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A BRIEF ANALYSIS OF POLICY AND LITIGATION

FERC Issues Civil Penalty Guidelines

John R. Morris

John R. Morris, an EI Principal, leads the energy practice at EI. He often testifies concerning pricing issues in electric power and natural gas markets.

On March 18, 2010, the Federal Energy Regulatory Commission (FERC) issued a Policy Statement on Penalty Guidelines to provide "fairness, consistency, and transparency" to its enforcement activities. FERC subsequently conducted three workshops to explain how the Guidelines work, after which it announced it would solicit additional comments before issuing final Guidelines.

The new Guidelines were necessary because the Energy Policy Act of 2005 granted FERC the ability to assess civil penalties up to $1 million per day per violation of FERC's regulations. Before that, FERC had little ability to assess civil penalties. Since 2005, the industries regulated by FERC have asked for greater clarity on how FERC would assess civil penalties because no clear discernible pattern emerged in the amount of civil penalties assessed in cases.

FERC's Guidelines follow the basic structure of the U.S. Sentencing Guidelines for Organizations in establishing a two-step process. In the first step, FERC calculates a base penalty. The base penalty is the greatest of three values. The first value is based upon the type of violation. The second is the pecuniary gain to the violator. The third is the loss to others caused by the violation. For example, consider a price manipulation case involving trades on a single day for more than 700,000 mmBtu of natural gas, a profit gain of $7 million and a market loss of $20 million. The violation type assessment is $17.5 million. But the base penalty is $20 million, the loss to others, because that is greater than both the violation type assessment and the gain to the violator.

In the second step, FERC multiplies the base penalty by minimum and maximum multipliers to provide ranges for civil penalties. The ranges allow FERC discretion in setting civil penalties based upon case-specific facts. The multipliers are based upon a "culpability score." If the violation involved high-level personnel at a large company with a history of violations and the company obstructed FERC's investigation, then the minimum and maximum multipliers would be at the highest levels of 2 and 4. If the violation did not involve high-level personnel, the company had no prior history of violations, the company had a vigorous compliance and ethics program, the violation was self-reported, and the company assisted the investigation, then the multipliers would be at the lowest levels of 0.05 and 0.2. In the example above, the civil penalty range would be $40 million to $80 million with the first set of multipliers and $1 million to $4 million with the second set. Thus, the culpability score is a major determinant of the civil penalties calculated under FERC's Penalty Guidelines.

Also In This Issue

Reasonable Royalties and "Comparable Licenses": Three Recent Court Rulings

Thomas R. Varner

Three recent court rulings in patent infringement suits address the methodologies used by damage experts to analyze reasonable royalties. In each of these cases, courts stressed the importance of properly considering "comparable licenses" in light of the patents-in-suit and the licensed products. Issues raised in these cases can be considered using the "Technology License Dataset" (TLD), a new dataset that comprises over 4,500 technology licenses from the high-tech and biotech fields that have been filed with the U.S. Securities and Exchange Commission (SEC).

The first case, *Lucent Technologies v. Gateway*, involved a "date-picker" tool that enables a user of Microsoft Outlook, among other programs, to enter dates using a monthly calendar grid. The jury in *Lucent* awarded $358 million for reasonable royalties; however, the Federal Circuit vacated the award.

The Federal Circuit identified a number of problems with the plaintiff's damage theory. Although the jury awarded a lump-sum dollar amount, the Federal Circuit reasoned that the amount was based on Lucent's expert's estimate of damages using a running royalty rate expressed as a percentage of sales. The Federal Circuit noted that the jury in *Lucent* had almost no testimony with which to make an economic comparison between lump-sum agreements and running royalty agreements. "For a jury to use a running-royalty agreement as a basis to award lump-sum damages, however, some basis for comparison must exist in the evidence presented to the jury."

Although one can mathematically convert a lump-sum royalty payment to a running royalty amount if the total sales in the royalty base are known, one should first consider the economic basis for such a conversion. An economic analysis of which form of royalty is preferred could include a number of factors, such as the risk aversion characteristics of the parties, the costs to observe covered sales, the existence of other licensees, the price elasticity of the licensed products, information asymmetries between the parties, and whether the expected use of the technology is known at the time of the negotiation. Analysis of the TLD supports the view that a running royalty rate is not automatically preferred for many types of agreements. The TLD indicates that over 40 percent of all software patent licenses submitted to the SEC specify financial consideration in terms of either a lump-sum amount or a fee per unit sold rather than as a percentage of sales.

Thomas R. Varner, an EI Vice President, has extensive experience in complex commercial litigation involving intellectual property, breach of contract, antitrust, and class action matters. He has also conducted research in high-tech, biotech, telecommunications, and manufacturing industries.

The Federal Circuit in *Lucent* also objected to the plaintiff's reliance on the "entire market value rule" in determining the royalty base. That rule allows an expert to use the entire market value of a product as the royalty base, even though a product may have features that are not covered by the patents-in-suit, as long as the patented features are the basis for customer demand for the product. In *Lucent* the Federal Circuit found that the product in question, Microsoft Outlook, clearly had many features other than the date-picker, and that those features accounted for most of the consumer demand for the product.

