DEPARTMENT OF JUSTICE ANTITRUST DIVISION

and FEDERAL TRADE COMMISSION

Hearing on:

COMPETITION AND INTELLECTUAL PROPERTY LAW

AND POLICY IN THE KNOWLEDGE BASED ECONOMY

Session 1: Analysis of Specific Licensing Practices

Session 2: Practical Issues Encountered in Antitrust Analysis: The Problem of Dealing with Uncertain or Disputed Patent Rights

Tuesday, May 14, 2002

Great Hall of the U.S. Department of Justice

333 Pennsylvania Avenue, N.W.

Washington, D.C.
MORNING SESSION PARTICIPATING PANELISTS:

Morning Session: Analysis of Specific Licensing Practices

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Shereff Friedman, Washington, D.C.
Joseph Farrell, Professor of Economics and Chair Of the Competition Policy Center, UC-Berkeley
Jonathan M. Jacobson, Partner, Akin, Gump, Strauss, Hauer & Feld, LLP
Abbott "Tad" Lipsky, Jr., Partner, Latham & Watkins, Washington, D.C.
David S. Sibley, John Michael Stuart Professor of Economics, University of Texas at Austin
J. Gregory Sidak, F. K. Weyerhaeuser Fellow in Law and Economics Emeritus, American Enterprise Institute
Gregory Vistnes, Vice President, Charles River
AFTERNOON SESSION PARTICIPATING PANELISTS:

Afternoon Session: Practical Issues Encountered In Antitrust Analysis: The Problem of Dealing with Uncertain or Disputed Patent Rights

Molly S. Boast, Partner, Debevoise & Plimpton
Joseph Farrell, Professor of Economics and Chair of the Competition Policy Center, UC-Berkeley
Salem M. Katsh, Partner, Shearman & Sterling
Joseph Kattan, Partner, Gibson, Dunn & Crutcher
Joseph Scott Miller, Assistant Professor, Lewis & Clark Law School
A. Douglas Melamed, Partner, Wilmer, Cutler & Pickering
M. J. Moltenbrey, Former Director of Civil Non-Merger Enforcement, Antitrust Division, Department of Justice
MORNING SESSION HEARING MODERATORS:

Michael L. Katz, Deputy Assistant Attorney General, Antitrust Division, Department of Justice

David T. Scheffman, Director, Bureau of Economics, Federal Trade Commission

C. Edward Polk, Jr., U.S. Patent & Trademark Office

AFTERNOON SESSION HEARING MODERATORS:

William Stallings, Department of Justice

John Hoven, Department of Justice

Suzanne Michel, Federal Trade Commission

C. Edward Polk, Jr., U.S. Patent & Trademark Office
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MORNING SESSION

(9:00 a.m.)

MICHAEL KATZ: Good morning and welcome. I'm Michael Katz. I'm the Antitrust Division's Deputy Assistant Attorney General for Economics. My colleagues and I are very glad that you've joined us for what we expect will be another interesting session of the hearings on competition and intellectual property law and policy in the knowledge based economy.

And if that weren't long enough, this morning's session goes by the catchy title Antitrust Analysis of Specific Intellectual Property Licensing Practices: Bundling and Temporal Extensions.

Those of you who slavishly read the website will notice that we dropped out
grantbacks. We may touch upon that, but it's not going to be the focus of what we're talking about this morning.

As you're all aware, these hearings are a cooperative effort. And joining me in representing the agencies this morning are David Scheffman, director of the Bureau of Economics at the Federal Trade Commission, and Edward Polk, an assistant solicitor at the U.S. Patent and Trademark Office. I'm delighted to be here with them.

We're also joined by a distinguished panel of economic and legal experts who are going to address three sets of questions. The first set of questions is going to ask how to treat IP bundling such as package licenses.

Now, of course, tying and bundling come up in many other contexts. An important subsidiary question is whether the antitrust treatment of intellectual property bundling should differ from the analysis of other forms...
of bundling or the bundling of other forms of property.

Specifically, I hope this morning's panelists will address what features of intellectual property are central to the analysis and/or distinguish intellectual property from other forms of property.

The second set of questions concerns temporal extensions. We will address the question of whether, absent trade secret concerns, are there circumstances under which it's appropriate for licensing payments, restrictions, or agreements not to compete to extend beyond the life of the patents being licensed.

And we'll also ask whether trade secrets can justify extensions beyond the life even if we think -- the panelists think -- that it may not be the case absent trade secrets.

Our third set of issues is a practical one. As for almost any licensing practice,
economic theories identify procompetitive and
anticompetitive effects. How can the courts deal
with the complexity of the issues both to reach
the right answers and to give private parties
some ability to predict how their licensing
practices will be treated?

Before we begin, I have to go over a

few housekeeping details. For security reasons
if you're not a DOJ employee, you must be
escorted around the building.

Antitrust Division paralegals wearing
name tags highlighted in green, the ones who
escorted you in, are available at the back of the
room to escort you out whether you want to leave
the building, go to the restroom, or go upstairs
to the seventh floor which I'm told is where
you'll have to go if you want your cell phone
to work.

Also, coffee, soda, water, and
breakfast pastries are available in the back
of the room, and you are to freely eat them
without assistance from the paralegals. So this
morning's session is going to be a combination
of presentations and discussions.

We'll spend around two hours
discussing IP licensing, principally bundling.
Then around 11:00 we're going to take a 15-minute
break and then come back for a 45-minute
discussion of methods used to extend the lives

of patents, finishing up the session around noon.

Around 1:30 these hearings will resume
with a session on how the agencies should resolve
uncertain or disputed patent rights in the
context of an antitrust investigation.

If you have any questions in the
audience, please come up to me during the break
and hand the questions to me in writing. Time
permitting I will pose the questions to the
panelists.

Now let's turn to the presentations.

I'll provide only the briefest of introductions,
and I refer you to today's program for the more
Our first speaker is Gregory Vistnes. He's a vice president at Charles River Associates, Washington, D.C., where he specializes in the economic analysis of antitrust and competition issues.

He recently was the Deputy Director for Antitrust in the FTC's Bureau of Economics, and before that he was an assistant chief in the Economic Analysis Group at the Antitrust Division. Greg will provide us with an overview of some of the economic theories related to the analysis of IP bundling. Greg?

GREGORY VISTNES: What I've been asked to do is give a brief overview of some of the economic theories with respect to bundling.

And then what I want to do is in the time that remains after covering the entire field of bundling in I think five minutes, is talk about why IP markets are a little bit special.
and what is it about these theories that are potentially unique or of special interest in the field of intellectual property.

Let me start out first by focusing on what are sometimes called the newer bundling theories or conglomerate theories of bundling. And in those, an article by Mike Whinston certainly provides one of the first theories. And I'll be focusing on what may be the most commonly discussed variant of Whinston's model.

What Whinston does is he starts out looking at a market with a monopolist in both markets A and B. And the monopolist faces a problem. The problem it faces is that it expects entry in one of these markets. Let's call it market B. And it's trying to dissuade that entry.

Now, one way it might try to dissuade entry is to say, well, gee, if you come into my market B, I'm going to set extraordinarily aggressive prices and you'll make no money. The
problem is that's not a credible threat. And so
how does the monopolist respond?

One way it can do that is through
bundling. And intuition here is by bundling one
of its monopoly products to the product in market
B, the one where entry is foreseen, in essence
what the monopolist does is the bundle puts --
it creates a hostage type situation for the
monopolist.

In other words, in order to continue
selling its highly profitable product A where it
will remain a monopolist, the bundle forces it
to continue making a lot of sales in market B.
So once entry takes place, the
only way it can continue to make those highly
profitable market A sales is by setting a very
aggressive price in market B. In essence it's
committing itself in order to sell product A to
be very aggressive in product B.

It's as if the bundle for the
monopolist, the monopolist is holding a gun up
to its head and saying, stop, don't enter or if you do I'll shoot myself. And in this case it's a credible threat, and the entrant is actually afraid of entry because it knows of the high price.

So what the bundling does here is it's a little bit different from my of the other theories in that the bundling is really just a means of achieving a different goal, that is, a means to commit to aggressive pricing.

The second model is the one by Carlton & Waldman. And what they do is look at a monopolist. But we'll leave it an unnamed monopolist in an operating systems market who again faces some sort of entry.

And the entry it fears is competition in the operating systems market. What they have is the way that this entry is going to take place is they fear that a browser is going to provide compatibility between software and between a future operating system.
And the existing monopoly is sustainable absent a browser because the software can't achieve compatibility with the competing operating system. So the solution to this problem again is achieved through bundling. And what the monopolist does is it introduces its own browser, bundles its operating system to the browser, and by doing so it essentially -- it creates a type of chicken and egg problem in which now with the bundled browser, the new browser -- the entrant browser -- cannot achieve compatibility with the operating system.

That means that future software can't achieve compatibility with a rival operating system. And so again the bundling under this theory -- and I know I'm running through this awfully quickly -- but the bundling again dissuades entry into the monopoly market. It's again a little bit different from the earlier variants of bundling theory.
But it's again directed at preventing entry into the monopoly market.

The third class is models that are put forth by Nalebuff and these are a little bit different. Let me first of all rather than characterize Nalebuff's model is just quickly run through the results, and then I'll try to get forth the intuitions on it.

And Nalebuff's basic premises or basic results are that bundling can result in lower prices. It can increase the profits of the bundler but in fact reduce the profits of single product rivals.

And his results show that in fact with multiproduct rivals, the first firm to bundle is going to achieve higher profits, whereas if the second firm follows suit and also bundles, that the profits of that firm actually fall.

It's a model in which bundling can actually result in extraordinarily aggressive competition if all firms follow through with the
bundling. And it's also a unique model in that it's a model in which market power is not really a prerequisite to having any of the effects that Nalebuff finds.

