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# Intellectual Property and the Law of Contract: The Case Against "Efficient Breach"

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Intellectual Property and the Law of Contract
The Case Against "Efficient Breach"

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# Intellectual Property and the Law of Contract:

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By

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ABSTRACT

In general sound general principles of contract law should carry over more or less seamlessly to the licensing of intellectual property. Those basic principles caution against attacks on standard form contracts that often contain liquidated damage provisions. This paper shows why over a broad range of cases involving two or more parties these liquidated provisions, properly calibrated, avoid the many disadvantages of using the theory of "efficient breach" to set damages. Chief among these difficulties are the high administrative costs of finding these damages, and the perverse incentives that they place on the defendant before breach and the plaintiff afterwards. Intellectual property licenses are not exempt from these many principles, which implies that these clear damage rules are typically optimal in first avoiding breach and then in resolve post-breach disputes.

## I Introduction: The Distinctiveness of Intellectual Property Law?

The general field of intellectual property (IP) has received, both in the United States and the European Union, extensive analysis in recent years. One way to classify recent scholarship is by the extent to which IP is regarded as a subset of the general law of property. Alternatively, it can be seen as a distinct field that is more or less *sui generis*, and thus governed by its own distinctive considerations. In my view, the correct approach is

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clearly the former.[1] Under that approach, it is critical to first set out the basic rules of property, contract, and tort as they apply to other resource types, and then to ask what modifications must be introduced to account for the distinctive features of different branches of IP law, including patents and copyrights. This approach is not unique to IP. A similar approach has to be used in order to understand, for example, the relationship between land law and water law—fields that have both strong commonalities and profound differences.

Admittedly, this method contains a certain element of risk insofar as it uses the general common law as the starting point for looking at IP law. In order for this method to work well, the baseline has to be secure. Yet nothing is more plain than that the traditional common law views on property, tort and contract themselves have been subject to constant attack in the academic literature. To give but one example, in 1943 Friedrich Kessler offered a somber view of contracts of adhesion that has prompted many parties to favor comprehensive regulation of ordinary consumer contracts.[2] Let that view prevail, and it is easy to see why there should be comprehensive regulation of such matters as shrink wrap contracts and IP licensing more generally.[3] It is therefore important to make clear at the outset which approach toward the various common law rules should be given pride of place. If the basic common rules are correct, using them leverages good ideas into new contexts, like IP law. But if those rules are incorrect, using them as a template extends

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1 Richard A. Epstein, 'The Disintegration of Intellectual Property? A Classical Liberal Response to Premature Obituary' (2010) 62 *Stanford Law Review* 455 .

2 Friedrich Kessler, 'Contracts of Adhesion—Some Thoughts About Freedom of Contract' (1943) 43 *Columbia Law Review* 629.

3 *See, e.g.*, Mark Lemley 'Intellectual Property and Shrink Licenses' (1995) 68 *Southern California Law Review* 1239.

bad ideas into IP law. It is a sad truth that both bad, as well as sound conceptions of property law can be extended into new domains.

Although I cannot argue the general point anew in this context, I take the same view toward IP contracts that I take toward the larger field of private rights. The basic distribution of common law entitlements contains four key components, supplemented by two forms of direct government intervention.[4] The first of these is a rule that allows for the acquisition of private ownership in those things that can be properly reduced to private ownership (not rivers or the World Wide Web). Indeed on this score, intellectual property follows the basic pattern because it too has a mixture of private property (for inventions and writings), which must interact with an IP commons. The so-called 'public domain' that includes shared terms of speech, general laws of mathematics and nature, and various forms of natural substances, must be kept distinct from the rest, which is left for private ownership.[5]

The second, which is the office of contract law, is to allow for voluntary agreements to increase the value of these resources by transfer, cooperation or any other type of arrangement that suits the fancy of the contracting parties. The third element is the protection of voluntary exchange by refusing to allow individuals to take the property of another without their consent. And last, there is the law of restitution or unjust enrichment whose major function is to provide compensation,, most notably in those cases where

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4 For a fuller development of this system, see Richard A. Epstein, *Simple Rules for a Complex World* (Harvard University Press, 1995).

5 For the most recent Supreme Court discussion, see *Association for Molecular Pathology v. Myriad Genetics*, 133 S. Ct. 2107 (U.S. 2013)(denying patent status to naturally occurring DNA but allowing it for complementary or cDNA).

property has been transferred from one individual to another by coercion or mistake. On top of this private system of law lie two other public systems: one of general taxation that is levied on income from all sorts of property or labour, and a second of eminent domain that allows for the movement of property from private to public ownership upon payment of just compensation.

