

# THE IMPACT OF EBAY ON PROSPECTIVE PATENT DAMAGES

George M. Newcombe  
Ariel Leichter-Maroko  
Simpson Thacher & Bartlett LLP  
2550 Hanover Street  
Palo Alto, CA 94304  
650-251-5000

## I. INTRODUCTION

The framework for remedying patent infringement was relatively settled until May 2006. Upon prevailing in a patent infringement case, patent holders would seek, and were generally entitled to, either lost-profits or reasonable royalty damages, and an injunction against further infringement. However, the Supreme Court's decision in *eBay Inc. v. MercExchange, L.L.C.* may have dramatically altered that framework by criticizing the standard by which courts grant injunctions in patent disputes.<sup>1</sup>

Prior to *eBay*, courts used a “‘general rule,’ unique to patent disputes, ‘that a permanent injunction will issue once infringement and validity have been adjudged.’”<sup>2</sup> Injunctions in non-patent cases, on the other hand, would issue only after satisfaction of a four-factor test.<sup>3</sup> *eBay* held that this distinction between patent and non-patent cases is unwarranted and injunctions in all cases should only issue upon satisfaction of the four-factor test.<sup>4</sup>

In light of the *eBay* decision, courts have more-closely scrutinized requests for injunction,<sup>5</sup> or remanded grants of injunction for failing to apply the four-factor test.<sup>6</sup> Some

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<sup>1</sup> *eBay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837, 1841 (2006)

<sup>2</sup> *Id.* at 1841 (internal citations omitted); *see also, Monsanto Co. v. Scruggs*, 459 F.3d 1328, 1342 (Fed. Cir. 2006) (citing *MercExchange, L.L.C. v. eBay Inc.*, 401 F.3d 1323, 1339 (Fed. Cir. 2005)) (“courts will issue permanent injunctions against patent infringement absent exceptional circumstances”).

<sup>3</sup> *See, e.g., Weinberger V. Romero-Barcelo*, 456 U.S. 305, 312-313 (1982).

<sup>4</sup> *eBay*, 126 S. Ct. at 1839.

<sup>5</sup> *E.g., TiVo Inc. v. EchoStar Communications Corp.*, 446 F.Supp.2d 664 (E.D.Tex. 2006)

<sup>6</sup> *E.g., Monsanto*, 459 F.3d at 1342.

courts have used *eBay* as a backdrop to invalidate other traditional beliefs, such as “that a finding of infringement and validity raises a rebuttable presumption of irreparable harm.”<sup>7</sup>

Post-*eBay* injunction jurisprudence is in its infancy, and it may be some time before the dust settles, but one large issue will likely dominate the analysis—what happens to patent holders who prevail on the merits but are denied injunctions. Prior to *eBay*, when patent holders were almost guaranteed an injunction upon a finding of validity and infringement, they could receive damages for past infringement and prevent the infringer from continued infringement by order of the court. Post-*eBay*, they can still receive damages for past infringement, but their chances of earning an injunction, and thereby preventing future infringement, seem to have diminished. This article will analyze the standards for issuing an injunction, how courts have approached requests for injunction in the months following *eBay*, and how courts might address future infringement of a valid and infringed patent in the event an injunction is denied. This article argues that the most desirable outcome in the event an injunction is denied is a compulsory license with a royalty rate equal to the reasonable royalty rate determined at trial for past infringement, enhanced by a factor reflecting the willfulness of future infringement.

## **II. THE EBAY PATENT INJUNCTION STANDARD**

### **A. Applying the Four-Factor Test**

The Supreme Court in *eBay* held that, in order to be awarded an injunction, a patent holder whose patent is valid and infringed must satisfy the same four-factor test required for injunctions in all other cases. The four factors are: “(1) that [the patent holder] has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff

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<sup>7</sup> *E.g., z4 Techs., Inc. v. Microsoft Corp.*, 434 F. Supp. 2d 437, 439 (E.D. Tex. 2006).