And that really is a key distinction with most of the other theories on bundling, is the distinction about do you need market power. Simple intuition in the Nalebuff model you can see with the classic pizza and beer markets. And running quickly through it, if we have four firms out there, two producers of beer, two of pizza, it's there I'm taking into account the externalities involved that if Brutus -- firm one -- lowers its price of pizza it induces demand for beer. But he doesn't really care because he doesn't own the beer firms.

If you get the merger without bundling, all of a sudden when Brutus lowers his price of pizza he realizes that some of that spillover demand goes to now his own beer producer.
And so that's a good thing. That creates the incentive for lowering the price of pizza. And that's a classic elimination of double marginalization. It's a fairly classic intuition with mergers of complements. Unfortunately this merged pizza-beer firm is still recognizing that although when they lowered the price of pizza it increases demand for beer, some of which spills over to their own beer production, it's also increasing the demand for other firms' beer. And that's kind of a frustrating result. And so bundling achieves a goal here of basically assuring that all of that spillover demand from the lower price of pizza goes directly to its own beer producer.

It's in effect saying that if you want to benefit from the lower price of pizza you need to buy my beer. And so the bundling here can create yet another incentive to lower the price. So it's a model in which the bundling
creates what a lot of folks other than Europeans might call an efficiency from the bundling. Also one of the effects of bundling is it can just reduce demand overall for what I’ve called firm three and firm four.

And the intuition there is that once the bundle takes place at a very low price, the only folks who are remaining interested in purchasing either the unbundled firm three pizza or the unbundled firm four beer are those people who care so little for the other product that they are willing to forgo what is really a very good deal on the bundled product.

So it causes in a sense harm to the competitors by reducing their overall demand. And the last point about bundling is bundling can in fact affect differentiation of competing products.

And what I have here is just a simple illustration that if you bundle together two low quality products and two high quality
products, you're in effect increasing the overall

differentiation between the competing products.

That increased differentiation can result in

higher prices.

Alternatively, if you bundle together

a high and a low quality pizza and beer and the

same thing with the other set, in essence your

bundled products become less differentiated than

they previously were. So in that case the

bundling can reduce differentiation and increase

competition.

So now what's special about IP

markets? And one of the differences which has

been talked about is clearly there are more

efficiency justifications or at least the

potential for efficiency justifications with

bundling, that there can often be the strong

complementarities that motivate the bundling and

also issues of reducing double marginalization.

Secondly, the question is: Is there a

greater anticompetitive potential from bundling?
And here I want to quickly discuss, first of all, there is a greater likelihood of market power in markets with IP bundling, the market power being a prerequisite in most cases to having a bundling or a tying theory.

Also, is there some notion that what may sometimes be the transitory nature of IP-based market power, does that somehow create an incentive for bundling that might not otherwise occur?

And lastly, are there greater incentives to block entry in markets with IP power, as I'll say, mainly because of the nature of costs in those types of markets?

So first with respect to IP and market power, I think there's at least a notion that in many cases the existence of intellectual property may in a sense convey some real market power. Certainly with a patent, depending on how strong or how broad the scope of the patent, that may confer some real market power. And if
nothing else, does that IP power then somehow at least get you over the first hurdle of most bundling theories?

Bundling theory says before we pass go, you need to show market power. The IP may provide that. You pass go and therefore, if nothing else, get a little more justification for concerns with bundling.

Cautioning however that this market power is just a necessary condition, not a sufficient condition, you still need to go through all the other steps of assessing whether or not these bundling theories apply even once you have market power.

I want to skip this last point about limited duration, just because I think I'm brushing up against time constraints, and talk about the incentives to block entry.

And here the point is that with so many -- with much of intellectual property --

the nature of intellectual property products
are characterized by high fixed costs and low variable costs or low marginal costs.

And those industries are more subject to when competition takes place for it to be very vigorous, very fierce competition that eliminates much of the rents, again depending on how much differentiation is left.

So the issue is that with IP markets is there a much stronger incentive to dissuade entry because there's so much profit effect from entry.

And similarly, when entry takes place, if that results in very vigorous competition, the entrant may in fact not have that much incentive for getting in in the first place because it knows most of the profits will evaporate.

Those sorts of circumstances may lead you in a situation where even if bundling doesn't have a big disincentive for the entrant, that the effect is relatively small, it may be enough to in essence be the straw that breaks the camel's
There are huge incentives for the incumbent to dissuade entry, and it may be relatively easy to dissuade that entry in the second place.

And many of those bundling theories that I so rapidly went over are in fact focused on exactly this issue, trying to dissuade entry. So that may be one reason why the bundling theories are particularly relevant to some of the IP markets.

Secondly, bundling to increase differentiation again may be important. If the bundling markets are otherwise relatively undifferentiated, it goes back to the issue of once entry takes place there's a tremendous amount of competition eliminating most of the rents.

So if bundling can achieve the increased differentiation, what I was trying to get at with those pictures of the pizza and the beer, then the bundling may in fact be a very
valuable or a very important means by which firms
can try to maintain their profits.

So in conclusion the theories
associated with IP with respect to bundling
are really the same theories that apply anywhere.

But the facts with intellectual property markets
are likely to be a little bit different, and they
may justify a little bit more concern.

There is certainly greater -- there
is certainly a scope for more potential for
anticompetitive bundling for the reasons we
talked about. The flip side is what we haven't
talked about -- there's probably likely to be
more scope for efficiencies.

It's going to make it different to
ultimately do the balancing. It's also going to
make it important to distinguish whether or not
the bundling is motivated by efficiencies, or
alternatively if the efficiencies are really more
just a cloak by which to get at some sort of a
per se argument on bundling.

And lastly, just the caution that
ultimately the analysis needs to be fact intensive rather than what sometimes seems to be the case of more theory intensive. Thank you.

(Applause.)

MICHAEL KATZ: Thank you. And moving right along given the schedule we have, our next speaker is Jonathan Jacobson, a partner in the antitrust practice group of Akin, Gump, Strauss, Hauer & Feld. He has extensive experience in antitrust and commercial litigation and is co-chair of the firm's national antitrust practice.

Jonathan I believe will provide an overview of the current state of legal practice and identify some difficulties that he sees with it. Jonathan?

JONATHAN JACOBSON: I'm going to talk about the legal analysis of tying and other bundling issues. We're told by the Supreme Court in the Jefferson Parish case that tying remains illegal per se. The scope of the per se rule is unclear.
But certainly the Supreme Court has told us that tying remains a per se offense. If tying really were illegal per se, if the courts uniformly applied a per se rule, it would be possible to counsel clients responsibly and clients would have a general idea of what they can do and what they can't do.

The rule would be wrong for reasons that we'll explore throughout the day today. But at least clients would be able to understand what they can and cannot do. Unfortunately the rules are totally far from clear. First of all, the agencies do not apply a per se rule. Some courts do. Some courts don't.

We have a statute that applies to patents but not other forms of intellectual property. Section 271(d) of the patent code applies a different standard to patent misuse defenses, and it's unclear whether that standard extends to antitrust violations arising out of patent based tying as well.

History and economic analysis tell us
that tying can be quite harmful. I think the
greatest episode where tying was used to cause
enormous social harm was back in the 1910s and
the 1920s during the period where the motion
picture trust having succeeded to the Edison
patents on the film projector basically required
everyone who was making a movie to join up with
them or else they could not get their films
projected and exhibited.

The result was an enduring monopoly
in the motion picture business, a series of
antitrust proceedings that extended for decades,
and problems that in the view of many have not
been solved since.

Certainly the Paramount decrees are
still outstanding and are creating somewhat of a
continued havoc in the motion picture industry
even today.

But the motion picture patents case
and other cases where tying has been shown to be
harmful aside, it certainly cannot be said that
tying is almost always or always harmful, which
is the standard that the Supreme Court says in other contexts should be applied to determine whether a practice is illegal per se or not. There are often, not always, but often strong efficiency justifications for tying arrangements. And a very good explanation of some of the efficiencies can be found in the recent en banc decision of the D.C. Circuit in the Microsoft case. The lower courts have recognized this and have found various ways of rebelling against the per se rule, creating a number of splits on very important issues. And I'm going to quickly run through five of them. First is whether the 271(d) statute eliminates the presumption of market power only from misuse cases or whether it applies to affirmative Sherman or Clayton Act cases as well. DOJ and FTC say no. A number of courts say no. But some courts including the Federal Circuit say yes.
If 271(d) does not apply, is there still a presumption of market power from the possession of a patent or copyright? Jefferson Parish says yes. A number of cases including the Sixth Circuit's decision in the Root case and the Abbott Labs case from the Federal Circuit say no. Another dispute: Can you assume market power from the mere possession of a copyright? We have a fairly recent decision in the MCA case from the Eleventh Circuit saying that Loew's, the 1962 Supreme Court decision, remains good law. We have the Root decision in the Sixth Circuit saying -- this is somewhat shocking to hear a Court of Appeals say flat out -- that the Supreme Court was just wrong and we're not going to obey what the Supreme Court has told us. Another unresolved issue is the extent to which evidence of justification is admitted. There's a clear conflict in the cases. The Ninth Circuit says the justification is admissible.
The Supreme Court has said no in a footnote in Jefferson Parish, and a number of Circuit Courts have followed that as well.

Yet another unresolved issue is whether anticompetitive effects more than sheer volume need be shown in the tied product market. Again we have a number of courts saying it's a per se offense. You don't have to show actual harm to competition.

We have a number of cases going exactly the opposite way. So we have clear conflicts in the courts on five very important issues relating to tying and bundling.

The result of this is when the client asks you about what the rules are governing bundling of intellectual property that you cannot give a clear answer. If the client is aggressive and wants to take his or her case up to the Supreme Court, you can say absolutely, yes, go ahead and do it.

