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Fed. Circuit gives increasing scrutiny to damages

In *Uniloc*, it rejected venerable 25% rule for patent damages and narrowed application of 'entire market value' rule.

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The U.S. Court of Appeals for the Federal Circuit was established nearly 30 years ago to create a uniform body of patent law and, some argued, to end the perceived unwillingness of some federal courts to honor patent rights. During the past several years, some critics of the patent system—including the authors of a 2003 Federal Trade Commission report—contended that the court had gone too far, recognizing and enforcing patent rights too vigorously, arguably stifling innovation and conferring windfall recoveries on the owners of weak patents. Several versions of legislation to "reform" the Patent Act have been introduced in Congress.

THE PRACTICE

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And in cases such as *eBay Inc. v. MercExchange LLC*, 547 U.S. 388 (2006), which considered rules governing injunctive relief, and *KSR Int'l Co. v. Teleflex Inc.*, 550 U.S. 398 (2007), regarding the standards for invalidating a patent for obviousness, the U.S. Supreme Court swung the pendulum back somewhat, restricting procedural and substantive rules that had favored patent owners.

Patent "reformers" have been acutely concerned with damages awarded by patent juries, especially in cases in which the patent at issue covers only a small part of the technology included in the defendant's product. Computer software and telecommunications equipment, for example, may include hundreds or thousands of inventions. Perhaps in reaction to these views, the Federal Circuit has given increased scrutiny to damages awards. In 2009, that court vacated a controversial $357 million award to the owners of a patent covering a "date picker" used in the calendar of Microsoft's popular Outlook program, finding that the verdict was based on "speculation or guesswork." *Lucent Tech. Inc. v. Gateway Inc.*, 580 F.3d 1301 (Fed. Cir. 2009). Last year, vacating another damages award, the court emphasized that "the trial court must carefully tie proof of damages to the claimed invention's footprint in the market place." *ResQNet.com Inc. v. Lansa Inc.*, 594 F.3d 860 (Fed. Cir. 2010).

The court's most recent step in this direction is *Uniloc USA Inc. v. Microsoft Corp.*, 2011 WL 9738 (Fed. Cir. Jan. 4, 2011). In one stroke, *Uniloc* did away with the venerable "25 percent rule," which sets a starting point for a damages analysis that assumes that 25% of the expected profits for a product incorporating patented technology will go to the patentee, with 75% reserved to the alleged infringer. *Uniloc* also narrowed application of the "entire market value" rule, under which a patentee may claim percentage royalties based on total sales of the accused product when the patented feature "creates the 'basis for customer demand' or 'substantially create[s] the value of the component parts.' "

The patent at issue in *Uniloc* covered a registration system designed to deter unauthorized copying of software. Uniloc claimed that Microsoft infringed the patent through its Product Activation feature that controls access to Word XP, Word 2003 and Windows XP. The feature requires a retail user of those programs to enter a 25-character product key. Only if a valid key is entered may the software be used beyond a short trial period.

Section 284 of the Patent Act provides simply that damages shall be "adequate to compensate for the infringement, but in no event

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less than a reasonable royalty for the use made of the invention by the infringer." Lost profits are available only when the patentee can show, among other things, that there are no noninfringing substitutes for the patented article and that it had the ability to bring the patented product to market. Therefore, a reasonable royalty—the monetary relief Uniloc sought—is the "predominant" measure of patent damages. To determine that royalty, a jury is typically told to imagine a hypothetical negotiation between a willing licensor and a willing licensee taking place at the time the infringement began.

UNILOC'S DAMAGES ANALYSIS

Dr. Joseph Gemini, Uniloc's damages expert, began his analysis by relying on an internal Microsoft document that valued the Product Activation function at "anywhere between $10 and $10,000 depending on usage." Taking the lowest figure, $10, as the "isolated value" of the infringing feature, he then applied the 25% rule, deriving a $2.50 baseline royalty for each licensed copy of the infringing software.

