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A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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Direct and Indirect Patent Infringement: Damages Issues and Licensing

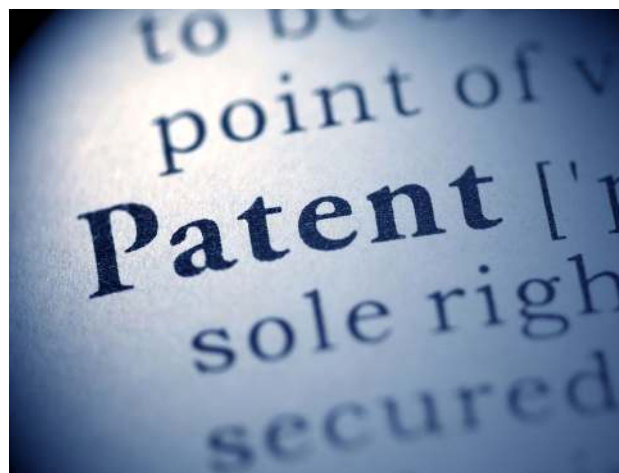
CONSIDERATIONS

There are two types of infringement, direct and indirect.[1] Parties can be liable for damages under either form of infringement. Not surprisingly, a patent holder's decision on whom to sue for infringement can have major implications on the size of the damage claim. This is often the case because the royalty base used to determine reasonable royalty damages can vary greatly between different actors.[2] Situations where multiple parties are potentially liable for damages raise several issues for the damage expert and the Non-Practicing Entity[3] ("NPE") to consider.

Direct patent infringement is defined as making, using, offering to sell, or selling any patented invention, within the U.S., or importing into the U.S. any patented invention during the term of the patent.[4] Indirect infringement has two forms, inducing infringement and contributory infringement.[5] Indirect infringement enables a lawsuit against a party who helped or caused a third party to infringe. Both a direct infringer and an indirect infringer (the party inducing infringement and/or the party contributing to infringement) are liable as infringers.[6]

In order for a party to be liable for indirect infringement, there must also be an instance of direct infringement by a third party.[7] In the case of induced infringement, there must be direct infringement and the alleged indirect infringer must knowingly induce infringement and possess specific intent to encourage another party's infringement.[8] Inducing may be instructing, directing, or advising the third party as to how to carry out direct infringement. Contributory infringement involves selling or importing into the U.S. "a component of a patented machine, manufacture, combination or composition, or a material or apparatus for use in practicing a patented process" that knowingly constitutes a material part of the invention and which does not have other substantial noninfringing uses.[9] For contributory infringement, there must be an instance of direct infringement and the alleged indirect infringer must knowingly sell or offer to sell to a third party a material component of the invention, that does not have commercial, non-infringing uses.

Statutory direct and indirect infringement each requires at least one party to directly infringe. This can pose a problem to holders of business-method patents and patents involving computer networking, use of web sites, and third-party servers, where the combined actions of multiple parties, if performed by one party would infringe, but where none of the parties alone directly infringe. To avoid direct infringement, separate parties could perform only one step of the patented method and escape liability for infringement. Joint or divided infringement, as established by the courts, seeks to close the legal loophole where neither the first nor third party directly infringe each and every step or element of a patented method, but the activity of both parties taken together infringes.[10]



The United States Court of Appeals for the Federal Circuit ("CAFC") clarified the level of coordination required between separate parties in order to find direct infringement by mul-

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CURRENT ISSUES: PRIVATE EQUITY AND HEDGE FUNDS

In recent years, more valuation analysts and forensic accountants have gained experience in engagements involving hedge funds and private equity (PE) funds. For those in that niche, it is useful to consider recent events and changes in the industry to assess overall outlook for future growth and business risk.

