “the complainant shall be entitled to recover general damages which shall be due compensation for making, using, or selling the invention, not less than a reasonable royalty therefor, together with such costs, and interest, as may be fixed by the court.”²⁴

Over time, the reasonable royalty standard has effectively swallowed up the established royalty standard,²⁵ and the established royalty has become less important.²⁶ The Federal Circuit now considers “[a]n established royalty [to be] the best measure of a ‘reasonable’ royalty for a given use of an invention because it removes the need to guess at the terms to which parties would hypothetically agree.”²⁷ But an established royalty is not the only measure of a reasonable royalty; evidence that does not meet the traditionally rigid standards of an established royalty may nevertheless be probative in determining a reasonable royalty.²⁸

The most common description of the reasonable royalty is that it is the amount that would have been agreed upon in a hypothetical negotiation between a willing patent owner and a willing licensee as of the time just before the infringement began and on the assumption that the patent was valid.²⁹ The hypothetical ***188** negotiation relies on fantasy: “it requires a court to imagine what warring parties would have agreed to as willing negotiators.”³⁰ At bottom, the reasonable royalty standard rests on speculation and is, as the Federal Circuit put it, “a difficult judicial chore.”³¹

Despite the difficulty of determining a reasonable royalty, it has become “the predominant measure of damages in patent infringement cases.”³² The addition of the reasonable royalty standard portended big business for non-practicing entities (NPEs),³³ who, by definition could not prove lost profits,³⁴ and who may have lacked sufficient non-litigation licenses to show an established royalty.³⁵ Once the reasonable royalty standard was in place, some NPEs--often pejoratively called “patent trolls”--could fashion a lucrative business model out of acquiring and holding a patent portfolio and suing or threatening to sue anyone who potentially infringed.³⁶

***189 c) The Georgia-Pacific Factors**

The proper measure of a reasonable royalty standard remains elusive.³⁷ How does one prove the royalty that would have resulted from a fictional negotiation in which both parties are willing to enter a license agreement but neither party is compelled to do so? That is the daunting task set before the parties disputing a reasonable royalty.

To aid this determination, the court in *Georgia-Pacific v. United States Plywood Corp.* surveyed the case law and set out a list of fifteen factors potentially relevant to the reasonable royalty calculation.³⁸ The factors are:

1. The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty.
2. The rates paid by the licensee for the use of other patents comparable to the patent in suit.
3. The nature and scope of the license, as exclusive or non-exclusive; or as restricted or non-restricted in terms of territory or with respect to whom the manufactured product may be sold.
4. The licensor’s policy and marketing program regarding licenses.

5. Any commercial relationship between the licensor and licensee.
6. The effect of selling the patented article on the licensee's other sales.
7. The duration of the patent and the term of the license.
8. The commercial success, profitability, and popularity of the product.
9. The advantages of the patent over prior art or practices.
10. The nature of the patented invention.
11. The extent and value of the infringer's use.
12. The customary allocation of profits between the licensee and licensor in the industry.
13. The portion of the profit attributed to the patented invention, rather than to another feature of the article or infringer.
14. The opinion testimony of qualified experts.
15. The amount that a licensor (such as the patentee) and a licensee (such as the infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement; that is, the amount which a prudent licensee- who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention- would have been willing to pay as a royalty and yet be able to make a reasonable profit and which amount would have been acceptable *190 by a prudent patentee who was willing to grant a license.³⁹ This "comprehensive (but unprioritized and often overlapping) list"⁴⁰ has enjoyed broad usage and gained acceptance in the Federal Circuit.⁴¹

For present purposes, the first and second factors are particularly relevant. The first factor looks to prior licenses of the patent-in-suit,⁴² and the second looks to prior licenses entered into by the infringer for comparable patents.⁴³ Both factors consider past or existing licenses as a guide in assessing the reasonable royalty, but the factors are not without limits. In several important recent decisions, the Federal Circuit has reversed reasonable royalty awards based on insufficiencies in prior licenses offered as evidence. Several of those decisions are discussed in Part 2, *infra*.

d) Litigation Licenses as Reasonable Royalty Evidence

A thorny issue has arisen with respect to the Georgia-Pacific factors that look to amounts paid by prior licensees: whether to allow the use of prior licenses that arose out of actual or threatened litigation (sometimes called "litigation licenses" or "settlement licenses"). Obviously, licenses previously granted by the patentee for the patent-in-suit or previously agreed to by the infringer for a comparable patent could offer significant insight into how the parties would behave in the hypothetical negotiation for the license of the patent-in-suit; however, a license entered into to settle litigation is far less useful in allowing the fact-finder to hypothetically construct the behavior of the parties, because the settlement likely involved substantial considerations external to the parties' valuation of the patent.⁴⁴ As the Supreme Court put it in an established royalty case:

It is clear that a payment of any sum in settlement 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 *191 sustained by the owners of the patent in other cases of infringement The avoidance of the risk and expense of litigation will always be a potential motive for a settlement.⁴⁵

Based on this Supreme Court language and on the notion of the disutility of litigation licenses, many courts have excluded litigation licenses from evidence in the reasonable royalty context.⁴⁶ Courts that have excluded litigation licenses have traditionally held them inadmissible based on one or more of three Federal Rules of Evidence: Rule 402 (relevance),⁴⁷ Rule

403 (balancing),⁴⁸ or Rule 408 (settlement).⁴⁹ Some courts that have historically banned litigation licenses from evidence have recently changed course based on dicta appearing in the Federal Circuit's recent decision in *ResQNet.com, Inc. v. Lansa, Inc.*⁵⁰ The next section examines ResQNet and related Federal Circuit cases.

2) ResQNet and the Current State of the Law

a) ResQNet

In *ResQNet*, ResQNet's (the patentee) expert relied on seven prior licenses as a "starting point" in determining the reasonable royalty.⁵¹ Five of the licenses were "re-bundling" licenses, permitting the licensees to re-brand the patentee's software, *192 re-bundle it with the licensee's own products, and resell the newly-bundled products.⁵² In addition, the licenses included services such as technical support and training, and did not specifically mention the patent at issue in the lawsuit.⁵³ ResQNet failed to offer evidence that the software in these re-bundling licenses (or the users of the software) practiced the patented method.⁵⁴ These licenses had a large sliding-royalty rate (a rate that changed depending on various circumstances).⁵⁵

The Federal Circuit contrasted the large royalty rates in the re-bundling licenses, which showed "no discernible link to the claimed technology," with the lower royalty rates in the remaining two licenses, which arose out of litigation.⁵⁶ Without evidence of the link, if any, between the re-bundling licenses and the patented method, those re-bundling licenses were essentially useless as evidence of a reasonable royalty.⁵⁷ The patent-in-suit dealt "with a method of communicating between host computers and remote terminals--not training, marketing, and customer support services. The re-bundling licenses simply ha[d] no place in this case."⁵⁸

According to the majority, ResQNet's expert relied almost exclusively on the first Georgia-Pacific factor--prior licenses of the patent-in-suit--in evaluating the reasonable royalty.⁵⁹ Consequently, after the Federal Circuit held that the trial court should have disregarded the re-bundling licenses, only the two litigation licenses remained as potential damages evidence.⁶⁰ The court observed in dicta "that the most reliable license in this record arose out of litigation," but also noted that "litigation itself can skew the results of the hypothetical negotiation."⁶¹ On remand, *193 the district court would have to reconsider the reasonable royalty calculation, and it "should not rely on unrelated licenses to increase the reasonable royalty rate above rates more clearly linked to the economic demand for the claimed technology."⁶² In concluding, the Federal Circuit faulted the district court for relying on the re-bundling licenses "without any factual findings that accounted for the technological and economic differences between those licenses and the [patent-in-suit]."⁶³ A district court "must consider licenses that are commensurate with what the defendant has appropriated."⁶⁴

In dissent, Judge Newman accused the majority of "creat[ing] a new rule whereby no licenses involving the patented technology can be considered . . . if the patents themselves are not directly licensed or if the licenses include subject matter in addition to that which was infringed by the defendant here."⁶⁵ The district court recognized that none of the licenses in evidence was "a perfect approximation of the hypothetical license between ResQNet and Lansa."⁶⁶ Judge Newman noted that "it is not necessary that the identical situation existed in past transactions, for the trier of fact to determine the value of the injury,"⁶⁷ and he accused the majority of depriving the fact-finder of relevant information.⁶⁸

The majority in *ResQNet* did not hold that a district court may never consider "any licenses involving the technology of [the patents-in-suit] bundled with additional technologies, such as software code."⁶⁹ Rather, the majority took issue with the district court's "considering ResQNet's re-bundling licenses to significantly adjust upward the reasonable royalty without any factual findings that accounted for the technological and economic differences between those licenses and the [infringed patent]."⁷⁰ The majority in *ResQNet* noted that reasonable royalty damages must be "carefully tie[d] . . . to the claimed invention's footprint in the marketplace,"⁷¹ and "[a]ny evidence unrelated to the claimed invention does not support *194 compensation for infringement."⁷² Where licenses are "radically different from the hypothetical agreement under consideration," they are generally not competent proof of damages.⁷³

b) The Aftermath of ResQNet

In the wake of *ResQNet*, many courts that formerly excluded litigation licenses reversed course.⁷⁴ The court in *ResQNet* indicated that litigation licenses have at least some probative value--it described one of the two litigation licenses as "the most reliable license in the record."⁷⁵ Consequently, any courts that previously excluded litigation licenses based only on their

supposed irrelevance under Rule 402⁷⁶ should view ResQNet as altering that analysis.⁷⁷

But few courts that excluded litigation licenses before ResQNet grounded the exclusions solely on irrelevance under Rule 402,⁷⁸ and nothing in ResQNet significantly impacts the other bases for exclusion: Rules 403 (probative versus prejudice balancing) and 408 (excluding settlement agreements).⁷⁹ Consequently, it makes little sense to abandon exclusionary rules predicated on Rules 403 or 408 in response to ResQNet. Even so, some courts are holding that ResQNet changed the litigation-license landscape entirely, so that litigation licenses are now broadly admissible.

For instance, before ResQNet, Judge David Folsom, District Judge for the Eastern District of Texas, excluded litigation licenses under Rule 403 concluding that the prejudicial effect of these licenses substantially outweighed their probative ***195** value.⁸⁰ ResQNet said nothing to diminish the prejudicial effect of litigation licenses,⁸¹ and its only reference to probative value was relative--that the litigation licenses in that case were more reliable than the completely-unreliable re-bundling licenses.⁸² Nevertheless, this same judge--without conducting a Rule 403 analysis at all--has determined that ResQNet mandates the admissibility of litigation licenses.⁸³

Nothing in ResQNet should change the positions of courts that previously relied on Rules 403 or 408 to exclude litigation licenses. The admissibility of litigation licenses simply was not before the court in ResQNet.

c) Other Recent Reasonable Royalty Cases

i) Lucent

In *Lucent Techs. v. Gateway, Inc.*, on which the ResQNet court relied, the Federal Circuit reversed a jury's damages award that rested on insufficient evidence.⁸⁴ Lucent, the patentee, sought reasonable royalty damages calculated as a running royalty, while Microsoft (which had intervened on behalf of defendant Gateway) sought a lump-sum reasonable royalty.⁸⁵ The jury awarded a lump-sum royalty of \$358 million.⁸⁶ Microsoft argued that insufficient evidence supported this award, and the Federal Circuit agreed.⁸⁷ The only licenses that Lucent had offered into evidence for the reasonable royalty calculation were prior licenses by Microsoft for technology that Lucent argued was comparable to the technology in its patent.⁸⁸ The court noted that only four of the eight licenses in evidence were lump-sum agreements.⁸⁹ It stopped short of holding "that a running-royalty license ***196** agreement cannot be relevant to a lump-sum damages award, and vice versa," but the party offering the dissimilar agreement must offer "some basis for comparison."⁹⁰ In other words, the party should present "particularized expert testimony explaining how various differences between the real and hypothetical license negotiations" would impact the appropriate royalty in the case.⁹¹

As for the four lump-sum licenses, the court pointed out that they appeared to provide for a cross-license of broad patent portfolios and for a lump sum additional payment by Microsoft, but Lucent failed to offer evidence that these licenses "were sufficiently comparable to support the lump-sum damages award."⁹² The court summarized the evidentiary shortcomings:

The law does not require an expert to convey all his knowledge to the jury about each license agreement in evidence, but a lump-sum damages award cannot stand solely on evidence which amounts to little more than a recitation of royalty numbers, one of which is arguably in the ballpark of the jury's award, particularly when it is doubtful that the technology of those license agreements is in any way similar to the technology being litigated here.⁹³

ii) Wordtech

In *Wordtech Systems, Inc. v. Integrated Networks Solutions, Inc.*,⁹⁴ defendant INS infringed Wordtech's patent covering an automated compact disc duplicator.⁹⁵ At trial, Wordtech introduced into evidence "thirteen patent licenses that it previously granted to third parties for rights to some or all of the patents-in-suit."⁹⁶ Stressing that "comparisons of past patent licenses to the infringement must account for 'the technological and economic differences' between them," the Federal Circuit reversed the jury's damages award of a lump-sum royalty.⁹⁷ Once again, the court held that the jury had an insufficient basis for comparison between the evidentiary licenses and the hypothetical license at issue.⁹⁸ Eleven of the licenses involved a running royalty.⁹⁹ The court acknowledged the potential relevance of these licenses, but found no basis for comparing the running royalties with the lump- ***197** sum award.¹⁰⁰ In addition, "Wordtech signed several of these licenses after initiating or threatening litigation against the licensees, and 'litigation itself can skew the results of the hypothetical negotiation.'"¹⁰¹ As

for the remaining two licenses, “[n]either license describe[d] how the parties calculated each lump sum, the licensees’ intended products, or how many products each licensee expected to produce.”¹⁰²

iii) Uniloc

In *Uniloc USA, Inc. v. Microsoft Corp.*,¹⁰³ the Federal Circuit rejected the ubiquitous 25% “Rule of Thumb” for the reasonable royalty analysis.¹⁰⁴ In doing so, the court summarized *Lucent*, *ResQNet*, and *Wordtech* as holding that “a patentee [cannot] rely on license agreements that [are] ‘radically different from the hypothetical agreement under consideration’ to determine a reasonable royalty.”¹⁰⁵ “The meaning of these cases is clear: there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case.”¹⁰⁶

d) A Distillation of the Case Law

The *ResQNet* line of cases does not teach that in order to provide admissible evidence of a reasonable royalty a prior license must exactly match the circumstances of a hypothetical negotiation. Instead, *ResQNet* and the related cases emphasize the importance of the offering party linking the prior license to the patent-in-suit. The offering party must explain how the agreement is useful in calculating the reasonable royalty, and how any different circumstances surrounding the prior license would affect the hypothetical negotiation at issue in the litigation.

***198** The necessity of a link between the prior licenses and the hypothetical license under consideration is not a new concept. In *Georgia-Pacific*, the court recognized the importance of such a link.¹⁰⁷ Some of the licenses offered in that case were for manufacture and sale outside of the United States, where the patentee had no facilities or plans to sell.¹⁰⁸ The court found these circumstances very different from a license to a direct competitor within the United States.¹⁰⁹ Accordingly, the court found “no sound basis for a meaningful comparison,” so that “the amounts of the royalties payable under the foreign licenses [did] not carry any significant weight with respect to the issue of a reasonable royalty.”¹¹⁰ Similarly, in a related context, the Federal Circuit has noted that a party seeking to rely on litigation licensing fees to show commercial success must demonstrate a nexus between the fees (the evidence of commercial success) and the merits of the invention.¹¹¹ Because it is “often cheaper to take licenses than to defend infringement suits,” a prior litigation license may not be useful to show that the patented invention enjoyed commercial success, and the patentee is responsible to demonstrate the nexus between the fees paid and the patent’s value.¹¹²

The takeaway from the *ResQNet* line of cases is that any prior licenses used to prove a reasonable royalty must be presented in a way that is useful to the fact-finder in calculating the reasonable royalty. If the prior licenses include a re-bundling agreement and service contracts, the evidence must be presented in a way that coherently links the license to the patent-in-suit and accounts for the value of the other licensed items. If the license is for a running royalty and the patentee is seeking a lump sum, the license must be presented in a way that allows the jury to confidently value the running royalty in terms of the bargaining parties’ expectations, so that the running royalty can be translated into a lump sum.

The more similar the licenses are to the hypothetical negotiation at issue, the greater their probative value. As the link between the prior license and the current ***199** litigation becomes more tenuous—for example, if the patent-in-suit was in the prior license, only one patent in a very large patent portfolio involved in a cross-license agreement resulting from litigation—the probative value of the license decreases. And, of course, the licenses must be at least minimally comparable in order to be at all probative.

Once the licenses meet a low threshold similarity requirement, the differences and similarities must be explained in a way that allows the jury to account for the differences in determining the relationship of the licenses to the reasonable royalty at issue. In other words, the jury must have some “testimony with which to recalculate in a meaningful way the value of [the offered agreements] to arrive at the . . . damages award.”¹¹³ The non-offering party will attempt to highlight the distinctions between the offered license and the hypothetical negotiation.