and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.”<sup>8</sup>

The *eBay* majority does not explain how to apply the injunction test to patent infringement. However, the two concurring opinions offer brief, albeit apparently conflicting, advice. Chief Justice Roberts, in his concurring opinion, lauds historical decisions as guides to applying the equitable test, saying “a page of history is worth a volume of logic.”<sup>9</sup>

Justice Kennedy, while not outright disagreeing with Chief Justice Roberts, seems to take the opposite view, saying that the circumstances of historical patent infringement cases are inapposite to many of today’s patent infringement cases. Specifically, Justice Kennedy notes three particulars about the current patent landscape that distinguish it from historical precedent:

- 1) “An industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees . . . . For these firms, an injunction, and the potentially serious sanctions arising from its violation, can be employed as a bargaining tool to charge exorbitant fees to companies that seek to buy licenses to practice the patent.”
- 2) In instances where “the patented invention is but a small component of the product the companies seek to produce and the threat of an injunction is employed simply for undue leverage in negotiations, legal damages may well be sufficient to compensate for the infringement and an injunction may not serve the public interest.”

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<sup>8</sup> *eBay*, 126 S. Ct. at 1839.

<sup>9</sup> *Id.* at 1842 (Roberts, C.J., concurring).

- 3) “[T]he burgeoning number of patents over business methods, which were not of much economic and legal significance in earlier times. The potential vagueness and suspect validity of some of these patents may affect the calculus under the four-factor test.”<sup>10</sup>

These three particulars likely encompass what Justice Kennedy feels are the main forces behind recent calls for patent reform. Indeed, many post-*eBay* journal articles have focused on the importance of the rise of “trolls” in the Supreme Court’s decision and the importance of a patent holder’s status as a “troll” (or a “firm[ that] use[s] patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees,” per Justice Kennedy’s description) in a post-*eBay* court’s decision to grant an injunction.<sup>11</sup>

## **B. Addressing the Right to Exclude**

Although the *eBay* holding, that patent cases should not merit unique considerations for issuing an injunction, seems reasonable, one problem raised by the standard application of the four-factor test to patent cases is how the right to exclude is protected without an injunction. This issue was briefly mentioned, but neither fully addressed nor resolved, in Chief Justice Roberts’ concurrence, when he discusses the history of issuing injunctions without applying the four-factor test. Chief Justice Roberts said “[t]his ‘long tradition of equity practice’ is not surprising, given the difficulty of protecting a right to exclude through monetary remedies that allow an infringer to use an invention against the patentee’s wishes--a difficulty that often implicates the first two factors of the traditional four-factor test.”<sup>12</sup> Perhaps the Chief Justice’s

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<sup>10</sup> *Id.* at 1842 (Kennedy, J., concurring).

<sup>11</sup> See, e.g., Howard Susser and Jerry Cohen, LEGAL ANALYSIS: SUPREME COURT ENDS SPECIAL TREATMENT FOR PATENT INJUNCTIONS, 5 B.B.J. 9 (November/December 2006); Thomas L. Casagrande, FEATURE: THE REACH OF EBAY INC. V. MERCEXCHANGE, L.L.C.: NOT JUST FOR TROLLS AND PATENTS, 44 Houston Lawyer 10 (November/December 2006).

<sup>12</sup> *Id.* at 1841 (Roberts, C.J., concurring)

reasoning can be reconciled with a denial of injunction by emphasizing the importance of the third factor, which is less affected by the “right to exclude,” and the fourth factor, which is not at all affected by the “right to exclude.”

Justice Kennedy’s concurrence, on the other hand, discounts the difficulty of remedying the right to exclude absent an injunction. “The traditional practice of issuing injunctions against patent infringers, however, does not seem to rest on ‘the difficulty of protecting a right to exclude through monetary remedies that allow an infringer to use an invention against the patentee’s wishes.’ Both the terms of the Patent Act and the traditional view of injunctive relief accept that the existence of a right to exclude does not dictate the remedy for a violation of that right.”<sup>13</sup>

Courts have applied the four-factor test and both concurrences as guidance, in bids by patent holders to protect their rights (including the right to exclude), to both grant and deny injunctions.

