The Increased Scrutiny of Reasonable Royalty Damages Awards

By Steven R. Hansen – April 18, 2012

In *Uniloc USA Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011), the Court of Appeals for the Federal Circuit signaled that reasonable royalty damages awards in patent cases would be held to a higher level of scrutiny than in the past. The court condemned the widely used "25 percent rule of thumb" for apportioning the profits accruing from sales of an infringing product between a patent holder and infringer and also clamped down on the use of the "entire market value" rule for determining the "base" to which a royalty percentage would be applied. *Uniloc* came on the heels of *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009), which restricted the range of licenses that could be considered in performing a reasonable royalty analysis. While the decisions may be hailed as an effort to curb windfall damages awards, especially for seemingly "minor" improvement patents, they require a level of proof and analysis that may be difficult or, in some cases, impossible to meet. Moreover, because the patent holder bears the burden of proof on damages, the heightened scrutiny of damages proof may ultimately collide with the statutory mandate that patent holders receive no less than a reasonable royalty on a finding of infringement.

Reasonable Royalty Damages

Under 35 U.S.C. § 284, upon a finding of infringement, "the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty . . ." "A 'reasonable royalty' contemplates a hypothetical negotiation between a patentee and the infringer at the time before the infringement began." *Riles v. Shell Exploration & Production Co.*, 298 F.3d 1302, 1311 (Fed. Cir. 2002). "The statute guarantees patentees a reasonable royalty even when they are unable to prove entitlement to lost profits or an established royalty rate." *Id.* While the statute may guarantee a reasonable royalty, "[t]he patentee bears the burden of proving damages." *Uniloc*, 632 F.3d at 1315.

The so-called *Georgia-Pacific* factors are generally used to arrive at a reasonable royalty and include factors such as the royalties received by the patentee for licensing the patent in suit, the rates paid by the licensee for the use of other similar patents, the nature and scope of the license (e.g., exclusive versus nonexclusive, territorial limitations), the patent holder's policy regarding maintaining a monopoly or licensing the invention, and the commercial relationship between the parties (e.g., whether they compete). *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).

The royalty calculation can be done in different ways. For example, a "lump sum" royalty may be determined, which is a fixed amount of money paid by a licensee for use of a patented invention. Alternatively, a "running royalty" tied to the number of units sold by the infringer may be calculated. In the case of a running royalty, the calculation is often broken down into a "royalty base" (e.g., total revenues from the sale of infringing products) and a percentage that is applied to the royalty base to

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arrive at the infringer's royalty payment to the patent holder. *See Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1325–26 (Fed. Cir. 2009).Because of the nature of the *Georgia-Pacific* factors, expert testimony is typically used to establish reasonable royalty damages.

***Uniloc*, the 25 Percent Rule, and the Entire Market Value Rule**

Ultimately, a reasonable royalty must be grounded in the financial gain that the infringer obtains by virtue of using the patented invention. The question becomes how to use the *Georgia-Pacific* factors in view of the often limited data that are typically available in infringement litigation to arrive at a number. This can become particularly perplexing where the accused product includes unpatented features that may be responsible for the revenues and profits generated by sales of the product.

The 25 Percent Rule

To develop a starting point for arriving at a reasonable royalty, many damages experts have relied on the 25 percent rule. "The 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 pay to the patentee during a hypothetical negotiation. The Rule suggests that the licensee pay a royalty equivalent to 25 percent of its expected profits for the product that incorporates the IP at issue." *Uniloc*, 632 F.3d at 1312. The 25 percent rule has been widely used. As the *Uniloc* court noted, "Lower courts have invariably admitted evidence based on the 25% rule, largely in reliance on its widespread acceptance or because its admissibility was uncontested." *Id.* at 1314.

No more. The *Uniloc* court pronounced the death of the 25 percent rule, holding "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 . . ." *Id.* at 1315. As this holding suggests, many damages experts used the 25 percent rule to obtain a "baseline" royalty, which was then adjusted upward or downward based on the *Georgia-Pacific* factors. Unfortunately, *Uniloc* provides no guidance concerning how to determine a proper baseline royalty figure in the absence of such rules of thumb.