3) Bases for Exclusion of Litigation Licenses: Rules 402, 403, and 408

Courts that have excluded litigation licenses from evidence have relied primarily on three Federal Rules of Evidence in reaching their conclusion. The first is Rule 402 (relevance).¹¹⁴ The second is Rule 408 (settlement offers and agreements).¹¹⁵ Finally, some courts exclude litigation licenses based on a Rule 403 balancing of the probative value and the prejudicial

effect of the licenses.¹¹⁶

Following ResQNet, courts remain divided as to discovery and admissibility of litigation licenses. Some courts have continued to impose a broad exclusion, noting that the seemingly off-hand remarks regarding litigation licenses in ResQNet were not sufficient to upset established case law.¹¹⁷ Other courts have determined that, following ResQNet, litigation licenses may be admissible.¹¹⁸ Courts following the second path have subdivided into two camps: those that allow discovery of (and *200 potentially admission of) settlement negotiations surrounding a litigation license,¹¹⁹ and those that do not.¹²⁰ This section examines the exclusion of litigation licenses under each of the three rules discussed above.

a) Rule 402

Rule 402 provides that irrelevant evidence is inadmissible.¹²¹ Evidence with any probative value--that is, evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence--is relevant.¹²²

i) Federal Circuit Precedent

Courts excluding litigation licenses for lack of probative value under Rule 402 usually rely on the Supreme Court's oft-cited statement in *Rude v. Westcott*:

It is clear that a payment of any sum in settlement 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. . . . The avoidance of the risk and expense of litigation will always be a potential motive for a settlement.¹²³

The Court's statement in *Rude* is quite accurate in the established royalty context in which that case was decided; a litigation license does not necessarily reflect the proper royalty, so a royalty agreed upon in the midst of litigation would not result in an established royalty. But courts have extended this statement to exclude *201 litigation licenses in the context of a reasonable royalty,¹²⁴ and have often inaccurately described *Rude* as a reasonable royalty case.¹²⁵

The extension of *Rude* to the reasonable royalty context is unwarranted because, in the reasonable royalty context, the offering party is not seeking to establish the litigation license as the royalty standard. Instead, the offering party is seeking to use it--with appropriate caveats and explanations--as evidence of a reasonable royalty.¹²⁶ Thus, it is a mistake--though an oft-committed one--for courts to treat *Rude* (reversing an award of damages where the award relied on a litigation license to determine an established royalty) as though it involved a determination of a reasonable royalty. And, although the first Georgia-Pacific factor is sometimes stated as "[t]he royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty,"¹²⁷ it is not obvious why evidence relevant to a reasonable royalty should be limited to evidence relevant to an established royalty.¹²⁸ Put another way, "the necessarily speculative hypothetical negotiation is rendered less speculative by use of as many facts as can be gleaned from the evidence to create a reasonable royalty."¹²⁹

Sitting by designation in a district court, Chief Judge Rader, the chief judge of the Federal Circuit, authored the most notable opinion excluding litigation licenses under Rule 402 in a reasonable royalty case, *Cornell University v. Hewlett-Packard *202 Co.*¹³⁰ In his unpublished opinion, Judge Rader cited two Federal Circuit cases--*Studiengesellschaft Kohle, m.b.H. v. Dart Industries, Inc.*,¹³¹ and *Deere & Co. v. International Harvester Co.*,¹³²--as establishing "a body of case law excluding license agreements 'eroded by litigation' as irrelevant to the Georgia-Pacific reasonable royalty analysis."¹³³ Judge Rader held that

[b]ecause the . . . licenses [were] signed under threat of litigation . . . [the] license amounts do not speak to 'the amount which a prudent licensee--who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention--would have been willing to pay as a royalty.' Accordingly, the offer and license amounts were eroded by litigation and are therefore irrelevant and inadmissible.¹³⁴

Neither of the two cases referenced in *Cornell* demand a broad exclusion of litigation licenses under Rule 402. In *Studiengesellschaft*, the Federal Circuit affirmed the district court's reversal of a special master's damages determination.¹³⁵

The special master admitted a prior litigation license into evidence, but largely ignored it.¹³⁶ The district court held that the special master erred by undervaluing this license, because the earlier litigation license was entered by the prior parties after a court of appeals held the patent to be valid and infringed; the only issue remaining in the earlier litigation was an accounting for damages.¹³⁷ At the time of the prior license, the patentee and infringer occupied the same position as the hypothetical negotiators in a reasonable royalty calculation; the patent was unquestionably valid, enforceable, and infringed.¹³⁸ This license was more relevant--not less relevant--than a non-litigation license, under which the parties may still differ on the validity or infringement of the patent.¹³⁹ Rather than holding litigation licenses to be irrelevant to a reasonable royalty determination, the Federal Circuit in *Studiengesellschaft* affirmed the district court's holding ascribing error to the special *203 master for ignoring the litigation license under the particular set of facts in that case.¹⁴⁰

In *Deere & Co.*, the district court excluded a prior license on the basis of Rule 408.¹⁴¹ The Federal Circuit held that this exclusion was error, because there was no evidence that the prior licensee had ever infringed the patent prior to the license agreement--in other words, there was no evidence of a disputed "claim" for the purposes of invoking Rule 408.¹⁴² Nevertheless, the Federal Circuit found that the error was harmless, because the district court alternatively found the prior license to be of such little probative value that it would not change the outcome.¹⁴³ The Federal Circuit expressly noted that the district court did not find the prior license inadmissible under Rule 402, but instead merely found the prior license to be "of little or no significance to the issues of an established royalty or a reasonable royalty."¹⁴⁴ The court held that the district court could "properly discount" the value of the prior license given the defendant's ongoing infringement in the market and the ongoing litigation, but that does not suggest that the license was irrelevant, particularly given the Federal Circuit's express conclusion that the district court did not find the license inadmissible under Rule 402.¹⁴⁵

ii) Courts' Conflation of Imperfection and Irrelevance

Neither *Rude* nor the Federal Circuit's prior cases have held litigation licenses irrelevant to a reasonable royalty determination. But this does not answer the more important question of whether such licenses are, in fact, irrelevant. The reasoning employed in *Cornell*--that litigation licenses are irrelevant because they do not mirror the hypothetical negotiation's standard of a prudent licensee who desired, as a business proposition, to obtain a license to manufacture and sell an article embodying *204 a patented invention--goes too far, because it conflates imperfection and irrelevance.

While the dissimilarities between an existing license's circumstances and those of the hypothetical royalty affect the precision with which the existing licenses suggest a reasonable royalty, such dissimilarities do not render existing licenses irrelevant. This logic would compel a finding of irrelevance for any license taken under circumstances differing from the hypothetical negotiation, including many kinds of licenses uncontroversially admitted into evidence. For instance, courts routinely admit and consider licenses entered well before or well after the date of the hypothetical negotiation, even though these licenses are often entered into under different prevailing circumstances existing at the time of the hypothetical license.¹⁴⁶ In fact, Judge Rader has recognized that although these licenses are not exact matches they are still relevant.¹⁴⁷ Like litigation licenses, these licenses are not perfect carbon copies of the hypothetical license, but neither are they irrelevant.

In the case of a license entered into at a different time than the hypothetical negotiation, the fact-finder must determine if any material market conditions or other circumstances differed at the time of the hypothetical negotiation. If there were material changes, the fact-finder must then determine how the existing conditions were reflected in the valuation of the prior license and how those conditions would affect the valuation of the hypothetical license. This is a difficult chore, and may limit the probative value of such a license, but it does not render it irrelevant. Likewise, it is unquestionably difficult to extract value-related considerations in a litigation license from the external considerations not related to the value of the patented invention. However, the litigation license still reflects, to some degree, the value of the patented invention (that is, the amount the prudent licensee would be willing to pay). As long as the value of the invention makes up any component of *205 the litigation license, it is relevant to answer the question of what the proper value of the invention is (that is, what value should be ascribed to a reasonable royalty).

iii) The Effect of Litigation Considerations on Non-Litigation Licenses

Litigation licenses do not become irrelevant simply because litigation considerations factor into the royalty amount. Royalties are usually paid to avoid litigation--most people who thought that they could infringe a patent with impunity would likely do so.¹⁴⁸

Even in licensing discussions occurring prior to any potential infringement, the parties incorporate assumptions regarding the

prospect of litigation into their analysis. For example, the recipient of a given licensing offer faces four alternatives. It may (1) accept or otherwise negotiate to obtain a license; (2) manufacture the contemplated product without a license and face potential litigation; (3) attempt to design around the patent (or, in cases where the party does not believe the contemplated product to infringe, redesign the contemplated product to give the patent a wider berth), then manufacture the re-designed product, and face potential litigation; or (4) abandon any plans regarding the contemplated product.¹⁴⁹ The recipient of the offer will attempt to factor in the likelihood and projected outcomes of litigation under the various scenarios in order to determine the most efficient option. Judge Easterbrook has it right:

[P]eople may settle patent litigation to reduce the costs of the legal process. The terms of a settlement reflect these costs as well as the parties' estimates about the probable outcome on the merits if the case proceeds Yet deciding whether to take a license entails a similar assessment of the risks posed by litigation--prediction and avoidance of costs before suit begins¹⁵⁰

iv) The Inescapable Role of the Patent's Value in a Litigation License

Like any other settlement, the amount a party is willing to pay or accept for a litigation license (LL) generally consists of three core components: the likelihood of liability (L, the party's assessment of patent strength); the expectation value of the damages (D, the party's assessment of the patent's value); and the party's expected *206 litigation costs (LC).¹⁵¹ In the absence of externalities,¹⁵² a rational patent-infringement defendant should be willing to pay in settlement an amount less than or equal to the expectation value of the total exposure in the litigation, $LL_{Def} \leq L_{Def} * D_{Def} + LC_{Def}$.¹⁵³ Similarly, a rational patent-infringement plaintiff should be willing to accept in settlement an amount greater than or equal to the expectation value of the net recovery in litigation, $LL_{Pla} \geq L_{Pla} * D_{Pla} - LC_{Pla}$.¹⁵⁴ Even where a license is almost exclusively the product of considerations external to the value of the license (such as costs of litigation and the likelihood of non-infringement), there is still some component of the settlement reflecting the patent's value--or its lack of value--to the parties.

Because the patent's value represents a necessary consideration in reaching a litigation license, the cost of a litigation license can provide information about the patent's non-litigation value to the parties to the license. Imagine a litigation license reflecting a lump-sum royalty of \$500,000. If we can discover the parties' belief of the patent strength (the likelihood of a finding that the patent is valid, enforceable, and infringed) and their expected costs of litigation, we can learn something about the patent's non-litigation value to the parties.¹⁵⁵ For example, if the plaintiff perceived only a 10% chance of liability, and estimated litigation costs to be \$250,000, then we know that the value of the patent as gauged by the patentee is less than \$7.5 million.¹⁵⁶ Similarly, if the defendant's expected litigation costs were \$400,000 and it perceived a 10% patent strength, it would settle for \$500,000 only if the patent value is greater than or equal to \$1 million. Royalty value is less likely to be a driving force in the settlement amount as the chances of recovery decrease, or as expected litigation costs increase, but the only way to eliminate royalty value *207 as a consideration in a litigation license (and, consequently, to eliminate any chance that the license has probative value in future litigation) is for both parties to be certain of a defense verdict.

Of course, the non-patent-value components of a settlement amount must be peeled away in order to glean any probative value. The fact-finder has to draw substantial inferences as she attempts to determine the settling parties' assessments of patent strength and litigation costs. But, as Judge Friendly put it in a case outside of the patent context, "the length of the chain of inferences necessary to connect the evidence with the ultimate fact to be proved . . . does not render the evidence irrelevant."¹⁵⁷ Put another way, "so long as a chain of inferences leads the trier of fact to conclude that the proffered submission affects the mix of material information, the evidence cannot be excluded at the threshold relevance inquiry."¹⁵⁸ As the chain of inferences upon which evidence depends for its probative value lengthens, the probative value decreases proportionately, but that is a question for Rule 403--not Rule 402.¹⁵⁹

The real question is not whether litigation licenses have probative value, but whether the probative value is large enough and reliable enough to be worth the effort of uncovering it. This question is addressed in the sections that follow.

b) Rule 408

Despite having some probative value, litigation licenses may nevertheless be excluded under Rules 403 or 408. Rule 408 precludes admission of settlement offers or agreements "when offered to prove . . . [the] amount of a claim that was disputed."¹⁶⁰ In the context of litigation licenses, courts often conflate a litigation license's diminished probative value with inadmissibility as a Rule 408 settlement communication.¹⁶¹ A Rule 408 exclusion, however, does not depend on the absence

***208** of probative value--the probative value or reliability of the offered license is generally irrelevant to exclusion under the language of Rule 408.¹⁶² Consequently, the Federal Circuit's statement about the reliability of the litigation license in ResQNet would not impact a Rule 408 analysis.¹⁶³

i) The Operation of Rule 408 in the Reasonable Royalty Context

It has been argued that Rule 408 does not apply in the reasonable royalty context because "evidence considered in reaching a reasonable royalty determination does not purport to 'prove' the amount of the claim," but is instead "used in conjunction with all other relevant evidence to assist the fact-finder in determining an amount of damages."¹⁶⁴ This argument parses too finely--it fails to account for the difference between evidence offered to prove the amount of the claim (any evidence ***209** offered for the purpose of proving the amount of the claim) and an assertion that the amount stated in the evidence is the correct amount of the claim. Stated differently, the rule does not require that the offeror be seeking to prove that the settlement amount is the correct amount of the claim, but merely that the offeror is offering the license as evidence of the amount of the claim.¹⁶⁵ Such is the case in the reasonable royalty context.

Moreover, the policy considerations behind Rule 408 apply to litigation licenses. Rule 408 was drafted to encourage settlement and to encourage full and frank negotiations.¹⁶⁶ The admission of settlement agreements in subsequent infringement litigation as evidence of a reasonable royalty would, at least to some degree, inhibit settlement. This is because settlement generally reflects a compromise--a resolution in which neither party fully receives that to which they believe they are entitled.¹⁶⁷ Because of the compromising nature of a settlement, a patentee may hesitate to settle for an amount less than what he believes is the patent's value if he knows that the settlement amount will be later used to prove the value of the patent. In other words, the parties now must include an additional consideration into the settlement calculus. Thus, instead of the patentee settling if $LL_{Pl.} \geq L_{Pl.} * D_{Pl.} - LC_{Pl.}$,¹⁶⁸ the patentee will settle only if $LL_{Pl.} \geq L_{Pl.} * D_{Pl.} - LC_{Pl.} + SL_{Pl.}$, where $SL_{Pl.}$ equals the plaintiff's expected decrease in subsequent reasonable royalty awards.¹⁶⁹

Consider an overly-simple potential settlement from a hypothetical patentee's point of view. The patentee intends to file two infringement lawsuits against similarly situated defendants, both of whom sold approximately 1 million infringing ***210** widgets. The patentee believes, after an honest evaluation, that its patent should command a royalty of \$1 per infringing widget manufactured, for a royalty of \$1 million for past infringement. The patentee also believes that trial would cost \$500,000¹⁷⁰ and, for present purposes, we will assume that the patentee is unusually confident in his success at trial,¹⁷¹ so that the patentee's settlement range begins at \$500,000.¹⁷² After negotiations, Defendant 1 has offered to settle for \$650,000, or \$0.65 per infringing widget. Leaving aside the possibility of an injunction or enhanced damages (assume that neither defendant willfully or knowingly infringed),¹⁷³ the patentee should accept the settlement agreement. But, if the patentee believes that the litigation license would be admitted into the trial against Defendant 2, the patentee must consider not only the discount in the settlement amount in this case from the amount it is entitled to receive (\$0.35 per infringing widget), but also the settlement's discounting effect on the future lawsuit, which instantly becomes worth less as a result of the settlement. With the litigation license in evidence, the patentee would no longer expect a jury to award \$1 per infringing widget as a reasonable royalty, despite the patentee's best efforts to explain away the reduced litigation license as a concession due to costs of litigation and the like.¹⁷⁴ So, if the patentee were to settle with Defendant 1, it may believe the best it could do at trial against Defendant 2 is only \$0.75 per infringing widget.¹⁷⁵ Settlement now costs the patentee \$600,000 instead of \$350,000. With litigation costs of \$500,000, the patentee should go to trial instead of settling. If, on the other hand, ***211** the agreement were inadmissible against Defendant 2, the patentee should settle with lawsuit against Defendant 1.¹⁷⁶ Thus, if Rule 408 was designed to promote settlement, its purposes support exclusion of litigation licenses.

ii) Rule 703 as an Exception to Rule 408

Even if a litigation license is excluded from evidence under Rule 408, it may enter through the back door in the form of expert testimony. This is because Rule 703 allows an expert to rely on inadmissible evidence in forming her opinion, if the evidence is "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject."¹⁷⁷ Some courts have held that experts generally may rely on litigation licenses and negotiations, as long as the expert does not rely on them exclusively.¹⁷⁸ This does not automatically make evidence of the litigation license admissible through the expert, however, because otherwise inadmissible facts "shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their probative value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect."¹⁷⁹ At least one court has "decline[d] to eviscerate Rules 408 and 403 by admitting the evidence of [litigation licenses] through the back door of Rule 703."¹⁸⁰ Thus, even if the court permits an expert to rely on litigation licenses in forming her opinion, evidence of those litigation licenses will not reach the jury unless the

proponent convinces the court that its probative value substantially outweighs its prejudicial effect. Because this requires a balancing test similar to that performed under Rule 403 (but with a different burden placement), the probative value versus prejudice dichotomy will be discussed in the next section, dealing with the admissibility of litigation licenses under Rule 403.

