

# VEDDER PRICE

# IP Strategies

Trends in patent, copyright, trademark and technology development and protection

May 2006

## VALUING INTELLECTUAL PROPERTY FOR SOFTWARE

Intellectual property, such as patents, trademarks, copyrights, trade secrets and proprietary know-how, together with less defined intangibles, such as labor skills, distributor relationships, facility locations and so forth, have become both the vast majority of companies' value and the fastest growing portion. A fair part of this increase has been the development and greater use of software to support production, research, financial reporting, human resource management and a broad range of operational and administrative functions to run the business.

Since the market value of companies is increasingly focused on intellectual assets, two key questions arise:

- How may the value of intellectual assets be measured?
- What strategies may be used to exploit their value?

Armed with this information, a company can better understand the source and extent of its underlying value and get **more for its investment money!**

### *Measuring Intellectual Assets: The Art of Valuation*

The three most basic techniques to value IP for software are similar to other products. They are the cost approach, the income approach and the market approach. The usefulness and applicability of each method depends upon the nature of the intellectual asset being valued and the purpose for the analysis. Also important is the context of

the valuation, *i.e.*, at a fair market, investment or other basis of valuation. While a fair market (willing buyer, willing seller) valuation is the typical basis for determining value in litigation and for tax purposes, an investment valuation (incorporating synergies of the acquirer) is often used to assess transactions. Additionally, the stage of development of the intellectual asset must be considered, so that the appropriate level of risk for commercializing the underlying product may be reflected. For instance, software code that is part of a product still in prototype is riskier and less valuable than code operating within an accepted product in the market.

### *The Cost Approach*

The cost approach can be used to estimate the value of the intellectual asset based upon the current cost to recreate or replace the intellectual asset with similar use and market position. The first issue in using the replacement cost approach is determining appropriate

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development costs. Among the costs to be considered are research and development, advertising, promotion and marketing. The second key issue is accurately estimating the development time and effort required for replacement. “Estimation models” typically rely upon the historical relationship of time to market for the development effort. The third key issue is that the cost of developing the intellectual asset does not reflect the viability or the future potential of that asset. Hence, where the likelihood of profits is low due to economic conditions, it may be difficult to value an asset regardless of historical or replacement cost.

These issues in the cost approach may be highlighted by considering the historical example of Microsoft Windows95®. Using Microsoft’s stated past efforts related to Windows95® development and testing (on August 25, 1995), a replacement cost estimate placed the value at roughly \$556 million.<sup>1</sup> This translated to only 4 percent of the entire market capitalization<sup>2</sup> of Microsoft at the time! Indeed, as reflected in the marketplace, Windows95® deserved a much larger allocation of Microsoft’s value.

Nevertheless, there is a major benefit to the cost approach. It applies well to all types of intellectual assets used internally in the business. For software in the early stages of development, it is relatively straightforward to estimate the cost of design, development, integration, and test efforts to reflect value. And, it doesn’t suffer possible “aggregation problems” from summing the values of multiple intellectual assets contained within a product, as discussed later under the income approach.

### ***The Income Approach***

The income approach is predicated on the value of future cash flows to be generated from an intellectual asset over its useful life. It is most readily applied to intellectual

assets marketed externally to third parties. The first step in using this approach involves projecting the future cash flows the asset is expected to generate. This requires an analysis of management forecasts, historical product and industry trends and general economic conditions.

The second step involves determining the present value of these cash flows through discounting. This discounting process uses a rate of return to reflect both the relevant risk associated with the asset and the time

value of money. Depending on the developmental stage of the intellectual asset, the discount rate will vary substantially. For example, in early development stages of software, the discount rate

may be in excess of 80 percent. As commercialization approaches, the rate may fall substantially, to 20 percent or less.

A major benefit of the income approach is that it captures the potential of ownership, including any licensing provisions to third parties. However, the income approach faces several limitations. For example, it is difficult to project reliable cash flows for newly developed software without any predecessor products due to the lack of historical experience. Additionally, since the value is based upon projected cash flows, it is necessary to distinguish cash flows arising from each specific IP within a product or business. This is the so-called “aggregation problem,” referred to above in the cost approach discussion. Many times, the value of the intellectual asset is intertwined with other intangible assets, such as assembled work forces, customer lists, and distribution networks. Some techniques that attempt to mitigate this challenge include the 25-percent rule,<sup>3</sup> excess earnings method,<sup>4</sup> income differential approach<sup>5</sup> and comparable profit split approach.<sup>6</sup> Additionally, a commonly used income approach technique is the relief from royalty method.

