



25 Percent, 50 Percent ... What's in a Number?

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Use of the 25% Rule in Determining Patent Damages



- The 25% Rule (sometimes modified to a 33% percent rule) was typically used as such:
 1. Calculate the operating profit margin for the product incorporating the patent-at-issue
 2. Take 25% (or 33%) of that operating profit margin as a “starting point” for a reasonable royalty
 3. Sometimes adjust that rate up or down.
- Experts would often essentially stop at step 2, and sometimes would use gross profits rather than operating profits

The 25% Rule in Patent Damages: An Example

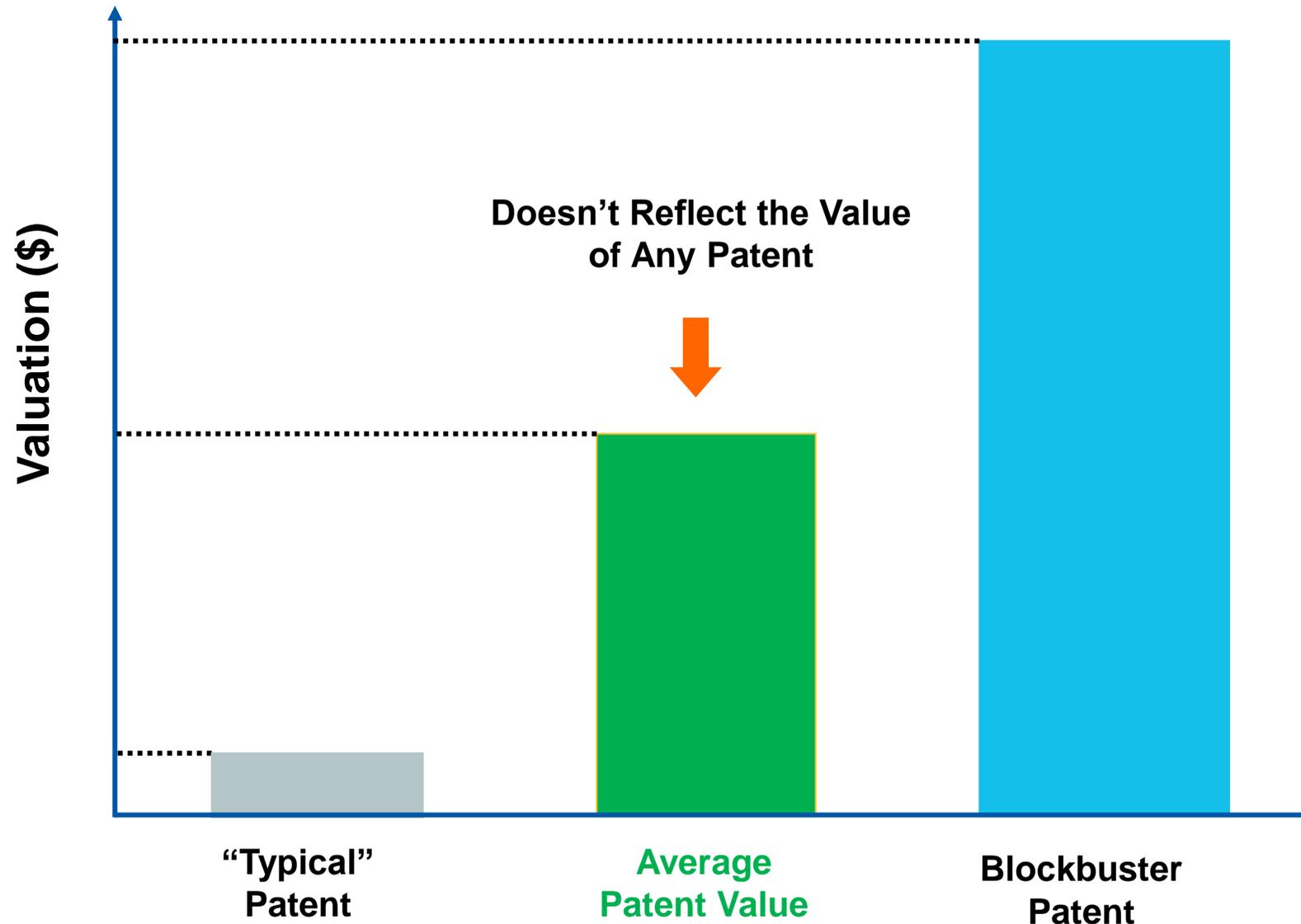


- A pre-launch document estimates costs and profit margins:

<u>Selling Price</u>	<u>Total Costs</u>	<u>Profit</u>	<u>Profit %</u>
6.00	5.79	0.21	3.5%
6.50	5.79	0.71	10.9%
7.00	5.79	1.21	17.3%
7.50	5.79	1.71	22.8%
8.00	5.79	2.21	27.6%
8.50	5.79	2.71	31.9%
9.00	5.79	3.21	35.7%
9.50	5.79	3.71	39.1%
10.00	5.79	4.21	42.1%

- The expert finds support that the price would be more than 10.00/unit
- Applies the 25% Rule to the 42.1% profit margin, for a royalty of 10.5%

What Is Wrong With Using Industry Averages?