***212 c) Rule 403 and the Probative Versus Prejudicial Balance**

Rule 703-based admissibility requires a balancing test, with the default rule being inadmissibility.¹⁸¹ Rule 403 requires a similar balancing test, but the default rule is admissibility.¹⁸² Under Rule 403, relevant evidence “may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence.”¹⁸³ Thus, if the litigation license is excluded under Rule 408, it may only come in through expert opinion, and only when the proponent shows that the probative value substantially outweighs the prejudicial effect. If it is not excludable under Rule 408, the party seeking exclusion must show under Rule 403 that the prejudicial effect substantially outweighs the probative value. Either rule requires a comparison of probative value and prejudicial effect, though the burdens rest on different parties under the two rules.

i) The Slight Probative Value of Litigation Licenses

As discussed in Part 3(a), *supra*, litigation licenses have some probative value to a reasonable royalty determination. The probative value will vary depending on the circumstances surrounding the litigation and the license, but most courts recognize that the probative value is usually limited by the myriad considerations that go into a litigation settlement.¹⁸⁴ If litigation licenses were afforded determinative value in determining a litigation license, “the giants of a given industry [could] use threats of costly and protracted litigation to extort an unreasonably low royalty from an impecunious patentee and then to force the patentee into the litigation while maintaining the hedge that the unreasonably low royalty rate would put a ceiling on damages.”¹⁸⁵ But, “[e]ven where the circumstances are likely to [have altered] the terms of a settlement license relative to a non-settlement license, an expert or fact-finder can determine the extent to which the settlement license terms are influenced by the initiation or anticipation of litigation. By considering the settlement license terms and the circumstances leading to the settlement, an expert or ***213** fact-finder can appropriately adjust the settlement license terms for use in a reasonable royalty determination.”¹⁸⁶

The probative value of litigation licenses depends on the circumstances of the case. If a litigation license is the only available license, the necessity for its admission increases, although the parties must still be given the chance to place it in context and argue why it does or does not accurately reflect the royalty value of the patent.¹⁸⁷ If, on the other hand, other licenses are available, or the industry has generally-established licensing practices, the probative value of the litigation license decreases significantly.¹⁸⁸ In the case of NPEs, litigation licenses will often be the only available licenses, and may have increased probative value.¹⁸⁹ For example, in *Clear With Computers, LLC v. Bergdorf Goodman Inc.*, the court commented that the settlement agreements at issue were important to any damage calculation because they would likely be the only licenses of the patents-in-suit, particularly since “[the Plaintiff’s] business is to litigate and license the patents; it does not compete with Defendants in the marketplace.”¹⁹⁰ Where the owner practices or actively licenses its patent, other evidence may be sufficient to establish a ***214** reasonable royalty even without the admission of litigation licenses with questionable probative value.¹⁹¹

Of course, where the differences between a prior license of any kind and the hypothetical negotiation at issue are too great, rendering the probative value of the prior license vanishingly small so that the offering party is unable to provide a “sound basis for a meaningful comparison,”¹⁹² the district court should exercise its gatekeeping role to exclude the evidence.¹⁹³ If a prior license is sufficiently distinguishable, then the probative value may be so small, and require such guesswork, that it is error to include it in the reasonable royalty calculation.¹⁹⁴ Thus, in *ePlus, Inc. v. Lawson Software, Inc.*,¹⁹⁵ the court excluded expert testimony where the expert selectively relied on litigation licenses with cross-licensed patents and a lump-sum royalty in a case in which the plaintiff sought a running royalty.¹⁹⁶ The court found it “difficult to perceive a ‘fit’ between a hypothetically negotiated reasonable royalty rate in the context of this case and the assumptions used by [the expert] to arrive at the royalty base on which he produced the royalty rates which he sponsors.”¹⁹⁷ Similarly, in *Alpex Computer Corp. v. Nintendo Co.*, the court excluded under Rule 403 a litigation license where the patentee was in bankruptcy at the time of the prior licensing, the patentee’s patent counsel testified that the patentee accepted ***215** the license “because it did not have sufficient funds to take its lawsuit to trial,” and both parties agreed that “the admissibility of [this evidence] could have a profound effect on potential damages” in the case.¹⁹⁸ In other words, as the Federal Circuit explained in *Uniloc*, the ‘licenses relied on by the patentee in proving damages [must be] sufficiently comparable to the hypothetical license at issue in suit,’

and the patentee's failure to demonstrate comparability 'weighs strongly against' any use of such non-comparable licenses.¹⁹⁹

To make the necessary comparison, the fact-finder must understand the relative strengths and weaknesses of the original parties' case and, more importantly, the original parties' beliefs (even if incorrect) regarding the relative strengths and weaknesses of their case. How likely is it that the defendant believed (even incorrectly) the patent to be invalid or not infringed? How great did the parties perceive the likelihood of an injunction to be, and how important was it to the defendant to avoid an injunction?²⁰⁰ A litigation settlement undoubtedly gives us some insight into the parties' perceived value of the claim,²⁰¹ but the value of the claim does not by itself prove the patent's value. A given settlement may reflect a discount for lack of certainty in validity or infringement, or it may significantly overcompensate the patentee because of the infringer's fear of an injunction or enhanced damages. And, of course, the settlement also incorporates the parties' litigation-cost expectations. All of these considerations (in addition to the other issues that are typical of non-litigation licenses) must be explored and removed if we are to bestow significant probative value on a litigation license.

***216** A quick overview of the analogous issue of property valuation provides some helpful insights into the use of litigation licenses.²⁰² Courts determining the fair market value of property traditionally hold that recent sales are the best evidence of the property's fair market value.²⁰³ On the other hand, "[t]o the extent that a sale is motivated in part by considerations other than the value of the property sold, the sale price carries [little] weight as evidence of actual value."²⁰⁴ When the sale occurs at arm's length, a recent sale price is presumed to be the fair market value, and the opposing party bears the burden to identify other circumstances negating its reliability.²⁰⁵ Sales resulting from litigation settlements, however, are not arm's-length transactions giving rise to such a presumption.²⁰⁶ Indeed, these sales may hold "negligible" probative value.²⁰⁷

Although litigation licenses have some probative value, that probative value may be inextricably intertwined with irrelevant--and, worse, prejudicial and confusing--information. If the probative material--the value of the patent to the parties--cannot with reasonable certainty be extracted from the other considerations that factored into the litigation license's amount, the license adds little to the reasonable royalty evidence in the case. If the use of the litigation license is at all prejudicial, it should be excluded in those circumstances. The next section discusses the potential prejudices resulting from the use of a litigation license, and compares and contrasts them with prejudices resulting from the use of non-litigation licenses.

ii) The Prejudicial Effect of Litigation Licenses

Under Rules 703 and 403, the probative value of the litigation license must be balanced against the prejudicial effect of admission of a litigation license into evidence. These potential prejudices include: (a) mini-trials (distractions from the main issues in the case by forcing sub-litigation of the prior case); (b) prejudice ***217** through a jury's over-reliance on litigation licenses; and (c) increased and invasive discovery into settlement negotiations.

(1) "Mini-Trials"

One obvious potential for prejudice in the admission of litigation licenses is that their probative value in a reasonable royalty determination (their utility in determining the amount of the hypothetical license) is buried beneath layers of external considerations contributing to the license value. In other words, the litigation license requires further explanation and analysis before it can be helpful in determining a reasonable royalty.

At the extreme, this further explanation could take the form of "a 'mini-trial' on similarities and differences in the facts regarding the 'same' claims against the other defendants to determine what, if any, light the [license] sheds on the value of the claim" against the alleged infringer.²⁰⁸ The defendant seeks to prove that the patentee had no viable claim against the prior defendants, so that the settlement value did not reflect the patent value, but was largely attributable to litigation costs and risks. The patentee, on the other hand, seeks to prove that the settlement value was discounted from the patent's value as a function of its own litigation costs and risks. Consequently, both of the parties ask the jury to analyze the strengths of the claims and defenses in the prior case in order to "show whether and to what extent the rate from a prior license agreement is the result of a compromise or reflects a desire to avoid litigation."²⁰⁹ Thus, the use of litigation licenses invites "mini-trials" into the merits of the prior claim, in order to interpret the settlement value.

(A) Non-Litigation Licenses and "Mini-Trials"

Few would dispute the point that the use of litigation licenses may require an in-depth analysis of the prior licensing

circumstances, but an objection might nevertheless be raised: even a non-litigation license that differs from the hypothetical negotiations in any material way necessitates some explanation in order to demonstrate its probative value.²¹⁰ Indeed, that was the lesson of ResQNet and its progeny.²¹¹

***218** For example, the hypothetical negotiation usually assumes that the parties are negotiating toward an unrestricted “bare” license.²¹² In contrast, a prior licensee may have received a discount if its licensed territory were limited, or paid a premium if it received an exclusive license.²¹³ Where a license grants rights to a bundle of patents, rather than just to the patent-in-suit, the licensee would presumably pay more than the hypothetical negotiator, because the licensee of a bundled license that includes the litigation patent would receive more than the licensee of a single license for only the litigation patent. Similarly, cross-licenses add a wrinkle because the licensee pays for a license to the patent in suit in part by granting a license to its own patents.²¹⁴ In order to extract usable information from one of these licenses, the fact-finder must draw conclusions regarding the value of the discounts associated with limited rights, or the premiums associated with additional rights (relative to the unrestricted bare license). In a cross-license, for example, the fact-finder must isolate the litigation patent on one side of the equation and monetize the other patents (or cancel them out) in order to gain insight into the value of the litigation patent to the prior parties.²¹⁵ In essence, a mini-trial is required on the value of all of the patents exchanged by and received by the Patentee.²¹⁶

Even a traditional bare license of only the litigation patent is not necessarily perfectly representative of the reasonable royalty analysis. The reasonable royalty analysis assumes that the parties know that the patent is valid, enforceable, and infringed ***219** by the defendant’s product:²¹⁷ in Lemley and Shapiro’s helpful shorthand, that the patent has a “patent strength” of 100%.²¹⁸ In the traditional setting, on the other hand, the royalty is discounted for uncertainties related to the patent strength.²¹⁹ Stated differently, the parties to a traditional license do not know with certainty that the patent is valid or would be infringed by the licensee’s product. Consequently, the level of uncertainty should result in a proportional discount on the royalty.²²⁰

Moreover, the market conditions surrounding a prior license may be different from those existing at the time of the hypothetical negotiation,²²¹ and the infringer may always argue that it would have paid—and the patentee would have accepted—significantly less than the amount of any prior license because of the size of the infringer,²²² the infringer’s expected sales volume,²²³ or the existing commercial relationship between the parties and associated goodwill.²²⁴ Roy Epstein summarized some of the dangers and difficulties involved in using any license in proving a reasonable royalty:

***220** The Georgia-Pacific factors invite the use of actual negotiated royalties as benchmarks. Comparables are always desirable in a damages analysis but they can be treacherous. It is necessary to control for many different license characteristics. However, the number of publicly disclosed royalty rates is limited, as is the amount of information on the terms of each license. There are probably few cases where an arm’s length royalty is available for a similar product negotiated at a similar time under similar terms for a similarly situated infringer/licensee.

Ensuring comparability raises a host of issues. License terms involving duration, field of use, and exclusivity, can vary widely. A particular rate may reflect a larger transaction in IP that includes cross-licenses. There may be non-cash features such as know-how transfer and product support that obscure the stand-alone value of the patent.²²⁵

This point is well taken—the use of any prior license to prove a reasonable royalty may involve a complex comparison and contrast between that license and the hypothetical negotiation.

(B) Litigation-Licenses and “Mini-Trials”

Although any license creates some risk of “sideshow” litigation by requiring a potentially-complex comparison in order to prove its utility to the reasonable royalty calculation, litigation licenses are unique in some significant ways. One important difference between the use of non-litigation licenses and litigation licenses is that the mini-trials required for a litigation license will usually be longer and more complicated than the mini-trials required for a non-litigation license.

The relevant comparisons between a prior license and a hypothetical negotiation can generally be carried out by the parties’ damages experts, who can offer an opinion as to the market value of the patent-in-suit as part of the prior licensees’ products relative to the infringer’s products. The damages expert can likely also analyze the marketplace similarity of the prior product and the infringing product. These analyses are necessary to both non-litigation licenses as well as litigation licenses. But a damages expert would likely not be competent to read the claims of the patent-in-suit onto the prior defendant’s accused products, and therefore could not opine on the relative strengths and weaknesses of the prior defendant’s case. ***221** Nor

would the damages expert ordinarily be able to opine on the potential merits of the validity arguments made in the prior litigation (which may have rested on different prior art than the validity arguments raised by the later accused infringer). In other words, in addition to testimony about marketplace distinctions between the prior licensed product and the infringer's product, a litigation license requires an analysis of the infringement and invalidity contentions raised by the prior parties.

The use of a litigation license may necessitate a full trial of the merits of the earlier case as part of a damages analysis in the later case. Not only is this time-consuming, but it is almost certain to confuse the issues for the jury, as the merits of one patent case become intertwined in the damages of another. The district court can invoke Rule 403 to exclude this time-consuming and confusing testimony regarding the prior infringement case, but any exclusion of this information severely decreases the probative value of the license, and increases the odds that the jury will erroneously assess the value of the license.²²⁶

On top of this, there is the potential for added confusion as to which court's claim construction should be read onto the prior accused products. If the prior litigation reached the claim construction stage (in which the district court construes the language in the asserted patent claims), it is almost certain that the first court construed the claims differently from the second.²²⁷ Of course, the previously-settling defendant would have been operating under the earlier claim construction, and that construction may be relevant to the strengths and weaknesses of the prior defendant's infringement analysis. The later court surely will want to exclude the prior court's construction out of fear of confusion, but to the extent it affects the claim analysis for the previous lawsuit, it is particularly relevant to assigning the appropriate weight to the previous settlement.

(2) Jury Over-Reliance on Litigation Licenses

The risks of prejudice resulting from the misuse or overemphasis of a litigation license are generally greater than the risks of prejudice associated from other kinds of licenses. In the case of litigation licenses, the litigation-created differences between the prior license and the hypothetical negotiations are not as apparent as they are with other kinds of licenses. For example, a jury presented with a prior bundled license including the patent-in-suit and two other patents will know that ***222** the patentee gave up more value in that license than in the hypothetical license for the single patent-in-suit. The jury should also recognize that, without some additional explanation, it cannot properly evaluate the relative value of the patents.²²⁸ The patent-in-suit would have accounted for an unknown proportion of the licensing rates, and common sense should alert the jury that it needs additional information to give significant probative value to the bundled license.²²⁹

In the case of a litigation license, however, it is less obvious that the license includes considerations external to the value of the patent; those considerations are not necessarily on the face of the license. Even if the jury learns that this is a litigation license and appreciates that settlements may be entered into to avoid litigation, the jury is extremely unlikely to appreciate the very significant costs of litigation, and the monetary value placed on avoiding litigation.²³⁰ The litigation license appears on its face to be highly probative of the reasonable royalty question, and the jury is less likely to recognize that it needs additional information.²³¹ Moreover, because juries inevitably tend to view settlements as an admission of the defendant's liability,²³² a jury learning of a prior litigation license will tend to assign the full value of the license to the patent by assuming--perhaps incorrectly--that the prior defendant infringed. Thus, there is a very substantial risk that the jury will assign the litigation license more probative value than it is due, both because it appears to be more similar to the hypothetical negotiation than it actually is and because it appears to be an admission of infringement.²³³

***223** (3) Litigation Licenses and the Need for Discovery of Negotiations

Most courts and commentators agree that permitting the routine discovery of settlement negotiations--even negotiations related to the settlement of a prior case--creates an atmosphere hostile to settlement.²³⁴ If that holds true in the patent context, then permitting discovery of the negotiations surrounding a litigation license inhibits patent litigation settlements, a result contrary to the general policy favoring settlement.²³⁵ Even if it is not accurate in patent litigation,²³⁶ discovery regarding the negotiations and the full details of the prior case is likely to be voluminous and time-consuming, so that its burden outweighs its benefit in most cases.²³⁷ Just as a litigation license creates a mini-trial that is a "case within a case," the discovery of the circumstances surrounding the prior litigation stands to make all or almost all of the discovery from the prior litigation relevant to the later litigation, plus additional discovery into the parties' negotiations.