Most clients are not quite that ready
to spend millions of dollars on legal fees. And
the advice to them has to be the cautious advice
which is, please, don't do it; the risk is too
great.

How do we get these conflicts fixed? Well, the best solution would be for
the Supreme Court to address a case involving
tying, involving intellectual property tying in
particular, and deal with these issues once and
for all.

But the Supreme Court, particularly in
recent years, has truly abdicated the antitrust
function. We have not seen the Supreme Court
grant cert. in an antitrust case in three years.
The last opportunity to take a tying case was
Microsoft. That case was turned down.
The Digidyne case many years ago
spawned dissent from a denial of certiorari by
Justices Blackmun and White. But still we have
no answer from the Supreme Court. There are few
cases in the courts of appeals that are really
eligible at this point for plenary Supreme Court
review.

And the prospect of a Supreme Court
solution at least in the near term has to be

regarded as poor. The Microsoft case I think
would have been a good chance to help. The
court in that case instead carved out a platform
software exception for the tying rule.

Now, if you read the opinion, it's
clear that the court's real problem was with the
per se rule for tying, with the analysis that the
Supreme Court had used in Jefferson Parish.
But rather than say we disagree and,
Supreme Court, you should fix the mess you've
made, the D.C. Circuit instead en banc carved out
a new exception, a platform software exception
for the per se rule that is questionable under
the Maricopa standard for per se analysis.
And in any event it makes it
difficult -- compounds the difficulty in giving
advice to clients. There have been a number of
efforts over the years to get Congress to fix the
problem.

There were hearings in 1996 with a
very clear statute that simply said there shall
be no presumption of market power from possession

of a patent or copyright, very clean, no
amendments. It simply stated what people
believed to be correct law, correct economic
analysis. The bill never got out of committee.

Tad Lipsky, who's on the panel today, testified
in favor of it.

The Justice Department, who only a
year before had joined with the FTC in issuing
the 1995 guidelines which clearly say that the
agencies will apply no presumption of market
power from possession of a patent or copyright,
nevertheless opposed the legislation on the
general grounds that Justice opposes most
legislation, which is that, please, Congress,

stay out of antitrust and let the courts fix
whatever messes they may have made.
That's a general standard that has a lot to commend it. But in this particular instance we had a very clean statute that could have helped the situation. In any event, it wasn't passed. There have been hearings again in November of this year in the House. There's no bill pending.

I think the odds on getting a legislative fix to the problem are small. If there is a legislative fix, one might speculate what might get appended to such legislation and whether that's something we really want at the end of the day.

So what's the good answer? I don't think there is a good answer. The best solution that I can propose particularly to the Department of Justice and Federal Trade Commission is to revive the amicus programs. Certainly Justice and FTC have been very active in their amicus programs in the past. But actively seek out cases involving
bundling. Actively seek out cases involving intellectual property bundling in particular. Get in at the District Court level. Get in at the Circuit Court level. Try to find a case that can be taken up to the Supreme Court. And I think that is the prospect that holds out the most hope for addressing the legal problem that we face today. Thank you very much.

(Applause.)

MICHAEL KATZ: Thank you, Jonathan. Actually without wanting to throw cold water on that, I know wherever I go I always carry a copy of Jefferson Parish with me. And in their concurrence, Justices Brennan and Marshall actually noted or pretty strongly hinted that they thought the per se treatment was a silly way to go. But they said, look, that's what we've done for years; Congress knows we do that; if Congress wants to change it, they will, and therefore we're going to keep doing it until
we're told by Congress not to, so that's at least
two people's view on the division of labor
between them.

Let me start I guess in some sense
with a ridiculous question, but that's the beauty
of being a moderator. Does anybody think that
Jefferson Parish provides a sound basis for the
treatment of tying? Do we have any defenders up

on the panel?

JONATHAN JACOBSON: Let me say that
the per se rule -- I'm probably one who thinks
that it's less insane than others. I think it
clearly creates far too many false positives.
But the number of cases in which the
defendant or practitioner cannot devise ways of
achieving the same efficiencies without tying is
relatively small. So the number of true false
positives I think is not as egregious as most
people think.

Having said that, the rule plainly
does not meet the standard for per se analysis,
always or almost always harmful to competition, and therefore has little to commend it.

MICHAEL KATZ: Anybody else?

DAVID SIBLEY: Continuing in the same vein when you say that tying shouldn't be per se, you have to think about what the alternative is.

And one important element of the alternative is how difficult and subtle would the analysis have to be in order to disentangle the effects of tying if you really wanted to do a rule of reason approach.

And I think the first presenter, Dr. Vistnes, gave us a very good idea that that analysis might have to be very subtle indeed.

MICHAEL KATZ: Let me ask a question specifically about IP. In Jefferson Parish it talks about a presumption that if a patent has been granted that gives the market power and raises concerns about tying and IP because the market power is there.

Something Greg Vistnes didn't touch
on was the fact that low marginal cost for intellectual property, even costs that could be zero if you're adding more lines on a CD, suggests that it could well be efficient just to take everything and put it out there on a bundle any way just to avoid the transactions cost.

So I was wondering if people would say a little bit about do you think that these problems are bigger problems in IP or less problems. Certainly economists, the first thing

they always say about tying is it's a mess. So what about how is that mess relative to other forms of property? Joe?

JOSEPH FARRELL: Well, I think tying and bundling is replete with confusion over two questions. And although I'm sure General Katz is not confused in his own mind, the way he put it might confuse weaker minds.

On the one hand in the short run static analysis of demand theory it's usually, not always, but usually true that charging a
lower marginal price leads to better allocative efficiency.

On the other hand -- and you can do some kinds of analyses of tying and bundling along those lines. And perhaps the pizza and beer example is a case in point.

On the other hand I think it's crucial when thinking about tying and bundling not to stop with that level of analysis and to also ask does this practice get in the way of someone who is interested in offering a better long run deal to consumers.

Now, one of the reasons I'm Mr. Rule-Of-Reason and don't like per se treatments of just about anything is that I think that's the key question to ask. And I think it's very unhelpful usually to use a word like tying or bundling to describe a practice in coming up with an answer to that question.

But I do think it's important to stress that just the fact that marginal cost is
low although it's certainly very relevant for
thinking about the effects of putting everything
out there on a CD, I don't think it tells you the
answer right away.

MICHAEL KATZ: To summarize your
answer, not only do we have to deal with all the
messiness of tying, but we have to deal with all
the messiness of predation as well.

JOSEPH FARRELL: Unfortunately, yes.

DAVID SCHEFMAN: I'm curious about
what the panelists think on one thing. If I
understood Jonathan right, he advanced the view

that the current state of the law although messy
and even moving to per se probably wouldn't
sacrifice a lot in terms of efficiencies if I
understood you right. Is that --

JONATHAN JACOBSON: I think there are
a number of cases, and I think it's the vast
majority of cases where the efficiencies from
tyling are relatively small.

I do believe, for example, let's
take Microsoft, that although there are clearly efficiencies in bundling the browser into the operating system, what are the efficiencies on precluding the use of alternative browsers through arrangements with OEMs, for example? I think in that kind of context the use of the per se rule albeit wrong is not as harmful as we might otherwise expect. There are alternatives for Microsoft like telling -- like not telling Dell don't bundle Netscape into your startup screen.

Having said that, the per se rule creates enormous cost in terms of firms without market power and with intellectual property rights trying to figure out the best way to exploit those rights. It can have a significant deterrent effect on small firms trying to enter a market where metering-based pricing through a tying arrangement may be the best way to exploit the intellectual property rights and achieve a
significant position in the market, where the
rule can be quite harmful.

So is the world going to end if
Jefferson Parish is not overruled in the next ten
minutes? No. Should it be overruled as soon as
we can get a case there? Yes.

GREGORY SIDAK: I wanted to make a
point about intellectual property being subject
to the traditional tying doctrines. I think that
an additional economic factor that needs to be
considered here is the greater relative
difficulty under the separate product prong of
the tying test.

When you're looking at products that

embody a lot of intellectual property and may be
subject to continuing technological innovation or
still developing consumer tastes, the very
definition of the product may not be particularly
fixed. It's easier to talk about beer and pizza
being separate products.

But for some of these software
products it may be harder. And I can imagine the
same would be true of pharmaceuticals and some
other kinds of patented IP.

TAD LIPSKY: Just a short addition
which actually segues from the previous two, I
mean think about the implications of the last two
comments. What's really -- it's a fact that
product scoping and combination decisions are
ubiquitous.

I mean do you buy this single serve or
six pack or in a case? Do you buy this just for
plastic cups or do you buy all your picnic
supplies? This is a ubiquitous kind of decision.

And if you agree with what Greg said
and agree with what Jon Jacobson said about the

potential harmful effects of the tie-in doctrine
on a lot of firms without any source of market
power, what you're really saying is that product
combination decisions like things that can be
categorized as ties ought to be presumptively
lawful, that there ought to be a presumption that
the choice of the characteristics of your product
and the combinations in which they are sold ought
to constitute kind of a free fire zone where
antitrust analysis and the civil court system
doesn't even come into play.

And so I think I agree with the spirit
of both of these previous remarks, that the
principal harm from the tie-in rule arguably is
not that it's not the exact right analysis in
that exceedingly rare set of circumstances where
there might be a problem from tie-in.

The real problem is that the rule is
potentially applicable to an enormous range of
harmless commercial decisions which nevertheless
tend to attract involvement with law enforcement
and the civil justice system. And that can

impose an enormous cost and deadweight loss.

MICHAEL KATZ: We touched on a number
of issues that we'll keep coming back to this
morning. But in my role as moderator I'm going
to just move us ahead blindly despite having a
bunch of questions I'd like to ask now because I'm sure we will come back to this.