The relief from royalty method assumes an IP owner would be willing to pay for the rights to use the IP within similar products if it did not otherwise have the right to it.

***“Depending on the developmental stage of the intellectual asset, the discount rate will vary substantially.”***

The intellectual asset is valuable because the owner avoids the costs of licensing or creating substitute technology. Hence, the owner is essentially “relieved from royalty.” The value of the intellectual asset is an interaction among three components—the projected revenues attributable to the technology, the hypothetical royalty rate between a licensor and licensee and an appropriate discount rate to reflect the inherent risk of generating the projected cash flows.

To determine an appropriate royalty rate to apply to projected revenues from a specific intellectual asset, use may be made of both market comparable and analytically determined rates.<sup>7</sup> An appropriate rate must consider available information about product profitability, relevant industry sector (manufacturing, retail, etc.), prior comparable agreements and the specific licensing terms and arrangements in the current agreement to be negotiated.

While this royalty rate identifies the contribution from a specific intellectual asset, an “aggregation problem” may still occur in using either market comparable or analytical methods to determine the rate. Accordingly, the software may be bundled with other intangible property such as customer support, marketing programs and distribution rights, all very common rights assigned in many third-party licensing agreements. Additionally, other terms within agreements may affect royalty rates observed in the marketplace such as exclusivity, fields of use, geographic restrictions and economic structures beyond an ongoing royalty rate.

### ***The Market Approach***

Under the market approach, the value of IP reflects the price at which comparable assets are purchased under

similar circumstances. Use of the market approach requires that comparable transactions be available. These transactions may include the recent sales price of the same or similar technology or the market price of the license for the same or similar asset to an independent third party.

A major attraction of the market approach is its simple application when a truly comparable transaction is available. This situation is most commonly found when

the intellectual asset represents a successor product or competitive substitute product to be widely marketed to third parties. Under these

circumstances, the market comparable approach represents the most appropriate approach for determining the value of the technology. Of course, the primary limitation associated with the market approach is the assessment of comparability or adjustments to intellectual asset considering technical, functional and economic factors.

One of the most profound drawbacks of the market approach is its reliance on *price* as a determinant of value.

Are price and value synonymous? Price is generally defined as the rate at which something trades in a market, while value is a philosophical construct that may or may not bear a close relation to

price.<sup>8</sup> In short, price is what you pay; value is what you get, considering the total experience. Hence, while price is an element of value, it is not equal to value.

A good example of the differences between price and value is in the software industry’s family of products—shareware, freeware or public domain. Shareware includes computer programs where the author retains full rights to the program and allows a free preview before purchase. Freeware includes computer programs that are free, but the author retains the publishing rights to later

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sale to a commercial vendor. Public domain software represents freeware, where the author has relinquished the rights to the program. All of these types of software have one similarity: a price of zero. Obviously, price does not necessarily correspond directly with value. Shareware, freeware and public domain software all allow for the ad-hoc setting of standards through market share seeding, such as Microsoft's freeware policy for Internet Explorer®.

### *The Intellectual Asset Management Initiative*

Today, intellectual assets can be used to transform a company's future. For example, nearly one-third of all U.S. patents issued to IBM are for software inventions. The value of patenting software to IBM is not in excluding others, as IBM has an open licensing policy, but to jockey more effectively in the marketplace with potential competitors and partners.<sup>9</sup> Indeed, IBM's licensing revenues have gone past \$2 billion annually. Other software firms have increased their filing of patent applications dramatically as well, most notably Microsoft. They recognize the need to protect their intellectual assets and to leverage licensing opportunities.

Intellectual asset management (IAM) represents a cross-functional process for companies to identify proprietary technology and know-how, map these assets to either internal processes or externally delivered products or services, determine appropriate protective measures, develop both internal and external exploitation strategies, assess insurance coverage and financial securitizing and analyze enforcement actions. It requires a cultural change and multidisciplinary cooperation to implement effectively.

