Advocate's EDGE

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Damages awards often are based on extensive testimony by financial experts, who may use certain theoretical tools — or rules of thumb — to calculate infringement damages. But in *Uniloc USA Inc. v. Microsoft Corp.*, the U.S. Court of Appeals for the Federal Circuit made it clear that experts should base their calculations on a case's actual facts, rather than rely on abstract theoretical tools, especially those used arbitrarily.

MICROSOFT CRASHES WITH JURY

Uniloc holds a patent on a registration system designed to prevent the unauthorized copying of software programs. The company sued Microsoft, claiming that Microsoft's Product Activation feature — which acts as a gatekeeper to some of its most popular software — infringed that patent.

> *The court criticized the rule for failing to tie a reasonable royalty rate to the facts of the case at issue.*

The jury returned a verdict of willful infringement and awarded Uniloc $388 million in damages. But the district court found that Uniloc's expert's use of the "25% rule" and the "entire market value" rule was improper and ordered a new trial on damages. Uniloc appealed.

FEDERAL CIRCUIT ASSESSES 25% RULE

The original damages award was based on the testimony of Uniloc's expert witness, who had estimated that damages should be approximately $565 million. He calculated that figure by applying the 25% rule, which, as the Federal Circuit explained, has been used to estimate the reasonable royalty rate that the manufacturer of a product using a patent would be willing to offer the patentee in a hypothetical negotiation for a license. The rule suggests the licensee pay a royalty rate equivalent to 25% of its expected profits for the product that incorporates the patent.

The Federal Circuit acknowledged that it had previously "passively tolerated" use of the 25% rule in cases where the rule's acceptability wasn't the focus. Lower courts have also "invariably" admitted evidence based on the 25% rule, largely because of its widespread acceptance or because its admissibility was uncontested.

In this case, though, the Federal Circuit squarely addressed the admissibility of the rule in light of *Daubert* and other landmark cases on the admissibility of expert testimony. The court found the rule to be "a fundamentally flawed tool for determining a baseline royalty rate in

a hypothetical negotiation" and concluded that expert testimony based on the rule is therefore inadmissible.

Specifically, the court criticized the rule for failing to tie a reasonable royalty rate to the facts of the case at issue, including the particular technology, industry or parties. The court concluded that Uniloc's expert's starting point of a 25% royalty rate was arbitrary, unreliable and irrelevant because it had no relation to the case facts.

BACKUP FAILS, TOO

Uniloc's expert also had applied the entire market value rule to "check" whether his original damages estimate was reasonable. He compared the entire market value to his calculation of Microsoft's approximate total revenue of $19.28 billion for the infringing Office and Windows products. He testified that his calculated royalty, which constituted only 2.9% of that revenue, was indeed reasonable.

However, as the Federal Circuit noted, the entire market value rule allows a patentee to assess damages based on the entire market value of the infringing product *only* if the patented feature creates the "basis for customer demand" or "substantially create[s] the value of the component parts." It was undisputed that Microsoft's Product Activation feature did neither.

In the Federal Circuit's view, this case provided a perfect example of the danger of admitting evidence of a defendant's entire market value where the patented component doesn't create the basis for customer demand. When a jury hears that a company has made, for example, $19 billion in revenue from an infringing product, the number skews its damages horizon — regardless of the patented component's contribution to that revenue.

CHOOSE THE RIGHT EXPERTS

As the *Microsoft* case demonstrates, attorneys need to use experts who will establish a factual foundation for damages calculations in patent infringement cases by considering factors that would play a role in actual royalty negotiations. Experts who rely on nothing more than abstract theories won't cut it.

WHY *GEORGIA-PACIFIC* IS MORE REASONABLE

While the U.S. Court of Appeals for the Federal Circuit in *Uniloc USA Inc. v. Microsoft Corp.* rejected the 25% rule (see main article), it reaffirmed the use of the *Georgia-Pacific* factors to frame the question of reasonable royalties in patent infringement cases. The court cited three of the 15 factors as being particularly important:

1. Actual royalties received by the patent holder for licensing the patent at issue,
2. Royalties paid by licensees of comparable patents, and
3. The portion of profit that may be customarily allowed in the specific business for the use of the invention or similar inventions.

The Federal Circuit found that, unlike the 25% rule, such factors "properly tie the reasonable royalty calculation to the facts of the hypothetical negotiation at issue." It reiterated, though, that evidence purporting to apply any of the *Georgia-Pacific* factors must be tied to the relevant facts and circumstances and the hypothetical negotiations that would have occurred.

