A Lesson in Prejudgment Interest Awards

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Prejudgment interest should be calculated as carefully as the underlying damages

A finding in *Alpex Computer Corp. v. Nintendo Co. Ltd.*, 34 USPQ2d 1167, concerned the determination of an award for prejudgment interest, and the methodology of doing so. The court found that the "award should be based upon defendant's borrowing rate, which is (sic) commercial paper rate, and should be calculated upon an after-tax basis." (*Id.* at 1169) While the damage award before interest of $208.3 million dwarfed the eventual prejudgment interest amount of $37.2, the latter amount is by no means trivial.

According to 35 U.S.C. section 284, as interpreted by the Supreme Court:

> An award of interest from the time that the royalty payments would have been received merely serves to make the patent owner whole, since his damages consist not only of the value of the royalty payments but also of the foregone use of the money between the time of infringement and the date of the judgment. (*Id.* at 1208)

Judge Wood of the Southern District of New York considered three questions concerning prejudgment interest:

1. The interest rate to be used.
2. The appropriate calculation of interest on either a pre-tax or post-tax basis.
3. The timing of the royalty payments on the basis of which the interest should be calculated.

He concluded the following:

1. A commercial paper rate was to be used.
2. On an after-tax basis.
3. With interest calculated on year-end royalty payments.

TYPE OF RATE

The patentee, Alpex, claimed that the appropriate interest rate was the prime rate plus 1%. The defendant, Nintendo, claimed it should be either a Treasury Bill rate (of unspecified maturity), or their borrowing cost, at a commercial paper rate (again of unspecified maturity).

Alpex's claim for prime plus 1% represented one of three alternative measures presented to the court. Alpex' expert presented evidence on three alternative uses of the eight years of lost royalty payments:

1. Alpex would have "emerged from bankruptcy and engaged in riskier investments similar to its historic investments"; or
2. Invested the royalty payments in intermediate government bonds, or
3. That a pre-tax rate of prime plus 1% "is an accurate proxy for the after-tax return. Alpex would have made in either case." (*Id.* at 1209)

Finding them to be speculative, the court was not persuaded by the evidence of first two options, and preferred the prime plus 1% rate from the options presented by Alpex, although she did not select it in the final analysis.

Judge Wood ultimately chose Nintendo's borrowing rate, the commercial paper rate, citing Northern District of Illinois Court of Appeals Judge Easterbrook as "recently (holding) that prejudgment interest should be analyzed as if the patentee had lent funds to the infringer during the pendency of the litigation." (*Id.* at 1208) Judge Wood later remarks that "Judge Easterbrook advises calculating interest at the market rate the infringer generally pays for money ..." (*Id.* at 1209) The court leaves open the possibility that the opportunity cost to the patentee may be appropriate, if the patentee presents "evidence relating to the use to which the patentee would have put the royalty payments."

Several points need to be considered in evaluating the opinion reached in this case:

1. The period of infringement covered eight years and a longer term rate may be appropriate under such circumstances, yet the issue is not discussed. (One typically expects that commercial paper rates have less than one year's maturity.)
2. The use of the infringer's borrowing rate is often not appropriate — the patentee may have alternative uses for investment of free cash, and not be willing to lend to the infringer. The fact of infringement effectively may force the patentee to lend to the infringer, but in the "but for" world one seeks in damages, one needs to consider whether that would be the arrangement that would have been in effect. (In choosing the infringer's cost of funds, Judge Wood refers to Judge Easterbrook's opinion *In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litigation,* 831 F. Supp. 1354, which recommended using the infringer's cost of funds. The Mahurkar opinion does not include the justification for using the infringer's borrowing cost, or compare it to alternative rates that may be appropriate.)
3. Compensation to the patentee for the cost of equity as opposed to debt alone is not considered. There are situations where it is appropriate to recognize that companies often are financed with both debt and equity — and the latter has a cost, which is typically higher than the cost of debt. In failing to consider the cost of equity as part of the

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prejudgment interest, one may run the risk of shortchanging the very longer term investors who tend to finance the research and development efforts upon which intellectual property often relies.

BEFORE OR AFTER TAX?