The valuation of intellectual assets represents a highly parametric exercise. Research and development expenditures, income forecasts and market transaction information are some of the many variables required to assess, analyze, and distill for determining value. To best exploit IP, companies must determine the highest and best use. That use may be for the products of the company or for other strategic purposes, which may include defensive protection, licensing, partnering, or financing. The

advantages, disadvantages, considerations and implications of the various valuation methods discussed herein must be weighed in light of these purposes as part of the "homework" done to evaluate the IP. However, the ultimate *realization of value* depends more on the IP owner's ability to commercialize products for market acceptance, negotiate financing or license agreements or successfully enforce its IP rights.

The penultimate benefit of a holistic IAM approach is the manifestation of intangible capital, enabling a business to manage its intellectual assets like hard assets. Accordingly, if you can "visualize" your technology, you can measure it. If you can measure your technology, you can manage it. And, if you can manage it, you can realize optimum value.

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<sup>1</sup> 11,567,800 hours, at \$100,000 per person-year, a standard software benchmark.

<sup>2</sup> 589,952,132 shares outstanding at \$24.03 per share, or roughly \$14.2 billion.

<sup>3</sup> The 25-percent rule is a rule-of-thumb often mentioned for beginning licensing negotiations. Whereupon, it has been observed that a licensor of a given invention is entitled to receive 25 to 33 percent of the profit achieved or expected to be achieved through invention exploitation. Meanwhile, 67 to 75 percent of the profits accrue to the licensee as compensation for increased risk in manufacturing, marketing, distribution and/or support.

<sup>4</sup> The Excess Earnings approach focuses on the income-producing capability of a given invention after a fair consideration, or economic rent, for contributory intangible and tangible capital. In essence, the royalty rate, which is applied to projected product sales (which embody the invention along with other potential tangible and intangible contributions) and discounted at an appropriate discount rate, would yield a value equal to the earnings generated by the invention's intangible property, net of required returns on working capital, fixed assets employed and contributory intangible assets.

<sup>5</sup> The income-differential approach identifies the incremental income expected to result from the use of the invention. The primary assumption underlying this approach is that the invention provides additional income relative to comparable substitute products. Under the income-differential approach, the derived value is a function of incremental margins net of any additional expenses required to use the invention.

<sup>6</sup> Under the Comparable Profit Split Approach, one estimates an invention's allocation of operating income based on balance sheet statistics of comparable public guideline companies.

<sup>7</sup> Similar to that described in prior footnotes.

<sup>8</sup> Earl Grinols, Professor of Economics, University of Illinois.

<sup>9</sup> Marshall Phelps, formerly VP Licensing, IBM Corporation; currently associated with Microsoft.

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## LEMELSON FINALE

The Lemelson Foundation did not file a Petition for a Writ of Certiorari with the U.S. Supreme Court from the decision of the U.S. Court of Appeals for the Federal Circuit (“Federal Circuit”). The Federal Circuit had affirmed the Nevada District Court’s decision in the Symbol/Lemelson case that the Lemelson patents were invalid based upon prosecution laches, that is an excessive lapse in the time between the original application and the eventual issuance of the patents. The failure to file the Petition for a Writ of Certiorari effectively ends the Symbol/Lemelson litigation.

In addition, The Lemelson Foundation moved to dismiss the corresponding litigation that had been pending in the United States District Court in Arizona that involved several hundred companies. Therefore, the Lemelson litigation relating to the Lemelson bar code patents has now come to an end.

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## VEDDER PRICE ADDS NEW ATTORNEYS TO INTELLECTUAL PROPERTY GROUP

**Christopher P. Moreno** is Counsel to the Firm and a member of the Intellectual Property Law group at Vedder, Price, Kaufman & Kammholz, P.C. Mr. Moreno has significant experience counseling a broad array of technology companies covering a wide variety of technically complex subject matter areas, including medical devices, wireless communication systems, communication networks, signal processing, semiconductor devices, computer software and business methods. Mr. Moreno has developed an understanding of the needs of clients through his previous in-house

experience, most recently as general counsel at Optobionics Corporation, a venture-backed startup developing a retinal prosthesis designed to restore vision for those afflicted with retinal degeneration, and prior to that, in the Intellectual Property department at Motorola, Inc. His direct line is 312/609-7842.

