

## Recent Developments in Patent Damages Law in the United States

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Over the past two years, the United States Court of Appeals for the Federal Circuit has issued several decisions intended to clarify the law of damages for patent infringement in the United States. All indications point to this trend continuing in 2011. Indeed, just four days into the new year, the Federal Circuit issued what many consider to be its most significant decision on damages in at least a decade. This decision, *Uniloc U.S.A., Inc. v. Microsoft Corp.*, did not just clarify existing law, it dramatically changed it. Although there is substantial debate among the patent community over whether the *Uniloc* decision is a significant improvement or an unfortunate step in the wrong direction, there is virtually unanimous agreement that it will change how patent infringement damages will be proven in future cases.

Uniloc's patent relates to a software registration system that prevents "casual copying"—the unauthorized use of software by a person who has "borrowed" an authentic installation disk from a licensed user. In the mid-1990's Microsoft, which was losing more than \$3.5 billion per year to casual copying, developed "Product Activation," an anti-piracy technology to prevent casual copying of its Windows and Office software products. Product Activation has been an enormous success for Microsoft, allowing Microsoft to generate billions of dollars in additional profits.

During trial, Uniloc set out to prove that Product Activation infringed Uniloc's patent and sought damages from Microsoft in the form of a "reasonable royalty." Under United States patent law, a reasonable royalty is an attempt to approximate the amount of money an invention is worth to an infringer. The most common way to approximate this value to imagine the result of a "hypothetical negotiation" between the patent owner and infringer at the time the infringement began. In this negotiation, both parties would know that the patent was valid and that what the infringer's planned activity infringed. The hypothetical negotiation attempts to estimate how much the infringer would have paid to engage in the infringing behavior. The result of the negotiation should not be too low—otherwise, the patent owner would not agree to license the patent—and the result should not be too high—otherwise, the infringer would switch to non-infringing technology or maybe even abandon the market altogether. The goal of the hypothetical negotiation exercise is to isolate the value of the invention.

At trial, Uniloc's damages expert engaged in a hypothetical negotiation analysis. He chose March 2001, when Microsoft first released Product Activation, as the hypothetical negotiation's date and discussed several Microsoft documents describing Product Activation's importance to Microsoft, Microsoft's high (81-87%) profit margin, and the fact that Product Activation was going to be used in Microsoft's most important products, Windows and Office. Uniloc's expert also isolated the value of the invention to Microsoft by relying on an internal "appraisal process" Microsoft had performed, which showed that Microsoft considered Product Activation to be "worth anywhere between \$10 and \$10,000" per activation. Uniloc's expert then conservatively chose the lowest reported value, \$10 per activation, and attempted to determine how Microsoft and Uniloc would have divided up that \$10 benefit in a hypothetical negotiation. To do this he applied the "25% rule," which assumes that an infringer would be willing to pay about 25% of the profits made from the infringement to the patent owner. He then took a number of other factors into account (such as the importance of

Product Activation to Microsoft and the parties' licensing practices) to determine that Microsoft would have agreed to pay \$2.50 per activation to Uniloc. He then applied that royalty to all infringing activations from the beginning of the damages period through the last date for which he had data. His data showed 225,978,721 activations, providing a total royalty of about \$565 million.

Recognizing that \$565 million was a large sum, Uniloc's expert then performed "a check to determine whether that number was reasonable." Microsoft's own documents showed that revenues from versions of Windows and Office with Product Activation amounted to more than \$19 billion and that Product Activation was responsible for about \$4.6 billion in additional profit. He then calculated that \$565 million amounted to an effective royalty of about 2.9% on the sales of the accused products, which, in his experience, was much lower than prevailing software royalty rates. He therefore concluded that a \$565 million royalty was "reasonable."

The jury found that Uniloc's patent was valid and infringed and that Microsoft should pay Uniloc about \$388 million in infringement damages. The Federal Circuit affirmed the jury's validity and infringement verdicts, but found that Uniloc's damages theory was flawed in two ways.

First, the Court determined that "the 25 percent rule of thumb is a fundamentally flawed tool" and that any damages analysis relying on it "is thus inadmissible." The Court reached this decision even though prior cases from the Federal Circuit had upheld damages awards based on the 25% rule. Moreover, the Court cited several studies showing that licensing experts and organizations not only consider the rule to be a useful "tool for analysis," but that fully 25% of licensing organizations use the rule "as a starting point in negotiations" and observed that "[l]ower courts have invariably admitted evidence based on the 25% rule, largely in reliance on its widespread acceptance or because its admissibility was uncontested." Nevertheless, the Court banned all future use of the 25% rule despite its widespread acceptance.

Second, the Court determined that Uniloc's expert's "check" of his damages award was improper. Specifically, the Court determined that where the patent covers just a part of a product, it is *never* proper to base a royalty on the product's price unless the patented feature is the source of consumer demand for the product. The Court determined that it did not matter that the effective royalty rate applied (2.9%) was much lower than prevailing royalty rates in the software industry even though another decision issued just a year earlier (*Lucent v. Gateway*) stated that there is nothing inherently wrong with "awarding a reasonable royalty based on either sale price or number of units sold" even where "the patented invention is a small component of a much larger commercial product" as long as the royalty rate applied (the percentage of the sale price awarded to the patent owner) was sufficiently low to accurately reflect the value of the invention. Indeed, more than sixty-five years ago, the Federal Circuit's predecessor articulated the common-sense rationale for such a rule: "It would make no difference in the ultimate compensation to plaintiff if the reasonable royalty were fixed at 5 percent of the selling price of the complete machine rather than 20 percent of one quarter of the sales price of the machine."

It is important to note that the *Uniloc* case is not yet over, and that both Uniloc and Microsoft have indicated that they will ask the other judges on the Court to review the original *Uniloc* decision (Microsoft will challenge the panel's holding of infringement and validity, and Uniloc will challenge the panel's decision on damages). While there is usually very little chance that the entire Court will grant any party's request that they rehear a case, many observers of the Court have stated that they believe the *Uniloc* decision's sweeping changes to patent law might make this a particularly good candidate for consideration by the entire court.

Stay tuned.

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