The Clear Decision In *Uniloc* Needs Clarification

By Drew E. Voth and Kathleen Petrich

Much has been written about the Federal Circuit Court of Appeal's ("CAFC") decision in the *Uniloc*[1] case eviscerating the 25% Rule, but relatively little about the equally eyebrow-raising decision relating to the Entire Market Value Rule.

The Rulings

Seldom has the CAFC come out with such bold language regarding financial/licensing theory as when it said in Uniloc:

> "This court now holds 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."[2]

While analysts and academics will undoubtedly continue to debate the value of the underlying studies testing the after-the-fact empirical validity of the 25% Rule (in fact see *les Nouvelles* Mach 2011 issue for such an article), the CAFC's relatively recent "Show Me The License!" mantra will likely be unswayed without specific analysis of comparable licenses. The use of a generalized basket of licenses or general rules-of-thumb, which may have no relation to the patent(s) at issue, are being viewed with much greater scrutiny. After all, in the rare case where an expert may pull together enough data to show that the practice in a particular industry involves the use of the 25% Rule in licensing negotiations, such data will likely already include underlying individual license data which could form a more direct analysis of the hypothetical license at issue.

What has received much less discussion, however, is the CAFC's comments on the Entire Market Value Rule ("EMVR"). The EMVR doctrine allows a patentee to claim damages based on the entire market value of an accused product containing patented and non-patented components only where the patented feature creates the "basis for customer demand."[3] The EMVR has been leveraged by plaintiffs against many defendants to garner massive damage awards, especially in the computer and software industries where even small royalty rates lead to huge damages when applied against vast nationwide sales volumes.[4]

At the district level in *Uniloc*, the jury awarded Patentee Uniloc damages of $388 million. The specific calculation wasn't disclosed, but was between the two damages experts' opinions. Microsoft's expert opined that damages could not exceed $7 million under the theory that Microsoft would have paid a lump sum for the use of the patent. On the other side, Uniloc's expert opined that damages were $565 million for reasonable running royalties.

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The following table shows how Uniloc's expert arrived at his calculation without invoking the EMVR:

Uniloc Expert's Calculation

	$	10	Value per Infringing Product Key
x		25%	Share of Value to Plaintiff under 25% Rule
=	$	2.50	Reasonable Royalty Per Unit
x		225,978,721	Total Infringing Units Sold
=	$	564,946,803	Total Damages

1. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011) (damages expert's testimony regarding the 25% "Rule of Thumb" excluded under *Daubert*).

2. *Uniloc*, 632 F.3d at 1315.

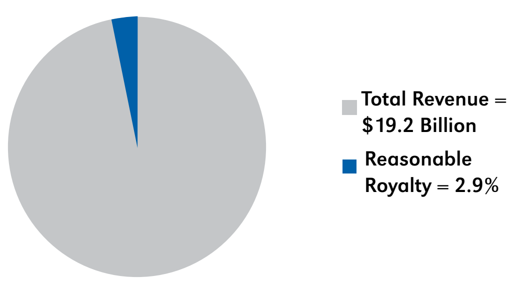
3. *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1336 (Fed. Cir. 2009); *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1549-50 (Fed. Cir. 1995).

4. While subsequently reduced or reversed, *see e.g.*, the jury awards in *Lucent Techs.*, 580 F.3d 1301, *Cornell University v. Hewlett-Packard Company*, 609 F. Supp. 2d 279 (N.D.N.Y. 2009), and *LaserDynamics v. Quanta Computer*, No. 2:06-cv-00348 TJW, (ED Tex., Marshall Div., 2010), Doc. No. 620.

The $10 value per unit is not the entire market value of the infringing software. Rather, it was based on valuation documents produced in discovery and represented the lowest value according to Uniloc's damages expert of the "Product Keys" (infringing technology's) value, which ranged from $10 to $10,000 depending on usage.[5]

Where the entire market value came into play was with the Uniloc expert's testing of the reasonableness of his royalty rate conclusion. In order to test the reasonableness of his $2.50 royalty-per-unit conclusion ($10 x .25 multiplier based on the aforementioned now disgraced 25% rule of thumb = $2.50/infringing unit), Uniloc's expert showed something similar to the following pie chart:

