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Board of Contributors: Figuring Royalty Rates For Patentees Can Be Complex

By: Peter Gampel

Attorneys involved in patent litigation should take into account other assets — apart from the technology — that contribute to the revenue and profitability of a patented product when making a damages valuation, according to Peter Gampel of Fiske & Co.

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There have been several high profile cases involving patent damages in recent years. At issue is the determination of lost profits or that of a reasonable royalty rate to be used for the damages valuation. The more difficult analysis pertains to the determination of the royalty rate. What previously was a widely used and customary valuation technique in patent litigation cases, the 25 percent rule, essentially was abolished in the case of Uniloc USA v. Microsoft Corp.

The 25 percent rule provided for a return to the patentee of a royalty rate equivalent to 25 percent of the licensee's expected profits for the product incorporating the technology at hand. The remaining 75 percent would presumably compensate the licensee for the manufacture, marketing and sale of the product, and related risk. The royalty rate is then determined by applying the 25 percent to the profits, with the result expressed as a percentage of sales.

Although traditionally used in the litigation context, outside of litigation valuation practitioners would not consider the 25 percent rule as a principle method, but as a mere rule of thumb, a corroboration technique at most, with more generally accepted fundamental income/market based analysis at the forefront.

A reasonable royalty rate often is premised on the hypothetical negotiation that would occur at the time of the infringement.

Take for example two different products. Product A is an integral and dominant part of the product to be sold by the licensee. Product B represents only a small, albeit important, component of the product to be sold by the licensee, but is not what would necessarily compel a purchaser to buy the product in the first place. Why should the patentee receive 25 percent under the latter scenario? Also, what about the impact of potential non-infringing substitutes on the royalty rate determination?

Another example could relate to the timing of the negotiation and affect the applicable agreed upon royalty rate. A patentee would expect more leverage in the negotiation if for example it has a ready-built manufacturing facility to take the product to market versus a licensee who would need to construct a plant.

In Uniloc, Judge Richard Linn stated that the method was arbitrary, unreliable and irrelevant, and therefore fails to pass muster under the Daubert standard. Judge Linn noted that use of the 25 percent rule as a starting point was unrelated to the facts of the case. In particular, the parties did not have a practice of beginning negotiations with a 25-75 split, or that the contribution of the product justified such a split. Furthermore, the expert did not base his 25 percent baseline on other licenses involving the patent at issue or comparable licenses.

This is not surprising. Some have argued the 25 percent rule should be a starting point for royalty rate determination, then adjusted above or below based upon facts and circumstances. But since there are no reasonable bases to even utilize it as a starting point, this also is arbitrary.

The factors that generally are considered in determining a royalty rate are set forth in Georgia-Pacific Corp. v. U.S. Plywood Corp. In undertaking a proper determination there are numerous considerations. Does the patented technology contribute to incremental revenue due to, for example, higher pricing? Or, is the technology a means to reduce product cost with no impact on revenue?

Often, practitioners will arbitrarily assume that any incremental profit stemming from the product as a consequence of employing the technology is totally attributable to the technology. That may not be the case. Other assets, intangible or otherwise, have value and are integral parts of the analysis as these assets contribute to the revenue and profitability of the patented product. As such, a licensee would not readily concede the rate of return for other assets contributed for the manufacture of the product.

Consideration also needs to be given to not only the quantum of revenue and profit, but also to its duration. An agreement for a royalty rate for an extended period of time may be impacted by potential obsolescence of the product or technology over time. Furthermore, the commencement date for the royalty rate application would vary depending upon the date that the product can be manufactured and marketed.

In Energy Transp. Group, Inc. v. William Demant Holding A/S , the 25 percent rule used by plaintiff pre-Uniloc was challenged by defendant, post-Uniloc, as unreliable. The U.S. Court of Appeals for the Federal Circuit indicated that the rule is a "fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation."

But the plaintiff's expert also included other analysis based on the industry and defendant's profit margins, in addition to a Georgia-Pacific analysis for factors pertaining to the parties' relationship, nature of the invention and the industry in which it pertained to; consequently the Federal Circuit declined to reduce the award to plaintiff.

It is noteworthy that the Federal Circuit indicated that it "does not endorse Georgia-Pacific as setting forth a test for royalty calculations, but only as a list of admissible factors in forming a reliable economic analysis."

In Whitserve, LLC v. Computer Packaging, Inc., the Federal Circuit vacated the plaintiff's award and remanded a new trial. At issue was the 25 percent rule, even though both sides adopted it at the trial and the court chastised plaintiff's expert in the manner that the Georgia-Pacific factors were applied.

The bottom line is that the patentee should earn a fair rate of return on the patented asset. The derivation of that royalty rate is a complex exercise. Nevertheless, if fundamental qualitative and quantitative analysis is properly employed and compared in a non-litigation context, the result should justify the means.

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