Uniloc USA v. Microsoft

Patent Infringement Damages

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Questions

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Summary of *Uniloc* Decision

- *Uniloc USA, Inc. v. Microsoft Corp.*, __ F.3d __ (Fed. Cir. Jan. 04, 2011)
- Affirming district court's (alternative) grant of new trial on damages, following $388M jury verdict
- At issue:
  - The "25% rule of thumb"
  - Use of the "entire market value rule" ("as a check")

Background

Basic reasonable royalty formula:

Damages =

Rate (%) x Base ($) x Apportionment Factor

Background

- 25% rule (RATE):
  - Prevailing patent owner is entitled, by statute, to at least a "**reasonable royalty** *for the use made of the invention by the infringer*"
  - Courts use 15-factor "Georgia-Pacific" test to determine what constitutes a reasonable royalty
  - Goal is to estimate outcome of a "hypothetical negotiation" between a willing licensor and licensee

Background

- 25% rule:
  - Originated with Robert Goldscheider in 1959 as a starting point
  - Based on assumption that an allocation of pre-tax profits of 75% (for the licensee) vs. 25% (for the licensor) accounts for the commercialization risk assumed by the licensee
  - Had been routinely employed as a guide to a reasonable royalty rate

Background

- Entire market value rule (BASE):
  - Allows a patentee to assess damages based on the entire market value of the accused product where the patented feature creates the “basis for customer demand”
  - Controversial, particularly when multiple-component hardware and software products are at issue

Summary of *Uniloc* Decision

- U.S. Patent No. 5,490,216 to a "System for Software Registration"
- Accused products: Microsoft Word XP, Word 2003, and Windows XP (product activation feature)
- District court:
  - Pre-trial: Denied Microsoft motion *in limine* challenging 25% rule ("perplexing" but "widely accepted") and seeking to exclude Uniloc's damages expert
  - Post-trial: Granted Microsoft motion for new trial on damages ("because the '$19 billion cat was never put back into the bag'")

Summary of *Uniloc* Decision

- Expert's methodology:
  - Relied on Microsoft internal document: "a Product Key is worth anywhere between $10 and $10,000 depending on usage"
  - Adopted $10 as value of product activation
  - 25% x $10 = $2.50 per product
  - No. copies sold = 225,978,721
  - @ $2.50 each = $565M

Summary of *Uniloc* Decision

- Expert's methodology (cont.):
  - *Georgia-Pacific* factors balanced, therefore $2.50 per copy rate was correct
  - Used entire market value rule "as a check":
    - Microsoft's total revenues from accused products: $19.28B
    - $565M represents only 2.9%
    - Therefore $565M is reasonable

Uniloc: 25% Rule

- Federal Circuit noted criticism:
  - "First, it fails to account for the unique relationship between the patent and the accused product."
  - "Second, it fails to account for the unique relationship between the parties. *See* Ted Hagelin, *Valuation of Patent Licenses,* Tex. Intell. Prop. L .J. 423, 425-26 (Spring 2004) (noting that the rule should not be used in isolation because it fails to 'account[ ] for the different levels of risk assumed by a licensor and licensee')"
  - "Finally, the rule is essentially arbitrary and does not fit within the model of the hypothetical negotiation within which it is based."

Uniloc: 25% Rule

- Court "has passively tolerated its use where its acceptability has not been the focus of the case"
- But held:

"*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."*

Uniloc: 25% Rule

- "The rule does not say anything about a particular hypothetical negotiation or reasonable royalty involving any particular technology, industry, or party."
- "This court's rejection of the 25 percent rule of thumb is not intended to limit the application of any of the *Georgia-Pacific* factors."
- "However, evidence purporting to apply to these, and any other factors, must be tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time."

Uniloc: Entire Market Value Rule

- "This case provides a good example of the danger of admitting consideration of the entire market value of the accused where the patented component does not create the basis for customer demand."
  - "Uniloc conceded that customers do not buy Office or Windows because of [the Product Activation feature]"
- "The disclosure that a company has made $19 billion dollars in revenue from an infringing product cannot help but skew the damages horizon for the jury, regardless of the contribution of the patented component to this revenue."

Uniloc Continues a Trend

- *Cornell Univ. v. Hewlett-Packard Co.* (N.D.N.Y. 2009):
  - Accused product: HP servers and workstations
  - But: "the claimed invention is a small part of the [instruction reorder buffer], which is a part of a processor, which is part of a CPU module, which is part of a 'brick,' which is itself only part of the larger server."
  - Award was based on the value of the entire CPU brick, not the invention or the IRB or even the processor (and Cornell had started with server as the base).
  - (CAFC) Judge Rader reduced Cornell's jury award from $184M to $54M: processor revenue the appropriate base

Uniloc Continues a Trend

- *Lucent Tech., Inc. v. Gateway, Inc.* (Fed. Cir. 2009):
  - Accused product: Microsoft Office Outlook
  - Invention: "date-picker" function
  - Parties agreed on $8B base (sales of 110 million products); Lucent sought 8% rate (= $561M)
  - Federal Circuit vacated $358M damage award:
    - Lucent's "comparable" licenses weren't (some lump-sum, some running royalties; lump-sum agreements either insufficiently described or not for comparable situation)
    - Damages expert conceded no "evidence that anybody anywhere at any time ever bought Outlook . . . because it had a date-picker"
    - Even a 1% rate on the entire computer as a base excessive

