

Economic Damages in Intellectual Property

A Hands-on Guide to Litigation

EDITED BY DANIEL SLOTTJE



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This book is dedicated to my brother, Jason, with love.



Contents

ABOUT THE AUTHORS		xv
INTRODUCTION		xxiii
PART ONE	IP Law on Economic Damages	1
CHAPTER 1	U.S. Case Law and Economic Damages in Patent Litigation <i>Chase Perry, Daniel Slottje, and Elizabeth Whitaker</i>	3
	Introduction	3
	Lost Profits	6
	<i>Tektronix, Inc. v. United States</i>	6
	<i>Panduit Corp. v. Stahl Brothers Fibre Works, Inc.</i>	6
	<i>Hanson v. Alpine Valley Ski Area, Inc.</i>	6
	<i>Paper Converting Machine Company v. Magna-Graphics Corporation</i>	6
	<i>Kori Corp. v. Wilco Marsh Buggies & Draglines, Inc.</i>	7
	<i>State Industries, Inc. v. Mor-Flo Industries, Inc.</i>	7
	<i>BIC Leisure Products, Inc. v. Windsurfing Int'l, Inc.</i>	7
	<i>King Instruments Corp. v. Perego</i>	7
	<i>Grain Processing Corp. v. Am. Maize-Products Co.</i>	7
	<i>Crystal Semiconductor Corp. v. Tritec Microelectronics, Int'l, Inc.</i>	8
	Price Erosion	8
	<i>Yale Lock Manufacturing Co. v. Sargent</i>	8
	<i>LAM Inc. v. Johns-Manville Corp.</i>	8
	<i>Brooktree Corp. v. Advanced Micro Devices, Inc.</i>	8
	<i>Crystal Semiconductor Corp. v. Tritec Microelectronics, Int'l, Inc.</i>	9
	Entire Market Value Rule	9
	<i>Paper Converting Machine Company v. Magna-Graphics Corporation</i>	9
	<i>Rite-Hite Corp. v. Kelley Co., Inc.</i>	9
	<i>Stryker Corp. v. Intermedics Orthopedics Inc.</i>	9
	<i>Fonar Corp. v. General Electric Co.</i>	9
	<i>Tec Air v. Denso Manufacturing Michigan Inc.</i>	10
	<i>Micro Chemical, Inc. v. Lextron, Inc. and Turnkey Computer Systems, Inc.</i>	10

Reasonable Royalty	10
<i>Columbia Wire Co. v. Kokomo Steel & Wire Co.</i>	10
<i>Aro Manufacturing Co. v. Convertible Top Replacement Co.</i>	10
<i>Georgia-Pacific Corp. v. U.S. Plywood Corp.</i>	10
<i>Tektronix, Inc. v. United States</i>	11
<i>Ellipse Corp. v. Ford Motor Co.</i>	11
<i>TWM Manufacturing Co., Inc. v. Dura Corp.</i>	11
<i>Fromson v. Western Litho Plate & Supply Co.</i>	11
<i>Slimfold Mfg. Co., Inc. v. Kinkad Industries, Inc.</i>	11
<i>Mahurkar v. C.R. Bard, Inc.</i>	11
<i>Maxwell v. J. Baker, Inc.</i>	12
<i>Minco, Inc. v. Combustion Engineering Inc.</i>	12
<i>Grain Processing Corp. v. Am. Maize-Products Co.</i>	12
Conclusion	12
 CHAPTER 2	
Trends in U.S. Patent Activity	15
<i>Felix Chan and Michael McAleer</i>	
Introduction	15
Data	17
Trends in U.S. Patent Activity	18
Trends in Patent Shares	20
Trends in U.S. Patent Growth Rate	22
Conclusion	24
 CHAPTER 3	
Trademark Infringement and the Legal Bases for the Recovery of Economic Damages	27
<i>Marc E. Ackerman and Daren M. Orzechowski</i>	
Introduction	27
Origins of Trademark Law	28
Development of Federal Trademark Law	30
Different Categories of Trademarks	31
Law of Trademark Infringement	33
<i>Strength of the Mark</i>	35
<i>Similarity between Defendant's and Plaintiff's Marks</i>	35
<i>Whether the Products Compete in the Marketplace</i>	36
<i>Likelihood That the Trademark Owner Will "Bridge the Gap"</i>	36
<i>Evidence of Actual Consumer Confusion</i>	36
<i>Defendant's Intent in Selecting Its Trademark</i>	36
<i>Quality of the Defendant's Goods or Services</i>	37
<i>Sophistication of the Consumers</i>	37
Remedies and Economic Recovery for Trademark Infringement	37
<i>Determining the Relevant Damages Period</i>	38
<i>Theories of Recovery under the Lanham Act</i>	40
<i>Statutory Damages in Counterfeiting Cases</i>	47
<i>Judicial Modification of Damages Award</i>	47
Conclusion	49