The Entire Market Value Rule

The *Uniloc* court also addressed the applicability of the "entire market value" rule in determining a royalty base. "The 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 creates the value of the component parts.'" *Id.* at 1318 (citations omitted).

In *Uniloc*, the patent in suit was directed to a software registration system to deter copying. *Id.* at 1298. The accused product was Microsoft's Product Activation feature that is incorporated into Microsoft Word XP, Word 2003, and Windows XP. *Id.* at 1297. The Microsoft Word products are sold as components of a larger program, Microsoft Office. After applying the 25 percent rule and the *Georgia-Pacific* factors to arrive at a $560 million-plus royalty, Uniloc's expert defended his analysis by comparing his royalty with Microsoft's $19 billion in sales revenues for Office and Windows and concluding that his royalty was only 2.9 percent of the sales revenues. *Id.* at

1318. The Federal Circuit held that it was improper and in violation of the entire market value rule to let Uniloc's expert testify regarding the total sales revenues for Office and Windows because there was no evidence that the entire market value of Outlook and Windows was derived from the patented contribution—the software registration system. *Id.* at 1321. The Federal Circuit affirmed the trial court's decision to grant a conditional new trial on damages because of the admission of the total revenue evidence, notwithstanding the fact that it was only used as a "check" on the legitimacy of the expert's royalty figure. *Id.* at 1321.

The *Uniloc* court took issue with Uniloc's suggestion that the sales prices of Office and Windows were an appropriate royalty *base*. Relying on *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009), Uniloc argued that the particular royalty base was irrelevant as long as the royalty *rate* was supported by the evidence. *Uniloc*, 632 F.3d at 1319. In *Lucent*, the court held that "the base in a running royalty calculation can always be the value of the commercial embodiment, as long as the magnitude of the rate is within an acceptable range (as determined by the evidence) . . . ." *Uniloc*, 632 F.3d at 1319, *citing Lucent*, 580 F.3d at 1338–39. However, the *Uniloc* court limited this part of *Lucent*'s holding based on the "context" of that case and held that "[t]he Supreme Court and this court's precedents do not allow consideration of the entire market value of accused products simply by asserting a low enough royalty rate." *Uniloc*, 632 F.3d at 1320. The court went on to hold that "[f]or the entire market value to apply, the patentee *must* prove that the patent-related feature is the basis for customer demand." *Id.*, citing *Lucent*, 580 F.3d at 1336 (emphasis in original). Unfortunately, *Uniloc* does not explain how a patentee can arrive at a proper royalty base when the entire market value rule does not apply.

***Lucent* Limits the Licenses Used to Establish a Reasonable Royalty**

Based on *Georgia-Pacific*, patentees often look to existing licenses for similar technologies to arrive at a reasonable royalty figure. In *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009), the Federal Circuit considered how "similar" such existing licenses must be. In *Lucent*, several Microsoft products, including Outlook, were accused to infringe the patent in suit due to their inclusion of a "date-picker" feature for selecting calendar dates in Outlook's drop-down calendar. *Id.* at 1317. To arrive at a royalty figure, Lucent's expert relied on a series of "PC-related patents" between a variety of parties. The court criticized Lucent's reliance on these agreements, stating that "some of the license agreements are radically different from the hypothetical agreement under consideration for the [patent in suit]" and that "with the other agreements, we are simply unable to ascertain from the evidence presented the subject matter of the agreements." *Id.* at 1327–28. The court also criticized Lucent's reliance on several "running royalty" agreements because the royalty sought by Lucent was a lump-sum royalty. *Id.* at 1329. As a result, the court held that the jury's award of over $357 million in damages was not supported by the existing license evidence. *Id.* at 1332. One of the licenses involved IBM's "entire patent portfolio protecting its one-time dominance in the personal computer market." *Id.* at 1328. Another of the licenses concerned a software development collaboration between Microsoft and Apple. The court was highly critical of Lucent's failure to connect the licenses to the patented technology, characterizing the evidence as "little more than a recitation of royalty numbers." *Id.* at 1330. While rightfully critical of Lucent's failure to make this connection, the *Lucent* opinion provides little guidance as to how closely existing licenses must be linked to a patented technology to constitute admissible evidence of a reasonable royalty.

