

March 24, 2011

### **The Federal Circuit Rejects the 25 Percent Rule as Fundamentally Flawed and Reviews the Entire Market Value Rule for Calculation of Patent Infringement Damages**

In a decision concerning the so-called “25 percent rule” and “the entire market value rule,” the Federal Circuit in the case of *Uniloc USA, Inc. et al. v. Microsoft Corp.*, Nos. 2010-1035, -1055 (Fed. Cir. Jan. 4, 2011), affirmed the U.S. District Court for the District of Rhode Island’s grant of a new trial on damages on the improper use of the entire market value rule. The Rhode Island District Court allowed Uniloc’s damages expert to proffer testimony on the 25 percent rule, which he did in addition to proffering testimony on the entire market value rule. The jury awarded Uniloc damages of \$388 million based on the testimony of Uniloc’s damages expert. On appeal, the Federal Circuit reviewed the propriety of the 25 percent rule, the application of the entire market value rule, and the excessiveness of the jury’s damages award.

Plaintiff Uniloc asserted claims of U.S. Patent No. 5,490,216 (the ’216 patent) against defendant Microsoft Corporation. The ’216 patent relates to a software registration system designed to deter copying of software by allowing the software to run without restrictions only if the system determines that the software installation is legitimate. Microsoft was accused of infringement by way of its Product Activation feature that acts as a gatekeeper to Microsoft’s Word XP, Word 2003, and Windows XP software programs. The feature requires the user to enter a 25-character alphanumeric product key contained within the packaging of Microsoft’s retail products. After entering a valid key, the user is asked to agree to Microsoft’s End User License Agreement, after which the licensor-licensee relationship is initiated.

The district court denied Microsoft’s pre-trial motion *in limine* seeking to exclude Uniloc’s expert’s trial testimony using the so-called 25 percent rule. In denying Microsoft’s motion *in limine*, the district court found that the 25 percent rule had been widely accepted in patent infringement cases. The district court judge noted that “the concept of a ‘rule of thumb’ was perplexing in an area of the law where reliability and precision are deemed paramount,” but rejected Microsoft’s request to exclude the 25 percent rule because the rule has been widely accepted. The district court thus considered Uniloc’s expert’s use of the “25 percent rule of thumb” to be reasonable. The district court, however, agreed with Microsoft regarding a second damages issue. Namely, the district court agreed that the Uniloc’s expert’s use of the entire market value rule as a “check” was improper because the allegedly infringing feature of Microsoft’s accused software products was not shown to be the basis of consumer demand for the accused products. The district court, therefore, granted Microsoft’s posttrial motion for a new trial on damages.

On appeal, the Federal Circuit first addressed the 25 percent rule. The Federal Circuit noted that “[t]he 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.” According to the 25 percent rule, the licensee pays “a royalty rate equivalent to 25 percent of its expected profits for the product that incorporates the IP at issue.” The Federal Circuit went on to emphasize that the rule has “met its share of criticism,” primarily under three categories. First, the 25 percent rule “fails to account for the unique relationship between the patent and the accused product.” Second, the rule “fails to account for the unique relationship between the parties.” Third, “the rule is essentially arbitrary and does not fit within the model of the hypothetical negotiation within which it is based.”

The Federal Circuit discussed *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 589 (1993), a seminal U.S. Supreme Court case on the issue of using expert testimony, which assigned the responsibility to district courts to ensure that “all expert testimony must pertain to ‘scientific, technical, or other specialized knowledge’” under the Federal Rules of Evidence. As a result, the Federal Circuit rejected the 25 percent rule. Specifically, it held that “the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation” and, furthermore, held that evidence relying on the rule is 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.”

The Federal Circuit, after striking down the 25 percent rule, reviewed Uniloc’s damages expert’s application of the entire market value rule. It reaffirmed that “[t]he entire market value rule allows a patentee to assess damages based on the entire market value of the accused product only where the patented feature creates the ‘basis for customer demand’ or ‘substantially create[s] the value of the component parts.’” Because it was undisputed that the accused Product Activation feature did not create the basis for customer demand, the Federal Circuit affirmed the district court’s ordering of a new trial on damages.