Our next speaker is Gregory Sidak who is the F. K. Weyerhaeuser Fellow in Law and Economics Emeritus at the American Enterprise Institute for Public Research and the president and chief executive officer of Criterion Economics LLC, an economic consulting firm based in Washington, D.C.

I understand that Greg is going to talk about some of the difficulties associated with pricing. If you're going to say things have to be unbundled, then you're going to have to talk about what the prices are.

And I think he's going to draw on some of his considerable experience in telecom regulation to talk about what can happen when you try to do that.

GREGORY SIDAK: Thank you. I do want to say something very briefly about liability rules before going on to the pricing issues which
I regard as more remedial in nature. I think that part of the problem that we observe in the application of traditional tying doctrine to intellectual property is that it's a square peg in a round hole because the traditional explanations for product bundling, as Greg Vistnes was pointing out earlier, don't necessarily fit some of these new kinds of strategic behavior.

And I think that the Microsoft case is a good example of this. David Sibley's theory there of partial substitutes where products that were once complements could change in their relationship, a browser could become the basis for an eventual substitute to an operating system, is a very interesting idea.

Although I certainly have some critical views of the Microsoft case, I think that the partial substitute theory of liability in a bundling context is something that should be taken seriously and is probably the most
provocative theory for a new cause of action in antitrust since the raising rivals' cost literature a decade or more earlier.

But that leads me to my next point.

If we want to try to give some additional flesh to that theory, I think there needs to be more formal analysis by the economists of how the process occurs within consumer demand theory that a complement turns into a substitute.

And I think that's something that wasn't so clearly articulated in the Microsoft case and something that I think would be useful as a matter of academic research and policy analysis.

Having said that, let me turn to the remedy issue. So much of the discussion of tying issues focuses on whether there is or is not liability. But let's assume that you find liability. Then what?

Presumably the rule against tying does not mean that a firm cannot offer product A and
product B in a bundle. What I understand it to mean is that product A, let's call it the tying product, has to be offered separately from product B.

But presumably the firm could still offer the bundle under a different pricing regime. Well, that then introduces the question: What is the price at which the unbundled version of product A, the tying product, what's the price at which it has to be offered in its unbundled state?

Or to put it a little bit differently, if you unbundle A and B and you are now selling A separately, when is the unbundled price of A so high as to be unreasonable, as to -- as to defeat the whole purpose of finding liability or maybe even give rise to a separate antitrust cause of action?

Well, this is a question that the Supreme Court and the Federal Communications Commission and a number of the people on this
panel to my right have spent a lot of time thinking about.

And in the decision that came down yesterday, Verizon Communications versus FCC, the Supreme Court upheld the pricing rule that the FCC adopted in 1996 called TELRIC, which is Total Element Long Run Incremental Cost.

This is a rule that was applied to the local telephone companies when they were required under the telecom act to unbundle their networks.

Simplify the facts.

Suppose that the network consists of just two pieces, the local loop that goes from your home or office to the central office switch, and then everything else in the network, but we can call that the switch just for simplicity.

So the question was what is the price that the incumbent must offer the unbundled loop which is the least easily duplicated piece in the network, to competitors for. Well, the TELRIC approach was one of many different pricing rules
being considered.

The other kinds of rules that are commonly discussed in a multiproduct regulated industry context are fully distributed cost pricing, Ramsey pricing, something called efficient component pricing, and more recently there's been recommendations for using real option theory to price access to networks.

The idea of long run incremental cost and the TELRIC rule was to figure out what that piece of the network would cost to replicate given an efficient design of the network at this point in time looking forward, and not to focus on historical cost.

So think about applying that in the tying case. Suppose we do have a situation where liability is found, particularly in an intellectual property situation. And the tying piece of intellectual property now has to be offered on an unbundled basis.

Well, one approach to doing the pricing is a top down approach where you take
the bundled price and you subtract out the
incremental cost of what was the tied product in
the bundle. And that would then give you an
avoided cost approach to calculating what the
unbundled price should be for product A.

Another approach -- and that approach
incidentally is what's used to price wholesale
services in telecommunications. The other
approach is called the bottom up approach where
you say what is the long run incremental cost of
product A, the tying product.

And this one, if you were to follow
the approach that the FCC has used you would say,
well, we estimate that TELRIC and we -- and that
includes a competitive return to capital, and we
include on top of that some contribution to the
recovery of common costs of this multiproduct
firm.

Now, in principle the bottom up
approach and the top down approach should get you
to the same answer, but in practice they may not.

And if they diverge in practice then there will
obviously be strategic decisions made by litigants to advocate one approach or the other.

Typically the access seeker argues under a top down approach that just subtracting out the avoided cost of what had been the tied product does not take into account that there are monopoly rents being earned and it does not take into account inefficiencies that this incumbent monopolist has been able to get away with.

On the other hand, the access provider, in this case the firm owning the tying product, would argue, well, there are actually additional incremental costs of unbundling my products. That may or may not be a persuasive argument to make.

But particularly in the case of intellectual property where you can add that additional piece of software to the CD-ROM at very low cost it may actually be more costly to disaggregate it.

Now, I think that if we start seeing a number of cases involving intellectual property
where there are findings of liability, the TELRIC pricing approach is as likely as any to be adopted by an antitrust court because it has gotten the stamp of approval from the Supreme Court as being a reasonable approach to the pricing of unbundled elements.

And it seems to me that an antitrust court that has found that a firm has -- which has been an unregulated monopolist if you will and has been found to have violated the antitrust laws, it seems to me that that court is going to be very content to apply a TELRIC model which has been applied in a regulated industry context to a firm that hasn't been found to have violated the antitrust laws and has been subject to rate regulation over a period of years and enjoyed a statutory monopoly.

So I would guess that we will see pricing controversies of this sort in the future once -- if and when there are more findings of liability in this context.

MICHAEL KATZ: Thank you.
(Applause.)

MICHAEL KATZ: Our next speaker is Tad Lipsky. He is a partner in the Washington, D.C. office of Latham & Watkins. 1981 to 1983 he served as deputy assistant attorney general under William Baxter where he supervised the preparation of the 1982 merger guidelines.

Tad is going to offer some insights for improving the litigation process and judicial decision making at home.

TAD LIPSKY: Thank you, Michael. And I also had the honor of shooting the nine no-nos in the head. First of all let me say what a great idea these hearings are, how honored I am to be included.

And it is a great pleasure to be here with friends and colleagues. And Greg of course is a former student although it's obvious he went overboard in hitting the books after he took my course 26 years ago or 28 years ago.

I also want to say for the benefit of the audience that if you picked up a copy of my...
remarks from the table on your way in, you might be a little confused. That was the just before final version. The final version is available now on the website.

And the reason it might be confusing is I want to focus on an idea conveyed by the new title of my remarks: Amateurs in black. The phrase actually comes from a speech that Justice Steven Breyer gave to the American Association for the Advancement of Science back a couple of years ago.

And he's actually quoting from Judge Acker, but anyway, I'll explain all that in a minute. But I want to focus my remarks completely on essentially the third question that Michael Katz posed at the beginning of these hearings:

How can the courts deal with the complexity of the issues both to reach the right answers and to give private parties some ability to predict how their licensing practices will be
per se rule, the tie-in doctrine, is very briefly summarized in my written remarks.

Anybody who's interested in how we got to the situation of having a per se rule will want to read the original scholarship by Ward Bowman, both his 1957 Yale Law Journal article and his 1973 book where the whole thing is traced in lurid detail. The per se rule under antitrust law actually originates from patent cases.

But at some point the per se rule that had evolved to the point of the International Salt case in the patent field jumped the tracks in the Northern Pacific Railway case so that the source of power under the per se rule didn't need to be intellectual property anymore. But in any event, that's what we got.

But what I would like to do in my remarks is assume that all of the per se rules that have plagued the tie-in doctrine and the intellectual property area for so many years will...
It's true that twenty years ago no less an authority than Donald Turner was referring to the per se rule on tie-ins as "ridiculous". So if Donald Turner puts a shoulder to the wheel and we still can't get anywhere, I suppose there might be grounds for pessimism. But I'm going to ignore them. I'm an optimist. And I think that eventually the real question will be how do we actually analyze, how do we bring to bear the proper expertise to evaluate the procompetitive and anticompetitive effects of tying, bundling, exclusive grantbacks, royalty terms -- royalty provisions that go beyond the term of an intellectual property grant, all the other areas that have been subject to per se rules either under antitrust or the misuse doctrine. Now, I'm sure that the antitrust economists on this panel and in this room will be
20 acutely aware that the Supreme Court has totally
21 revolutionized the process of evaluating expert
22 testimony in federal civil trials.

There are four cases beginning with
a case called Daubert which I refer to as the
Daubert quartet which basically completely
reversed the premises about the evaluation of
expert testimony.

It used to be the rule was that
testimony on a scientific question was subject to
the so-called general acceptance test. But that
was totally changed by these four opinions
starting with Daubert in 1993.

The rule now is that the federal trial
judge, the District Court judge must assume the
position of gatekeeper and make an independent
evaluation subject to review for abuse of
discretion of the relevance, reliability, and
fit of expert testimony.

And it has pretty much totally
revolutionized the way that the presentation of
expert testimony goes in federal civil trials.

And I think one of the remarkable things you'll find is a whole series of decisions in antitrust cases following Daubert that reject -- where a trial judge sometimes rejects testimony or an Appellate Court -- even more embarrassing, an Appellate Court reverses a decision to admit expert testimony. And these courts are not afraid of economic credentials. As I've pointed out, a lot of the testimony has been rejected under the Daubert rule in antitrust cases coming from people who have tenured positions at leading American universities. And a couple of them have Nobel Prizes in economics.

