

Federal Circuit's Rejection of "25 Percent Rule of Thumb" and Applicability of the "Entire Market Value Rule" Casts Further Doubt on Calculating Damages in Patent Cases

On Jan. 4, 2011, the U.S. Court of Appeals for the Federal Circuit held that the so-called 25 percent rule of thumb analysis that damages experts have been using to calculate a "reasonable royalty" in patent cases is "fundamentally flawed." *Uniloc USA Inc., et al. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011). The Federal Circuit found that, because the 25 percent rule merely applies a general theory that is untethered to the facts of a case, "[e]vidence relying on the 25 percent rule of thumb is thus inadmissible under *Daubert* and the Federal Rules of Evidence." *Id.* at 1315. The Federal Circuit also affirmed the district court's rejection of the use of the "entire market value rule," which Uniloc's expert used as a "check" on his calculation of damages. *Id.* at 1319.



Striking down the 25 percent rule has important implications for patent damages in both existing and future patent litigation. In addition, the Federal Circuit's refusal to apply the "entire market value rule" in *Uniloc* serves as a caution to litigants who seek to use that doctrine as a way to try and increase the size of any damages award. As a result, the *Uniloc* decision is critical for every company that faces any current or potential risk of patent litigation.

Background

The 25 percent rule of thumb has long been a starting point of a reasonable royalty analysis. The rule—which the Federal Circuit observed has "met its share of criticism"—is based on the idea that, in a hypothetical negotiation, a licensee generally agrees to pay the patentee a royalty rate equivalent to 25 percent of the licensee's expected profits on products that incorporate the intellectual property at issue in the case.

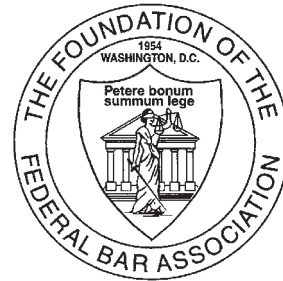
In the *Uniloc* case, Uniloc sued Microsoft, alleging that a certain feature of Microsoft's Word XP, Word 2003, and Windows XP infringed Uniloc's patent. The jury agreed and awarded Uniloc \$388 million in damages (less than the approximately \$564 million that was due to Uniloc, according to its expert, who bases his opinion upon the 25 percent rule). These damages represented a "reasonable royalty" that Uniloc and Microsoft would have hypothetically agreed upon at the time the infringement began. In arriving at his

damages model, Uniloc's expert also used the "entire market value rule" as a "check" against his 25 percent rule of thumb used to calculate damages. The "entire market value rule" allowed Uniloc's expert to calculate damages based on the revenue from Word XP, Word 2003, and Windows XP, rather than limiting the revenue base to what was attributable to the claimed invention. Because Uniloc failed to prove that the patented invention was what drove customer demand for the products, the district court found that the rule was used inappropriately in this instance.

Following the jury's verdict, the district court granted Microsoft's motion for a judgment as a matter of law of noninfringement in part and ordered a new trial on infringement and willfulness, thereby effectively nullifying the jury's damage award.

The Appeal

On appeal, the Federal Circuit first observed that the "admissibility of the 25 percent rule has never been squarely presented to this court" but acknowledged that it has "passively tolerated" the rule's use over the years. *Id.* at 1314. After first reviewing the standards for the admissibility of expert opinions, the Federal Circuit concluded that U.S. Supreme Court precedent requires experts to "justify] the application of a general theory to the facts of the case." *Id.* at 1316. If an expert cannot do so, then the proffered theory is inadmissible. *Id.* at 1317. Given that, according to the Federal Circuit, the 25 percent rule is based on generalized empirical evidence about licenses, the court concluded that the rule is nothing more than "an abstract and largely theoretical construct [that] ... does not say anything about a particular hypothetical negotiation or reasonable royalty involving any particular technology, industry or party." *Id.* Furthermore, the court found that it "is of no moment" that the 25 percent rule is merely a "starting point" for a reasonable royalty analysis (damages experts used the rule as a baseline and then applied other case-specific factors to adjust the rate up or down). According to the court, "[b]eginning from a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the case nevertheless results in a fundamentally flawed conclusion." *Id.* Because the Uniloc expert's damages opinion (which was based



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on the 25 percent rule) was not related to the facts of the case, the expert's damages opinion was "arbitrary, unreliable, and irrelevant." *Id.* at 1318.

With respect to the Uniloc expert's use of the "entire market value rule" to "check" his calculation using the 25 percent rule of thumb, the Federal Circuit found that, because Uniloc failed to show that the patented invention was the basis for consumer demand for the accused products, the use of that doctrine was improper. According to the Federal Circuit "[t]his case provides a good example of the danger of admitting consideration of the entire market value of the accused where the patented component does not create the basis for customer demand." *Id.* at 1310. The Federal Circuit agreed with the district court that, once Uniloc's expert disclosed the amount of estimated revenue Microsoft earned on the accused products, "[t]he \$19 billion cat was never put back into the bag," regardless of whether or not Uniloc adequately demonstrated that customers' demand for the accused products was derived from the patented invention (and not for other reasons). *Id.*

Thus, the Federal Circuit held that Microsoft is entitled to a new trial on damages. Because the Federal Circuit also reversed, in part, the district court's posttrial finding of noninfringement, ordering a new trial on damages means that Uniloc may still obtain a damage award in the case.

Implications of the Decision

The implications of the *Uniloc* decision on the analysis of damages in patent cases are tremendous. Because most patentees seek "reasonable royalties" (rather than lost profits, the other general mode of analysis), until now, damages opinions often began with the 25 percent rule of thumb and then "adjusted" the royalty rate up or down in light of the facts of the case. This starting point of damages analyses is now impermissible. In addition, the *Uniloc* decision provides further warning to plaintiffs that, in order to use the "entire market value rule," they must present evidence to show that the infringing aspect of the product is what drives consumer demand for the product.

Now that the 25 percent rule has been repudiated, the future promises to bring new and creative modes of analysis to arrive at a "reasonable royalty" in patent cases, and these analyses are likely to result in new disputes about the admissibility of damages opinions. Given the Federal Circuit's holding in the *Uniloc* case, both plaintiffs and defendants are well advised to tie their analyses of damages firmly to the facts of the case, rather than relying on general statements or modes of analysis. **TFL**

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