The Federal Circuit found that use of the entire market value rule by Uniloc’s expert as a “check” was improper. For the entire market value rule to apply, “the patentee *must* prove that the patent-related feature is the basis for customer demand.” During the district court trial, after having heard Uniloc’s damages expert testify about the entire market value of the accused products being \$19 billion, the jury was instructed that it could not, however, award damages based on Microsoft’s entire revenue from all the accused products in the case. Nonetheless, “[a]s the district court aptly noted, ‘[t]he \$19 billion cat was never put back into the bag.’” Because “the entire market value of the accused products has not been shown to be derived from the patented contribution,” its consideration here by the jury at the district court was in “clear derogation of the entire market value rule.” Therefore, “the district court did not abuse its discretion in granting a conditional new trial on damages for Uniloc’s violation of the entire market value rule.”

A copy of the slip opinion can be found at <http://www.cafc.uscourts.gov/images/stories/opinions-orders/10-1035.pdf>.

## Updates on Transfers in the Eastern District of Texas

### 1. *Microsoft*: Transferred from Texas to Washington State

In November 2010, the Federal Circuit ordered a case transferred out of the Eastern District of Texas in *In re Microsoft Corporation*, No. 2010-M944 (Fed. Cir. Nov. 8, 2010). This is one of a line of cases attempting to transfer lawsuits out of one of the most frequently selected forums for patent infringement claims.

Over the course of the last two years, the Federal Circuit has redefined the landscape for cases brought before the U.S. District Court for the Eastern District of Texas by nonpracticing entities (NPEs—sometimes referred to as “patent trolls”). Specifically, since the Fifth Circuit issued its *en banc* decision providing new guidance on the standard for transferring cases in *In re Volkswagen of America, Inc.*, 545 F.3d 304 (5th Cir. 2008) (*en banc*), the Federal Circuit has found ample opportunity to interpret that case and apply its holdings to patent infringement actions in the Eastern District of Texas. Based on the *Volkswagen* case, the Federal Circuit has granted numerous mandamus petitions forcing the Eastern District of Texas courts to transfer cases out of that district.<sup>1</sup> The Federal Circuit in *In re Microsoft Corporation* rejected another argument that plaintiffs have relied on to keep their cases in the Eastern District of Texas.

In the underlying district court case, plaintiff Allvoice Developments (Allvoice) filed a patent infringement action against Microsoft Corporation in the Eastern District of Texas alleging infringement of patented speech recognition technology based on functionality found in certain Microsoft operating systems. Allvoice incorporated its company in Texas just 16 days before filing the suit against Microsoft and maintains a physical office in Tyler, Texas (located in the Eastern District). However, Allvoice has no employees at its Tyler office or anywhere in the United States. Microsoft sought transfer to the Western District of Washington, where Microsoft’s headquarters and a substantial number of employees are located. Microsoft indicated that all of its witnesses knowledgeable with the sales, marketing, and product direction for its accused products reside in the Western District of Washington, and all of the relevant documents and evidence relating to the marketing, development, and design of the accused products are also in that district.

The district court denied transfer based in large part on the fact that Allvoice was incorporated under the laws of Texas and maintained an office in Tyler, Texas. The district court also held that third-party witnesses located in New York, Massachusetts, and Florida would find Texas more convenient than Washington, and that access to documents only slightly favored transfer because Allvoice’s documents were at its offices in the Eastern District of Texas.

The Federal Circuit disagreed and ordered the case to be transferred to the state of Washington. The Federal Circuit found that Allvoice’s alleged ties to Texas and the Eastern District forum, including incorporating under the laws of Texas just before bringing suit, were clearly in anticipation of litigation and were nothing more than an attempt to manipulate venue. In reaching its conclusion to order transfer to the Western District of Washington, the Federal Circuit again stressed that “courts [should] ensure that the purposes of jurisdictional and venue laws are not frustrated by a party’s attempt at manipulation.” The Federal Circuit again recounted its recent mandamus decisions that help define the

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1. See, e.g., *In re Zimmer Holdings, Inc.*, 609 F.3d 1378 (Fed. Cir. 2010) (Morgan Lewis IP Update, September 22, 2010); *In re Nintendo Co.*, 589 F.3d 1194 (Fed. Cir. 2009); *In re Hoffmann-La Roche Inc.*, 587 F.3d 1333 (Fed. Cir. 2009); *In re Genentech, Inc.*, 566 F.3d 1338 (Fed. Cir. 2009); and *In re TS Tech USA Corp.*, 551 F.3d 1315 (Fed. Cir. 2008).

boundaries for bringing—and keeping—cases in a particular district, ultimately deciding that the facts in this case favored transfer.