Some courts, concerned about allowing discovery of settlement negotiations, have opted to admit litigation licenses into evidence while foreclosing discovery of the accompanying negotiations.²³⁸ This solution is unworkable, because discovery of the negotiations is a necessary corollary of the admission of litigation licenses. As explained below, such discovery allows

the parties to extract the probative value *224 of the license²³⁹ and eliminates the unfair advantage otherwise held by the party involved in the prior settlement.²⁴⁰ Consequently, courts that are concerned about the potential impact of discovery of settlement negotiations should exclude the litigation licenses from evidence rather than admit them while denying discovery of the negotiations.²⁴¹

(A) Extracting the Probative Value from Litigation Licenses

As discussed above, along with the value of the patent, the parties' perceptions regarding patent strength, litigation costs, and enhanced damages are incorporated into the amount of their litigation license. As a result, discovery of those perceptions--as reflected in negotiations--enhances the probative value of the litigation license.²⁴²

One traditional response to this point is that the settlement communications lack relevance because they are full of self-serving statements and hyperbole. The argument suggests the necessity of negotiations makes sense in theory, but is untrue because

*225 [t]he words spoken during a negotiation are not necessarily true representations of a party's position. The nature of negotiations, and indeed often the key to negotiating to one's own advantage, is to reveal only that which enhances one's position. Thus negotiations can be filled with significant posturing and half-truths that convey little useful information as the parties seek to feel out the other side, establish trust, and gain some advantage.²⁴³

This argument inaccurately assumes that self-serving statements in a prior negotiation are irrelevant to the use of the resulting license in later litigation. Even if negotiating parties make no concessions and only offer "significant posturing and half-truths" during settlement negotiations, such self-serving statements reveal important information about the negotiating posture of the parties in the prior litigation.²⁴⁴ The later parties must be able to identify the arguments raised and relied upon in the prior litigation to assess the patent strength (or, more accurately, the parties' assessment of the patent strength at the time they entered into the litigation license). For example, if the alleged infringer in the later litigation is arguing that the royalty value of the patent is lower due to a cheap design-around,²⁴⁵ it becomes important to know whether the prior alleged infringer raised the same argument before settling. If a realistic design-around argument were raised, it would be included in the prior defendant's self-serving statements made to seek a concession during the negotiations. And, if there is in fact a realistic design-around, the reasonable royalty is much lower than what would have been agreed to by a licensee who did not consider, or who could not use, the design-around option.

More importantly, it is inaccurate to suggest that negotiation statements-- even if self-serving--are inherently untrustworthy. Even self-serving statements must be supported by facts and law. In fact, there is less room for blustering in negotiations after litigation inception than outside litigation, because positions regarding invalidity, unenforceability, and infringement are solidified or weakened based on what is revealed during discovery.

During litigation, the scope of each party's private information is likely to shrink, as the discovery process forces each party to share critical information with the other party. As information becomes *226 available to both parties, the parties will begin to cooperate from a common set of facts and understandings. This common set of facts and understandings permits a settlement license negotiated using this information to reflect a more accurate assessment of the value of the patent-at-issue.²⁴⁶

So, for example, a party may say, "Your patent will probably be determined to be invalid at trial," even if it doubts the veracity of this assertion, but the party must include the reasons for its position--what facts and what law support its claim of invalidity.²⁴⁷ From these reasons, we can get a better understanding of how strong the argument is and, generally, the prior parties' likely assessments of that argument. The strength of this position-- rather than the potentially self-serving words the party uttered--help to determine the probative value of the amount of the litigation license.

MSTG, Inc. v. AT&T Mobility L.L.C. reflects the dilemma courts face in this context, where settlement negotiations are clearly probative, but general policy militates against the production or admission of such negotiations.²⁴⁸ There, the court held that settlement negotiations were discoverable, because they would likely "provide grounds for deciding if MSTG's prior licenses are--or are not--sufficiently comparable to the patents-in-suit to be used in calculating a reasonable royalty."²⁴⁹ At the same time, the court hesitated to permit discovery of settlement negotiations because of the potential impact on future settlements.²⁵⁰ In the end, the court permitted discovery, but limited its decision to "the specific facts at issue between the parties in this case."²⁵¹

(B) Avoiding Asymmetry in the Parties' Knowledge of Relevant Facts

The purpose of discovery is to foster the exchange of relevant information between the parties.²⁵² This Article has already shown settlement negotiations to be ***227** highly relevant in assessing the probative value of a litigation license as evidence of a reasonable royalty. In the absence of discovery, however, only the party involved in the prior litigation holds that relevant information. There is a clear asymmetry of relevant knowledge at the outset of the case. Foreclosing discovery permits the previous litigant to hold on to that asymmetrical knowledge. This is not unheard of--various privileges, such as the attorney-client privilege or the physician-patient privilege, act similarly in other contexts;²⁵³ but, like other privileges, any settlement-negotiating privilege could presumably be strategically waived.

A discovery privilege allows the settling party to unilaterally decide when to produce beneficial settlement communications, while depriving the other party of the right to inspect settlement communications that may be harmful to the settling party's position.²⁵⁴ For instance, imagine a scenario in which the patentee, in settlement communications, made a significant concession in its settlement demands--a concession that it attributed to unusually-high anticipated litigation expenses. The patentee would then produce this communication in discovery and, presumably, use it at trial.²⁵⁵ On the other hand, if the alleged-infringer from the previous litigation had agreed to settle for \$1 million because its litigation expenses would be at least that much, the infringer in the later litigation would not have any way of discovering this fact or introducing it at trial. In other words, in the absence of discovery, the settling party has exclusive knowledge of relevant facts and gets ***228** to use them or hold silent about them depending on the perceived benefit of each course.

(C) Removing the Incentive to Inflate Patent Licenses

The admission of litigation licenses has the potential to work significant mischief when combined with the exclusion of settlement negotiations and surrounding circumstances--patentees will begin to creatively settle litigation to enlarge the apparent license value. The potential for this mischief has been recognized by practicing lawyers, who have recommended that "if your company is a defendant in a multi-defendant case, you may be able to entice the patent owner to settle for a lower dollar amount in exchange for structuring your settlement to reflect a high effective royalty rate that the patentee can use in pursuing other larger defendants."²⁵⁶

One way of manipulating the effective license rate is for patentees to shift the royalty from past infringement to the forward-looking license for future use of the invention.²⁵⁷ Suppose, for example, that Patentee sues BigCo, who has manufactured 1 million infringing products and, during settlement negotiations, informs Patentee that it intends to manufacture 500,000 more infringing products. If the parties would otherwise agree to a running royalty of \$1 per manufactured product, Patentee could offer simply to dismiss the litigation with prejudice²⁵⁸ or covenant not to sue for past infringement in a separate agreement, and then agree to a running royalty of \$2.75 per manufactured product, with a guaranteed up-front payment of \$1,375,000 to be applied toward the first 500,000 products. This scheme saves BigCo \$125,000 based on its expectations, and may prove a wise investment for Patentee, who expects to use this license in litigation against other entities.²⁵⁹ If the settlement negotiations are not discoverable or admissible,²⁶⁰ the jury may not be provided the context with which to see through this manipulation, and would instead only be presented with a license reflecting an inflated royalty rate of \$2.75 per infringing product.

***229** (D) The Federal Rules of Evidence and Settlement Negotiations

There is no basis in the Federal Rules of Evidence under which a court could properly admit a litigation license but exclude the accompanying settlement negotiations.²⁶¹ Rule 408 applies equally to a settlement agreement and to negotiations,²⁶² so if the rule does not bar the license, it also does not bar the negotiations. Rule 408 does not allow a party to "have it both ways" by arguing for admission of the settlement agreements but exclusion of the accompanying negotiations.²⁶³ If the litigation license is probative, so, too, are the negotiations.

While a court might rely on Rule 403 to admit a litigation license but exclude the corresponding negotiations, this reliance would be misplaced. As explained above, the negotiations serve to strengthen the probative value and decrease the prejudice--at least to the non-settling party--resulting from admission of the litigation license.

d) Summarizing the Considerations Impacting the Admission of Litigation Licenses

As demonstrated in ResQNet, Lucent, Wordtech, and Uniloc, the Federal Circuit in recent years has taken a strong stance against what it has perceived to be district courts' and juries' over-reliance on evidence with little probative value. The court's emphasis on the need for a substantive connection between the license offered and the pending litigation does not result in the wholesale exclusion of litigation licenses, but it should instruct trial judges to be especially cautious in handling such licenses.

The preceding sections underscore how attenuated the probative value of litigation licenses can be. There will be cases where the probative value is significantly greater than average, either because of the settlement circumstances²⁶⁴ or because of the lack of any other kinds of useful licenses or evidence in general.²⁶⁵ Thus, *230 there may be situations in which litigation licenses should be admitted. Nevertheless, the court should begin its analysis with a thumb on the scale against the admission of litigation licenses as a result of the questionable and speculative probative value weighed against the prejudices that inhere in the use of litigation licenses.

A court deciding whether to admit litigation licenses under Rule 403, Rule 703, or both, should consider a number of factors. First, it should consider the availability of any non-litigation licenses, which are likely more probative and almost certainly less prejudicial. The court should also consider other available probative evidence on the reasonable royalty question, such as industry standards or other factors enumerated in Georgia-Pacific.²⁶⁶ The court should examine the arguments likely to be raised if the litigation license is admitted--that is, how extensive and confusing any resulting mini-trial would be.²⁶⁷ The court should consider the likely probative value of the license, bearing in mind that the offering party must be able to establish a sufficient link to the hypothetical negotiation before the license is sufficiently useful to warrant admission, even in the absence of any prejudicial effect.²⁶⁸ The court should consider the need for and extent of discovery into the surrounding negotiations, as well as the effect that such discovery--and its potential admission at trial--may have on settlements more generally.²⁶⁹ Finally, the court should consider any particulars of the case, such as whether the prior negotiations reveal that the patentee manipulated the litigation license to give it an inflated value.²⁷⁰

In the usual case, the probative value of the litigation license will be slight and difficult to extract, while the risk of prejudice and confusion resulting from its admission will be significant. In other words, in the usual case, the license's "probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, *231 waste of time, or needless presentation of cumulative evidence,"²⁷¹ and the license should be excluded.

Conclusion

Litigation licenses have a long and controversial history in the realm of the reasonable royalty. These licenses have, however, stirred even more controversy in recent years due at least in part to the substantial increase in litigation by non-practicing patent owners and to the Federal Circuit's ResQNet decision. Although some courts have indicated that ResQNet fully resolves the litigation-license controversy, that conclusion is unwarranted.

Courts that have referred to litigation licenses as "irrelevant" to a reasonable royalty determination have done so based on their conflation of imperfection with irrelevance; although litigation licenses are not a perfect match for the hypothetical negotiation, they are certainly capable of informing the analysis. Thus, it is inaccurate to say that they are irrelevant under Rule 402. Nevertheless, litigation licenses often have a very small probative value, because it is difficult to distinguish the role played by patent value in a litigation license from settlement considerations that do not speak to the reasonable royalty at all.

Balanced against the slight probative value of the litigation license is the risk of substantial prejudice and confusion that results from litigation licenses. In particular, the use of litigation licenses risks long and complex mini-trials in which the merits of the prior litigation are tried as part of the damages evaluation in the later litigation--a full case within a case. These licenses also risk over-reliance by juries, who may not fully appreciate the heavy role that litigation considerations external to the patent's value play in a decision to settle an infringement case. Finally, any use of these licenses requires voluminous and intrusive discovery into the prior parties' settlement negotiations. Consequently, litigation licenses should generally be excluded from evidence under the probative versus prejudicial balancing tests set forth in Rule 403 and Rule 703.

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1 35 U.S.C. § 284 (2006), amended by, Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011).

2 Lucent Techs., Inc. v. Gateway, Inc., 580 F.3d 1301, 1324 (Fed. Cir. 2009).

3 Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538, 1577-78 (Fed. Cir. 1995); see also Panduit Corp. v. Stahl Bros. Fibre Works, Inc., 575 F.2d 1152, 1159 (6th Cir. 1978) (“Determination of a ‘reasonable royalty’ after infringement, like many devices in the law, rests on a legal fiction. Created in an effort to ‘compensate’ when profits are not provable, the ‘reasonable royalty’ device conjures a ‘willing’ licensor and licensee, who like Ghosts of Christmas Past, are dimly seen as ‘negotiating’ a ‘license.’”).

4 This article addresses only the use of litigation licenses for purposes of proving a reasonable royalty. It does not address their potential use as evidence of patent validity. Licenses--as part of commercial success-- are a secondary consideration in determining a patent's validity. In other words, the licensing of a patent does not directly show that a patented invention represents a new and non-obvious innovation, but a patented invention's success in the marketplace, including its licensing by market participants, may provide circumstantial evidence of the patented invention's novelty and usefulness. See 2 Donald S. Chisum, Chisum on Patents § 5.05 (2010).

5 See, e.g., Michael J. Chapman, Using Settlement Licenses in Reasonable Royalty Determinations, 49 IDEA 313, 315 (2009); Parker Kuhl, Rescue Me!: The Attack on Settlement Negotiations After ResQNet v. Lansa, 26 Berkeley Tech. L.J. 269, 269-70 (2011); E. Danielle Thompson Williams & Leslie T. Grab, Contemporary Issues in Patent Royalty Damages, Patent Law Practice Center (Oct. 13, 2010, 7:00 PM), www.patentlawcenter.pli.edu/2010/10/13/contemporary-issues-in-patent-royalty-damages/ (discussing the differing conclusions of post-ResQNet cases).

6 ResQNet.com, Inc. v. Lansa, Inc., 594 F.3d 860 (Fed. Cir. 2010).

7 As used in the Patent Act, the patentee is anyone who holds title to the patent--not necessarily limited to the person who was originally granted the patent. 35 U.S.C. § 100(d) (2006).

8 BIC Leisure Prods., Inc. v. Windsurfing Int'l, Inc., 1 F.3d 1214, 1218 (Fed. Cir. 1993).

9 Proof of causation for the lost sales is especially onerous where non-infringing functional alternatives are available on the market, or where the patent holder may not have had sufficient capacity to make and sell the products. See 7 Chisum, *supra* note 4, § 20.05(2)(e)(v)-(2)(e)(vii). In addition, the patented invention often represents only a small portion of the defendant's product, rendering proof of causation and damages difficult. *Id.* § 20.05(3). Moreover, lost profits may be a function of irreversible price erosion--the unlawful competition in the marketplace may cause the price of the invention to decline and create a market resistance to a subsequent price increase, so that the patentee suffers lost profits not only for the infringer's sales, but also for its own future lost sales (if it maintains its current price) or for future sales at the lower price caused by the infringer's activities. See *In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 831 F. Supp. 1354, 1384 (N.D. Ill. 1993) (“Although the royalty cannot be greater than compensatory damages in a case such as this, compensatory damages can exceed the reasonable royalty. An infringer's activities do more than divert sales to the infringer. They also depress the price. Competition drives price toward marginal cost.”).

10 7 Chisum, *supra* note 4, § 20.06.

11 *Id.*

12 Rude v. Westcott, 130 U.S. 152, 164 (1889).

13 Christopher B. Seaman, Reconsidering the Georgia-Pacific Standard for Reasonable Royalty Patent Damages, 2010 BYU L. Rev. 1661, 1667 (2010).

14 35 U.S.C. § 284 (2006) amended by, Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011).

15 See Lucent Techs., Inc. v. Gateway, Inc., 580 F.3d 1301, 1325 (Fed. Cir. 2009) (discussing lump-sum and running royalties); see also Studiengesellschaft Kohle, m.b.H. v. Dart Indus., Inc., 862 F.2d 1564, 1573 (Fed. Cir. 1988) (affirming district court’s finding that special master erred by awarding a straight running royalty instead of conforming the reasonable royalty award to patentee’s previous licensing practice of a sliding scale royalty with a creditable down payment).

16 7 Chisum, supra note 4, § 20.02.

17 See Keystone Mfg. Co. v. Adams, 151 U.S. 139, 147 (1894) (awarding nominal damages); Rude v. Westcott, 130 U.S. 152, 167 (1889); Dobson v. Dornan, 118 U.S. 10, 17 (1886); Black v. Thorne, 111 U.S. 122, 124 (1884); Blake v. Robertson, 94 U.S. 728, 733-34 (1876); New York v. Ransom, 64 U.S. 487, 491 (1859).

18 7 Chisum, supra note 4, § 20.02(2)(a) (“[T]he Supreme Court oscillated on the question of allowing general damages for use or sale of the plaintiff’s invention where the plaintiff could not show an established license rate or specific lost profits.”). In early America, litigation by the non-practicing entity was virtually unheard of--there was less incentive for the NPE to litigate under the pre-reasonable royalty damages scheme. The rise of NPE litigation is a relatively recent phenomenon, and the “patent troll” is largely a recent phenomenon. See Daniel P. McCurdy, Patent Trolls Erode the Foundation of the U.S. Patent System, Sci. Progress, Winter 2008-09 at 78-79 (describing the rise in NPEs characterized as trolls and the increase in patent-troll litigation).

19 See, e.g., U.S. Frumentum Co. v. Lauhoff, 216 F. 610, 625 (6th Cir. 1914) (having “no hesitation” in affirming right of patentee to recover a “reasonable royalty”).

20 235 U.S. 641, 649 (1914).

21 Id.

22 Act of Feb. 21, 1922, ch. 58, 42 Stat. 392.

23 Act of Aug. 1, 1946, ch. 726, 60 Stat. 778.

24 Id.

25 The Patent Reform Act of 2009, as introduced on March 3, 2009, by Senator Leahy, would have consolidated the two, expressly providing that, where there is an established royalty, a court may award reasonable royalty damages based on the established royalty. Patent Reform Act of 2009, S. 515, 111th Cong. § 4 (as introduced by Sen. Leahy, Mar. 3, 2009). The version of the bill approved by the Judiciary Committee omitted the entire section of the bill in which this provision was found. Patent Reform Act of 2009, S. 515, 111th Cong. (as reported by S. Comm. on the Judiciary, Apr. 2, 2009). The Senate never voted on the amended bill, and it died at that stage. In 2011, Senator Leahy re-introduced the amended version of the bill, with some modifications. Patent Reform Act of 2011, S. 23, 112th Cong. (as introduced by Sen. Leahy, Jan. 25, 2011).

