

A Quick Guide To Patent Damages Discovery

Law360, New York (August 12, 2016, 1:20 PM ET) --

The calculation of damages plays a central role in patent infringement litigation. When we approach this problem, one of the first questions to arise is what types of information will we, as attorneys and economic experts, need, both from the client and from the opposing party, in order to quantify damages. Although we always consider and provide guidance in the context of the specific facts and issues of the case at hand, our response to that question is fairly consistent.

A standard set of documents that most businesses routinely maintain in the ordinary course of business can provide valuable information regarding the issues that arise in nearly every patent damages analysis. Below we share the discovery items that appear on our standard “wish list,” and explain how they are likely to prove useful in the calculation of damages in a typical patent infringement case.

1. Sales Data

We cannot emphasize enough the importance and relevance of sales data, both for the accused products sold by the alleged infringer, and for the patented products sold by the patentee. These sales data necessarily represent the starting point for any serious assessment of the economic injury caused by alleged infringement.

Under the general heading of “sales data” we typically include information on revenues, quantities sold, and prices. In almost all cases counsel would be well-advised to request all three.

Most revenue accounting systems will record both gross and net sales. The former quantity generally represents the revenue that would be realized if all sales were transacted at some standard or list price. The latter represents the revenues received after allowance for returns, discounts, free goods, or other such deductions, and is generally the most relevant concept for purposes of analysis, as it corresponds to the value actually received by the company.

For what products should you request sales data? In general, there are four categories of products that may be relevant:

1. Products allegedly covered by the patent, including those sold by the patent owner and the accused infringer. These make up the heart of the dispute, and would include products marked or marketed with



Kevin Neels



Pallavi Seth



Jeffrey C. Metzcar

the patent number, indivisible products that include a patented component, and products made with a patented process.

2. Other nonpatented products that are sold in the same market and that compete with the patented products. This category would include any other products that customers might consider as an alternative to the patented products, and that might constrain the prices at which the patented products can be sold. If there are other significant noninfringing alternatives available in the market, their presence, characteristics and sales volumes must be accounted for. Sales data for noninfringing alternatives will be crucial if it should become necessary to rely on the market share rule to calculate lost profits, as permitted by the Federal Circuit in *State Industries Inc. v. Mor-Flo Industries Inc.*[1]

3. Any products that might be candidates for treatment as convoyed sales. Information on unpatented products and/or services commonly sold with the accused products or patented products could influence the computation of lost profits, or provide evidence to support arguments regarding what is a reasonable royalty rate. Such information can also help to demonstrate the likelihood of irreparable harm if infringing sales are permitted to continue, and thus may strengthen the patent owner's arguments for granting a temporary or permanent injunction against ongoing sales of the accused products.

4. Comparator products that do not compete with the patented products, but that fall into the same broad category of products, or that are made using similar materials and processes. Information on the sales and pricing of such comparator products can be extremely useful in evaluating price erosion that may have been caused by sales of the accused products, and subsequently in quantifying the economic injury that such price erosion may have caused. The first suggestion that a patent owner may have been injured due to price erosion may come from a drop in the prices the patent owner is able to command at the time when the sale of accused products began. However, to prove that price erosion has occurred one must present evidence indicating that any such drop in price was caused by the sale of accused products, and not by some unrelated factor. In this situation, information on price movements of comparable products not influenced by the sale of accused products can provide valuable insights.

If multiple products are at issue it will of course be desirable to request data broken down by product.

It will often be desirable, if possible, to request data starting at a point in time prior to the introduction of the accused products. The ability to track and measure changes in prices and quantities at the point when the sale of accused products began can provide valuable insights into the dynamics and competitive structure of the relevant market.

2. Cost Data

It will almost always be necessary to ask for information on costs. To be most useful, the cost data should cover the same universe of products as the requested sales data, and at the same level of individual product detail.

Under generally accepted accounting principles, companies are required to calculate the cost of goods sold ("COGS"). These costs represent the cost of producing whatever is being sold. They will include labor, materials costs, and generally some allocation of overhead costs that are closely tied to production, such as quality assurance costs, or the costs of factory-level supervision and management.[2] If possible, it is often desirable to break the COGS down by these cost categories, since overhead and other burden costs may tend to vary less with changes in production levels than, say,

direct labor or materials costs.

To interpret cost data properly it is important to obtain information on how costs are assigned to products. If the product in question is large, expensive, complex or highly customized, it might be the case that each individual product is assigned a billing code to which labor and materials costs are charged as they are incurred. In many manufacturing operations, however, the only product-level costs that are available are standard costs. Standard costs are really projections of the per-item costs that the company expects to incur, and are prepared prior to actual production in order to permit companies to track costs and profits in close to real time as production and sales take place. In general, however, actual input prices and productivity will differ somewhat from initial projections. Any such differences will show up as manufacturing cost variances. In order to get an accurate picture of costs it is often necessary to request information on both standard costs and on variances.[3]

The other category of costs that will be relevant are the overhead costs of sales, general and administrative costs (“SG&A”). These costs usually vary to some degree with changes in production levels, but rarely in direct proportionality. It may be necessary to request annual or quarterly SG&A costs over some extended period of time, so as to permit an empirical assessment of the extent to which they change with changes in sales.

