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IP Litigation News

Reasonable Royalty Damages: The "25 Percent Rule" Is Dead!

The Federal Circuit has recently rejected the so-called "25 percent rule" long used by litigants and accepted by federal courts to establish a "reasonable royalty" as compensation for patent infringement under Section 284 of the Patent Act. In its January 4, 2011 *Uniloc* decision,[1] the court stated unequivocally:

> 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]

Consequently, Microsoft was granted a new trial on damages after Uniloc had obtained a $388 million jury verdict based on its expert's conventional analysis and testimony with respect to a reasonable royalty relying in part on the 25 percent rule of thumb.

From now on, all patent litigants will be barred from presenting such evidence to derive a baseline royalty as a starting point for establishing a reasonable royalty, even though the baseline royalty is adjusted to reflect the venerable "*Georgia-Pacific* factors." This development has significant implications for the damages phase of patent infringement litigation.

Section 284 Patent Act Damages for Infringement

Section 284 provides in pertinent part:

> Upon finding for the claimant the court shall award the claimant damages 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, together with interest and costs as fixed by the court.[3]

Because lost profits are often difficult to establish under applicable legal principles,[4] litigants commonly attempt to establish a reasonable royalty for the claimed infringement, a process in which retained experts for both sides offer competing analyses and opinions as to a "reasonable" royalty under the circumstances of the case. As the *Uniloc* court noted, "[a] reasonable royalty is the predominant measure of damages in patent infringement cases."[5]

[1] *Uniloc USA, Inc. v. Microsoft Corp.*, No. 2010-1035, -1055 (Fed. Cir. Jan. 4, 2011).

[2] *Id*. at 41.

[3] 35 U.S.C. § 284.

[4] To recover lost profits, a plaintiff must establish by a preponderance of the evidence that "but for" the infringing sales, there is a reasonable probability that the plaintiff would have made the infringing sales and the resulting profits. The courts generally require that plaintiff satisfy the four-part *Panduit* test: (1) demand for the patented product; (2) absence of satisfactory noninfringing alternatives; (3) manufacturing and marketing capability to exploit the demand; and (4) the amount of profit that would have been achieved. *Panduit Corp. v. Stahlin Brothers Fibre Works*, 575 F.2d 1152 (6th Cir. 1978).

[5] *Uniloc* at 36.

Heretofore, it was typical for plaintiff's expert to use (and defendant's expert to contest) an analysis which began with the 25 percent rule of thumb (or a variation of it) and refined the resulting baseline royalty according to the expert's application of the 15 *Georgia-Pacific* factors (further discussed below) to arrive at a proposed reasonable royalty rate. In this analysis, it is presumed that the parties would have agreed upon this royalty in a hypothetical negotiation at the time the infringement began. The resulting royalty rate is applied to appropriate revenues or profits, as the case may be, to arrive at the projected damages for the infringing use of the patented invention. Briefly, here is how these components of this analysis fit together.

The 25 Percent Rule

This approach is based on the assumption that, as a general matter, a patent licensee should retain most (i.e., 75 percent) of the expected profits from the use of the invention and pay a royalty of the remaining 25 percent of those expected profits to the patentee for the right to use the invention. The court expressed the concept this way:

> As explained by its leading proponent, Robert Goldscheider, the rule takes the following form: An estimate is made of the licensee's expected profits for the product that embodies the IP at issue. Those profits are divided by the expected net sales over that same period to arrive at a profit rate. That resulting profit rate, say 16 percent, is then multiplied by 25 percent to arrive at a running royalty rate. In this example, the resulting royalty rate would be 4 percent. Going forward (or calculating backwards, in the case of litigation), the 4 percent royalty rate is applied to net sales to arrive at royalty payments due to the IP owner.[6]

[6] *Uniloc* at 36–37.

The Georgia-Pacific *Factors*

With a baseline royalty rate established, the parties' experts would then offer conflicting opinions, applying the so-called *Georgia-Pacific* factors to the specific facts and circumstances of the case in order to adjust the baseline royalty rate derived from the 25 percent rule. In theory, these adjustments result in the reasonable royalty that the (presumably willing and fully informed) parties would have agreed upon for the use of the patented invention at issue in a hypothetical negotiation at the outset of the infringing activity.[7] Of the 15 broadly defined factors to be considered, some may favor an upward adjustment while other factors may suggest a downward adjustment. The parties' respective experts will usually differ significantly in their adjustments and resulting reasonable royalty opinion.

