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A BRIEF ANALYSIS OF POLICY AND LITIGATION

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Hearings Planned on Rail Competition

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Allison M. Holt, a Senior Economist, specializes in empirical microeconomics and has extensive consulting experience, including analysis of antitrust matters and calculation of damages.

The Surface Transportation Board (STB), the agency which regulates railroads, plans to hold public hearings in May to study how freight-rail regulations could be changed to increase competition. The proposed changes would make it easier for shippers to challenge rates and gain easier access to alternative railroads, increase competitive access to shippers' facilities by other railroads, and limit the ability of larger railroads to enforce interchange commitments.

Unlike most other industries, railroads are not subject to the Sherman or Clayton Acts. Rather, the STB regulates mergers and competitive conduct. The STB has allowed the industry to become increasingly concentrated, and over the past decade rates have increased substantially. Shippers have complained that these increases result from a lack of competition among the railroads. The industry has responded that the higher rates contributed to the revival of its financial health. Moreover, the industry argues that it has high fixed costs and requires the higher rates to invest in maintaining and expanding its infrastructure.

The hearings proposed by the STB will primarily address three areas related to competition. First is the bottleneck issue, which arises when part of a route can be served by only one carrier even though large sections of the route can be served by several carriers. Of particular concern are "captive shippers," those with only one railroad at their origin or destination.

Second is the related question of competitive access, when the STB requires a railroad to allow its competitors to use its facilities to reach a shipper. Under current rules, the STB may require a railroad to allow its competitors to move shipments over its tracks to serve captive shippers, but only if the captive shipper can show that the railroad has used its market power to charge excessive prices. The STB will consider whether it should more readily order competitive access.

Finally, the STB will address "interchange commitments." These commitments generally arise when a large railroad sells a line to a small, short-line railroad. Such sales often include a contractual requirement that prohibits the short-line railroad from routing traffic to the selling railroad's competitors.

The hearings will explore the use and availability of alternative routes, the use of competitor facilities and track, the financial health of the railway industry and the role the financial health of a carrier should play in determining the price for access to a route. After the hearings, the STB will consider whether it should change its policies towards competitive access and interchange commitments.

Also In This Issue

Uniloc and the Demise of the 25 Percent Rule

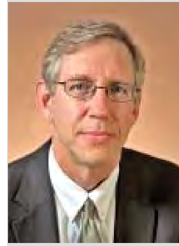
Thomas R. Varner discusses a recent Federal Circuit decision that raises the standards for expert testimony on reasonable royalties in patent infringement suits, and the decision's relation to his research on technology licenses. The decision in *Uniloc USA v. Microsoft* ends the use of the 25 percent rule of thumb as a basis for damages in patent infringement suits. The decision also states that the use of "comparable licenses" will be scrutinized as to the nature of the licensed technologies, the covered products, the conversion between lump-sum and running royalties and the circumstances surrounding the negotiations. *Uniloc* and other recent decisions addressing patent damages show that damages estimates must be tied to the facts in a case and be based on properly selected comparable agreements and sound economic reasoning.

Omnicare: The Rationality of Unilateral Actions and Proof of Antitrust Conspiracy

David A. Argue, Kent W Mikkelsen and John M. Gale review a recent Seventh Circuit decision concerning economic evidence of a conspiracy. The decision upheld the ruling of a lower court that a pharmacy, Omnicare, had presented insufficient evidence to infer an agreement between two health insurers, UnitedHealth Group and PacifiCare. Omnicare argued that because PacifiCare's actions were inconsistent with economically rational unilateral behavior, a conspiracy could be inferred. The Seventh Circuit, however, reasoned that PacifiCare's behavior could have been rational even without a conspiracy and granted summary judgment to defendants.

Uniloc and the Demise of the 25 Percent Rule

Thomas R. Varner



Thomas R. Varner, an EI Vice President, has experience in complex commercial litigation involving intellectual property, breach of contract, antitrust, and class action matters. He has also conducted extensive research in technology licensing across a wide range of industries. Dr. Varner authored the 2010 study published in les Nouvelles.