So the courts are not shy about exercising this discretion. But in addition to these rulings -- I should also say it's my personal opinion that the Daubert court was actually -- actually had a precursor in antitrust law, that the origins of the Daubert rule can be
found in the decisions of the Supreme Court in Matsushita and in Brooke Group versus Brown & Williamson Tobacco.

Both cases hinged very critically -- well, completely in the case of Zenith Radio versus Matsushita and to a significant degree in Brooke Group on the reliability and the fit to the facts of expert testimony. I don't have time to go into that. But I see Daubert as falling very much into line with a trend that was begun in the field of antitrust.

So the Supreme Court, all of those Daubert decisions, nine-zero. The Supreme Court was unanimous that federal trial judges, District Courts need to conduct this independent evaluation.

If you go over the process by which expert testimony is evaluated in federal trial, I think -- well, I wish I had time to support this but I obviously don't. The federal trial courts
I think need some incentive to improve the quality control on expert testimony.

I think that is essentially the concern that lies at the heart of the Daubert quartet and the two predecessor rulings. Justice Breyer has actually given some public addresses on this subject. He's spoken to the AAAS in what are referred to -- the title of my remarks is taken from a quote from that.

And basically what Justice Breyer is doing is he is appealing to various organizations and institutions that can evaluate the capabilities of expert witnesses in the hope that by cooperating with the courts and cooperating with the selection of experts in the civil justice system, perhaps even by certifying experts which I think essentially is what he's trying to propose, that the quality of the expert testimony can be improved.

And that is really the focus of my point. When we get to the business of actually
evaluating the pro- and anticompetitive impact of all these various patent licensing practices, we are going to need institutions superior to those that we have now to generate improvements in the quality of economic analysis. And I've outlined some things that I've thought of that might go in that direction somewhat along the lines that Justice Breyer has been suggesting in his public speeches and to some extent also in his opinions. The National Academy of Sciences does appoint members in the category of economic science. They are an extremely distinguished group. But the only stated criterion for membership is distinguished and continuing contributions to original research, not very specific from the standpoint of the objectives of antitrust litigation. I've also sort of poked and prodded around the American Economic Association to see
15 if they were interested in getting into the
16 business of determining qualifications for
17 experts who might be called upon to testify in
18 antitrust disputes.
19 They are not interested. The AEA is
20 extremely sensitive to any activity that could be
21 characterized as creating a professional barrier
22 to entry. And so they are not interested in this

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1 little project. That's fine. But I think that
2 there are some other avenues.
3 There's of course the ability to
4 appoint an expert that every District Court has
5 under Rule 706(a). Perhaps the continued
6 implementation of the Daubert rule will lead to
7 more frequent resort to that rule.
8 There are other devices that have been
9 used, the use of a particularly skilled law clerk
10 as in Judge Wyzanski's rulings in the United Shoe
11 Machinery cases back in the 1950s where Carl
12 Kaysen was his law clerk, not a very happy
13 model to use.
In the Microsoft case Lawrence Lessig was employed by the trial court. I suppose the jury is still out so to speak on whether that was a good idea or not.

But I really -- my main point is that we should be encouraging some -- we should find some additional new supporting institution to improve the quality of the experts so that we can better evaluate the pro- and anticompetitive effects for these practices when the per se rule is finally abandoned.

And let me just close with a quotation from Justice Breyer which again is taken from Judge Acker.

He says that unless and until there is a national register of experts on various subjects and a method by which they can be fairly compensated, the federal amateurs wearing black robes -- by which he means of course the federal trial judges -- will have to overlook their new gatekeeping function lest they assume the
intolerable burden of becoming experts themselves
in every discipline known to the physical and
social sciences and some as yet unknown but sure
to blossom.

MICHAEL KATZ: Thank you.

(Applause.)

MICHAEL KATZ: Let's take a few
minutes for questions here and start with the
second presentation first and ask the panel to
what extent do they think that there's actually

some market mechanism that's going to start
working with experts.

People having Daubert motions brought
against them successfully, certainly the legal
profession seems to keep track of who's been
Dauberted. Do you think that's going to start
affecting the behavior of experts? And will it
be a good effect?

TAD LIPSKY: I think it already has.

But I would rather hear from other panelists on
the issue.
GREGORY SIDAK: I'm absolutely positive it has. I've had one conversation with a famous economist who was very concerned about the implications of one of the notorious Daubert cases that Tad was alluding to. And it really changed the way he was willing to delegate certain kinds of analysis in a case to support staff. So I think that that's clearly one implication of it. But I think there's already been a market reaction to this. And I'm not trying to make a commercial plug for any consulting firm.

But I think the fact that many academics who wind up being expert witnesses affiliate with a firm that then has a brand name and a reputation that is at risk. That is a kind of bonding mechanism that may be relied upon to a greater extent now as a certificate of quality.

DAVID SCHEFFMAN: I think the process -- having been an expert witness a lot -- that Daubert has been largely very beneficial.
And people are clearly aware and subject -- and experts can assume that they are going to be subject to Daubert challenge no matter what their credentials. The credentialing issue is really a false issue, as you can see from the Nobel Prize. There's plenty of highly credentialed people who according to the judge's opinion didn't really do the necessary work to offer expert opinions. And so their testimony should be rejected if that's right. It's really what's more the content. And I don't know a way to get that other than the judge seeing what the experts are putting forward and seeing that this guy who just got on a case a month ago obviously couldn't have done enough work to offer a reasoned opinion. Obviously I think as you know in most antitrust issues there isn't metaphysical certainty in economics. You're going to have a hopefully good economist on each side. And I think that's beneficial rather than just having
lawyers on each side.

It's good to have someone bring in what's really the central content of an antitrust case and have the fact finder wrestle with different opinions. It is a benefit to the system. And I think Daubert is working well and is affecting the process and it will work itself out.

MICHAEL KATZ: I'll just throw in my own two cents worth. One thing that actually strikes me as a little peculiar about the entire gatekeeper role is that it seems to be saying that the jury is not competent to evaluate what the expert is saying about the antitrust case, which seems to me then raises a fundamental issue of what it is the jurors are competent to do in an antitrust case.

If they can't judge the truthfulness of the central witness, that seems to me actually a serious question whether they can do anything useful. But let's move on to some other topics.
JOSEPH FARRELL: Sorry. Can I have --

MICHAEL KATZ: Sure.

JOSEPH FARRELL: I'd just say I haven't followed this issue closely. But I have read one or two of the Daubert opinions. And in one case I was pretty unimpressed with the judge's reasoning behind excluding the witness' testimony.

So we shouldn't assume that this is going to be a very well functioning mechanism if it's mediated through penalty on being excluded as opposed to careful consideration of what the witness said and whether it made sense.

GREGORY SIDAK: I agree with that.

I think that of the three well known cases that I'm aware of, one of them was an egregious false positive.

MICHAEL KATZ: Let me then go back to what Greg was saying about seeing the possibility of TELRIC now being used in antitrust cases as ensuring that understood bundling is
really taking place. The question I have -- this
may be a question for Greg or for Joe since he's
now the recognized authority on TELRIC.
You're allowed to gloat for one day
after the Supreme Court ruling, Joe. After that
you have to go back to being your modest self.
But the question is what would TELRIC mean for IP
or for software. I was wondering if either one
of you could say something about what that would
look like if that's the way these go.
GREGORY SIDAK: I think the first
factor that would be distinguishing is the low
marginal cost. So if you're looking at the long
run incremental cost of a piece of software,
you're getting pretty close to a price of zero.

So obviously there's a lot of thought
that has to go into whether something being
added to that is monopoly rent or is it just
quasi-rent, a return to the legitimate investment
in product development and innovation.
JOSEPH FARRELL: Well, let's see.
Yesterday I had the choice of reading the Supreme Court ruling or preparing for today, and I thought I would prepare for today. I didn't realize that it wasn't a choice.

First of all on the point Greg just made, TELRIC is meant to be long run incremental cost which includes fixed costs. And so it would be a misimplementation of TELRIC to not include the development cost for the software.

But I don't want to make too much of that because that might be heard as suggesting that you could do this well. And I'd just like to say the Telecommunications Act is not regular antitrust law. I don't think anybody thought it was. There's a reason it's a separate act.

It's kind of an emergency measure to de-monopolize an industry that is extraordinarily difficult, extraordinarily difficult to de-monopolize.

And when we talk about tying and bundling policy in general in antitrust, the goal
I think is not to try to remove the quasi-rents that a firm legitimately has in its intellectual or other property individually.

It's to try to do something about possible clever strategies by which it can increase those quasi-rents by tying things together.

The goal in the Telecommunications Act was not to leave the Bells and other incumbent LECs with the full monopoly or quasi-monopoly, quasi-rents from their facilities. And that's part of what made it so difficult.

And it's part of the reason why as the act said you have to have a cost based rather than, for instance, top down or just structural remedy.

So it seems to me -- I hope Greg is wrong. I hope that TELRIC will not be generally applied in antitrust unbundling situations because it seems to me that the Telecommunications Act and TELRIC try to do quite
a lot more than we should be trying to do in antitrust unbundling cases.

MICHAEL KATZ: Joe, let me put you on the spot. For one thing we talked earlier about marginal cost being zero.

And you said -- I took your answer to be well that makes a real problem when you try to use some sort of cost floor to judge whether the behavior should be allowed under the antitrust laws or not because you get a floor of essentially zero.

And I thought you were saying that was too shortsighted a view of what should be allowed. You're saying, I think correctly, that TELRIC would be a mess in the case of IP. Do you think it's just a mistake to try to have any sort of cost standard at all? Or is there an alternative approach you would recommend?

JOSEPH FARRELL: In the case of IP bundling you mean?

MICHAEL KATZ: Yes, right.
JOSEPH FARRELL: You know, this is sort of what I was going to say in any presentation but we can speed up my presentation if I say it now. Just as a personal matter but I suspect it might be applicable to other people too, I don't know what goes on inside other people's heads.

