

## The Demise of the 25% Rule for Determining a Reasonable Royalty in Patent Litigation

The *Uniloc v. Microsoft*<sup>1</sup> precedential decision is interesting enough for its procedural history, but of primary importance is the Federal Circuit's clear rejection of the 25% Rule for determining a reasonable royalty.

Under this "Rule," the economic benefit from the licensee's (infringer's) use of the subject intellectual property is allocated between the licensor (patent holder) and licensee. This approach involves a belief that, in general, licensors and licensees in non-litigated technology licenses tend to share in the benefits of the technology in a fixed proportion (most commonly thought to be 25 percent, but as discussed below, can be within a range of values) regardless of the type of technology involved, the product markets covered, or the scope of the patents. This has resulted in what has been called the "25% rule-of-thumb," which would apportion 25 percent of the operating profits from the infringing technology to the patent holder/licensor and 75 percent to the defendant/licensee. This 25% Rule is sometimes used as a starting point in a hypothetical negotiation.<sup>2</sup> Over time, several variations proposing different percentage splits have been proposed. Various rules-of-thumb percentage splits include: 25 percent to 33 percent (applied to profits or sometimes to cost savings); 5 percent to 50 percent (of profits or cost savings); and 10 percent (applied to capitalized costs).<sup>3</sup> While the Federal Circuit has not weighed in specifically on the 5, 50, or 10 percent rules, one would have to assume that the conclusion it reaches in *Uniloc* would apply.

After 10 days of trial, the jury found that Microsoft infringed the asserted claim of Patent No. 5,490,216 ('216 patent), the asserted claim was valid, the infringement was willful,

and Uniloc was entitled to \$388 million in damages.<sup>4</sup> The damage award was based on the testimony of Uniloc's damages expert, Mr. Gemini, who testified that damages should be \$564,946,803.<sup>5</sup> This was based on hypothetical negotiation between Uniloc and Microsoft where Mr. Gemini applies the 25% Rule to an estimated value of the invention (not estimated operating profits) to determine the patent holder's allocated share which Mr. Gemini uses as his base royalty rate. He then adjusts this base rate up or down based on an analysis of the *Georgia-Pacific* factors.<sup>6</sup> Mr. Gemini also testified to a trial exhibit that showed his reasonable royalty as a percent of total accused product sales of \$19 billion. The court found that this exhibit erroneously implied a connection between the patented invention, related to product activation keys, with the sales of Microsoft Office XP, Windows XP and Office 2003 products.<sup>7</sup>

Following the verdict, Microsoft filed a motion for judgment as a matter of law ("JMOL") of non-infringement and no willful infringement of Uniloc's asserted claims to the '216 patent and, in the alternative, of granting a new trial on infringement and willfulness. The U.S. District Court for the District of Rhode Island granted Microsoft's motions.<sup>8</sup> The District Court stated that a new damage trial is appropriate even if the Federal Circuit reversed or vacated the JMOL because, in part, Uniloc should *not* have been able to use the \$19 billion figure in front of jurors.<sup>9</sup>

Uniloc appealed the decision of the District Court to the U.S. Court of Appeals for the Federal Circuit. Uniloc also appealed the District Court's alternative grant of a new trial on damages.<sup>10</sup> On January 4, 2011, the Federal Circuit reversed the District Court's



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grant of JMOL of non-infringement and the District Court's alternative grant of a new trial on infringement as an abuse of discretion. The Federal Circuit did affirm the District Court's JMOL of no willfulness, rendering the alternative grant of a new trial on willfulness moot. Further, regarding Mr. Gemini's use of the 25% Rule, the Federal Circuit ordered a new trial on damages "[b]ecause the jury's award was fundamentally tainted by the use of a *legally inadequate methodology*."<sup>11</sup>

35 USC 284 Damages, states that "[u]pon 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." Damage experts have successfully used a number of methodologies in determining a reasonable royalty – all based on varia-

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### expert TIP

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tions of cost, market, and income-based valuation approaches. One income-based approach to determining a reasonable royalty was to use the "25% Rule."<sup>12</sup>

Historically, the 25% Rule has most often been used when there is no licensing history for the patent technology, if there is no information on comparable licenses, or as a reasonableness check on a reasonable royalty derived using another approach. The 25% Rule can yield spurious results—when applied to companies with low or negative net margins, possibly greatly underestimating the value of the intellectual property by using an infringer's poor business performance to the detriment of the patent owner, or can overstate the value when applied to a product where the patented feature does not form the basis for consumer demand for the product. This was the case in the *Uniloc* litigation.