This year's Federal Circuit decision in *Uniloc USA v. Microsoft* has put an end to use of the so-called "25 percent rule" as a basis for determining reasonable royalties in patent infringement suits. The 25 percent rule is a general rule of thumb that suggests, as a starting point in a negotiation, that a licensee would pay 25 percent of its expected profits as a royalty for products that incorporate the licensed intellectual property (IP). For decades, district courts allowed expert testimony on reasonable royalties in patent infringement suits to be based, at least in part, on consideration of the 25 percent rule. However, in *Uniloc* the Federal Circuit stated, "[e]vidence relying on the 25 percent rule of thumb is...inadmissible under Daubert and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue."

The 25 percent rule has had a number of proponents and was often used by experts in estimating reasonable royalty damages. An article published in 1997 by Degnan and Horton reported that about a quarter of respondents to a voluntary survey of licensing professionals used the 25 percent rule as a "starting point" in licensing negotiations. An article published in 2002 by Goldscheider, Jarosz and Mulhern argued that licensing and profitability data provided some support for the rule's use, although they admitted, "there is quite a variation in results for specific industries....and [the 25 percent rule] should be considered in conjunction with other (qualitative and quantitative) factors that can and do affect royalty rates."

> "Not only has the Federal Circuit disallowed the 25 percent rule, but it has indicated that use of "comparable licenses" will be given careful scrutiny..."

In spite of its past use as a basis for patent damages opinions, the 25 percent rule has several serious shortcomings. First, there is no theoretical basis for the 25 percent rule. Economic theory provides no reason why technology should generally be worth 25 percent of the profits related to products embodying it. A simple technology that has many substitutes may be worth very little, regardless of the profitability of those products, while an enabling technology without viable substitutes may be worth much more than 25 percent of the profits from the covered products.

Second, there is very little published empirical data to support the rule. The 2002 study noted above purports to show an empirical basis for the 25 percent rule but presents data that appear to refute it. This study calculated the ratio of median royalty rates as a share of revenues to operating profit margins for firms in 15 industries. The study found that this ratio ranged from -3 percent to +493 percent, with only four industries out of the 15 examined having ratios between 20 percent and 30 percent. Moreover, the data presented in the study showed only a low correlation between royalty rates and operating profit margins on an industry-wide basis.

Third, damages experts in patent litigation have inconsistently applied the 25 percent rule. Some proponents of the rule have framed it in relation to the "whole arsenal" of IP embodied in a product, while others have claimed that it applies to the incremental contribution of IP to a product's profitability. Proponents of the rule often cite it as one of many factors to consider in determining a reasonable royalty rate; in some instances, however, experts have used the rule as the primary basis for selecting a reasonable royalty.

The Court in *Uniloc* touched on many of these points in concluding that the 25 percent rule was no longer admissible as a basis for consideration by experts. Quoting from its recent decision in *ResQNet.com v. Lansa*, the Court stated that expert testimony on reasonable royalties "must carefully tie proof of damages to the claimed invention's footprint in the market place." The Court summarized, "...there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case....The [rule] does not say anything about a particular hypothetical negotiation or reasonable royalty involving any

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Omnicare: The Rationality of Unilateral Actions and Proof of Antitrust Conspiracy

David A. Argue, Kent W Mikkelsen and John M. Gale

The Seventh Circuit recently affirmed a lower court decision granting summary judgment to defendants in *Omnicare, Inc. v. UnitedHealth Group, Inc. et al.* Among other things, plaintiff alleged a complex "gun-jumping" conspiracy by UnitedHealth Group ("United") and PacifiCare Health Systems, Inc. ("PacifiCare") to extract below-competitive pricing from Omnicare. Although the matter also presented the question of whether the alleged behavior could have constituted antitrust injury, both courts focused on the likelihood of a conspiracy. Ultimately, both found that PacifiCare's behavior was consistent with economically rational unilateral action and that Omnicare presented insufficient evidence to infer an agreement between United and PacifiCare.