In this paper, I shall not discuss the rules that relate to the acquisition of property rights in land or IP, or those that relate to eminent domain and taxation. Instead I shall concentrate on the interplay of the rules of contract and the rules of tort, as they work in both contexts. This connection is deep. A law of tort that does not offer strong property rights protection to land or IP will allow various non-owners to use property without taking licenses from their owner. A strong property rights protection in turn forces outsiders to contract with property owners in order to use that property. Then, once contracts are established, a strong property rights protection requires, to the extent that the law can arrange it, strict conformity with the basic contractual provisions, rather than a weaker view of contract law that invites what is commonly called an "efficient breach," whereby the promisor has an option to breach so long as he pays full expectation damages.[6] Part I critiques the theory of efficient breach against the general backdrop of the tort law. Part II extends the analysis to IP, by asking whether there ought be any changes in the applicable rules, and if so, why.

## II Efficient breach in the law of contract

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6 *See, e.g.*, Charles J. Goetz & Robert E. Scott, 'Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77 *Columbia Law Review* 554. For an early critique, see Daniel Friedmann, 'The Efficient Breach Fallacy' (1989) 18 *The Journal of Legal Studies* 1.

1 Two-Party Disputes

Contract disputes can arise only when parties choose to voluntarily enter into agreements, and they are far more likely to do this if they can be strictly enjoined from using other people's property without their consent. Once they have made their promises, the question is whether contract law shows the same determination to hold individuals to them. Accordingly, one central dispute in the law of contract is whether the promisor should be obligated to carry out his promise, or whether that promise should be treated as containing a *concealed* option. Under the so-called theory of 'efficient breach,' that concealed option would allow the promisor to choose between performing or paying damages, so long as those damages are set at a level that puts the promisee in as good of a position as she would have enjoyed if the promise had been performed in full. The origins of this theory are found in the famous remark of Oliver Wendell Holmes: 'The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass.'[7] By awarding promisees damages only, the efficient breach theory implicitly rejects the use of injunctive relief and specific performance on the grounds that these 'property right' solutions create bargaining difficulties of their own by allowing the promisee to 'hold up' the promisor in costly negotiations that can easily transfer gains to the promisee as a result of her efforts.[8]

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[7] Oliver Wendell Holmes, Jr., *The Common Law* (Boston: Little, Brown and Co., 1881) 301. In fairness to Holmes, he also notes the role for equitable relief, which he considers to be only an "exceptional one." *Id*. at 300-301.

[8] The terminology derives from Guido Calabresi & Douglas Malamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089. For my earlier criticism of its implicit bias toward liability rules, see Richard A. Epstein, 'A Clear View of *The Cathedral*: The Dominance of Property Rules' (1997) 106 *Yale Law Journal* 2091.

At root, therefore, much of this debate over the choice of remedies asks the question of which remedial structure causes greater disruption to commercial activity. The underlying case for 'efficient breach' rests on the implicit proposition that there are cases in which breach plus compensation is likely to yield a more favorable social result than the simple performance of a contract. All such disputes arise when positive transaction costs prevent the parties to any given agreement from renegotiating their original agreement if some change in circumstances makes it clear that some third party attaches greater value to certain goods than the contractual promisee. The basic insight that follows is that so long as the promisor can pay off the promisee to the full extent of her expectations, he should be allowed to breach the contract in order to capture the social gains that derive from supplying goods or services to a third party. Since the original promisee is theoretically indifferent between the cash received and the promised performance, there is a clear social good by allowing the new transaction to a third party. To be sure, none of the surplus in this situation is captured by the aggrieved promisee, but the transaction is Pareto efficient from a social perspective. So long as two parties are made better off and no party is made worse off, the transaction should go forward.

It is instructive to note that this theory has no support anywhere in observed commercial practice. The question of whether it makes sense to break one contract in order to be able to enter into a second does not raise some novel social issue that has never been considered in the annals of business transactions. Once parties are alerted to this possibility they should be able to negotiate their own agreement that arranges for the release of the one contract and the formation of the second. To be sure, there are positive transaction costs in negotiating this agreement, just as there are in any other. But by the same token, the parties negotiating this agreement will be sensitive to that fact and thus seek to reach an agreement that minimizes the transaction costs in the second stage of the arrangement. One way to achieve that result is to economize on the costs that are needed to sort out whether the option should be exercised. On this question there is a uniform answer from past practice in virtually all areas of law, which suggests that all such options require the seller to pay a liquidated sum of money in order to escape the initial obligation if there is to be any payment obligation at all. The practice is well nigh universal. In employment contracts, termination agreements typically feature liquidated damage clauses that formulate a payment based on a combination of years worked and salary arrangements. In complex mergers and acquisition transactions, termination fees are specified in dollars, not in terms of general expectation damages. In real estate transactions, options are expressed in dollars, and their exercise dates are clearly set out in the contract in question. In each of these cases, there may be difficult business decisions that face either or both parties, but they are done against a backdrop that at no point makes reference to expectation damages. And, more importantly, there is no toleration of the enormous period of limbo between the exercise of this supposed option and the determination of its supposed price.