Microsoft had challenged the 25% Rule *in limine* and attempted to exclude Uniloc expert Mr. Gemini's testimony. The District Court rejected Microsoft's position, noting that while the rule has been widely accepted, "the concept of a 'rule of thumb' is perplexing in an area of law where reliability and precision are deemed paramount."<sup>13</sup> The Federal Circuit admit-

ted to its own historical toleration of the use of the 25% Rule when acceptance of the rule had not been the focus of the case.<sup>14</sup>

Criticisms of the 25% Rule broadly fall into three categories. First, the 25% Rule fails to account for the unique relationship between the patent and the accused product. Second, it fails to account for the unique relationship between the licensor and licensee and the different levels of risk assumed by these parties. Third, the 25% Rule is "essentially arbitrary and does not fit within the model of the hypothetical negotiation."<sup>15</sup>


In its *Uniloc* decision, the Federal Circuit states,

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.<sup>16</sup>

The patentee bears the burden of proving damages. This requires that the patentee sufficiently tie expert testimony to the facts of the case. If the

patentee fails to do this, then the testimony must be excluded.<sup>17</sup> Using a rule of thumb fails in this regard. The Federal Circuit considers using the 25% Rule to derive a base rate is beginning from "a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the facts of the case [such as through the application of the *Georgia-Pacific* factors] nevertheless results in a fundamentally flawed conclusion."<sup>18</sup>

The fallout from the Federal Circuit's *Uniloc* decision was immediate. On January 6, only 2 days following the Federal Circuit decision, a federal magistrate in Marshall, Texas, citing *Uniloc*, vacated a \$139 million jury award for Versata Software against SAP, where the plaintiff's expert used the 25% Rule.<sup>19</sup> The *Uniloc* decision is likely to impact many more pending cases where experts have submitted damage estimates relying in whole or in part on the 25% Rule.

Even through the 25% Rule is used in real-world patent licensing negotiations, use of this rule never provided the analytical rigor required for a determination of a reasonable royalty. The 25% Rule was occasionally used in litigation to fill a void where comparable licenses did not exist and where there was insufficient fact and financial data to determine a reasonable royalty rate. Courts, including the Federal Circuit, need to be more open and much more consistent in allowing all licensing information into the record – including bundled licenses containing the patented technology, settlement licenses, and information related to licensing negotiations.<sup>20</sup> Existing licenses need not be perfectly comparable to be useful. In fact, as valuation experts know, perfect comps may never exist for any asset. However, having adequate relevant licensing information will allow the expert to make necessary adjustments to arrive at a supportable reasonable royalty. 