Omnicare's allegations arose in the context of a June 2005 agreement between United and PacifiCare to merge, a transaction that was ultimately completed in December 2005. In the intervening months, both firms were preparing to offer insurance under the Medicare Part D prescription drug program, which would commence in January 2006. To obtain government approval to offer Part D insurance, United and PacifiCare were each required to assemble a network of pharmacies from which their enrollees could obtain prescriptions. The networks needed to include pharmacies like Omnicare that deliver drugs to patients in long-term care ("LTC") facilities. United brought Omnicare into its network through a contract with payment rates favorable to Omnicare. Negotiations between PacifiCare and Omnicare, however, failed to reach an agreement. Subsequently, PacifiCare obtained government approval of its pharmacy network without including Omnicare.

In October 2005, Omnicare interpreted an email from United to mean that after the merger, PacifiCare would maintain its own pharmacy network, which would include Omnicare only if a separate PacifiCare-Omnicare contract were signed. As a result, Omnicare contacted PacifiCare in early November 2005 and asked for its "best offer." PacifiCare sent back its standard first-offer contract, which Omnicare signed without any counteroffer or amendment. Importantly, a provision of the contract permitted PacifiCare to invite any other insurer to join the contract and pay the

EI Principal David A. Argue submitted expert reports and provided deposition testimony on behalf of defendants. Senior Vice President Kent W Mikkelsen and Vice President John M. Gale assisted with the analysis. This article is drawn from a more detailed version that appears in the Spring 2011 Antitrust Healthcare Chronicle.

same rate as PacifiCare. After the merger, United learned about the PacifiCare-Omnicare contract, which was more favorable than the United-Omnicare contract. United then informed Omnicare that United would join the PacifiCare-Omnicare contract. Omnicare filed suit, alleging fraud and various antitrust violations.

Among Omnicare's antitrust allegations was the claim that, prior to consummation of the merger, United and PacifiCare conspired to pay below-competitive rates to Omnicare. Omnicare had scant, if any, direct evidence of a conspiracy, but it argued that a conspiracy could be inferred from the actions of PacifiCare and United. Omnicare's inference might be sustained if it were able to show that PacifiCare's behavior was inconsistent with economically rational unilateral action. According to Omnicare, PacifiCare and United agreed that PacifiCare would refuse to negotiate with Omnicare for any rate other than the relatively low rate contained in PacifiCare's standard first-offer contract. Omnicare argued that this supposed no-compromise position was not in PacifiCare's unilateral interests because PacifiCare allegedly incurred enormous risks by adhering to that position and proceeding without Omnicare in its network.

The risks alleged by Omnicare were three-fold. First, Omnicare claimed that without Omnicare in its network, PacifiCare might not obtain government approval to offer Part D insurance. Second, Omnicare also claimed that PacifiCare's Part D business might be severely damaged when PacifiCare enrollees in LTC facilities served exclusively by Omnicare were unable to get their drugs. Third, Omnicare alleged that United might respond to either of these events

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Demise of the 25 Percent Rule

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particular technology, industry, or party."

The Federal Circuit decision in *Uniloc*, along with other recent decisions addressing patent damages (*e.g., Lucent Technologies, ResQNet.com* and *Wordtech Systems*), has made it clear that damages estimates must be tied to the facts in a case and be based on sound economic reasoning. Not only has the Federal Circuit disallowed the 25 percent rule, but it has indicated that use of "comparable licenses" will be given careful scrutiny as to the nature of the licensed technologies, the covered products, the conversion between lump-sum and running royalties, and the circumstances surrounding the negotiations.

An article published in the September 2010 issue of *les Nouvelles*, "Technology Royalty Rates in SEC Filings," which analyzed thousands of technology license agreements, showed that royalty rates vary significantly depending on what rights, if any, are bundled with patent rights. For example, royalty rates in technology licenses for "bare" patent rights differ significantly from rates for licenses that include technological "know-how" or other rights. Royalty rates also vary based on the subject industry, whether the license was arrived at via settlement of litigation, and whether the licensor was a commercial or non-commercial entity, among other factors. Just as damages experts often have relied on the 25 percent rule without rigorous basis, many also have relied upon "comparable licenses" without investigating whether these licenses actually were comparable in these and other dimensions. The Federal Circuit's recent set of decisions addressing reasonable royalties in patent infringement suits makes clear that future expert damages opinions must be carefully tied to the facts of the case, be based on properly selected comparable agreements, and be based on sound economic reasoning.

