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The 25% Rule Lives On

Law360, New York (September 08, 2010) -- Reports of the imminent demise of the 25 Percent Rule have been greatly exaggerated. In a recent guest column in IP Law360, economists Alan Cox and Stephen Rusek contend that several new decisions by the U.S. Court of Appeals for the Federal Circuit suggest that use of the 25 Percent Rule has no place in reasonable royalty analysis, and that use of the rule should be rejected in "Daubert motions, in verdicts or in post-trial judgments as a matter of law."[1]

This conclusion is unsupported by an evaluation of the current state of the law and reveals a fundamental misunderstanding of the rule and its appropriate application in an IP valuation exercise.

In spite of the Cox/Rusek hopes, reasonable royalty testimony based, at least in part, on the 25 Percent Rule was actually upheld by the Federal Circuit in i4i v. Microsoft,[2] the latest case to address the use of the rule. Not only does the law there and elsewhere not appear to be moving in the Cox/ Rusek direction, it should not.

As we discuss in this article, a review of the criticisms set forth in the Cox/Rusek article reveals a fundamental misunderstanding of the rule and its appropriate application. The rule suggests a royalty payment equivalent to 25 percent of a licensee's expected long-run profit rate for a product that practices certain IP.

The rule cannot and should not be used in every royalty exercise. Nor should a royalty exercise ever consider only the rule, especially if better data on incremental benefits are available. It is improper applications of the 25 Percent Rule that Cox/Rusek (and the courts) should have issue with, not the rule itself.

Recent Case Law

Two of the court cases that Cox/Rusek write about as "supportive" of the Federal Circuit's "move" toward throwing out the 25 Percent Rule are Cornell v. Hewlett-Packard,[3] and Lucent v. Gateway.[4]

The first was not a Federal Circuit case, but was heard by Chief Judge Rader, sitting by designation. It dealt with computer processors and ultimately led to Judge Rader's reduction of the damages award to $53 million.

The second was an appeal to the Federal Circuit. Dealing with a patent that covered Microsoft's date-picker tool, the Federal Circuit vacated and remanded the $358 million damages award. Neither case, however, had anything to do with the 25 Percent Rule. The rule was not argued about, or decided on. The royalty analyses in those cases relied on other valuation tools.

In spite of their research, Cox/Rusek and other colleagues[5] have been unable to cite to a single court case that has determined that the rule, and/or its application (for that matter), is “junk science.”

In fact, in an IP Law360 guest article in December, Cox (along with NERA colleague Mario Lopez) asserted that the appeal in the i4i v. Microsoft case gave the Federal Circuit the “opportunity to finally declare the 25 Percent Rule as unreliable under Daubert.”[6]

One of the authors of this guest article (Mike Wagner) was the damages expert retained by the patent owner in the i4i case. Among other tools, he did use the 25 Percent Rule. He also considered a substantial amount of other economic evidence as to the contribution of the patent-in-suit to the success of Microsoft products.

On appeal, one of the issues addressed was the proper use and application of the 25 Percent Rule. At oral argument, one question from the appellate court was: “What about the 25 percent rule? ... Why is that not just something pulled out of the air, that we ought to be able to be willing to accept that methodology?”[7]

Considering the answer to that question, in conjunction with the other arguments that were presented, the Federal Circuit ultimately wrote how the 25 Percent Rule was used at trial by Wagner. Critically, it did not reverse the damages ruling nor did it find the rule to be “junk science.”

The i4i court passed on this “opportunity” to rule as Cox and his colleagues predicted. In fact, to our knowledge, no court that has addressed the topic has found analysis under the 25 Percent Rule to be irrelevant or inadmissible.[8] And many have found it to be quite useful.

Proper Understanding of the Rule

Cox and his colleagues have not fairly represented (or perhaps understood) the bases or proper application of the 25 Percent Rule.

A paper by two of the authors here (John Jarosz and Carla Mulhern) that was published in les Nouvelles (the Journal of the Licensing Executives Society) in December 2002 described the underpinnings of the rule, the factual support for the rule, and the ways in which the rule should and should not be used.[9]

Among the important conclusions were the following:

- The rule emanated from a set of 1950s licenses, early court cases and established licensing practices. Its usefulness was confirmed by a careful examination of years of licensing and profit data, across companies and industries. (The rule did not come out of “thin air”).

- The rule should not be used in lieu of a consideration of the specific contribution of the IP at issue, particularly relative to non-infringing alternatives.

