ARE Patent Litigation Alert:
Uniloc USA v. Microsoft: Federal Circuit Held the 25% Rule of Thumb By Damages Expert is a Fundamentally Flawed Tool for Determining a Baseline Royalty Rate In Patent Damages Analysis

January 4, 2011

Author(s): Joseph Casino and Michael Kasdan

On January 4, 2011, the U.S. Court of Appeals for the Federal Circuit held in U*niloc USA Inc. et al. v. Microsoft Corp*. et al., 2010-1035 (Fed. Cir. January 4, 2011) that the 25% "rule of thumb" often used by patent damages experts is a fundamentally flawed tool for determining a baseline royalty rate in the context of determining a reasonable royalty damages amount.

The 25% Rule (i.e., 25% of the expected profits for a product) has often been used by damages experts to approximate the reasonable royalty rate that a patented product manufacturer would be willing to offer to pay the patentee during a hypothetical negotiation. In practice, the 25% Rule is often used in damages cases to provide a starting point in the reasonable royalty analysis, which is then adjusted up or down based on an application of the Georgia-Pacific factors. Proponents of the 25% Rule have argued that its accuracy has been born out based on studies of profit information and royalty rate information across industries.

As noted by the Federal Circuit, however, the 25% Rule has also been the subject of criticism, because:

(1) it fails to account for the unique relationship between the patent and the accused products;

(2) it fails to account for the unique relationship between the parties; and

(3) the rule is essentially arbitrary and does not fit within the model of the hypothetical negotiation within which it is based. (Slip. op. at 38).

In spite of these criticisms, lower courts have almost invariably admitted evidence based on the 25% Rule, largely in reliance on its widespread acceptance or because its admissibility was uncontested, and to this point the Federal Circuit has "passively tolerated its use where its acceptability has not been the focus of the case." (Slip. op. at 39).

In *Uniloc*, a Federal Circuit panel consisting of Chief Judge Rader and Circuit Judges Linn and Moore squarely addressed the propriety of using the 25% Rule and concluded that, as a matter of Federal Circuit law, "the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation." (Slip op. at 41). Accordingly, the Federal Circuit rejected the use of the 25% Rule as inadmissible under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 589 (1993) and Federal Rule of Evidence 702. In so doing, the Federal Circuit emphasized that damages evidence must be tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time, but that the 25% Rule is an arbitrary general rule unrelated to the specific facts of a given case.

In support of its reasoning, *Uniloc* cited to its recent decisions in Lucent Technologies and ResQNet, where it held that a patentee could not rely on license agreements that were "radically different from the hypothetical agreement under consideration" to determine a reasonable royalty. (Slip op. at 43). *Uniloc* concluded that "[r] elying on the 25 percent rule of thumb in a reasonable royalty calculation is far more unreliable and irrelevant than reliance on parties' unrelated licenses, which we rejected in ResQNet and Lucent Technologies." (Slip op. at 45). Thus, the *Uniloc* holding is consistent with a trend in Federal Circuit decisions to be stricter in the type of evidence that is permissible to prove damages. See Michael Kasdan and Joseph Casino, "Federal Courts Closely Scrutinizing and Slashing Patent Damage Awards," Patently-O-Patent Law Journal (March 2010)(available at http://www.patentlyo.com/files/kasdan.casino.damages.pdf).

Of note, the Federal Circuit in *Uniloc* also rejected the use of the Entire Market Value Rule as "a check" on the proposed reasonable royalty amount. In *Uniloc*, the patentee's damages expert compared his proposed reasonable royalty amount to the total revenue of Microsoft Office and Windows, and concluded that his proposed royalty amount was indeed reasonable because it represented only a small percentage of those total revenues. (Slip op. at 47-48). In rejecting this approach, the Panel cited to the Federal Circuit's recent decision concerning the Entire Market Value Rule in *Lucent Technologies* and again reinforced that the use of the Entire Market Value Rule, even as a so-called "check" on reasonableness, is inappropriate unless there is proof that the patent-related feature is the basis for customer demand. (Slip op. at 51, 53).

It is also worthwhile to note that in Uniloc, the Federal Circuit affirmed the district court's grant of Microsoft's motion for judgment as a matter of law ("JMOL") of no-willful infringement, because the jury's verdict on willfulness was not supported by substantial evidence. *Citing In re Seagate Tech., LLC*, 497 F.3d 1360, 1371 (Fed. Cir. 2007) (*en banc*), the Federal Circuit clearly stated that *Uniloc*, the patentee, has failed to meet the threshold objective prong of Seagate, which is "a patentee must show by clear and convincing evidence that the infringer acted despite an objectively high likelihood that its actions constituted infringement of a valid patent." Specifically, the Federal Circuit found "Uniloc has failed to meet the threshold objective prong of Seagate [since] Uniloc has not presented any evidence at trial or on appeal showing why Microsoft, *at the time it began infringement*, could not have reasonably determined that [its products] did not meet the claim limitations" (Slip op. at 32). Due to the failure of Uniloc to show that a reasonable jury could find Microsoft's conduct objectively reckless on the evidence presented, the Federal Circuit affirmed the district court's grant of JMOL of no willfulness. This holding is significant since the Federal Circuit did not consider any subjective evidence of willfulness, such as copying, and judged objective recklessness at the time infringement began (rather than, for example, after a *Markman* ruling).

If you have questions about this case or its impact on U.S. patent law, please do not hesitate to contact us.

Joseph Casino and Michael Kasdan were Partners and Suzue Fujimori is an associate at Amster, Rothstein & Ebenstein LLP. Their practice specializes in intellectual property issues including litigating patent, trademark and other intellectual property disputes, and drafting and negotiating intellectual property license agreements. Suzue may be reached at sfujimori@ arelaw.com.