The reasons why this is the case depend on the very type of transaction costs rationales that are said to drive the movement toward the theory of efficient breach in the first instance. In dealing with this topic, it is critical to divide expectation damages into two classes. By the first, the promisor either refuses or is unable to perform. In these situations, the correct measure of damages is usually the contract/market differential. Indeed in cases dealing with nonperforming sellers, the U.S. Uniform Commercial Code makes it clear that if the buyer is able to cover in the marketplace, she will not be allowed to recover any consequential damages that could be avoided if cover had been executed.[9] There are powerful reasons to support this general rule. The issue of consequential damages is always inextricably tied up with the parallel question of whether the aggrieved buyer is in a position to mitigate the losses in question. Mitigation strategies make perfectly good sense when one person is trying to figure out how to minimize her damages wholly apart from any legal dispute. The single individual internalizes all the gains and losses from this decision, and thus has every incentive to correctly trade off the costs needed to mitigate those damages against the benefits derived from the mitigation activity. Even in the simplest situation there may be multiple paths toward mitigation, some of which necessarily involve introducing a new risk in order to deal with the prior loss. It is highly unlikely that any outsider can have strong enough information to override the single individual's choice, although it is equally likely that a party faced with difficult mitigation options will hire professional advisors in order to help navigate her way through difficult decisions.

The problems associated with mitigation do not get any easier when it arises in the context of a dispute in which the party who is charged with the obligation to mitigate

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[9] U.C.C. § 2-712 (3) provides: '(3) Failure of the buyer to effect cover within this Section does not bar him from any other remedy.' But that provision is immediately qualified in comment 3, which provides:

> 3. Subsection (3) expresses the policy that cover is not a mandatory remedy for the buyer. The buyer is always free to choose between cover and damages for non-delivery under the next section. However, this subsection must be read in conjunction with the section which limits the recovery of consequential damages to such as could not have been obviated by cover.

necessarily knows that residual damages will be charged to the defendant. At this point, each act of mitigation has external effects on the breaching party which could easily lead the innocent party to overinvest in mitigation, knowing that someone else will pick up the tab. Knowing that this moral hazard remains, courts do not give a blank check to an innocent plaintiff in dealing with her mitigation expenses. Instead courts wade into the dispute in order to analyze whether the plaintiff's mitigation unduly taxes the breaching defendant. That inquiry in turn increases the administrative costs to both parties far beyond what they would be if some liquidated sum had been specified in advance. Neither party benefits from that ex ante imposition.

Some of the confusions that plague this area are evident in the important case of *Parker v. Twentieth Century Fox Film Corporation*.[10] There, the California Supreme Court raised the question of whether the actress Shirley MacClaine was under a duty to mitigate damages when Fox told her that it would no longer make the musical "Bloomer Girl," and requested that she make the western "Big Country, Big Man," in Australia no less, for the same $750,000 fee. The question of whether the second movie is a partial or complete substitute for the first is not easy to answer. Movie stars have reputations and career paths that could be altered for the worse, or the better, by moving from one type of picture to the other. Additionally, there is the possibility that the mitigation was both reasonable and partial, so that the potential range of damages is not confined to either zero or the full amount of the picture.

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10 474 P.2d 689 (Cal. 1970). For incisive commentary. see Victor P. Goldberg, 'Bloomer Girl Revisited, or, How to Frame an Unmade Picture' (1998) 1998 *Wisconsin Law Review* 1051.

