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The 25-Percent Rule ... 2.0

Law360, New York (August 19, 2011) -- "Data! Data! Data!" he cried impatiently. "I can't make bricks without clay." (Sir Arthur Conan Doyle, "The Adventure of the Copper Beeches.")

Methods or Data?

The Federal Circuit's Uniloc decision has buried for good the damages method known as the "25-percent rule." But Uniloc reflects a fundamental ambiguity in recent damages jurisprudence: When should the trial court restrict inappropriate methods, and when should it restrict inappropriate data?

New plaintiff theories have emerged to exploit this ambiguity. Much like the 25-percent rule did during its long reign, these theories have the potential to persuade trial courts, thereby influencing actual negotiations and eventually becoming "widespread practice." That potential is all the greater for those methods that are supposedly traceable to "science."

On the other hand, recent experience suggests that lay courts, finding themselves suspicious of that "science" and/or unable to judge its applicability, may attempt to limit the method by instead banning the data to which the method is applied.

This column reviews the relationship between methods and data in recent cases, and samples plaintiff methods that — if not subjected to real scientific scrutiny — could produce the worst of all worlds: unscientific methods, like the 25-percent rule, "tolerated" by the courts, coupled with restrictions on the data that could disprove them.

Recent Cases

Recent Federal Circuit cases manifest some uncertainty over the grounds on which to strike the 25-percent rule, and more generally over the distinction between methods and data.

Given that the order being appealed did not mention the 25-percent rule, the Uniloc panel went out of its way to conduct its own Daubert inquiry and to find the rule "fundamentally flawed" because it "fails to tie a reasonable royalty base to the facts of the case." Of course, the 25-percent rule does not concern the royalty base (infringing sales) per se, but the rate of profit on those sales. Moreover, many valid scientific rules — such as the law of gravity — are generally accepted, precisely because they are not tied to particular facts or data. In any event, the problem with applying the 25-percent rule is not the data, but the absence of any scientific support for a method that attributes 25 percent of a licensee's profit to an individual patent.

Uniloc also restricted the application of another method, the entire market value rule (EMVR). The panel warned of "the danger of admitting consideration of the entire market value of the accused [product] where the patented component does not create the basis for customer demand." Again, this is a restriction on data, employed to restrict a method. Moreover, this passage could be interpreted as prohibiting a party from using the defendant's

accused sales to compute a royalty rate, or even mentioning those sales before the jury.

This interpretation can produce counterintuitive results. For example, suppose a plaintiff has previously negotiated revenue-based running royalties (or even widely varying lump-sum payments). There may exist a simple mathematical relationship between licensee payments and revenues, and this relationship may even prove an established royalty rate for the plaintiff's patents. In such cases, it makes little scientific sense to prohibit consideration of the defendant's revenue, if the only purpose is to calculate revenue-based damages at the established royalty rate. By depriving the parties of sales data, such prohibitions may deny to them the use of a legitimate method.

The Uniloc panel also quoted Lucent's holding that "licenses relied on by the patentee in proving damages [must be] sufficiently comparable to the hypothetical license at issue in suit." The panel placed the burden of establishing comparability on the plaintiff, and noted that "the patentee's failure to do so 'weighs strongly against the jury's award' relying on such non-comparable licenses." But this and related language leaves unclear whether it was the expert's superficial method of comparing the licenses — "little more than a recitation of royalty numbers" — that was defective, or whether it was the data — including licenses that settled litigation — that were inadmissible per se.

Differences over how to resolve this question emerged explicitly in *ResQNet v. Lansa*, where the majority rejected the plaintiff expert's use of "licenses with no relationship to the claimed invention" (except, perhaps, to license software code that may have embodied the patented invention). This is a restriction on data. In remanding the case, however, the majority directed that "the trial court should not rely on unrelated licenses to increase the reasonable royalty rate" above the rates found in straight patent licenses — not an absolute rejection of the data, but a restriction on the method by which they are used.