The Impact of *Uniloc* and *Lucent* on Patent Holders

The Federal Circuit's reaction to the jury awards in *Uniloc* and *Lucent* is understandable. Both cases involved a minor patented software feature incorporated into a much larger and otherwise "feature-rich" software package. However, the cases provide little guidance to patent holders who seek to "get it right." Moreover, they ignore the practical realities and limited information faced by patent litigants in seeking to prove a reasonable royalty figure. These difficulties undoubtedly gave rise to the 25 percent rule in the first place.

Difficulties Obtaining a Reasonable Royalty Analysis

The evidence that is generally available in a patent lawsuit usually includes the infringer's revenues and profits from sales of the accused product and, in some cases, cost information for various components of the accused product. Companies often do not track the revenues and profits attributable to individual components or features, especially in the case of items like software. Thus, the universe of available financial data can be quite limited. When that is so, how does one arrive at a reasonable royalty base if the salable unit revenues cannot be used because of the inapplicability of the entire market value rule? *Uniloc* provides no guidance on this point but expressly requires that patentees "give evidence tending to separate or apportion the defendant's profits and the patentee's damages between the patented feature and unpatented features" based on evidence that is "reliable and tangible, and not conjectural or speculative." *Uniloc*, 632 F.3d at 1318, *citing Garretson v. Clark*, 111 U.S. 120, 121 4 S. Ct. 291, 28 L. Ed. 371 (1884).

Survey evidence such as that used in trademark cases may be helpful if the accused product is widely sold to third parties. On remand and following the issuance of the *Uniloc* opinion, Lucent's expert conducted a survey to determine that 7 percent of all purchasers of Outlook who used the drop-down calendar (which incorporated the infringing date-picker) would not have bought the program in the absence of the calendar. *Lucent Technologies, Inc. v. Microsoft Corp.*, No. 3:07-cv-2000, 2011 U.S. Dist. LEXIS 130571, at *20 (S.D. Cal. Nov. 10, 2011). He further determined that 43 percent of all Outlook users used the drop-down calendar and that Microsoft therefore would have lost 3 percent of its 109.5 million Outlook licenses in the absence of the calendar. *Id.* The court accepted this evidence but rejected Lucent's assertion that the royalty base for each unit of Outlook sold as part of Microsoft Office was $67 because it was based on the "Home and Student version" of Outlook. *Id.* at *40. Ultimately, the court accepted Microsoft's contention that because Outlook is one of four programs in Microsoft Office—each of which is priced identically when sold as a stand-alone program—the correct royalty base would be one-fourth of the Microsoft Office sales price. *Id.* at *43–45. The trial court's decision underscores the difficulty in determining which analysis and which data will be deemed sufficient given the information that is available to patent litigants.

It is also often quite difficult to find licenses that are "comparable" to the patent in suit, when the patent has not been licensed. By definition, a patentable invention is novel and nonobvious, and the technology covered by licenses to other patents will often differ significantly. In many cases, no licenses are available. In other cases, they are confidential and in the hands of third parties and can only be obtained through third-party discovery.

Parties are often forced to broaden the scope of the licenses on which they rely or perform their royalty analysis without the benefit of any existing royalty data. In many cases, parties will even serve discovery requests for non-patent licenses (i.e., trademark, copyright, and trade secret licenses) in an effort to obtain some hard data with which to begin a reasonable royalty analysis. On remand, the *Lucent* court admitted evidence of two licenses covering "graphical user interfaces such as [patent in suit], and declined to permit the use of other licenses." *Id.* at *53.

Are Zero Reasonable Royalty Damages Possible?
What happens if a patent holder's damages case cannot withstand the Federal Circuit's heightened scrutiny of reasonable royalty awards? For example, in some cases, it may not be possible to conduct surveys or use other techniques to apportion profits between the patented and unpatented features of an accused product. Licenses that are sufficiently comparable may be unavailable. Normally, when a party cannot satisfy its burden on an issue, the court finds against the party and enters judgment accordingly. The burden of proof imposed on patentees suggests that they may not be entitled to any reasonable royalty damages if they cannot satisfy the requirements of *Uniloc* and *Lucent*, a prospect that is more significant in view of the somewhat limited universe of financial data that are available in patent cases.