CHAPTER 4	Explaining Venue Choice and Litigant Preferences: Solving the Delaware “Mystery”	67
	<i>Donald F. Parsons Jr., Jack B. Blumenfeld, Mary B. Graham, and Leslie A. Polizoti</i>	
	Introduction	67
	Delaware’s Historical Prominence in Patent Litigation	68
	Unmatched Judicial Experience	69
	Predictable Case Management	71
	<i>Rare Transfer</i>	71
	<i>Early Scheduling Conference and Predictable Dates</i>	72
	<i>Flexible Approaches</i>	72
	Frequent Patent Trials	74
	<i>High Number of Trials</i>	74
	<i>Infrequent Summary Judgment</i>	75
	High Win Rates and High Damages	76
	The Mediation Bonus	78
	Conclusion	78
CHAPTER 5	Commonly Debated Issues in Performing Economic Damages Analyses in Intellectual Property Matters	83
	<i>Chase Perry, Clarke B. Nelson, and Elizabeth Whitaker</i>	
	Introduction	83
	Damages under U.S. Patent Law	84
	Commonly Debated Issues in Intellectual Property Damage Calculations	84
	<i>Definition of the Relevant Market</i>	84
	<i>Reliance on the “Book of Wisdom”</i>	85
	<i>Where to Begin a Georgia-Pacific Analysis</i>	86
	<i>Application of the “Entire Market Value” Rule</i>	86
	<i>Interpretation and Application of the “25 Percent” Rule</i>	87
	<i>Incremental versus Gross or Operating Profits to the Patent Holder</i>	87
	<i>Calculating Marginal Costs</i>	88
	<i>Exclusivity and Duration of the Hypothetical Licenses: Factors 3 and 7 under Georgia-Pacific</i>	88
	<i>Acceptability of Noninfringing Substitutes</i>	88
	<i>Analytical Approach to a Royalty</i>	89
	Conclusion	90
PART TWO	Economics of Patent Damages	93
CHAPTER 6	Loss of Profits as a Measurement of Damages in Patent Infringement Matters	95
	<i>Vincent A. Thomas, Christopher Gerardi, and Dawn Hall</i>	
	Introduction	95
	Lost Sales of Patent Owner’s Patented Products	96
	<i>Methodology (Panduit Test)</i>	96
	<i>Case Example</i>	102

Lost Sales of “Nonpatented” Products That Compete with Infringing Products	107
<i>Methodology</i>	107
<i>Case Example</i>	107
Lost Sales of Convoeyed (“Add-on”) Products	107
<i>Methodology</i>	107
<i>Case Example</i>	108
Price Erosion	108
<i>Methodology</i>	108
<i>Case Example</i>	109
Increased Costs/Accelerated Market Entry	109
<i>Methodology</i>	109
<i>Case Example</i>	110
Conclusion	110
 CHAPTER 7	
The Law of Demand and Lost Profits Analysis	113
<i>Robert Basmann, Michael Buchanan, Esfandiar Maasoumi, and Daniel Slottje</i>	
Introduction	113
The Law of Demand and Its Evolution	115
Supply and Demand Models	115
<i>Assumptions and Definitions</i>	117
<i>Demand</i>	117
<i>Supply</i>	117
<i>Simple Supply and Demand Curves</i>	118
<i>Change from the Equilibrium Point</i>	119
<i>Supply Curve Shifts</i>	121
<i>Elasticity</i>	123
<i>Vertical Supply Curve</i>	124
<i>Market Structure</i>	125
<i>Example: Supply and Demand in a Six-Person Economy</i>	126
Case Studies	128
Conclusion	131
 CHAPTER 8	
A Holistic Approach to Patent Damages Analysis	133
<i>Ryan Sullivan</i>	
Introduction	133
Ice Cream Industry	135
<i>Market Overview</i>	135
<i>Data Description</i>	136
<i>Infringement Illustration</i>	137
Market-Share Rule	139
<i>Methodology</i>	139
<i>Application to Ice Cream Industry</i>	140
<i>Discussion</i>	140
Price Erosion	142
<i>Methodology</i>	142
<i>Application to Ice Cream Industry</i>	143

