



In *Uniloc USA, Inc. v. Microsoft Corp.*, the Federal Circuit Gives Thumbs Down to the "25 Percent Rule of Thumb"

On January 4, 2011, the United States Court of Appeal for the Federal Circuit decided *Uniloc USA, Inc. v. Microsoft Corp.*, Court of Appeals Nos. 2010-1035, -1055 (Fed. Cir. Jan. 4, 2011). This was the second appeal to reach the Federal Circuit in long-running litigation between the two companies over Microsoft's Product Activation feature in Word and Windows.

After a full trial, a jury had determined that Microsoft's software with the feature infringed claims of Uniloc's patent-in-suit (U.S. Patent No. 5,492,216), and that the infringement was willful. The jury awarded Uniloc US\$388 million in damages. Following post-trial motions, the district court held that Microsoft's product did not infringe the Uniloc patent as a matter of law, that Microsoft alternatively was entitled to a new trial on damages and that, in any case, the infringement was not willful. Uniloc appealed.

On appeal, the Federal Circuit ruled that the jury had sufficient evidence to support its verdict of infringement, but agreed with the district court that the willfulness finding did not have an adequate evidentiary basis. The court also reinforced its prior holdings that evidence supporting application of the "entire market value" rule had to be predicated on a finding that the patented component created the basis for customer demand for the larger product. While of interest to the parties, of course, these rulings broke no new legal ground. What did break new ground was the Federal Circuit's review of the damages award. In particular, the court held that the so-called "25 percent rule of

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Contacts:

[Alicia M. Choi](#)
+1.703.720.7896

[David S. Elkins](#)
+1.650.843.3378

[Nathan Lane III](#)
+1.415.954.0249

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thumb," an often-criticized but commonly used method of determining reasonable royalty damages in patent cases, is "fundamentally flawed" and disapproved.

Damages in patent cases are typically calculated either as lost profits or, most often, as a reasonable royalty. Section 284 of the Patent Code specifies a reasonable royalty as the floor, or minimum damages payable by an infringer for the use made of a patented invention. Put simply, a reasonable royalty is the amount that a willing licensor would accept and a willing licensee would agree to pay for use of the patented invention through a "hypothetical negotiation" occurring at the time infringement began. The reasonable royalty is sometimes expressed as a royalty rate applied to a royalty base comprised of infringing sales. Other times the reasonable royalty is expressed as a lump sum.

Any reasonable royalty analysis depends on a number of factors, such as the circumstances of a given case determining which factors predominate, and how the factors influence the royalty rate to be applied (i.e., moving it up or down). Some courts and economic experts have relied on the 25 percent rule of thumb as the basis for that analysis. As stated by the Federal Circuit, "the 25 percent rule of thumb is a tool that has been used to approximate the reasonable royalty rate that the manufacturer of a patented product would be willing to offer to pay to the patentee during a hypothetical negotiation." (Slip Op. at 36.) The rule is applied by first determining the licensee's expected profits for the product that incorporates the patented technology. Of those expected profits, 25 percent are "assigned" to the patent holder. Expressed as a formula, where "P" is the infringer's expected profit margin (expressed as a percent of revenues) for the infringing products and "R" is the royalty rate to be paid to the patent owner, $R = 0.25(P)$. The resulting royalty rate can then be applied to net sales of the patented product on an ongoing basis to determine the amount owed.

While the 25 percent rule had some foundation in academic literature, it was also widely criticized. (*Id.* at 37-39.) Because of its relative simplicity, however, it has been determined by a number of district courts to be an acceptable methodology for ascertaining reasonable royalty damages. (*Id.* at 39-41.) While the Federal Circuit had never directly ruled on the propriety of the 25 percent rule before *Uniloc*, it had implicitly accepted the rule in cases where the parties had not directly challenged it. (*Id.* at 39.) The *Uniloc* case thus represented, according to the court, the first opportunity for the Federal Circuit to consider directly the propriety of the 25 percent rule of thumb.

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underpinnings of the 25 percent rule and its use in the district courts, the Federal Circuit flatly disapproved it:

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. (Slip Op. at 41.)

The Federal Circuit rejected the application of the rule not only as the basis for a final conclusion of damages, but also as a starting point for the application of the so-called *Georgia-Pacific* factors (*Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970)) that district courts typically use as a tool to determine reasonable royalties, with the Federal Circuit's repeated approval. (Slip Op. at 46.) As the court observed, "beginning from a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the facts of the case nevertheless results in a fundamentally flawed conclusion." (*Id.*)

Beyond its express disapproval of the 25 percent rule, the *Uniloc* court reaffirmed the fundamental proposition that the testimony and economic theory utilized by economic experts who offer opinions on reasonable royalty rates and damages must be tied to the specific facts of each case. (*Id.* at 45-46.) Generalized rules of thumb or other simplifying techniques in damages analysis are unlikely to pass muster in future cases brought before the Federal Circuit. While rejecting a "one-size-fits-all" approach to patent infringement damages, *Uniloc* leaves plenty of room for the application of sound economic theory to the factual record developed during the course of litigation.

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2011

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