The *Microsoft* case is another point of reference for companies that find themselves defending patent infringement cases in the Eastern District of Texas. When the plaintiff has no legitimate ties to that district, but attempts to create ties to that district to manipulate a tie to the Texas venue, there is a higher probability that the case can be successfully transferred to a more convenient forum.

A copy of the opinion can be found at <http://www.cafc.uscourts.gov/images/stories/opinions-orders/2010-m944.11-8-10.1.pdf>.

## **2. *Vistaprint*: No Transfer Out of Texas**

In December 2010, after ordering the *Microsoft* case transferred out of Texas in the *In re Microsoft Corporation* case (discussed above), the Federal Circuit allowed the pendulum to swing back and declined to transfer a case out of the Eastern District of Texas. In the case of *In re Vistaprint Limited and Officemax Inc.*, No. 954 (Dec. 15, 2010), the Federal Circuit clarified the judicial economy standard set out in the earlier case *In re Zimmer Holdings, Inc.*, 609 F.3d 1378 (Fed. Cir. 2010).

The Federal Circuit held that denying a transfer in the *Vistaprint* case was warranted based in part on “more than negligible” gains in judicial economy. In the *Vistaprint* case, the district court had substantial experience with the patent based on a prior litigation and had issued a lengthy claim construction opinion; there was also a second co-pending case before the court involving the same patent. Therefore, based on the judicial economy and an individualized consideration of all factors, the Federal Circuit agreed that the case should remain in the Eastern District of Texas.

The Federal Circuit also noted that, oftentimes, a transfer analysis may dictate only one correct outcome, and in those cases (e.g., *In re Microsoft*), transfer may be appropriate. However, in other cases, the transfer analysis may create a reasonable range of choices. And, “[u]nder such circumstances, it is entirely within the district court’s discretion to conclude that in a given case the . . . factors of public interest or judicial economy can be of ‘paramount consideration,’ and as long as there is plausible support of record for that conclusion we will not second guess such a determination, even if the convenience factors call for a different result” (citation omitted). Such was the case in the case of *In re Vistaprint*.

However, the Federal Circuit also cautioned that its holding is not intended to give patent owners a free pass to maintain all future litigations involving the same asserted patent(s) in the same venue. Instead, a lower court’s decision to deny transfer will be upheld where there are sufficient gains in judicial economy and when the lower court performs a detailed analysis of the other factors explaining why the case should not be transferred.

A copy of the opinion can be found at <http://www.cafc.uscourts.gov/images/stories/opinions-orders/10-m954o.pdf>.

## **3. *Aliphcom*: Transferred from California to Texas**

In February 2011, just a few months after denying a transfer in the case of *In re Vistaprint* (discussed above) based on judicial economy, the Federal Circuit refused to vacate an order transferring a case *into*

the Eastern District of Texas from California based on similar reasoning. See *In re Aliphcom*, No. 971 (Feb. 9, 2011).

In May 2010, Aliphcom received a letter indicating that some of its products were infringing two patents owned by patentee Wi-LAN. One week later, Aliphcom filed a declaratory judgment action in the Northern District of California seeking declarations of invalidity and noninfringement of the Wi-LAN patents. Wi-LAN then requested a transfer of the declaratory judgment action to the Eastern District of Texas where it was currently litigating two previously filed suits involving the same patents.

The district judge in the Northern District of California agreed with Wi-LAN and ordered the case to be transferred to the Eastern District of Texas, finding that although certain factors counseled in favor of keeping the case in California, “the risk of inconsistent judgments and waste of judicial resources must outweigh the equitable concerns of Aliphcom’s convenience in litigating its claims.” Aliphcom petitioned the Federal Circuit to order the judge in the Northern District of California to vacate the transfer order and keep the case in California.

The Federal Circuit agreed with the California district court and allowed the transfer of the case to the Eastern District of Texas. In the wake of *Vistaprint*, it was no surprise that the Federal Circuit reiterated its analysis regarding judicial economy as a factor in determining whether a transfer should be granted. In particular, the Federal Circuit stated that “having the same . . . judge handle this and the co-pending case involving the same patent would be more efficient than requiring another magistrate or trial judge to start from scratch.” Therefore, the Federal Circuit ruled that the California district court did not clearly and indisputably abuse its discretion transferring the declaratory judgment case to Texas.

A copy of the opinion can be found at <http://www.ca9.uscourts.gov/images/stories/opinions-orders/2011-m971.2-9-11.1.pdf>.

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