

Federal Circuit: Shifting Away From Estimated Patent Royalties

By Sean T. Carnathan,
Litigation News Associate Editor

Earlier this year, the U.S. Court of Appeals for the Federal Circuit issued a game-changing decision regarding the law of patent damages. In *Uniloc USA, Inc. v. Microsoft Corp.*, the court rejected as arbitrary and unreliable a previously well-recognized measure of patent damages, which used a rule of thumb of 25 percent to estimate a reasonable royalty for the patent holder.

Patent holder Uniloc sued Microsoft, alleging that a certain feature of Microsoft's Word and Windows software programs infringed its patent. The jury agreed, finding that Microsoft had willfully infringed Uniloc's patent. The jury awarded Uniloc \$388 million in damages, after hearing evidence and expert testimony regarding application of the 25 percent rule. The district court granted Microsoft's motion for judgment as a matter of law, however, nullifying the jury's damages award and leading to the appeal.

THE DEVELOPING LAW OF PATENT REMEDIES—FROM INJUNCTIONS TO DAMAGES

Uniloc likely represents a turning point in patent remedies. In its ruling rejecting the 25 percent rule as a measure of damages, the Federal Circuit noted that it had never before been squarely presented with an issue regarding application of the 25 percent rule, acknowledging that it had "passively tolerated" the use of this rule in the past.

"This is an early case in the development of the law of patent royalties, in which we will see the Federal Circuit play an active role," says Robert M. Asher, Boston, cochair of the Patents Subcommittee of the Section of Litigation's Intellectual Property Litigation Committee. For many years, explains Asher, injunctions were the usual goal in patent litigation. A plaintiff who established liability could virtually count on entry of an injunction in its favor. This changed in 2006, when the Supreme Court issued its decision

in *eBay v. MercExchange, L.L.C.*, in which it made injunctions more difficult to obtain. *eBay* set forth a four-part test to determine whether an injunction is warranted. After *eBay*, the focus for most patent plaintiffs then switched to damages, measured by lost profits flowing from the infringement. This measure of damages can be quite large but makes sense only for claims by a company against a competitor. For a plaintiff who is not competing in the market with the patent, the measure of damages applied is a "reasonable royalty."

UNILOC ABOLISHES 25 PERCENT RULE

Before the *Uniloc* decision, the 25 percent rule was a widely used tool to approximate the reasonable royalty rate a manufacturer of a patented product would pay. A royalty rate that is "reasonable" is one approximating the agreed-upon price for the invention in a hypothetical negotiation before infringement occurred. Such reasonable rates also are purportedly based on years of licensing and profit data.

After liability was established, Uniloc's expert applied this rule as a shortcut to simulating this hypothetical negotiation. In rejecting the 25 percent rule, the court emphasized the need for the expert to consider facts regarding the parties, type of technology, and industry to support application of such a general rule. As a result, the court held that evidence relying on the 25 percent rule is inadmissible as a matter of law because it fails to tie the royalty to the facts of the case.

The *Uniloc* decision also addresses the "entire market value rule," which allows a patentee to offer evidence of the entire market value of the product as a basis for estimating damages, but only when the patented feature is the "basis for customer demand." In *Uniloc*, the court held that admission of entire market evidence was improper where the patented feature was a very small component of the challenged product.

In addition to *Uniloc*'s rejection of a set percentage as a measure of reasonable royalties, patent practitioners see two fundamental concerns underpinning the *Uniloc* decision and the developing law of patent remedies. First, in recent years, "non-practicing entities," sometimes known pejoratively as "patent trolls," have become an increasingly large part of the patent litigation world, according to Asher. [See Patent Litigation Facts and Trends—Impact of Patent Trolls.] Non-practicing entities (NPEs) do not design, manufacture, or distribute products. These plaintiffs invest in patents to pursue infringement actions rather than to exploit the patented technology. Because these plaintiffs have no lost profits to pursue as damages, and because of the concern that their activity discourages innovation, the reasonable royalty measure of damages has become increasingly important.

Second, "this case is consistent with prior patent cases such as *Markman*," adds Asher, "which reflect a distrust of the jury's ability to handle patent cases. It reflects a concern about the trustworthiness of jury determinations and tries to withhold information that a jury may misconstrue."

PATENT LITIGATION FACTS AND TRENDS— IMPACT OF NON-PRACTICING ENTITIES



NPEs are significant players in the arena of patent infringement litigation—they are successful 31 percent of the time in pursuing infringement claims.



On the other hand, practicing entities have a success rate of 40 percent on infringement claims.



NPEs generally obtain higher damages awards. Since 2001, average damages awards for NPEs are more than triple those for practicing entities.

Source: **PriceWaterhouseCoopers 2010 Patent Litigation Study**

There is no consensus on theories of damages apportionment, as different companies take different positions based on their particular lines of business. For example, high-tech companies may embed hundreds of patented components within their products. With more potential infringement claims at stake, these companies support changes to current patent decisions and law. Pharmaceutical companies and biotech companies generally have a smaller number of patents covering their products and are less concerned with patent reform. NPEs, of course, would prefer retention of the 25 percent rule, which usually requires less proof for recovery.