26 7 Chisum, supra note 4, § 20.06(2).

- 27 Monsanto Co. v. McFarling, 488 F.3d 973, 978-79 (Fed. Cir. 2007) (“When the patentee has consistently licensed others to engage in conduct comparable to the defendant’s at a uniform royalty, that royalty is taken as established and indicates the terms upon which the patentee would have licensed the defendant’s use of the invention.”). Nevertheless, even an established royalty may be less than a reasonable royalty, in which case the statute mandates the award of the higher reasonable royalty. For example, where an established royalty is artificially depressed due to widespread infringement, the appropriate award is a higher reasonable royalty. Nickson Indus., Inc. v. Rol Mfg. Co., 847 F.2d 795, 798 (Fed. Cir. 1988).
- 28 H.B. Fuller Co. v. Nat’l Starch and Chem. Corp., 689 F. Supp. 923, 949 (D. Minn. 1988) (“The licenses ... are insufficient to prove an established royalty as they were entered into after this litigation began and are tainted by this litigation. However, the licenses provide some indication of an appropriate license rate”); 7 Chisum, supra note 4, § 20.07(2)(a); Wordtech Sys. Inc. v. Integrated Networks Solutions, Inc., 609 F.3d 1308, 1319 (Fed. Cir. 2010).
- 29 Lucent Techs., Inc. v. Gateway, Inc., 580 F.3d 1301, 1324-25 (Fed. Cir. 2009). The reasonable royalty is also described as the sum “which would be accepted by a prudent licensee who wished to obtain a license but was not so compelled and a prudent patentee, who wished to grant a license but was not so compelled.” Horvath v. McCord Radiator & Mfg. Co., 100 F.2d 326, 335-36 (6th Cir. 1938). The reasonable royalty is sometimes calculated under the “analytical method,” which looks at the infringer’s projected profits on the infringing product, but the hypothetical negotiation is the “more common approach.” Lucent, 580 F.3d at 1324. The infringer’s projected profits-- the subject of the analytical approach--are incorporated into the hypothetical negotiation, which includes the expected profit as a factor affecting the hypothetical bargain the parties would strike, but allows for consideration of other things, such as where the infringing product is a loss leader but is expected to create profits through convoyed sales. *Id.* at 1324-25.
- 30 Fromson v. W. Litho Plate & Supply Co., 853 F.2d 1568, 1575 (Fed. Cir. 1988), overruled by Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v. Dana Corp., 383 F.3d 1337 (Fed. Cir. 2004).
- 31 Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538, 1577-78 (Fed. Cir. 1995); see also Panduit Corp. v. Stahl Bros. Fibre Works, Inc., 575 F.2d 1152, 1159 (6th Cir. 1978) (“Determination of a ‘reasonable royalty’ after infringement, like many devices in the law, rests on a legal fiction. Created in an effort to ‘compensate’ when profits are not provable, the ‘reasonable royalty’ device conjures a ‘willing’ licensor and licensee, who like Ghosts of Christmas Past, are dimly seen as ‘negotiating’ a ‘license.’”).
- 32 Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292, 1312 (Fed. Cir. 2011).
- 33 NPEs can include institutions, such as universities, whose research may create new, patentable inventions, even though the institution does not market the invention. eBay Inc. v. MercExchange, L.L.C., 547 U.S. 388, 393 (2006).
- 34 The NPE, of course, had no lost profits, because it had no lost sales. Poly-America, L.P. v. GSE Lining Tech., Inc., 383 F.3d 1303, 1311 (Fed. Cir. 2004) (“[T]he patentee needs to have been selling some item, the profits of which have been lost due to infringing sales, in order to claim damages consisting of lost profits.”).
- 35 See Studiengesellschaft Kohle, m.b.H. v. Dart Industries, Inc., 862 F.2d 1564, 1572 (Fed. Cir. 1988) (“[O]ffers to license made at a time when ‘litigation was threatened or probable’ should not be considered evidence of an established royalty.”).
- 36 The “patent troll” moniker conceptualizes the NPE as waiting under the bridge (the patented invention) for someone to cross (to use the invention), and then attempting to extract a fee for crossing the bridge. Christopher A. Harkins, Fending off Paper Patents and Patent Trolls: A Novel “Cold Fusion” Defense Because Changing Times Demand It, 17 Alb. L.J. Sci. & Tech. 407, 410-11 (2007). Patent trolls are often entities formed to acquire and hold patents from inventors, who may not have the time, desire, or resources to participate in the market or to litigate against infringers. *Id.* at 412.
- 37 Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538, 1577-78 (Fed. Cir. 1995).

38 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970), modified, 446 F.2d 295 (2d Cir. 1971).

39 Id.

40 ResQNet.com, Inc. v. Lansa, Inc., 594 F.3d 860, 869 (Fed. Cir. 2010). Although the Federal Circuit described the list as “comprehensive” in ResQNet, the list has also been described as non-exhaustive. Lear Auto. Dearborn, Inc. v. Johnson Controls, Inc., No. 04-73461, 2011 U.S. Dist. LEXIS 5203, at *11-12 (E.D. Mich. Jan. 20, 2011).

41 Lucent Techs. Inc. v. Gateway, Inc., 580 F.3d 1301, 1324-25 (Fed. Cir. 2009); Interactive Pictures Corp. v. Infinite Pictures, Inc., 274 F.3d 1371, 1385-86 (Fed. Cir. 2001).

42 The first Georgia-Pacific factor has not been strictly limited to those royalties “proving or tending to prove an established royalty.” See 7 Chisum, supra note 4, § 20.07 (“Prior and existing royalties could be considered as evidence of a reasonable royalty without regard to whether they fully met the prior standards for an established royalty.”).

43 See ResQNet.com, 594 F.3d at 881 (“[C]onsideration may be given to royalties paid by the licensee to others.”).

44 See infra Part 3(c)(i) (“[T]he giants of a given industry [could] use threats of costly and protracted litigation to extort an unreasonably low royalty.”).

45 Rude v. Westcott, 130 U.S. 152, 164 (1889); see also General Motors Corp. v. Blackmore, 53 F.2d 725, 729 (6th Cir. 1931) (settlement agreements “lack[] that element of volition upon the part of the infringers which was necessary to show true or actual value by showing what others were generally willing to pay and the licensors willing to accept”).

46 See, e.g., Donnelly Corp. v. Gentex Corp., 918 F. Supp. 1126, 1134 (W.D. Mich. 1996) (in granting a motion in limine to exclude litigation licenses, inaccurately stating that the “Federal Circuit ... has squarely held that in patent infringement litigation such as this the rates paid in the industry as a result of settlement negotiations may not be considered since they do not accurately reflect what a willing licensee would pay a willing licensor in an arm’s length negotiation”). Neither of the court’s cited Federal Circuit cases held this. See also American Original Corp. v. Jenkins Food Corp., 774 F.2d 459, 464 (Fed. Cir. 1985) (holding that district court did not err in awarding lower reasonable royalty than amount paid in litigation license, and noting that the litigation license “does not establish ... the minimum reasonable royalty,” because “[a] royalty at which a patentee offers to license his invention, particularly when coupled with a claim of infringement, is not necessarily the same rate as that upon which a hypothetical willing licensee and willing licensor would agree”); Hanson v. Alpine Valley Ski Area, Inc., 718 F.2d 1075, 1078-79 (Fed. Cir. 1983) (holding that district court did not err in rejecting patentee’s settlement offers as proof of an established royalty, because “the latter requires actual licenses, not mere offers to license” and because “the offers were made after the infringement had begun and litigation was threatened or probable”).

47 See infra Part 3(a) (discussing the inadmissibility of irrelevant evidence).

48 See infra Part 3(c) (discussing probative versus prejudicial balance).

49 See infra Part 3(b) (discussing exclusion of settlement evidence).

50 See ReedHycalog UK, Ltd. v. Diamond Innovations, Inc., 727 F. Supp. 2d 543, 546 (E.D. Tex. 2010) (“Historically, courts have excluded licenses made to settle litigation, finding their probative value highly questionable.... However, based on ResQNet.com, Inc. v. Lansa, Inc., 594 F.3d 860 (Fed. Cir. 2010), some parties are arguing, and some courts are finding, that settlement licences are admissible to prove a reasonable royalty.”).

51 ResQNet.com, Inc. v. Lansa, Inc., 594 F.3d 860, 869-70 (Fed. Cir. 2010).

52 Id. at 870.

53 Id.

54 Id. at 871 n.1 (discussing lack of a nexus between expert’s proposed royalty rate and the other offered patent royalty rates).

55 Id. at 871.

56 Id.

57 See id. (“Without that link ... ‘[w]e ... cannot understand how the [fact finder] could have adequately evaluated the probative value of [the] agreements.’” (quoting Lucent Techs. Inc. v. Gateway, Inc., 580 F.3d 1301, 1328 (Fed. Cir. 2009))). ResQNet’s expert testified that the products in the re-bundling licenses were “based on” the patented invention, but that testimony was “a far cry from a conclusion that ResQNet’s products are coextensive with the claimed invention.” Id. at 871 n.1.

58 See id. at 871-72 (“The first Georgia-Pacific factor, which Dr. David found to be controlling and which the district court in turn adopted, must consider licenses that are commensurate with what the defendant has appropriated.”).

59 Id. at 870 (“He considered a few of the other Georgia-Pacific factors, but dismissed them because ‘[f]or the most part, the other factors have no real impact here.’”); but see id. at 881 (Newman, J. dissenting and concurring) (arguing that the majority mischaracterized the expert’s analysis of the factors, and that he “discussed all fifteen factors”).

60 See id. at 870 (discussing the two royalty rates that were not rebundled licenses).

61 Id. at 872. Although the admissibility of the litigation licenses was not before the court in ResQNet, the court seemingly approved the consideration of the previously-admitted litigation licenses; it noted that Lansa (the defendant) did not need to present separate evidence of a reasonable royalty, because it was entitled to rely on the evidence already in the record (the litigation licenses) to establish a reasonable royalty.

62 Id. at 872-73.

63 ResQNet.com, Inc., 594 F.3d at 873.

64 Id. at 872; see also Wordtech Sys. v. Integrated Networks Solutions, Inc., 609 F.3d 1308, 1320 (Fed. Cir. 2010) (clarifying that any comparison of past licenses to the infringement “must account for key differences between them”).

65 594 F.3d at 876 (Newman, J., dissenting).

66 Id. at 877.

67 Id. at 879.

68 Id.

69 Id. at 876.

70 Id. at 873 (emphasis added). Judge Newman argued that the district court provided sufficient factual findings, but the majority disagreed.

71 ResQNet.com, Inc., 594 F.3d at 869 (stating that damages must be tied to market place presence).

72 Id. (discussing that unrelated evidence to the claimed invention is null).

73 Id. (quoting Lucent Techs. Inc. v. Gateway, Inc., 580 F.3d 1301, 1327-28 (Fed. Cir. 2009)).

74 See Volumetrics Med. Imaging, LLC v. Toshiba America Med. Sys., Inc., No. 1:05-CV-955, 2011 WL 2470460, at *14 (M.D.N.C. June 20, 2011) (the “vast majority of courts to consider the relevance of settlement agreements (and offers) to the subject of patent damages in light of ResQNet.com” have found them to be relevant).

75 ResQNet.com, Inc., 594 F.3d at 872.

76 See Volumetrics Med. Imaging, 2011 WL 2470460, at *10 (“Before the decision in ResQNet.com, district courts across the country had divided sharply (and, based on the Court’s research, rather evenly) in their assessments (in a variety of procedural contexts) of whether litigation-inspired licensing terms have relevance to the determination of a ‘reasonable royalty.’”); see also GE v. DR Sys., No. CV 06-5581, 2007 U.S. Dist. LEXIS 44644, at *6 (E.D.N.Y. June 20, 2007) (“[S]ettlement agreements reached to resolve litigation or threatened litigation are generally not relevant to the issue of what may constitute a reasonable royalty.”); Monsanto Co. v. Bayer Bioscience N.V., No. 4:00CV01915, 2005 U.S. Dist. LEXIS 46068, at *56 (E.D. Mo. Oct. 28, 2005) (“Based on the overwhelming case law on the subject, the settlement agreements are not relevant to the reasonable royalty rate”) (internal quotations omitted).

77 As shown in Part 3(a), *infra*, litigation licenses are relevant to the question of the reasonable royalty.

78 See, e.g., Cornell Univ. v. Hewlett-Packard Co., No. 01-CV-1974, 2008 U.S. Dist. LEXIS 39343, at *9-14 (N.D.N.Y. May 8, 2008) (excluding litigation licenses under both Rule 402 and Rule 408).

79 The bases for exclusion are examined in more detail *infra* in Part 3.

80 Spreadsheet Automation Corp. v. Microsoft Corp., 587 F. Supp. 2d 794, 801 (E.D. Tex. 2007).

81 The court in ResQNet recognized the prejudicial effect of litigation licenses, noting that “litigation itself can skew the results of the hypothetical negotiation.” ResQNet.com, Inc. v. Lansa, Inc., 594 F.3d 860, 872 (Fed. Cir. 2010).

82 Id. at 872-73 (discussing why the litigation licenses were used).

83 See Datatransaction Corp. v. Wells Fargo & Co., No. 2:06-CV-72, 2010 U.S. Dist. LEXIS 25291, at *19 (E.D. Tex. Mar. 4, 2010) (“In light of ResQNet, litigation-related licenses should not be excluded from the March 2010 Phase I trial in the above-captioned case.”).

84 580 F.3d 1301, 1328 (Fed. Cir. 2009) (discussing why the evidence provided to jury was insufficient).

85 Id. at 1325.

86 Id. at 1324.

87 Id.

88 Id. Licenses reflecting amounts previously paid by the infringer to license comparable technology go to the second Georgia-Pacific factor. Regardless of whether the prior licenses relate to Georgia-Pacific factor 2 [prior licenses by the infringer for comparable technology] or factor 1 [prior licenses by the patentee for the patent-in-suit], the court applies the same “general criteria for comparing patent licenses.” *Wordtech Sys., Inc. v. Integrated Networks Solutions, Inc.*, 609 F.3d 1308, 1319 (Fed. Cir. 2010).

89 Lucent, 580 F.3d at 1328 (discussing the lump-sum agreements).

90 Id. at 1330.

91 Id.

92 Id. (discussing Lucent’s burden on damages).

93 Id.

94 609 F.3d 1308 (Fed. Cir. 2010).

95 Id. at 1310-11 (detailing the background information of the cases).

96 Id. at 1319 (discussing plaintiff’s damages evidence).

97 Id. at 1320 (quoting *ResQnet*, 594 F.3d at 873).

98 Id. at 1318-22.

99 Id. at 1320 (stating the lack of evidence supporting jury’s finding).

100 Id.

101 Id. at 1320-21 (quoting *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 872 (Fed. Cir. 2010) (discussing the context of the licenses that were considered)).

102 Id. at 1320. This background information into the parties’ calculation of the lump sum is required in order to draw a comparison to the infringer’s intended use at the time of the hypothetical negotiation. Put differently, if a licensee intending to produce 1 million

licensed products signed a lump-sum license for \$1 million, a licensee intending to produce 250,000 licensed products would expect to negotiate a smaller lump-sum payment. The jury needs to know the prior licensee's projections at the time of the prior license in order to conduct the hypothetical negotiation based on the patentee's and infringer's projections.

103 632 F.3d 1292 (Fed. Cir. 2011).

104 Id. at 1315. Prior to *Uniloc*, patent damages experts often used the 25% rule of thumb as a starting point for their hypothetical negotiation. The rule assumes that 25% of the anticipated profits from the use of a patented invention would go to the patentee as a royalty--the infringer would keep the other 75%. *Uniloc*, 632 F.3d at 1312-13. The rule of thumb is based on averages from empirical data. Id. The Federal Circuit criticized the rule's failure to account for the individualities of a given case. Id. at 1317-18.

105 Id. at 1316 (quoting *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301, 1327 (Fed. Cir. 2009)).

106 Id. at 1317.

107 *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970), modified, 446 F.2d 295 (2d. Cir. 1971).

108 Id. at 1139.

109 Id. ("The rights granted by USP to the foreign licensees were completely different from the rights appropriated by GP, which sold its infringing product in competition with USP throughout the United States.").

110 Id.

111 One way to demonstrate patent validity is by showing that the patented invention enjoyed commercial success--that is, that it was well-received in the market. One way to evidence commercial success is by showing the existence of prior licenses--if a great number of entities licensed the patented invention, this indicates (but generally does not conclusively prove) patent validity. Because it does not directly demonstrate validity, but instead merely provides circumstantial evidence of validity (e.g., nonobviousness), commercial success is known as a secondary consideration. *GSI Grp., Inc. v. Sukup Mfg. Co.*, No. 05-3011, 2008 U.S. Dist. LEXIS 80088, at *14 (C.D. Ill. Oct. 8, 2008).