When I face an antitrust case I try to ask how does this behavior or does this behavior really get in the way of rivals or potential rivals offering a better deal in the long run. And from that point on it really becomes fundamentally situational and fact intensive.

And I personally don't find it terribly helpful to throw around abstract terms like bundling and tying. I find it's more helpful to ask suppose somebody wants to come in and offer a better product, or suppose a rival wants to cut price; how does this behavior or how does this structure get in the way.

So given that I find that initially
somewhat unhelpful, I don't find it easy at all
to answer a question like should there be a cost
standard involved in doing it. You'd really have
to ask me at least about a particular set of
facts.

MICHAEL KATZ: Well, let me do this.
Let me tell people who you are and then let you
talk about whatever you want for a few minutes
and we'll ask you some questions about what you
just said since getting you out of order -- for
those of you who don't already know, Joe Farrell
is a Professor of Economics at the University of
California-Berkeley.

He's also the Chair of the Competition
Policy Center there and an Affiliate Professor of
Business. As well as being a coauthor of mine
and an academic colleague, he was one of my
recent -- or most recent -- predecessors as the
DAAG for Economics here at the Antitrust
Division.

He also was my successor as chief
economist at the FCC, which is where he had the
role in TELRIC and leading up to yesterday's
Supreme Court decision. So Joe is going to offer
his thoughts, some additional thoughts on the
economics of IP bundling and licensing and
whatever else he wants to speak about.

(Technical support discussion.)

MICHAEL KATZ: Apparently there was
some natural order. Originally David was simply
scheduled to go first. And I thought I would try
reversing the order between Joe and David, but
apparently the technical gods do not want that to
happen. So if we can we'll have David go first.

(Technical support discussion.)

MICHAEL KATZ: While the overhead
projector is being set up, I'll introduce David
Sibley who currently holds the John Michael
Stuart Centennial Professorship of Economics at
the University of Texas at Austin.

He's served as an economic consultant
to both the U.S. Department of Justice and the

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Federal Trade Commission. And I guess we'll have
to ask him whether he's ever been a consultant
for the PTO. Anyway, we're delighted he's here.

And he will discuss situations in
which his analysis indicates that certain
unilateral licensing practice terms can be
problematic. In particular something near and
dear to the hearts of all economists is whether
certain functions are concave or convex.

DAVID SIBLEY: You've heard lots of
seasoned advice from other people. Here's some
of the unseasoned variety from me. This is a
work in process with Simon Wilkie from Cal Tech.

For those of you who like to follow comings and
going of economists in Washington, Simon is
going to be the next chief economist at the FCC.

Now, clearly economists talk a lot
about the economic effects of contracting
practices of one sort or another. But usually
the emphasis really is on what an optimally
designed contract would be like or would people
enter in on a certain contract.
I'll be talking about that in a way.

But my concern is really more with having signed a contract, can folks get out of it efficiently. So I guess I call this efficient withdrawal from an IP contract.

Suppose we have two firms that are considering licensing the current state of the art from an IP holder knowing that at some future date a new state of the art is going to arrive and there will be some IP holder that has that.

Now, their choices are: Don't license the current state of the art; go on with something kind of clunky and not very good and wait for the new IP to come along and sign with the new guy when he does come along; Or to sign a contract with the owner of the current IP, and that contract might perhaps exceed the length of time that it would take for the new contract to arrive.

Now, if one does sign a contract with the current IP, then when the new one comes along a licensee might want to sort of get out of the
old contract and then sign up with the new one.

Now, in a way this is a -- or should be a kind of classic IP issue. Economists all the time talk rather blithely about new technologies coming along, and of course people sign up with the new technology.

But there isn't much thought given to how long that takes; does the process of switching customers from the old one to the new one happen in a particularly good way.

And that's really what my talk is going to be about. Now, a lot of contracts whether they are IP or otherwise have abrogation clauses. I've read a number.

And a lot of them say that if you walk from a contract -- in this case an IP contract -- you have to compensate the current IP holder for the direct and indirect harm caused by your withdrawing from the contract which in many cases is an unexceptional sort of idea.

But there may be cases in which that leads to unexpected effects. Suppose, for
example -- this is the only graph or anything in
the least mathematical.

Suppose that we have these two
licensees and each licensee produces output.
And there are some benefits that the current IP
holder gets depending on how many units of output
are produced with his particular technology.
So on this axis we have units of
output produced with the current IP. And on this
axis we have dollar benefits accruing to the
current IP holder. Now, the way I've drawn it,
this curve rises as you might expect.
That is the larger the number of units
of output that embody the current IP owner's IP,
the better off he is. This could be through
royalty payments, the ability to produce
complementary products, perhaps advertising
revenues, all kinds of things.
But notice the way I've drawn it it
rises at an increasing rate. That is to say, as
extra units of output are produced using the IP
of the currently optimal IP owner, the better off
he is at an increasing rate.

Now this could come about because of scale economies for example, scale economies of production or advertising scale economies or there are lots of ways it could happen. And as we'll see this actually gives rise to a problem. I'll come back to this.

We're going to assume initially that two licensees have signed contracts with the current IP holder and then a newer and better IP comes along.

And I'm also going to suppose that holding fixed the other licensee, either licensee could profitably buy his way out of the old contract, i.e. pay off the current IP holder for his lost benefit and switch some or all of his output to the new technology.

Now, one benchmark economists always use and which to a large extent is embodied in a lot of antitrust principles as well is economic efficiency.

And in this case economic efficiency
would say that the two licensees would withdraw output from the current IP and go with the new latest and greatest IP up to the point where the marginal benefit to them of withdrawing another unit of output from the current stuff to the new stuff equals the marginal damage cost to the current IP owner.

Unfortunately for the efficient functioning of this process the abrogation clause that I went over a minute ago combined with these economies of scale here gives rise to a problem.

Let's suppose that you are the first IP -- or the first licensee to try to in a sense buy you out of this contract. Well, this is the benefit to the current IP owner of having both of you guys signed up with him.

Let's suppose that each licensee produces 50 units. So the first one to withdraw has to pay the difference between this point and that point which is quite a lot. Whereas the second one to withdraw only has to pay this much.
So there's a coordination problem.

Each licensee wants to be the last to exercise the abrogation clause. Now, this fact has some consequences.

Assuming that someone does sort of test the waters, the first licensee to withdraw as I just indicated pays quite a high price but reduces the price that the second licensee has to pay. So there's kind of a positive externality between licensees.

That is, the first one confers a positive externality on the second one. However total output withdrawn from the current IP and shifted into the new, latest, and greater IP is less than the efficient benchmark level that I talked about earlier.

And furthermore, licensees wait too long to do this. Now, I'm assuming here that each licensee has a positive rate of time discount. So the efficient thing to do is if you're going to withdraw output do it right away.
Why wait, because of time discounting.

Well, in this case they wait. And in fact we have examples where they wait a long time. Now, these first three bullet points are in the case where both licensees signed up. So they are sort of waiting each other out, not wanting to go first because they would prefer to go second and pay less for bailing out.

The result is they wait a long time.

There is another possible outcome to this particular scenario which I didn't put on the transparency. And that is both guys don't sign the contract.

You could rationally it turns out have a situation in which one of the two licensees doesn't sign with the current IP. He just waits for the new IP to show up and then puts all of his output into that.

In that case the one who has signed clearly will withdraw right away because there's no coordination problem then. But there's still
an economic cost because the one who did not sign
the contract with the current IP uses a less than
currently state of the art technology and until

new IP comes along.

And he only does that because of his
coordination problem that I've described. So
whether one licensee signs the contract or both
licensees sign the contract, there's still an
economic cost.

Now, some implications here.

Long-term contracts can be particularly
exclusionary if the owner of the current IP
enjoys economies of scale in the way that I've
suggested here.

And the exclusion doesn't necessarily
come about because of nefarious acts by the owner
of the IP. It simply comes about because of the
interaction of this abrogation clause which is
quite a common one and the presence of scale
economies.

The current IP owner doesn't actually
have to do anything to make it difficult for
people to switch from his technology to the new
one when it comes along. The coordination
problem does that for him.

Now, when new technology arrives,
the coordination problem means that a licensee
doesn't buy his way out of the current IP even if
it were theoretically possible for a third party
who would say, Farrell, you go first and,
Mr. Polk, you go second or sort of break the
coordination problem that way.

Even if things would work out fine
with a third party refereeing who goes first,
that doesn't happen here because of the
individual coordination problem.

Now, if the current IP owner operates
under constant returns where that diagram that I
went through sort of just goes up like a straight
line, then we don't have a problem. People
withdraw the right amount from the current IP,
put it into the new IP, and they do it
Now, I've tried to think about other ways of designing abrogation clauses that wouldn't give rise to these problems or wouldn't create other problems. And it's actually not that easy to do.

A little later on in the talk I may be talking about a paper by Aghion and Bolton which is a very different paper but it involves an abrogation clause which is a liquidated damages clause. That is to say, you don't really have to pay the current IP owner in my setting the exact cost to him if you're withdrawing output. You just pay a fixed amount, liquidated damages. Now, if that's the way contracts look, that would get around all these problems. However, if you've read the Aghion and Bolton paper, it may give rise to other ones, i.e. the ones that Aghion and Bolton talked about. So I guess that's all I'll say except...
to re-emphasize that what makes the party go is
the abrogation clause itself, not that the IP --
current IP owner is doing anything bad.

And I'll also I mention I guess that
since Michael Katz mentioned concavity as well as
convexity that if the diagram showed decreasing
returns to scale for a reason I haven't yet -- I
haven't yet come up with a good story for why
that would be true.