	<i>Discussion</i>	143
	Market Simulation	145
	<i>Methodology</i>	145
	<i>Application to Ice Cream Industry</i>	148
	<i>Discussion</i>	150
	Conclusion	150
	Appendixes	152
	<i>A. Epstein Method for Price Adjustment</i>	152
	<i>B. Antitrust Logit Model (ALM)</i>	152
CHAPTER 9	Commercial Success: Economic Principles Applied to Patent Litigation	159
	<i>Jesse David and Marion B. Stewart</i>	
	Introduction	159
	Summary of the Case Law	160
	Economic Criteria	162
	Two Case Studies	165
	Conclusion	167
CHAPTER 10	Reasonable Royalty as a Measure of Damages in Patent Infringement Matters	171
	<i>Vincent A. Thomas, Christopher Gerardi, and Dawn Hall</i>	
	Introduction	171
	What Is a “Reasonable” Royalty?	172
	<i>License Agreement</i>	172
	<i>Royalty</i>	172
	<i>“Reasonable” Royalty</i>	172
	Methods for Determining a Reasonable Royalty Rate	173
	<i>Established Royalty</i>	173
	<i>Hypothetical Negotiation (Georgia-Pacific Factors)</i>	173
	<i>Analytical Approach</i>	175
	<i>Cost Savings</i>	175
	<i>Alternative Design/Noninfringing Alternatives</i>	175
	Case Example	176
	<i>Background Information</i>	176
	<i>Barbara Witness Calculation</i>	177
	<i>John Expert Calculation</i>	178
	Conclusion	178
CHAPTER 11	The “Analytical Approach” as a Technique to Determine a Reasonable Royalty	181
	<i>Lance E. Gunderson, Stephen E. Dell, and Scott W. Cragun</i>	
	Introduction	181
	Summary of the Case Law	182
	Economic Considerations	184
	Case Example	185
	<i>Background</i>	185
	<i>Plaintiff’s Use of the Analytical Approach</i>	185

	<i>Defendant's Use of the Analytical Approach</i>	187
	<i>Damages Summary</i>	187
	Conclusion	188
CHAPTER 12	A Quasi-Comparable Approach to Reasonable Royalty Determination	191
	<i>Jeffrey A. Dubin</i>	
	Introduction	191
	Scope, Duration, and Noninfringing Substitutes	193
	<i>Variety of Computer Upgrade Technologies</i>	193
	<i>Duration Limitations</i>	195
	Value of a Consumer Upgrade Option	196
	Determining a Reasonable Royalty	197
	Conclusion	198
CHAPTER 13	Using Statistics in Patent Cases: A Case Study	201
	<i>Esfandiar Maasoumi and Matthew G. Mercurio</i>	
	Introduction	201
	Dr. M's Methodology	202
	General Similarity among Mallets	205
	Statistical Tests	206
	Nonindependence of Mallet Characteristics	208
	Presentation of Statistical Evidence	210
PART THREE	Economics of Copyright, Trademark, and Trade Secret Damages	213
CHAPTER 14	Using Statistics in Copyright Cases	215
	<i>Daniel Millimet, Michael Nieswiadomy, and Daniel Slottje</i>	
	Introduction	215
	Economic Models	215
	Deterministic versus Stochastic Models	216
	Line of Best Fit: Regression Analysis	218
	Fundamentals of Hypothesis Testing	219
	Hypothesis Testing in a Regression Model	222
	Hypothesis Testing in a Copyright Damages Case	224
	Case Study: <i>Peter Plaintiff v. the Yazoo Yeti</i>	224
	Conclusion	228
CHAPTER 15	Quantification of Damages in Trademark Cases	231
	<i>Blake English</i>	
	Introduction	231
	General Trademark Information	231
	<i>General Definition</i>	231
	<i>Inclusive Definitions</i>	232
	<i>Distinctiveness</i>	232
	<i>Registration</i>	233