ESI preservation guidelines can help your clients avoid sanctions

Electronically stored information (ESI) continues to be a hot topic in the courts. Among other issues, the quantity and numerous sources and formats of ESI can make satisfying the duty of preservation difficult. The Delaware Court of Chancery has attempted to address the problem by releasing some guidelines on ESI preservation. If you have clients among the large percentage of U.S. companies incorporated in Delaware, these guidelines can help them avoid sanctions.

TAKE REASONABLE STEPS

As you know, the duty of preservation requires litigation parties to take "reasonable steps" to preserve information that's potentially relevant to the litigation and within their possession, custody or control. This duty includes ESI, of course.

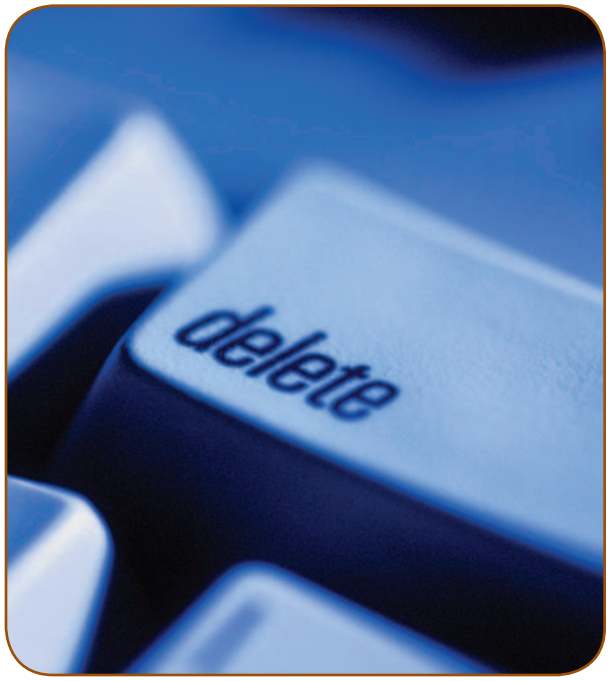
Failing to preserve ESI can prove costly. The court could impose sanctions such as stiff monetary penalties, exclusion of evidence, adverse inference jury instructions or even dismissal or default. Earlier this year, in *Victor Stanley, Inc. v. Creative Pipe, Inc.*, a Maryland district court ordered the defendant to pay more than $1 million in sanctions for the willful loss and destruction of ESI.

Attorneys should discuss with their clients the need to identify how custodians store ESI.

NEW GUIDELINES

While the question of reasonableness will vary by case, the Delaware court advises that, in most cases, parties and their counsel should:

Take a collaborative approach to the identification, location and preservation of potentially relevant ESI.



The guidelines stress the need — at the very minimum — for the parties and their counsel to confer early in the litigation regarding ESI preservation and develop and oversee identification and preservation processes.

Appropriate IT department representatives should be included in discussions about the preservation processes. The parties and their counsel can agree to limit or even skip the discovery of ESI. After preservation has been addressed, counsel for all parties should discuss the scope and timing of discovery of ESI.

Develop and distribute written instructions for ESI preservation. Distribution should be in the form of a litigation hold notice to custodians of potentially relevant ESI. Any updated, amended or modified instructions also should be disseminated. If a litigation hold notice hasn't been disseminated by the time litigation has commenced, counsel should instruct clients to take reasonable steps to act in good faith and with a sense of urgency. This will help clients

avoid the loss, corruption or deletion of potentially relevant ESI.

Document steps taken to prevent the destruction of potentially relevant ESI. According to the court, business laptops, home computers and external storage drives like flash drives are particularly vulnerable. Attorneys should discuss with their clients the need to identify how custodians store ESI. This includes their document retention policies and procedures and the processes that administrative or other staff might use to create, edit, send, receive, store and destroy information for the custodians. And attorneys must take reasonable steps to verify information they receive about how ESI is created, modified, stored or destroyed.

WHAT'S SUFFICIENT?

The Delaware court's ESI guidelines note that developing and implementing a preservation process *after* litigation has commenced may not be sufficient to avoid sanctions if potentially relevant ESI is still lost or destroyed. On the other hand, the guidelines indicate that the court will consider the good-faith preservation efforts of a party and its counsel.

Spotting deception in fraud interviews

You'd expect a thief to lie when questioned by a fraud examiner. But it may come as a surprise to learn that even employees innocent of occupational theft may be less than honest during fraud interviews. Fortunately, experienced fraud investigators are skilled at spotting deception in perpetrators and bystanders alike.

VERBAL SIGNS

Fraud investigators look for several verbal signs that their interview subjects aren't telling the whole truth. These include changes in speech patterns, such as speaking faster or more slowly; changes in volume; and coughing or throat clearing.

Dishonest subjects also might repeat questions, answer a question with another question, or offer oaths of truthfulness such as, "I swear to God." It's also common for employees who are hiding something to make vague responses, claim they can't remember details, stall for time or attempt to change the subject.

