Rule of Thumb No More

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The United States Court of Appeals for the Federal Circuit issued an important decision Jan. 4 on the determination of reasonable royalties in patent infringement damages. In *Uniloc USA, Inc. v. Microsoft Corporation*, the Court soundly rejected the use of the 25 percent Rule of Thumb, which had been increasingly used by damages experts and tacitly accepted by many courts.

In the *Uniloc* matter, Microsoft was accused of infringing Uniloc's '216 patent for a software registration system that deters the illegal copying of software on multiple computers. The accused product was Microsoft's Product Activation feature that acted as a gatekeeper to Word XP, Word 2003 and Windows XP software programs.

Section 284 of Title 35 of the United States Code provides that on finding infringement of a valid patent, damages shall "in no event [be] less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court." A reasonable royalty is often determined on the basis of a hypothetical negotiation occurring between the parties at the time infringement began. Frequently, to assist in valuing the license that would have resulted from the hypothetical negotiation, parties look to the 15 factors laid out in the decades-old district court case *Georgia-Pacific Corp. v. U.S. Plywood Corp*.

At trial, Uniloc's damages expert relied on a pre-litigation Microsoft document that valued the Product Key between $10 and $10,000 depending on usage. Uniloc's expert took the low end of the range, or $10, as "the isolated value of Product Activation." He applied the 25 percent rule, thereby assuming that the patent holder would receive 25 percent of the value of the product, and established a baseline royalty rate of $2.50 per license. He then considered several of the *Georgia-Pacific* factors and concluded that the factors in favor of Uniloc and Microsoft would generally balance out.

Based on 225,978,721 licenses of the at-issue products sold, and the royalty rate of $2.50 per license, he reached a reasonable royalty of $564,946,803.

Finally, the expert checked the reasonableness of this amount by comparing it against an estimate of Microsoft's gross revenue of $19.28 billion from the at-issue products, which resulted in a royalty rate of 2.9 percent. Based on his experience that royalty rates for software were generally above 10 percent, the expert concluded that his calculated royalty was reasonable. The jury awarded Uniloc $388 million in damages.

The Court found that Uniloc's expert's starting point of a 25 percent royalty "had no relation to the facts of the case, and as such, was arbitrary, unreliable and irrelevant." The Court added, "The use of such a rule fails to pass muster under *Daubert* and taints the jury's damages calculation" and granted a new trial on damages.

History of the 25 Percent Rule

The 25 percent rule, first written about by Robert Goldscheider in 1971, suggests that "the licensee pay a royalty rate equivalent to 25 per cent of its expected profits for the product that incorporates the IP at issue" (Robert Goldscheider, et al., *Use of the 25 Percent Rule in Valuing IP*, les Nouvelles, December 2002, pages 123–124). The licensee, having undertaken substantial development, operational and commercialization risks, would retain the remaining 75 percent of the profits.

Further research found that across all industries, the royalty rate as a percentage of average operating profit margins ranged from 8.5 percent for semiconductors to 79.7 percent for automotive, (Goldscheider, page 133). Also, a 1997 study showed that 25 percent of licensing organizations used the 25 percent rule as a starting point in negotiations (Goldscheider, page 127). Typically, damages experts have used the rule to establish a baseline royalty rate, then adjust based on the *Georgia-Pacific* factors.

While the 25 percent rule was widely used by some experts, there were many experts who objected to its use. Opponents had argued that the rule:

- Failed to account for the unique relationship between the patent and the accused product;
- Failed to account for the unique relationship between the parties;
- Was arbitrary and did not fit within the model of the hypothetical negotiation within which it is based; and
- Was not meaningful for products subjected to multiple licenses, as profits would be quickly depleted by multiple licensors each claiming 25 percent thereof.

Additionally, the historical background of the 25 percent rule is somewhat incongruous as it relates to valuing a single patent in a hypothetical negotiation for damages caused by infringement within the United States. According to Goldscheider, the 25 percent rule was premised on 18 licenses entered into by a Swiss company (a U.S. subsidiary) covering worldwide sales (Goldscheider, page 123). Moreover, these licenses were for a "portfolio of valuable patents," as well as for "a continual flow of know-how; trademarks developed by the licensor; and copyrighted marketing and product description materials" (Goldscheider, page 123). Thus, the 25 percent royalty was developed for multiple patents, as opposed to only one patent, for worldwide sales, as opposed to only U.S. sales, and for substantial other intellectual property rights as opposed to no other property rights.

The Court's RejectŠn of the 25 Percent Rule

In its ruling, the Court first dismissed the supposed widespread acceptance of the 25 percent rule, stating:

"The admissibility of the bare 25 percent rule has never been squarely presented to this court. Nevertheless, this court has passively tolerated its use where its acceptability has not been the focus of the case, or where the parties disputed only the percentage to be applied ..., but agreed as to the rule's appropriateness. Lower courts have invariably admitted evidence based on the 25% rule, largely in reliance on its widespread acceptance or because its admissibility was uncontested."

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The Court then soundly rejected the use

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of the 25 percent rule, stating: "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."

The Court refers to three prior cases, *Lucent Technologies*, *ResQNet* and *Wordtech*, as a reminder that "evidence of royalty rates from licenses without a relationship to the claimed invention could not form the basis of a reasonable royalty calculation."

The Court further states: "The meaning of these cases is clear: there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case. The 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement. The rule does not say anything about a particular hypothetical negotiation or reasonable royalty involving any particular technology, industry, or party. Relying on the 25 percent rule of thumb in a reasonable royalty calculation is far more unreliable and irrelevant than reliance on parties' unrelated licenses, which we rejected in *ResQNet* and *Lucent Technologies*. There, the prior licenses at least involved the same general industry and at least some of the same parties as the hypothetical negotiations at issue, and in *Wordtech* even involved licenses to the patents in suit entered into by the patentee-plaintiff. Lacking even these minimal connections, the 25 percent rule of thumb would predict that the same 25%/75% royalty split would begin royalty discussions between, for example, (a) TinyCo and IBM over a strong patent portfolio of twelve patents covering various aspects of a pioneering hard drive, and (b) Kodak and Fuji over a single patent to a tiny improvement in a specialty film emulsion."

The Court dismisses the 25 percent rule method, ruling that, "Beginning from a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the facts of the case nevertheless results in a fundamentally flawed conclusion."

Going Forward

The Court, citing *ResQnet*, states, "To be admissible, expert testimony opining on a reasonable royalty rate must 'carefully tie proof of damages to the claimed invention's footprint in the market place.'" In particular, the Court cited *Georgia-Pacific* "factors 1 and 2—looking at royalties paid or received in licenses for the patent in suit or in comparable licenses—and factor 12—looking at the portion of profit that may be customarily allowed in the particular business for the use of the invention or similar inventions" and considers them "valid and important factors in the determination of a reasonable royalty rate." 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."

While the 25 percent rule of thumb is essentially dead for purposes of litigation, other tools are available for experts to establish a reasonable royalty rate that would meet the Court's criteria. A reasonable royalty analysis should focus on the incremental economic benefits derived from the patented invention, in the form of increased sales volumes, lower costs or higher sale prices, and on the standards used by the industry to share in the economic benefits obtained from the technology. The experts should consider pre-existing licenses, license negotiations and perhaps even settlement agreements, as well as out-of-pocket design-around costs and costs of any expected economic disruption.

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