Clearly, any inquiry of this sort undertaken from the ex ante perspective is one that consumes substantial resources, so the question arises why parties would agree to bear the costs of those renegotiations at the time of the original deal. In fact it seems pretty clear that the entire mitigation controversy has no place in the "play or pay" contract at issue in the case. The operative provision in the agreement provided: 'We [defendant] shall not be obligated to utilize your [plaintiff's] services in or in connection with the Photoplay hereunder, our sole obligation, subject to the terms and conditions of this Agreement, being to pay you the guaranteed compensation herein provided for.' Read literally, this provision makes it clear that MacClaine is not entitled to demand specific performance of the contract, i.e. that Fox incur the heavy expenses of making the film even if it would otherwise choose not to. But by the same token, it in no way conditions the payment of the guaranteed compensation upon an uncertain duty of mitigation that would need to be read into the contract, which makes perfectly good sense as it stands. Making this a fixed option reduces the costs of separation to both sides, and it puts Fox in the position of having to make a serious judgment on whether to commit itself to making this film. Similarly, MacClaine now has to limit her own commitments so as to be available to make the film in question: taking the money is thus not a free good. To be sure, the parties could have agreed on a smaller sum in the event of breach, but in this commercial context there is no reason to overturn the judgment of two sophisticated parties by working through the consequential damages in a way required by the theory of efficient breach. Nor should anyone regard these circumstances as novel or difficult. Any construction contract, for example, poses major challenges in determining consequential damages when—for good reason or ill—a complex construction or software development project does not finish on time.

The reason, moreover, why these formula clauses tend to displace the general rules on consequential damages is that they solve two imperatives at the same time.[11] At the first stage of the agreement, they make it clear that the defendant who is in breach does not get a free ride from the plaintiff. The fixed sum thus acts as a deterrent against breach and (partial) compensation to the injured plaintiff. At the second stage of the agreement, the provision of liquidated damages means that the plaintiff is no longer in the enviable position of knowing that she can offload some portion of her mitigation costs on the defendant. Instead, the plaintiff is now put in the correct economic position whereby she takes into account all of her costs and benefits, just as she would do if there had been no agreement or no breach in the first place. Quite simply, the mitigation function that the plaintiff seeks to maximize after the receipt of the fixed sum is $F(x) + d$, where $F(x)$ is the function that would apply if there had been no contract at all, and $d$ is the fixed sum collectible from the defendant. Under the standard rules of calculus, the fixed term drops out in seeking to find the appropriate maximum gain (or minimum loss). This positions the plaintiff in her initial value maximizing position as if no contract had ever been written, which is what an efficient system of damages requires. The system of efficient breach thus is not efficient at all.

The same point becomes true if we consider it in connection with the standard distinction developed in both the law of contract and the law of tort between good faith breaches of contract and deliberate breaches. For these purposes, a good faith breach arises when the defendant finds himself unable to perform the contract for circumstances

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11 Richard A. Epstein, 'Beyond Foreseeability: Consequential Damages in the Law of Contract' (1989) 18 *Journal of Legal Studies* 105.

beyond his control. In these cases the possibility of raising some defence of impossibility or frustration is always lurking in the background, but even if this prospect is negated, it becomes clear that contract damages, however set, are not intended to punish a defendant who has not made any serious misstep. But in other cases where the breach itself is deliberate, moral hazard issues become large, and the level of damages awarded should take into account that risk.

This position is made clear in those cases like *Acme Mills v. Johnson*,[12] where (on one interpretation of the facts at least) the defendant had promised a particular crop grown on his land to the plaintiff which he then sold to a third party, knowing that he was in breach of contract. On that decision, the expectation measure of damages for the disappointed buyer was the contract/market price differential, which works reasonably well when there is, at least, a prospect of cover. But by the same token, the likelihood of breach would have been substantially reduced if the court adopted a restitution measure of damages, whereby the plaintiff would be entitled to receive any higher amount that the seller had received from some third party at the time of the interim sale.

The great advantage of that restitution measure is that it means that the seller who acts in deliberate breach is put into a no-win situation. If the price moves down after the sale to the third party, the seller is still under a duty to disgorge the proceeds of the third party sale, which are arguably ill-gotten gains. If the price moves up before delivery, the seller can be hit with the increased contract/market differential. By making sure that the breaching seller loses in all states of the world, this system, if consistently enforced, acts as a quasi form of injunctive relief in the transaction. As such, leaving the seller with an

[12] 33 S.W. 784 (Ky. 1911).

expected negative return means performance should take place, eliminating the need to calculate damages in the first place. Note that in this sense, the rule operates similar to an injunction against the sale to a third party, which thus leaves the seller with no effective option other than performance to this plaintiff.