### **III. POST-EBAY CASES DENYING INJUNCTION**

Some post-*eBay* cases have granted injunctions after applying the four-factor test,<sup>14</sup> while others have used the four-factor test to deny injunctions.<sup>15</sup> Although the four-factor test calls for an in-depth assessment of effect of the injury and monetary remedy to the patent holder, the burden an injunction would place on each party, and the effect of an injunction on the public, the relatively-short post-*eBay* era has shown that courts will likely grant an injunction to a patent holder that uses its patent to produce a product, and deny an injunction to a patent holder that

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<sup>13</sup> *Id.* at 1842 (Kennedy, J., concurring).

<sup>14</sup> *E.g. Tivo Inc. v. EchoStar Comm. Corp.*, 446 F.Supp.2d 664 (E.D. Tex. 2006);

<sup>15</sup> *E.g. z4 Techs.*, 434 F. Supp. 2d at 437.

merely derives license fees from its patent.<sup>16</sup> The next section looks at one court's application of the four-factor test to deny an injunction and imply a prospective royalty to a patent holder that does not use its patent to produce a product, but rather seeks license fees for its patent.

#### A. **z4 Techs., Inc. v. Microsoft Corp.**

The Eastern District of Texas found that patent holder z4 did not satisfy the four-factor test, outlined in *eBay*, to obtain an injunction against infringers Microsoft and Autodesk.<sup>17</sup> The patents at issue in *z4* describe methods for activating software, incorporation of which prevents unauthorized use of the software.<sup>18</sup>

##### 1. *First factor – irreparable harm*

In applying the first factor, irreparable harm, *z4* held that a finding of infringement and validity does not raise a rebuttable presumption of irreparable harm.<sup>19</sup> Instead, the Court placed the burden of proving irreparable harm on the plaintiff,<sup>20</sup> and found that plaintiff *z4* did not satisfy the burden.<sup>21</sup> The court noted that lost profits, loss of brand name recognition, and loss of market share are types of injuries that are irreparable, and “[t]here is no logical reason that a potential consumer or licensee of *z4*’s technology would have been dissuaded from purchasing or licensing *z4*’s product activation technology for use in its own software due to Microsoft’s infringement[, and] Microsoft’s continued infringement does not inhibit *z4*’s ability to market, sell, or license its patented technology . . . .”<sup>22</sup>

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<sup>16</sup> Compare, e.g., *Paice LLC v. Toyota Motor Corp.*, 2006 WL 2385139 (E.D. Tex. 2006) (denying injunction where the patent holder uses the patent solely for license fees, rather than to produce products) with *Tivo*, 446 F.Supp.2d at 664 (granting injunction where patent holder used its patent to produce a product, and was a direct competitor of the infringer).

<sup>17</sup> *z4 Techs.*, 434 F. Supp. 2d at 437.

<sup>18</sup> *Id.* at 438.

<sup>19</sup> *Id.* at 439-40.

<sup>20</sup> *Id.* at 440.

<sup>21</sup> *Id.* at 441.

<sup>22</sup> *Id.* at 440.

2. *Second factor – inadequacy of legal remedy*

In applying the second factor, inadequacy of remedy at law, z4 argued that monetary remedies could not “compensate z4 for the loss of its right to exclude Microsoft from making, using, offering for sale, or selling its invention.” The Court disagreed, finding that “Microsoft’s use of z4’s intellectual property does not exclude z4 from selling or licensing its product to any sector of the market or threaten z4’s brand name recognition or good will in any way. z4 is only excluded from selling or licensing its technology to Microsoft.”<sup>23</sup>

3. *Third factor – balance of hardships*

In applying the third factor, balance of hardships, the Court noted that an injunction would force Microsoft to either redesign all of its Windows and Office software to remove the small component that is covered by the patents, or deactivate the activation features covered by the patents. The Court found that a redesign would be prohibitively expensive (especially since the release of new versions of Microsoft software, not containing the infringing features, was imminent), and that deactivating the activation features would lead to widespread piracy. On the other hand, the hardship sustained by z4 would be Microsoft’s continued use of its patents, which the Court found was remediable by monetary damages. Therefore, the Court found that the balance of hardships leaned in Microsoft’s favor.