Uniloc Continues a Trend

- *ResQNet.com, Inc. v. Lansa, Inc.* (Fed. Cir. 2010):
  - Vacated $506,305 damages award based on 12.5% of infringing software revenues
    - Award based on "speculative and unreliable evidence divorced from proof of economic harm linked to the claimed invention"
    - Allegedly comparable licenses:
      - Five out of seven related to software-<u>service</u> bundles

Uniloc Continues a Trend

- *Wordtech Sys., Inc. v. Integrated Networks Solutions, Inc.* (Fed. Cir. 2010):
  - Vacated $250,000 lump-sum award
  - Evidence proffered (thirteen previously-granted licenses on some/all of the patents at issue):
    - Lacked key information (including how the two lump-sum amounts were calculated and the nature and number of the licensee's intended products)
    - Failed to "account for 'the technological and economic differences' between them"

Litigation Lessons

- Evidence offered by the patent owner will be closely scrutinized
- "Comparable" licenses have to be comparable:
  - Lump-sum vs. running royalty
  - Covered patents and products
  - Relationships between the parties
  - Circumstances that yielded the license

Litigation Lessons

- Entire market value rule (and the "multiplier"): need reliable evidence linking demand to the patented feature, and its incremental value
  - Sales/price data for products with vs. without feature
  - Consumer surveys/focus group testing
  - Company documents
  - Industry/trade reports
- Defendant's failure to offer rebutting expert testimony does not satisfy plaintiff's burden

Uniloc USA v. Microsoft

Implications for Patent Licensing

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Stating the Obvious

- Federal Circuit holding in *Uniloc* has no binding effect on licensing negotiations
- BUT – Clear implications for licensing
  - The issue in *Uniloc* was the proper determination of the outcome in a realistic licensing negotiation between a willing licensor and licensee
  - *Daubert* requires that the damages methodology be tied to the particular facts of the hypothetical negotiation

Two Questions

- The royalty base ($)
  - The dollar amount on which royalties are calculated
- The royalty rate (%)
  - The percentage amount of the royalty base which are paid as royalties

The Royalty Base ($)

- Federal Circuit held that the royalty base must take into account the contribution of the infringed patent to the accused product's sales – incremental profit
  - No evidence that the "product activation feature" (the infringed patent) was the basis for customer demand for the accused products (Word 2003,Word XP, Windows XP)
    - Implicit suggestion that "product activation feature" had no value and, therefore, made no contribution to sales of MS products

The Royalty Base ($)

- In the context of licensing negotiations, the Federal Circuit decision may underestimate and overestimate the royalty base
  - Underestimation
    - The "product activation feature" may not have formed any direct basis for customer demand
    - But – in the absence of the "product activation feature" there would be much more unlawful copying of MS products
    - Microsoft may have to raise the price of its products to cover unlawful copying losses and customers may have to pay more for MS products
    - Lower price for MS products would directly affect customer demand and sales of MS products

The Royalty Base ($)

- Overestimation
  - There may be a predicate step to determining contribution of infringed patent to product sales
  - Every dollar of sales must contribute to the rate of return on **all** of a firm's assets
    - Tangible assets (e.g. plants, buildings, equipment)
    - Intangible assets (e.g. management skill, employee training)
    - Intellectual property assets
      - Reputational IP assets (e.g. trademarks)
      - Technical IP assets (e.g. patents)
  - Sales may have to be disaggregated to determine the portion attributable to technical IP assets in order to calculate the proper royalty base

The Royalty Base ($)

- *Daubert* calculation of royalty base

Royalty base = (total sales) x (% sales attributable to technical IP) x (% sales attributable to infringing patent)

- Percentage sales attributable to infringing patent can be calculated by comparing the competitive advantage the infringing patent contributes to the accused product **and** the competitive advantage a comparable patent contributes to a substitute product

The Royalty Rate (%)

- Definitely not 25% of licensee profits, no matter how royalty base is calculated
  - No relevance to technology, industry or parties
- Realistic royalty rate should reflect three factors
  - The degree of risk assumed by the licensor and licensee
  - The amount of pre-license and post-license investment made by the licensor and licensee
  - And a fair division of patent value between licensor and licensee

The Royalty Rate (%)

- Degree of risk assumed by licensor and licensee
  - Technical risk – technology's state of development
  - Intellectual property risk – strength of patent
  - Market risk – number and market shares of firms in market
  - Combined risk can be used to discount expected sales
- In case of lump-sum payment, licensor passes all risk to licensee
- In case of running royalties, licensor and licensee share risk equally

The Royalty Rate (%)

- The amount of pre-license and post-license investment made by licensor and licensee
  - Licensor pre-license investment
    - Internal – salaries; equipment; overhead
    - External – grants; contracts; awards
  - Licensee post-license investment
    - Internal – time and resources required to bring technology to market
    - External – grants; contracts; awards

The Royalty Rate (%)

- Division of patent value between licensor and licensee
- Ideal division of patent value
  - Licensor and licensee receive equal rate of return on their respective investments in technology
  - Rate of return is based on risk-adjusted value of patent

The Royalty Rate

- *Daubert* reasonable royalty rate

Licensor (LR) ROI = Licensee (LE) ROI

LR ROI = (Royalty Payment – Investment) ÷ Investment

LE ROI = (Patent Value – Royalty Payment – Investment) ÷ (Royalty Payment + Investment)

Thank You

Questions?