Uniloc's Reasonable Royalty Rate



The expert showed that multiplying the 225,978,721 infringing units by the average sales price per unit of $85 resulted in total revenue $19.21 billion, and that dividing his royalty conclusion into this total yielded a royalty rate of 2.9 percent. The expert then concluded that a "2.9 percent rate was reasonable" because, in his experience, "royalty rates for software are generally above—on average, 10 percent or 10 percent, 11 percent."[6]

In post-trial motions, Microsoft moved, in part, for a new damages trial based on improper use of the EMVR. Microsoft argued that the use of the EMVR "check" was improper because it was undisputed that the product activation patent "Product Key" at issue was not the basis of the consumer demand for Microsoft's Office and Windows products. Microsoft argued that the Uniloc expert's testimony tainted the jury's damages deliberations, regardless of its categorization as merely a "check" on the overall value. The District Court agreed and granted a conditional new trial on damages based on the improper use of the EMVR.[7]

On appeal, Uniloc made a number of substantive arguments in an attempt to sway the CAFC on this issue including the following:

1. First, the royalty was based on a licensee share of the $10 per unit value, not on the entire market value of the infringing products;
2. Second, the use of the $19 billion total revenue figure was used only as part of a reasonableness check calculation;
3. Third, the jury was instructed not to base its damages calculation on the entire market value rule, and they must be presumed to have followed that instruction; and
4. Fourth, the CAFC ruled in *Lucent* that the entire market value of the products may appropriately be admitted if the royalty rate is low enough.

'The Cat is Out of the Bag'

The CAFC was unswayed by any of Uniloc's arguments and ruled that the District Court did not abuse its discretion in granting a conditional new trial on damages for Uniloc's violation of the EMVR. The CAFC summarized the problem of wrongly applying the EMVR as in the *Uniloc* case:

> This case provides a good example of the danger of admitting consideration of the entire market value rule of the accused where the patented component does not create the basis for the customer demand. As the district court aptly noted, "[t]he $19 billion cat was never put back into the bag even by Microsoft's cross-examination [of the Uniloc expert] and re-direct of [the Microsoft expert], and in spite of a final instruction that the jury may not award damages based on Microsoft's entire revenue from all of the accused products in the case." [Uniloc II cite omitted] This is unsurprising. 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.[8]

At the district court trial, Uniloc challenged

5. *Uniloc*, 632 F.3d at 1311.

6. *Uniloc*, 632 F.3d at 1318.

7. *Uniloc USA, Inc. v. Microsoft Corp.*, 640 F.Supp.2d, 150, 184-185 (D.R.I. Sept. 29, 2009)("*Uniloc II*")

8. *Uniloc*, 632 F.3d at 1320.

Microsoft's expert on cross-examination trying to get the point across that the Microsoft's $7 million damage calculation was only .00003 percent of the entire market value of the infringing products. But the CAFC was not amused by Uniloc's argument and chose to characterize the expert witness cross examination tactics as "derision" and that tying back to the entire market value may have inappropriately contributed to the jury's rejection of his calculations.[9]

Even if Uniloc was only using the EMVR as a "check" and the jury's verdict was not based wholly on the entire market value check, the award was based in part on a faulty foundation. The CAFC found that the district court did not abuse its discretion in granting the conditional new trial on damages in violation of the EMVR.

Further, with regard to Uniloc's reference to the *Lucent* case, the CAFC ruled:

> "The Supreme Court and this court's precedents do not allow consideration of the entire market value of accused products for minor patent improvements simply by asserting a low enough royalty rate."[10]

Implications

As clear as the CAFC's position was relating to the 25% rule, the ruling presents potentially challenging precedent for future cases regarding use and introduction of the entire market value. While it isn't difficult to see the logic behind the potential jury tainting that might result from bandying about a $19 billion entire market value figure and deriding the opposing expert on the basis of an entire market value argument, the CAFC's decision could be read from one perspective to potentially limit even the introduction the entire market value of a single infringing product (which was $85 in this case). Imagine that Uniloc's expert had calculated his 2.9 percent royalty check simply by dividing his $2.50 royalty into the $85 entire market value of the average infringing unit and avoided any discussion of the vastly larger total sales value figures. While this approach would have yielded the same conclusion for the expert, would the rulings by the District Court and the CAFC have been the same assuming a similar jury award?