This form of damage relief, moreover, is picked up in the law of conversion, in those settings where the defendant cuts (at his own expense) timber that belongs to the plaintiff.[13] If the defendant thinks in good faith that he owns the timber, he has no defence against liability, but the requisite measure of damages is the price that he receives for the sale of the timber, less his costs of production. But if he acts in bad faith, then the offset of his labour costs is no longer allowed, so that the defendant is put into a position whereby he necessarily loses from this transaction. Again the rules operate as an imposed form of injunctive relief, and once again are the optimal solution. Indeed, one of the most powerful arguments against the theory of efficient breach as a descriptive matter is that the existence of equitable remedies, like specific performance and injunctive relief, is flatly inconsistent with the theory of efficient breach. Thus, simple examples such as the use of specific performance in real estate contracts at the instance of either the buyer or the seller is evidence to the difficulty of determining consequential damages for a buyer who cannot get the property he needs or for a seller who cannot move property that she wishes to sell. Similarly, with labour contracts, under which specific performance is never awarded, it is possible in many cases to get injunctive relief against working for a rival, as happened in

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[13] *See, e.g.*, Maye v. Yappan, 23 Cal. 306, 307-308 (1863). For further discussion on conversion generally, see Oliver Wendell Holmes, Jr., *Id.* at 97.

the famous English case of *Lumley v. Wagner*,[14] when Joanna Wagner was prevented from singing for a rival, and its companion case of *Lumley v. Gye*,[15] where injunctive relief against a third person was awarded as well.

2 The Many-Party Problem

The analysis thus far has proceeded on the implicit assumption that the only parties that have an interest in an ordinary contract dispute are the parties to the arrangement. While that assumption may be true in connection with such doctrines and *res judicata*, it is surely wrong in thinking about contracts that operate in any business setting where these remedial issues are likely to be litigated. More specifically, any individual contract has to be set into its larger business context along two separate dimensions. The first dimension involves the problem of a single seller having many different buyers. The second dimension involves situations where a given contract forms but a single link in a longer chain of distribution. The two sets of relations are not mutually exclusive, for nothing is more common than for a single seller to have multiple customers, who each possess further downstream relationships.

In this context, it is worth remembering that the original Calabresi/Melamed article asks about the choice between damages and injunctions in a modern mythical two-party dispute between Chief Justices Marshall and Taney.[16] Let us assume for the moment that in such two-party cases it is an open question whether a damage remedy dominates either

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14 42 Eng. Rep. 687 (Ch. 1852)

15 118 Eng. Rep. 749 (K.B. 1853)

16 Calabresi & Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089 at 1091.

specific performance or injunctive relief. That balance is decisively changed when additional parties are joined into the arrangement. In these situations it would be sheer business madness for a party consensually to grant to all its trading partners an option to perform or to pay expectation damages. In these cases, once a single party decides that it is in its interest to repudiate performance and pay expectation damages, the entire "single seller, multiple buyers" framework will quickly start to disintegrate. Thus suppose that the seller decides it does not wish to deliver to some buyers but will deliver to others. The disappointed buyers will find themselves at a competitive disadvantage with other parties who occupy parallel positions in the distribution chain and will wonder whether they will have a damage action against the seller who has preferred other individuals who are in like positions. Conversely, if it is the buyer that decides to obtain cheaper supplies elsewhere, there is now an open temptation for other buyers to also abandon their contracts. At that point, the number of damage actions can multiply quickly. It will take a long time for these disputes to resolve, and during the interim the contractual relationships will continue to go south. In addition, the business environment surely will get worse if litigation produces different results on different timetables. It is very clear that to keep this entire enterprise in flow, the norms have to be set strongly against any deliberate breach by either buyer or seller in this contract setting. Specific performance and injunctions may not be able to deliver perfectly on that promise, but they are surely infinitely preferable to a contractual regime that regards breach as on a moral and legal par with performance. So much of any business environment, particularly among repeat transactors, depends on the implicit social norms that govern any case, and it can hardly make sense for any legal rule to facilitate the break down of parity between the parties.

The same result arises within any given contractual chain. Thus suppose that the first seller refuses to deliver goods to the first buyer, who in turn is no longer able to perform its contracts of sales or service with the next layer of downstream parties. Finding out consequential damages gives rise to delicate questions of whether certain damages are said to flow from the defendant's nonperformance.

At this point at least two difficulties surface. But ever since *Hadley v. Baxendale*,[17] it is clear that not all consequential damages—in that case lost profits— are recoverable, but only an indefinite subset of these claims that are said to come within the joint contemplation of the parties can be recovered. What those might be is a constant source of contention because in *Hadley* itself, the only definitive conclusion was that 'lost profits' from the delayed return of the crankshaft could not be recovered. But the case said not a word as to what the appropriate measure of recovery should be in that case or in any of the countless permutations of the basic formula. But so long as it is clear that lost profits is not a fixed standard, there must be doubt about whether implementation of the efficient breach standard is even feasible whenever there are sequential contracts.

