

# Awarding Prejudgment Interest

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*Analysis providing insights for parties deciding whether to litigate or risk infringement*

**A** finding in *Alper Computer Corp. v. Microsoft Co., Ltd.*, 56 USPQ2d 1147, 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 1981 commercial paper rate, and should be calculated upon an after-tax basis." (Id. at 1149). While the damage award before interest of \$209.3 million divided the overall prejudgment interest amount of \$17.2 million, 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 usually serves to make the pre-trial award whole, since the damages award is not only of the value of the royalty payments but also of the opportunity of the courts for suitable time of infringement and the state of the judgment. (Id. at 1149).

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.

Judge Wood concluded the following:

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

## Type of Rate

The patentee, Alper, claimed that the appropriate interest rate was the prime rate plus 1%. The defendant, Microsoft, claimed it should be either a Treasury Bill rate (of unregulated treasury), or their borrowing cost, at a commercial paper rate (rate of unregulated treasury).

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

1. Alper would have "emerged from bankruptcy and engaged in riskier investments similar to its historic investments." (id.)

2. Invested the royalty payments in intermediate government bonds. (id.)

3. That a pre-tax rate of prime plus 1% "is an accurate proxy for the after-tax return Alper would have made in either case." (Id. at 1234)

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

Judge Wood ultimately chose Microsoft'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 been funds to the infringer during the presidency of the litigation." (Id. at 1239) Judge Wood later remarks that "Judge Easterbrook advises calculating interest at the market rate the infringer generally pays for money." (Id. at 1239). The court leaves open the possibility that the opportunity cost to the patentee may be appropriate, if the

patentee presents "evidence relating to the uses 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, but the issue is not discussed. (See typically experts 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 ordinarily may favor 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, (by choosing the infringer's cost of funds, Judge Woods refers to Judge Easterbrook's opinion in *Microsoft Double Layer Promotional Calendar Patent Litigation*, 801 F. Supp. 1354, which recommended using the infringer's cost of funds. The Mahanark opinion does not include the justification for using the infringer's borrowing cost, or compare it to alternative uses that may be appropriate.)

3. Comparison 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 not face 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?

Alper proposed using a before-tax rate of interest, "arguing that a pre-tax rate . . . is an accurate proxy for the after-tax return Alper would have made on its investments of the royalty payments." (Id. at 1209.) The patentee's expert also testified, however, that "in a matter of 'pure economics,' prejudgment interest should be calculated on an after-tax basis." (Id. at 1209.) *Nimrod's* expert also testified to an after-tax interest rate, in which the patentee identified two 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 analysts, 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 8% and a 40% tax bracket (yielding an after-tax effective interest rate of 4%). If the pre-tax rate is used, the interest will be \$80, which will be reduced to \$68 after taxes. If the after-tax rate is applied, the interest will be \$68, which will be reduced to \$38 after taxes. Generally, it is understood that damages awards are treated as like after-tax income to the plaintiff. Therefore, if the latter methodology is used, the actual interest award will shortchange the plaintiff and hence, fit the findings. Further, if the interest is applied to an after-tax damage award, which is then taxed, the award is inappropriately re-

duced twice over.

Judge Wood notes that "Courts" refused 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 or damages. Financially, it is generally understood that it is appropriate to match the type of 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

*Nimrod'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.) Alper's expert assumed a "mid-year payment assumption, effectively assuming that six months of royalties are paid after they are earned, and six months of royalties are paid before they are earned." (Id. at 1209-10.)

Judge Wood ruled in favor of *Nimrod's* methodology.

Interestingly, *Nimrod's* expert argued that Alper's method was the "equivalent of assuming royalty payments were made on a daily basis," (which effectively inflates prejudgment interest." Based on the information in the opinion, *Nimrod's* 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 change the deferral evenly through the mechanism of one mid-year payment. Alper's attempt to limit *Nimrod's* argument that a mid-year convention was tantamount to daily compounding failed to convince the court, however. Lacking a compelling rebuttal to *Nimrod's*'s argument, Alper 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 Alper may have been shortchanged in its prejudgment interest award in three ways: first, by using the 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 Alper of the use of funds invested throughout the year until the end of the year. Some may believe it is hard to argue that Alper was shortchanged in an overall damages award of approximately \$245 million. Not all plaintiffs will be awarded so precisely 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.