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Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.

John R. Bone, CPA, CFF – jbone@srr.com
Jake M. Powers – jpowers@srr.com

Introduction

In *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.* the Court of Appeals for the Federal Circuit (Federal Circuit) upheld a damages award ruling that a 5% royalty awarded by the jury was not excessive. While not groundbreaking, the Federal Circuit's decision does bring some clarity on two issues that relate to determining a reasonable royalty: 1) whether a sales commission is relevant to the determination of reasonable royalty; and 2) whether a prior sale places a limit on the reasonable royalty. The decision also reaffirms the common belief that reasonable jurors can find alleged alternatives either not acceptable or not available.

Case Background

The patent-in-suit, U.S. Patent No. 5,852,277 ("the '277 Patent"), issued December 22, 1998, and was assigned to Spectralytics, Inc. ("Spectralytics").

The '277 Patent describes a laser cutting device used to manufacture stents. Prior to the '277 Patent, stents were typically cut using a Swiss-styled machine where the workpiece and the cutting tool were separately and rigidly mounted to dampen vibration, but vibrations nevertheless occurred during the cutting process and caused unwanted movement, which limited the precision of the cutting. The '277 Patent produced a superior product by eliminating the vibrations associated with the cutting style of the previous Swiss-style machines by rigidly mounting the workpiece directly on the cutting tool.[1] In doing so, the '277 Patent was able to "eliminate the deleterious effects of vibration by a design that ensured that if the laser tool and workpiece did move or vibrate, they moved in precise unison."[2]

Spectralytics and Norman Noble, Inc. ("Noble") are both producers of coronary stents. Spectralytics and Noble had both hoped that Cordis would select it as the producer of coronary stents for eventual resale to users. However, after representatives of Noble toured the Spectralytics plant in connection with a possible business arrangement between the companies, Noble built a machine that, as described in the '277 Patent, mounted the workpiece directly on the cutting tool. Cordis ultimately awarded an exclusive supply contract to Noble and agreed to indemnify Noble for any patent infringement.

[1] The Federal Circuit specifically stated that, "It was not disputed at trial that the Spectralytics '277 machine achieved improved precision and enabled more intricate pattern design as compared with prior steel stents." *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1340 (Fed. Cir. 2011)

[2] *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1340 (Fed. Cir. 2011)

Procedural History and Damages Opinions Expressed at the District Court

Spectralytics filed suit in July 2005 alleging Cordis infringed at least one claim of the '277 Patent. In August 2006, Spectralytics added Noble as a defendant.

Trial was held in the U.S. District Court for the District of Minnesota. Spectralytics' damages expert testified to a 20% royalty based on the *Georgia-Pacific* factors. The evidence presented to support the 20% royalty included: 1) Spectralytics had never licensed a competitor under relevant patents; 2) at the time of the hypothetical negotiation, Spectralytics and Noble were direct competitors in the market for metal stents; 3) it was not disputed that the product manufactured using the machine covered by the '277 Patent was superior to prior products; 4) over a six-year period Noble generated approximately $447 million in sales of stents made with the infringing machine to Cordis; and 5) Noble's profit margin was about 67%. There was also testimony that Cordis would have played a role in the hypothetical license negotiation in view of its agreement to indemnify Noble for patent infringement. The defendant's damages expert testified to a low lump sum payment, and apparently did not suggest any royalty rate.

At the conclusion of the trial, a jury sustained the validity of the patent, found defendants Cordis and Noble willfully infringed the patent, and awarded damages calculated as a 5% royalty on Noble's infringing sales to Cordis. Judgment was entered on February 3, 2009.[3]

After the Jury's verdict, the defendants filed a motion for a Judgment as a Matter of Law ("JMOL"), which was denied by the district court judge.[4] In its ruling on the JMOL, the district court devoted 24 out of 39 pages of its Order on Post Trial Motions specifically to the issue of damages.

Defendants appealed to the Federal Circuit. Among the issues addressed in its appeal, the defendants argued that the 5% royalty was excessive for reasons stated below.

On June 16, 2011, the Federal Circuit issued its opinion finding the evidence to be sufficient and therefore upheld the award based on a 5% royalty rate.

