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IpQ

ENHANCING YOUR IP IQ™

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KEY IDEAS:

WHERE TO BEGIN? . . .
SETTING RATES FOR REASONABLE ROYALTIES

One of the toughest conceptual problems in IP litigation is pinpointing a "reasonable" percentage rate to use when analyzing and calculating reasonable royalty damages. Calculation of a running royalty requires two distinct elements, the royalty base itself, which is then multiplied by the royalty percentage rate to arrive at the reasonable royalty.[1]

To date, the royalty base and apportionment of patent value in determining that base have garnered most of the attention. The critical issue of divining the appropriate percentage royalty rate, on the other hand, has received far less press. That may be about to change. Recent Federal Circuit cases seem to recognize the differences between the two components[2] and are delving more deeply into the issue of how to establish the royalty rate.[3]

A threshold issue relating to the analysis and determination of a royalty rate is present in virtually every IP case: What "baseline" or starting point should be used to analyze the appropriate royalty rate?

It is clear that a running royalty rate is described as a percentage, and the famous *Georgia Pacific*[4] factors are frequently used to adjust the percentage up or down.[5] But where do we begin the analysis of the percentage rate? What's the baseline percentage for the analysis?

Given the requirement for making this determination in almost every case and the Federal Circuit's ongoing focus on damages, a working knowledge of how to determine a baseline royalty rate should be a part of your IP IQ.

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1 *Cornell Univ. v. Hewlett-Packard Co.,* 609 F. Supp. 2d 279, 286 (N.D.N.Y. 2009) (Fed. Cir. Judge Rader sitting by designation).

2 *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1339 (Fed. Cir. 2009); *Cornell Univ.*, 609 F. Supp. 2d at 286.

3 *See, e.g., Lucent Techs., Inc.*, 580 F.3d at 1327 *et seq.; ResQNet.com, Inc. v. Lansa, Inc.,* 2010 WL 396157, at *7-11 (Fed. Cir. Feb. 5, 2010).

4 *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970) *modified and aff'd*, 446 F.2d 295 (2d Cir. 1971).

5 *See, e.g., i4i L.P. v. Microsoft Corp.*, 589 F.3d 1246, 1268 (Fed. Cir. 2009).

Available Valuation Methodologies

There are three well-recognized methods for valuing IP: (1) the cost approach, (2) the market comparable approach, and (3) the income approach.[6] The latter two methods require use of a baseline royalty rate as a part of the analysis, while the first is rarely, if ever, used.

market-driven buyer demand or a lack thereof may lead to "Blair Witch Project" technology (high buyer value/low developer cost) or "Ishtar" technology (low buyer value/high developer cost).

1. Cost Approach Rarely Used

"The cost method of valuation measures the value of an asset by the cost to replace the asset with an identical or equivalent asset."[7] The basic assumption underlying this method of asset valuation is that the cost to acquire or develop the asset is commensurate with the economic value that asset will develop over its life.[8]

This logic's flaw, however, is readily apparent. It makes no difference to the marketplace how much it cost the IP owner to develop the technology. The technology is worth as much or as little as the buyer is willing to pay for it. Thus, market-driven buyer demand or a lack thereof may lead to "Blair Witch Project" technology (high buyer value/low developer cost) or "Ishtar" technology (low buyer value/high developer cost). As a consequence, scholars have widely discredited the cost method of valuation which is little used in the reasonable royalty context.[9]

But consider the *Grain Processing* case.[10] While not adopting the cost method, in an underlying opinion the district court held that the cost difference between the infringing and market-acceptable non-infringing products (3 percent) was a cap on reasonable royalty damages.[11] On appeal, the Federal Circuit did not rule on use of the cost differential as a royalty cap, but did note that the parties had not appealed the 3 percent royalty rate.[12]

an alleged infringer could argue that the reasonable royalty rate should not exceed the cost of using a market-acceptable alternative.

By applying this logic in the appropriate case, an alleged infringer could argue that the reasonable royalty rate should not exceed the cost of using a market-acceptable alternative. While the Federal Circuit later claimed not to have addressed whether *Grain Processing* has applicability in the reasonable royalty context,[13] the logic is compelling. And, using this approach, there is no need to find a royalty rate baseline!