4. *Fourth factor – public interest*

The Court found in favor of Microsoft on the fourth factor, the public interest. The Court noted that “Microsoft’s . . . products are likely the most popular software products in the world . . . [and that] any minor disruption to the distribution of the products in question [that] could occur

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<sup>23</sup> *Id.* at 441; it is interesting to note that the Court’s interpretation of the right to exclude may be inaccurate. While the “right to exclude” normally seems to imply the patent holder’s right to exclude *others* from using its patent, the z4 Court appears to interpret the “right to exclude” as the patent holder’s *right to not be excluded from licensing by others*.

. . . would have an effect on the public due to the public's undisputed and enormous reliance on these products.”

5. *Disposition*

Although the Court denied a permanent injunction, it recognized that “in light of denying z4’s proposed permanent injunction, an efficient method for z4’s recovery of future monetary damages post-verdict is needed.”<sup>24</sup> In its discussion of the second factor (adequacy of remedy at law), the Court found that calculating royalties for future infringement would not be difficult and “[could] be made based on the same reasonable royalty calculation used . . . at trial and by referring to Microsoft’s internal records showing the number of sales for the infringing copies of software during the time period.”<sup>25</sup> The Court accordingly severed the post-verdict causes of action and ordered z4 to file a new suit.<sup>26</sup> The Court also ordered Microsoft “to file quarterly reports in the new action . . . indicating the number of units sold. This will preserve z4’s rights to future monetary damages in an efficient manner, while relieving Microsoft of the hardship [of] a permanent injunction.”<sup>27</sup>

The z4 Court recognized that, in light of the fact that it refused to order the infringer to stop infringing, it needed to remedy future infringement. However, while the Court said that royalties for future damages would be based on the same calculations used for reasonable royalty for past damages, it has yet to order (in the newly-filed matter) the precise royalty rate for future infringement.

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<sup>24</sup> *Id.* at 444.

<sup>25</sup> *Id.* at 442.

<sup>26</sup> *Id.* at 444.

<sup>27</sup> *Id.*



## B. **Finisar Corp. v. Directv Group, Inc.**

On the other hand, the Court in another patent infringement case in the same district has ordered a precise royalty rate for future sales of the infringing product under a compulsory license.<sup>28</sup> In addition to ordering Defendants to pay \$104 million plus prejudgment interest for past damages, the Court ordered Defendants, “for the remaining life of the . . . patent[-at-issue], to pay Plaintiff an ongoing royalty of \$ 1.60 per [infringing product], activated by . . . the Defendants . . . after June 16, 2006.”<sup>29</sup>

The *Finisar* Court did not explain how it arrived at the \$1.60-per-unit ongoing royalty, but the past damages award was approximately \$1.32 per unit, according to Defendant.<sup>30</sup> The similarity between the compulsory license royalty rate and the past damages royalty rate<sup>31</sup> suggests that the *Finisar* Court either applied the past royalty rate to the compulsory license, or used a nearly-identical calculus to determine it.

## IV. **COMPULSORY LICENSE**

### A. **Propriety of compulsory license in the current patent landscape**

Several problems arise from awarding royalties for future infringement. First, an award of royalties for future infringement is, in fact, a compulsory license. Even if this license calls for royalties far greater than those that would be provided by using the *Georgia-Pacific* factors, the patent holder is essentially forced to license its patent, and is thereby denied its right to exclude others from enjoying the patent. Second, a compulsory license might require ongoing

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<sup>28</sup> *Finisar Corp. v. Directv Group, Inc.*, 2006 U.S. Dist. LEXIS 76380 (E.D. Tex. 2006).

<sup>29</sup> *Id.* at \*4-5.

<sup>30</sup> Brief for Defendant at 3-4, *Finisar Corp.*, 2006 U.S. Dist. LEXIS 76380 (No. 295).

