wiley

ALERT

Federal Circuit Patent Bulletin: *Aqua Shield v. Inter Pool Cover Team*

December 22, 2014

"An especially inefficient infringer—e.g., one operating with needlessly high costs, wasteful practices, or poor management—is not entitled to an especially low royalty rate simply because that is all it can afford to pay without forfeiting or unduly limiting its profit if it uses the patented technology rather than alternatives."

On December 22, 2014, in *Aqua Shield v. Inter Pool Cover Team*, the U.S. Court of Appeals for the Federal Circuit (Wallach, Taranto,* Chen) vacated and remanded the district court's summary judgment that Inter Pool Cover Team (IPC) infringed U.S. Patent No.6,637,160, which related to enclosures designed to cover pools or create sun rooms, and judgment that Aqua Shield was entitled to damages in the form of a royalty of $10,800 and that IPC had not been willful in its infringement. The Federal Circuit stated:

After making a finding of infringement, "the court shall award the claimant 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." The "value of what was taken"—the value of the use of the patented technology—measures the royalty. A traditional heuristic for assessing this market value is to posit a "hypothetical negotiation" between the patentee and adjudicated infringer and to "attempt[] to ascertain the royalty upon which the parties would have agreed had they successfully negotiated an agreement just before infringement began." The inquiry, besides being hypothetical, involves approximation: "[t]he hypothetical negotiation tries, as best as possible, to recreate the ex ante licensing negotiation scenario and to describe the resulting agreement." . . .

The district court correctly noted that the infringer's actual profits earned during the period of infringement can be relevant to the inquiry, but it erred in the use it made of IPC's profit figures. What an infringer's profits actually turned out to have been during the infringement period may be relevant, but only in an indirect and limited way—as some evidence bearing on a directly relevant inquiry into anticipated profits. Thus, when the infringer is a profit-making enterprise, a "reasonable royalty is the amount that 'a person, desiring to manufacture[, use, or] sell a patented article, as a business proposition, would be willing to pay as a royalty and yet be able to make[, use, or] sell the patented article, in the market, at a reasonable profit.'" In hypothetical-negotiation terms, the core economic question is what the infringer, in a hypothetical pre-infringement negotiation under hypothetical conditions, would have anticipated the profit-making potential of use of the patented technology to be, compared to using non-infringing alternatives. If a potential user of the patented technology would expect to earn X profits in the future without using the patented technology, and X + Y profits by using the patented technology, it would seem, as a prima facie matter, economically irrational to pay more than Y as a royalty—paying more would produce a loss compared to forgoing use of the patented technology.

The hypothetical negotiation is hypothetical not only because, in the typical case, no successful pre-infringement negotiation ever occurred, but also because the negotiation is constructed on hypothetical assumptions. Most basically, the method assumes infringement and validity of the patents and willingness of the parties to negotiate an agreement. Another hypothetical assumption, bearing particularly on the anticipated-profits inquiry, abstracts away from the particular infringer's degree of efficiency. An especially inefficient infringer—e.g., one operating with needlessly high costs, wasteful practices, or poor management—is not entitled to an especially low royalty rate simply because that is all it can afford to pay without forfeiting or unduly limiting its profit if it uses the patented technology rather than alternatives. Thus, the royalty the particular infringer could profitably pay by going about its business in its particular way does not set the market value that the hypothetical negotiation aims to identify.

Real-world application of this conceptual structure often involves "approximation and uncertainty," and the ultimate royalty determination must reflect the two-sided nature of the posited negotiation. The inquiry, besides being hypothetical, asks about a comparative business prediction in an uncertain, complex world, and many variables may affect the hypothetical forecast, including costs and availability of non-infringing alternatives, the patented technology's role in the firm's (expected) overall business, and the (expected) actions of competing firms in the market. Moreover, various kinds of evidence, such as licenses, business prognostications, and information about cost savings or value enhancements compared to alternatives, where such evidence is reliable, relevant, and not unduly prejudicial, may be used in the inquiry to determine "the economic value of the patented technology in the marketplace" at the relevant time. But we do not have before us broad questions about what evidence meets admissibility standards or would support a sustainable royalty award.

