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25 Percent, 50 Percent ... What's In A Number?

Law360, New York (June 21, 2011) -- As has been much reported, in this venue and others, the United States Court of Appeals for the Federal Circuit, in its recent decision in Uniloc USA Inc. and Uniloc Singapore Private Limited v. Microsoft Corporation, determined that the so-called "25-percent rule" is a "fundamentally flawed tool" in patent damages calculations.

In particular, the court found the use of the 25-percent rule — in which the starting point (and, often, the ending point) for damages is an amount equal to 25 percent of the expected profits derived from a product embodying the invention — to be "arbitrary, unreliable and irrelevant." We agree wholeheartedly.

As explained in a chapter in a book edited and published by economists at NERA Economic Consulting, "A Critique of Noneconomic Methods of Reasonable Royalty Calculation," the 25-percent rule is flawed precisely because it has no relationship with the incremental value of the technology embodied in the patent.

By way of illustrating the fundamental flaw in the rule, a patented technology that only allows the patent holder to increase the profit derived from his product by 1 percent (for example, a patent on an unnecessary but clever feature) would, at least as a starting point, be eligible for damages amounting to 25 percent of the product's profit. That makes no sense, and the "25-percent rule" was justifiably — and at long last — refuted.

One question that the Uniloc case has raised in the context of patent damages is whether another oft-used percentage — namely the midpoint in the bargaining range of a hypothetical negotiation — is subject to the same critique as was successfully leveled at the 25-percent rule. The answer to that question is "no." While care must be used in its application, the consideration of the midpoint of a bargaining range is a useful paradigm, rooted in rigorous, well-established economic theory and — in marked contrast to the 25-percent rule — directly tied to the facts of the case.

The midpoint of a hypothetical bargaining range is directly tied to the facts of the case, and, specifically, to the incremental value of the patent, because the endpoints of that bargaining range – namely, the two parties' bargaining positions – depend on what each party stands to gain or lose as a result of the hypothetical negotiation. Like any other bargaining transaction, before reaching an agreement, the parties will consider the costs and benefits that they would experience should a bargain be struck.

In any bargaining situation, for both parties to ultimately agree on the outcome, the expected benefits of the agreement must outweigh the expected costs for each party. The costs and benefits, therefore, dictate the range of feasible outcomes whereby both parties can benefit from the licensing agreement.

These costs and benefits, which are case-specific, depend on factors such as the benefits of a license to the infringer, the cost to the infringer of designing around the patent, the profits at risk to the patent holder as a result of the infringement. That is, the bargaining range is explicitly determined by considering the incremental effect of licensing the patented technology, relative to the infringer's next-best, non-infringing available alternative.

In particular, it is not a clear-cut, black-and-white determination as to whether one should look at the profits of the whole product, the profits related to a specific functionality, or some other set of profits; rather one must determine which profits are incremental to the specific patented technology. (Of course, in some instances, the patented technology may be the only method of implementing a particular functionality or of selling the product as a whole, and, as such, the profits related to the feature or the entire profits of the product may correctly be viewed as the incremental profits.)

Once that bargaining range has been established, by a review of the facts of the case, any outcome within that bargaining range has, at a minimum, the desired characteristic that each party would be better off under the terms of the deal than it would be without the agreement. Outcomes derived from the 25-percent rule were not necessarily consistent with that basic economic premise of bargaining.

The next step is to determine where, within that bargaining range, the reasonable royalty would fall. Economics teaches that the final outcome of the negotiation within the bargaining range depends on the ability of each party to credibly threaten to continue to negotiate until the negotiation reaches a desirable outcome for that party. In economics, this is called a party's discount rate.

The intuition is that, if one party is more motivated than the other to come to an agreement — perhaps because that party needs the cash for continued operations or because the usefulness of the patent diminishes considerably if the agreement is delayed — then the more motivated party will push harder for a deal and may therefore settle for a less desirable outcome, all else equal.

If, however, both sides have equal bargaining power — a reasonable place to begin an analysis of a reasonable royalty — then a well-known economic model of bargaining predicts that, under certain assumptions, the parties will split the benefit of the bargain, and the reasonable royalty corresponds to the midpoint of the bargaining range. (See Rubinstein, A. (1982), "Perfect Equilibrium in a Bargaining Model," Econometrica, 50:97-110.)

In particular, the model is one in which the two parties alternate making offers and counteroffers until an agreement is reached and in which there is no advantage to being the first to make an offer. Of course, as with all economic models, care must be taken to ensure that the model's assumptions are consistent with the facts of the case. However, the midpoint of the bargaining range does provide a reasonable and economically grounded starting point for an analysis of where, within that range, the reasonable royalty falls.

The initial evidence from the courts indicates that our viewpoint will prevail. In one recent case (Sanofi-Aventis Deutschland GmbH et al. v. Glenmark Pharmaceuticals Inc., USA et al.), the District Court of New Jersey denied a motion to exclude reasonable royalty testimony that relied on the midpoint of the bargaining range because this methodology is based on the specific facts of the case and is, therefore, not akin to the use of the 25-percent rule. Hopefully, future courts considering this issue will concur.

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