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## CASE LAW REVIEW

### U.S. SUPREME COURT

#### SUPREME COURT OVERTURNS FEDERAL CIRCUIT RULE INSTRUCTING COURTS TO ISSUE PERMANENT INJUNCTIONS AGAINST PATENT INFRINGERS

*eBay, Inc. v. Mercexchange, L.L.C.*  
(U.S. Supreme Court – May 15, 2006)

In Federal tort cases, a prevailing plaintiff may seek a permanent injunction forcing the defendant to cease a particular activity. In intellectual property actions, permanent injunctions generally include, among other things, prohibitions against continued infringement. Although the Patent Act gives Federal district courts the discretionary power to award injunctions in accordance with principles of equity and on reasonable terms, Federal Circuit case law generally took an opposite approach that automatically awarded a permanent injunction upon adjudication of infringement. In the present case, the United States Supreme Court refused to acknowledge the Federal Circuit’s departure from established equity practice in view of the clear language of the Patent Act

and given the application of traditional principles of equity in other courts.

In the lower courts, Mercexchange brought a cause of action against online giant eBay and Half.com for infringing a business-method patent directed toward an electronic market designed to facilitate the sale of goods between private individuals in a trusted environment. After finding infringement, the District Court refused to enter a permanent injunction because the patent was directed to a business-method, a category of patents often scrutinized by the public and used as a catalyst to execute changes in Patent Office review policies and to introduce legislation in Congress aimed at lowering the presumption of validity for business-method patents. The District Court also cited a concern that a permanent injunction would invite a continuous stream of unwanted contempt hearings directed at determining whether each of Defendants' post-trial business-method developments infringed the patent. Lastly, the Court explained that the patentee would not suffer irreparable harm because the patentee was willing to license its patents while not otherwise practicing the invention and because the patentee failed to ask for a preliminary injunction.

According to Federal Circuit opinion, however, the "right to exclude recognized in a patent is but the essence of the concept of property" and thus a permanent injunction should issue as a matter of course in all but rare instances to protect the public interests or important societal needs. (*See Mercexchange, L.L.C. v. eBay, Inc.* (Federal Circuit – March 2005)). Because the District Court's reasons failed to rise to the level of an exceptional circumstance, the Federal Circuit reversed the denial for a permanent injunction.

The United States Supreme Court unanimously disparaged the analysis of both the District Court and the Federal Circuit, noting that district courts have discretionary power to grant permanent injunctive relief in patent cases when soundly based on traditional principles of equity. When asking a court for a permanent injunction, these principles require the patentee to prove that: (1) it has suffered an irreparable injury; (2) it will not be adequately compensated by legal remedies (*e.g.*,

money damages); (3) the benefit it would receive given the injunctive relief is not outweighed by the hardship the injunction would impose upon the infringer; and (4) the public interest is not disserved by the injunction. According to the Supreme Court, the District Court erred where it categorically denied that a patentee/licensor could recognize an irreparable injury. Similarly, the Federal Circuit erred where it misapplied the mandates set by Congress in the Patent Act and instead generally required the mechanical issuance of permanent injunctions without sufficient regard to the four-factor test articulated above. The Supreme Court specifically refuted the Federal Circuit by drawing analogies to established copyright law where permanent injunctions do not automatically follow findings of infringement.

In a concurring opinion, newly appointed Chief Justice Roberts explained that courts have regularly granted injunctive relief following the majority of patent cases over the past two centuries. While this historical analysis "does not entitle a patentee to a permanent injunction or justify a general rule that such injunctions should issue," the Chief Justice hinted that a permanent injunction may be adequate in many patent cases if necessary to protect a patentee's right to exclude others from making, using, offering to sell, selling or importing the patented invention.