FOR BETTER OR FOR WORSE?

"[The *Uniloc*] decision is a step in the right direction toward a better definition of what a royalty should be, but we have a long way to go," says Asher. "A reasonable royalty is not an easy thing to determine. It is never going to be a science."

"The courts are on the way to solving the substantive problems with patent damages," in cases such as *Uniloc* and *eBay v. MercExchange*, argues Mark A. Lemley, who is the William H. Neukom Professor of Law at Stanford University Law School and teaches intellectual property law.

Not everyone, of course, believes this change in the law is a positive development. Rather, the new rules are "ill-advised and contrary to the interests of patent owners' settled expectations," according to Donald R. Dunner, Washington, DC, past chair of the ABA's Section of Intellectual Property Law and the lawyer who argued the case for *Uniloc*. Before the *Uniloc* decision, the 25 percent rule had been an analytical tool in use for decades, explains Dunner, who asserts a change in the law of this magnitude should only be made by the court sitting en banc. *Uniloc* subsequently filed a petition for panel rehearing and rehearing en banc. When this article went to press, *Uniloc's* petition was still pending.

Uniloc is a clear signal that to prevail on an infringement claim, the patent holder must carefully lay a factual foundation that establishes the relevance of any analytical tool used by its expert to the facts of the case—the patents involved in the suit, the products, and the parties. It also is more likely that patent holders are going to encounter greater difficulty in recovering high royalty amounts as damages. Congress, however, may not be satisfied with solely relying on the appellate decisions to define how to achieve greater clarity and predictability in patent damages law.

PATENT REFORM LEGISLATION CURRENTLY PENDING

As court battles rage on, Congress continues to consider a legislative solution to patent reform. Lawmakers have introduced comprehensive patent reform legislation every year since 2006, and the debate is taking on more urgency. Congress is currently considering the latest iteration of a patent reform bill, the Patent Reform Act of 2011 [See Highlights of the Patent Reform Act of 2011], which includes further guidance to the courts regarding their duties as evidentiary gatekeepers for patent damages evidence. The goal of the bill, according to Senator Patrick Leahy (D-VT), one of the bill's sponsors, is to mandate "a rigorous gate keeping role for the court, pursuant to which judges will assess the legal basis for the specific damages theories and jury instructions sought by the parties. The gate keeping provisions will ensure consistency, uniformity, and fairness in the way that courts administer patent damages law." Under this "gate keeper" provision, the court would have to ensure a reasonable royalty is awarded for only the economic value attributable to the patent's specific contribution to the product, a theory known in the patent bar as "damages appor-

tionment." If passed, the legislation will be the most significant patent reform in over 50 years.

The proposed "patent reform bill would achieve two useful procedural goals," says Lemley. First, patent reform would "make sure that judges take seriously their responsibility to serve as a gatekeeper for damages theories. Currently, not all courts do. Second, reform legislation would permit phasing of patent trials so parties can have a real trial on damages. Under current decisions, some defendants are afraid to submit too much evidence on damages, in the event that they are deemed to be conceding liability," Lemley notes.

Although the full impact of *Uniloc* and the prospect of patent reform are undetermined, whatever the ultimate rules become, the law of patent damages will be fiercely debated in the coming years.

RESOURCES

- *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011).
- *eBay v. MercExchange, LLC*, 547 U.S. 388 (2006).
- ② A Closer Look: Patent Litigation Trends and the Increasing Impact of Nonpracticing Entities (PriceWaterhouseCoopers 2009), available at www.pwc.com/us/en/forensic-services/publications/2009-patent-litigation-study.jhtml.
- ② The Continued Evolution of Patent Damages Law (PriceWaterhouse Coopers 2010), available at www.pwc.com/us/en/forensic-services/publications/assets/2010-patent-litigation-study.pdf.

HIGHLIGHTS OF THE PROPOSED PATENT REFORM ACT OF 2011

FIRST-INVENTOR-TO-FILE

The act would move closer toward a first-to-file system, rather than a "first to invent." Each patent application would be given an "effective filing date," and the patentability would be judged on whether any prior art was available prior to the filing date.

DAMAGES

The act would require that a court "identify methodologies and factors that are relevant to the determination of damages" and that "only those methodologies and factors" be considered when determining the damages award. In addition, prior to the introduction of damages evidence, the court would be required to consider either party's contentions that the other's damages case lacks a legally sufficient evidentiary base, and must order bifurcation of the damages portion of a trial if requested.

TRENDS IN DAMAGES AWARDS (IN MILLIONS)

Both ranges show the average jury verdict award



Source: www.pwc.com/us/en/forensic-services/publications/assets/2010-patent-litigation-study.pdf

THE FTC WEIGHS IN

In its March 2011 survey, "The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition," the Federal Trade Commission discusses problems faced by U.S. courts in determining "reasonable royalties" and development of an economically grounded approach to calculating patent damages that more closely replicates the market value of the invention.

Source: www.ftc.gov/os/2011/03/110307patentreport.pdf