The Federal Circuit's Comments

The primary damages issue before the Federal Circuit as posited by the defendants was: "Did the district court err in denying JMOL on damages, where (a) the damages award was based on a 5% royalty that was not related to any *Georgia-Pacific* factor, (b) the patentee was willing to sell all of its assets (including the '277 patent) for a small fraction of the "reasonable royalty" that the jury awarded, and (c) the accused infringer could have implemented acceptable non-infringing alternatives for even less?[5] In the following sections we address how the Federal Circuit addressed the defendant's assertions.

A sales commission paid is not irrelevant in determining a reasonable royalty

Defendants argued that the 5% royalty awarded by the Jury was based on a 5% sales commission Norman Noble paid to its salesman, Jack Lundeen, for introducing Noble to Cordis.[6] To support their argument, the Defendants relied on *ResQNet*[7] and stated:

> In vacating the damage award, this Court held that the evidence supporting a reasonable royalty must be tied to "the claimed invention's footprint in the market place" and that "[a]ny evidence unrelated to the claimed invention does not support compensation for the infringement but punishes beyond the reach of the statute."[8]

Defendants then pointed out that the 5% sales commission paid "suffers from the same infirmities"[9] and has no "discernable link to the claimed technology"[10] and as a result should also be vacated.

The district court observed that "Cordis does not really know if the Jury based its award on Lundeen's commission and the fact that Lundeen's commission was five percent did not somehow put the number five off limits to the jury"[11]. The Court agreed with the district court's observation regarding the 5% commission and added that it "was not irrelevant to a hypothetical negotiation between Spectralytics and Norman Noble because it shed light on what Norman Noble was willing to pay to procure a business relationship with Cordis."[12]

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3 *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 650 F. Supp. 2d 900, 903-904 (D. Minn. 2009)

4 It should be noted that much of the motion practice at the District Court concerning damages was focused on the appropriateness of applying a running royalty to products (stents) that are manufactured using an infringing tool. Defendants did not raise this issue to the Federal Circuit.

5 Joint Principal and Response Brief for Defendants-Cross Appellants Cordis Corporation and Norman Noble Inc. at 4, *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, No. 05-1464 (Fed. Cir. 2011)

6 Jack Lundeen was a former Spectralytics' salesman that went to work for Norman Noble; *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1346 (Fed. Cir. 2011)

7 *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860 (Fed. Cir. 2010)

8 Joint Reply Brief for Defendants-Cross Appellants Cordis Corporation and Norman Noble Inc. at 28-29, *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, No. 05-1464 (Fed. Cir. 2011)

9 Id. at 29

10 Id.

11 *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1346 (Fed. Cir. 2011)

12 Id.

A prior sale of business assets that included the patent-in-suit does not necessarily place a cap on the value of the patent

In 2003, Spectralytics sold all of its assets for $4 million plus a contingent 25% of any recovery for patent infringement. In light of the $22.3 million royalty awarded by the Jury, Defendants argued that "[a] reasonable royalty that is more than five times greater than what Spectralytics received for all of its assets cannot be correct."[13]

Spectralytics argued that the $22.3 million royalty award was not unreasonable because: "(a) the jury applied a running royalty to a ten-year damages period; (b) [Spectralytics' primary shareholder] was given a contingent interest in the lawsuit; and (c) validity and infringement are presumed in the hypothetical negotiation, but not in real-world negotiations."[14]

Defendants pointed out that: (a) the duration of the damages period may hold some relevance if the '277 Patent were about to expire when it was sold but it does not expire until October 2016, meaning that the sale price represented 13 years of remaining life; (b) in the hypothetical negotiation, the two parties would have been Spectralytics and Noble and that Spectralytics' primary shareholder's compensation is irrelevant; and (c) that while the hypothetical negotiation and real-world negotiations may contain different assumptions, there is overlap between the two given the use of real-world license agreements to establish a royalty rate in a hypothetical negotiation.

The district court found that the jury could have reasonably concluded that the sales price had little to do with the outcome of the hypothetical negotiation.