In another concurring opinion, Justice Kennedy addressed Chief Justice Roberts' comments, noting that the historical practice of granting permanent injunctions merely reflects the application of the four-factor test in a different economic environment where patentees generally commercialized (*i.e.*, made, used, sold and imported) their inventions. The modern landscape, however, is characterized by corporations and patentees that also rely on licensing revenue and thus use a variety of tools to drive royalty rates and other licensing costs. For this reason, the hard and fast rule followed by the Federal Circuit stunted the district courts' ability to adapt to "rapid technological and legal developments in the patent system," unlike the four-part discretionary test that otherwise stood the test of time across a variety of legal disciplines. Accordingly, Justice Kennedy acknowledged that money damages may appropriately compensate the

patentee and serve the public interest in cases where the threat of an injunction is used to exert undue influence on those that wish to commercially develop the invention and further in cases involving business-method patents, described as particularly valuable in modern times notwithstanding their “potential vagueness and suspect validity.”

**Practice Tip:** With this keystone case, the Supreme Court returned a degree of uniformity to injunction practice by signaling an end to the automatic application of permanent injunctions following adjudications of patent infringement. More importantly, nearly half of the members of the Court concurred with Justice Kennedy and expressed their belief that legal damages may be appropriate in modern patent cases given today’s economic realities. For these reasons, patent owners are advised to be mindful of the manner in which they exploit patented inventions when asking for injunctive relief, as lower courts will surely be persuaded by Justice Kennedy’s observations.

**SUPREME COURT BURIES ANTITRUST RELIC OF  
20TH CENTURY:  
COURTS MAY NO LONGER PRESUME MARKET POWER  
IN A PATENTED TYING PRODUCT TO SUPPORT  
PER SE ANTITRUST CLAIMS**

***Illinois Tool Works, Inc. v. Independent Ink, Inc.*  
(U.S. Supreme Court – March 1, 2006)**

Intellectual property owners are charged with compliance with a variety of laws and regulations. Most IP owners are familiar with provisions of the Patent Act, the Lanham Trademark Act, the 1976 Copyright Act and various state trade secret laws. Generally these traditional sources of IP law indicate what is required for IP protection and what acts constitute infringement of these rights. Because IP owners are often thought to possess monopoly power in their respective markets, such owners are also

counseled to be mindful of the Sherman Act, the Clayton Act and the Federal Trade Commission Act. Collectively, these antitrust regulations prohibit illegal restraints of trade and unfair competition in the market.

Specifically, patent owners must be cognizant of their contracts and marketing schemes to avoid prohibited patent misuse or other antitrust behavior prohibited in the Patent Act and various antitrust regulations. For example, a patentee engages in illegal conduct where entering into an improper tying arrangement that conditions the sale of a patented product (the “tying product”) on the sale of an unpatented product (the “tied product”). Tying arrangements are prohibited where the seller exploits “control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.” *Jefferson Parish Hosp. Dist. No. 2 v. Hyde* (U.S. Supreme Court 1984). In other words, the seller engages in an illegal tying agreement when it has sufficient power in the market for the tying product such that competition is restrained in the market for the tied product.

Regardless of the power patent owners actually wield, Federal courts throughout most of the 20th Century regularly attributed to patentees the power to control markets relating to their patented inventions. Accordingly, American jurisprudence generally found patentees, when engaged in tying agreements, liable for violations of antitrust law under the theory that the patent provided its owner the ability to “undermine competition on the merits in the second market.” *Jefferson Parish*. Congress, however, implicitly rejected the judiciary’s practice of presumptively assigning monopoly power to patent owners in its 1998 amendments to the Patent Act where it stated that patentees are not guilty of misuse in tying arrangements “*unless, in view of the circumstances, the patent owner has market power in the relevant market for the patent or the patent product . . . on which the sale is conditioned.*”

In view of this background and further noting that the “vast majority of academic literature recognizes that a patent does not necessarily confer market power,” the

Supreme Court explained that many tying arrangements involving patents do not violate defining principles of a free market. Accordingly, the Court held that an antitrust plaintiff may no longer establish a *per se* violation of antitrust regulations by pointing to a patented tying product in a tying arrangement. “In all cases involving a tying arrangement, the plaintiff must prove that the defendant has market power in the tying product.”

**Practice Tip:** In this 2006 opinion, the Supreme Court took great strides to better align its jurisprudence to the economic realities of patent ownership and tying arrangements. Patent owners are no longer put at a severe disadvantage and are provided the opportunity to engage in tying arrangements provided that their patent rights do not afford them substantial power in the tying market such that they effectively control the tied market. Because patentees are still vulnerable to antitrust violations under both the Patent Act and a variety of other federal regulations, we recommend that patent owners consult IP and antitrust counsel prior to engaging in any tying arrangements or bundling arrangements involving the sale of a patented product or the licensing of a patent.