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6 Robert Goldscheider, *et al., Use of the 25 Per Cent Rule in Valuing IP*, les Nouvelles, December 2002, at 126. In *Lucent*, the Federal Circuit describes two methods for analyzing reasonable royalty damages, the analytical method (corresponding to the income method) and the hypothetical negotiation (corresponding to the comparable method). *Lucent Techs., Inc.*, 580 F.3d at 1324.

7 Ted Hagelin, *A New Method to Value Intellectual Property*, 30 AIPLA Quarterly Law Journal 353, 359 (Summer 2002).

8 *Id.*

9 *See, e.g., id.* at 360.

10 *Grain Processing Corp. v. Am. Maize-Prods. Co.,* 185 F.3d 1341 (Fed. Cir. 1999).

11 *Id.* at 1353 n.5.

12 *Id.* at n. reference

13 *Micro Chem., Inc. v. Lextron, Inc.,* 317 F.3d 1387, 1393 (Fed. Cir. 2003)

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While many thousands of licensing agreements are undoubtedly in place at any given moment, identifying truly comparable agreements (which would withstand Federal Circuit scrutiny) and teasing out the details of those agreements can be a daunting and complex task.

2. Market Comparable Approach Faces *Lucent* Scrutiny

The market approach values IP based on comparable transactions between unrelated parties.[14] Use of this approach in the IP context requires (1) a market for comparable intellectual property, (2) a sufficient number of market transactions, (3) publicly available information on the terms of the comparable transactions (in particular the royalty rate), and (4) independent parties.[15]

When using this approach, the devil is in the details. While many thousands of licensing agreements are undoubtedly in place at any given moment, identifying truly comparable agreements (which would withstand Federal Circuit scrutiny) and teasing out the details of those agreements can be a daunting and complex task.

The first obstacle facing the patent owner is finding licensing transactions whose terms are publicly available. A number of potential sources for such information include Royaltysource®, RoyaltyStat®, Intellectual Property Research Associates, and the SEC's EDGAR archives.[16]

Some pundits have also tried to establish industry standards for license rates.[17] But the ability to access detailed information on truly comparable licenses is limited. In most instances, the parties to those licenses consider the terms to be confidential.

The second obstacle raises its head once the terms of "comparable" licensing transactions are identified. Recent Federal Circuit case law suggests that the patentee faces a difficult burden. In *Lucent*, the patentee's expert offered eight comparable licenses as part of his analysis under *Georgia-Pacific* factor number two, "[t]he rates paid by the licensee for the use of other patents comparable to the patent in suit."[18] Initially, the court drew two conclusions:

> When we examine these license agreements, along with the relevant testimony, we are left with two strong conclusions. First, some of the license agreements are radically different from the hypothetical agreement under consideration for the Day patent. Second, with the other agreements, we are simply unable to ascertain from the evidence presented the subject matter of the agreements, and we therefore cannot understand how the jury could have adequately evaluated the probative value of those agreements.[19]

The Federal Circuit then undertook a rigorous examination of each of the comparable licenses offered by the patentee. Ultimately, the court concluded that, "the evidence as presented did not reach the "substantial evidence" threshold and there-

14 Hagelin, *supra* note 6, at 362

15 *Id. citing* Gordon V. Smith & Russell L. Parr, Valuation of Intellectual Property and Intangible Assets 131-47 (3d ed. 2000).

16 Russell L. Parr, Royalty Rates for Licensing Intellectual Property 181-85 (John Wiley & Sons, Inc. 2007).

17 *See* Hagelin, *supra* note 6, at 373; Ted Hagelin, *Valuation of Patent Licenses,* 12 Tex. Intell. Prop. L.J., 423, 442-52 (2003-2004).

18 *Lucent Techs., Inc.*, 580 F.3d at 1327-28.