Trademark Infringement Litigation	234
<i>Concepts Unique to Trademark Infringement</i>	234
<i>False Advertising</i>	235
<i>Nonmonetary Remedies</i>	236
Calculating Trademark Damages	236
<i>Types of Damages</i>	236
<i>Other Damages Issues</i>	239
Case Study: Calculating Damages for Trademark Infringement	240
<i>Summary of Case Assumptions</i>	241
<i>Damages Calculation</i>	241
Conclusion	245
CHAPTER 16 Economic Damage Quantification in Trademark Matters	249
<i>Jeffrey A. Dubin</i>	
Introduction	249
Basis for the Demand Approach	251
Demand Analysis and Brand Profitability	252
Data Description	254
<i>Nielsen Reports</i>	254
<i>SAMI Reports</i>	255
<i>Socioeconomic Data</i>	255
<i>Leading National Advertisers Data</i>	255
<i>CPI Data</i>	255
Analysis	256
Estimated Trademark Fractions and Conclusions	259
CHAPTER 17 Evaluation of Damages Claims in a Trade Secrets Case	265
<i>Robin C. Sickles and Ashok Ayyar</i>	
Introduction	265
Case Background: <i>AAA Technologies v. BBB, Inc.</i>	266
Damages Calculations	267
Summary of Opinions	269
Reliance on Interview Questions	270
Spurious and Unreliable Interview Results	271
<i>Flawed Survey Design</i>	271
<i>Flawed Survey Implementation</i>	272
<i>Flawed Interpretation and Use of Survey Results</i>	273
Uncertainty in the Model	274
Royalty Rates	276
Conclusion	278
CHAPTER 18 A Primer on Trademarks and Trademark Valuation	281
<i>Michealyn Corbett, Mohan Rao, and David Teece</i>	
What Is a Trademark?	281
<i>What Constitutes an Acceptable Trademark?</i>	282
<i>Different Types of Trademarks</i>	283
<i>A Trademark Is Not the Same as a Trade Name or Brand</i>	283

XIV CONTENTS

<i>A Trademark Is Not the Same as Goodwill</i>	284
<i>Why Do We Care about Trademarks and Why Are They Needed?</i>	285
<i>How Does One Obtain a Trademark?</i>	286
<i>How Are Trademarks Protected and How Can They Be Damaged?</i>	287
<i>Trademarks and the Internet</i>	288
How Are Trademarks Valued?	289
<i>Principles of Licensing</i>	289
<i>Cost Approach</i>	291
<i>Market Approach</i>	291
<i>Income Approach</i>	293
Conclusion	294

INDEX	297
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Daren Orzechowski is an intellectual property attorney with White & Case LLP in New York. Mr. Orzechowski represents clients in various industries, including electronics, entertainment, media, publishing, sports, and software. In addition to assisting clients in complex licensing transactions as well as intellectual property acquisitions and transfers, he represents clients in litigations involving issues of trademark, patent, copyright, trade secret, unfair competition, and libel law. Mr. Orzechowski received his B.A. from Tufts University (1996) and his J.D., cum laude, from Fordham University School of Law (1999).

Donald F. Parsons

The Honorable Donald F. Parsons was appointed to the Delaware Court of Chancery on October 22, 2003. Prior to his appointment, Vice Chancellor Parsons was a partner at Morris, Nichols, Arsht & Tunnell in Wilmington, Delaware, where he specialized in patent and other intellectual property litigation for 24 years.

Chase Perry

Chase Perry is a director in the FTI Forensic and Litigation Consulting practice and is based in Dallas, Texas. Mr. Perry has significant experience in providing financial and economic analysis related to the calculation of damages in disputes, particularly those involving intellectual property. He has been designated as an expert witness, filed expert reports, and given expert deposition testimony on damages issues.

Leslie A. Polizoti

Leslie A. Polizoti is an associate in the intellectual property group at Morris Nichols, where her practice focuses on patent litigation. In 2002 Ms. Polizoti served as an extern for the Honorable Randy J. Holland, Associate Justice of the Delaware Supreme Court.

Mohan Rao, Ph.D.