But if it did, then everything happens
at the right time, but it turns out then too much
of what's withdrawn from the contract, because
you always want to be first. Okay. Thanks.

That's it.

MICHAEL KATZ: Thank you.

(Applause.)

MICHAEL KATZ: I think all the things
I said about Joe Farrell's identity are still
true to the best of my knowledge. So take it
away, Joe.

JOSEPH FARRELL: It's not my fancy
background to do the PowerPoint I'm happy to tell you. There we go. All right. Bundling, as I said earlier, is in some sense about two questions. And it's important not to confuse them.

In the case of intellectual property bundling, it seems to me that the second question takes on a slightly different, perhaps very different slant from what it does in generic industries.

So the competitive analysis of bundling is partly about how bundling affects users' -- buyers' -- willingness to go without the product, in other words, how it affects demand. And in that part of the analysis you think about the pro-efficiency benefits of reducing the marginal price towards marginal cost. And you perhaps also think about the effects on pricing decisions of existing firms of having the bundling.
And that relates to the pizza and beer example, for example, that Greg Vistnes described. So sort of the generic econ one alternative to buying the bundled products is you don't buy the bundled products, you, the consumer.

So the second part -- now that's interesting and it's worth thinking about.

And it's relevant certainly for the antitrust analysis. But it's not central to the antitrust analysis I think, if I can make that distinction.

What I think is more antitrust-like and also at least as relevant to the antitrust analysis is what effect does this practice have on somebody else, an existing rival or a potential entrant who might be interested in in some way in offering a better deal.

And can bundling be a barrier to entry? Can it cause rivals to exit? Can it cause rivals to raise their price and thus reduce their willingness if not their ability to offer a
better deal?

So in a generic bundling analysis it seems to me -- and I'm treating tying at the same time as bundling here -- you have to ask that fundamental question. Well, of course that's true here too.

But there's a particular version of that which I don't think has a very close parallel although it has some parallel in the generic case.

And that is challenging the intellectual property. So is challenge specific to intellectual property? It seems like it. Usually in a bundling or tying analysis you don't think about a competitor coming along and saying, well, you're selling that pizza but it's actually not your pizza. So I'm going to talk more, much more later today about incentives for challenge. But what I want to do right now is just point out that the analysis of tying or bundling needs to
deal with both the demand side effect and the competitive effect.

And one of the big competitive effects in IP bundling is going to be challenge. So now what about attaching -- by which I mean tying and/or bundling -- intellectual property to intellectual property or other goods?

I'm not going to say anything very substantive here partly because, as I said earlier, I don't think my brain works that way in this coming up with observations in response to these abstract nouns, but also partly because of time.

But I think it is widely believed that putting together these products is apt to affect private incentives to challenge the IP. And I'll talk about that right now. Yes, I'll talk in a moment and then more later today about whether that's actually going to be true.

But what I want to do now is just raise very briefly a thorny issue which is in a
conventional analysis we have some idea -- we have a pretty good idea actually -- what the correct incentive, economically correct incentive as Professor Sibley would put it, the economically efficient incentive is to enter and compete against an existing product. And you can ask is that incentive affected by the bundling or the tying. In the case of challenging intellectual property, it's not so clear at all I think what the economically efficient incentive to challenge is.

There are obviously effects in this market from a successful challenge to intellectual property. If we want to be hard nosed about it and say you've got to look in this market, well, the effects are rather dramatic and positive. Namely, you get rid of the mark-up attributable to the intellectual property. But that's obviously not a very good analysis because the effect of challenging the IP is partly that
you reduce potential innovators’ expectations of how much they might collect from IP in the future.

So although there's the usual question of do you use a consumer surplus standard or total surplus standard, you also I think have to look at the intellectual property incentives effects of profits.

Let me skip over that one and just talk a little bit about a couple of examples.

There are potential profit gains and market power gains from attaching intellectual property to something structural that can give you long lasting market power. Let me just mention a couple of examples.

In the telephone industry one of the things that happened early in the industry was the Bell System took the patent which was primarily on the handsets, what non-phoneheads call phones, the things that sit on your desk.

And when that patent expired it looked
like they were not going to have any market power
to speak of anymore because other people could
produce these handsets in a pretty similar kind
of way.

And what happened instead was that the
Bell System effectively attached, physically
attached these handsets to a network of wiring.
And of course a network of wiring is a market
asset much less susceptible to rapid, small
scale, and easy challenge.

It's the original network effect. In
the case of Star Pagination it's not so clear
that you can physically distinguish the two
goods.

But it seems to be what's going on
there is you have some intellectual property,
namely on a rather arbitrary system of page
numbering, and it gets in some sense hooked up
with the network effects of attorneys wanting a
common system to refer to legal documents.
And so the intellectual property
becomes more valuable by being incorporated in this network product. So is all this a problem?

Well, clearly in those examples, and I think in many others, structural features in the market are amplifying the rewards to the intellectual property and amplifying the short run or ex post harm to consumers from the intellectual property.

If you think about the foundations of intellectual property policy you realize that what you're saying is that in some circumstances based on market structure features you're giving much more market power if you like as a reward to the innovation than in other circumstances.

Well, is that good or bad? Economic theory answers with a resounding yes. It is good or bad. There may be some presumption there if you have a particularly big amplification where the network effects are a lot bigger than the network independent increase in value. But then there's a problem.
And I've referred to this elsewhere as the difference between V which is the increase in value from having the superior product available holding fixed network effects, so comparing the world versus a but-for world in which you have the same network but with the less developed technology.

That I call V. V can be a lot less than the full reward to implementing your IP and thus gaining control of a network industry which I refer to as V plus N where N is the value of the network effects themselves.

And this possible presumption that I refer to in the last line but one is the idea that if N is a lot bigger than V then there's a competitive problem here, that the market power attributable to the innovation is not commensurate with V but is perhaps a lot bigger than V.

That doesn't tell us what to do. It certainly doesn't tell us in what circumstances a
A feasible unbundling policy is going to be the answer to what to do. But I think it does pose a version of the question. That's it.

(Applause.)

MICHAEL KATZ: Actually, Joe, let's start with a somewhat technical question.

Your last point you were making about the amplification of the returns to IP because of various first mover advantages, what about the counterargument that says, look, if V is small, then the rivals ought to be able to do something like just lower their prices.

Is there some other way of offering value? And basically the point is, sure, someone ends up being the dominant network, but they had to compete to get there.

And so you need to have a theory that explains why a small change in a certain part of the technology early on changes the entire path of the industry, and not only that but the rents over the life of the industry change.
dramatically. In a lot of cases it wouldn't actually work.

JOSEPH FARRELL: In some cases it wouldn't work that way. That's right. Actually let me put in a plug, not for my own work here, but for the journal that I used to edit. In the Journal of Industrial Economics, 1992, Professor Katz and Professor Shapiro published a paper, "Product Introduction with Network Externalities."

And buried in the appendix to that paper and apparently unknown as far as I can tell to both of its authors at this late date is the answer to that question. And it turns out that if you do a sophisticated, sublime, perfect analysis of this question, if the quality difference is large enough that the superior technology will still win even after losing one day's or one cohort's or one generation's adoption, okay, and that may be a large threshold or a small threshold.
depending on how big a cohort is.

If the quality difference is that big and that may be quite small, then the superior technology in effect doesn't have to fight for its win. That is, the rents it gets include the network benefit.

On the other hand, if you have a smaller quality difference then what Professor Katz, 2002, said is right. And the network benefit gets dissipated from the seller's point of view or transferred to consumers through the ex ante competition.

MICHAEL KATZ: While you're correcting my economics, I'll correct your grammar. I believe what's there is not the answer. It's an answer. It was in the appendix for a reason.

Let me ask Professor Sibley. You talked about the implications of your analysis.

If you could talk about the antitrust implications of your analysis or the policy implications as you see them. I guess I'd ask
about two parts to that as well.

One is you were talking about if I understand correctly situations where these problems could arise in some sense innocently because the -- I take it the way you had it, if one thought about intent it was that the licensor just said, look, I want to internalize these effects; I'm being harmed if people pull off; I'm trying to internalize it, and lead to coordination problem, being completely innocent. Certainly there's also the possibility that absent the underlying economies of scale or any sort of technological reason you just say, look, I'm going to have a big penalty for pulling off because I want to try to lock people in. I was wondering if you could address each of those situations.

DAVID SIBLEY: Sure. I don't want whether this exists, but there is the possibility

that the current IP owner might have said the first guy to leave has to buy me a new toaster or
some sort of penalty to being the first one to leave.

I suppose it's -- this represents thinking beyond what I've done. But in a court setting one might find that claimed economies of scale were sort of claimed basically to create this coordination problem and in fact may be rather slight.

It could also be the case that perhaps if we wanted to look for possible malignant intent by the owner he might do things which would create those economies of scale whose only intent would be to create this particular coordination problem.

Apart from a particular wrinkle on exit from contracts that I was talking about today, I should point out that a lot of contracts I've read do have other disincentives to people leaving.

For example, if you were licensing a technology to someone and you said that the basic
license rate is $10 billion a unit but I'm going
to give you a discount so that after the discount
you'll only have to pay a tenth of a cent per
unit, but of course if you abrogate the contract
then retroactively we apply the original price.
So that would be creating a huge sunk cost to
exiting the contract.

MICHAEL KATZ: Would you see there
being an antitrust prohibition of something where
someone had a contract that, say, reflected the
economies of scale so they really are just
charging the marginal loss to them?

DAVID SIBLEY: I think I would only
see an antitrust prohibition if I could think of
an abrogation clause that wouldn't give rise to
this problem and was otherwise a good one.

MICHAEL KATZ: Joe, you wanted to say
something.