INDUSTRY SIZE

Together, the hedge and private equity industries had nearly $6 trillion in Assets under Management (AUM) last year. AUM for hedge funds totaled $2.6 trillion at the end of 2012, including $116.3 billion in investment gains last year.[1] The global private equity market is even larger, at $3.2 trillion.[2]

AUM in the hedge fund industry set a record in 2012, as did the absolute number of funds.[3] However, there appears to be an increasing level of concentration in hedge fund assets; in 2011, over half the industry's AUM was reflected in 322 funds managing over $1B.[4] Much of the inflow to hedge funds last year was to funds with over $5B in AUM.[5] There were 71 new U.S. hedge funds launched in 2012 totaling $24.9 billion in AUM, up from 50 new funds with $19.96 billion in AUM the year before.[6]

LEGISLATIVE/GOVERNMENTAL ISSUES

A number of developments have the potential to impact hedge and private equity funds going forward.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into law in July 2010. This required hedge funds with AUM of $100 million or greater to register with the Securities and Exchange Commission. One of the primary goals of Dodd-Frank is to increase transparency and oversight.[7]

Another aspect of Dodd-Frank is the so-called "Volcker Rule," named for Paul Volcker, former Chairman of the Federal Reserve. The Volcker Rule precludes banks from owning or sponsoring hedge or private equity funds above three percent of their Tier 1 Capital, or engaging in proprietary trading of its own assets, subject to certain exceptions.[8] It is expected that implementation of this rule will result in the sale or disposition of hedge/PE fund businesses; some transactions have already occurred. Earlier last year, Credit Suisse sold its PE segment, Strategic Partners, to Blackstone Group; also in 2013, JP Morgan spun off its PE division into an independent unit called One Equity Partners.[9]

Taxation of carried interest is an ongoing issue that has been debated in Congress for years. "Carry" (also known as "promote" in the real estate industry) provides a disproportionate share of the gain when an asset is sold to the general partner of a private equity fund, often 20 percent. Carry is typically taxed at capital gains rates rather than as ordinary income. Several proposals by the Obama Administration to tax carried interest as ordinary income have been made, but have not been successful to date.

An investigation by the New York Attorney General was noted in September 2012, relating to the use of management fee waivers and the potential for tax avoidance from them.[10] These relate to the practice by some private equity firms of opting to forego payment of management fees (thereby avoiding tax), and using those "waived" fees as future capital contributions. However, in an article on this issue, Reuters noted the use of management fee waivers "is already falling out of favor", noting that only 20 percent of surveyed private equity firms used this practice.[11]

CURRENT ISSUES - HEDGE FUNDS

One of the major issues facing hedge funds today is increasing competition. Traditional asset managers and private equity firms alike have developed hedge fund-like products.

One survey noted an expectation that separately managed accounts would continue to proliferate at many funds in order to attract or retain investors.[12]

Another issue facing the industry is that older hedge fund managers are looking for answers to succession issues, either opting to sell their interests internally, or to sell all/part of their funds to outside investors.[13] In addition, the need for greater economies of scale may drive more hedge funds to consolidate.[14] Combined with the potential for sales arising from Dodd-Frank restrictions, these issues could result in a greater number of industry transactions going forward.

CURRENT ISSUES - PRIVATE EQUITY

Many PE funds have faced challenges to sell older assets acquired during the peak of the last decade. However, investment returns have remained relatively favorable compared to other types of investments. Bain & Company noted that "in good times and bad, PE returns have consistently topped those generated by public equities."[15]

The number of transactions involving exits from PE investments increased in 2012, in North America in particular.[16] EBITDA multiples for large leveraged buyouts in the U.S. increased.[17] However, the increased time it has taken to sell off assets has reduced rates of return overall.[18] Pitchbook noted that the median holding period for PE investments sold in 2011 was 4.8 years, which marked the fourth annual increase and the longest median holding period in more than 10 years.[19]

Because exits from portfolio investments have been slower than in the past, this has affected the ability of many limited partners to invest in new funds since their capital was taken up in older funds. This was offset to some extent by an increase in investment by sovereign wealth funds.[20] Fears that the federal stimulus could be coming to an end caused stocks and bond prices to fall which has created uncertainty going forward.

Many funds noted the need to find new investments. Last year the industry overall had $900 billion in "dry powder" available for deals, including pre-recession commitments from LP's made in funds formed before 2008.[21]

As with hedge funds, there are indications of transactional activity at some PE funds. For example, some funds have sold a piece of their firms to investors.

FUND RAISING

Sources noted challenges with fund raising in both the hedge and PE segments. One survey noted that 49 percent of hedge fund respondents cited fund raising and marketing as their chief concern this

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year.[22] PE fund raising in 2012 was similar to that achieved in 2009-2011.