112 *Iron Grip Barbell Co. v. USA Sports, Inc.*, 392 F.3d 1317, 1324 (Fed. Cir. 2004) (internal quotations omitted).

113 *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301, 1330 (Fed. Cir. 2009).

114 See, e.g., *GE v. DR Sys.*, No. CV 06-5581, 2007 U.S. Dist. LEXIS 44644, at *6 (E.D.N.Y. June 20, 2007) ("[S]ettlement agreements reached to resolve litigation or threatened litigation are generally not relevant to the issue of what may constitute a reasonable royalty."); *Monsanto Co. v. Bayer Bioscience N.V.*, No. 4:00CV01915, 2005 U.S. Dist. LEXIS 46068, at *56 (E.D. Mo. Oct. 28, 2005) ("Based on the overwhelming case law on the subject, the settlement agreements are not relevant to the reasonable royalty rate").

115 See, e.g., *Cornell Univ. v. Hewlett-Packard Co.*, No. 01-CV-1974, 2008 U.S. Dist. LEXIS 39343, at *9-14 (N.D.N.Y. May 8, 2008) (excluding the negotiation offer amounts under Rule 408).

116 *Alpex Computer Corp. v. Nintendo Co.*, 1994 U.S. Dist. LEXIS 3343, at *28-38 (S.D.N.Y. Mar. 16, 1994) ("In light of the foregoing substantive law governing damage calculations in patent cases, the court finds evidence of Alpex' [sic] licensing offers inadmissible under Rule 403.").

- ¹¹⁷ See, e.g., *Software Tree, LLC v. Red Hat, Inc.*, No. 6:09-CV-097, 2010 U.S. Dist. LEXIS 70542, at *10-11 (E.D. Tex. June 24, 2010) (distinguishing ResQNet, as the admission of litigation related agreement was not before that court); see also *MSTG, Inc. v. AT&T Mobility LLC*, No. 08 C 7411, 2011 U.S. Dist. LEXIS 5533, at *37-38 (N.D. Ill. Jan. 20, 2011) (describing the parties' disagreements of ResQNet's meaning); *Williams & Grab*, supra note 5.
- ¹¹⁸ *Caluori v. One World Techs., Inc.*, No. CV-07-2035-CAS, 2012 WL 630246, at *4 (C.D. Cal. Feb. 27, 2012); *MSTG, Inc.*, 2011 U.S. Dist. LEXIS 5533, at *37-38; *Williams & Grab*, supra note 5.
- ¹¹⁹ See, e.g., *Auto. Merch. Sys., Inc. v. Crane Co.*, No. 3:03-CV-88, 2011 WL 5025907, at *6 (N.D. W. Va. Oct. 21, 2011) (granting motion to compel disclosure of settlement negotiations); *Delphi Auto. Sys., LLC v. Vehicle Occupant Sensing Sys., LLC*, No. 10-10886, 2011 U.S. Dist. LEXIS 42236 (E.D. Mich. Apr. 19, 2011) (granting motion to compel documents related to negotiations of litigation licenses and concluding that, after ResQNet, both the agreement and the contemporaneous negotiations were discoverable); *MSTG, Inc.*, 2011 U.S. Dist. LEXIS 23417, at *13 (granting motion to compel documents pertaining to settlement negotiations); *Datatransury Corp. v. Wells Fargo & Co.*, No. 2:06-CV-72, 2010 U.S. Dist. LEXIS 25291, at *19-20 (E.D. Tex. Mar. 4, 2010) (granting discovery of negotiations surrounding litigation licenses).
- ¹²⁰ See, e.g., *Avocent Redmond Corp. v. Raritan Americas, inc.*, No. 10-CV-6100 (S.D.N.Y. Sept. 26, 2011) (acknowledging potential relevance of confidential mediation communications related to litigation license but foreclosing discovery); *Pandora Jewelry, LLC v. Bajul Imps., Inc.*, No. 1:10-CV-135SNLJ, 2011 U.S. Dist. LEXIS 27340, at *6 (E.D. Mo. Mar. 17, 2011) (allowing discovery of litigation licenses, but not allowing discovery of related settlement agreements or negotiations).
- ¹²¹ Fed. R. Evid. 402 ("All relevant evidence is admissible, except as otherwise provided by the Constitution of the United States, by Act of Congress, by these rules, or by other rules prescribed by the Supreme Court pursuant to statutory authority. Evidence which is not relevant is not admissible.").
- ¹²² Fed. R. Evid. 401.
- ¹²³ *Rude v. Westcott*, 130 U.S. 152, 164 (1889).
- ¹²⁴ See *Spreadsheet Auto. Corp. v. Microsoft Corp.*, 587 F. Supp. 2d 794, 797 (E.D. Tex. 2007); *Williams & Grab*, supra note 5, at 2 ("Although the royalty at issue in *Rude v. Westcott* was an established royalty, courts have often cited the above-referenced language to support the prohibition of the use of settlement licenses in the context of a reasonable royalty.").
- ¹²⁵ See, e.g., *ePlus, Inc. v. Lawson Software, Inc.*, 764 F. Supp. 2d 807, 813 (E.D. Va. 2011) (citing *Rude* for the proposition that, "[a]t one time, it was the rule that settlement agreements simply could not be considered at all in the reasonable royalty calculus."); *Wang Labs., Inc. v. Mitsubishi Elecs. Am.*, 860 F. Supp. 1448, 1452-53 (C.D. Cal. 1993) ("It is 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. This is because royalties paid under threat of suit may reflect the licensee's desire to avoid the risk and expense of litigation.").
- ¹²⁶ See *Chapman*, supra note 5, at 323 ("The fundamental difference between an established royalty and a reasonable royalty is that an established royalty represents an actual, transaction-based measure of the market value or price--under specific terms and conditions--of a particular patent, while a reasonable royalty is an estimate of damages owed to a patent holder due to the infringement of his or her patent."); *id.* at 324-25 (contrasting the stringent requirements of precision in proving an established royalties with the more lax standards for proving a reasonable royalty and the differences in the admissible evidence to prove each).
- ¹²⁷ *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970), modified, 446 F.2d 295 (2d Cir. 1971) (emphasis added).

128 See *Cincinnati Car Co. v. N.Y. Rapid Transit Corp.*, 66 F.2d 592, 595 (2d Cir. 1933) (Hand, J.) (“Though the payments were not established royalties, we need not disregard them, any more than the master did. It is true that they were settlements for infringements, but both parties may have been influenced by a wish to be done with litigation; that consideration is a sword with two edges.”); see also Chapman, *supra* note 5, at 323 (describing important distinctions between a reasonable royalty and an established royalty).

129 *Studiengesellschaft Kohle, m.b.H. v. Dart Indus., Inc.*, 862 F.2d 1564, 1573 (Fed. Cir. 1988).

130 No. 01-CV-1974, 2008 U.S. Dist. LEXIS 39343, at *9-14 (N.D.N.Y. May 8, 2008).

131 862 F.2d 1564 (Fed. Cir. 1988).

132 710 F.2d 1551 (Fed. Cir. 1983).

133 *Cornell Univ. v. Hewlett-Packard Co.*, No. 01-CV-1974, 2008 U.S. Dist. LEXIS 39343 at *11-12 (N.D.N.Y. May 8, 2008).

134 *Id.* at *14.

135 *Studiengesellschaft Kohle, m.b.H. v. Dart Indus., Inc.*, 862 F.2d 1564, 1580 (Fed. Cir. 1988).

136 *Id.* at 1571.

137 *Id.* at 1570-71 (affirming the district court’s finding of validity, and reversing the district court’s finding of non-infringement with respect to the relevant patent).

138 *Studiengesellschaft Kohle m.b.H. v. Dart Indus., Inc.*, 666 F. Supp. 674, 682 (D. Del. 1987).

139 *Id.* The patentee and third-party licensee entered into the litigation license after the infringer began infringing the patent, so the litigation license was not a precise fit: the hypothetical negotiation is presumed to occur immediately prior to the infringer’s first infringement. Nevertheless, the license was highly probative.

140 Courts now universally recognize the probative value of a litigation license where the prior settlement occurred after a determination of validity and infringement but before a final damages award. See, e.g., *Snellman v. Ricoh Co.*, 862 F.2d 283, 289 (Fed. Cir. 1988). In fact, such a license more closely approximates the conditions of a hypothetical negotiation than the traditional license. A traditional license may run the gamut in terms of the parties’ beliefs regarding patent strength--thus, a traditional license may reflect a discount for uncertain infringement and validity. In a post-verdict litigation license, such doubts have been significantly reduced. There could still have been the possibility of reversal on appeal in the lawsuit giving rise to the litigation license, but the uncertainties have been greatly reduced relative to a traditional license, because reversal on appeal is a rarity.

141 *Deere & Co. v. Int’l Harvester Co.*, 710 F.2d 1551, 1554 (Fed. Cir. 1983).

142 *Id.* at 1557.

143 *Id.* at 1558.

144 Id. at 1556.

145 Id. at 1557 (“Moreover, as the White license was negotiated against a backdrop of continuing litigation and IH infringement of the Schreiner patent, the district court could properly discount the probative value of the White license with regard to a reasonable royalty.”). The prior license in Deere was not a litigation license, but was instead a license with a “relatively minor competitor” who held “3% or less of the market.” Additionally, the license was entered into against the backdrop of the ongoing patent litigation between Deere and International Harvester.

146 The hypothetical negotiation is assumed to occur immediately prior to the first infringement by the infringer. See, e.g., *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301, 1324 (Fed. Cir. 2009) (“[T]he hypothetical negotiation or the ‘willing licensor-willing licensee’ approach[] attempts to ascertain the royalty upon which the parties would have agreed had they successfully negotiated an agreement just before infringement began.”); *Wang Labs., Inc. v. Toshiba Corp.* 993 F.2d 858, 870(C.A. Fed. 1993) (“The key element in setting a reasonable royalty ... is the necessity for return to the date when the infringement began.” (quoting *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1079 (Fed. Cir. 1983))).

147 See *IP Innovation L.L.C. v. Red Hat, Inc.*, 705 F. Supp. 2d 687, 691 (E.D. Tex. 2010) (“Mr. Gemini should have at least inaugurated his analysis with reference to the existing licenses to the patents-in-suit Mr. Gemini disregarded these licenses because Xerox entered into these agreements in the mid-1990’s, a decade before the alleged hypothetical negotiation date. However, these licenses are far more relevant than the general market studies on which Mr. Gemini primarily relied in his expert report.”); see also *Studiengesellschaft Kohle m.b.H. v. Dart Indus., Inc.*, 862 F.2d 1564, 1571-72 (Fed. Cir. 1988) (holding that district court did not err in relying on licenses entered into ten years after the hypothetical negotiation because the reasonable royalty standard is sufficiently flexible to accommodate such licenses).

148 This is not a normative assertion merely a descriptive one.

149 In addition, the offeree could initiate litigation for declaratory relief or initiate reexamination proceedings in the PTO but, in the meantime, it must still decide whether to go forward with its manufacturing plans in the absence of a license.

150 *In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 831 F. Supp. 1354, 1379 (N.D. Ill. 1993) (Easterbrook, J., sitting by designation).

151 See J. Alexander Tanford, *The Pretrial Process* 344-349 (2003). The settlement calculations also take into account other considerations, such as the time-value of money and the parties’ immediate need for funds or resolution. *Id.*

152 In some cases, a party’s financial circumstances could create settlement pressure. Or other externalities--such as a contemplated sale-- could create pressure on a party to resolve litigation. There are numerous considerations besides the three core components that may drive settlement demands.

153 This formula is simplified, because most parties do not identify only a single potential damages award. A party might decide that there is a 10% chance of a finding of no infringement, a 10% chance of a finding of invalidity, and an 80% chance of a finding of a valid and infringed patent. The party may further decide that there is a 20% chance of a reasonable royalty award of \$500,000, a 40% chance of an award of \$1 million, and a 20% chance of an award of \$1.5 million. These estimates add complexity to the formula, but do not change its basic underlying structure.

154 As with litigation outcomes, a party may consider the likelihood of different litigation costs and incorporate each into its formula. The emphasis is not on what the actual litigation costs will be, or on what the actual damages award would be, but on the parties’ expectations of those costs or awards at the time of the negotiation.

155 We would also need to learn of and eliminate any external factors creating settlement pressure or settlement resistance.

- 156 If the value were, for example, \$10 million, the plaintiff would have calculated its likely recovery based on its assessment of patent strength as \$1 million, and reduced that by the \$250,000 in expected litigation costs to calculate a settlement threshold of \$750,000. It would not have settled for less.
- 157 *United States v. Ravich*, 421 F.2d 1196, 1204 n.10 (2d Cir. 1970).
- 158 *United States v. Quattrone*, 441 F.3d 153, 188 (2d Cir. 2006).
- 159 *Ravich*, 421 F.2d at 1204 n.10 (rejecting common law “inference upon inference” test and noting that drawn out inferential chains do not defeat relevance but subject challenged evidence to Rule 403 considerations); see also *ePlus, Inc. v. Lawson Software, Inc.*, 764 F. Supp. 2d 807, 813 (E.D. Va. 2011) (“It is now ... well-settled that settlement agreements entered into in the context of litigation may be considered, but that they have minimal probative value respecting the calculation of reasonable royalties.”).
- 160 The language of the rule makes inadmissible evidence of “(1) furnishing or offering or promising to furnish--or accepting or offering or promising to accept--a valuable consideration in compromising or attempting to compromise the claim; and (2) conduct or statements made in compromise negotiations regarding the claim.” Fed. R. Evid. 408(a). The rule was amended, effective December 1, 2011, to provide that settlement evidence “is not admissible--on behalf of any party--either to prove or disprove the validity or amount of a disputed claim.”
- 161 *Cornell Research Found., Inc. v. Hewlett-Packard Co.*, No. 5:01-CV-1974, 2007 WL 4349135, at *17 (N.D.N.Y. 2007) (“[M]any of the cases addressing the issue now presented tend to conflate two separate, often competing concepts both of which are often at play--the privilege interposed by Rule 408, under which otherwise potentially relevant information is excluded in order to foster the policy favoring compromise of disputed claims, and relevance under Rule 402 of the Federal Rules of Evidence.”); see also *Pioneer Corp. v. Samsung SDI Co.*, No. 2:06-CV-334, 2008 U.S. Dist. LEXIS 107079, at *14-15 (E.D. Tex. Oct. 2, 2008) (“Numerous Courts have relied on the Supreme Court’s reasoning in *Rude v. Westcott* and likewise found that license fees negotiated under the threat of litigation are inherently unreliable and properly excludable under Rule 408.”).
- 162 Paul F. Rothstein, *Federal Rules of Evidence* § 408 (3d ed. 2010) (“Some jurisdictions do not apply the ban where the size of the offer approaches the amount of the claim on the theory that the probative value of the evidence is high. Rule 408 does not make such a distinction. Apparently the drafters were more concerned with encouraging settlement than with probative value.”); *Cornell Research Found.*, 2007 WL 4349135, at *17 (noting that Rule 408 is not grounded in considerations of relevance but in privilege); but see Fed. R. Evid. 408, 1972 advisory committee notes (describing potential irrelevance as one basis for exclusion). Some early commentators argued that the rationale for Rule 408 was the lack of relevance. The advisory committee rejected this theory in favor of the theory that the purpose of the rule is to promote settlement. 2 Christopher B. Mueller & Laird C. Kirkpatrick, *Federal Evidence* § 4:57, at 134 (3d ed. 2007).
- 163 Courts disagree as to whether the admissibility of a litigation license as evidence of a reasonable royalty is governed by Federal Circuit law or by regional circuit law. Compare *Small v. Nobel Biocare United States*, 2011 U.S. Dist. LEXIS 77838, at *11 n.2 (S.D.N.Y. July 19, 2011) (stating that where the determination of a discovery dispute implicates substantive patent law, Federal Circuit law applies), with *Big Baboon Corp. v. Dell, Inc.*, 2010 U.S. Dist. LEXIS 108027, at *12 (C.D. Cal. Oct. 8, 2010) (concluding that regional circuit law controls a discovery dispute regarding discovery of settlement agreements for reasonable royalty purposes). Courts also disagree about whether the Rule applies to exclude settlement evidence related to a prior lawsuit against a different party. Compare, e.g., *Donnelly Corp. v. Gentex Corp.*, 918 F. Supp. 1126, 1133-34 (W.D. Mich. 1996) (“[I]t is obvious that [Rule 408] itself does not preclude evidence of these compromises ... because the offers to compromise the claims do not concern the claim being litigated in this case.”), with, e.g., *Cornell Univ. v. Hewlett-Packard Co.*, No. 01-CV-1974, 2008 U.S. Dist. LEXIS 39343, at 9-14 (N.D.N.Y. May 8, 2008) (“To facilitate settlement, Rule 408 protects negotiations between one of the parties to a case and a third party.”). It is not necessary to resolve these disputes for purposes of this Article.
- 164 *Chapman*, supra note 5, at 327. Similarly, one might argue that the litigation license is being used to prove the amount of the current claim--not the amount of the previous claim. (The rule seems to be concerned with using the evidence to prove liability for, invalidity of, or amount of the prior claim--not some different claim.) The problem with this argument is that the probative value of the litigation license is derived solely from its use in proving the value of the prior claim--in fact, external considerations like litigation costs must be peeled from the royalty amount in order to reach the probative aspect of a litigation license. See supra Part 3(a); see also *Chapman*, supra note 5, at 355 (“By considering the settlement license terms and the circumstances leading to the

settlement, an expert or fact-finder can appropriately adjust the settlement license terms for use in a reasonable royalty determination.”).