This question is worrisome for damages experts as the CAFC's ruling could be construed as prohibiting discussion of the entire market value (the sales price) of an infringing product where the EMVR hasn't been proven applicable. Experts routinely discuss the sales prices of alleged infringing products in their damages reports. For example, *Georgia-Pacific* factors 8, 12 and 13 all reference the profitability of the product using the patent when performing reasonable royalty damages analyses[11]. As profits are often calculated and discussed in terms of the difference between sales prices (entire market values) and expenses, it would seem unlikely that an expert could adequately complete a damages analysis without reference to the entire market value, even where the EMVR may not apply.

It is also necessary to discuss sales prices when converting a royalty rate shown in dollars to a royalty rate shown as a percent in order to be able to compare the rate to comparable industry royalty percentages as Uniloc's expert attempted to do (*Georgia-Pacific* factor 12). Recall that the Uniloc expert opined at 10 percent—11 percent was a reasonable industry royalty rate range. In order to convert his $2.50 reasonable royalty conclusion into a percentage for comparison, the expert needed to use either the average entire market value of a single infringing product ($85) or, as he chose to do, divide his damages conclusion by the entire market value of all infringing products. Either approach would yield the 2.9 percent percentage royalty that the expert needed in order to perform his "check" comparison to industry average rates.[12] By remaining silent on these normal and customary uses of the entire market value, many believe that the CAFC has cast some doubt on a simple mathematical calculation that could be essential to compare the opined rate to industry benchmarks.

The CAFC's stated grounds for dismissing Uniloc's alternate argument that the entire market value of the products may appropriately be admitted if the royalty rate is low enough is also potentially problematic. As Uniloc's argument is summarized by the

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9. *Id*. at 1321.

10. *Id*. at 1320 citing *Garretson v. Clark*, 111 U.S. 120, 121, 4 S.Ct. 291, 28 L.Ed. 371 (1884) and *Lucent Techs*, 580 F.3d at 1336.

11. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970).

12. Interestingly, CAFC's Chief Judge Rader (sitting by designation) partially precluded the testimony of the same Uniloc expert in a different matter for use of what appears to be a similar industry range of 10%-11% because the expert "offers no evidence that the alleged industry agreements are in any way comparable to the patents-in-suit." *IP Innovation v. Red Hat, Inc.*, 705 F.Supp.2d 687, 689-690 (E.D. Tex. 2010). However, there is no mention of this particular issue having been argued by the parties or addressed by the CAFC in *Uniloc*.

CAFC, it is not surprising that the CAFC would reject a low rate, or any rate for that matter, that was not tied to the facts and circumstances of the case and related to the patent at issue. However, the CAFC's statement that, "the Supreme Court and this court's precedents do not allow consideration of the entire market value of accused products for minor patent improvements simply by asserting a low enough royalty rate"[13] should not be construed as a blanket prohibition against utilizing the entire market value in cases where the EMVR doesn't apply. As further stated by the CAFC in *Lucent*, "The license agreements admitted into evidence (without objection from Microsoft, we note) highlight how sophisticated parties routinely enter into license agreements that base the value of the patented inventions as a percentage of the commercial products' sales price. There is nothing inherently wrong with using the market value of 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."[14] The critical point from the CAFC here was that the royalty rate can, and is, often a function of the entire market value of a product even in situations where the EMVR doesn't apply, but the rate must reflect the value of the patent as compared to the entire product. The CAFC's statement reflects the realities of the licensing marketplace where most running-rate licenses are based on a percentage of revenue and an acknowledgment of *Georgia-Pacific* factor 13 calling for the apportionment of profit to the patented feature versus other elements.

Uniloc Take 2

The CAFC declined to rule on Microsoft's argument that damages were excessive. "Because this court is affirming the district court's grant of new trial on damages, and because the two bases on which Uniloc's damages case was built have both been rejected, it would be premature to consider the excessiveness of damages that could arise on remand. This court thus expresses no opinion on the excessiveness or reasonableness of the damages awarded by the jury."[15]

Given the CAFC's rulings, on remand it may not be surprising to see Uniloc's expert come to the same conclusion or perhaps something even higher, albeit via a different method. Instead of using the 25% Rule to allocate the patent's $10 value between the parties, the expert may simply rely on the other *Georgia-Pacific* factors in a relative bargaining position analysis. If the expert is feeling particularly adventuresome, he may even re-offer his industry analysis showing that software rates are somewhere around 10 percent—11 percent and sway the relative bargaining position toward $8.50 per unit (based on an average $85 per unit selling price). Given Judge Rader's exclusion of the use of general industry average rates in other matters, it is unlikely that Uniloc's expert would pursue this latter argument without reference to specific comparable licenses.

