Post *Uniloc* — Calculating Reasonable Royalty Damages: *What's a Damages Expert to Do?*

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When a reasonable royalty is the appropriate measure of patent damages,[1] damages are most often expressed as the product of a royalty rate (expressed as a percent) multiplied by a royalty base (expressed as product revenues). Recent Federal Circuit decisions have impacted not only the determination of a reasonable royalty rate, but also the permissibility of a royalty base tied to the entire value of the product incorporating the patented feature. The damage expert is now faced with a unique set of challenges–where the only certainty may be that the Federal Circuit will have to further clarify several damages issues addressed in its recent decisions.

While the entire market value ("EMV") rule is applicable to both lost profit damages and reasonable royalty damages, here it will only be discussed as it relates to reasonable royalty damages. The EMV rule "permits recovery of damages based on the value of a patentee's entire apparatus containing several features when the patent-related feature is the *'basis for customer demand'"*[2] and/or the substantial value of the product sold.[3] Over the past several years, the courts have focused attention on the appropriate royalty base to use in calculating reasonable royalty damages and have increasingly restricted the use of the EMV rule.

In the real world, royalties on patented product features are often expressed as a percent of total product revenues, even when that feature is not the basis for product demand. Total product sales are usually easily determined and relatively straightforward to audit. However, in patent litigation the patent holder may seek to broaden the royalty base order to inflate damages. If the royalty base is large enough, then applying even a very modest royalty rate can result in substantial damages. A modest royalty rate has jury appeal as being conservative, but applied to an inflated royalty base can still yield damages of tens of millions of dollars or more. Such was the case in *Lucent Technologies, Inc. v. Gateway, Inc.*[4]

In this case, the accused infringing feature was the date-picker calendar tool in Microsoft Outlook, Money, and Windows Mobile. Initially, Lucent's damages expert estimated damages of $561.9 million, based on a running royalty of 8 percent on almost $8 billion of accused software product sales.[5] Microsoft challenged the jury's damage award of $358 million on the basis that the award was based, erroneously, on the EMV rule.[6] (It should be noted that Lucent's damages expert first estimated damages using a lower royalty rate applied to "infringing" computers. The District Court granted Microsoft's motion *in limine* and excluded such testimony. Lucent's damages expert then tried to arrive at the same damage number at trial by using a higher royalty rate and a lower royalty base using software sales.)[7] The Court of Appeals for the Federal Circuit ("CAFC") vacated the damage award and ordered a new trial on damages. The CAFC stated that "[t]here is nothing inherently wrong with using the market value for the entire product, especially when there is no established market value for the infringing component or feature, so long as the multiplier accounts for the proportion of the base represented by the infringing component or feature."[8] In other words, a royalty base using the entire value of the product could be appropriate as long as the royalty rate reflects an accurate apportioning of value between the patent feature and other non-patented product features. This decision seemed to recognize that product revenues are often used as the royalty base for patented features. This is allowed as long as the royalty rate is proportionate to the relative importance of the patented feature.

The CAFC seemed to narrow use of the EMV rule in its *Uniloc v. Microsoft* ruling earlier this year.[9] In the *Uniloc* case, Uniloc's damage expert showed the jury the reasonableness of his estimated reasonable royalty damages, resulting from infringement of a product activation feature, by comparing his estimate of damages to total Microsoft Office and Windows software sales. The trial court determined that the jury award of $388 million was based on the testimony of Uniloc's expert. The District Court ruled that a new damages trial was appropriate because Uniloc should not have used the entire $19 billion value of the software for a patent that was limited to a product activation feature in front of the jury because the "$19 billion cat [related to total product sales] was never put back into the bag."[10]

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On appeal, the CAFC sided with the District Court on the improper use of the EMV rule. In addition, the CAFC seemed to further limit use of the EMV rule by stating that the entire market value of a product cannot be used as a royalty base if the patented feature does not drive consumer demand for the product. The CAFC stated that both Supreme Court and CAFC precedents do not allow the use of the entire market value of accused products as a royalty base for minor patent improvements simply by asserting a low enough royalty rate.[11] This seems to be at odds with the CAFC's 2009 opinion in *Lucent v. Gateway.* Further, the CAFC reasoned in *Uniloc* that if the entire market value of a product is not the appropriate royalty base, it makes no sense to use it even as a reasonableness check.[12]

