

# The Federal Circuit Tackles the 25 Percent Rule and the Entire Market Value Rule

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The Federal Circuit began the new year with a bang when it decided *Uniloc USA, Inc. v. Microsoft Corp.*, No. 2010-1035. In this case, the court categorically rejected the much-reviled (or much loved, depending on one's view) "25 percent rule" for calculating patent infringement damages. The court also dismantled Uniloc's damages theory based on the entire market value rule, concluding that "the jury's damages award was fundamentally tainted by the use of a legally inadequate methodology."

This case represents the Federal Circuit's continuing effort to refine the law governing patent damages. Beginning with its 2009 decision in *Lucent Technologies Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009), the court has issued a number of decisions that emphasize the necessity of a firmer evidentiary foundation to support the jury's damages award. In *Uniloc*, the court reinforces the necessity of proving with specific evidence why a particular royalty rate and amount is reasonable.

*Uniloc* is particularly significant because it apparently puts to sleep the rule of thumb known as the "25 percent rule." The panel "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."

In view of this holding, every current damages award based on the 25 percent rule is vulnerable on appeal. Furthermore, every damages theory invoking the 25 percent rule in current litigation is subject to attack and possible exclusion. Should this ruling withstand further review, this could be a major game-changer for patent litigation.

## Background and Summary

Uniloc is the owner of U.S. Patent No. 5,490,216 (the '216 patent). The '216 patent "is directed to a software registration system to deter copying of software." The claimed invention is essentially a computational algorithm that enables the confirmation of authorized software installation.

Uniloc asserted infringement of the '216 patent by Microsoft's Product Activation feature, used in programs such as Word XP and Windows XP. Anyone who has installed a Microsoft Office program has probably used this feature. It is the 25-character alphanumeric product key listed on the software package that must be entered before the software is fully installed. The Product Activation feature prevents the software from being

installed on unauthorized machines, e.g., multiple computers.

The present appeal is a continuation of the ongoing battle between Uniloc and Microsoft. The panel's decision addresses many issues. In this iteration, the Federal Circuit reversed the district court's grant of JMOL on non-infringement, reversed the grant of a new trial, affirmed the grant of JMOL of no willful infringement and affirmed the denial of Microsoft's JMOL motion on invalidity.

Our summary here focuses on the damages decision. The trial court granted Microsoft's motion for a new trial on damages.

Having found infringement, the jury awarded damages of \$388 million. Uniloc's expert, Dr. Gemini, opined that damages should be about \$564 million. He reasoned that the Product Activation Key had a value of at least \$10. Dr. Gemini then applied the 25 percent rule and explained that "25% of the value of the product would go to the patent owner and the other 75% would remain with Microsoft, resulting in a baseline royalty rate of \$2.50 per license issued." Then he "multiplied the \$2.50 royalty rate by the number of new licenses to Office and Windows products, 225,978,721, to get a final reasonable royalty of \$564,946,803." Dr. Gemini then performed a "reasonableness check" by calculating what the royalty rate for the \$564 million based on the gross revenues for the products. Based on his reasonableness check, his calculated royalty equated to 2.9% of the entire market value of the Office and Windows products.

In response, Microsoft's expert contended that a lump sum royalty of \$7 million was proper. Microsoft also challenged Uniloc's reliance on the 25 percent rule in an *in limine* motion, which the district court had denied.

Microsoft also disputed Dr. Gemini's use of the entire market value rule, arguing that "the Product Activation was not the basis of the consumer demand for Microsoft's Office and Window's products." The district court agreed and granted a new trial because the "\$19 billion cat was never put back into the bag."

### **Death to the 25 Percent Rule(?)**

On appeal, the Federal Circuit categorically rejected the use of the 25 percent rule:

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.

This ruling appears to be a complete ban on the use of the 25 percent rule of thumb in any patent case. At a minimum, a patentee would be well-advised not to mention this rule of thumb before Judges Linn, Rader or Moore.

The panel provided a reasoned analysis of the history and infirmities of the 25 percent rule. The court acknowledged that it "has passively tolerated" application of the rule "where its acceptability has not been the focus of the case although the rule has long been applied." The court further explained what it saw as

fundamental flaws with the rule:

- "First, it fails to account for the unique relationship between the patent and the accused product."
- "Second, it fails to account for the unique relationship between the parties."
- "Finally, the rule is essentially arbitrary and does not fit within the model of the hypothetical negotiation within which it is based."

In the end, the court emphasized the logical and evidentiary foundation required in order to rely on royalty rates and license agreements when arguing for a particular reasonable royalty. "[T]here 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." In other words, "[t]o be admissible, expert testimony opining on a reasonable royalty rate must 'carefully tie proof of damages to the claimed invention's footprint in the market place.'"

### **Entire Market Value Rule**

The panel also firmly rejected Uniloc's application of the entire market value rule. The court concluded that using the entire market value rule as a "reasonableness check" was not permissible. Uniloc's expert presented no evidence that the patented component formed the basis for consumer demand.

The panel explained that "Uniloc's use of the \$19 billion 'check' was improper under the entire market value rule." Citing Supreme Court and Federal Circuit precedent, the panel concluded that one cannot consider "the entire market value of accused products for minor patent improvements simply by asserting a low enough royalty rate."