- The rule is especially useful when the IP at issue comprises a significant portion of the product value and when the incremental benefits of the IP are otherwise difficult to measure. The flip side is that the rule provides little assistance when there are many value contributors and/or when incremental benefits can be estimated with a fair degree of certainty using other methods.

- Licensing professionals,[10] courts and reasonable royalty experts use the 25 Percent Rule, or a similar profit sharing analysis, frequently in determining royalties.

- The rule is a fairly rough tool that should be used in conjunction with other tools, such as an analysis of market comparables and/or a consideration of the Georgia-Pacific[11] factors. Analysis of such factors often will result in a royalty that is higher or lower than that suggested by the rule.

Criticisms of the Rule

Cox/Rusek leveled several specific criticisms of the rule, most of which are addressed in the 2002 les Nouvelles paper.

- The rule emanated only from a sample of licenses of a single client of Robert Goldscheider. In fact, that was one of many sources of the rule. Critically, the common sense and early observations were confirmed, albeit broadly, by a more detailed examination of the relationship between profits and royalty rates. Other analysts, have undertaken further study of the economic validity of the tool, finding it to be a useful starting point for a more detailed royalty analysis.[12]

- If the true incremental benefits of any IP are, say, $6, a rational licensee should never have to pay more than $6, regardless of what the rule says. We agree. And the 2002 paper says that.

- The profit and royalty rate data relied upon in the 2002 paper came only from publicly traded companies. We agree. A robust dataset of royalty rate and profit data for private companies was simply not available. Further, Cox/ Rusek have provided no evidence in support of their implicit contention that the relationship between royalty rates and profits would differ substantially for private companies.

- Underlying licenses differ in their terms, one to the next. We agree. That is why we described our 2002 analysis as broadly supportive of the merits of the rule, but cautioned that a more detailed fact-specific examination must be done in each case. A royalty analysis must be done with care, and is comprised of both science and art.

- The operating profit margins used were for the entire company, rather than just for the product itself. The paper acknowledges the unavailability of product-specific data and explores the likely impact of this data deficiency using a reasonable proxy.

- The royalty to profit ratios vary across licenses and industries. We agree. But as the paper notes, the majority of industries examined had ratios of royalty rates to profit margins within +/- 5 percent of the 25 percent to 33 percent range as indicated by the rule. Moreover, as noted above, the specifics of a company and industry must be taken into account in doing a full royalty analysis. (The rule is not and should not be used as “one size fits all.”)

- The rule often leads to an unbalanced application of the Georgia-Pacific factors. It is not clear what Cox/Rusek mean by this criticism. Consideration of the 25 Percent Rule should be combined with an analysis of other factors, such as those set out in Georgia-Pacific. It is up to the analyst to be balanced in his or her own consideration of this one tool along with other available evidence.

Conclusion

Cox/Rusek have suggested that the 25 Percent Rule is “junk science.” Their preferred method of determining a reasonable royalty appears to be to calculate the incremental economic benefit that the IP provides, using this as an upper bound on the royalty.

As noted above and in the 2002 paper, we agree. However, in practice, rarely can one identify the next best alternative to use of the IP, let alone accurately isolate the incremental benefit associated solely with the use of that IP.

Use of a rule of thumb is no more “junk science” than application of a rigorous scientific method that relies on flawed or inaccurate inputs.

Cox/Rusek appear to believe that “supporters” of the 25 Percent Rule are of the belief that the rule should be used in all royalty assignments and should be used in isolation. Nothing could be further from the truth, at least in the minds of these authors.

In the absence of perfect information isolating the incremental benefit of the IP, the royalty expert must rely on a variety of tools and information, combined with his or her judgment, to arrive at a royalty conclusion.

The 25 Percent Rule has proven to be quite useful for licensing executives, courts and royalty experts for many years. Properly used, the 25 Percent Rule is likely to and should live on as a useful tool in royalty analysis.

--By John C. Jarosz (pictured) and Carla S. Mulhern, Analysis Group Inc., and Michael Wagner, LitiNomics Inc.

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[1] Alan Cox & Stephen Rusek, “The Demise Of Junk Science And The 25% Rule,” IP Law360, July 28, 2010.

[2] i4i Ltd. P’ship v. Microsoft Corp., 598 F.3d 831 (Fed. Cir. 2010).

[3] Cornell Univ. v. Hewlett-Packard Co., 609 F. Supp. 2d 279 (N.D.N.Y 2009).

[4] Lucent Techs. v. Gateway Inc., 580 F.3d 1301 (Fed. Cir. 2009).