An example of how the *Uniloc* decision is being interpreted by the district courts can be seen in *Mirror Worlds v. Apple.*[13] In *Mirror Worlds*, the judge cited the *Uniloc* decision regarding the EMV rule as the basis to exclude the plaintiff's damages opinion which was relied upon by the jury. The court found no proof that the feature drove demand for Apple hardware or software and the court would not allow a reduced royalty rate to be applied to the EMV royalty base as an attempt to apportion value to the patented feature.[14]

What's a damages expert to do? As discussed in "Apportionment of Intellectual Property Damages and the Entire Market Value Rule" (*FVLE* Issue 11, February/March 2008), obtaining persuasive support in discovery regarding the importance of the patented feature to customer demand is of primary importance in determining the applicability of the EMV rule. Documents that can be expected to address the importance of patented features are the parties' marketing materials, including product web sites, promotional and print advertisements, product packaging, internal business plans and market analyses, analyst and industry reports, articles in trade publications, and SEC filings, such as Form 10-K reports detailing products and competition. Customer and/or market surveys may indicate the importance of the patented feature. However, proving the importance of the patented feature may fall short of supporting the position that the patent feature forms the basis for customer demand.[15] In fact, it is reasonable to expect that many products do not have one separate feature that forms the sole basis for consumer demand. Many features may combine to form the basis for customer demand. It is unclear whether the CAFC would allow the EMV rule to be applied in instances where multiple features combine to create product demand.

The CAFC's *Uniloc* decision not only impacts the applicability and use of the EMV rule for determining a royalty base, but also impacts the selection of a royalty rate. As stated in a *FVLE* article earlier this year,[16] the CAFC's *Uniloc* decision also determined that use of the 25 percent rule to determine a reasonable royalty rate was prohibited.[17] This prohibition on use of the 25 percent rule, together with the CAFC's 2010 decisions in *ResQNet v. Lansa, Inc.* and *Wordtech Systems, Inc. v. Integrated Networks Solutions, Inc.*, have added to the level of difficulty in determining a reasonable royalty rate.

In *ResQNet* the CAFC rejected the parties' unrelated licenses, stating that "evidence of royalty rates from licenses without a relationship to the claimed invention could not form the basis of a reasonable royalty calculation."[18] In *Wordtech Systems,* the CAFC rejected licenses to the patents in a suit entered into by the patentee-plaintiff. The CAFC is clear that there must be a factual basis to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue.[19]

In an order issued in September 2011 in *Tyco Healthcare Group LP v. Applied Medical Resources Corp*., an Eastern District of Texas judge, citing both *Lucent Techs. v. Gateway, Inc.* and *Uniloc v. Microsoft*, ruled that the plaintiff's expert could not testify about industry royalty rates because they were not comparable to the medical products at issue in the litigation.[20]

What's a damages expert to do? The issue of the restricted use of the EMV of a product in the royalty base and the issue of determining a royalty rate can be solved if the damages expert is able to determine a reasonable royalty on a per unit basis, independent of the value of the entire product. A per unit royalty can be based upon a variety of factors including: patent-related price premiums, expanded market share, protected or preserved market share, or cost savings.[21] In the event that the determination of a per unit royalty is not feasible, the expert must push for expanded discovery on existing licenses in order to adequately address the court's concerns regarding comparability. This expanded discovery includes product market information, sales unit and revenue information, and margin information for all products covered under possibly comparable licenses. It is this additional discovery that will allow the expert to show[22] how comparable the technology and market characteristics are with those of the patent and product covered by the patent. It is hard to imagine making the argument that a license agreement is comparable to the hypothetical license without understanding the economic underpinnings of both the proposed comparable license and the hypothetical license.

One common theme in the CAFC decisions discussed above is that the court seems to be disallowing shortcuts or oversimplification in the estimation of reasonable royalty damages. No shortcuts for determining the importance of patented features; no shortcuts in determining a royalty rate; and no shortcuts in determining a royalty base. As has always been the case, there is no substitute for well-supported rigorous analysis.