Mohan Rao is a director with LECG, an international economics and business consulting firm. He specializes in intellectual property, antitrust economics, and economic analysis in complex commercial disputes. His IP expertise includes valuation, business strategy, and the interplay between IP and antitrust issues. Dr. Rao is an author of the chapter on econometric analysis in the *Litigation Services Handbook*, a leading reference for economic and financial experts. He also teaches courses on valuing intellectual property at the Licensing Executives Society. Prior to LECG, Dr. Rao was a vice president with Charles

River Associates and a professor at UCLA. He has a B.S. in engineering from the University of Michigan, a predoctoral fellowship from Harvard University, and a Ph.D. from the University of Colorado.

Robin C. Sickles, Ph.D.

Robin C. Sickles is professor of economics and professor of statistics at Rice University. He received his B.S. in economics from the Georgia Institute of Technology in 1972 and his Ph.D. in economics from the University of North Carolina at Chapel in 1976. He is a member of the American Economics Association and the Econometric Society, is a fellow of the *Handbook of Economics* and the *Journal of Econometrics*, and is cited in *Who's Who in Economics*, *Who's Who in America*, *Who's Who in World*, and *Who's Who in Social Sciences Higher Education*. He has authored or coauthored more than 90 articles and papers and two books. He has held or holds senior editorial positions with the *Journal of Applied Econometrics*, *Communications in Statistics: Theory and Methods*, *Southern Economic Journal*, *Journal of Business and Economics Statistics*, *Journal of Econometrics*, and *Empirical Economics*. He is editor-in-chief of the *Journal of Productivity Analysis* and a director in the Houston office of LECG, LLC.

Daniel Slottje, Ph.D.

Daniel Slottje has provided consulting services to clients in various industries. He has significant experience in litigation consulting, including economic damages and statistical issues. In addition to advising counsel, he has provided testimony in these matters as well as in others. Dr. Slottje is a professor of economics at Southern Methodist University in Dallas, Texas, and a senior managing director with FTI Consulting. He has published more than 120 articles and written books on many economic issues.

Marion B. Stewart, Ph.D.

Marion B. Stewart is a senior vice president at NERA and chaired NERA's intellectual property practice between 1996 and 2006. His interest in the economics of intellectual property began with his doctoral dissertation on industrial research and development and has ranged from fundamental economic research on "preemptive innovation" to practical calculation of the value of patents and trademarks. His analysis of large-firm research and development rivalry, published in the *Quarterly Journal of Economics*, was a seminal investigation of the impact of mandatory licensing and other profit-sharing mechanisms on the rate of innovation. At NERA, his IP practice has focused on the valuation of patents and trademarks, consideration of the commercial success of patented inventions, and the calculation of economic damages resulting from alleged infringement. He has investigated the importance of IP in numerous industries.

Ryan Sullivan, Ph.D.

Ryan Sullivan is the chief economist of Quant Economics, Inc., and is an expert in economics, finance, and statistics. Dr. Sullivan applies his skills in three areas: litigation

consulting, business consulting, and financial markets. On the litigation front, he provides expert economic analysis for disputes involving intellectual property and technology, antitrust and unfair competition, financial markets and services, and other commercial litigation. For businesses, Dr. Sullivan assists companies in licensing technology and valuing assets. In the financial markets arena, he develops and applies statistical models for active investors. Dr. Sullivan earned his B.A., M.A., and Ph.D. in economics from the University of California, San Diego. Dr. Sullivan is committed to research and analysis that consistently produces reliable results.

David Teece, Ph.D.

David Teece is an applied industrial organization economist who has studied and consulted on issues on technological change, technology transfer, and intellectual property for over two decades. He is the Mitsubishi Bank Professor at the Haas School of Business at University of California, Berkeley, where he also directs the Institute of Management, Innovation and Organization. He is also chairman of LECG, a publicly traded expert services firm. Professor Teece has a Ph.D. in economics from the University of Pennsylvania and has held teaching and research positions at Stanford University and Oxford University. He has authored over 150 books and articles including “When is Virtual Virtuous? Organizing for Innovation” (with Hank Chesbrough), “Profiting from Technological Innovation,” and *Managing Intellectual Capital*.