Nor is the measure of damages the sole issue that arises in these cases. There is always the question of whether the initial buyer is excused by some doctrine of frustration or impossibility in dealing with its downstream partners, or, failing that, whether additional time should be allowed for the first buyer to cover, so that the breaching seller pays, perhaps, only partial damages. In those industries with high volume transactions under legal regimes that look to just-in-time performance, no one can intelligently operate today if they know that all sorts of contingent liabilities will pile up for tomorrow. Saying

[17] 9 Ex. 341. 156 Eng.Rep. 145 (1854).

that specific relief is needed does not capture what is at stake. What is desired and demanded is the actual and timely performance that allows a vast network of interconnected contracts to be performed on time, without legal disputes. In a world in which there is a need to secure parity between parties at the same level of distribution and to make sure that all interconnected contract chains work well, expectation damages and the theory of efficient breach are not sustainable. The key point is to create a business environment in which informal adjustments resolve glitches in the various chains, and that cannot be done if the law sets expectation damages as its background social norm. It is for good reason that business people of all stripes and persuasions reject the view that contracts give options to breach for expectation damages. No one wants them.

## III Intellectual Property

The question is how these various insights carry over to IP law. On this point, I have long maintained the basic position is that the one major difference between intellectual property rights (IPRs) and those in land and other tangible assets derives from the simple but powerful proposition that information is replicable and divisible in ways that physical objects are not. The ability to reproduce IP at or near zero cost means that a perpetual monopoly over an invention or writing comes at too high of a social cost. So the obvious response is to set limited terms over which these property rights may be exercised, longer for copyrights than for patents, otherwise leaving the basic set of tort and contract remedies intact.[18]

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[18] Richard A. Epstein, *What Is So Special About Intangible Property? The Case for Intelligent Carryovers, Competition Policy and Patent Law Under Uncertainty: Regulating Innovation* (G. Manne & J. Wright, eds. Cambridge University Press.. 2011) 42

If this is the case, then the theory of efficient breach works no better in connection with IP than it does in other forms of disputes. If damages are the sole remedy for breach of contract, potential users of IP must decide whether to license a patent or just use it, preferring to pay damages when caught. This again gives rise to all the hard questions of consequential damages if the unlicensed use by one party diminishes the value of the lawful use by the property holder or its licensees. There are the same difficulties with calculating consequential damages in individual cases. And there is the further problem of trying to coordinate the activities of multiple parties if persons who make contractual commitments are free to abandon them at a whim, which makes it difficult to enforce any complex arrangements that involve sublicenses and cross-licenses with complex provisions. This last issue is exceptionally important in two other contexts: standard setting organizations and patent portfolios. First, standard-setting organizations (SSOs) have to work out complex sharing arrangements, which is hard to do if member firms retain the option to pull out at any time. The point in these cases is to make sure that the standards work, and the evidence from the field all indicates that disputes within these SSOs are handled voluntarily so that there is no reason to think that state intervention is needed to overcome some imaginary holdout problem.[19] Second, IP patent portfolios often must be created for the efficient deployment of technology. No buyer wants to endure the costs of

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19 *See* Richard A. Epstein, F. Scott Kieff & Daniel Spulber, 'The FTC, IP and SSOS: Government Hold-Up Replacement Private Coordination' (2012) 8(1) *Journal of Competition Law & Economics* 1, n. 24, available at http://jcle.oxfordjournals.org/content/8/1/1.full?keytype=ref&ijkey=1tuKfhz2vhZ1CdU (noting lack of internal dissatisfaction with these organizations). The article offers an extended critique of FEDERAL TRADE COMMISSION, 'The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition' (2011) 236, available athttp://www.ftc.gov/os/2011/03/110307patentreport.pdf .

licensing hundreds of separate patents without any assurance that they will work well together. The ability of inventors or third persons to create patent pools which can then be licensed on an exclusive or nonexclusive basis—usually the latter—is an essential element in maximizing the value from various technologies. Yet this simple practice could not take place if members of a patent pool could try to deny usage of their patent to others. Damages for the anticipated loss make no sense in this context. Specific performance of the promise is necessary for the pool to operate effectively. Similarly, it is often the case that many patents may have to be used in combination by SSOs, which for the most part have had an enviable record in assembling all needed patents through a variety of voluntary arrangements, which would hardly work well if the doctrine of efficient breach allowed withdrawal from these pools at will.