## FEDERAL CIRCUIT

### CLAIM PREAMBLES MAY LIMIT CLAIM SCOPE AND THE APPLICABILITY OF THE DOCTRINE OF EQUIVALENTS IF IT SERVES TO DISCLAIM SUBJECT MATTER

***Bicon, Inc. v. The Straumann Co.***  
(Federal Circuit – March 20, 2006)

Generally, a court will not limit the scope of a claim to the subject matter disclosed in the preamble where the body of the claim recites the complete invention. Thus, a preamble that merely provides a purpose or statement of

intended use will rarely impact claim scope. However, in a recent Federal Circuit opinion, the Court reaffirmed that when both the preamble and the body of the claim define subject matter of the claimed invention the preamble must so limit claim scope. In this case, a lengthy preamble provided antecedent basis for elements provided in the claim body and was thus necessary to properly define the structure of the claimed device.

After setting aside Bicon’s arguments for literal infringement, the Court relied on a similar argument to reaffirm the District Court’s finding of noninfringement based on the doctrine of equivalents. The majority of Federal Circuit case law surrounding the doctrine of equivalents focuses on whether the accused device performs substantially the same function in substantially the same way to achieve the same result as the claimed subject matter. Alternatively, it is proper to ask whether the accused device deviates from the claimed subject matter only via insubstantial differences. In the present case, however, the Court failed to address either inquiry and instead focused on the “detailed recitation of structure” in the preamble that “correspondingly limited recourse to the doctrine of equivalents.” In other words, the Court explained that the claim implicitly disclaimed subject matter and could not recapture it under the doctrine of equivalents. Because the accused device was characterized by features inconsistent with the preamble, the Federal Circuit held that the lower court’s finding of noninfringement was proper.

**Practice Tip:** Once a preamble breathes life into the claim, its contents may be used as a disclaimer. Thus, unless a particular preamble term is absolutely necessary for the claim, we advise not using it to describe a purpose or statement of intended use. Based on the present opinion, at least three members of the Federal Circuit are willing to limit scope under literal infringement and further prohibit applications of the doctrine of equivalents in view of a specific and detailed reference to claim structure in a preamble.

**AN ACCUSED INFRINGER'S GOOD FAITH BELIEFS FOUND  
IRRELEVANT WITH RESPECT TO FINDINGS OF INDIRECT  
INFRINGEMENT AND WILLFULNESS**

***Golden Blount, Inc. v. Robert H. Peterson Co.*  
(Federal Circuit – February 15, 2006)**

The Patent Act affords patentees the ability to assert causes of action for direct and indirect infringement. Indirect infringement may be established by proving that the defendant contributorily caused third parties to directly infringe the patent or that the defendant's actions actively induced direct infringement by third parties. In the present case, the accused supplied primary and secondary burners for a gas fireplace assembly with manuals instructing customers to connect the individual burners so as to infringe the patent. Relying on this fact, the Federal Circuit affirmed the patentee's right to circumstantially establish that customers directly infringed her patent without any evidence to the contrary. The Court further noted that the only intent required to establish indirect infringement under an inducement theory was the intent to cause acts that constitute direct infringement. Because Peterson intended its customers to follow the instructions provided in the manuals, the necessary element of intent was established. The Court held that it was irrelevant whether the defendant held a good faith belief that the manuals did not teach an infringing assembly.

In affirming the District Court's finding of willful infringement, the Federal Circuit observed that the defendant had disdainfully dismissed the patent rights of the patentee when she relied on incompetent oral opinions of counsel in accord with defendant's admission that the "suit was not a very meaningful case 'dollarwise.'" In response to a first letter from the patentee, Peterson sought the advice of counsel regarding the viability of the cause of action. Without performing any actual analysis, Peterson's attorney noted that the claims would not be infringed or would be invalid if Peterson could establish that it was merely practicing the prior art by making, using and selling its accused products. Apparently satisfied with this response, Peterson ignored

two subsequent letters from the patentee and failed to take any subsequent action until after suit was filed. Thereafter, Peterson's counsel provided two additional oral opinions regarding the accused device and the asserted patent rights. Seemingly inconsistent with the defendant's assertion that the case was not important from a financial perspective, Peterson attempted to erect an illusory shield using hasty advice of counsel to protect itself from a subsequent finding of willful infringement. However, the opinions were deemed incompetent for either failing to consider the prosecution history or a physical sample of the accused device. Thus, whatever protection Peterson sought to create was insignificant in view of its otherwise reckless and deliberate disrespect directed at plaintiff.