Uniloc's counsel will also likely criticize Microsoft's expert again, perhaps by showing that the $7 million conclusion translates to 3.1 cents per unit which seems small when compared against a $10 per unit value, which would suggest that the relative bargaining position would be 99.7 percent in favor of Microsoft and 0.3 percent in favor of Uniloc.

Microsoft, on the other hand, may decide to sharpen its attack on the underlying valuation, rebutting the $10—$10,000 per unit conclusion of that valuation, and perhaps focus on design around costs which could serve as a proxy for the value of the overall technology.

Whatever the case, a new jury means a whole new ball game and perhaps the CAFC will take another swing at clarifying some of its original points and the proper use of the EMV even where the EMVR doesn't apply.

Lack of Clarity in Post Uniloc District Court Cases

Subsequent district court cases post *Uniloc* have been mixed on the application of the EMVR.[16] In *Inventio AG v. Otis Elevator Co.*,[17] the district court, as gatekeeper, denied Otis' motion to exclude In-

13. *Uniloc*, 632 F.3d at 1320.

14. *Lucent*, 580 F.3d at 1339

15. *Uniloc*, 632 F.3d at 1321.

16. *See e.g., Inventio AG v. Otis Elevator Co.*, 2011 WL 3359705 (S.D.N.Y. June 23, 2011)(damages expert excluded from basing his damages calculation on EMVR); *PACT XPP Technologies, AG v. Xilinx, Inc.*, 2012 WL 1666390 (E.D. Tex. May 11, 2012)(motion to exclude damage expert apportionment did not run afoul of the EMVR where the parties agree that the EMVR does not apply but expert adopts of the opinion that the patented technology accounts for 30% of the value of the accused products without verifying the value or tying it more closely to the value of the patented feature based on the contention that the 30% figure is derived from customer surveys and internal reports").

17. *Inventio AG v. Otis Elevator Co.*, 2011 WL 3359705 (S.D.N.Y. June 23, 2011).

ventio's damages in their entirety, citing *Uniloc*;[18] however, the court granted Otis' motion to exclude Inventio's damages expert from proving reasonable royalty damages using the EMVR, citing *Lucent*.[19] Citing Uniloc, Judge McMahon stated that he personally saw some problems with the expert's analysis that could be highlighted to the jury, but that the expert's starting point for the calculation of a reasonable royalty was not (as alleged by Otis) "untethered from the facts of the case." Inventio's expert selected a starting point royalty rate at which [previous patentee] had licensed the pertinent patent to Inventio. The court noted that although the license was admittedly from a related company rather than a third party, it did not "untether" the license from the facts of the case. Rather, the suitability of the license should go to the weight or lack of weight that the trier of fact might wish to accord the license data.

In partially precluding Plaintiff's expert's testimony, Judge McMahon's opinion found Lucent the clear CAFC rule on the EMVR which states that for the EMVR to apply, the patentee must prove that the patented feature is "the basis for the customer demand." Further, Judge McMahon found that Lucent requires that a patentee:

> "must in every case give evidence tending to separate or apportion the defendant's profits and the patentee's damages between the patented feature and the unpatented features, and such evidence must be reliable and tangible, and not conjectural or speculative… He must show… that the profits and damages are to be calculated on the whole machine, for the reason that the entire value of the whole machine, as a marketable article, is properly and legally attributable to the patented feature."[20]

Judge McMahon stated that *Uniloc* "can fairly be said to have obfuscated this 'quite clear' rule a bit by stating the Entire Market Value Rule applies only where the patented feature (1) creates the basis for customer demand or (2) substantially creates the value of the component parts." The learned Judge opined that, "To my knowledge, Formulation (2) does not appear in prior case law (and certainly not in prior Supreme Court case law). However, I understand that the Federal Circuit to have been paraphrasing (inaccurately) [CAFC] Chief Judge Rader's articulation of what it means for a patented component to be 'the basis for customer demand' of a product that contains both patented and non-patented elements."[21] Judge McMahon highlighted that Inventio's expert did not purport to base his opinion on whether the patented destination dispatching elevator feature "substantially creates the value of the component part; rather, [the expert] opines that damages should be based on the entire market value of an (allegedly) infringing Otis elevator installation because that feature is a 'substantial basis for demand' for the entire elevator installation at the seven accused installations." Judge McMahon stated that a "substantial basis for demand" appears nowhere in the jurisprudence as a test for ascertaining the use of the EMVR.[22]