In dissent, Judge Pauline Newman highlighted the difficulty with eliminating data to restrict a disputed method: Under the majority's rule, "... no licenses involving the patented technology can be considered [even when] subject matter in addition to that which was infringed ... was [properly] evaluated by the damages expert." As Judge Newman noted, this apparent confusion over data and methods "leave[s] the damages analysis without access to relevant information."

New Plaintiff Methods

If the Federal Circuit exhibits uncertainty over inappropriate methods and data, some experts have exacerbated the problem by distorting, or even severing, the proper linkage between them. Typically, this confusion involves one of two strategies:

- appeals to irrelevant authority — invoking a recognized scientific method to justify the use and interpretation of unrelated data;
- suppression of relevant data — exploiting restrictions on data to introduce unscientific methods that are difficult to disprove without that data.

Appeals to Irrelevant Authority

Nash Bargaining

A primary example is the use of the so-called "Nash bargaining solution." John Nash received the Nobel Prize for general theorems on bargaining and competitive equilibrium. Applied to a special case — a one-shot bargain between two parties having equal bargaining power —

Nash's theory predicts that parties will divide equally whatever surplus the bargain creates.

In a licensing context, some experts invoke the Nash solution to suggest that the patentee and infringer would have split the infringer's entire operating profit, as in the recent *Bedrock v. Google* and *Versata v. SAP* cases. Unchecked, Nash bargaining could become the new "25-percent rule 2.0" — i.e., the "50-percent rule." When that method produces illogical results (as it must, when misapplied), courts may be tempted, as in *ResQNet*, to limit the method by restricting the data to which it is applied (e.g., by expanding the "entire market value rule" to prevent the parties from considering the infringer's total profit, as well as its total sales).

The failure here lies with the expert's erroneous application of the method to the data. In Nash theory, the "surplus" refers to the additional gain created by the invention, not the total profit of the accused product (unless the two are the same).[1] By itself, Nash theory says nothing about how to compute that additional gain.

The "Edgeworth Box"

Similarly, economic experts sometimes cite the "Edgeworth Box." This two-dimensional graph describes trade between abstract entities (such as consumers, firms or countries). In the patent litigation context, an Edgeworth diagram is used to show the range of possible royalty rates. Edgeworth methods demonstrate that, under certain conditions, a unique outcome exists.

But as typically applied, this method merely lends scientific panache to the common-sense observation that parties will strike a bargain somewhere between the licensee's maximum and the licensor's minimum rates (assuming they overlap). As an empirical matter, even this range of data may be hard for an expert to observe. And, without a great deal more technical machinery, Edgeworth's method says nothing about how to find the equilibrium within the range.

Bilateral Monopoly

A third legitimate economic concept that usually has no relationship to the data is "bilateral monopoly." A single seller of a good having no close substitutes in a relevant market is a monopolist. Other things equal, the possession of monopoly power enables a monopolist to raise prices above the competitive level. Symmetrically, markets having only a single buyer (e.g., some government procurements) may exhibit "monopsony power," driving prices down. In general, in a market having a single seller and a single buyer, each has bargaining power that countervails the other's.

Experts sometimes characterize the bargaining relationship between licensee and licensor as a "bilateral monopoly." This is usually a misnomer.

To assert "monopoly," one must first define an allegedly monopolized market. Even though the patentee is the only licensor of a patent, that fact does not, by itself, define a relevant market. As the U.S. Federal Trade Commission and U.S. Department of Justice Antitrust Guidelines for the Licensing of Intellectual Property explain, there will often be actual or potential close substitutes for the patented invention, which belies the claim of monopoly. Similarly, the patentee often has multiple actual or potential buyers (licensees), who use the invention to compete downstream. When there exist multiple close substitutes (sellers) and/or multiple competing licensees (buyers), "bilateral monopoly" does not exist. And even when it does, that "method" says nothing, by itself, about the resulting royalty rate.

In general, the invocation of these methods is a red flag, because they have no connection to the data. A second such flag is the use of methods that take advantage of the absence of data.

