

Replacing the 25 Percent Rule with Fact-based Evidence

A Guide to Finding and Analyzing Royalty Rates

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Until recently, common practice and legal precedent had established the 25 percent rule of thumb (the “25 Percent Rule”) as an acceptable approach to approximating reasonable royalty rates that licensees would be willing to pay to licensors, based on profit, as part of a hypothetical arms-length negotiation.

On January 4, 2011, the United States Court of Appeals for the Federal Circuit changed that practice irrevocably when it deemed the 25 Percent Rule inadmissible during the *Uniloc USA V. Microsoft* patent infringement case (the “Uniloc Ruling”).

In the Uniloc Ruling, the Court pronounced the 25 Percent Rule a fundamentally flawed tool for determining a baseline royalty rate, and concluded that evidence supported by the 25 Percent Rule was inadmissible in the case because it does not tie a reasonable royalty base with the factual profile of the case at issue.

The Uniloc Ruling sets a new precedent that more stringent analysis and documentation will be required to develop a position that can withstand this new level of scrutiny. This decision also has global implications as it is likely to be considered in similar matters under the jurisdiction of country regulators (tax authorities) and global organizations such as the OECD.

USING FACT-BASED EVIDENCE AS AN ALTERNATIVE

In the wake of the Uniloc Ruling, it is clear that analysts will need to be as thorough as possible in performing due diligence to support their estimation of a reasonable royalty rate.

Toward that end, a more defensible approach for determining reasonable royalty rates for infringement damages, for intercompany licensing, and for the transfer of intangibles may involve the examination of third-party license agreements that are sufficiently similar to the subject situation or tested transaction.

Third-party licensing agreements may provide the most defensible source of fact-based evidence for several reasons. First, there is a substantial, publicly-available repository of representative license agreements in the US SEC, Canada SEDAR and other open information sources due to government regulations calling for public companies to file these material contracts. Second, an adequate percentage of these publicly-available license agreements offer un-redacted royalty rate information along with other licensing terms that are key factors of comparability such as licensing parties, product descriptions, territories and exclusivity. Third, the licensing terms within these license agreements can offer arms-length comparable transactions, which can present an unbiased model from which to determine a reasonable baseline royalty rate or set of royalty rates.

FINDING FACT-BASED EVIDENCE

When seeking fact-based evidence as the basis for estimating a reasonable royalty rate, defining your search methodology based on the functional profile of the tested transaction is a key factor in performing due diligence.

Defining Criteria

A prudent first step in defining the criteria of the search methodology begins with the identification of all intangibles related to the subject situation or tested transaction. Types of intangibles include:

- Manufacturing intangibles such as patents, inventions, formulations, recipes, processes, technical information, designs, patterns, or know-how;
- Marketing intangibles such as trademarks, trade names, trade dress, brand names, or service marks;
- Copyrights and literary, musical, or artistic compositions;
- Franchises (or business systems);
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or training materials;
- Software or source code; and
- Intangible generating services: research and development, engineering, or marketing.

After the appropriate intangibles have been identified and inventoried as the basis for matching comparable transactions, a pivotal next step is to identify what key factors of the subject situation or tested transaction affect comparability and, therefore, the final results. US Treasury regulations §1.482-(c)(iii) offers a useful description of the various factors that impact comparability, which are defined as:

- Being used in connection with similar products or processes within the same general industry/market;
- Have similar profit potential (this is difficult to quantify);
- Terms of transfer;
- Stage of development;
- Rights to receive updates, revisions, modifications;
- Uniqueness of the property;
- Duration of the license/contract/agreement;
- Risks assumed by the transferee (i.e. economic and/or product liability);
- Existence/extent of any collateral transactions; and
- Functions and/or services to be performed by each party.

These factors of comparability are generally accepted by global analysts, although perhaps not in this exact form. Having a referenceable list of comparability factors developed beforehand is a useful method for ensuring a consistent critique of each license agreement.

Sourcing Intangibles License Agreements

Fact-based evidence in the form of license agreements exists for each type of intangible. However, finding a defensible set of comparable transactions from license agreements can be an arduous process depending on the resource used.

There are a variety of sources for this information, but generally they can be classified into three main categories: government information databases (free), multi-purpose information databases (subscription-based), and royalty rate databases (subscription-based).

