

Determining Lost Profits from IP Infringement

Damages Are Not Always Patently Obvious

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“In the strange heat all litigation brings to bear on things, the very process of litigation fosters the most profound misunderstandings in the world.

- *Renata Adler, American Author & Journalist*

Introduction

In today’s economy, intellectual property (IP) has become a primary source of shareholder wealth and in many cases, represents the principal group of assets on a firm’s balance sheet. As a result, corporate strategy often includes protecting IP assets through aggressive, legal enforcement.

In the context of IP litigation, the Federal Circuit defines compensatory damages as lost profits caused by infringement, but the method by which lost profits are determined isn’t always clear and the inputs to the damages computation is not always readily ascertainable. Various cases highlight the need to examine several variables to ensure accuracy and defensibility of the damages claim in the prosecution of an infringement case.

The Damages Framework

The basic framework for estimating economic damages under U.S. Patent law is set forth in Title 35 of the United States Code (“U.S.C.”) § 284, which states: “Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement.” Damages are assessed as lost profits, reasonable royalties, or a combination of the two. And, to recover lost profits the patent owner must show a reasonable probability that it would have received the additional profits “but for” the infringement. Further, the courts have prescribed no one particular method by which the patent owner must meet this burden.¹

In assessing the integrity of the lost profits claim, case law suggests that that the issue be framed in the context of existing “acceptable” non-infringing substitutes for the patentee’s product. That is, if it is determined that there are *no* non-infringing substitutes, courts readily infer that the infringer diverted sales from the patentee and award lost profits for the sales diversion. Lastly, the courts have sometimes noted that competition from an infringer affects prices, but to date they do not appear to have brought together the sales diversion, price, and quantity issues in a unified analysis.

The Damages Model

The prevailing model for computing damages in an IP infringement lawsuit is set forth in the Panduit Case.² Under Panduit, causation can be demonstrated if the patent owner establishes several factors to be present, including:

- 1) **Demand for the Product** – This factor requires that the claimant establish that demand exists for the patented “feature” of the product. To assess this demand, the analysis centers on the functionality of the invention and the user’s perceived value of it.

¹ *King Instruments Corp. v. Perego*, 65 F.3d 941, 952, 36 U.S.P.Q.2d (BNA) 1129, 1137 (Fed. Cir. 1995).

² *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152 (Sixth Circuit 1978).

- 2) **Absence of Acceptable Non-infringing Substitutes** – This requires the claimant to evaluate the degree of substitution on both the demand and supply sides.
- 3) **Capability to Exploit the Demand** – In this case, the claimant must illustrate the capacity to exploit the demand from both a manufacturing and marketing perspective.
- 4) **Profit That *Would Have Been Made*** – Provided, the claimant has established the first 3 factors, the fourth factor requires an analysis of the incremental costs the firm would have incurred in meeting that demand.

Calculating Lost Sales & Profits

Assuming the claimant has met the burden of the Panduit framework, the analyst next develops the lost sales and associates profits model. This is based on the premise of a market that would have existed “but for” the infringement. That is, this hypothetical market and associated profit profile is compared to actual performance to ascertain the amount of “lost profits.”

After determining the “but for” price and sales volumes, a profitability analysis is performed. This analysis must be tempered by market and competitive forces to determine what the patent holder would have made on those lost sales. In a multi-firm market, for example, the patent holder would not expect to capture all of the sales from the infringing company. Again, the Panduit factors play a role in assessing the claimant’s ability to capture sales absent the infringing party. That is, the lost sales must be evaluated in light of, say, the existence of non-infringing acceptable substitutes that would also garner demand.

Lastly, once the lost sales are determined, total lost profits can be calculated by measuring the incremental profits on the lost sales plus profits lost due to price erosion. And, if lost profits cannot be proven, a reasonable royalty serves as an alternative for the damage award.

Reasonable Royalty

The economic factors that determine the value of a patent and thus determine lost profits damages also influence the determination of a reasonable royalty. And, the general starting point for determination of a reasonable royalty award is the Georgia-Pacific case.³ The Georgia-Pacific factors are influenced by the presence or absence of acceptable substitutes. These factors include items such as the royalties received by the patentee for the licensing of the patent, the rates paid by the licensee for the use of other patents comparable to the patent, and the established profitability of the product made under the patent, among others. And, just as with the Panduit factors, the Georgia-Pacific factors highlight the importance of substitutes in determining a patent’s value.

Conclusions

Properly estimating lost profits damages in a patent infringement case requires an analysis of both the actual market and the prospective market that would have been present “but for” the infringement. Key factors in the analysis include, but are not limited to, (i) Demand for the Patented Product Feature, (ii) Presence of Acceptable Substitutes on the Demand and Supply Side, (iii) Opportunity Costs, (iv) Accurate Sale Volume Forecasts, and (v) Capacity to Exploit Demand. Further, if lost profits cannot be proven, a reasonable royalty serves as an alternative and the assessment of a reasonable royalty is affected by the same factors as in the lost profits computation.

³ *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970).

Valuation Expertise

As the information economy grows, IP will continue to be an increasing source of competitive advantage and shareholder wealth for many companies. In addition, the financial reporting, tax and regulatory environments continue to evolve. As a result of these factors, there has emerged a critical need for independent, robust opinions of value that will withstand scrutiny within a variety of contexts. VALCOR is uniquely qualified to help companies with their IP and intangible asset valuation needs by providing comprehensive solutions that are based on substantial experience and reputation for integrity and independence.

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