

Federal Circuit Hints at Future Limits on Patent Damages in *i4i v. Microsoft* Opinion

By Theodore Baroody¹

A federal court jury in Tyler, Texas awarded \$200 million in damages for patent infringement against Microsoft last year.² The patent at issue concerned a relatively specialized custom XML³ editing feature that the jury found to be present in certain versions of Microsoft Word[®]. Late last year, the Federal Circuit issued its opinion affirming the damages award, but declined to address a key question: how can a damages finding of such magnitude be supported by such an apparently innocuous feature entirely unknown to and unwanted by most users of Microsoft Word? The question went unanswered due to procedural matters. The oral argument before the Federal Circuit⁴, however, shines a bright light on the current thinking of some of the Federal Circuit Judges as to the best measures of the reasonableness of a jury award for patent infringement involving a reasonable royalty calculation. Patent litigators should take note, as the Judges' questioning at oral argument is a beacon for the defendant in the next large patent infringement case.

According to the testimony, i4i, Inc. began as a software consulting business in the late 1980s. The company developed a custom XML editor, obtained a U.S. patent in 1998, and had several products that implemented the claimed invention, including one version that was an "add-on" to Microsoft Word. There was evidence at trial that Microsoft and i4i had discussions concerning Microsoft using an i4i XML editor as a plug-in, but instead Microsoft launched its own XML editor in 2003 as part of Word. Microsoft argued at trial that i4i's product was "plagued with quality issues," that i4i had lost roughly \$26 million from 1999-2003, and that the entire company had been valued during the relevant time frame at less than \$2 million. To counter this, i4i introduced internal documents from Microsoft stating that Microsoft Word as of 2000 did not have an XML editor and needed one, and introduced evidence of presentations made by Microsoft that allegedly illustrated the possible integration of i4i's XML editor product with Microsoft Office[®], a suite of software in which Microsoft Word is often bundled.

At trial, i4i's damages expert applied the well-known methodology from the *Georgia-Pacific*⁵ case and testified that a reasonable royalty of \$98 per unit would result from a hypothetical negotiation between the parties as of the date of the first infringement during 2003. The \$98 figure was then multiplied by the number of Word units used in an infringing manner, which was limited to business users in the U.S. and estimated by a survey to be 2.1 million (roughly 2% of all U.S. users).⁶ Compared to the \$1- \$5 million Microsoft had paid to license other patents, Microsoft argued that the \$98 royalty was grossly excessive. In opening, Microsoft's counsel pointed out that he had purchased a copy of Microsoft Word from Amazon.com for \$97.98.⁷

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² Judge Davis enhanced the damages by a further \$40 million based on a finding of willful infringement. The case is *i4i L.P. v. Microsoft Corp.*, case no. 07-cv-113 in the U.S.D.C. for the Eastern District of Texas (Tyler Division).

³ XML is a mark up language that allows "tags" to be appended to data such as text, and the tags provide information that can be used to display it, such as how or where text may appear, or other information related to it.

⁴ The audio of the oral argument is available at: <http://oralarguments.ca9c.uscourts.gov/searchscript.asp> (search for "i4i").

⁵ *Georgia Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).

⁶ The damages expert for i4i testified that the survey was based on a total of 46 respondents.

⁷ There was also evidence that there are versions of Word sold to businesses that retail for approximately \$200.

To value Microsoft's use of the claimed invention and arrive at the \$98 figure, i4i's damages expert departed from the usual analysis of patent license rates for comparable technologies, and instead testified that he chose as a benchmark a third-party product called XMetal that retailed at \$499 (which was apparently referenced in Microsoft internal documents as an XML editor product which Microsoft had used internally prior to developing its own XML editor). He then applied Microsoft's profit margin of 76.6%, and used the "25% rule" to apportion the profit that the inventor would keep as the reasonable royalty.⁸ As to the 25% rule, i4i's damages expert testified at trial: "[m]any people use this approach. Some people don't like it, but it's widely used."

One of the renowned members of the patent bar, Donald Dunner, argued before the Federal Circuit on behalf of i4i in Microsoft's appeal of the judgment. Mr. Dunner, under vigorous questioning by the Circuit Judges, was asked:

But you think a \$500 software package for XML which is only a tiny portion of the huge functionality offered by Microsoft Word is a reasonable one-to-one substitute for the two? You think every person that bought and used Microsoft Word for an infringing use would have alternatively bought the \$500 XML XMetal product as an alternative if Word did not offer that functionality? ***That's totally irrational....*** (response by D. Dunner omitted)

He used everyone who uses XML functionality in Word. But even the people who use the XML functionality in a \$200 product, how can you suggest that every one of them would have bought a \$500 product if they couldn't, right?

Since i4i could rely only on the benchmark XMetal product consistent with its damages expert's trial testimony, Mr. Dunner stated in response:

Your honors, ...we submit that if a person wanted to use XML functionality, and they had choices, and they did not want to buy a whole [unintelligible] system, that they would have been willing for those who wanted to use it, those who infringe...they would have paid.

The Federal Circuit has thus clearly communicated its concern with both the 25% rule and methodologies that do not apportion the value of the patented feature relative to the full price of a product. These two issues clearly await the next large patent verdict brought before the Federal Circuit.

Despite the Federal Circuit affirming i4i's \$200 million award, a key practice tip that may be taken from this decision is that a strategically planned defense in patent infringement litigation may benefit from addressing with detailed expert testimony the issues of apportionment of the patented feature's value and the criticisms of the "25% rule" at trial to create a record that might support a smaller damages judgment. At a minimum, such a record would provide a better opportunity for the Federal Circuit to reduce or remand such an award on appeal.

⁸ According to i4i's damages expert's trial testimony, there was also an additional downward adjustment of the royalty base in the amount of 3.5% related to a possible non-infringing use.