Vincent A. Thomas

Vincent A. Thomas is a senior managing director in FTI’s Forensic practice in Chicago and serves on FTI’s National Intellectual Property Leadership team. He has over 15 years of experience assisting companies and plaintiffs’ and defendants’ counsel with complex economic, financial, accounting, and valuation issues and specializes in matters involving intellectual property including patent, copyright, trade secret, and trademark. He has conducted several complex studies of damages and on several occasions has provided expert testimony in U.S. federal and state courts as well as at arbitration. Prior to its acquisition by FTI, Mr. Thomas was a partner in KPMG’s Forensic Services practice, where he served as a member of the National Intellectual Property Leadership team. Mr. Thomas has also served in corporate financial and management positions, including director and chief financial officer.



Introduction

This book is a “hands-on” guide to how economists, accountants, and financial analysts, interacting with attorneys and their clients, quantify damages in litigation matters involving intellectual property (IP) matters. In this arena of pure applied microeconomics, statistics and econometrics are playing an ever-increasing role. Patent activity in the United States has grown at remarkable levels in the past 20 years (as can be seen in Chapter 2). Concurrent with the filing of new patents has been an attendant increase in the level of IP litigation. In an effort to promote greater uniformity in certain areas of federal jurisdiction and to relieve the pressure on the dockets of the Supreme Court and the courts of appeals for the regional circuits, Congress in 1982 established the U.S. Court of Appeals for the Federal Circuit. This court assumed the jurisdiction of the U.S. Court of Customs and Patent Appeals and the appellate jurisdiction of the U.S. Court of Claims. As a result, a relatively new field of expertise has arisen, that of the IP economic damages expert. Damages expertise has become the purview of economists, accountants, financial analysts, and attorneys alike. This book presents an overview of how individuals in this field, working alone or as members of a multidisciplinary team, evaluate and ultimately quantify economic damages in various types of IP matters. The book should be of interest to anyone interested in this burgeoning field, both from an academic and/or career path perspective. In addition, attorneys will find this book useful; they are the end users of this talent pool, as they need experts to quantify damages in their cases. In addition, many attorneys are serving as damages experts themselves, so the book might be particularly useful to them. The contributors to this book are a diverse group of intellectual property professionals including attorneys, economics professors, certified public accounts, and others who consider themselves to be experts on economics damages or to be damages professionals.

It is very important to note that all of the opinions in this book represent the views of the particular author or team of coauthors who rendered those opinions. A fundamental pillar of academic freedom is that each individual scholar must by necessity have the right to express his or her views in an unfettered and uncensored way. As the editor of this book,

I do not necessarily agree with any or all of the views of all the contributors; likewise, they may well not agree with any or all of my views on the appropriate way to quantify damages in any particular IP matter. It is left to the reader to evaluate the various methods for damages quantification and to determine which method(s) are most sound for the problem at hand. Concurrently, the views expressed by the individual contributors do not necessarily reflect those of the organizations for which they work, or for other individuals affiliated with the same organization. The discussions in many of the chapters are of a general nature and frequently are for illustrative purposes only. They are not intended to address the specific circumstances of any individual or entity. Each case is different and should be evaluated in light of its own facts. In specific circumstances, the services of a professional should be sought. In the chapters by my coauthors and me, the views and opinions are solely ours and do not reflect any opinions of FTI Consulting, Inc. or its clients as to the proper measure of damages.

Chapter 1, by Chase Perry, Elizabeth Whitaker, and me, discusses the evolution of case law pertaining to the calculation of economic damages in patent infringement matters in the United States. This chapter is not intended as a representation of giving legal opinions. The cases are presented from the perspective of damages expert, not as a legal opinion or treatise. Studying how court decisions have evolved in the context of the analysis of economic damages in disputes over patents reveals that economic theory, although sometimes applied imprecisely, has come to be of paramount importance in the valuation of IP and the calculation of economic damages.

In **Chapter 2**, Felix Chan and Michael McAleer describe graphically and empirically trends and patterns in the level and growth of patent activity in the United States over time, with additional statistical information on worldwide patent activity. The purpose of registering patents in the United States (and elsewhere) is to protect the intellectual property of the innovators and rightful owners. Although this book is primarily concerned with the quantification of economic damages in IP matters, it is important to understand U.S. trends in patent activity over time to be able to discern the patenting “basis” from whence innovation arises and for which protection requirements may increase over time, fueling the causal nexus for litigation over time.