While Judge McMahon acknowledged that a patented feature that created a "substantial basis for demand" would tend to support the reasonableness of a higher royalty rate, he went on to state:

> "But as long as other [non-patented] features of a product contributed to the customer's decision, Supreme Court precedent (which the Federal Circuit is powerless to overrule) demands that there be an apportionment of the defendant's profits and the patentee's damages between the patented feature and the various unpatented features of the "whole machine" (in this case, the entire elevator installation)."[23]

Judge McMahon opined that Inventio's expert needed to provide evidence that the customer demand for an entire elevator system was based on the patented technology (elevator dispatch system) rather than on other factors, such as "vendor's history, reliability, price or ability to get the job done on time."[24] In the present case, the expert was partially excluded because although he was able to provide evidence that the patented technology was a desirable feature, he did not provide a "sound economic connection between the product's desirability and any contention that the [patented technology] was

18. *Id*. at *3.

19. *Id*. at *3-4, *6.

20. *Id*. at *4 (citing two old Supreme Court cases *Seymour v. McCormick*, 57 U.S. 480, 491 (1853) and *Garretson v. Clark*, 111 U.S. 12, 121 (1884)).

21. *Id*. f1(commenting on the inaccurately paraphrasing Chief Judge Radar's articular of what it means for a patented component to be the basis for customer demand of a product that contains both patented and non-patented elements in *IP Innovation v. Red Hat, Inc.*, 705 F.Supp.2d 687, 689 (E.D. Tex. 2010)(Radar, C.J., sitting by designation)).

22. *Id*.

23. *Id*. at *4.

24. *Id*.

the basis for the public demand for an Otis elevator"[25] [Emphasis in the original].

In another recent decision, *Man Machine Interface Technologies, LLC v. Vizio, Inc.*,[26] the district court appears to have accepted yet another variation to the 'substantial basis of customer demand' in allowing the application of the EMVR. This case revolved around a multi-function thumb switch feature of a television remote control. Defendant argued that Plaintiff's expert violated the EMVR by "incorporating into her damages calculations… the estimated revenue based on sales of the entire remote control unit, when the evidence indisputably shows that the allegedly patented feature (*i.e.*, the thumb switch configuration) is not the basis for consumer demand for the remote controls." In partially denying Defendant's motion and allowing the EMVR application, the court ruled that because the thumb-switch was "such a prominent feature in the remote, a reasonable juror could conclude that the thumb-switch is the primary driver of consumer demand for the device." Here, this district court has introduced perhaps yet another shade of consumer demand in terms of a "primary driver."

Interestingly, this court also ruled that Plaintiff failed to "satisfy its burden of showing that the thumb-switch device drove customer demand for Defendant's higher priced remotes" which contained additional non-patented features such as Bluetooth and a full QWERTY keyboard. Instead of disallowing the EMVR application to the higher priced remotes in its entirety, the district court allowed the entire value of the higher priced remotes to be included in the royalty base, but limited the royalty rate to that of the lower priced remotes.

So Where Does this Lead Us?

While the Uniloc ruling was clear on the 25% Rule, it may have unintentionally obscured the EMVR. The EMVR basis espoused in *Lucent* appears clearer as it derives directly from Supreme Court law, albeit old law. There will undoubtedly be continuing confusion at the trial court level until the EMVR standard in *Uniloc* is readdressed. ■

25. *Id*. at *5 (The mere fact that customers at the seven allegedly infringing installations elected to purchase an elevator system with seamless destination dispatching does not, without more, establish that the system's entire market value derived from that single feature. Because the plaintiff proffered no evidence on this point, the expert's testimony was excluded from allowing him to base his damages on the entire market value of the elevator installation.)

26. *Man Machine Interface Technologies, LLC v. Vizio, Inc., et al*., No. 8:10-cv-00634-AG-MLG (C.D. Cal February 27, 2012) Omnibus Order Dkt. No. 185.