(Endnotes on next page)

[1] Patent infringement damages in the U.S. are covered by Title 35 of the United States Code, Section 284. This section of the code establishes a reasonable royalty as the floor for patent damages. Specifically, this section states that damages shall be "adequate to compensate for the infringement, but *in no event less than a reasonable royalty* for the use made of the invention by the infringer…." Title 35 of the United States Code, Section 284. Emphasis added.

[2] *Rite-Hite Corp. v. Kelley Co., Inc.,* 56 F.3d 1538, 1549 (Fed. Cir. 1995), emphasis added; see also *State Indus., Inc. v. Mor-Flo Indus., Inc.,* 883 F.2d 1573, 1580 (Fed. Cir. 1989).

[3] *Fonar Corp. v. General Electric Co.,* 107 F.3d 1543, 1549, 1553 (Fed. Cir. 1997). In addition to the patented element or feature being the basis for customer demand, the unpatented and patented components must be part of a single assembly or analogous to a single functioning unit. See e.g., *Velo-Bind, Inc. v. Minnesota Mining & Mfg. Co.,* 647 F.2d 965, 211 USPQ 926 (9th Cir.), cert. denied, 454 U.S. 1093, 102 S.Ct. 658, 70 L.Ed.2d 631 (1981) and *Kalman v. Berlyn Corp.*, 914 F.2d 1473, 1485, 16 USPQ2d 1093, 1102 (Fed. Cir. 1990); *Rite-Hite Corp.,* 1550.

[4] *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009).

[5] *Ibid.*, 1323.

[6] *Ibid.*, 1324.

[7] *Ibid.*, 1338.

[8] *Ibid.*, 1339.

[9] *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F3d 1292 (Fed. Cir. 2011).

[10] *Ibid.,* 1311-12.

[11] *Ibid.,* 1320.

[12] *Ibid.,* 1321.

[13] *Mirror Worlds, LLC v. Apple, Inc.,* 784 F. Supp. 2d 703 (E.D. Tex. 2011).

[14] *Ibid.,* 727.

[15] In *I.P. Innovation LLC v. Red Hat, Inc.,* 705 F. Supp. 2d. 687, 690 (E.D. Tex. 2010), the court rejected the notion that an online user forum touting the patented feature as essential was sufficient to show that the patent feature formed the basis for customer demand. Similarly, in *Mirror Worlds,* the court rejected consumer surveys as being sufficient evidence that the patented feature drove customer demand. See *Mirror Worlds,* 726-27.

[16] See "The Demise of the 25% Rule for Determining a Reasonable Royalty in Patent Litigation," *FVLE* Issue 29, February/March 2011, pp. 20-21 and 23.

[17] *Uniloc,* 1315. Despite Robert Goldschieder's protests to the contrary, it seems unlikely that damage experts will be using the 25% Rule to support their estimates of reasonable royalties in the future. Robert Goldschieder was recognized by the Federal Circuit as the leading proponent of the 25% Rule. See *Uniloc*, 1295. Mr. Goldschieder attempts to differentiate between the 25% rule-of-thumb rejected by the Federal Circuit and his "Classic 25% Rule." See, Robert Goldschieder, "The Classic 25% Rule and the Art of Intellectual Property Licensing," *Duke Law & Technology Review,* 2011 No., 006, p. 3, *http://www.law.duke.edu/journals/dltr/articles/2011dltr006*, accessed October 8, 2011.

[18] See *Uniloc,* 1316, citing *ResQNet.Com, Inc. v. Lansa, Inc.,* 594 F.3d 860, 870-72 (Fed. Cir. 2010).

[19] *Uniloc,* 1317.

[20] *Tyco Healthcare Group LP v. Applied Medical Resources Corp.,* E. D. Tex., Civil Action No. 9:09-CV-176, Order on Motions *in Limine,* September 23, 2011, p. 6.

[21] While the expert will need to assess the reasonableness of the royalty relative to the products total value, the expert should be prepared for the likelihood that the opposing side may object to such a comparison in front of the jury. As discussed above, this was a key issue in the *Uniloc* case, i.e., the $19 billion cat let out of the bag.

[22] Show–as in an exhibit laying out all the factors and characteristics that allow the expert to make a comparison between existing licenses (and royalty rates contained therein) and the hypothetical license and its resulting royalty rate.