Government databases are often the most challenging resource for locating comparables, as these vast repositories were designed to accommodate a diverse audience seeking information for a wide range of purposes. In the US SEC EDGAR database, for example, the available information is indexed very broadly and the key attributes that could help an analyst find comparable transactions in license agreements are not easily searchable. Further, license agreements in EDGAR are not necessarily filed in one intuitive location, such as exhibit 10 material contracts (as many analysts believe), which increases the risk of missing a pivotal comparable. Not surprisingly, many analysts consider government databases more time-consuming and less reliable than other sources of market comparable data.

Multi-purpose information databases offer another resource for locating comparable license agreements but, in general, are similar to government databases in terms of the broad organization of their data. While most multi-purpose databases will have more sophisticated search tools, both the manner in which the documents are indexed and the way the results are presented may not provide a clear and comprehensive fact pattern necessary for conducting a thorough comparables analysis.

Specialized royalty rate data providers offer another alternative information source and their tools and outputs tend to be aligned with the analyst's specific needs when performing a license agreement search. Royalty rate data providers aggregate intangibles information and organize key terms into searchable attributes that can significantly streamline the search process. In addition to offering more sophisticated search filters, most royalty rate data providers will offer a summary of licensing terms and comparable criteria needed for each transaction matched within the defined search methodology. An example summary is shown in Exhibit 1, which was provided by the ktMINE Royalty Rate Finder.

While summaries offered by royalty rate providers can offer a helpful snapshot of the license agreement, it is important to note that reading the full agreement text is still a critical step in performing due diligence. In fact, reviewing all licensing terms contained in a license agreement document is the only way to validate that those terms fully support the factual profile of the subject situation or tested transaction. Reading the full text will also provide assurance that the document itself is usable, as some databases occasionally provide royalty rates from trade journals, financial newspapers or magazine articles gathered from unusable sources. Royalty rate comparables from unsubstantiated sources, such as newswire listings, cannot be used in court or with tax authorities unless backed up by a full text, corroborating license agreement.

ANALYZING FACT-BASED EVIDENCE

Once the search methodology has been employed and a set of potential comparables has been found, the next steps in a prudent license agreement analysis are:

- Perform an initial review of identified license agreements (i.e., review agreement summaries);
- Perform a detailed review of appropriate agreements (i.e., review actual license agreements);
- Select comparable license agreements and, therefore, royalty rates; and
- Construct an arm's length range.
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Validating Comparability

As an analyst reviews potential comparable license agreements, a thorough and savvy examination of all licensing terms is critical. Exhibit 1 provides an example of a license agreement that has been summarized to show key licensing terms that can affect the comparability of one transaction to another.

Exhibit 1: License agreement summary example from ktMINE's Royalty Rate Finder database

Agreement 5 of 26				
Synopsis				
<ul style="list-style-type: none"> Grant the right to use Patent Rights to manufacture the Machines (for the generation of hydrogen) in the People's Republic of China. 				
Agreement ID:	28465			
Filing Company:	LANDMARK ENERGY ENTERPRISE, INC.			
Licensor(s):	DALIAN LANDMARK ENERGY TECHNOLOGY CO., LTD			
Licensee(s):	DALIAN AQUARIUS ENERGY TECHNOLOGY U.S.A..CO., LTD			
Effective Date:	09/15/2010			
Term:	This Agreement shall commence as of the Effective Date and shall continue in full force and effect for a period of 3 years, and shall automatically renew for additional 3 years periods, unless either party provides written notice of non-renewal to the other party, not less than sixty (60) days prior to the expiration of any one (1) year term.			
Type:	MANUFACTURING/PROCESS INTANGIBLE			
Industry:	INDUSTRIAL EQUIPMENT AND MACHINERY			
SIC Code:	—			
Territory:	PEOPLE'S REPUBLIC OF CHINA			
Exclusivity:	MULTI-EXCLUSIVITY			
Royalty Rates				
View Royalty Rate Text Statistics Only Actuals Only Statistics and Actuals				
License Actuals	Value	Agreement Base	Modifier	Common Base
	6%	TOTAL SALES PRICE	In the event that Dalian Aquarius sell the Machines to any other third party, Dalian Aquarius shall pay a license fee equal to 6% of the total sales price to Dalian Landmark.	NET SALES

Actions

- [View Agreement](#)
- [Comment on this Agreement](#)
- [View Royalty Rate Text](#)
- [Add to Set...](#)

In Sets

Not in any saved sets

In Exhibit 1, the **Synopsis** details the rights being granted and for what type of intangible(s). In this case, the license agreement applies to a patented technology as well as trademarks, trade names, logos and the goodwill associated with each. All are key factors of comparability, as a patent and trademark license agreement would not be an appropriate comparable to use in benchmarking a patent-only transaction unless an analyst could precisely allocate a certain percentage of the royalty to each type of intangible.