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by canceling the merger or renegotiating the merger on terms less favorable to PacifiCare than if PacifiCare had a successful Part D business. Omnicare argued that PacifiCare would not have tolerated these risks if it were acting independently, but under the alleged conspiracy with United it would have a "safety net" to sustain its alleged inflexible bargaining position. The safety net allegedly enabled United to bring Omnicare into the PacifiCare network through the United-Omnicare contract if no PacifiCare-Omnicare agreement were reached. United allegedly furthered the conspiracy through a deceptive email that caused Omnicare to sign the PacifiCare contract. The alleged conspiracy resulted in Omnicare's receiving below-competitive rates from United and PacifiCare that were ostensibly lower than rates paid by any other major insurer.

To avoid summary judgment, Omnicare had to produce evidence that "tended[ed] to exclude the possibility that the alleged conspirators acted independently rather than in concert." Neither court agreed with Omnicare's arguments. Both concluded, among other things, that PacifiCare could reasonably have been following a tough negotiating strategy on its own, not in coordination with United. PacifiCare never refused to compromise with Omnicare over the payment rate. Ultimately, Omnicare simply signed the PacifiCare contract without attempting to negotiate a higher payment rate. The rationality of PacifiCare's actions did not depend on the existence of a conspiracy-induced safety net. Indeed, PacifiCare did not need a safety net at all since, if necessary, it could simply have signed with Omnicare after Medicare Part D started. There was no reason to believe Omnicare would have refused PacifiCare's acceptance of Omnicare's contract at the later date. Nor did the supposed safety net of the United contract protect PacifiCare if it did not get a contract with Omnicare. PacifiCare could not rely on United's contract with Omnicare because the United-Omnicare contract required Omnicare's consent to add PacifiCare. Furthermore, if PacifiCare's negotiating strategy had damaged its Part D business, an illegal PacifiCare-United conspiracy would not have prevented United from backing out of or renegotiating the merger agreement. Moreover, the mere existence of a low payment rate does not imply that it was necessarily a below-competitive rate achieved by a conspiracy. Omnicare had other contracts with lower rates for which no allegations of conspiracy were raised. In addition, PacifiCare's low rate can readily be explained by Omnicare's failure to negotiate for a higher one.

The Omnicare appeals decision comports with well-established precedent on proof of a conspiracy. Omnicare's arguments failed to persuade either court that PacifiCare's actions were economically rational only in the context of a conspiracy with United. Thus, the courts granted the defense summary judgment on the conspiracy allegations, but some interesting antitrust issues as to whether the alleged behavior could have even constituted antitrust injury remain unaddressed.

EI News and Notes

FTC Agrees to Modify El Paso Consent Decree

The FTC agreed to modify a consent decree that arose from the El Paso Energy Corporation's ("El Paso") 2001 acquisition of the Coastal Corporation. The FTC agreed to change certain provisions of that decree because changed circumstances implied that those provisions were no longer necessary to assure competition among offshore natural gas pipelines. EI Principal Philip B. Nelson and Vice President Henry B. McFarland assisted the law firm of Vinson & Elkins in persuading the FTC to modify the decree.

Investigation of Copyright Protection Policies

EI Principal Stephen E. Siwek guided a comprehensive inspection of the copyright protection policies of the Nantong home textile markets. His findings were recently incorporated in a World Intellectual Property Organization ("WIPO") sponsored report entitled "Study on the Impact of Enhanced Protection in the Development of the Textile Market in Nantong, China." Mr. Siwek has been instrumental in furthering the global efforts of WIPO to encourage nations to measure the economic contribution of copyright-based industries. He also has been closely associated with the development of the WIPO Guide for the measurement of copyright industry contributions.

Testimony on Damages for Storing Spent Nuclear Fuel

EI Principal Jonathan A. Neuberger recently testified in the U.S. Court of Federal Claims on behalf of the Department of Justice in the case *Detroit Edison v. United States*. The hearing, which took place one year after the main trial, focused on expert testimony involving issues related to plaintiff's claim for financing-related damages associated with costs it allegedly incurred to store spent nuclear fuel (SNF) at its Michigan nuclear power plant. The fuel had to be stored due to the Department of Energy's delayed acceptance of SNF from the nuclear utility industry. A decision in this case is still pending.

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