The Court further rejected Peterson's argument that the holding in *Knorr-Bremse System Fuer Nutzfahrzeuge GMBH v. Dana Corp.* (See January 2005 IP Newsletter) prevented a court from drawing adverse inferences based on an incompetent opinion by counsel. The Federal Circuit explained that *Knorr-Bremse* had no relevance to the instant facts as defendant failed to assert the attorney-client privilege with respect to the oral opinions. Had defendant made such an assertion, the Court noted that it would be improper to draw any adverse inferences regarding the content of the opinions. However, in the instant case Peterson provided testimony illustrating the incompetent nature of the opinions and thus the District Court properly considered this evidence when evaluating willfulness.

***Practice Tip:*** Purveyors of goods are reminded that the Patent Laws allow patentees to recover for indirect infringement. Accordingly, proper attention to the content of literature marketed, produced or attached to such goods should be scrutinized with an eye toward how other consumers and entities will likely make use of such information.

Building upon recent developments in the field of willful infringement, it is worth restating that the Patent Laws continue to place upon each of us an affirmative duty to avoid infringement. Although defendants need not obtain or produce an exculpatory opinion from counsel to discharge this duty, courts are free to make findings based on evidence introduced at trial. Thus, as in the present case, the competency of a lawyer's opinion may be successfully attacked and held against a relying party if the letter or oral testimony regarding the opinion is part of the record. Accused infringers and counsel are reminded that competency reigns king and that only an opinion that properly considers the law, the patent, the accused device and the prosecution history may be deemed adequate and assist in protecting an infringer from treble damages.

**CLAIM CONSTRUCTION: WRITTEN DESCRIPTION MAY NOT LIMIT CLAIM SCOPE**

***NCube Corp. v. Seachange Int'l, Inc.*  
(Federal Circuit – January 9, 2006)**

Reviewing, among other things, the claim term “upstream manager” in a patent directed to a high bandwidth, scalable server in a networked system, a recent Federal Circuit opinion refused to import a limitation into the claims noting that to do so would render another claim redundant. In a well-crafted dissent, Justice Dyk criticized the majority for failing to follow the recent *en banc* Federal Circuit opinion in *Phillips v. AWH Corp.* (See September 2005 IP Newsletter) and for improperly expanding “a poorly drafted patent to cover an invention that was not actually claimed or described in the specification.”

Citing *Phillips*, Justice Dyk explained that a patent's specification is the single best guide to the meaning of a disputed term and that the construction true to the claim language and that most naturally fits with the written description will be the proper interpretation. According to the dissent, the term “upstream manager” should have

been limited to a device that routes requests from a client device to a media server service using logical (*e.g.*, virtual) addresses because any construction allowing the device to route based on physical (*e.g.*, machine) addresses would: (1) contradict the purpose of the invention articulated by the patentee; (2) cut against the patentee's statements that “the present invention” included a device that routes based on logical addresses; and (3) have no support in examples provided by the patentee. In other words, because the patentee carefully described the invention in the specification as logical-address dependent, the patentee could not subsequently ignore this clear disclaimer during litigation.

The thrust of the majority's opinion focused on dependent claim language requiring a virtual connection between upstream (*i.e.*, from the client to the server) and downstream addresses (*i.e.*, from the server to the client) for a client. Based upon this claim feature, the majority held that the independent claim at issue must not be limited to having an upstream manager using only virtual addresses for, if such a construction were possible, two claims would have the same scope. Refuting this interpretation, Justice Dyk observed that virtual addressing is not required to create a virtual connection between upstream and downstream addresses. Even if virtual addressing were a prerequisite to the virtual connection feature, the dissent argued that it would not be redundant to read the logical address limitation into the independent claim as a result of other dependent elements not present in the independent claim.

