

Rule Of Thumb Struck Down by Federal Court – Good Riddance

I'll admit it. I've used 3% as a Rule of Thumb for annual inflation. I often assume that the stock market will return about 10% per year. Imprecise, but not that far off if you assumed it was true. That's what I want out of a rule of thumb. This is consistent with the origin of the term "Rule of Thumb" which, as I understand it, came from wood workers who used the width of their thumbs rather than rulers for measuring things, imprecise yet reasonably reliable.

For some reason, a common rule of thumb in valuation is that 25% to 33% of earnings should be attributed to intellectual property. If we think of profit as the aggregate return on a given portfolio of assets, it is not unreasonable to attribute some amount of profit to intellectual property. However, I have never found any solid support explaining why 25% to 33% makes sense, any evidence that buyers and sellers actually use this metric to negotiate licensing transactions, and for that matter how it is actually applied (multiplied against pretax profit, EBIT, EBITDA, etc). It's almost as if the world has collectively punted on the issue because of the complexity of the question. Despite this, I have found a surprising amount of conviction that it is reasonable and in fact have been scrutinized for straying from these generally accepted percentages.

In January of 2011, the Federal Circuit Court of Appeals rejected this rule of thumb as a matter of law (Uniloc USA v. Microsoft Corp). In the case at issue, the patented feature related to the use of an authorization "key" during the installation of software. Citing the rule of thumb, the plaintiff's expert attributed 25% of Microsoft's software profit to this patented feature to arrive at damages to Uniloc – over \$560 million. An authorization key makes good sense but that's not why I bought Microsoft Office.

The Court held that the rule of thumb "...fails to tie a reasonable royalty base to the facts of the case and [as a theoretical construct] is a fundamentally flawed tool." In addition, "It is of no moment that the 25% rule of thumb is offered merely as a starting point to which the *Georgia Pacific* [a famous royalty rate case] factors are then applied to bring the rate up or down. 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."

Well said.



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