NONVERBAL TELLS

As in a poker game, physical and behavioral tells also can tip off fraud investigators. A subject who's lying might, for example:

- Make dismissive or excessive hand motions,
- Cover their mouths with their hands,
- Purse or bite their lips,
- Blink their eyes excessively, or
- Play with or chew on objects such as pens.

And as counterintuitive as it may sound, dishonest subjects sometimes are reluctant to end the interview — because they aren't certain they've convinced the investigator of their honesty.

RESPONDING TO DECEPTION

When an investigator suspects an employee of lying, he or she attempts to pinpoint the parts of the statements that are deceptive — usually by pressing for additional information. The investigator also tries to identify the reason behind the deception. What topic was under discussion at the time the employee showed signs of distress?

That topic may help the investigator determine whether the employee is the fraud perpetrator and is lying to protect him- or herself or simply knows something and is trying to protect another party. An employee also could lie in response to threats of retaliation or even out of shame over behavior unrelated to fraud, such as an extramarital affair.

It's important to remember that signs of deception don't necessarily mean that an employee is lying or guilty of fraud. Some employees feel anxious or intimidated in interview situations, regardless of the subject. To reduce possible misinterpretation of verbal and nonverbal signs, fraud investigators typically start interviews by putting their subjects at ease so they can establish a baseline of the employees' "normal" behavior for sake of comparison.

LEAVE IT TO THE EXPERTS

A fraud investigator's ability to recognize untruthful interview subjects is just one more reason to engage such an expert as soon as one of your clients suspects fraud. Owners and managers often believe they can root out fraud themselves, but they're usually wrong.

Punitive damages

Are you asking the right questions?

Whether you're representing the plaintiff or the defendant, you need to provide judges and juries with the information and context they need to make a fair punitive damages award. Although the U.S. Supreme Court has suggested that there may be constitutional limits on the size of punitive damages awards, an appropriate award generally depends on the defendant's financial condition. Professional damages experts can help you ask the right questions and present information in court that will bolster your case.

BREAKING IT DOWN

Experts consider several questions when building a framework for punitive damages, starting with: Who is responsible?

An expert witness for the defense can break a company into its components, providing jurors with a proper perspective on the division or department most directly responsible for the wrongdoing. Jurors can be shown that the division they have determined to be culpable can be adequately penalized even if

the award won't significantly affect the bottom line of the overall company.

Breaking down a company also can help humanize the defendant. The jurors might begin to see that the defendant isn't an unfeeling corporate entity but an organization made up of many individuals. Jurors may identify with innocent bystanders — including shareholders and employees — who will be adversely affected by a disproportionate punitive damages award.

A plaintiff's expert, on the other hand, can help overcome juror resistance by highlighting the layers of financial resources available to a corporate defendant.

ILL-GOTTEN GAINS

Damages experts also ask how the defendant profited from the alleged wrongdoing. Profits gained as a result of the defendant's misconduct often play a central role in determining an appropriate award. Jurors, however, might not understand that revenues or sales aren't the same as profits.

Experts, therefore, demonstrate the actual or expected profits from the misconduct. A defense expert will take into account any expenses the defendant incurred as a result of claims that grew out of the transgression, including those associated with recalls or redesigns.

A plaintiff's expert can highlight costs that the defendant avoided because of its wrongful conduct. Or the expert might show how the defendant could have precluded recall or redesign costs by acting properly.

LOOKING FOR DEEP POCKETS

Another critical question addresses the defendant's resources. Plaintiffs frequently cite the defendant's net worth to support their contention that only a large award will prove punitive.

While net worth may give a general idea of the defendant's ability to pay, defense experts can show jurors that the specific assets that contribute to net worth also must be examined. Experts may advise jurors to consider the form the assets take — for example, the percentage in cash. Fixed and other noncash assets might not be easily converted to cash, or their conversion might even make it difficult, if not impossible, for the business to continue operating.

The plaintiff's expert, on the other hand, might emphasize the defendant's ability to generate cash in the near future. A company that has a negative net worth because of high initial costs could produce impressive cash and profits later on.

Jurors might begin to see that the defendant isn't an unfeeling corporate entity but an organization made up of many individuals.

Also, by the time a particular claim reaches the punitive award stage, the defendant may have already lost judgments for substantial sums. An expert testifying for the defense can explain how these liabilities affect the defendant's financial statements and overall financial status.

COMMON SENSE

Punitive damages experts decipher financial statements, explain the realities of the defendant's financial condition and analyze any gains the defendant derived from its alleged conduct. When you consider all the things these professionals can help you do, going to court with an expert is simply common sense.