The second case, *Cornell University v. Hewlett-Packard*, involved a small sub-component of a computer processor. The processor would be used as part of a CPU brick, which in turn would be part of a larger computer server. The jury awarded the plaintiff $184 million in reasonable royalty damages based on a royalty rate of 0.8 percent applied to a royalty base of $23 billion, the sales of the defendant's CPU brick products. The court rejected Cornell's use of Hewlett-Packard's CPU brick sales as the appropriate royalty base and reduced damages to $53 million. The court stated that a more appropriate royalty base would be "the smallest salable infringing unit with close relation to the claimed invention–namely the processor itself."

The *Cornell* ruling highlights the importance of analyzing royalty rates in relation to the royalty base. For example, data in the TLD indicate that the median royalty rate for bare patent licenses covering software technology is 4.0 percent if the technology is used in software, but less than 1.5 percent if the product is used in computer hardware.

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SEC v. Goldman Sachs: Political-Legal Risks and Economic Strategies for Litigators and Transaction Planners

Dino D. Falaschetti

The Securities and Exchange Commission (SEC) introduced a new source of uncertainty to the financial exchanges when it sued Goldman, Sachs & Co. for fraud in marketing a collateralized debt obligation (CDO). The suit not only questioned the integrity of one of the world's best-known financial services firms, it encouraged many to reconsider the political-legal risks that other such firms may be facing. These risks may be rising as policymakers turn their attention from concerns about financial system collapse to questions about who may have been responsible, and even liable, for losses incurred during the recent economic downturn.

Assessing responsibility for losses requires understanding who knew what, when they knew it, and how markets valued such information. These questions can be difficult to address in normal times, and may be even harder to address during economic fluctuations, when system-wide effects can mask true securities fraud or suggest fraud when none exists. Economic models of how financial disclosures relate to market performance frequently help lawyers both as transaction planners and litigators, and may be especially important for success if legal risks have indeed grown following this unusually volatile period of financial market activity.

Economic models offer a fundamental benefit in seeing through accounting information that does not always reflect financial realities and in working through complicated deal structures that can make it hard to identify who relied on financial disclosures and whether omissions caused material harm. This advantage comes from logically building, from the ground up, an empirically verifiable case for how corporate governance practices may have affected the content of disclosures or the decision to disclose, as well as quantitative assessments of the possible consequences (if any) for various stakeholders. Less formal methods, by comparison, provide relatively weak guidance for distinguishing between potentially important forces and do not measure any relevant effects in a manner that can withstand rigorous tests.

Applied to cases like Goldman, good models facilitate a careful consideration of how financial derivatives strengthen economic performance, as well as how their construction and marketing can go wrong. For example, by letting investors buy into pools of loans (e.g., credit card balances or home mortgages), asset-backed securities (ABS) offer a low-cost mechanism for diversifying away from risks that are specific to any particular loan. This cost reduction can ultimately pass through to initial borrowers.

Dino D. Falaschetti is a Special Consultant for EI, an associate professor of law and economics at the Florida State University College of Law, and the Gleed Chair of Business Administration at Seattle University. He previously was a senior economist for the President's Council of Economic Advisers.

CDOs take this strategy a step further, giving investors an opportunity to select where they want to stand in line when receiving cash flows from an ABS. Those who buy into "senior tranches" participate first in these cash flows, followed by those who buy into "mezzanine tranches" and, finally, "equity tranches." By letting investors buy risks that best suit their appetites, a CDO can further the efficiencies that an ABS makes possible.

To produce these efficiency gains, however, the securities market must avoid becoming a market for "lemons." This problem is perhaps most familiar in the market for used cars. There, buyers' skepticism about the quality of cars for sale can reduce their willingness to pay for any car, even those that may truly be high quality. Similarly, when the quality of loans in an ABS is hard to measure, investors will curb their willingness to pay not only for the ABS, but for the derivative CDO.

To productively address this issue, corporate and securities laws must address the lemons problem at a lower cost than would market mechanisms (e.g., arms-length contracts). Corporate law works toward this goal by assigning directors and officers of financial service firms a duty to act as a fiduciary for shareholders (and, possibly, other stakeholders). Securities law tends to play an even more prominent role and, in both cases, important questions include whether a misrepresentation *materially* affected investor decisions and *caused* a loss.

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The third case, *ResQNet.com v. Lansa*, involved software technology that downloads screen information from a remote mainframe computer onto a local PC. The plaintiff's damage expert estimated reasonable royalty damages using a royalty rate of 12.5 percent based, in part, on seven "comparable licenses." Five of these seven licenses were for re-branding or re-bundling of software products and software code. The Federal Circuit rejected the expert's reliance on these five licenses and stated, "[T]he trial court should not rely on unrelated licenses to increase the reasonable royalty rate above rates more clearly linked to the economic demand for the claimed technology."

