Patent Litigation Alert

What Kind of Bag Holds a $19B Cat? *Uniloc v. Microsoft*: Federal Circuit Rules on Reasonable Royalty Damages Issues

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On January 4, 2011 the Federal Circuit in *Uniloc USA, Inc. v. Microsoft Corp.* made two significant rulings on recurring issues in the area of patent damages:

- It eliminated the criticized 25% "rule of thumb" frequently used as a baseline for determining reasonable royalty damages, and
- It clarified that evidence of entire market value calculations—where the plaintiff attempts to tie the reasonable royalty to the full value of a product containing the patented invention—will not be permitted in absence of clear economic justifications.

Uniloc is another installment in the trend marked by the recent *ResQNet.com v. Lansa* decision where the Federal Circuit pronounced that plaintiffs in patent cases "must carefully tie proof of damages to the claimed invention's footprint in the market place."

BACKGROUND OF THE CASE

In *Uniloc*, the plaintiff asserted U.S. Patent No. 5,490,216 ("the '216 patent"), relating to anti-piracy software registration. Uniloc accused Microsoft's Product Activation feature for Windows XP and Word 2003 of infringement of the '216 patent. At trial the jury found claim 19 of the '216 patent valid and infringed and awarded Uniloc $388 million.

Uniloc's damages theory was based on an internal Microsoft document ascribing a $10 to $10,000 value to "Product Keys." From that document, the expert took the lowest "isolated" value of Microsoft's Product Activation feature, $10, and then applied the "25% rule of thumb," to determine a baseline royalty rate. This rule, which the expert invoked based on its past "accept[ance] by Courts as an appropriate methodology in determining damages" allocates 25% of product value to the inventor and 75% to the licensee.

The expert then considered the factors outlined in *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970) to determine whether they necessitated any adjustments to the presumptive rate and concluded they did not. Multiplying $2.50 (25% of the $10 'isolated' Product Activation value) by 225,978,721, the total number of licenses for the accused products, the expert arrived at a total damages figure of over $564 million. Finally, the expert performed what he termed a "reasonableness check" on the ultimate damages figure—because it was "a significant amount of money"—by multiplying the total number of accused product licenses by their average sales price. The jury was presented with a demonstrative comparing the proposed damages award with this total revenue figure, $19.28 billion.

Following the jury verdict, the district court granted a new trial on damages on the basis that the jury had been improperly presented with entire market value calculations (the district court noted the "$19 billion cat was never put back into the bag"), but rejected Microsoft's contention that the expert's use of the 25% rule of thumb also warranted a new trial.

THE FEDERAL CIRCUIT'S DAMAGES RULINGS

The 25 Percent Rule

After tracing the history of the 25% rule, the Court observed that it had not previously squarely addressed its admissibility, but rather had "passively tolerated its use where its acceptability has not been the focus of the case." Relying on other recent Federal

Circuit decisions, *ResQNet* and *Lucent*, which require evidence of a reasonable royalty to be closely tied to the technological area under discussion, the Court noted more generally that there must be a basis in fact to associate royalty rates used in prior licenses to the particular hypothetical negotiation at issue. The "25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement," because it does not provide evidence of what would happen in a particular hypothetical negotiation or a particular technological area. In the illustrative example provided by the Court, the 25% rule makes the same royalty rate prediction for a negotiation involving a portfolio of foundational patents over hard drives as it would for a single patent to a small improvement in film emulsion. Accordingly, the court concluded:

> This court now holds as a matter of Federal Circuit law that the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation. Evidence relying on the 25 percent rule of thumb is thus inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue.

(Slip. Op. at 41.) The court went on to hold that the use of the *Georgia-Pacific* factors to adjust the rate could not remediate the underlying error of using the 25% rule.

The Entire Market Value Rule

The Circuit goes on to make clear that patentees cannot get entire market value calculations in through the back-door when the entire market value rule is not applicable. The entire market value rule provides that, where a patented component is the basis for consumer demand of a larger product, the revenues for that larger product may properly be used as the royalty base when determining a reasonable royalty. Here, the entire market value rule was unavailable: the Microsoft Product Activation feature is clearly not what drives demand for Microsoft's word processing software or operating systems. Nonetheless, Uniloc had presented the jury with Microsoft's $19B revenue figure as a "check" on its damages calculation. The Federal Circuit agreed with the district court that this was inappropriate. In particular, it criticized cross-examination of defendants' damages expert using the $19B figure and effective royalty rate of 0.000035%. It noted that these numbers "cannot help but skew the damages horizon for the jury, regardless of the contribution of the patented component to this revenue."

IMPLICATIONS

Uniloc marks another important step towards requiring patent plaintiff's to rigorously prove damages with facts logically connected to the value of the patented invention. Going forward, because of the clear pronouncements from the Federal Circuit in *ResQNet*, *Lucent* and now *Uniloc*, it is expected that district courts will more strictly scrutinize patent damages evidence and will be more likely to exclude material not directly tied to a sound damages theory.

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