<sup>31</sup> The difference between the two royalty rates may be even less than indicated here, because the \$1.32-per-unit past damages royalty rate was derived by defendants (the amount was granted as a lump sum by the jury without delineating a per-unit rate), who were interested in calculating the lowest possible per-unit rate in order to minimize the resulting compulsory license royalty rate. The plaintiff’s derivation of the per-unit royalty was not available at the time of this writing, and may have been substantially higher than the \$1.32 posited by defendants.

monitoring by the court to ensure that the judgment is enforced well into the future. Third, it might require constant adjustment by the court as sales of the infringing product, market forces, and changing landscape may necessitate altering royalty rates in the future. Fourth, the infringer might not be violating a court order (as it would if it were enjoined) if it alters its product to even slightly differ from the product addressed in the infringement case in order to avoid paying a royalty. Instead, in such instance, the patent holder might be forced to resue the infringer for infringement by the slightly-modified product.

These problems may have contributed to the reluctance of past courts to issue compulsory licenses in patent infringement cases.<sup>32</sup> Furthermore, *eBay* did not address the power of a court to impose a compulsory license, or whether such imposition would be advisable.<sup>33</sup>

Nevertheless, if a court denies an injunction pursuant to the four-factor test outlined in *eBay*, the only option available to address future infringement (if the court chooses to address future infringement at all) appears to be a compulsory license. If the court issues neither an injunction nor a compulsory license, the infringer would be free to continue infringement, and the patent holder would be forced to sue the infringer again for the continued infringement.

Mitchell G. Stockwell, in the Journal of the Patent and Trademark Office Society, lays out seven factors he feels a court should consider before imposing a compulsory license.

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<sup>32</sup> See, e.g., *Dawson Chemical Co. v. Rohm and Haas Co.*, 448 U.S. 176, 215 (“Compulsory licensing is a rarity in our patent system, and we decline to manufacture such a requirement . . .”); *id.* at n.21 (“Compulsory licensing of patents often has been proposed, but it has never been enacted on a broad scale.”); *But see Shatterproof Glass Corp. v. Libbey-Owens Ford Co.*, 758 F.2d 613, 628-29 (Fed. Cir. 1985) (affirming a compulsory license royalty rate equal to reasonable royalty rate granted by the jury).

<sup>33</sup> *eBay*, 126 S. Ct. at 1839; 88 J. Pat. & Trademark Off. Soc’y 747, 756.

- (1) Opportunity to work the invention – the patent holder should have the right, itself, to use or license the patent before the court compels it to license the patent to others;
- (2) Future transfer – the patent holder should have had the opportunity to sell the patent if a court considers a compulsory license, since a compulsory license may impair the patent holder's ability to sell the patent;
- (3) Standards and interoperability – where the patent is essential to a standard or interoperability of products, a compulsory license would reduce the burden on third parties and encourage use of, and improvement on, the patented technology;
- (4) Administrative burden – a court should consider whether industry or practice changes or modifications to the infringing product would lead to further litigation, even in the presence of a compulsory license;
- (5) Improvements by the infringer – a factor weighing in favor of a compulsory license is whether the infringer substantially improved on the patented product or technology, and thereby contributed to the art;
- (6) Patentee's conduct – a court should consider inequitable or inappropriate conduct by the patentee during trial as grounds for a compulsory license;

(7) Intervening rights – a court should consider whether the patent holder modified its claims during patent examination and issue to cover preexisting technology when deciding whether to grant a compulsory license.<sup>34</sup>

Stockwell’s analysis of factors the court will likely consider is thorough, and mirrors many of the considerations a court might make in evaluating the propriety of an injunction.<sup>35</sup>

## **B. What should a compulsory license royalty rate be?**

### **1. *Compulsory license royalty equal to reasonable royalty***

Since there is neither a statutory provision, nor substantial caselaw precedent for a compulsory license, compulsory license royalty rates are not settled. One option is to set a compulsory license royalty rate equal to the reasonable royalty rate determined at trial. This appears to have been the option used by *Finisar*, and seems, at first glance, consistent with current patent damages practice (absent the spectre of injunction), since it does not involve crafting new calculations for future infringement. Instead, it projects the current reasonable royalty calculation onto a hypothetical future infringement case with the same parties, patents, and infringing products.