The patent statute says otherwise, requiring that the patent holder receive "no less than a reasonable royalty." 35 U.S.C. § 284. How does this requirement square with the burden of proof placed on the patentee and the Federal Circuit's scrutiny of damages awards?

The case law suggests that the answer is not clear. In *Lindemann Maschinenfabrik v. American Hoist & Derrick Co.*, 895 F.2d 1403 (Fed. Cir. 1990), the Federal Circuit attempted to resolve this apparent tension by holding as follows:

> [T]he statute obviates the need to show the fact of infringement when infringement is admitted or proven, but that does not mean that a patentee who puts on *little or no satisfactory evidence* can successfully appeal on the ground that the amount awarded by the court is not 'reasonable' and therefore contravenes section 284.

Id. at 1408 (emphasis added).

Notably, *Lindemann Maschinenfabrik* cites the Third Circuit's opinion in *Devex Corp. v. General Motors Corp.*, 667 F.2d 347 (3d Cir. 1981), in which that court held that "[i]n the absence of any evidence as to what would constitute a reasonable royalty in a given case, a fact finder would have no means of arriving at a reasonable royalty, and none could be awarded." *Id.* at 361. Some district courts have read *Lindemann Maschinenfabrik* to mean that "[w]here the record lacks any evidence of a reasonable royalty rate, the Federal Circuit has approved of awarding 'zero damages' . . . ." *Boston Scientific Corp. v. Johnson & Johnson*, 550 F. Supp. 2d 1102, 1120 (N.D. Cal. 2008). *See also KEG Techs., Inc. v. Reinhart Laimer*, 436 F. Supp. 2d 1364, 1370 (N.D. Ga. 2006). In *DePuy Spine, Inc. v. Medtronic Sofamor Danek, Inc.*, 567 F.3d 1314, 1335 (Fed. Cir. 2009), the Federal Circuit affirmed a judgment of a zero percent royalty rate but did so based on the patentee's failure to raise a timely objection to the verdict under the regional circuit's law.

The "zero royalty" cases may perhaps be distinguished from those in which a patent holder puts on a colorable, albeit legally insufficient, damages case as the former cases tend to involve situations where the patent holder forgoes putting in evidence of reasonable royalty damag The *KEG Technologies* court expressly interpreted the Federal Circuit precedents as requiring a "do-over" if the proof turns out to be inadequate and as distinguishing such cases from those in which the patent holder initially elects to forgo reasonable royalty damages altogether. *KEG Technologies*, 436 F. Supp. 2d at 1371 n.3. Both the *Uniloc* and *Lucent* decisions followed "do-over" approach. However, is it workable to keep remanding cases until the parties get it right, especially when the Federal Circuit's increased level of scrutiny suggests that reasonable royalty awards are more likely to be deemed insufficiently supported? Such an approach is inefficient and taxes an overburdened court system.

Is It Time to Consider a Statutory Damages Regime in Patent Law?

Unlike the patent statute, the copyright statute allows a copyright holder to elect "statutory damages" in an infringement suit in an amount of not less than $750 or more than $30,000 for any one work. 17 U.S.C. § 504. While these amounts may be less than would be appropriate in the case of patent infringement, it may be worth considering whether to provide a fixed award or fixed range of awards as the "floor" in cases of patent infringement. This could avoid the n for either a "do-over" or a zero damages award where the patentee's reasonable royalty ca insufficient to pass Federal Circuit muster. Given that the "fact of infringement establishes the fact of damage because the patentee's right to exclude has been violated," *Lindemann Maschinenfabrik*, 895 F.2d at 1406, it is reasonable to set some minimum amount of compensation to which a patent holder would be entitled upon a finding of infringement, while at the same time minimizing the burden currently placed on the courts by remanding and re-trying damages issues. While the Federal Circuit may be applauded for demanding greater rigor in damages analyses, patent holders should be guaranteed some compensation for the unauthorized use of their inventions without the need for a damages "do-over."

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