Royalty rates do vary considerably depending on the type and scope of agreement, as data in the TLD show. Among technology agreements filed with the SEC, the median royalty rate for software re-bundling or re-marketing licenses is approximately 14 percent, whereas the median royalty rate for bare patent software licenses is approximately 3 percent, almost a five-fold difference in royalty rates. The remaining two licenses considered by the plaintiff's expert in *ResQNet.com* arose out of litigation over the patents-in-suit. The Federal Circuit indicated a willingness to consider such agreements as part of a reasonable royalty analysis. In determining the relevance of settlement agreements on reasonable royalties, an expert should consider a number of factors including the stage of litigation in which a settlement occurred, the magnitude of fixed payments, the release from other ongoing litigation between the parties, the outcome of related legal proceedings, and the presence of other non-patent related agreements between the parties.

These three patent infringement rulings highlight the careful scrutiny courts have recently given to "comparable licenses," which are often an important resource for a damage expert in determining reasonable royalties. The issues discussed above – use of licenses with different forms of payment, consideration of the royalty base in conjunction with the royalty rate, and recognition of differences in royalty rates based on the type of license agreements – are all important matters to address in a damages analysis. This heightened scrutiny by the courts should lead to more careful analysis by experts and improve the economic basis for patent infringement damages analysis.

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Understanding the economics behind these terms creates opportunities for both transaction planners and litigators. For the planner, integrity of process matters, especially for establishing the good faith of decision makers (and even of the planner itself). How were decisions made about what to disclose? Did decision makers stand to benefit from a transaction as individuals, or only indirectly through stronger firm performance? When addressing such questions, it is useful to consider whether the process risks being seen (after the fact) as having set up a zero-sum game where decision makers benefit at the expense of those who are fooled into buying lemons, or whether it can more fairly be characterized (even when decisions ultimately go wrong) as having involved decision makers who are interested in building and maintaining a positive reputation for themselves, for their products and services, and for their firm.

For litigators, a compelling theory about what counts as "material" and "causal" is crucial. Here again, economic reasoning and methodology can be valuable. On the question of materiality, an economic analysis of what was known and disclosed at the time of an alleged misrepresentation can firmly establish whether, for example, investor expectations about the likelihood and magnitude of losses for a CDO tranche would have been significantly different. And for the question of causation, quantitative methods have become almost indispensable for evaluating what would have happened in the absence of alleged misrepresentations. Economic models can be combined with statistical methods, for example, to quantify market responses to possible misrepresentations and calculate explicit bounds on how much confidence those estimates deserve.

Given the statute of limitations for private 10b-5 actions (the earlier of two years after the discovery of the facts constituting the violation or five years after such violation), many commentators see the Goldman case as the tip of a litigation iceberg that will become more apparent during the next couple of years. The analytical tools described in this note can go far to strengthen or rebut the theories of participating litigants and better equip future transaction planners.

EI News and Notes

Competitive effects of a proposed acquisition of casinos

EI Principal William P. Hall testified on behalf of Icahn Partners in United States Bankruptcy Court. Icahn Partners controls an Atlantic City casino and submitted a plan to acquire three others. Dr. Hall, who has testified before the New Jersey Casino Control Commission (NJCCC) on three separate acquisitions, testified that competition would continue to remain vigorous even if Icahn Partners controlled the four casinos. Thus, neither the Federal Trade Commission nor the NJCCC was likely to object if the court were to accept the plan. The court agreed with Dr. Hall's testimony and concluded that neither agency would stop the acquisition.

Speedo USA and United States Swimming, Inc. defeat unfair competition claims

EI President Jonathan L. Walker was the antitrust liability expert for Defendants Warnaco Swimwear, Inc. (dba "Speedo USA") and United States Swimming, Inc. in a case involving advanced swimsuits. TYR Sport Inc. sued Speedo USA, the U.S. distributor of Speedo brand swimwear, and United States Swimming, the national governing body overseeing U.S. participation in international swimming competitions. TYR alleged restraint of trade, false advertising, and disparagement of TYR's brand of swimsuit. The court granted summary judgment for the Defendants in part because of a lack of proof of harm to competition.

Baby Center, LLC succeeds in arbitration

EI Vice President Laura A. Malowane assisted Baby Center in a claim against them by GSI Commerce Solutions. The matter involved allegations that the Internet retailer had breached a contract with GSI. For the JAMS arbitration hearing of the matter, Dr. Malowane assisted Baby Center in identifying the erroneous calculations and faulty assumptions in the plaintiff's expert's damages report. The arbitrator cited many of these errors as reasons for his conclusion that the plaintiff's expert's damage analysis was unreliable and for his final award of damages of $1.

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OFFICES:

1200 New Hampshire Avenue, NW
Suite 400
Washington, DC 20036
[p] (202) 223-4700
[f] (202) 296-7138

5980 Horton Street
Suite 250
Emeryville, CA 94608
[p] (510) 547-6910
[f] (510) 547-5162

www.ei.com