***Practice Tip:*** Patentees and their competitors are reminded that although recent case law improved claim construction methodology, it remains difficult to predict the outcome in any given case. As presently demonstrated, the written description will not always trump other doctrines of claim construction where claim terms may be subject to broader scope based on the scope of other claims. Claim construction

remains and will likely continue to remain a volatile area of patent law subject to a variety of interpretations. Counsel is reminded to draft patents with an eye toward this foreseeable problem.

## OBVIOUSNESS TEST RECAPPED BY FEDERAL CIRCUIT

### *In re Leonard R. Kahn* (Federal Circuit – March 22, 2006)

According to the Patent Act, a patent may not issue if the differences between the subject matter disclosed and that claimed in an application would have been obvious at the time of the invention to a person having ordinary skill in the relevant art. Although much has been written regarding this basic Patent Law inquiry, the Federal Circuit, in a recent appeal from the Patent Office's Board of Patent Appeals and Interferences, felt it necessary to carefully restate the considerations necessary to support the legal conclusion of obviousness. Because of the fundamental nature of this test, the Court's opinion provides useful insight into a process that regularly consumes valuable time of Patent Office Examiners, practitioners and inventors. Among other things, the opinion explores the close relationship between the analogous art test and the motivation-suggestion-teaching test applied by Patent Office Examiners to reject obvious subject matter.

The Court's opinion tracks the obviousness inquiry and thus begins with a recitation of necessary considerations that inform the process. They include identifying relevant prior art, examining the differences between the prior art and the claims at issue and ascertaining the level of skill attributable to an ordinary person in that art. Against this framework, the obviousness inquiry, according to the Court, must be focused on avoiding hindsight analysis. That is, an Examiner may not use an application as a blueprint or manual to assemble prior art, thereby rendering the combination obvious. A rebuttable case of obviousness is

established only through sufficient explanatory proof detailing why one of ordinary skill in the art would have been motivated to select and combine one or more references in the claimed manner.

Preliminarily, not all prior art is relevant. Only art that is analogous may be used in an obviousness rejection. Thus, an early consideration in an Examiner's inquiry necessarily involves application of the analogous art test, which requires the Patent Office "to show that a reference is either in the field of the applicant's endeavor or is reasonably pertinent to the problem with which the inventor was concerned." According to the Court, this elementary inquiry should be informed by common sense of one having ordinary skill in the art.

Once the relevant prior art is defined and each and every claim element identified, the heart of the inquiry shifts to the application of the motivation-suggestion-teaching test that requires the provision of "some rationale, articulation, or reasoned basis to explain why the conclusion of obviousness is correct." Importantly, the analysis may involve an express or implicit showing that the combination is obvious based on the combined prior art teachings, the knowledge of the hypothetical skilled artisan and the general – not necessarily specific – nature of the problem that confronted the inventor. If one having ordinary skill in the art would have been directed or motivated to assemble the prior art components as claimed, then a rebuttable case of obviousness has been established.

Of significance to the above inquiry is the application the Court used to uphold the Patent Office's finding of obviousness. The Court upheld the rebuttable finding of obviousness, noting that it was proper to look at the problem confronting the inventor and the nature of the prior art references. In other words, because the invention dealt with providing a reading machine for visually impaired individuals capable of speaking given words based on selection of text "looked at" on an acoustic display by an operator, the Patent Office properly considered a reference directed at the "augmentation of vision of those who have lost their vision or have had their visual faculties diminished, ... that is useful in

teaching a deprivee to apprehend the position of a virtual sound source as representing a point in space, ... and that ... may be used as a rudimentary reading device.”

**Practice Tip:** As demonstrated, the motivation-suggestion-teaching test picks up where the analogous art test leaves off and further serves to prevent the Office from piecing together unrelated or disjointed prior art based on an applicant’s disclosure. Applicants are reminded that a strong obviousness conclusion may be made based on the

nature of the prior art reference. Thus, the analogous art test appears to play a lead role by defining what art may be considered and sometimes supplying sufficient motivation to combine teachings. In other words, the problem facing the inventor prior to her conception may have an obvious solution if components of that solution are identified in prior art relating to that problem.

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