Private equity fund raising was showing signs of recovery of late; $48 billion was raised in the second quarter of 2013, the highest quarterly amount in four years.[23] Bain noted that prospects overall "may be slowly improving."[24]

According to Bain, it takes one and a half years on average to raise capital for a new private equity fund.[25] Factors include past performance and stable fund management, among other things.

VALUATION ISSUES

One source noted that the discounted cash flow (DCF) method "is most widely used and assigned the greatest weight" to the valuation of hedge fund firms.[26] The market approach (guideline companies and transactions) is sometimes also used, albeit with lesser frequency. The size of the public companies may make comparison to smaller funds more problematic.

Valuation analysts sometimes separately value two income streams – using a lower discount rate (or higher multiple) for less risky management fees and a higher discount rate (or lower multiple) for the share of fund profit referred to as incentive fees/carried interest/promote. However, these two sources of revenue are not two independent revenue streams, but are closely related. If a fund frequently loses money, and its only source of revenue is from management fees, then investors are likely to pull their money out of the fund. In that case, management fees are at risk of declining.

Regarding the potential for growth, Deloitte noted that larger hedge funds may be better able to grow this year but that those in niches and "scalable smaller managers" would likely have opportunity to grow as well.[27] In private equity, investment opportunities were likely in healthcare, oil/gas, real estate, infrastructure and distressed debt.[28]

SUMMARY

Hedge and PE funds now represent nearly $6 trillion in managed assets worldwide. These business segments have many regulatory issues and risks, but also potential for significant long-term growth.

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1 *http://www.risk.net/hedge-funds-review/news/2252478/hedge-fund-aum-hits-usd26-trillion-in-2012*, citing a report by eVestment. Estimates of industry-wide AUM by *www.barclayhedge.com* are somewhat smaller, at approximately $2.3 trillion at December 31, 2012, rising to approximately $2.42 trillion by June 30, 2013. Those estimates include Fund of Funds AUM. See *http://www.barclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html*

2 See *http://www.efinancialnews.com/story/2013-02-04/private-equity-manoeuvres-for-elbow-room?ea9c8a2de0ee111045601ab04d673622*; several sources noted the industry was at the $3 trillion mark in mid 2012.

3 "2013 Hedge Fund Outlook" by Deloitte Center for Financial Services.

4 Ezra Zask, Amanuel Alemu and Philip Deely, "Trends in Hedge Fund M&A and Valuation: 2000-2012," citing Mr. Zask's *All About Hedge Funds*, second edition, McGraw Hill, 2013, page 87.

5 *Hedge Fund Outlook: Water, Water Everywhere*, Rothstein Kass | Institute, April 2013, page 16.

6 *www.hedgefundintelligence.com*, "US/Americas: The end of something."

7 *http://www.sec.gov/spotlight/dodd-frank.shtml*

8 *http://www.skadden.com/newsletters/FSR_The_Volcker_Rule.pdf*

9 *http://www.trefis.com/stock/cs/articles/186344/with-volcker-rule-knocking-credit-suisse-sells-private-equity-business/2013-05-14*; *http://www.forbes.com/sites/scottgamm/2013/06/14/jpmorgan-to-spin-off-private-equity-business-as-volcker-rule-comes-to-life/*

10 "Analysis: New York AG's private equity probe may have little bite," Reuters, September 7, 2012. *http://www.reuters.com/article/2012/09/07/us-private-equity-tax-idUSBRE88606E20120907*

11 *Ibid.*

12 *Hedge Fund Outlook: Water, Water Everywhere*, Rothstein Kass | Institute, April 2013, page 24.

13 *Ibid.*

14 *Hedge Fund Outlook: Water, Water Everywhere*, Rothstein Kass | Institute, April 2013, page 15.

15 *Global Private Equity Report 2013*, Bain & Company, page 56.

16 PitchBook 3Q 2013 Benchmarking Report, page 15, www.pitchbook.com. References to North American transactions are taken from the *Global Private Equity Report 2013*, Bain & Company.

17 *Global Private Equity Report 2013*, Bain & Company, pages 9-10.

18 *Global Private Equity Report 2013*, Bain & Company, pages 2-3 and 30.