Next, Gemini considered whether the 25% rate should be adjusted in light of the well-known *Georgia-Pacific* factors, a group of overlapping considerations described in a 1970 district court opinion that are traditionally used to guide juries considering damage issues. The factors take into account royalties on comparable patents, the relationship between the patentee and the infringer, the profitability of the infringing product and the importance and benefits of the invention. Finding that the factors, as a whole, favored neither party, he left the $2.50 royalty rate unchanged. Multiplying that royalty by the nearly 226 million copies of infringing Office and Windows products yielded a "reasonable" royalty of just under $565 million.

Gemini's final step was to "check" his conclusion by comparing it to the gross revenues generated by the infringing products. At an average sale price of $85, those revenues were $19.28 billion, meaning that his total royalty figure was about 2.9% of sales. Arguing that industrywide software royalty rates are "on average" above 10% of sales, he concluded that this "check" validated his conclusion. Although the jury cut Uniloc's demand by more than 30%, it nevertheless delivered a huge verdict—$388 million.

On Microsoft's motion for a new trial, the district court grumbled that "the concept of a [25%] 'rule of thumb' is perplexing in an area of law where reliability and precision are deemed paramount," but found that use of the rule was permissible because of its wide acceptance. The court granted a new trial, however, because it found Gemini's reference to Microsoft's $19 billion in sales had been prejudicial. Use of that figure was equivalent to invoking the entire-market-value rule, but Uniloc had not made the required threshold showing that the patented invention was the basis for demand for the product. Indeed, no such showing could be made—no consumer buys software because of a product key that limits access.

Unlike the district court, the Federal Circuit found no need to defer to the broad recognition of the 25% rule. Citing more than a dozen decisions, it acknowledged that "[l]ower courts have invariably admitted evidence based" on the rule, "largely in reliance on its widespread acceptance or because its admissibility was uncontested." In fact, in March 2010, the Federal Circuit itself appeared to approve use of the rule, combined with consideration of the *Georgia-Pacific* factors—just the analysis Gemini did for Uniloc—in another case against Microsoft, *i4i L.P. v. Microsoft Corp.*, 598 F.3d 831 (Fed. Cir. 2010). In that case, the Federal Circuit dismissed Microsoft's complaints about the rule as going to "weight, not admissibility," of the expert opinion.

The Federal Circuit concluded now, however, that the rule's one-size-fits-all approach was inconsistent with the requirement that damages analysis be tailored precisely to the technology, products and parties in each case. Therefore, the rule "is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation." Thus, it "would predict that the same 25%/75% royalty split would begin royalty discussions between, for example, (a) TinyCo and IBM over a strong patent portfolio of twelve patents covering various aspects of a pioneering hard drive, and (b) Kodak and Fuji over a single patent to a tiny improvement in a specialty film emulsion."

The Federal Circuit had no more tolerance for Gemini's use of Microsoft's total revenues to "check" his conclusions. Because the purpose of the "check" was to "lend…legitimacy" to Gemini's conclusion, Uniloc was, in effect, invoking the rule although the necessary predicate—that the patented invention is the basis for consumer demand—could not be established. The court rejected Uniloc's argument that it could refer to Microsoft's total revenues as long as the claimed royalty rate was low enough: "The disclosure that a company has made $19 billion in revenue from an infringing product cannot help but skew the damages horizon for the jury, regardless of the contribution of the patented component to this revenue." For all of these reasons, the Federal Circuit affirmed the grant of a new trial on damages.

The Uniloc decision clearly reflects the Federal Circuit's acute concerns about large damages awards in cases in which the plaintiff's patent arguably contributes little to the market appeal of a complex product. It can also be seen as part of a continuing process that has eliminated unique remedial rules in patent litigation.

Legislation now before Congress would codify the entire-market-value rule (allowing its application only when the patentee can show that the invention's "specific contribution over the prior art is the predominant basis for market demand for an infringing product or process") and require that district courts make explicit findings specifically identifying acceptable damages methodologies. Backers of these bills argue they are necessary to ensure that federal courts play an effective gatekeeper role. Opponents say that recent Federal Circuit decisions such as *Uniloc* show that legislation is unnecessary because the courts are already on the job.