However, this option may seem unfair to the patent holder. Reasonable royalty calculation involves determining the result of a *hypothetical* negotiation between the parties at the time of first infringement, since an *actual* negotiation never happened at the time of first infringement. However, an actual negotiation *is* possible in deciding a prospective royalty, which should begin around the time of final judgment in the case. Therefore, applying the result

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<sup>34</sup> 88 J. Pat. & Trademark Off. Soc’y, *supra*, note 28 at 756-59.

<sup>35</sup> *Id.* at 759.

of a hypothetical negotiation at some point in the past to parties available to presently negotiate seems inapposite to patent damages policy.

2. *Compulsory license royalty equal to reasonable royalty enhanced for willfulness*

Instead, another option, which this article advocates, is for the court to order a compulsory license equal to the reasonable royalty determined at trial for past infringement, enhanced for willfulness, which could result in treble damages going forward. This is essentially a present award equal to the amount the patent holder should ultimately receive if no injunction and no remedy for future harm were granted and the patent holder merely continued to sue the infringer in the future for what should be, as a matter of law, willful infringement.

Absent a compulsory license, if the patent holder is not granted an injunction, the infringer may continue to infringe without immediate recourse from the court. The parties can then either negotiate a license going forward, or the parties can fail to negotiate a license. In the first instance, where the parties negotiate a license, no further action would be required of either party or the court. However, in the second instance, where the parties fail to negotiate a license, the infringer can continue to infringe without violating a court order. The patent holder can then sue the infringer again for infringement. At that point, validity and infringement have already been determined, and the infringer is collaterally estopped from defending against them. Since the infringer knew the patents were valid and infringed, the continued infringement is also willful. Therefore, the patent holder will be entitled to enhanced damages—up to treble damages and attorneys fees.

Certainly, the patent holder's right to exclude includes its right to refuse to license to a prospective (or past) infringer, regardless of how objectively unreasonable that refusal is. Therefore, imposition of any compulsory license violates the patent holder's right to exclude.

However, a compulsory license rate equal to (or greater than) that which the patent holder would receive from the court if it sued a willful infringer of its valid patent, might as a matter of fact (though not as a matter of law) protect the patent holder's right to exclude in all but the most extreme situations.

While a reasonable royalty is not necessarily the upper limit of what an infringer would be willing to pay to license the patent, a royalty rate three times that amount may approach the upper limit of what an infringer would pay, especially since the reasonable royalty calculation itself factors in costs of substitute technologies and designs-around, as well as the demonstrated profitability of the product incorporating the patent. Enhanced damages as a result of willfulness are designed to be punitive, and are not likely to represent a royalty that a rational market participant would bear. Therefore, a compulsory license of a reasonable royalty rate determined at trial for past infringement, enhanced by a factor reflecting a finding of willfulness, should allow the patent holder to exclude most rational actors from practicing the patent in the absence of an injunction.

A compulsory license royalty measure equal to a reasonable royalty enhanced by willfulness serves at least five functions:

- 1) It protects the patent holder's right to exclude, in all but the most extreme circumstances, by setting the compulsory license rate substantially above what the court had previously deemed reasonable;
- 2) It compensates the patent holder (albeit imperfectly) for any remaining loss of the right to exclude by awarding up to treble damages;

- 3) It provides a cap to what the infringer must pay in order to use the patent, as opposed to an injunction, which allows the patent holder to demand an infinite fee to use the patent;
- 4) It minimizes future litigation because it obviates the need for the patent holder to sue for continued infringement;
- 5) It lowers transaction costs on the parties and reduces the burden on the public of tying up the courts in future litigations.

#### **IV. CONCLUSION**

A patent holder used to be able to count on an injunction to protect against future infringement upon a finding of validity and infringement. The patent holder would then often be able to use that injunction to negotiate future license fees from the infringer. The *eBay* decision changed that, as it and Justice Kennedy's concurrence make clear that automatic injunctions are not appropriate, either according to precedent or pursuant to public interest. However, no provision was made, either in *eBay*, or by Congress, to promote compulsory licensing. Therefore the most consistent and efficient solution to address future infringement is for courts to issue a compulsory license equal to what the patent holder would receive if it were to sue the infringer in the future for continued infringement, enhanced by a finding of willfulness.