19 Private Equity Exits Report 2012 Annual Edition, PitchBook and Grant Thornton, page 6.

20 *Global Private Equity Report 2013*, Bain & Company, page 24.

21 *Global Private Equity Report 2013*, Bain & Company, page 3.

22 *Hedge Fund Outlook: Water, Water Everywhere*, Rothstein Kass | Institute, April 2013, page 16.

23 PitchBook 3Q 2013 Benchmarking Report, page 15, www.pitchbook.com.

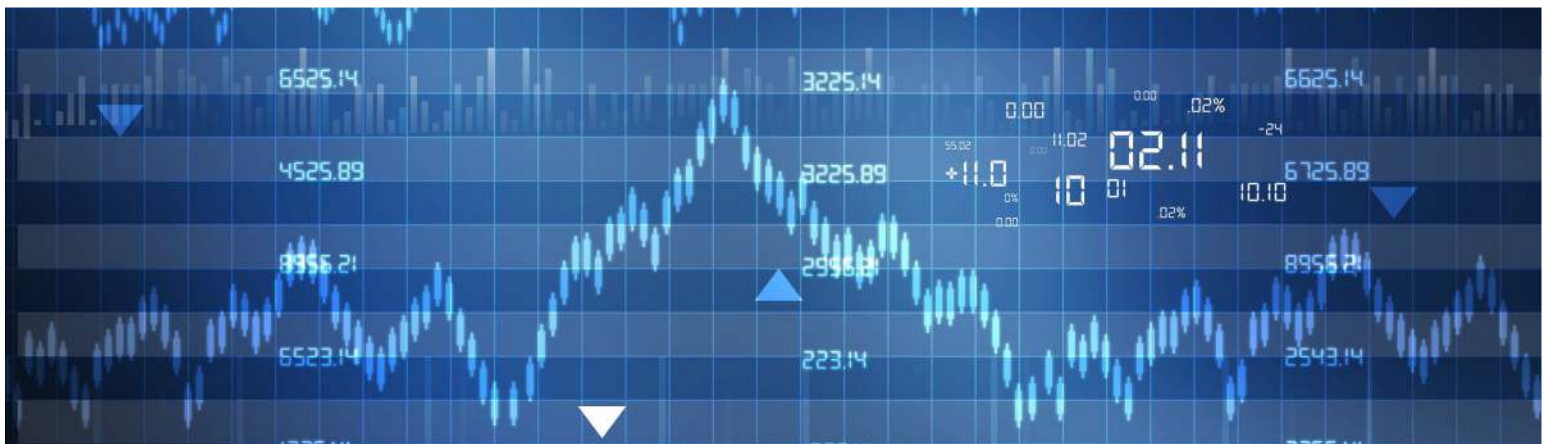
24 *Global Private Equity Report 2013*, Bain & Company, page iii.

25 *Global Private Equity Report 2013*, Bain & Company, page 21.

26 Ezra Zask, Amanuel Alemu and Philip Deely, "Trends in Hedge Fund M&A and Valuation: 2000-2012."

27 2013 Hedge Fund Outlook, Deloitte Center for Financial Services, page 3.

28 2013 Private Equity Fund Outlook, Deloitte Center for Financial Services.



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tiple parties performing different parts of a single claimed method. Under both *BMC Resources v. Paymentech, L.P.* and *Muniauction, Inc. v. Thomson Corporation*, the CAFC determined that in order to infringe, "the entire method must be performed at the control or direction of the alleged infringer."[11] A single "mastermind" is needed, where one party controls the actions of another party.[12] Commercial or contractual relationships between the parties being accused of divided infringement is not sufficient to prove joint infringement. There must be control by one party over the other party(ies).[13]

As discussed above, a patent holder can target multiple parties for patent infringement. Each party is potentially liable for damages. In addition, a patent holder can accuse one party of both direct and indirect types of infringement. I have been involved in several cases recently where wireless telephone company clients have been sued by NPEs and were accused of "directly and/or contributorily infringed, and/or induced infringement" of various patents. In addition to suing the wireless carriers, the plaintiffs also sued infrastructure vendors and wireless handset manufacturers. The plaintiffs had also entered into license agreements with other infrastructure vendors, wireless handset manufacturers and wireless carriers – all at substantially different royalty rates (stated or derived). These license agreements also provided downstream coverage for customers utilizing the patented methods. We were left with the situation where certain call volumes that were processed through a licensed vendor's infrastructure were noninfringing or that certain call volumes that were made with licensed handsets were noninfringing. This left a substantial patchwork of calls that were not licensed.