Endnotes on page 23



## VI. Professionalism

- <sup>1</sup> *Uniloc USA, Inc. and Uniloc Singapore Private Limited v. Microsoft Corporation* (Fed. Circuit, 2011), Slip Op. (<http://www.ca9.uscourts.gov/images/stories/opinions-orders/10-1035.pdf>, accessed January 5, 2011).
- <sup>2</sup> See Robert Goldscheider, John Jarosz, and Carla Mulhern, "Chapter 22: Use of the 25% Rule in Valuing Intellectual Property," *Intellectual Property: Valuation, Exploitation, and Infringement Damages*, 4th edition, Ed. Gordon V. Smith and Russell L. Parr (Hoboken: John Wiley & Sons, Inc., 2005), pp. 410-426.
- <sup>3</sup> Richard B. Troxel and William O. Kerr, *Assets and Finances: Calculating Intellectual Property Damages* (Thomson Reuters, 2010), p. 282.
- <sup>4</sup> Decision and Order, *Uniloc USA, Inc. and Uniloc Singapore Private Limited v. Microsoft Corporation*, No. 03-440 S (D. R.I. Sept. 29, 2009), 10 (<http://docs.google.com/gview?url=http://docs.justia.com/cases/federal/district-courts/rhode-island/ridce/1:2003cv00440/4770/412/0.pdf?1270169445&pli=1&chrome=true>, accessed Jan. 13, 2011).
- <sup>5</sup> *Uniloc v. Microsoft* (Fed. Cir.), at 33.
- <sup>6</sup> *Uniloc v. Microsoft* (Fed. Cir.), at 33-34. See *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970), modified, 446 F.2d 295 (Second Cir. 1971), cert. denied, 404 U.S. 870 (1971) for a listing and discussion of the *Georgia-Pacific* factors.
- <sup>7</sup> Decision and Order, *Uniloc v. Microsoft*, No. 03-440 S, at 4, and 60-65. Microsoft's damages expert, Mr. Napper, testified that the maximum damages would be no more than \$7 million based upon a maximum lump-sum payment. See *Uniloc v. Microsoft* (Fed. Cir.), at 33.
- <sup>8</sup> *Uniloc v. Microsoft* (Fed. Cir.), at 2.
- <sup>9</sup> Decision and Order, *Uniloc v. Microsoft*, No. 03-440 S, 60-65, and Susan Decker and Cary O'Reilly, "Microsoft Wins Reversal of Uniloc \$388 Million Patent Verdict," Bloomberg.com, September 30, 2009 00:01 (<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ad2zU0RrUn6Q>, accessed Jan. 13, 2011). Use of total accused product sales is a misapplication of the entire market value rule, wherein the entire value of a patented product is attributed to the patented feature when that feature forms the basis for consumer demand for the product. Clearly a patent dealing with activation code technology does not form the basis for Microsoft's products.
- <sup>10</sup> *Uniloc v. Microsoft* (Fed. Cir.), at 2.
- <sup>11</sup> *Ibid.*, at 2-3, emphasis added.
- <sup>12</sup> See, for example, *i4i Ltd. Partnership v. Microsoft Corp.*, 598 F.3d 831, 852 (Fed. Cir. 2010) and *Fonar Corp. v. General Electric Co.*, 107 F.3d 1543, 1553 (Fed. Cir. 1997).
- <sup>13</sup> *Uniloc v. Microsoft* (Fed. Cir.), at 35.
- <sup>14</sup> *Ibid.*, at 39.
- <sup>15</sup> *Ibid.*, at 38.
- <sup>16</sup> *Ibid.*, at 41.
- <sup>17</sup> *Ibid.*, at 41-42.
- <sup>18</sup> *Ibid.*, at 46.
- <sup>19</sup> Victor Li, "Uniloc Decision Helps SAP Void \$139 Million Patent Verdict," *The American Lawyer*, January 13, 2011 ([http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202477930995&Uniloc\\_Decision\\_Helps\\_SAP\\_Void\\_Million\\_Patent\\_Verdict](http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202477930995&Uniloc_Decision_Helps_SAP_Void_Million_Patent_Verdict), accessed Jan. 13, 2011).
- <sup>20</sup> See, for example, *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009) and *ResQNet.com, Inc. v. Lana, Inc.*, 594 F.3d 860, including the dissenting opinion of Circuit Judge Newman.

- A. An expert shall accept only engagements that are within the expert's area of competence and training. An expert shall not purport to be an expert in matters in which the expert has limited knowledge or experience, or in any matter in which professional peers with the same level of knowledge and experience would not hold themselves out as experts.
- B. An expert shall ensure that all tests, analysis and other operations leading to conclusions and opinions are based on adequate and accepted procedures within the profession. An expert who uses procedures that are considered experimental or controversial should so say in rendering any report or conclusions.
- C. An expert witness shall be clear about the strength of the expert's conclusion. An expert witness shall indicate when an opinion is inconclusive because of insufficient research or insufficient data.
- D. An expert witness shall update an opinion in light of new information if there is continuing reliance on the opinion. If an expert witness changes an opinion on a material matter after providing a report to the client, the expert shall promptly provide the client with a supplementary report explaining the change.
- E. An expert should strive to understand the standards applicable in the jurisdiction to the use and admissibility of an expert's opinion.
- F. An expert's written report should reflect the expert's independent analysis and opinion. While an expert and the retaining attorney may discuss the contours, scope and subjects of the report, the final product must conform to the expert's findings and conclusions.
- G. An expert witness shall not conceal or destroy documents or evidence that are or may be discoverable.
- H. An expert shall not knowingly present opinions or testimony that are false or misleading.
- I. An expert witness should not accept the client's characterizations or conclusions without exercising due diligence by inquiring into the underlying facts.
- J. The expert witness shall provide opinions that are reasoned and based on the expert's own analysis. The expert shall not unreasonably exclude issues that are material to the client's purpose and within the expert's expertise.

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