$388M Verdict Reversed, Experts Recalculate

By Robert Ambrogi

Damages experts in patent cases may be heading back to the drawing board after the Federal Circuit Court of Appeals set aside a $388 million jury verdict against software giant Microsoft Corp. The court concluded that a formula widely used by experts to calculate reasonable royalties in patent litigation is "fundamentally flawed" and does not stand up to the test for admissibility of expert testimony.

At issue in the case was the so-called 25 percent rule of thumb, a tool used by licensing and accounting experts to approximate the reasonable royalty rate that a manufacturer would be willing to pay for a license to use a patented product. Although it has its critics, the 25 percent rule is commonly used in patent litigation, particularly in software cases, and its admissibility into evidence is rarely challenged.

Even the Federal Circuit, by its own admission, "has passively tolerated" the use of the rule "where its acceptability has not been the focus of the case."

All that changed Jan. 4 with the circuit court's ruling in an infringement lawsuit brought by software company Uniloc USA involving product-activation technology used by Microsoft in its Office XP, Office 2003 and Windows XP products. The court squarely rejected the rule as a basis for calculating damages.

"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," Circuit Judge Richard Linn wrote for the appellate panel, which also had Circuit Chief Judge Randall R. Rader and Circuit Judge Kimberly A. Moore. "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."

Determining a Reasonable Royalty

Federal patent law sets the measure of damages for infringement as "in no event less than a reasonable royalty for the use made of the invention by the infringer." Establishing a reasonable royalty has proved to be a vexing challenge in litigation. Courts often look to what the parties might have agreed to as a royalty in a "hypothetical negotiation" at the time the infringement began.

The 25 percent rule evolved as a way of approximating the reasonable royalty that a licensee would be willing to pay in such a hypothetical negotiation. The rule assumes that the licensee would be willing to pay a royalty equivalent to 25 percent of its expected profits from the use of the patented technology.

Relying on this rule, Uniloc's expert witness testified that Uniloc's damages were $565 million. He arrived at this figure by using Microsoft's own appraisal that set the value of the product-activation key as at least $10. Applying the 25 percent rule to arrive at a royalty of $2.50, he then multiplied that by the number of units Microsoft sold, nearly 226 million, to arrive at his conclusion.

As a way of checking the reasonableness of his conclusion, the expert performed a second calculation. He estimated the gross revenues for the products at issue in the case and then determined the percentage of that amount that the damages would represent. Figuring that Microsoft's gross revenues would have been $19.28 billion, his damages number of $565 million would be 2.9 percent of that total. This confirmed his opinion that the royalty he had calculated was reasonable, he testified.

No Basis in Fact

For the Federal Circuit, the fundamental flaw in the 25 percent rule is that it is arbitrary and generic and bears no relation to the facts of any particular case. If the testimony of an expert has no relation to any issue in the case, then it is not relevant and should not be admitted, the court reasoned, quoting the Supreme Court's seminal case on the admissibility of expert testimony, *Daubert v. Merrell Dow Pharmaceuticals Inc.*, 509 U.S. 589 (1993).

"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 Federal Circuit said. "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."

When Uniloc's expert was asked in his testimony about his basis for using the 25 percent rule, he answered that it is "widely accepted" and that he has seen it used by others. But he offered no testimony tying the 25 percent rate to the specific parties or technology at issue in this case.

"[The expert's] starting point of a 25 percent royalty had no relation to the facts of the case, and as such, was arbitrary, unreliable, and irrelevant," Judge Linn wrote. "The use of such a rule fails to pass muster under *Daubert* and taints the jury's damages calculation."

Guidelines for Future Cases

For lawyers and experts alike in patent litigation, the Federal Circuit's unequivocal rejection of the 25 percent rule may have them heading back to the drawing board with regard to damages estimates in other cases. Fortunately, the court offered guidance as to what types of evidence they can use going forward.

"To be admissible, expert testimony on a reasonable royalty rate must 'carefully tie proof of damages to the claimed invention's footprint in the market place,'" the court said, quoting from its earlier opinion involving reasonable royalty rates, *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860 (Fed. Cir. 2010).

For more on the *ResQNet* case, see the previous Bullseye article, Top 10 Expert Rulings of 2010.

As it has done before, the court expressly sanctioned the use of the so-called *Georgia-Pacific* factors, a set of considerations for calculating a reasonable royalty derived from the opinion, *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970).

"In particular, factors 1 and 2 – looking at royalties paid or received in licenses for the patent in suit or in comparable licenses – and factor 12 – looking at the portion of profit that may be customarily allowed in the particular business for the use of the invention or similar inventions – remain valid and important factors in the determination of a reasonable royalty rate."

Even so, the court cautioned that any evidence involving these factors "must be tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time."

Use of 'Entire Market Value Rule'

In a separate section of its opinion, the court discussed the expert's use of Microsoft's gross revenue as a "check" on the reasonableness of his royalty rate. The court concluded that the expert's use of the "entire market value rule" was improper and should not have been admitted into evidence.

While not rejecting the rule outright, the court said that it applies only to cases in which the patented feature creates the "basis for customer demand" or "the value of the component parts." In this case, the product-activation technology played no part in creating customer demand—to the contrary, it was there to protect Microsoft against pirated use of its products.

It did not matter that the expert used the rule only as a check and not as his primary method of calculating damages, the court said, because it contributed to the overall legitimacy of the expert's conclusion. "Even if the jury's damages calculation was not based wholly on the entire market value check, the award was supported in part by the faulty foundation of the entire market value."

The Federal Circuit's ruling sends the case back to U.S. District Court in Rhode Island, where there will be a new trial on the issue of damages.

Uniloc USA, Inc. v. Microsoft Corporation, ___ F.3d ___ (Fed. Cir. Jan. 4, 2011).