The Uniloc *Decision*

The jury awarded Uniloc $388 million, based in part on its expert's opinion that reasonable royalty damages for Microsoft's infringing sales of Office and Windows licenses should be over $500 million. The expert's analysis was fairly typical. He selected a conservative profit value of $10.00 per unit for the functionality of the accused product—a software product activation key installed with each license for security purposes—and multiplied that value by 25 percent to establish a baseline royalty of $2.50. Next, he considered adjustments based on his application of the *Georgia-Pacific* factors. In his opinion, these various factors balanced out,

[7] The *Georgia-Pacific* decision articulated 15 broad interrelated evidentiary factors to be considered in determining a reasonable royalty under the specific facts of the case. Some of these factors relate to the relationship and licensing activities among the parties and in the industry or analogous businesses for the patented invention or comparable inventions. Additional factors relate to the value of the patented invention, such as anticipated profits from the sale of the patented invention or convoyed sales, benefits and utility of the patent, duration of the patent, availability of noninfringing alternatives, the amount that willing and informed parties would reasonably have agreed upon in the hypothetical negotiation and expert opinion with respect thereto. *Georgia-Pacific Corp. v. U.S. Plywood Corp.* 318 F. Supp. 1116, 1120–21 (S.D.N.Y. 1970), *modified and aff'd,* 446 F.2d 295 (2d Cir.), *cert. denied*, 404 U.S. 870 (1971).

resulting in a final royalty rate of $2.50 per unit. He then multiplied this royalty rate by the number of new Office and Windows licenses sold during the applicable period, resulting in a final reasonable lump-sum royalty of over $500 million.

As a "check" of the reasonableness of his calculated royalty, *Uniloc's* expert compared it to Microsoft's revenues from the sale of those Office and Windows licenses at an average price of $85 per license during the relevant period—a total of $19.28 billion. This comparison reflected that his calculated royalty would be approximately 2.9 percent of these total revenues, which he opined was reasonable and well within the 10 percent or 11 percent range of industry royalty rates for software.

On appeal, the Federal Circuit for the first time directly considered the propriety of using the 25 percent rule as evidence to support a reasonable royalty under Section 284. After an extensive analysis of the 25 percent rule of thumb,[8] the court rejected it as "*a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation . . . because it fails to tie a reasonable royalty to the facts of the case at issue*."[9]

Having started from this flawed 25 percent premise, application of the various *Georgia-Pacific* factors, however rigorous, could not save the resulting royalty evidence from inadmissibility. In the court's view:[10]

> It is of no moment that the 25 percent rule of thumb is offered merely as a starting point to which the *Georgia-Pacific* factors are then applied to bring the rate up or down. 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.[11]

The court emphasized that its rejection of the 25 percent rule is not intended to limit the application of the *Georgia-Pacific* factors if these factors are tied to the relevant facts and circumstances of the particular case and the hypothetical negotiations that would have taken place at the relevant time. These remain valid and important factors in determining a reasonable royalty.

Entire Market Value Rule

Moreover, the court also rejected Uniloc's use of the entire market valuation of the Windows and Office licenses as a "check" on the reasonableness of the calculated royalty. The entire market value rule requires that the patented feature or component creates the basis for customer demand or substantially creates the value of the component parts.[12] It was clear that the accused product activation key was not the reason customers purchased Office or Windows, and Uniloc did not base its proposed royalty on the entire market value rule. The court concluded that the use of this approach, even only as a check, was prejudicial and improper under these circumstances because the requirements of the rule were not met and the jury could have been influenced by the $19 billion disclosure despite curative instructions.[13]

Conclusion

A "reasonable royalty" is likely to continue as the dominant measure of compensation for patent infringement under Section 284. Without the ability to rely on the 25 percent rule, litigants and their respective experts will be relying more heavily on industry surveys and other analyses in applying the various *Georgia-Pacific* factors to the specific facts and circumstances of the case to reconstruct the hypothetical negotiations that would have

[8] *Uniloc* at 35–47.
[9] *Id*. at 41 (emphasis added).
[10] *Id*.
[11] *Id*. at 46.

[12] *Id*. at 48 (citing *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1336 (Fed. Cir. 2009), and *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1549–50 (Fed. Cir. 1995)).
[13] *Id*. at 51–54.

taken place between the parties in light of those factors at the relevant time. Although the many complex factors relating to a reasonable royalty will differ in each case, the plaintiff is always required to establish infringement damages with reasonable certainty. Without the benefit of the 25 percent rule or a variation that has long been available, that task is likely to be more difficult and costly in newly filed actions as well as currently pending cases yet to reach trial. Given their renewed importance, a follow-up newsletter will be published discussing the *Georgia-Pacific* factors.

If you have any questions regarding this article, please contact **Stanley B. Block** at 312-609-7505.

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