We deal here only with a challenge to the soundness of the district court's particular use of IPC's profits in its rationale. For purposes of Aqua Shield's challenge, two points are key. First, anticipated incremental profits under the hypothesized conditions are conceptually central to constraining the royalty negotiation . . . .

Second, "[e]vidence of the infringer's actual profits generally is admissible as probative of his anticipated profits."

Contrary to Aqua Shield's broader contention, therefore, the district court did not err in considering IPC's profits. But it did err in treating the profits IPC actually earned during the period of infringement as a royalty cap. That treatment incorrectly replaces the hypothetical inquiry into what the parties would have anticipated, looking forward when negotiating, with a backward-looking inquiry into what turned out to have happened. The district court's analysis also incorrectly replaces the inquiry into the parties' anticipation of what profits would be earned if a royalty (of amounts being negotiated) were to be paid with an inquiry into what profits were earned when IPC was charging prices without accounting for any royalty. Thus, the district court seems to have simply assumed that any royalty paid by IPC would have directly reduced its profits, dollar for dollar. But that would not be true, in general, if IPC could have raised its prices (over what it actually charged for infringing sales) to account (fully or partly) for a royalty payment. The district court did not find, and IPC has not argued here, that IPC was selling in a perfectly competitive market in which it was forced to act as a pure price-taker. We have not been shown proof that this case is different from the typical one in which pricing might be adjusted to account for a royalty based on sales price. Indeed, IPC has not pointed to any evidence supporting the district court's conclusion that a royalty should be a percentage of profits rather than sales revenues. . . . We vacate the district court's royalty calculation and remand for redetermination in a manner consistent with this opinion. On remand, the court should consider all relevant record evidence, including the advantages of the patented product, the ease and cost of designing around the claimed invention, and the relevance of IPC's actual profits to what IPC's expectations would have been in a hypothetical negotiation.

To prove that its patent was willfully infringed, a patentee must make two related showings. First, it must "show by clear and convincing evidence that the infringer acted despite an objectively high likelihood that its actions constituted infringement of a valid patent." Second, "the patentee must also demonstrate that this objectively-defined risk (determined by the record developed in the infringement proceeding) was either known or so obvious that it should have been known to the accused infringer." . . .

In a later willfulness determination, the significance of a preliminary-injunction denial depends on why the preliminary injunction was denied. In this case, the Eastern District of New York's decision to deny Aqua Shield's motion for a preliminary injunction cannot reasonably be read to support a conclusion that any substantial basis existed for doubting infringement or validity. The New York court denied Aqua Shield's motion because of personal-jurisdiction questions and because Aqua Shield lacked sufficient knowledge of IPC's product to make the required showing of a likelihood of success on the merits. Personal jurisdiction does not speak to infringement or validity at all. And Aqua Shield's ignorance of IPC's products appears irrelevant to a validity analysis and does not indicate what an infringement analysis of those products would show once the details of those products were fully known—as they were all along to IPC. The denial of Aqua Shield's motion for a preliminary injunction is thus a legally insufficient reason for determining that IPC did not willfully infringe.

With respect to the willfulness of any infringement that occurred after summary judgment of infringement, the evidence cited by the district court stops short of demonstrating that IPC did in fact design around the '160 patent and, if so, when. The court pointed to evidence that IPC instructed its factory to fix the end panels of its pool enclosures in place, in a manner it believed to avoid the patent's claims. Questions remain about whether that change was actually implemented or whether the resulting products avoided infringement. Both inquiries are relevant to the issue of willfulness. They may also bear on the royalty issue, because they may be relevant to the ease and cost of designing around the patented technology. We therefore vacate the court's decision that IPC did not willfully infringe and remand . . . .