WSGR ALERT

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UNILOC V. MICROSOFT: FEDERAL CIRCUIT CONFIRMS NECESSITY OF TYING DAMAGES THEORY TO FACTS OF THE CASE

The Federal Circuit's January 4, 2011, ruling in *Uniloc USA Inc. v. Microsoft Corp.*[1] is a significant decision regarding damages recovery in patent infringement claims. The *Uniloc* holding abolished the "25 percent rule"—a methodology sometimes used to calculate reasonable royalty for infringement damages—as a "fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation."[2] And, in keeping with the recent trend of denying overly broad applications of the "entire value market rule," the Federal Circuit rejected the methodology used by Uniloc's expert because the patented invention did not drive consumer demand for the accused products.[3]

In short, *Uniloc v. Microsoft* signals that to prevail on a damages claim, the patentee must carefully lay a factual foundation that establishes the relevance of any analytical tool used by the patentee's expert to the facts of the case—the patents in suit, the products, and the parties.

Background

Uniloc's U.S. Patent No. 5,490,216 ("'216 patent") is directed to a software registration system that deters the improper copying of software. The system allows the software to run without restrictions (in "use mode") only if the system determines that the software installation is legitimate.

Uniloc accused Microsoft's Product Activation feature, which acts as a gatekeeper to Microsoft's Word XP, Word 2003, and Windows XP software programs, of infringing the '216 patent. The jury returned a verdict of willful infringement, rejected Microsoft's invalidity defenses, and awarded Uniloc $388 million in damages. The district court granted a new trial on damages based on the improper use of the entire market value rule. On appeal, the Federal Circuit affirmed the district court's ruling on the basis that the damages award was fundamentally tainted by the use of a legally inadequate methodology.

The Federal Circuit Decision – Damages

The "25 Percent Rule"

To determine its $338 million damages award, the jury relied on two different analytical tools used by Uniloc's expert: the 25 percent rule and the entire market value rule. The 25 percent rule, used by Uniloc's expert, is a tool that has been used to approximate the reasonable royalty rate that the manufacturer of an accused product would be willing to offer to pay the patentee during a hypothetical negotiation. The rule apportions 25 percent of the value and profits of the accused product to the patent holder and the remaining 75 percent to the manufacturer.

The Federal Circuit acknowledged that it had passively tolerated the use of the 25 percent rule in the past.[4] However, in *Uniloc*, the court rejected the expert's reliance on the 25 percent rule as an arbitrary "one size fits all" approach. The court expressly held that the 25 percent rule was a fundamentally flawed tool because it failed to tie the reasonable royalty base to the facts of the case at issue, namely "the three P's"—the patents in suit, the products, and the parties.[5]

Any tool or methodology must take into account the unique relationship between the patent and the accused product (i.e., the importance of the patented feature to the profits of the product sold, or the potential availability of close substitutes or equally attractive noninfringing alternatives).[6] It also must account for the unique relationship between the parties, such as the different levels of risk assumed by a licensor and licensee.[7] Unless the patentee sufficiently ties the use of any given methodology to the unique facts of the case, it is unlikely the patentee will meet his burden. In short, Uniloc failed to meet its burden because the expert's starting point of a 25 percent royalty had no relation to the facts of the case.

The Entire Market Value Rule

Under the entire market value rule, a patentee may seek damages based on the

[1] *Uniloc USA Inc. v. Microsoft Corp.,* No. 03-CV-0440 (Fed. Cir. Jan. 4, 2011).
[2] Slip Op. at 41.
[3] Slip Op. at 54.
[4] Slip Op. at 39.
[5] Slip Op. at 41, 43.
[6] Slip Op. at 38.
[7] Slip Op. at 38.

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value of an entire apparatus when the patented invention is merely a single component if three conditions are met: (1) the infringing component must form the basis for customer demand for the entire machine, including the parts beyond the claimed invention; (2) the infringing and noninfringing components must be sold together as a functional unit or be parts of a complete machine; and (3) individual infringing and noninfringing components must be analogous to a single functioning unit.[8]

Uniloc's expert used the entire market value rule to "check" his initial damages calculation, by estimating the gross revenues for the accused products at $19.28 billion. Based on this figure, the expert concluded that his initial damages calculation resulted in a royalty rate well within the range of reasonable royalty rates for software.[9] The Federal Circuit held that because Uniloc failed to show that the patented invention was the basis for consumer demand for the accused products, the use of the entire gross revenue of Outlook and Windows was a violation of the rule.[10] The court stated that once the expert disclosed the amount of estimated revenue Microsoft earned on the infringing products, "[t]he $19 billion cat was never put back into the bag," regardless of whether or not Uniloc adequately demonstrated that the entire market value for the accused products was derived from the patented invention.[11]

Ultimately, the Federal Circuit reiterated that it is now clearly the case that all the evidence on damages, whether allegedly precedential licenses, the entire market value evidence, or analytical tools such as the 25 percent rule, must be closely tied to the circumstances of the particular case and be shown to accurately reflect the value of the patented invention to the product and market under consideration.

For more information on the *Uniloc v. Microsoft* decision or any related matter, please contact a member of Wilson Sonsini Goodrich & Rosati's intellectual property litigation practice.

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[8] *See Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 286-87 (N.D.N.Y. 2009).
[9] Slip Op. at 34-35.
[10] Slip Op. at 51-52.
[11] Slip Op. at 51-52.