While wireless carriers do sell handsets, these sales often break even or lose money. Wireless carriers are in business to sell use of their network. This generates recurring subscriber revenue. Not surprisingly, these NPE plaintiffs did not seek a royalty based on handset sales. Instead, they sought a running royalty from the wireless carriers based upon service revenue (the monthly reviews received by carriers for subscriber calls and/or data service). Given that subscriber revenue for the major wireless carriers is hundreds of millions of dollars per month, even a small running royalty results in a huge reasonable royalty damage number. Interestingly, the NPE plaintiffs had already licensed some infrastructure vendors and wireless handset manufacturers at fairly modest rates, both in real terms and when viewed as percent of equipment revenues royalties.

The CAFC recognized in *Grain Processing* that "a rational would-be infringer is likely to offer an acceptable noninfringing alternative, if available, to compete with the patent owner rather than leave the market altogether."[14] Because of the disparity in license terms offered the clients and the equipment manufacturers, one noninfringing alternative available to the wireless carriers was to pay the licensing fees of the unlicensed infrastructure vendors and handset manufacturers. This, it turned out, was far less expensive than licensing under initial terms presented to the carriers by the NPEs. The remaining unlicensed equipment vendors were brought into the settlement process and the carriers' vendors were able to secure terms similar to those of the already licensed infrastructure and wireless handset manufacturers. These new vendor licenses covered the wireless carriers and the matters settled.

WHAT WAS LEARNED?

- Companies can be held liable for damages resulting from infringing patent method claims even when they do not perform all the steps in a claim.
- Being able to pursue direct (and divided) infringement and indirect infringement claims against the same alleged infringer provides the patent holder multiple opportunities to prove liability and obtain damages.
- Reasonable royalty damages can be substantially different depending upon whether the direct or indirect infringer is sued and their respective revenues, profits, and royalty bases.
- While licenses with other direct or indirect infringers may not be strictly comparable,[15] in that they are with parties that do not manufacture or employ the patented technology in the same way as the alleged infringer, these licenses are useful in determining a potential ceiling on what a willing licensee would pay.
- If you are an NPE establishing a licensing program, you should weigh the benefits of targeting easy settlements against the likelihood that these lower licensing rates could establish a royalty for very different classes of licensees.

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1 35 U.S.C. 271(a) through (c).
2 This article focuses on reasonable royalty damages on the assumption that the patent holder is not practicing the patent or producing products that compete with the defendant's infringing product(s).
3 An NPE is a non-pejorative term that can be defined as a patent owner who does not manufacture or use the patented invention, but rather than abandoning the right to exclude others from practicing a patented invention. An NPE seeks to enforce its right through the negotiation of licenses and litigation.
4 35 U.S.C. 271(a).
5 35 U.S.C. 271(b) and (c).
6 35 U.S.C. 271(b) and (c).
7 *DSU Med. Corp. v. JMS Co., Ltd.*, 471 F.3d 1293, 1303 (Fed. Cir. 2006).
8 *ACCOBrands, Inc. v. ABA Locks Mfrs. Co.*, 501 F.3d 1307, 1312 (Fed. Cir. 2007).
9 35 U.S.C. 271(c).
10 *BMC Resources, Inc. v. Paymentech, L.P.*, 498 F.3d 1373, 1379 (Fed. Cir. 2007).
11 *Muniauction, Inc. v. Thomson Corp.*, 532 F.3d 1318, 1323 (Fed. Cir. 2008) citing *BMC Resources, Inc. v. Paymentech, L.P.*, 498 F.3d 1373, 1380-81 (Fed. Cir. 2007).
12 *Muniauction, Inc. v. Thomson Corp.*, 532 F.3d 1318, 1329 (Fed. Cir. 2008).
13 Ibid.
14 *Grain Processing Corporation v. American Maize-Products Company*, 185 F.3d 1341, 1351 (Fed. Cir. 1999).
15 See *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120; 1970 U.S. Dist. LEXIS 11541; 166 U.S.P.Q. (BNA) 235.

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