In the next area, parties to the license agreement are captured – **Filing Company, Licensor(s) and Licensee(s)**. This information is useful in ensuring that a transaction satisfies the criteria of being a third-party transaction, as opposed to a transaction between related parties, which will contain an unbiased market royalty rate(s).

The **Effective Date** is a key comparability factor, as it shows this transaction to be contemporaneous with market conditions of 2010, which may be quite different from those of previous years depending on the industry, type of IP, and other relevant factors. Transactions taking place around the same time as the subject situation generally are more comparable than those that are older. Market conditions regularly change and a solid comparability analysis takes this into account.

The **Term** field defines the length of the license agreement and provides necessary insight for an analyst trying to identify comparable agreements that are not expired or do not have significantly different term than the subject situation.

The **Agreement Type** field lists all applicable category(s) from which intangibles are being licensed in this license agreement. While the Agreement Type field provides good shorthand on the nature of the intangibles being licensed, it is wise to read the full text of the license agreement to see if there are any other conditions that could affect the comparability of this transaction. For example, if an analyst was looking to benchmark a royalty rate for a patent-only transaction and a comparable included licensing terms for both patent and know-how intangibles, this may call for an adjustment with respect to any utilized royalty rates. This is also an instance where the full license agreement would provide critical context and support for the adjusted calculation.

The **Industry** and **SIC** (Standardized Industrial Classification) fields may appear to go hand in hand here, but they are actually quite different in terms of reliability and results.

The SIC code represents what was filed with the government database at the time of submission, if one was actually provided. If SIC is used as a search criteria and a means for rejecting transactions, the analyst should take note of the potential risks. First, filing companies do not always supply an SIC code

when submitting their documentation. Second, the filing company SIC code may have no correlation whatsoever to the intangibles being licensed or the industry in which the licensee can exploit the intangibles, which means an analyst could overlook a pivotal comparable that was filed under a misrepresentative SIC code.

Case in point, in Exhibit 1, the summary shows an SIC code of 9995, which is the code for Non-Operating Establishments. Yet the intangibles being licensed in this agreement are more closely related to the Broadcast and Cable, Business Services, Computers: Hardware and Software, Internet, Public Safety, and Telecommunications industries. If an analyst were seeking intangibles related to the latter industries but only relied on an SIC search, this potential comparable might be missed.

Alternatively, a more reliable criterion to use (if available) when seeking intangibles from a particular vertical market may be Industry. In Exhibit 1, the Industry(s) field documents all applicable industries directly related to the intangibles being licensed therein and the industries in which the licensee has the right to exploit the intangibles. Searching by Industry typically allows an analyst to more precisely, and more comprehensively, identify potential comparable transactions directly related to a particular vertical.

Territory and **Exclusivity** are both good indicators of the potential market impact from the agreement based on licensing reach, but territory is often one of the first factors dismissed in a litigation situation as being of lesser importance than other comparability criteria. This happens primarily in cases where there is a lack in the number of total license agreements for that geography. For instance, it is nearly impossible to find specific license agreements that exploit an intangible solely in Ireland, so it may be more likely to find a comparable agreement with coverage in Europe or the World than one from specific geographies.

Royalty Rates are key factors of comparability and the detailed summary in Exhibit 1 offers full breakdown of all rates within the license agreement, including tiers. In instances where a license agreement has tiered or multiple royalty rates – which can be for a single intangible, and/or across a group of intangibles – a thorough analysis of how each rate impacts the overall value is critical in approximating a reasonable royalty rate. Once again, reading the full license agreement is a vital step toward ensuring that comprehensive due diligence has been performed as it is the only way one can see, and address, all collateral transactions such as lump sums, milestone payments, etc. that may impact the results of an analysis.

While there is no guidance to the appropriate number of comparables to choose – comparability could be determined by just one transaction – it is prudent to analyze any and all possibilities and to allow statistical calculations, such data documenting an interquartile range, to assist in identifying a comparable range.

SUMMARY

Finding and analyzing fact-based evidence may provide the most defensible method for approximating reasonable royalty rates in the wake of the Uniloc Ruling. There is a substantial repository of fact-based evidence available in the form of third-party license agreement data and documentation, and specialized royalty rate data providers can provide analysts with an efficient and reliable portal to finding representative transactions. As a result, when comparable transactions are identified and analyzed with a thorough methodology and comprehensive search process, fact-based evidence can support the resulting analysis with proof of thorough due diligence that can stand up in litigation matters.