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Evaluating the Robustness of "Market Determined" Rates in Litigation Settings

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Individuals serving as financial experts in the legal field (e.g., financial damages) may utilize rates that are presumed to be "market determined." Such use is frequently embodied in the formulation of a "should have been" scenario, which when compared to an actual outcome yields a difference. Pending adjustments, this difference provides the basis for a calculation of financial damages.

Royalty rates are a good example of rates that are utilized in disputes involving intellectual property.

In general terms and by way of example, if a patent has been licensed to some number of licensees at a royalty equal to 5% of sales revenue, the general consensus will likely be that the market-determined rate is 5% of revenue.

Extrapolating the 5% rate to a financial damages situation, it would be applied to the infringer's sales base to determine the royalties that should have been paid. These should have been royalties represent the financial damages owed to the patent holder.

The simplicity of the solution is, unfortunately, premised on the robustness, or lack thereof, of the 5% rate.

The robustness is a unique outcome in economic theory referred to as a "bilateral monopoly" (yes, you read that right, a bilateral monopoly). This occurs with a market structure consisting of a single seller and a single buyer. The typical Economics 101 example is a labor union (the single seller) employed by a single large employer in a factory town (the single buyer).

There is no question that the two groups in the factory town will ultimately reach an agreement about wages. There is, however, a question of whether the result could be characterized as market determined.

Because the market lacks a sufficient number of buyers and sellers interacting over a sufficient period of time to establish a true equilibrium price, the robustness of the agreed-upon wage is questionable. Instead of market forces dictating a market wage, the result is based on factors such as the negotiating skill and bargaining power of the parties.

For financial experts, the takeaway from this dynamic is to appreciate the importance of how a particular rate might have been established.

For experts working on behalf of litigants when a previously established rate is available, questions to consider include:

- Is the publicized rate potentially the result of a bilateral monopoly?
- Could the negotiating skill and bargaining power of the litigants be different from those of the parties which established the original rate?
- Does the rate make sense in light of risk-adjusted returns for the original negotiators as well as the litigants?

Depending on the situation, attempting to gauge the robustness of a royalty rate would seem to be a useful exercise for a financial expert.

For an expert who is attempting to rely on a publicized rate, presenting information that demonstrates the rate has been market determined will increase its reliability.

Alternatively, an expert who is seeking to challenge the applicability of a publicized rate should be looking for facts that align with a bilateral monopoly explanation. This explanation may provide a basis to diverge from what may initially appear to be a benchmark rate.

About the Author

Allen Jacque is a senior manager in the valuation, forensic, and litigation services practice. He provides financial, accounting, and economic analyses to attorneys in connection with disputes involving contractual breaches, infringement of intellectual property assets, professional malpractice, fraud/misrepresentation, and personal injury-related losses. Allen has testified as an expert witness in federal court regarding financial damages. He also specializes in consulting matters requiring skills in econometrics, statistics, corporate finance, electronic discovery, and forensic accounting. Contact Allen at 847.562.4649, or email him at ajacque@wipfli.com.

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