19 *Id.* at 1327.

fore no reasonable jury could have found that Lucent carried its burden of proving that the evidence, under the relevant *Georgia Pacific* factors, supported a lump-sum damages award of $357,693,056."[20]

In doing so, the Federal Circuit ruled, "on post-trial JMOL motions, district court judges must scrutinize the evidence carefully to ensure that the 'substantial evidence' standard is satisfied, while keeping in mind that a reasonable royalty analysis 'necessarily involves an element of approximation and uncertainty.'"[21]

Even more recently, in *ResQNet,* the Federal Circuit vacated and remanded a damages award based on comparable licenses offered as part of an analysis under *Georgia-Pacific* factor number one ("The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty.").[22] In that case, the court concluded, "the district court's award relied on speculative and unreliable evidence divorced from proof of economic harm linked to the claimed invention and is inconsistent with sound damages jurisprudence, . . . "[23]

If truly comparable agreements are identified and the details of the agreements are available, those agreements can be used to establish a baseline for the royalty rate analysis.

When and if the above two hurdles are surmounted, the royalty rate analysis still requires a starting point. If truly comparable agreements are identified and the details of the agreements are available, those agreements can be used to establish a baseline for the royalty rate analysis.

3. Income Method Includes the Loved/Loathed '25% Rule of Thumb'

The Income Method values an IP asset based on the present value of the future income stream expected during the life of that asset.[24] Once again, four factors are at play: (1) the net income the patented technology is expected to generate, (2) the time period during which that income is expected to flow, (3) the present value discount rate (risk-free rate of return plus an adjustment for inflation), and (4) an adjustment for the risk of realizing the future income.

The 25% Rule is particularly useful when the IP at issue is a significant portion of the product value and/or the IP's incremental benefits are difficult to measure.

The most famous/infamous step in using the Income Method involves use of the "25% Rule of Thumb."[25] The rule's use is straightforward: "The Rule suggests that the licensee pay a royalty rate equivalent to 25 percent of its expected [operating] profits for the product that incorporates the IP at issue."[26] Applying the Income Method, the initial or "baseline" rate is established once the income flow is determined by using the 25% Rule of Thumb.[27] Then that rate is adjusted upward or downward based on application of the relevant *Georgia-Pacific* factors.[28] The 25% Rule is particularly useful when the IP at issue is a significant portion of the product value and/or the IP's incremental benefits are difficult to measure.[29]

20 *Id.* at 1335.
21 *Id.* at 1336.
22 *ResQNet.com, Inc. v. Lansa, Inc.,* 2010 WL 396157, at *7 (Fed. Cir. Feb. 5, 2010).
23 *Id.*
24 Hagelin, *supra* note 6, at 363.
25 Goldscheider, *supra* note 5, at 126.
26 *Id.* at 123.
27 *Id.* at 126-28.
28 *Id.* at 128.
29 *Id.* at 126.

The 25% Rule has been widely criticized. Some practitioners have suggested that use of rules of thumb (presumably including the most famous rule of thumb) be banned altogether in determining damages. Even Goldscheider noted others' criticisms of the Rule.[30] Yet, very recently, the Federal Circuit has recognized use of the 25% Rule without criticism.[31] When used to corroborate findings, rather than as an end in itself, the Rule seems reasonable.

Absent use of the 25% Rule of Thumb, the Income Method still requires a baseline percentage for the analysis. One is left with using one of the other comparable methodologies for finding a starting point percentage rate.

Legal Limits on the Analysis

It is important to note that the parties are not left entirely to their own devices in determining the royalty rate baseline. In keeping with the *Daubert*[32] and *Kumho Tire*[33] decisions, the trial court serves as a gatekeeper "to exclude expert testimony that is irrelevant or does not result from the application of reliable methodologies or theories to the facts of the case."[34]

Using proprietary "Black Box" analysis, the expert arrives at a royalty rate based on steps and a unique methodology that only she can understand or appreciate. Recent case law suggests that this approach to deriving the rate baseline is an endangered species.

