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## REASONABLE ROYALTY DAMAGES AND LICENSE STRUCTURE: WHY SOME EXPERTS GO RUNNING WHEN THEY SHOULD TAKE THEIR LUMPS.

By Philip Johnson, Ph.D.,  
Econ One, Sacramento, CA

License structure issues can have a big impact on a reasonable royalty damages analysis. Not all patent damages experts have the training it takes to properly analyze the economic issues that surround license structure. In fact, some patent damages experts automatically assume a running royalty rate without considering an alternative--in spite of the fact that it is common in royalty negotiations for parties to agree to fixed payments, generally a lump sum at the time the license is executed.<sup>1</sup> Indeed, basic economic theory suggests that absent an economic justification, the negotiated royalty payment would be a lump sum. Ignoring license structure issues in the analysis of the parties' hypothetical negotiation can result in lower damages (i.e., lower relative to what the hypothetical negotiation would have yielded). Patent damages experts should include an assessment of the appropriate license structure in their reasonable royalty calculation.

It has long been established in economic theory that payment structures (like running royalties) lead to economic losses in ways lump sum payments do not. A running royalty increases a licensee's marginal costs, leading to reduced sales and profits for the licensee and licensor to share. This "problem" is lessened if some or all of the royalties are paid upfront. As a result, both sides of the negotiation may be better off with a substantial upfront lump sum payment.

Yet, in the "real world," many negotiated

patent license agreements have some form of running royalty (which are sometimes coupled with a lump sum payment). So, why--apparently contrary to the economic theory described above--are there so many license agreements with running royalties? Again, economic theory is the key to understanding the economic justifications for a running royalty structure. Analyzing the relevance of the economic context to a specific hypothetical negotiation is the key to determining license structure and the size of lump sum payments (if any).

Essentially, running royalties share risk between the licensee and licensor. This risk sharing can be economically efficient. For example, under a running royalty scheme, a licensor will receive larger payments if the licensee's commercialization is successful and smaller payments if commercialization is unsuccessful. So in a situation where commercialization of the patent technology carries substantial risks<sup>2</sup> and the patent holder is less risk averse than the would-be licensee or can affect the success of the commercialization effort in the post-license environment, a running royalty scheme makes economic sense.<sup>3</sup>

Commercial uncertainty can create efficiencies favoring running royalties for other reasons as well. A licensee might have less information about the usefulness of a technology than the patent holder in which case the patent holder would be in a better

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position to know (evaluate) the associated risks. In this circumstance, the willingness of the patent holder to accept part of the risk (through a running royalty) could be an important signal to the licensee that the patent holder believes strongly in the patented technology's potential for success.

The difficulty coming to an initial agreement can also create efficiencies favoring a running royalty. For example, a running royalty can eliminate the need to come to agreement about the prospective size of the market in cases where there is a high degree of uncertainty about the size of the commercial opportunity and widely differing perspectives on the future sales or profitability of the product.

Further, a running royalty is a form of licensor-provided financing in instances where the would-be licensee may face a liquidity constraint (i.e., the licensee might have difficulty convincing capital markets to provide the funds needed to pay a large lump sum fee). Finally, when licensee and licensor are competitors, the output reduction (and accompanying higher prices) that running royalties create may be attractive to both parties.

It is necessary to evaluate the presence or absence of these factors as significant elements in the negotiation to assess the appropriateness of a running

royalty (in the presence of these factors) or a lump sum payment (in the absence of these factors). Given that many patents are licensed well before a product is ready for market, the factors discussed above are generally present in those license negotiations. As a result, running royalties are commonly reported in negotiated licenses.

However, the typical hypothetical negotiation posited for calculating a reasonable royalty for patent damages is assumed to occur after research and product development has been completed and the product has been brought to market. Therefore, if the product containing the technology has already been commercialized, many of the factors (described above) motivating a running royalty will no longer be relevant. Risk and uncertainty will likely be lower because many (or all) of the development hurdles will have been overcome and the product may have a sales track record establishing its demand. Thus the circumstances in which lump sum payments are most likely to occur are exactly those under which most hypothetical negotiations are assumed to occur. As a result, damages experts should closely examine the circumstances surrounding the hypothetical negotiation and separately determine the appropriate royalty scheme. Ignoring circumstances that point towards lump sum royalty payments can result in understated damages.

<sup>1</sup> Lump sum payments and/or upfront payments refer to fixed payments that do not depend on the performance of the parties, the technology or the licensed products. For the remainder of the paper, I refer to both categories as lump sum.

<sup>2</sup> For example, if the product in question has never been marketed or if the licensee faces significant technical or legal hurdles in bringing the product to market.

<sup>3</sup> The recent Supreme Court decision in *MedImmune Inc. v. Genentech Inc.*, appears likely to further increase the size and incidence of lump sum payments. This decision increases patent holders' risk of having patents invalidated after licensing (because of lowering the cost of challenging patents). This increased uncertainty of future license payments should lead licensors to reduce that risk by increasing their use of lump sum licenses