Rejection of the 25% Rule in the Calculation of a Reasonable Royalty Rate

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Though the “25% Rule,” which presumes that 25 percent of the operating profit from the sale of an infringing good is a reasonable royalty rate, has been frequently relied upon as a starting point in calculating patent infringement damages for more than 40 years, the Federal Circuit recently held that this rule of thumb “is a fundamentally flawed tool.” While patentees are entitled to a reasonable royalty rate (i.e., the rate that the parties would have agreed to in a hypothetical licensing negotiation before infringement occurred), the 25% Rule “fails to tie a reasonable royalty base to the facts of the case at issue.”

In *Uniloc v. Microsoft*, Uniloc sued Microsoft over Microsoft’s use of a mechanism for preventing non-licensed copying of software over multiple computers. The accused product was Microsoft’s Product Activation feature of Microsoft’s Word XP, Word 2003, and Windows XP software programs. Following a jury trial, the jury found that Microsoft willfully infringed the Uniloc patent and awarded Uniloc $388 million in damages.

The damages awarded Uniloc were based largely on a calculation by Uniloc’s expert that relied on the 25% Rule as starting point for determining a reasonable royalty rate. The expert testified that the rule-of-thumb was not altered by the application of the *Georgia-Pacific* factors such that the reasonable royalty rate was 25 percent of the profits derived from each activation of Microsoft’s infringing software programs. Though Uniloc’s expert used the lower end of the range of the estimated profit of $10 to $10,000 per activation, the expert ultimately calculated that based on the number of sales of the infringing products and the 25 percent royalty rate, the total royalty should amount to $565 million.

On appeal, the Federal Circuit ordered a new trial on the issue of damages, stating that the district court determination was “fundamentally tainted by the use of a legally inadequate methodology.” While the Federal Circuit has “passively tolerated” such calculations in the past, the court held that this rule could no longer be relied upon in determining the reasonable royalty rate. Further, the court concluded that relying on the 25% Rule as a starting point for applying the *Georgia-Pacific* factors is also prohibited. “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.”

The Court noted that the 25% Rule fails to consider the value of the patented invention, the availability of alternatives, the ease with which the invention could be designed around, the importance of the patented invention to the overall product, and the relationship between the parties. As stated by Chief Judge Rader of the Federal Circuit, sitting by designation in *IP Innovation v. Red Hat* in the Eastern District of Texas, any damage theory must “account for the economic realities of [the] claimed component as part of a larger system.” Case No. 2:07-cv-447
(E.D. Tex., March 2, 2010). Indeed, damage calculations must be based on facts from, for example, technical experts, business documents, business personnel testimony, sales data, surveys, and comparable licenses, rather than on an expedient, but overly simplified rule-of-thumb.

While generic data giving average royalty rates in an industry can be useful, the patentee must lay a factual foundation to establish the relevance of any contract or analytical tool used by an expert to the facts of the case. Because damage calculations are now necessarily more fact intensive, parties faced with litigating potential damages may benefit from discussing these considerations earlier with their qualified patent counsel or damage experts to better prepare for settlement negotiations or the damages portion of a patent infringement suit.

This advisory was prepared by Nutter’s Intellectual Property practice. For more information, please contact your Nutter attorney at 617-439-2000.

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