The Federal Circuit agreed that the 2003 sales price does not render a 5% royalty unreasonable because the value assigned to the '277 patent in 2003 reflected a very deep discount because Spectralytics "hoped that the patent would survive any challenge to its validity, but Spectralytics did not really know for certain, and it could not really know for certain without paying millions of dollars in legal fees to launch lengthy and risky litigation…"[15]

Reasonable jurors can find alleged alternatives either not acceptable or not available

While the 15 *Georgia-Pacific* factors, which are commonly considered in the determination of a reasonable royalty, do not expressly consider the impact of acceptable non-infringing alternatives, the trial court provided the jury with a non-exhaustive list of 11 factors to consider, one of which expressly addressed whether "an acceptable, non-infringing alternative was available [to the accused infringer] when the alleged infringement began."[16]

Factors Given to Jury

1. What royalties did [the defendants] or others pay for licenses to patents comparable to the [patent-in-suit]?
2. Did [the patent holder] have a policy of licensing or not licensing the [patent-in-suit]? What were the terms of those licenses?
3. Was [the patent holder] in competition with [the defendants]?
4. Does the ability to use the patented invention help in selling other products or services?
5. How profitable was the patented device? Was it commercially successful or popular?
6. What advantages and benefits did the patented invention provide over devices not claimed in the [patent-in-suit]?
7. Was an acceptable, non-infringing alternative available to [the defendants] when the alleged infringement began?
8. How extensively did [the defendants] use the patented invention, and what was the value of that use to them?
9. Is there a customary portion or percentage of the profit or selling price that is customarily paid in the field as a royalty for the use of patented inventions comparable to the invention claimed in the [patent-in-suit]?
10. What portion of profit is attributable to the patented invention versus other factors such as unpatented elements or unpatented manufacturing processes, or features or improvements developed by [the defendants]?
11. What opinions do experts have as to what would be a reasonable royalty?

[13] Joint Reply Brief for Defendants-Cross Appellants Cordis Corporation and Norman Noble Inc. at 31, *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, No. 05-1464 (Fed. Cir. 2011)
[14] Id. at 32
[15] *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1347 (Fed. Cir. 2011)
[16] Id. at 1345

Defendants argued that "the royalty is much larger than the cost of switching to non-infringing alternatives"[18] The defendants presented two non-infringing alternatives: 1) a modified version of the '277 machine made in October 2008 by Noble; and 2) a modified version of a Comtal machine that was available in 1998. Spectralytics responded and pointed out that "Noble's October 2008 machine was not available until ten years after the infringement began"[19] and "that it took years to prove a system workable."[20] Also, Noble had rejected that machine because it was "'not user friendly' and did not function correctly."[21] It also pointed out that Cordis owned a modified Comtal machine but never used it.[22]

The district court upheld the jury's finding and stated that "the jury was not required to accept the defendants' position that these alternative machines were available and acceptable, in light of the contrary evidence."[23] This ruling is consistent with *Grain Processing Corp. v. American Maize-Products Company*[24] where it was stated that a fact finder "must proceed with caution in assessing proof of the availability of substitutes not actually sold during the period of infringement."[25]

The Federal Circuit upheld the district court's ruling by stating, "We agree with the district court that a reasonable jury could have found that the alleged alternatives were either not acceptable or not available, and that such a finding was supported by substantial evidence."[26]

Conclusion

In the end, the Federal Circuit agreed with the district court that the jury's choice of a 5% royalty was not "outrageously high" in view of the expert testimony that 20% was reasonable and appropriate in light of trade practices and the economic and competitive circumstances.

John R. Bone, CPA, CFF, is a Managing Director in the Dispute Advisory & Forensic Services Group at Stout Risius Ross (SRR). He has 20 years of experience serving as either an expert witness or consultant in an array of litigation matters, including commercial contract disputes, intellectual property disputes, and antitrust matters. Mr. Bone can be reached at +1.312.752.3378 or jbone@srr.com.

[18] *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1346 (Fed. Cir. 2011)
[19] Id.
[20] Response and Reply Brief of Plaintiff-Appellant Spectralytics, Inc. at 62, *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, No. 05-1464 (Fed. Cir. 2010)
[21] *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1346 (Fed. Cir. 2011)
[22] Id.
[23] Id.
[24] *Grain Processing Corp. v. American Maize-Products Company*, 185 F.3d 1341 (Fed. Cir. 1999)
[25] *Spectralytics, Inc. v. Cordis Corporation and Norman Noble, Inc.*, 649 F.3d 1336, 1346 (Fed. Cir. 2011)
[26] Id.