Chapter 3, by intellectual property attorneys Marc Ackerman and Daren Orzechowski, presents trademark law as it pertains to economic damages. The chapter educates the reader on the history and purpose of American trademark law, the current law of trademarks in the United States as it relates to infringement and damages, and the legal bases for calculating trademark infringement damages. The authors discuss the origins of trademark law and the dual benefit that it provides to trademark owners as well as consumers. This background serves to increase the reader’s understanding of how goodwill is captured in trademarks and the scope of trademark rights. It also provides an overview of some of the basic terminology that may be encountered in analyzing trademarks, including a discussion of the varying levels of strength, and corresponding value, that a mark may

possess. Finally, the authors provide an overview of the federal law regarding trademark infringement and the economic recovery to which a successful litigant may be entitled.

Chapter 4, by Donald Parsons, Jack Blumenfeld, Mary Graham, and Leslie Polizoti, presents an interesting discussion on how litigants may select a venue in patent disputes and how some courts have become magnets for attracting patent litigation. The authors focus on Delaware, which seems to be heavily involved in patent litigation. This venue is interesting because it does not appear to favor litigants of either persuasion in its trial outcomes yet attracts a lot of patent litigation. The authors offer several interesting hypotheses on why Delaware has attracted so many patent cases.

Chapter 5, by Chase Perry, Clarke Nelson, and Elizabeth Whitaker, presents some interesting discussions on how experts may disagree about particular aspects of a damages methodology or about the underlying assumptions of the economics damages quantification process in determining reasonable economic damages.

Chapter 6, by Vincent A. Thomas, Christopher Gerardi, and Dawn Hall, discusses the fact that, in patent litigation, the guiding principle in computing damages is that of “adequately compensating” the patent owner for the infringement. Such adequate compensation can be measured in different ways, one of which being the profits that a patent holder has lost as a result of the infringer’s presence in the marketplace. The authors identify certain measures of profits lost by the infringer, provide an explanation of the methodology behind such measures including case examples, and comment on factors one should consider when claiming such measures

Chapter 7, by Robert Basmann, Michael Buchanan, Esfandiar Massoumi, and me, notes that in many lost profit cases, the *Panduit* factors are invoked. A proper analysis requires the practitioner to adhere to the well-known economic principles embodied in the law of demand. Although “the law of demand” is easy enough to understand, some of the exceptions and dynamics that arise in its use, as well as the conceptual disputes, are not as generally well understood. It is important to have a strong grounding in the basic concepts of demand and supply in order to fully understand how to model and quantify damages in lost profit matters.

Chapter 8, by Ryan Sullivan, discusses the notion that in real-world markets, prices and quantities are jointly determined. However, in patent litigation, Dr. Sullivan argues this fundamental economic principle is often ignored. He uses a hypothetical patent infringement suit in the ice cream industry to demonstrate what he refers to as a “holistic approach” to patent damages analysis. His approach argues that patent infringement can have an effect on prices, quantities, and other economic factors, such as product substitution. His analysis illustrates what he considers appropriate methods for implementing a holistic approach that addresses these factors and the impact they have on profits.

Chapter 9, by Jesse David and Marion Stewart, addresses the situation that arises when a party accused of infringing a patent contends that the asserted patent is invalid because of obviousness. The authors note that to help evaluate that issue, courts may consider whether

the patented invention is a “commercial success.” Determining whether an invention has, or has not, been a commercial success is primarily an economic exercise and can be tested, and economists increasingly assist courts in evaluating this issue. This chapter discusses these economic tests and considers them alongside another test suggested by economic principles, namely, whether the patented invention has earned or can be expected to earn a positive net return on invested capital after accounting for all the relevant costs associated with developing and commercializing the product. The authors, both economists, analyze the commercial success standard in the context of two recent cases in which they applied these principles.

Chapter 10, also by Vincent Thomas, Christopher Gerardi, and Dawn Hall, presents a thorough discussion of how one quantifies or determines a reasonable royalty in a patent infringement matter, including a complete discussion of the well-known *Georgia-Pacific* case.

Chapter 11, by Lance Gunderson, Stephen Dell, and Scott Cragun, explores how a party seeking reasonable royalty damages may use various techniques as support for a contended reasonable royalty. One of the methods to support a reasonable royalty analysis, the analytical approach, is a way to value the benefit or excess profits of the patented feature(s) of a product relative to a normal rate of return or the profit generated by a prior product or what is common in a given industry or company profits. Determining whether the facts support the use of the analytical approach is critical; otherwise other methods may be more appropriate. The authors argue that case law is not entirely clear on the approach and that it may be applied inappropriately. They discuss the traditional elements of the analytical approach that lead to its application in determining a reasonable royalty and also analyze a recent case in which this approach was used in context of a reasonable royalty calculation.