165 See *Belton v. Fibreboard Corp.*, 724 F.2d 500, 505 (5th Cir. 1984) (finding reversible violation of Rule 408 where jury instructions “directed the jury to consider the settlement as part of the proof of the amount of the claim” (emphasis added)).

166 See supra note 163.

167 Where the plaintiff does not actually compromise below the legitimate value of the patent, but instead receives more than the patent is actually worth (where for example, the defendant’s settlement is driven more by expected litigation expenses or fear of injunction than the value of the patent), settlement would likely not be inhibited at all by the prospect of the later use of the license in infringement litigation. The use inures to the plaintiff’s benefit, so the plaintiff is not deterred from settlement, and the defendant is likely to perceive itself to be unaffected by the potential use of the license in future litigation. To the extent the defendant has an interest, that interest may militate in favor of settlement, because the defendant may expect that potential future infringers would be the defendant’s competitors, and anything that increases the price that competitors pay for a license inures to the defendant’s benefit.

168 See Tanford, supra note 151 and accompanying text.

169 The same would be true of an alleged infringer, to the extent the alleged infringer perceived any possibility of an increase in the reasonable royalty rate of potential future infringement, but the infringer is less likely to take this into account than the patentee because future infringement suits are more speculative for the infringer than for the patentee. Because any future infringement suit against this defendant would involve a different patent, courts are more likely to exclude this litigation license from consideration in the later litigation, and juries are less likely to give it significant weight.

170 This is a conservative estimate based on statistical data. See American Intellectual Property Law Association, Report of the Economic Survey 35 (2011) (noting that, in 2011, median costs through discovery of patent-infringement litigation with less than \$1 million at risk through discovery was \$350,000, and median cost through completion was \$650,000. Median cost of infringement litigation with \$1 million-\$25 million at risk was \$1.5 million through discovery and \$2.5 million through completion).

171 See, e.g., *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 880 (Fed. Cir. 2010) (Newman, J., dissenting) (arguing that patent litigation is notoriously unpredictable). No litigant knows with certainty that it will recover all of the damages it is seeking, but adding litigation uncertainty into the mix would only complicate the math without materially altering the analysis. The point of this exercise--that admission of litigation licenses into evidence adds another cost into the cost of settlement, and that this cost may be settlement-prohibitive--remains unchanged by litigation uncertainty.

172 See Tanford, supra note 151, at 344-49 (explaining settlement range calculations).

173 35 U.S.C. § 283-85 (2006). Enhanced damages and attorneys’ fees are fairly rare. In a survey of 1209 patent cases that reached verdict, Professor Kimberly Moore found that some measure of enhanced damages was awarded in 147 of them (about 12%), and attorneys’ fees were awarded in 84 (about 7%). Kimberly A. Moore, *Judges, Juries, and Patent Cases: An Empirical Peek Inside the Black Box*, 99 Mich. L. Rev. 365, 380, 394 (2000).

174 See *Alpex Computer Corp. v. Nintendo Co.*, No. 86-CV-1749, 1994 U.S. Dist. LEXIS 3343, at *28-38 (S.D.N.Y. Mar. 16, 1994) (“Alpex has claimed damages exceeding \$200 million. Nintendo’s experts, on the other hand, will testify that damages should be approximately \$400,000. Although they can testify to this figure without reference to the licensing offers at issue here, Nintendo’s damages experts have asserted that admissibility of Alpex’s offers to license the patent for \$400,000 would probably cap Alpex’s recovery at that amount.”).

175 The patentee’s settlement range in the lawsuit against Defendant 2 would also be reduced as a result of the reduction in expected

damages.

176 It has been suggested that in “most circumstances, the incremental costs associated with possible consideration of a settlement license in subsequent litigation are likely to be too small relative to other considerations that affect a patent holder’s decision to settle” and the only settlement agreements that will be affected are those in which the patentee contemplates the possibility of suing other alleged infringers. *Chapman*, supra note 5, at 330. But the NPE, who makes a business out of litigation and often simultaneously or consecutively sues multiple parties, obviously places significant weight on the likely effect of settlement on pending and future litigation. And there is no reason to think that any other patentee is so myopic as to completely ignore the possibility of additional infringement litigation.

177 Fed. R. Evid. 703.

178 See, e.g., *Pioneer Corp. v. Samsung SDI Co.*, No. 2:06-CV-384, 2008 U.S. Dist. LEXIS 107079, at *19-21 (E.D. Tex. Oct. 2, 2008) (stating that experts need not be entirely excluded for having considered litigation royalty rates, provided they do not rely exclusively on such evidence); *Spreadsheet Auto. Corp. v. Microsoft Corp.*, 587 F. Supp. 2d 794, 801 (E.D. Tex. 2007) (“As to whether the entire report should be excluded, the Court finds that because Mr. Gemini does not rely exclusively upon settlement agreements reached under threat of litigation, he may properly consider such royalty rates and the underlying agreements in the formation of an opinion.” (emphasis omitted)).

179 Fed. R. Evid. 703.

180 *Alpex Computer Corp. v. Nintendo Co.*, No. 86-CV-1749, 1994 U.S. Dist. LEXIS 3343, at *38 (S.D.N.Y. Mar. 16, 1994).

181 The presumption is apparent because the offering party must prove that the probative value “substantially outweighs” the prejudicial effect.

182 Under Rule 403, the objecting party must show that the probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence. Fed. R. Evid. 403.

183 Fed. R. Evid. 403.

184 *Honeywell Int’l, Inc. v. Nikon Corp.*, No. 04-1337, 2009 U.S. Dist. LEXIS 17115, at *7-8 (D. Del. Mar. 4, 2009) (“On conducting its own independent review of the caselaw, the Court, like the Special Master, is unable to identify any cases, either from this District or the Federal Circuit, in which licenses taken under threat of litigation were given significant weight, particularly in jury cases.”).

185 *Tights, Inc. v. Kayser-Roth Corp.*, 442 F. Supp. 159, 165 (M.D.N.C. 1977). The counter-argument, of course, is enhanced damages--that the “giants of the industry” could be forced to pay for willful infringement.

186 *Chapman*, supra note 5, at 355.

187 See, e.g., *Clear with Computers, LLC v. Bergdorf Goodman, Inc.*, 753 F. Supp. 2d 662, 663-64 (E.D. Tex. 2010) (noting the importance of discovery pertaining to settlement negotiations related to litigation licenses because, “[i]n this case, the settlement communications are likely to be key in determining whether the settlement agreements accurately reflect the inventions’ value or were strongly influenced by a desire to avoid or end full litigation”).

188 *Volumetrics Med. Imaging, LLC v. Toshiba Am. Med. Sys.*, 1:05-CV-955, 2011 U.S. Dist. LEXIS 65422, at *57 (M.D.N.C. June 20, 2011) (“For example, a settlement license may lack significant probative value in the reasonable royalty calculus if the record

contains other comparable, non-settlement licenses. Conversely, if few (or no) licenses of the latter sort exist, licenses from settlements may serve a more useful (or even necessary) function in the ‘hypothetical negotiation’ analysis.” (footnote omitted)).

189 It may be technically inaccurate to frame this in terms of increased probative value. Technically, it is the need for this evidence that renders it desirable in such circumstances. Where it is cumulative or other sufficiently probative evidence exists, the court should exclude the litigation license because its marginal probative value (the probative value to be gained after consideration of the other evidence) is likely not worth the intrusive discovery into settlement negotiations, the significant unpacking (and, in reality, guesswork) required to extract the probative value from the litigation license, and the mini-trial on infringement and validity that would likely result from the admission of the litigation license. And, most people agree that the probative value of litigation licenses is usually less than non-litigation licenses. See *Honeywell Int’l, Inc. v. Nikon Corp.*, No. 04-1337, 2009 U.S. Dist. LEXIS 17115, at *7-8 (D. Del. Mar. 4, 2009).

190 Clear with Computers, 753 F. Supp. at 664 (“Moreover, in this case, the settlement agreements will likely be the only licenses of the patents-in-suit, making an accurate understanding of them more important.... CWC has not shown that there are other non-litigation licenses that reflect the value of the invention. Therefore, the settlement negotiations have increased relevance, and the prejudice to CWC is of decreased significance. The Court expects that its finding here allowing discovery will be the exception, not the rule, and in most cases discovery of the negotiations will not be warranted.”).

191 When the entity is a practicing entity, even if there are no non-litigation licenses, there are other sources of evidence likely more helpful than a litigation license would be. For example, “when the patent’s owner ... also makes the patented article, the profitability of the owner’s manufacture and sale also determines the royalty that would be charged.” In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig., 831 F. Supp. 1354, 1383 (N.D. Ill. 1993), aff’d 71 F.3d 1573 (Fed. Cir. 1995). Presumably, an owner practicing the patent would license the patent, even to a competitor, if the licensing fee were greater than its expected profit (which may include some amount for goodwill and name recognition to be generated by the product).

192 *Georgia-Pacific v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1139 (S.D.N.Y. 1970), modified, 446 F.2d 295 (2d Cir. 1971).

193 See, e.g., *Clear with Computers, L.L.C. v. Bergdorf Goodman, Inc.*, 753 F. Supp. 2d 662, 663 (E.D. Tex. 2010) (“Whether the settlement agreements are admissible will likely depend on whether they are an accurate reflection of the inventions’ value.”). In *Lucent*, the court declined to examine the admissibility of the licenses, because Microsoft failed to object to them at trial. *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301, 1325 (Fed. Cir. 2009).

194 See *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1317 (Fed. Cir. 2011) (finding reversible error in using 25% rule of thumb, even as merely a “starting point” for the reasonable royalty calculation, because “[b]eginning from a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the facts of the case nevertheless results in a fundamentally flawed conclusion. This is reflected in *Lucent Technologies*, in which unrelated licenses were considered under *Georgia-Pacific* factor 1, but this court held that the entire royalty calculation was unsupported by substantial evidence.”).

195 764 F. Supp. 2d 807, 813-14 (E.D. Va. 2011) (granting motion to exclude expert’s testimony and noting that “[t]he disparity of circumstances between the settlement agreement lump sum licenses and the hypothetical negotiation for a running royalty and the temporal differences make it difficult to find that the ‘fit’ component is met”).

196 The expert, without offering an adequate explanation, rejected the use of litigation licenses that had low royalty rates. *ePlus, Inc. v. Lawson Software, Inc.*, 764 F. Supp. 2d 807, 814 (E.D. Va. 2011).

197 *Id.*

198 No. 86-CV-1749, 1994 U.S. Dist. LEXIS 3343, at *32-33 (S.D.N.Y. Mar. 16, 1994).

199 *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1316 (Fed. Cir. 2011) (quoting *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1325, 1332 (Fed. Cir. 2009)) (alteration in original).

200 Professors Lemley and Shapiro argue that “the threat of an injunction can enable a patent holder to negotiate royalties far in excess of the patent holder’s true economic contribution.” Mark A. Lemley & Carl Shapiro, Patent Holdup and Royalty Stacking, 85 Tex. L. Rev. 1991, 1993 (2007). This threat may be diminished in the wake of Supreme Court’s decision in eBay, requiring a patentee to meet the traditional standards in order to obtain a preliminary injunction. eBay Inc. v. MercExchange, L.L.C., 547 U.S. 388, 394 (2006).

201 See Chapman, supra note 5, at 349 (“[T]he mere fact that the terms of a settlement license may be influenced in part by a desire to avoid litigation expenses does not mean that settlement license terms are inherently biased or unreliable for the purpose of determining a reasonable royalty.... [A] settlement agreement for \$50,000--less than the expected costs of litigation--is likely to provide valuable information about the value of the underlying infringement claim. In the latter case, a reasonable inference that the value of the claim is less than the expected costs of litigation can be drawn, unless some other rationale is provided to explain the patent holder’s willingness to accept such a settlement.”). Other explanations exist for the settlement of a given claim, including “the patent holder’s lack of resources to pursue litigation, significant uncertainty in establishing liability, or strategic licensing considerations (such as ... a reluctance to adopt an aggressive licensing stance against a key customer).” Id. at n.141.

202 Because the reasonable royalty inquiry is, in essence, an inquiry into the fair market value of the patent, it is no surprise that the language of a reasonable royalty inquiry is almost identical to the language of a fair-market-value inquiry: “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” United States v. Cartwright, 411 U.S. 546, 551 (1973) (quoting Treas. Reg. § 20.2031-1(b)).

203 See, e.g., Schonfeld v. Hilliard, 218 F.3d 164, 178 (2d Cir. 2000) (quoting Suitum v. Tahoe Reg’l Planning Agency, 520 U.S. 725, 741-42 (1997)).

204 Josten-Wilbert Vault Co. v. Bd. of Equalization for Buffalo Cnty., 138 N.W.2d 641, 643 (Neb. 1965).

205 Schonfeld, 218 F.3d at 178-79.

206 Union Oil of Cal. v. Bd. of Educ. of Gahanna-Jefferson Pub., 526 N.E.2d 309, 313-16 (Ohio App. 1987) (holding that price reached for real property in settlement of lawsuit was insufficient evidence to support the Board of Tax Appeals’s valuation of the property at the sale price).

207 Id. at 315.

208 Pioneer Hi-Bred Int’l, Inc. v. Ottawa Plant Food, Inc., 219 F.R.D. 135, 145 (N.D. Iowa 2003).

209 Tyco Healthcare Grp. LP v. E-Z-EM, Inc., No. 2:07-CV-262, 2010 U.S. Dist. LEXIS 18253, at *5 (E.D. Tex. Mar. 2, 2010).

210 See Chapman, supra note 5, at 337-40 (describing the “comparable method” mode of analysis, which involves examining licensing terms of comparable licenses to create terms for a hypothetical license).

211 See, e.g., Richard Raysman and Peter Brown, Settlement Licenses and Reasonable Royalties, Law Tech. News, May 11, 2011 (“Courts performing reasonable royalty calculations typically exercise vigilance when considering past licenses to technologies other than the patent-in-suit or to different types of licenses for the same technology and take into account the economic circumstances of the contracting parties.” (describing BIAX Corp. v. NVIDIA Corp., No. 09-CV-01257, 2010 WL 4038728 (D. Colo. Oct. 14, 2010))).

212 The reasonable royalty is almost always (though not necessarily) based on a “bare” or “naked” unrestricted license. John M.

Skenyon et al., Patent Damages Law and Practice, § 3:23 (2011).

213 Id. (relating to the third Georgia-Pacific factor: “The nature and scope of the license, as exclusive or non-exclusive; or as restricted or [non-restricted] in terms of territory or with respect to whom the manufactured product may be sold.”).

214 See, e.g., LG Display Co., Ltd. v. AU Optronics Corp., 722 F. Supp. 2d 466, 472-73 (D. Del. 2010) (in assessing reasonable royalty, considering expert testimony regarding eight cross-licenses in which each party licensed its entire patent portfolio and one party paid a “balancing payment” to the other).

215 Consider the following example, where P_1 is the Litigation Patent, and P with a subscript numeral represents a different patent. Patentee licenses P_1 , P_1 , P_2 , and P_3 in exchange for \$500,000 and licenses to P_4 and P_5 . The equation is $P_1+P_1+P_2+P_3=P_4+P_5+500,000$. When P_1 is isolated, the equation becomes $P_1=P_4+P_5+500,000-P_2-P_3$. In order to have useful information about the value of P_1 , the fact-finder must either assign monetary values to the remaining patents or be able to cancel them out. The Patentee will argue that P_1 , P_2 , and P_3 were not worth very much, while P_4 and P_5 were very valuable (to maximize the value of P_1), while the infringer will argue the opposite.

216 There is tension between the negotiating posture that the patentee likely would have assumed in the earlier license negotiations and the arguments the patentee would make in the later litigation. In the prior license negotiations, the patentee would have downplayed the value of a license of the third party’s patents as it attempted to maximize its negotiating position (i.e., “Your patents are not very valuable. Mine are very valuable. Therefore, you must pay me a significant royalty in addition to the cross-licenses or give me a license to more patents.”). In seeking a reasonable royalty in later litigation, the patentee will argue that the third party’s patents held significant value (i.e., “I only agreed to this cross-license because the third party’s patents are very valuable, just like the patent-in-suit is very valuable.”). Thus, the litigation defendant should look at the negotiations between the patentee and the prior licensee for helpful evidence.

217 Paul M. Janicke, Contemporary Issues in Patent Damages, 42 Am. U. L. Rev. 691, 722-23 (1993).

218 Lemley & Shapiro, supra note 200, at 1996-99, 2022.

219 See Janicke, supra note 217, at 722-23 (explaining that in a real life situation, “there is always substantial doubt about patent validity”); Chapman, supra note 5, at 352 (citing Edward F. Sherry & David J. Teece, Royalties, Evolving Patent Rights, and the Value of Innovation, 33 Res. Pol’y 179, 184-85 (2004)).