Even at a Broad Level, the 25% Rule Misses the Mark



Figure 6
Royalty Rates and Licensee Profits

Industry	Median Royalty Rate	Average Operating Profits	Royalty as % of Profit Rate
Automotive	5.0%	6.3%*	79.7%
Chemicals	3.0%	11.6%	25.9%
Computers	2.8%	8.0%	34.4%
Consumer Goods	5.0%	16.2%	30.8%
Electronics	4.5%	8.8%	51.3%
Energy & Environment	3.5%	6.6%	52.9%
Food	2.3%	7.9%	28.7%
Healthcare Products	4.0%	17.8%	22.4%
Internet	5.0%	1.0%	492.6%
Machine/Tools	3.4%	9.4%	35.8%
Media & Entertainment	9.0%	-304.5%*	-3.0%
Pharma & Biotech	4.5%	24.5%	17.7%
Semiconductors	2.5%	29.3%	8.5%
Software	7.5%	33.2%	22.6%
Telecom	5.0%	14.1%	35.5%
Total	4.3%	15.9%	26.7%

* Fewer than 5 observations in data set.

Robert Goldsceider, John Jarosz, and Carla Mulhern, *Use Of The 25 Per Cent Rule In Valuing IP*, Les Nouvelles, December 2002, pp 123-133.

- An average rate is right for a specific piece of IP only by accident

Death of the 25% Rule in Patent Damages: *Uniloc v. Microsoft*



- 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 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.
- “...no relation to the facts of the case, and as such, was arbitrary, unreliable, and irrelevant. The use of such a rule fails to pass muster under Daubert and taints the jury’s damages calculation.”

CAFC Requirements for Patent Damages



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1. Reasonable Royalties must tie to the incremental value of the patented technology, compared to next-best alternatives
2. Royalty Bases used for determining damages must be apportioned to tie it to the patented technology
3. Benchmark Rates may be used, but must be strongly comparable to the patent(s)-at-issue

The Nash Bargaining Solution



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- One common methodology in patent damages has been to apply the so-called “Nash Bargaining Solution” (NBS) to determine a reasonable royalty.
- The NBS posits that, under certain conditions, when two parties are negotiating over a known surplus, the resulting agreement should reflect a 50-50 split of that surplus.

The Nash Bargaining Solution



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- This has been used in patent damages context for years, as follows:
 1. Identify the “gains from trade” from reaching an agreement, accounting for the net benefits from licensing out and licensing in, including the next-best non-infringing alternative technologies available to the licensee.
 2. The royalty that results in an equal sharing of the “gains from trade” is a reasonable royalty.
 3. Again, if there are other factors that have not yet been considered, adjust that royalty to account for them.
- Its use picked up substantially following the death of the 25% Rule and it has been the subject of much debate in the courts

Nash Bargaining Solution – Recent Court Decisions



- Some courts have rejected its use:
 - *Oracle Am., Inc. v. Google Inc.*, 798 F. Supp. 2d 1111, 1119–21 (N.D. Cal. 2011)
 - *Dynetix Design Solutions, Inc. v. Synopsys, Inc.*, No. 11-5973, 2013 WL 4538210, (N.D. Cal. Aug. 22, 2013)
 - *Robocast, Inc. v. Microsoft Corp.*, No. 10-1055, 2014 WL 350062 (D. Del. Jan. 29, 2014)

- Others have allowed its use:
 - *Mformation Techs., Inc. v. Research in Motion Ltd.*, No. 08-4990, 2012 WL 1142537 (N.D. Cal. Mar. 29, 2012)
 - *Gen-Probe Inc. v. Becton Dickinson & Co.*, No. 09-2319, 2012 WL 9335913 (S.D. Cal. Nov. 26, 2012)
 - *Sanofi-Aventis Deutschland GmbH v. Glenmark Pharms. Inc., USA*, No. 07-5855, 2011 WL 383861 (D.N.J. Feb. 3, 2011)

A Recent CAFC Decision on NBS



- **VirnetX, Inc. v. Cisco Systems, Inc. (Fed. Cir. 2014):**
 - The Nash theorem arrives at a result that follows from a certain set of premises. It itself asserts nothing about what situations in the real world fit those premises. Anyone seeking to invoke the theorem as applicable to a particular situation must establish that fit, because the 50/50 profit-split result is proven by the theorem only on those premises. [Patent owner's expert] did not do so.
 - [E]ven if an expert could identify all of the factors that would cause negotiating parties to deviate from the 50/50 baseline in a particular case, the use of this methodology would nevertheless run the significant risk of inappropriately skewing the jury's verdict.

- **But notes:**
 - [T]he Nash Bargaining Solution does offer at least one noticeable improvement over the 25% rule: where the 25% rule was applied to the entire profits associated with the allegedly infringing product, the Nash theory focuses only on the incremental profits earned by the infringer from the use of the asserted patents. But while we commend parties for using a theory that more appropriately (and narrowly) defines the universe of profits to be split, the suggestion that those profits be split on a 50/50 basis—even when adjusted to account for certain individual circumstances—is insufficiently tied to the facts of the case, and cannot be supported.



- The 25% Rule has been discredited by the CAFC as not being at all related to the value of the underlying IP, and other averages are unlikely to be appropriate
- NBS relates to the value of the IP, but the CAFC is not convinced that the resulting split is better than other possible splits
- Comparable transactions that are “closely linked” to demand for the IP provide can be the basis for an appropriate valuation



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