

## Patent Law's Gordian Knot

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Jonathan S. Masur, [The Use and Misuse of Patent Licenses](#), 110 **Nw. U. L. Rev.** 115 (2015).

When a patent holder does not manufacture or sell a product, it cannot seek “lost profits” in the event the patent is infringed. Rather, courts must determine a “reasonable royalty”—generally, what an infringer hypothetically would have paid if the patent holder had licensed the patent, assuming it was valid and infringed, in the private market before the infringer began its unlawful acts. Such market rates are usually determined by examining other licenses for the patent-in-suit, or for patents sufficiently similar to the patent-in-suit.

In the brilliant article *The Use and Misuse of Patent Licenses*, Jonathan S. Masur unpacks what is often expressed but not suitably explained: that reasonable royalty determinations in the law of patent damages are substantially circular, leading to paradoxes and other conundrums that cannot easily be solved. The basic intuition is straightforward. Courts attempt to value patents in reasonable royalty determinations by looking to the market. Yet, market actors must bargain in the shadow of the law. Hence, a circularity.

For ordinary private law scholars, the response generally would be, “Who cares?” Assuming violations of the law are not a regular occurrence, then the market can still set reliable rates sufficiently divorced from judicial pronouncements. Slightly modifying an example in Masur’s article, take for instance the tort of conversion. This cause of action allows private owners of goods that have been stolen, or simply borrowed and damaged substantially, to recover the fair market value of the good from the wrongdoer.

In conversion, determining the fair market value of an ordinary good—say a bicycle that has been stolen—isn’t too difficult. Just assess what the good is selling for on average, and damages are fairly well-determined. However, imagine that the government and courts decided today that conversion was the *only* legal action owners could take for damages if their goods were stolen and the only punishment inflicted on the wrongdoer (i.e., criminal theft is abolished). In this instance, there would be a huge incentive to steal the bicycle in the street, because the worst that could happen for the wrongdoer is paying the fair market value of the bicycle (setting aside litigation costs for a moment), and the best would be getting the bicycle for essentially nothing. As Masur indicates, such an instance is akin to a “heads I win, tails I tie” outcome, not providing much of a deterrent.

The result is that the price of bicycles would fall—because they could be easily stolen or, alternatively, to compensate for increased amounts spent on locks and other theft-prevention devices (which I assume, for sake of argument, are separate products from the bicycle). Of course, the price could fall only so far because the marginal cost to produce a bicycle sets a minimum price floor. But, again, for the sake of argument, imagine that these costs are negligible. As prices fall, courts set the damages from conversion lower and lower, thereby increasing the incentive to steal bicycles even more. The feedback loop between the market and courts would eventually cause the price of bicycles to decline rapidly, potentially killing the market itself.

What a bizarre hypothetical, one might quip. Well, bizarre perhaps for bicycles, but not for patented inventions. Why? As Masur insightfully recognizes, for unpracticed patents, a civil suit for reasonable

royalties is typically the only way to recover for infringement. In this regard, since the Supreme Court's [eBay decision](#), for most patentees seeking reasonable royalties, injunctive relief is unavailable, implying that the only remedy is money damages—for past *and* future infringement. Next, because the marginal costs of producing an additional good covered by a patent are often small—think pharmaceutical drugs—there is often no hard floor to stop prices from falling, at least *ex post*. Finally, unlike bicycles, patents are relatively unique assets, making them very difficult to value, and the key information to determine reasonable royalties lies with the parties, who tend to massively exaggerate or undervalue patent value, as the case may be, via their experts in court.

Thus, Masur properly concludes that the usual way out of the circularity dilemma of contract and tort remedies is not typically available for reasonable royalties. Masur masterfully spells out this argument in extensive detail, all the while digging quite a deep conceptual hole for the ostensible foundation of a sizeable share of patent law remedies as practiced. Like conversion absent criminal or other sanctions, as courts look to the marketplace and as infringers take their chances, reasonable royalties will generally spiral downward to the potential demise of patents altogether.

Further complicating this landscape, Masur rightly contends, patentees—realizing as much—will, like someone engaging in a fraudulent insurance scheme, do all they can to inflate the nominal value of licenses so that courts impose damages *greater* than the “fair market value” of the patent. For example, in addition to providing a naked license to the patent, patentees can offer consulting services, know-how, or other benefits but price them into the apparent “royalty rate.” For patentees that sell products to licensees, they can inflate the royalty rate and discount product prices. As courts look to these increased licensing rates, the market will respond by increasing the rates on ordinary licenses, ballooning licensing awards in the courts.

Perhaps all of these effects negate each other? Unfortunately (for us), Masur is again dead on the mark: “It may be tempting to conclude that these effects will balance one another out, or at least come close enough to doing so that it is safe to ignore them. But this would be error. It would be pure fortuity....” (P. 144.) Of course, these negating effects – as well as the other factors used to determine reasonable royalties – while not fully in balance, do keep the system from completely collapsing. With that said, there is little belief that current royalty determinations are fairly accurate, even on average, across large numbers of cases.

So, what is the upshot? Although Masur recounts that it is usually “in the nature of legal scholarship to write comedies rather than tragedies” (P. 156), reasonable royalties appear to be the recalcitrant exception. Masur suggests in this and later work that courts wholly abandon reliance on comparable licenses. Yet, he and others have yet to propose workable alternatives that suitably further the aims of the patent system. While actual valuation of the benefit of the patented invention relative to the next best alternative would escape these dilemmas, estimating these amounts is notoriously difficult.

So is there no hope? Instead of attempting to cut this Gordian Knot, I have proposed in previous work that we essentially burn it. Rather than restoring the patent holder to some mythical “state of nature of the market,” courts would do better to focus on damages that adequately reward the patentee for its innovative contribution so as to set appropriate *ex ante* incentives to innovate. Market transactions may be one input into such a determination, but other factors, such as the patentee’s research and development costs, commercialization costs, opportunity costs, and risk of failure would arguably better calibrate with the aim of patent law to promote innovation. More on that in future work. In the meantime, we are left with the maelstrom so ably explicated by Masur. Anyone seeking to understand the precise headwinds, tailwinds, and sidewinds of this storm is well-advised to read Masur’s meticulous depiction.

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