Chapter 12, by Jeffrey Dubin, explores the situation when intangible technology assets have value arising from proprietary knowledge, processes, or methods that provide competitive advantages through product differentiation or favorable cost structures. The purpose of the chapter is to calculate a royalty rate for a technology intangible asset using economic analysis of quasi-comparables. The method calculates what consumers would be willing to pay for a patented feature embodied in a consumer good. Analyzing products, with and without the patented feature, allows quasi-comparability even in situations where true comparable sales do not exist. The author demonstrates that market information can establish an upper bound to the royalty and profit rate attributable to a technology intangible. Finally, Professor Dubin applies this model to a computer CPU upgrade technology used in the early 1990s.

Chapter 13, by Esfandiar Maasoumi and Matthew Mercurio, explains that while the use of statistics (particularly survey methods) in copyright and trademark matters continues to grow, statistics has seen far less use in patent cases. However, elementary statistics can be a powerful tool in investigation of patent liability. Of course, as in other fields where applied statistics are used, statistics are just as often misused. The authors’ analysis

illustrates how statistics can be used as well as some pitfalls and potential misuses of statistics in conceptualizing the “similarity” of two products, and possible solutions.

Chapter 14, by Daniel Millimet, Michael Nieswiadomy, and me, describes the general logic of hypothesis testing and illustrates how this tool and others from the field of statistics can be used to determine the impact of an important explanatory variable in an actual copyright infringement case. The field of econometrics is essentially a branch of applied statistics, but one being practiced by individuals who are also trained economists. We demonstrate that rigorous econometric techniques can play an important role in intellectual property rights cases to assist the judge or jury in determining the level, if any, of damages to award.

Chapter 15, by Blake English, discusses the fact that in a time of increasing reliance on intellectual property, trademarks have become a key component in the successful strategy of many businesses. Trademark applications filed with the United States Patent and Trademark Office (USPTO) have nearly doubled in the past 10 years. A basic understanding of trademarks as well as relevant damages considerations can be of tremendous benefit to companies that rely on these forms of IP to identify their products or services as well as to the firms that assist them in resolving trademark disputes.

Chapter 16, also by Jeffrey Dubin, looks at one approach to splitting the profits between owners and users of a trademark, the 25 percent rule. This rule of thumb states that typically one-quarter to one-third of the profit should be apportioned to the licensor for the use of the trademarked product. Professor Dubin suggests that regardless of the validity of the rule, it is commonly cited and applied in the licensing community. The chapter develops an econometric estimate of the trademark fraction based on an economic analysis of trademark value. Trademark fractions determined for five products using econometric demand analysis show considerable variation and are generally much larger than the 25 percent rule would suggest.

Chapter 17, by Robin Sickles and Ashok Ayyar, presents a case study of a matter, *AAA v. BBB*, handled by the first author, in which trade secret information was allegedly misappropriated. Reviewing the case record brought to light problems that existed in the preparation of damages claims. By flagging these issues in practicum, the study outlined and explored in this chapter should serve as a guide to the trade secrets aspect of intellectual property damages claims. The authors begin with what they believe is a strategy and method for building a sound damages model and then annotate their findings.

Finally, **Chapter 18**, by Michealyn Corbett, Mohan Rao, and David Teece, presents a broad overview of what a trademark is and how to quantify damages in a matter involving trademarks. These authors, all economists, present a different perspective on trademark damages from the one presented in Chapter 15 by Blake English, who is a CPA. This chapter outlines how a trademark is a distinctive word, phrase, name, or symbol that is used in commerce to indicate the source of a good or service and to distinguish it from the goods or services of others. Like patents, trademarks can constitute a significant portion of a firm’s asset value; therefore, they need to be strategically developed and protected. This chapter

provides a primer on trademarks and trademark valuation. The authors also discuss their take on the economic principles of licensing and describe some of the commonly used approaches to trademark valuation, particularly in the context of licensing trademarks.

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Economic Damages in Intellectual Property



IP Law on Economic Damages
