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Jennifer L. Dzwonczyk

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Federal Circuit Rejects Use of the 25 Percent "Rule of Thumb" in Patent Damages

On January 4, 2011, the Federal Circuit threw out the use of the "25 percent rule of thumb" in patent damage awards and also placed limitations on the "application of the entire market value rule."

In a lengthy decision on a number of issues, the Federal Circuit (J. Linn*, C.J. Rader, and J. Moore) threw out the often-used "25 percent rule of thumb" as a matter of Federal Circuit law:

The 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 underlying case

Uniloc's U.S. Patent No. 5,490,216 relates generally to a software registration system to deter unauthorized software copying, by allowing the software to run in "use" mode, as opposed to "demo" mode, only if a local license identifier matches the identifier generated by the vendor's remote system.

Uniloc accused Microsoft's Product Activation feature, utilized in Microsoft's Word and Windows XP products, of infringement. During installation of these products, users enter a unique, valid alphanumeric product key in order to activate the software.

The 25 Percent Rule Of Thumb

At trial, Uniloc's expert, Mr. Gemini, opined that damages should be \$564,946,803 based on a hypothetical negotiation between the parties and the *Georgia-Pacific* factors. Relying principally upon a Microsoft document attributing a monetary value range to the product key, Mr. Gemini took the lowest value of that range, \$10, and applied the 25 percent rule of thumb to serve as his baseline royalty calculation of \$2.50 per license.¹ Thus, Mr. Gemini multiplied the 225,978,721 licenses by the \$2.50 royalty to generate Uniloc's reasonable royalty figure of \$564,946,803. Ultimately, the jury awarded Uniloc \$388 million.

The Federal Circuit's opinion, authored by Circuit Judge Linn, discussed the origins of and general acceptance of the 25 percent rule of thumb in some detail, noting that the Federal Circuit had "passively tolerated its use where its acceptability ha[d] not been the focus of the case." (Slip Op., at 39.) However, the Court also recognized that the admissibility of this rule had never been squarely presented to it. (*Id.*)

Reiterating *Daubert* and *Kumho Tire*, the Court emphasized the importance of ensuring that all FRE 702 expert testimony be specifically tied to the facts of the case. "If the patentee fails to tie the theory to the facts of the case, the testimony must be excluded." (Slip Op., at 42.) Highlighting three recent cases where the Federal Circuit had rejected reliance on prior unrelated licenses, this Court found that relying on the 25 percent rule of thumb in a reasonable royalty calculation would be "far more unreliable and irrelevant than reliance on parties' unrelated licenses, which we rejected in *ResQNet* and *Lucent Technologies*." (*Id.*, at 45.) "In short, Gemini'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." (*Id.*, at 47.) The Federal Circuit therefore affirmed the grant of a new trial on damages.

The Entire Market Value Rule

Additionally, Mr. Gemini performed a "check" to determine whether his royalty figure was reasonable, by comparing it to his calculation of Microsoft's approximate total revenue for Office and Windows of \$19.28 billion. Thus, Mr. Gemini testified during trial that his calculated royalty accounted for only 2.9% of Microsoft's revenue, and that in his experience, royalty rates for software tended to be above 10 or 11%.

The district court agreed with Microsoft that Uniloc's use of the entire market value rule was improper because it was undisputed that Product Activation did not create the basis for customer demand for the accused products nor substantially created the value of the accused products, and granted a new trial on damages.

On appeal, the Federal Circuit affirmed, reiterating that the entire market value rule permits a patentee to assess damages based upon the entire market value of the accused product *only* where the patented feature creates the basis for customer demand or substantially creates the value of the component parts. (Slip Op. at 51.) As there was no basis for this connection, Uniloc inappropriately relied upon the entire market value rule, and a new trial was appropriate on these grounds as well.

Other Issues

The Federal Circuit also reversed the district court's judgment as a matter of law that Microsoft did not infringe, affirmed the district court's judgment as a matter of law that there was no willfulness, and affirmed the district court's denial of judgment as a matter of law of invalidity.

Practical Effect

This decision will have substantial impact in patent damage awards as plaintiffs often rely upon, at least in part, the 25 percent rule of thumb. This case also should limit the number of damage awards which may be premised upon the entire market value rule.

¹ Mr. Gemini considered the *Georgia-Pacific* factors but concluded that they balanced out and did not ultimately affect the baseline royalty rate.