Alpex proposed using a before-tax rate of interest, ''arguing that a pre-tax rate...is an accurate proxy for the after-tax return Alpex would have made on its investments of the royalty payments.'' (*Id.* at 1209) The patentee's expert also testified, however, that ''as a matter of 'pure economics,' prejudgment interest should be calculated on an after-tax basis.'' (*Id.* at 1209) Nintendo's expert also testified to an afte-tax interest rate, in which the patentee identified no errors, and which the Court adopted.

The opinion is silent, however, as to whether the after-tax interest rate is to be applied to before-tax royalty payments (which is generally not recommended by financial analysis), or to after-tax royalty amounts (which generally is). The record in this case may contain detail not included in the opinion, but suffice it to illustrate by example the dangers of mixing after-tax rates and before-tax funds: Assume a $1,000 before-tax royalty payment, a pre-tax interest rate of 10% and a 40 % tax bracket (yielding an after-tax effective interest rate of 6%). If the pre-tax rate is used, the interest will be $100, which will be reduced to $60 after taxes. If the after-tax rate is applied, the interest will be $60, which will be reduced to $36 after taxes.

Generally, it is understood that damages awards are treated as taxable income to the plaintiff. Therefore, if the latter methodology is used, the actual interest award will shortchange the plaintiff and benefit the infringer. Further, if the interest is applied to an after-tax damage award, which is then taxed, the award is inappropriately reduced even further.

Second, Judge Wood notes other ''Courts'' refusal to calculate prejudgment interest on an after-tax basis in other cases (as being) typically a function of technical difficulties relating to after-tax calculations that are not as troublesome here.'' (*Id.* at 1209) At times, it is appropriate to use a weighted average cost of capital (''WACC'') (which takes into account both debt and equity) as a useful measure of the time value of money on damages. Financially, it is generally understood that it is appropriate to match the type discount rate to the type of funds being discounted, *i.e.* apply a before-tax discount rate to before-tax profits or cash flows, and an after-tax discount rate to after-tax profits or cash flows. It is also true that financial practitioners have technical difficulty translating a WACC, which is determined on an after-tax basis, to a before-tax rate. Damages awards are generally expected to be taxable. Therefore, one is often left to determine the present value of before-tax lost profits using an after-tax discount rate — an imperfect solution, albeit one to which a perfect alternative may not be available. In light of the court's acceptance of using an after-tax rate, it may be acceptable in the future to discount after-tax profits using an after-tax discount rate, and simply adjust the final amount to a before-tax basis.

DATE OF APPLICATION OF PREJUDGMENT INTEREST

Nintendo's expert assumed that royalty payments would be paid at the ''end of each year in which the underlying revenues were made.'' (*Id.* at 1209) Alpex's expert advocated a ''mid-year payment assumption, effectively assuming that six-month's of royalties are paid after they are earned, and six-month's of royalties are paid before they are earned.'' (*Id.* at 1209-10) Judge Wood ruled in favor of Nintendo's methodology.

Interestingly, Nintendo argued that Alpex's method was the ''equivalent of assuming royalty payments were made on a daily basis... (which) artificially inflates prejudgment interest.'' Based on the information in the opinion, Nintendo is incorrect in this assertion. The use of a mid-year payment assumption, with interest being calculated once a year, attempts to recognize that money flows in throughout the course of a year, and attempts to compensate the creditor and charge the debtor evenly through the mechanism of one mid-year payment. Alpex's attempt to rebut Nintendo's argument that a mid-year convention was tantamount to daily compounding failed to convince the court, however. Lacking a compelling rebuttal to Nintendo's argument, Alpex was awarded interest compounded only from year-end to year-end, which was lower than it might otherwise have been.

In sum, it appears that Alpex may have been shortchanged in its prejudgment interest award in three ways: first, by using too short a maturity on the borrowing rate that was used, and not taking into account the cost of equity; second, by applying an after-tax rate to a pre-tax damages amount, which would then be subject to tax; and, third, by using a period for compounding interest that deprived Alpex of the use of funds earned throughout the year until the end of the year. Some may believe it is hard to argue that Alpex was shortchanged in an overall damages award of approximately $245 million. Not all plaintiffs will be awarded so princely a sum, however, and it is important to calculate prejudgment interest with the same degree of care and attention that is granted to the determination of the underlying damages.