# Client Alert.

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# Damages Experts in Patent Cases Can No Longer Use the "25 Percent Rule of Thumb" to Determine Royalty Rates

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How should a patent holder and a company that infringes a patent divide the profits obtained by use of the patent holder's invention? This question forms a vital part of the "hypothetical negotiation" that determines the damages that are awarded in most patent cases. For at least 15 years, many damages experts have employed the "25 percent rule of thumb" to support their conclusions on this question. On January 4, 2011, the Federal Circuit put an end to this process:

"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." (*Uniloc USA v. Microsoft Corp.*, slip op. at 41 (Jan. 4, 2011)).

While the Federal Circuit's opinion addressed a number of other liability and damages issues, *Uniloc* will certainly be remembered for the ruling quoted above. In its rejection of the 25 percent rule of thumb, the Federal Circuit echoed other recent decisions that have sought to rein in large damages verdicts awarded by juries in patent cases. Many in industry will likely applaud the Federal Circuit's decision because they believe that the 25 percent rule of thumb arbitrarily pushed damages awards higher. Nonetheless, because the opinion eliminates the use of this "rule of thumb" without replacing it with a new rule on how to split the profits earned by an infringer, only time and more verdicts will tell if the decision reduces, increases, or has no affect on the size of jury awards.

In the case that was on appeal, Uniloc sued Microsoft in the District of Rhode Island for infringing U.S. Patent No. 5,490,216, which patents a method designed to combat the casual copying of software. Uniloc accused a software activation feature for Microsoft's Word XP, Word 2003, and Windows XP of infringing the '216 patent. At trial, the jury found Uniloc's patent valid and willfully infringed by Microsoft and awarded Uniloc $388 million in damages. After the trial, the district court granted Microsoft's motion for judgment as a matter of law that the '216 patent was not infringed and that there was no willfulness, and in the alternative granted a new trial on these issues. The district court also ordered a new trial on damages. The district court denied Microsoft's motion for judgment of a matter of law that the '216 patent was invalid. On appeal, the Federal Circuit reversed the district court's holding regarding infringement, and reinstated the jury's verdict that the patent was valid and infringed. The Federal Circuit agreed, however, that there should be a new trial to determine the appropriate measure of damages.

In its opinion, the Federal Circuit stated that a new damages trial was necessary because of Uniloc's damages expert's reliance on the 25 percent rule of thumb. In determining the amount of the reasonable royalty sufficient to compensate a patentee for infringement, damages experts generally conduct a "hypothetical negotiation," which attempts to derive the royalty the parties would have negotiated. Here Uniloc's damages expert began his analysis from the premise that a

typical patentee would be able to command a royalty equal to 25 percent of the expected profit generated by the use of the invention in the infringing product. From this baseline, Uniloc's damages expert then evaluated whether to increase or decrease the rate based on the 15 factors set forth in *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970). Uniloc's expert concluded that a baseline royalty rate of $2.50 per licensed product was the appropriate royalty. Applying this rate to the 225,978,721 Windows licensed products resulted in a total requested damages amount of $564,946,803. The jury awarded 69 percent of the requested amount.

In considering whether it was appropriate to use the 25 percent rule of thumb, the Federal Circuit analyzed prior cases that applied the rule as well as scholarship in the legal and economic fields that had referred to the rule. The court acknowledged that prior court decisions had passively tolerated the rule's use since at least 1977. Nonetheless, addressing the issue square-on, the Federal Circuit held that Uniloc's expert started in the wrong place. "[T]he 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation." (Slip op. at 41.) The Federal Circuit echoed other recent decisions regarding the use of prior license agreements in damages analysis and emphasized the importance of case-specific evidence to justify an expert's methodology when calculating a reasonable royalty to be awarded as damages. "The meaning of these cases is clear: 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 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement." (Slip op. at 45.) The expert improperly used "the 25% rule of thumb as an arbitrary, general rule, unrelated to the facts of this case." (Slip op. at 47.)

Uniloc's attempt to defend its expert's use of the rule by pointing to the Georgia-Pacific analysis was unsuccessful. The Federal Circuit wrote that it "is of no moment that the 25 percent rule of thumb is offered merely as a starting point to which the Georgia-Pacific factors are then applied to bring the rate up or down. 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." (Slip op. at 46.) From now on, the district courts must exercise their gate-keeping function to prevent evidence based on the 25 percent rule of thumb from going to the jury, unless there are concrete, case-specific facts that would support its application.

The Federal Circuit's opinion also addressed the entire market value rule, which has been another hot topic in the determination of patent damages. As a validation of Uniloc's damages theory, Uniloc's expert testified that he performed a "check" by comparing the total requested damages to the total revenues that Microsoft obtained from the licensed software (some $19 billion). This comparison made the requested damages appear small—only 2.9% of revenues from the infringing products. That, however, was the problem. The Federal Circuit agreed with the district court that reference to the entire market value of a product is inappropriate in cases where the asserted patent does not drive demand for the accused product. The Federal Circuit noted that Uniloc had conceded that "customers do not buy Office or Windows because of Product Activation." (Slip op. at 49.) Uniloc could not escape the affect of its concession just because its expert used the revenues as a "check" and not as the basis for his calculations.

The Federal Circuit's decision offers Microsoft a new opportunity to reduce the damages that it will pay Uniloc for its infringement. The Court's combined rulings on the 25 percent rule of thumb and the entire market value rule also seem likely to drive the ultimate award down. But what do they mean for everyone else?

The answer is unclear. From here on out, no well-informed lawyer or damages expert will make reference to or rely on the 25 percent rule of thumb in any expert report or testimony. How then will experts divide the profits obtained from use

of an invention? The opinion points strongly to the importance of case-specific evidence regarding the value of the invention, its economic benefits and the standards used by the involved parties or by others in the industry to divide the economic benefits obtained from technological improvements. Depending on the evidence, patent holders and their experts may argue that the split should be more than, less than, or exactly 25 percent. Alternatively, they might use a wholly different method of analysis. Time will tell if the new metrics will pass muster with the courts or obtain traction with juries. In the meantime, the Federal Circuit has relegated the otherwise commonly applied 25 percent rule of thumb to the legal trash heap.

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