[5] See, e.g., Gregory Leonard & Lauren Stiroh, “A Practical Guide to Damages,” at 50-52, in Economic Approaches to Intellectual Property: Policy, Litigation, and Management (Gregory Leonard & Lauren Stiroh ed., NERA 2005); Alan Cox & Mario Lopez, “Two Economists Take On I4i v. Microsoft,” IP Law360, Nov. 23, 2009; Elizabeth Bailey, Alan Cox & Gregory Leonard, “Three Cases Reshaping Patent Licensing Practices,” Managing Intellectual Property, Mar. 2010.

[6] Alan Cox & Mario Lopez, “Two Economists Take On I4i v. Microsoft,” IP Law360, Nov. 23, 2009.

[7] Oral Argument, at 24, i4i L.P. v. Microsoft Corp., 589 F.3d 1246 (Fed. Cir. 2009) (Appeal No. 2009-1504), Sept. 23, 2009. See Elizabeth Bailey, Alan Cox & Gregory Leonard, “Three Cases Reshaping Patent Licensing Practices,” Managing Intellectual Property, Mar. 2010. See also, Jesse David & Kara Gorski, “Economists’ View Of Recent Patent Damages Decisions,” Edgeworth Economics, Apr. 2010.

[8] Tights Inc. v. Kayser-Roth Corp., 442 F. Supp. 159 (M.D.N.C. 1977); Busse v. United States, 437 F. Supp. 928 (E.D. Wis. 1977); Fromson v. Western Litho Plate & Supply Co., 853 F.2d 1568 (Fed. Cir. 1988); Belknap v. Commissioner, T.C. Memo 1989-210 (T.C. 1989); W.L. Gore & Assoc. Inc. v. International Medical Prosthetics Research Assoc. Inc., 1990 U.S. Dist. LEXIS 15497 (D. Ariz. May 10, 1990); Mobil Oil Corp. v. Amoco Chems. Corp., 915 F. Supp. 1333 (D. Del 1994); Fonar Corp. v. GE, 107 F.3d 1543 (Fed. Cir. 1997); Ajinomoto Co. v. Archer-Daniels-Midland Co., 1998 U.S. Dist. LEXIS 3833 (D. Del. Mar. 13, 1998); Standard Mfg. Co. v. United States, 42 Fed. Cl. 748 (Fed. Cl. 1999); Bose Corp. v. JBL Inc., 112 F. Supp. 2d 138 (D. Mass. 2000); Civix v. Expedia, 2005 U.S. Dist. LEXIS 45948 (N.D. Ill. Oct. 25, 2005); Carbo Ceramics Inc. v. Keefe, 166 Fed. Appx. 714 (5th Cir. Tex. 2006); GSI Group Inc. v. Sukup Mfg. Co., 641 F. Supp. 2d 732, 745 (C.D. Ill. 2008); Uniloc USA Inc. v. Microsoft Corp., 632 F. Supp. 2d 147 (D.R.I. 2009); Paice LLC v. Toyota Motor Corp., 609 F. Supp. 2d 620 (E.D. Tex. 2009); ResQNet.com Inc. v. Lansa Inc., 594 F.3d 860 (Fed. Cir. 2010); i4i Ltd. P’ship v. Microsoft Corp., 598 F.3d 831 (Fed. Cir. 2010); Soverain Software LLC v. Newegg Inc., No. 6:07 CV 511(E.D. Tex. Aug. 11, 2010. See also, Donald Chisum, Chisum On Patents, 7 § 20-03[3] [iv], 20-188, 20-189 (1993 and Supp. 1997).

[9] Robert Goldscheider, John Jarosz & Carla Mulhern, “Use Of The 25 Per Cent Rule In Valuing IP,” Vol. XXXVII No. 4 les Nouvelles 123 (Dec. 2002).

[10] Mr. Goldscheider received the LES Outstanding Contribution in Licensing Award, recognizing his development of the 25 Percent Rule as a standard for licensing royalty rate determination. See “Meeting Recap: Annual Meeting Sets Sail in Vancouver,” Vol. XIV No. 4 LES Viewpoints 6 (Nov. 2007).

[11] Georgia-Pacific Corp. v. United States Plywood Corp., 318 F. Supp. 1116 (S.D.N.Y. 1970), modified and aff’d, 466F.2d 295 (2d Cir. 1971).

[12] Jonathan Kemmerer & Jiaqing Lu, “Profitability and Royalty Rates Across Industries: Some Preliminary Evidence,” SSRN, May 31, 2008; Jiaqing Lu, “The 25% Rule Still Rules: New Evidence from Pro Forma Analysis in Royalty Rates,” Licensing Economics Review, Apr. 2010, at 2.