Suppression of Relevant Data

"Sue for the Moon; Settle for Moonshine"

A classic plaintiff strategy has been to employ some damages method that produces a large demand, knowing that the best data with which to impeach that method — such as the plaintiff's own prior settlements — were usually inadmissible. Without directly ruling on their admissibility, the Federal Circuit has begun to rely on such settlements, as in *ResQNet* (both majority and dissent), leading some trial courts (e.g., *IP Innovation v. Red Hat* and *Novell*) to admit them. In certain cases, the admission of prior settlements exposes their inconsistency with a plaintiff's damages theory.

Per-Unit Royalties

Because of the Federal Circuit's increasingly stringent interpretation of the EMVR (suppressing the use of data on the defendant's revenues), there has been a marked shift in the past year to per-unit royalty theories (which only require data on the quantity of infringing units, not infringing revenues). For example, in *IP Innovation*, Judge Randall Rader (sitting by designation) struck the plaintiff's damages theory because it calculated damages as a percentage of the defendants' revenue, though he subsequently admitted a per-unit theory.

For most damages-related purposes, however, replacing a 2-percent royalty on a \$100 unit with a \$2-per-unit royalty (untethered to revenue) is a distinction without a difference (though real-world parties justifiably choose one structure over the other). Though some try, experts cannot hide behind the court's exclusion of revenue data to avoid a rigorous apportionment of profits, which generally requires consideration of the defendant's infringing revenues (and costs).[2]

Mix and Match

A more pernicious abuse of the per-unit method is to match the rate observed in one contract to the quantity observed in another. For example, a \$2-per-unit royalty on an optional computer peripheral might be matched to the quantity of computer units themselves — a different market and demand function — the product of which could yield a damages payment several orders of magnitude larger than observed royalty payments for the peripheral.

A natural defense to such a claim is to compare the payment demanded with the defendant's revenues or profits. But such a defense confronts defendants with the choice of waiving the exclusion of their revenue or profit data (under a current interpretation of the EMVR), or risking an outsized damages award.

"Industry Standards"

In information technology-related cases, plaintiffs sometimes allege an "industry standard" royalty structure, such as the "IBM standard," which they typically characterize as a royalty rate of 1 percent of sales per licensed patent, up to 5 percent. In *Acqis v. IBM*, recently tried in the Eastern District of Texas, *Acqis* offered a former IBM employee to testify regarding the alleged "standard."

Notably, *Acqis*'s expert claimed that the same "standard" also applied to each of IBM's co-defendants. Among other deficiencies, this theory compels other information technology firms to prove a negative: that such a "standard" does not exist, or is inapplicable to firms other than IBM. This method risks forcing a defendant to produce all its (unrelated) licenses to demonstrate the nonexistence or inapplicability of the "standard."

Are such data then admissible? Must they be produced? If produced, can the plaintiff then rely on them for other purposes, even though they are "unrelated"?

"Chicken"

Plaintiffs also may offer potentially inadmissible theories strategically, in effect betting that, if the court suppresses the data relied upon, it will also permit the plaintiff to "supplement" its method rather than go to trial without a damages claim. For example, in *IP Innovation and Bedrock*, trial courts admitted the plaintiff's new theory 30 days (or less) before trial.

Conclusion

As Versata's recent \$345 million damages award against SAP demonstrated, the era of big damages claims is not over. Fortunately, courts have restricted some methodological abuses. Unfortunately, they have sometimes done so by restricting potentially useful data. Even useful data, such as litigation settlements, can generate large damages claims, as in *Mondis Technology's* request to triple its existing royalty rates in its claim against *LG Electronics et al.*

Sooner or later, the Federal Circuit will have to distinguish "bad methods" from "bad data" — perhaps in ruling squarely whether, and using what methods, litigation settlements can be considered — hopefully by preserving the evidence while rejecting its unscientific misrepresentation.

--By Jonathan Putnam, [Charles River Associates](#)

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[1] See "25 Percent, 50 Percent ... What's In A Number?" *IP Law360*, June 21, 2011.

[2] A comprehensive effort to grapple with these issues can be found in the damages retrial of *Lucent v. Microsoft* (Order Granting in Part and Denying in Part Defendant Microsoft's Motions In Limine, S. D. Cal., June 16, 2011).

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