> To avoid just this quandary, the traditional rules allow injunctions to issue as a matter of course. The major exceptions to this general rule tended to apply to cases of potential misconduct by patent holders, such as laches. The basic rule applies whether the unauthorized use is made by a total stranger or by a licensee who makes an unauthorized use of a patent or copyright. The key decision of the United States Supreme Court in *eBay v. MercExchange*[20] decided that the new standard for dealing with injunctions was contained in this four-part test:[A] plaintiff must demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest

20 547 U.S. 388 (2006).

> would not be disserved by a permanent injunction. [Citations omitted]. The decision to grant or deny such relief is an act of equitable discretion by the district court, reviewable on appeal for abuse of discretion.[21]

On its face. the decision works a major shift—and for the worse—by muddying the waters for proof of the injunction. The earlier view was one that assumed that the damage remedies afforded could not do an adequate job, especially if they had to be brought against multiple parties, all of whom could seek to use the patented technology, which is—as a matter of public record—easy for others to access. At this point, it should be clear that this four-fold inquiry has to increase in complexity as the number of potential parties to the dispute increases. Having to prove irreparable injury, or its flip-side test that legal remedies are inadequate, could itself be a major undertaking that could vary depending on exactly what use the patent holder makes of its invention, including its licensing activities to third parties. Balancing hardships again requires a detailed investigation of the business plans of both parties to the dispute, and raises the uncertain prospect that some infringers could be enjoined while others could not. Finally it is something of an act of faith to decide what the public interest requires above and beyond the faithful enforcement of the property rights that the patent confers upon its owner. The situation thus looks wholly different from the more traditional view that considers narrow exceptions to the basic rule based on plaintiff's delay or misconduct, both of which are within the plaintiff's ability to avoid. In its stated form, the weakness of the injunctive remedy necessarily places greater stress on the overall damage regime, which could increase with the proliferation of parties who choose to stay out of the patentee's licensing orbit.

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21 *Id*. at 391 .

In dealing with this issue, the tendency against injunctions has a profound influence on how damages might be calculated. On this issue the Federal Trade Commission (FTC) has taken the stance that since the injunction is abusive, the damage remedy should not be so strong as to operate as a de facto injunction, as in the conversion cases. Accordingly, it argues:

> To form a coherent remedies system, the legal rules governing ongoing royalties must be consistent with the rationale that supported denying the injunction in the first place. As discussed above, that rationale may consider problems of hold-up that enable patentees that assert patents ex post to extract royalties based on the sunk investment of the infringer. When a court denies an injunction to ensure that the patentee cannot use the threat of injunction to extract more than the market reward for its inventive contribution, it stands to reason that the ongoing royalty should align with that market reward.[22]

The clear implication of this proposition is that the damage awards that should be collected from those who bypass the licensing system should be no greater than those of people who choose to operate within it. The FTC Report thus offers an open invitation not to take out licenses, even though an uncertain future damage action is worth far less than a prompt and secure license payment. The ostensible reason here is the "hold-up" problem that allows the licensor" to extract royalties based on the sunk investment of the infringer." But extraction is always a two-way street. Thus it is critical to also ask the prior question of whether the infringer commits a form of extraction when it refuses to enter into an

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22 FEDERAL TRADE COMMISSION, 'The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition' (2011) 236, available at http://www.ftc.gov/os/2011/03/110307patentreport.pdf.

agreement or decides to repudiate a previously licensed agreement. More specifically, it may well be economically prudent for users of a known technology to undertake ventures that fall within the scope of a patented technology, hoping the problem will go away if it does not take out a license. The better course of action is to negotiate the deal first, in many cases by playing off one patent holder against another. In some cases, there may be issues if a given patentee has a strong monopoly position. But so long as that monopoly rests solely on the distinctiveness of the patented technology, the patentee is supposed to be able to charge royalties that will allow it to cover the front-end costs of its invention. If the monopoly comes from an illicit combination, standard antitrust principles should be able to rein in the parties to the agreement. By no stretch of the imagination should a party that had a menu of choices at the onset of an agreement invoke a claim of 'hold-up' to back out of a deal. No matter which variation occurs, the FTC's concern with extraction does not support any regime that restricts the patentee to marginal cost, at which point the entire IP scheme is undermined, because the holder of the IP is no longer able to recover the fixed cost of its investment. But it is no easy matter to figure out what the appropriate royalty or damage figure should be, since there is no unique way in which the fixed costs of an invention can be allocated among its users, which is yet another reason why voluntary transactions are superior in practice. Recall that in the absence of any breakdown in market institutions it is, and should be, impermissible to infer the existence of some illicit form of monopoly power solely from the fact that a plaintiff holds a patent.[23]