Key: Application of Methodologies

Experience and case law suggest that you should consider three broad categories when wading into finding the proper reasonable royalty percentage rate:

Black Box – The "Black Box" method for deriving the baseline rate and determining the reasonable royalty is instantly recognizable. Using proprietary "Black Box" analysis, the expert arrives at a royalty rate based on steps and a unique methodology that only she can understand or appreciate. Recent case law suggests that this approach to deriving the rate baseline is an endangered species. District courts and the Federal Circuit seem intent on reversing judgments based on what the courts perceive are impenetrable or result-driven methodologies.[35] Prudent counsel will steer clear of methodologies that, by design, no one other than the paid expert can fully comprehend.

The "Mechanical" approach to deriving a baseline rate and a resulting reasonable royalty is a sure cure for juror insomnia, and I do not recommend it as a trial tactic.

Mechanical – The "Mechanical" approach to deriving a baseline rate and a resulting reasonable royalty is a sure cure for juror insomnia, and I do not recommend it as a trial tactic. In practice, this approach goes something like this: (1) expert is qualified (so far so good); (2) expert adopts a rule of thumb to determine the rate baseline (25% sounds about right and is widely used); (3) expert drones through all (heaven forbid) or key (a bit better) *Georgia-Pacific* factors and adjusts baseline rate up and down and opines on the proper royalty rate; (4) at the close of the recitation, counsel coughs loudly to rouse the jury from its stupor.

30 *Id.* at 130-31.

31 *i4i L.P. v. Microsoft Corp.*, 589 F.3d 1246, 1268 (Fed. Cir. 2009).

32 *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993).

33 *Kumho Tire Co., Ltd. v. Carmichael,* 526 U.S. 137 (1999).

34 *Micro Chem., Inc. v. Lextron, Inc.*, 317 F.3d 1387, 1391 (Fed. Cir. 2003).

35 *See, e.g., Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d at 1335 (Fed. Cir. 2009); *ResQNet.com, Inc. v. Lansa, Inc.*, 2010 WL 396157, at *7 (Fed. Cir. Feb. 5, 2010); *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 286 (N.D.N.Y. 2009).

As you can readily see, the mechanical approach lacks pizazz. No matter how hard counsel and the expert try, the presentation is boring. This is a problem if you are the aggrieved IP owner, but may be not such a bad thing if you are the alleged infringer.

Given that Goldscheider suggested the 25% Rule of Thumb be used in concert with other valuation techniques,[36] however, another approach seems preferable.

Comprehensive Analytical – The "Comprehensive Analytical" method blends the best of all the methodologies tailored for use in the specific case to maximize the likelihood of a credible, reasonable and reliable result. For example, relying on the hypothetical negotiation sanctioned by *Georgia-Pacific* factor number 15, the expert will look to case-specific facts relevant to the hypothetical negotiation. Mindful of *Grain Processing,* the expert will consider relevant market factors and use sound economic proof.[37] The expert will also consider comparable license agreements and perform an income valuation.

Based on all of this information, the expert may then develop a hypothesis regarding an appropriate starting point for the rate analysis. The expert may want to consider the 25% Rule of Thumb as corroborative of the initial conclusion. After that, the expert will consult the *Georgia-Pacific* factors relevant to the case to determine a final royalty rate.

Use of these factors is formative, however, rather than mechanistic. While this approach may not be as predictable as a legislatively or judicially mandated formula, it provides the flexibility necessary to complete the analysis in a given case while still affording the opportunity to meet the case-law-mandated requirements for admissible opinion testimony.

Is It Time for *Georgia-Pacific* v. 2.0?

Given the complexity and risk for litigants inherent in the current system for formulating an opinion on the royalty rate, perhaps the time has come to streamline and clarify the rules.

The Federal Circuit's express intent to do this very thing in light of the pending patent reform legislation may mean we will soon see real movement in this area in upcoming cases. No doubt, all concerned would benefit from much-needed case law development of the law in this area.

I suggest it definitely is time to revisit and fine-tune the *Georgia-Pacific* factors. In doing so, the Federal Circuit could *inter alia,* (1) clarify factors relating to the analysis of the royalty base as opposed to the royalty rate, (2) establish parameters for admissible comparable license, and (3) clarify the use of "Rules of Thumb."

36 Goldscheider, *supra* note 5, at 132.

37 *ResQNet.com, Inc. v. Lansa, Inc.,* 2010 WL 396157, at *7.