220 See Janicke, supra note 217, at 722-23 (“With the vagaries of claim interpretation, prosecution history estoppel, and so on, infringement is seldom ‘known’ short of trial and appeal” (footnotes omitted)); see also *Alpex Computer Corp. v. Nintendo Co.*, No. 86 Civ. 1749 (KMW), 1994 U.S. Dist. LEXIS 3343, at *28-38 (S.D.N.Y. Mar. 16, 1994).

221 The hypothetical negotiation occurs just prior to the infringement. *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1324-25 (Fed. Cir. 2009). If the prior license was entered much earlier or later than that time, the market conditions may have changed, affecting the royalty that the patent would command. In addition, the patentee may suggest that ongoing infringement of his patent deflated the licensing fees that he was able to command earlier. See *Alpex Computer Corp. v. Nintendo Co.*, 1994 U.S. Dist. LEXIS 3343, 28-38 (S.D.N.Y. Mar. 16, 1994) (“In cases involving widespread infringement, the deflationary pressures on license rates may be especially strong.”).

222 See, e.g., *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1317 (Fed. Cir. 2011) (noting absurdity of applying same royalty rate even to begin royalty discussions “between, for example, (a) TinyCo and IBM over a strong patent portfolio of twelve patents covering various aspects of a pioneering hard drive, and (b) Kodak and Fuji over a single patent to a tiny improvement in a specialty film emulsion”).

223 If a large number of products incorporating the technology are expected to be sold, the Patentee would presumably agree to a smaller running royalty than if only a few patent-incorporating products are expected to sell.

224 See *Finjan, Inc. v. Secure Computing Corp.*, 626 F.3d 1197, 1211-12 (Fed. Cir. 2010) (“We have recently reiterated that use of past patent licenses under factors 1 and 2 must account for differences in the technologies and economic circumstances of the contracting parties.... Parr explained that Finjan did not compete with Microsoft but does compete against Secure; that Finjan received significant intangible value from Microsoft’s endorsements of Finjan; and that the license involved a lump sum instead of a running royalty. These differences permitted the jury to properly discount the Microsoft license.” (citations omitted)).

225 Roy J. Epstein, *Modeling Patent Damages: Rigorous and Defensible Calculations*, 5-6 (2003), http://www.royepstein.com/epstein_aipla_2003_article_website.pdf. Similarly, where the license at issue is a license taken by the infringer to “comparable” technology, the parties will dispute how comparable the previously-licensed technology is, in order to dispute its probative value to the reasonable royalty. See *Wi-Lan v. Research in Motion*, Civil No. 10cv859-W (CAB), 2010 WL 2998850, at *3-4 (S.D. Cal. Jul. 28, 2010).

226 See *Insight Tech., Inc. v. Surefire LLC*, No. 04-CV-74-JD, 2009 U.S. Dist. LEXIS 97183, at *4 (D.N.H. Oct. 8, 2009) (“The introduction of the Glock settlement terms would necessitate a lengthy explanation to the jury of the economics of litigation risk, competition, and other considerations that inform a litigation settlement. All of this evidence would be collateral, and therefore confusing and a waste of time.”).

227 It is extremely common for different district courts to construe the same claims differently. For instance, in *American Piledriving Equipment, Inc. v. Geoquip, Inc.*, 637 F.3d 1324, 1326-27 (Fed. Cir. 2011), the patentee initiated seven lawsuits in seven different district courts, and “no two ... construed all three [claim] terms the same way.”

228 In *Trell v. Marlee Elecs.*, 912 F.2d 1443, 1446 (Fed. Cir. 1990), the Federal Circuit held that the district court improperly relied on an exclusive European license fee because the license was exclusive and conveyed broader rights than the hypothetical license. The patentee had the burden of demonstrating the probative value of this license for purposes of the reasonable royalty; the infringer “did not have the burden of going forward with evidence to rebut proof of a royalty paid by another for an exclusive license involving additional inventions.” *Id.* at 1447.

229 The Federal Circuit emphasized this in *Lucent*, when it declared the absence of probative value of a particular cross-license in which the jury “never learned anything about [the cross-licensed] patent rights and how valuable or essential those rights were.” *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301, 1331 (Fed. Cir. 2009).

230 Justice Breyer was famously flabbergasted and outraged to learn the cost of discovery in complex commercial cases. Daniel Fisher, *The Data Explosion*, *Forbes* (Oct. 1, 2007), <http://members.forbes.com/forbes/2007/1001/072.html>. If Supreme Court justices are shocked at the cost of litigation, it is hardly surprising that juries lack such knowledge.

231 See generally *Fenner Invs., Ltd. v. Hewlett-Packard Co.*, No. 6:08-CV-273, 2010 WL 1727916, at *1-2 (E.D. Tex. Apr. 28, 2010) (holding that litigation licenses risk juror confusion, and collecting cases).

232 *Stockman v. Oakcrest Dental Ctr., P.C.*, 480 F.3d 791, 800 (6th Cir. 2007) (“The almost unavoidable impact of the disclosure of such evidence is that the jury will consider the offer or agreement as evidence of a concession of liability.” (quoting Jack B. Weinstein & Margaret A. Berger, *Weinstein’s Evidence* 408-31 (1991))).

233 The litigation license also creates a potential for prejudice on the merits--as opposed to damages--of the infringement claim. If a prior defendant settled despite raising an invalidity argument similar to that raised in this case, the jury may wrongly conclude that the prior defendant’s invalidity claim--which is the same as the current defendant’s invalidity claim--lacked merit. This prejudice could be avoided by bifurcating the trial to separate the liability portion of the trial and the damages portion, but, in the absence of bifurcation, it presents an important consideration to the admission or exclusion of a litigation license.

234 See, e.g., Wayne D. Brazil, *Protecting the Confidentiality of Settlement Negotiations*, 39 *Hastings L.J.* 955, 985 (1988) (“[C]ourts that admit evidence from settlement negotiations discourage communication about settlement and impair the rationality of settlement discussions, and thus help to defeat the policy of encouraging consensual resolution of disputes.”); Kuhl, *supra* note 5, at

2295-98.

235 See *Thomas v. Law Firm of Simpson & Cybak*, 244 F. App'x 741, 744 (7th Cir. 2007) (discussing general policy of encouraging settlement expressed in Rule 408).

236 There is some reason to think that admitting settlement negotiations to prove a reasonable royalty would not inhibit settlement in the patent context. Concessions made by a patentee in settling prior litigation will inure to the Patentee's benefit when damages are assessed in the subsequent litigation, because the patentee can use them to persuade the jury that the royalty rate was discounted by litigation costs or uncertainty, so that the rate in the litigation license understates the patent's actual value. For example, if the patentee conceded in the prior litigation that its infringement claim was tenuous, it can argue that the value of the patent is higher, but it settled for less in the earlier litigation because of the doubtful infringement claim. The same is true where the defendant was the licensee in the prior suit, and the license is being used to show rates paid by the defendant for comparable technology under the second *Georgia-Pacific* factor. Of course, a patentee would not want its earlier concessions regarding liability (for example, that the patent might be invalid) in a later infringement suit, but those worries could be substantially eliminated through bifurcation of the trial into a liability phase and a damages phase.

237 See Fed. R. Civ. P. 26(b)(2)(C) (requiring courts to limit discovery where the burden or expense outweighs the likely benefit).

238 See Kuhl, *supra* note 5, at 293-98 (referring to the Northern District of California as an example of a court that prohibits discovery of settlement negotiations).

239 As one court put it, without the context surrounding the negotiations, such as "the parties' respective assessments of their claims," "the royalty paid by [the prior defendant] has minimal, if any, relevance to this litigation." *Creative Internet Adver. Corp. v. Yahoo! Inc.*, No. 6:07-CV-354, 2009 U.S. Dist. LEXIS 129938, at *5-6 (E.D. Tex. May 7, 2009).

240 See *Hickman v. Taylor*, 329 U.S. 495, 507 (1947) ("[M]utual knowledge of all the relevant facts gathered by both parties is essential to proper litigation. To that end, either party may compel the other to disgorge whatever facts he has in his possession.").

241 There remains some question as to whether the "prejudice" contemplated in Rule 403 includes prejudice to extrinsic social policies (such as the general policy in favor of promoting settlement), as opposed to prejudice to the parties or the individual case at issue, but there is much support for the proposition that Rule 403 "prejudice" includes prejudice to broader social policies. See Edward J. Imwinkelried, *The Meaning of Probative Value and Prejudice in Federal Rule of Evidence 403: Can Rule 403 Be Used to Resurrect the Common Law of Evidence?*, 41 *Vand. L. Rev.* 879, 889-891 (1988) (discussing case law that supports the idea that judges may consider extrinsic social policies).

242 See *Tyco Healthcare Group LP v. E-Z-EM, Inc.*, No. 2:07-CV-262 (TJW), 2010 U.S. Dist. LEXIS 18253, at *7-8 (E.D. Tex. Mar. 2, 2010) ("[T]he district court should make 'factual findings that account[] for the technological and economic differences between [previous] licenses and the [patent-in-suit].' It necessarily follows that, in light of the admissibility and importance of prior related settlement agreements, ... the underlying negotiations are relevant to the calculation of a reasonable royalty using the hypothetical negotiation damages model.") (citations omitted); *Clear with Computers, L.L.C. v. Bergdorf Goodman, Inc.*, 753 F. Supp. 2d 662, 663-64 (E.D. Tex. 2010) ("Whether the settlement agreements are admissible will likely depend on whether they are an accurate reflection of the inventions' value. In this case, the settlement communications are likely to be key in determining whether the settlement agreements accurately reflect the inventions' value or were strongly influenced by a desire to avoid or end full litigation.") (citations omitted); *Cornell Res. Found., Inc. v. Hewlett-Packard Co.*, No. 5:01-CV-1974, 2007 WL 4349135, at *17 (N.D.N.Y. Jan. 31, 2007) ("The determination of admissibility of the challenged evidence may well turn upon an analysis of context, informed by the history of the parties' negotiations, and the question of whether a threat of litigation was made and had advanced sufficiently, at the time of the negotiations, to undermine significance of the resulting license or the parties' discussions and effectively negate the reliability of any benchmarks established during those negotiations, for purposes of determining a reasonable royalty").

243 Kuhl, *supra* note 5, at 295.

244 Kuhl, *supra* note 5, at 295.

245 A design-around suggests that the patent holds little value because there is an alternative to infringement--the infringer can accomplish substantially the same results without infringing the patent, by using some other process or product. The design-around argument does not hinge on a non-infringing alternative that perfectly replicates the result of the patented invention. The design-around may be less efficient, less attractive, or less user-friendly. But, at some point, the infringer would opt to employ even a sub-optimal design-around rather than take a license at what it considers to be too high a rate. In other words, design-around options serve to reduce the reasonable royalty by capping what a prospective licensee would agree to pay in lieu of using the sub-optimal design-around.

246 Chapman, *supra* note 5, at 353.

247 Thomas A. Mauet, *Pretrial 401* (Viki Bean et al. eds., 7th ed. 2008) (noting that parties in negotiation must “justify their positions with supporting facts, and challenge the other side’s positions with contradictory facts”); *id.* at 403 (stating that, at settlement conferences, presentations should be “factually based and shorn of emotional rhetoric”); J. Alexander Tanford, *The Pretrial Process 360* (2003) (differentiating between unproductive “haggling” and productive “negotiation, [which] consists not only of exchanging offers and demands, but of supporting them with arguments based on the merits of the case”).

248 No. 08-C-7411, 2011 U.S. Dist. LEXIS 23417, at *11 (N.D. Ill. Mar. 8, 2011).

249 *Id.*

250 See *id.* at *13 (noting traditional reluctance of courts to order discovery of settlement negotiations).

251 *Id.*

252 See Fed. R. Civ. P. 26 advisory committee’s note (1983) (“The purpose of discovery is to provide a mechanism for making relevant information available to the litigants. ‘Mutual knowledge of all the relevant facts gathered by both parties is essential to proper litigation.’” (quoting *Hickman v. Taylor*, 329 U.S. 495, 507 (1947))).

253 The Sixth Circuit, in *Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc.*, 332 F.3d 976, 979-980 (6th Cir. 2003), applied a broad privilege to statements made in the course of settlement negotiations. In the reasonable royalty context, most courts have not applied this privilege, and one court that did (the Eastern District of Texas) has changed course in the wake of *ResQNet*. See, e.g., *Big Baboon Corp. v. Dell, Inc.*, No. CV-09-01198-SVW, 2010 U.S. Dist. LEXIS 108027, at *15-16 (C.D. Cal. Oct. 8, 2010) (ruling against a broad settlement privilege); *Tyco Healthcare Group LP v. E-Z-EM, Inc.*, No 2:07-CV-262 (TJW), 2010 U.S. Dist. LEXIS 18253 (E.D. Tex. Mar. 2, 2010) (noting a shift in the court’s approach toward the discoverability of settlement negotiations).

254 The point is not that the settling party could employ a selective waiver--when a party waives a privilege, the scope of the waiver generally extends to the entire subject-matter of that privilege. See *New Phoenix Sunrise Corp. and Subsidiaries v. Comm’r of Internal Revenue*, 408 F. App’x 908, 919 (6th Cir. 2010) (noting that privilege will be waived by any material relating to the subject matter at issue). Instead, the point is that the settling party could choose to waive the privilege when production of the settlement negotiations as a whole would tip in its favor.

255 Although “[t]he protections of Rule 408 cannot be waived unilaterally,” Fed. R. Evid. 408 advisory committee’s note to 2006 amendments, Rule 408 governs admission, not discoverability. See *Phoenix Solutions, Inc. v. Wells Fargo Bank, N.A.*, 254 F.R.D. 568, 584 (N.D. Cal. 2008) (noting that the rule applies to the admissibility of evidence at trial, not to whether evidence is discoverable). The Sixth Circuit’s expanded discovery privilege can, of course, be waived unilaterally, simply through disclosure of the evidence. Even if the court excluded the negotiation statement itself at trial, the patentee could have a person who participated in the settlement decision to testify that the litigation license reflects a significant concession based on unanticipated

litigation expenses. The infringer, on the other hand, has no real insight into such positions.

256 Brian Pandya, *Why Pay More? Using Patent Settlements to Calculate Reasonable Royalty Rates*, *Corporate Counsel* (May 31, 2010), available at <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=1202458974224>.

257 A litigation license may include a license for past use of the patented invention (the infringement at issue in the litigation) and a license for future use of the patented invention. Some commentators have argued that “the forward-looking portions of many settlement licenses are very similar to non-settlement licenses,” and “forward-looking settlement licenses provide valuable insight in determining a reasonable royalty.” Chapman, *supra* note 5, at 351-52.

258 While this is not technically a license, the doctrine of *res judicata* would prevent Patentee from re-asserting its claims for any prior infringement.

259 Just as any patentee must consider the effect of a settlement discount on future litigation, so, too, will it consider the effect of an over-valued settlement on future litigation.

260 If the negotiations are discoverable but not admissible, the court might exclude a license like this based on Rule 403 grounds when the court is confronted with the circumstances surrounding the license.

261 It is possible that there could be grounds outside of the Federal Rules for prohibiting discovery of negotiations, such as local rules restricting disclosure of confidential mediation communications. In *Avocent Redmond Corp. v. Raritan Americas, Inc.*, No. 10-CV-6100 (S.D.N.Y. Sept. 26, 2011), the court relied on the Federal Circuit’s local rules to foreclose discovery of confidential mediation communications related to a litigation license.

262 See Fed. R. Evid. 408(a)(2) (indicating both conduct and statements made in compromise negotiations are treated equally).

263 *Pharmastem Therapeutics, Inc. v. Viacell, Inc.*, No. 02-148 GMS, 2003 U.S. Dist. LEXIS 27869, at *5 (D. Del. Oct. 7, 2003).

264 For example, the probative value of a settlement is significant when the settlement is reached following a finding of validity and infringement. See *Studiengesellschaft Kohle m.b.H. v. Dart Indus., Inc.*, 666 F. Supp. 674, 682 (D. Del. 1987) (noting the significant probative value of particular litigation licenses).

265 See *Clear with Computers, L.L.C. v. Bergdorf Goodman, Inc.*, 753 F. Supp. 2d 662, 664 (E.D. Tex. 2010) (“Moreover, in this case, the settlement agreements will likely be the only licenses of the patents-in-suit, making an accurate understanding of them more important. CWC’s business is to litigate and license the patents; it does not compete with Defendants in the marketplace. CWC has not shown that there are other non-litigation licenses that reflect the value of the invention. Therefore, the settlement negotiations have increased relevance, and the prejudice to CWC is of decreased significance.”).

266 See *supra* note 38 (setting forth the factors potentially relevant to reasonable royalty calculations).

267 See *supra* notes 208-227 and accompanying text (considering potential burdens of necessary mini-trials).

268 See *supra* notes 184-207 and accompanying text (discussing how probative value will vary depending on circumstances surrounding litigation).

269 See *supra* notes 234-263 and accompanying text (discussing costs and benefits of allowing discovery regarding settlement negotiations).

²⁷⁰ See supra notes 256-260 and accompanying text (discussing opportunity for manipulation of license values in context of inflation).

²⁷¹ Fed. R. Evid. 408.