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[23] *See, e.g.*, Ill. Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28 (2006); Kenneth W. Dam, 'The Economic Underpinnings of Patent Law' (1994) 23 *Journal of Legal Studies* 247, 249-50 ("[T]he right to exclude another from 'manufacture, use, and sale' may give no

Fortunately, in general, the use of injunctions has proved to be more durable than one might have expected because the post-*eBay* developments are strongly predisposed to injunctive relief in those cases where the patentee either patents or licenses the technology or both.[24] Yet even here a delay in securing licenses could result in the loss of injunctive relief if this requirement is taken too literally. At this point the attention tends to shift to the controversial role of 'patent assertion entities,' where the complaints are that these alleged patent trolls have spurred a massive abusive litigation that traps people into the painful choice between paying undeserved royalties or suffering the costs of litigation. In the United States, this entire matter has been the subject of a White House Task Force designed to investigate this possible source of abuse,[25] which has been a pronounced concern of many prominent public officials.[26]

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significant market power, even when the patent covers a product that is sold in the market.").

[24] *See,* Rachel M. Janutis, 'The Supreme Court's Unremarkable Decision in eBay Inc. v. Mercexchange, L.L.C.,' 14 *Lewis & Clark Law Review* 597 at 604-08 (noting that district courts have been issuing equitable relief in over 70% of cases post *eBay*); Jake Phillips, 'eBay's Effect on Copyright Injunctions: When Property Rules give way to Liability Rules,' 24 *Berkeley Technology Law Journal* 405 at 420; O2 Micro International LTD., v. Beyond Innovation Technology Co., Ltd., 449 Fed.Appx. 923 (Fed. Cir. 2011) (affirming district court issuance of permanent injunction); Acumed LLC v. Stryker Corp., 551 F.3d 1323 (Fed. Cir. 2008) (affirming district court issuance of permanent injunction).

[25] THE WHITE HOUSE, 'Fact Sheet: White House Task Force on High-Tech Patent Issues' (Jun. 4, 2013) available at http://www.whitehouse.gov/the-press-office/2013/06/04/fact-sheet-white-house-task-force-high-tech-patent-issues.

[26] Charles Schumer, 'A Strategy for Combating Patent Trolls' (2013) *Wall Street Journal*, available athttp://online.wsj.com/article/SB10001424127887323844804578531021238656366.html?KEYWORDS=SChumer+Patents

I believe that this presents a one-sided view of the issue.[27] Litigation abuses are not the exclusive province of parties that assert patent claims. It is equally possible for defendants to resist demands for damages when they have appropriated the patented technologies of other individuals. Any system that assumes that all abuse takes place in one direction will create incentives for abuse by the side that receives excessive protection from the patent system. There is much that can be done to control litigation abuses on both sides by dealing with such difficult issues as pretrial discovery, which at least under the American system can reach costs of mammoth proportions.

**IV Conclusion**

This article has offered an extended critique of the use of the formula of expectation damages as the sole remedy in cases of breach of contract. The problem here is not unique to intellectual property because it tracks the same disputes as they arise in other contexts. The damage system that fails in the general case is not likely to succeed in the specific domain of IP. The central function of a sound system of remedies is not to deal with those cases in which one side has not performed its contractual obligations, but rather to create a framework that reduces the likelihood of breach in the first place. No system of contract remedies can achieve that result perfectly, but in combination with a set of social sanctions they can decrease the probability of breach and thus the strain on the overall legal system. Indeed on this view, the greatest vice of the theory of efficient breach is that it undermines the social fabric in favor of controlling breaches by announcing to the world that all contracts contain options to perform or pay damages, where the measure of damage is that

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[27] For my response, see Richard A. Epstein, 'Trolling for "Patent Trolls,"' (Jun. 11, 2013) Defining Ideas, available at [http://www.hoover.org/publications/defining-ideas/article/149096](http://www.hoover.org/publications/defining-ideas/article/149096) .

which puts the plaintiff in as good a position as she would have been, absent a breach. It is a bad social message to communicate, given the flaws in applying that remedy and the costs of administering it. No voluntary contract has ever adopted this form of option, which offers sound reason enough why that approach should be spurned as a matter of positive law. The use of specific performance and injunctions should have a secure place in contract law, just as it has a secure place in the tort law. This should not be undermined by false appeals to the notion of efficiency by which the law, in peculiar fashion, imposes on parties remedies that, when fully informed, they never choose for themselves.