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Federal Circuit Rejects 25 Percent Rule of Thumb for Reasonable Royalty Damages Analysis and Reaffirms Limits on Application of Entire Market Value Rule

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The Federal Circuit in *Uniloc v. Microsoft*, No. 2010-1035, -1055, (Fed. Cir. 2011), decided for the first time that the 25% rule of thumb for calculating reasonable royalty damages is inadmissible. The 25% rule had been widely used by damages experts, and accepted by district courts, in patent cases to allocate 25% of an alleged infringer's profits to the patentee. The Federal Circuit rejected the 25% rule of thumb as a starting point for a reasonable royalty damages analysis because this "rule" is not tied to the specific facts of a particular hypothetical negotiation. The Court also reaffirmed that the entire market value rule is only appropriate where the patented technology is the basis for customer demand of the product. This decision will have a significant impact on pending patent litigations and appeals because many damages experts have relied upon the 25% rule of thumb and used the entire market value rule to assess damages, even when the patented feature does not drive product demand.

Uniloc's complaint in this case centered on Microsoft's Product Activation technology, used in certain versions of Microsoft's Windows and Word products. The Product Activation technology sends encrypted information about an end user's computer and software to determine whether the user is running a validly licensed copy of Microsoft's software.

At trial, Uniloc's damages expert adopted a value of \$10 per activation key and applied the 25% rule of thumb to calculate a reasonable royalty of \$2.50 per

activation key. This royalty rate was applied to over 226 million copies of Microsoft's products, resulting in total proposed royalty of almost \$565 million. As a purported reasonableness check, Uniloc's expert showed the jury that this royalty was only 2.9% of the gross revenue of \$19.28 billion, the entire market value of the accused products. The jury returned a judgment of \$388 million in damages.

On appeal, the Federal Circuit held that the 25% rule of thumb is "fundamentally flawed" and "inadmissible" because it is not tied to the specific facts of the case.

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.

Although the 25% rule of thumb had been widely used and accepted as a starting place for a reasonable royalty analysis, it has also been consistently criticized because it does not account for the unique relationship between the patent and the accused products, it does not account for the relationship between the parties, the allocation of risks, or the relevant industry, and it is arbitrary and does not fit within the model of the hypothetical negotiation.

In rejecting the 25% rule of thumb, the Court looked to well-established case law that requires that expert testimony pertain to the specific issues in a case under *Daubert* and the Federal Rules of Evidence. The Court reviewed the Supreme Court's holdings in *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1997) and *General Electric v. Joiner*, 533 U.S. 136 (1997), in which technical expert testimony was rejected for applying scientific studies and a method of analysis not pertinent to the facts of the case.

The bottom line of *Kumho Tire* and *Joiner* is that one major determinant of whether an expert should be excluded under *Daubert* is whether he has justified the application of a general theory to the facts of the case. Consistent with this conclusion, the court has held that any evidence unrelated to the claimed invention does not support compensation for infringement but punished beyond the reach of the statute.

Comparing the 25% rule to the irrelevant license agreements in *Lucent Techs., Inc. v. Gateway, Inc.* 580 F.3d 1301 (Fed. Cir. 2009), *ResQNet.Com, Inc. v. Lansa, Inc.* 594 F.3d 860 (Fed. Cir. 2010), and *WordTech Systems, Inc. v. Integrated Networks Solutions, Inc.*, 609 F.3d 1308 (Fed. Cir. 2010), the Court held that "the 25 percent rule of thumb is far more unreliable and irrelevant than reliance on the parties' unrelated licenses."

The meaning of these cases is clear: there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case. The 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement. The

rule does not say anything about a particular hypothetical negotiation or reasonable royalty involving any particular technology, industry, or party. Relying 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*.

Finally, the Court rejected Uniloc's use of the entire market value rule, even as a check, because Microsoft's Product Activation technology was undisputedly not the basis for customer demand and the disclosure of Microsoft's \$19 billion in gross revenues "cannot help but skew the damages horizon for the jury, regardless of the contribution of the patented component to the revenue." The Court clarified that its ruling in *Lucent Technologies* did not relieve Uniloc from proving that the patented feature was the basis for customer demand before applying the entire market value rule.

The Supreme Court and this court's precedents do not allow consideration of the entire market value of accused products for minor patent improvements simply by asserting a low enough royalty rate. *See Garretson*, 111 U.S. at 121; *Lucent Techs.*, 580 F.3d at 1336 ("In one sense, our law on the entire market value rule is quite clear. For the entire market value rule to apply, the patentee *must* prove that the patent-related feature is the basis for customer demand" (emphasis added, internal citations omitted)); *Rite-Hite*, 56 F.3d at 1549 (same); *Bose Corp. v. JBL, Inc.*, 274 F.3d 1354, 1361 (Fed. Cir. 2001) (same); *TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895, 901 (Fed. Cir. 1986) ("The entire market value rule allows for the recovery of damages

based on the value of an entire apparatus containing several features, when the feature patented

constitutes the basis for customer demand.”).

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