Some categories of non-COGS costs can be tied directly to the products of interest. Examples might include sales commissions or royalties owed. The availability of data on, and the relevance of such costs will vary, depending upon the circumstances of the case.

3. Pricing Documents

Internal company documents describing how prices are set often provide valuable insights into the nature of the market in question, and provide context for the interpretation of raw price data. For example, it is often helpful to understand the relationship between list prices and actual transaction prices, since in some industries these prices can diverge substantially. It is also helpful to understand discounting practices, the role of group purchasing organizations, and whether and under what circumstances after the fact rebates might be granted. Pricing documents can also provide valuable insights into the competitive structure of the market into which the accused products are sold.

4. Information on Product Distribution

We often request information about how a company brings its product to market. Does it have a dedicated sales force? Does it rely upon contract salespeople? Does it sell through distributors? Through retail stores? Online? The answers to such questions often provide valuable insights into the company’s incremental selling costs. They also have implications for how easily the company might be able to accommodate significant increases in sales volume — one of the factors that must be addressed in order to prove lost profits damages.

5. Licenses

We also request copies of any licensing agreements involving any party to the case. This request should of course encompass any licenses covering the patents-at-issue, as well as any licenses covering related or comparable technologies. This request should be construed broadly to include in-licenses, out-licenses, litigation settlements, intracompany licenses, licenses granted in conjunction with distribution agreements, and agreements involving the outright purchase or sale of intellectual property.

Other related documents that may provide useful information regarding the valuation of the patents-at-issue include transfer pricing studies involved in intracompany sales, or intangible asset valuation studies prepared in connection with an acquisition.

6. Business Plans

Business plans can be a powerful and unexpectedly rich source of information. For example, such plans often identify and describe competitive products, which might reveal the presence (or absence) of noninfringing alternatives. Business plans will often identify competitors, and in so doing can clarify the nature of the competitive relationship between the patent owner and alleged infringer. Business plans may also provide the best source of quantitative information about relative market shares, a crucial input to application of the market share rule.[4]

Perhaps most importantly, because business plans typically take a forward-looking view of the marketplace, they can provide valuable information about the expectations of market participants at a specific point in time — pre-infringement. Business plan forecasts may thus shed light on what sales might have been “but for” the introduction of an infringing product.

In situations in which corporate funds have been requested to support the development of a technology or the acquisition and installation of equipment embodying a patented technology, one can often find documents describing the benefits that the project is expected to generate and projecting the returns the company is likely to realize on its investment. Such “business case analyses” can, when available, be especially useful as a source of quantitative projections of the economic benefits associated with the patented technology.

7. Marketing Materials

Another category of information that we frequently find useful are marketing and promotional materials relating both to the patented and to the accused products. Given the growing emphasis that courts place on the importance of isolating the specific contributions and value associated with the patented technology, it is often helpful to see how prominently the patented features are displayed in company promotional materials. A number of different types of documents may be useful for this purpose, including product brochures, catalogs, advertisements, sales training materials, and selling guides prepared for use by the company’s sales force.

8. Market Research Reports

A final category of information that we sometimes find useful when it is available includes market research reports. Such reports can include customized consumer market research studies conducted on behalf of the company, as well as more general overview reports prepared by third-party market research firms. Market reports can provide useful insights into the structure of the market in which products are sold, the value of the patented feature relative to nonpatented features, and the extent to which the patented feature drives demand for the patented product.

Conclusion

While the particulars of each patent damages case may differ, we have found that the set of documents described above will generally provide parties involved in patent litigation with the materials they need

to begin to map out their damages case and develop their case strategy.

—By Kevin Neels and Pallavi Seth, The Brattle Group Inc., and Jeffrey C. Metzcar, Thompson Hine LLP

Kevin Neels, Ph.D., and Pallavi Seth, Ph.D., are principals in The Brattle Group's Washington, D.C., office. Jeffrey Metzcar is a partner in Thompson Hine's Dayton, Ohio, office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] State Industries, Inc. v. Mor-Flo Industries, Inc., 883 F.2d 1573 (Fed Cir. 1989).

[2] See Zimmerman, Jerold L. Accounting for Decision Making and Control, McGraw-Hill, Eighth Edition, at pp. 45-47 for further details about overhead costs.

[3] See *id.*, at Chapter Twelve for more details about standard costs and variances.

[4] See State Industries, Inc. v. Mor-Flo Industries, Inc., 883 F.2d 1573 (Fed Cir. 1989).