JOSEPH FARRELL: Maybe this gets to
that. You said you had done some thinking about
potential other ways to do abrogation. In the
model you described I think the abrogation penalty was calculated as if the second licensee was not going to abrogate. But then in fact he did. So you might think that would solve it. Actually I wonder whether that actually could make it worse if the effect of -- true effect of the first abrogation is that both parties leave. So then in a causal sense the first party should pay the whole, not just the big half.

DAVID SIBLEY: There are these externalities between licenses. And actually in the modeling I'm assuming that if you -- I think I said this, that if you dictated who was going to go first, they would both find it privately rational to bail the old contract. It's simply that because of this coordination problem if you leave it -- let them do it in a decentralized way -- they won't do it very efficiently. You could also get rid of this simply by having a dictator, someone saying you go first or never mind the contracts; here's what
you pay.

MICHAEL KATZ: I have another question for Joe. Joe is a young man. He has not learned the lesson in life that one shouldn't mess with the moderator. So, Joe, I'll ask you a question.

It seems like you have enunciated an antitrust principle today or a policy basis which is if you see something you don't like then we'll do something about it, but you're not going to tell anybody in advance what that is.

So let me ask how people would advise their clients in that world. And obviously the serious question is you have identified some of the problems that have this sort of cost based rule that clearly has a problem.

You've talked about how it makes a lot more sense to look at the specific facts, to have a welfare standard, to ask does the practice harm welfare or not.

But the serious issue as you know of course is if things are that fact intensive and that detailed, is there any way for the parties
to predict what the outcome of say a Justice
Department analysis would be? How will they know
what they can and can't try doing?

JOSEPH FARRELL: Yes. I think there's
no really good answer to that. The best answer
I can give is for corporate counsel or outside
counsel not to ask, well, are you tying; are you
not tying; is this price below cost or above
cost.

But to ask why are you doing this;
what are the efficiencies, are there other ways
to achieve the efficiencies; do you expect it to
block competition.

And for the advice to be based on the
counsel's good -- excuse me -- on the client's
good faith answers to those questions rather than
on answers to what might be perhaps more
mechanical questions but less relevant questions.

MICHAEL KATZ: Jonathan, could you add
something?

JONATHAN JACOBSON: I think Justice
Brandeis actually addressed this in the hearings
that led to the Clayton Act and the FTC Act. And basically what he said is if you want me to tell you where the line is, I can't tell you where the line is. I can tell you how close you might approach the line so that you can be safe. And the real policy question that raises is what is the efficiency loss between what is safe and where the ultimate line is. It's my -- this goes back to the question that David asked earlier. It's my sense that at least in the case of bundling practices the degree of efficiency loss from not being able to tie as opposed to achieving the business objectives through some other means is rather limited. It's real. It's particularly real in the case of the IP presumption where we're presuming market power for people that really just don't have any at all. But in general if you follow the Brandeis approach in the tying context you will
not lose an awful lot of efficiency. You're not
going to be able to tell where the line is. But
that's not as serious a problem as you may think.

MICHAEL KATZ: Greg Vistnes?

GREGORY VISTNES: I just want to
follow up on what Joe was saying. I think
there's -- it's a little bit of a strange thing
for an economist to be saying.

But I think Joe's approach to
assessing bundling problems is actually a very
good one in that it's a lot easier to tell from
how a firm is operating what their intent is.

Are they really pursuing bundling to
help themselves to make themselves more efficient
competitors or is it more directed at harming the
rivals? I think a firm itself will often have
a very good feel as to what this bundling is
motivated or directed at.

And in practice as far as, well, we
have a lot of economic theories; we can try to
impart them; we can try to tell does the
theory work.
In practice what I've often seen is that the, quote, theory behind a case is really driven by the facts that the folks in the agency, perhaps more the attorneys than the economists, are going to be looking at the documents. The documents and the interviews, all this non-, quote, pure economic evidence will be reflecting the intent of the parties. And if the antitrust agencies see the intent of causing harm to the rivals, I think nine out of ten times they will find a theory to buttress that sort of intent type story. It may not be a very rigorous economic theory. But I think it's a theory that will make the attorneys sufficiently comfortable to often take that to court or at least significantly get in the affairs of the parties and make them wish they had never done it.

DAVID SCHEFMAN: Let me respond to that. I think we clearly need more clarity on what Greg just said. I'd add the predicate as I
think he would that no agency for a long time

would pursue that sort of case on a per se --
simply per se basis.

They would think that they had a
bona fide monopoly and a bona fide theory of
anticompetitive effects. And then intent
evidence is certainly of some relevance.

Jonathan, I'm curious when you talked
about counseling you didn't talk about who were
the likely plaintiffs here. Bringing an
antitrust case is very expensive.

So I presume one of the discussions is
who would be likely to mount an effort to sue us,
and isn't that -- doesn't that to some extent
cure the problem. That is, if you are not
forcing or you are not excluding in an overt way,
you're probably not going to get sued.

Now, there are instances certainly of
those others where you are going to get sued
where per se is inappropriate. But doesn't that
question solve a lot of the problem or not?
Absolutely. The rules on antitrust injury and standing limit the set of plaintiffs in the outset. The number of cases where the federal agencies get involved is very limited. Unless you're dealing with a very high profile technology or you're really stupid, you are not going to get into federal agency difficulty on most counseling situations. And the likelihood of getting sued is fairly small. So you can be fairly aggressive. On the other hand, given the state of the law today you just can't advise a client that has an intellectual property right that it's okay to tie with a patent or copyright. It's just too dangerous.

And bear in mind I think that the practical impact of these rules is not necessarily felt strictly in the counseling situation. I think the unfortunate aspect, the
aspect that has elicited so much scholarly
criticism over the years, is counseling in the
context where you are about to bring an

infringement suit.

And the question is not in the open
field would you expect a Department of Justice
complaint for this conduct or would you expect a
private complaint attacking this conduct.
The question is to what degree are you
willing to put your intellectual property at risk
with the notorious overbreadth of the misuse
doctrine where your misuse does not necessarily
have to be in connection with the behavior that
you're challenging in your infringement suit.
And the penalty for misuse is you're
completely deprived of any ability to enforce
your intellectual property.
And it's just a fact that for as long
as I have been a lawyer it's per se malpractice
to fail to advise a client who is considering an
intellectual property infringement suit that he
must be prepared to litigate any manner of crazy antitrust or misuse counterclaim -- or misuse defense.

MICHAEL KATZ: Let me ask you a

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question about it. I certainly agree with what you're saying. I have in fact been involved in litigation where that's exactly what happened. It involved package licensing. But all of that said, it seems like package licenses are actually fairly common. And so it seems like companies in fact are not being deterred from engaging in that form of bundling. I was wondering if you could sort of respond to that.

JONATHAN JACOBSON: Michael, I think you'll find that package licenses are extremely common, but the offer is not an all or nothing offer which will take the client out of the tying situation, an element of the offense being coercion. So I think most package licensing
contexts, at least that have been advised by counsel, involve an alternative other than the package license. Now, that invariably in a close case will get you into the issues that Greg was talking about earlier, you know, what's the price.

But one way to package licenses and not get immediately hauled into Federal District Court is to make sure there's an alternative available.

MICHAEL KATZ: As you were saying you immediately get into instead of saying it's a coercive package you hear that it's a coercive pricing. And you get in these endless debates about whether there are realistic alternatives or not.

JONATHAN JACOBSON: Yes, but the courts have really closed the door pretty much all the way on those claims, and the number of claims of that nature that succeed are small. They are very difficult to pursue. And the
safety net for the client is reasonably tight.

MICHAEL KATZ: So does that suggest in fact for intellectual property that bundling is in a big safe harbor and as long as you're careful to have it all realistic looking or reasonable, whatever word one wants to put to it,

for the individual prices that then you're home free?

JONATHAN JACOBSON: Maybe not all the way, but it also raises the point of what's the efficiency in really insisting that the entire package be taken as opposed to offering the ability to take lesser included of the entire package.

TAD LIPSKY: This is a comment and also a question for Jon. For many years I think the key precedent on this bundled pricing issue has been -- for plaintiffs anyway -- the SmithKline case in the Third Circuit which now that 3M LePage's -- I think it is subject to a petition for rehearing -- I can't remember
whether it has been granted. So are you really as confident as you sound in advising clients that they are essentially home free on bundling pricing where intellectual property is involved?

JONATHAN JACOBSON: The LePage's case, whichever side you're on, is a fairly extreme case where there's also a lot of evidence that what 3M was trying to do was basically put private label tape out of business. And the number of cases that rise to that level of potential antitrust defense again are relatively small. My point is that the difficulty of proving that the pricing bundle is sufficiently coercive to withstand a claim given the expense of bringing an antitrust case I think deters an awful lot of plaintiffs, doesn't give you a complete safety zone, but gives you a measure of comfort that you can be -- achieve your business objectives without an undue threat of being hauled into court.
Can lightning strike and you'll get sued for these practices? Absolutely. It does happen. It just doesn't happen that often.

MICHAEL KATZ: Let me ask a final question of the panel, and it's whether people make this distinction or not. Some people distinguish between a tie-in and a tie-out, one being the requirement that you purchase the product; if you want to get A from me, you also have to purchase B from me.

The other requirement is it that if you want to buy A from me, you can't buy B from anyone else.

And there is certainly an intuition that suggests that second one could be more of a problem, particularly if you think about something like a package license where in the one case you might say, look, you have to buy all if you take our whole package it's a low price but that gets us over transactions costs.

And, Joe Farrell notwithstanding, the
marginal costs of throwing the extra intellectual
property is zero. Some people think it is a very
different situation than when you say, okay, you
have to take our IP and guess what you have to
agree not to use other people's.

I wonder if people make a distinction
there or not or you think that those -- either
you need symmetrical treatment or they both are
hard or does anyone on the panel want to jump in

TAD LIPSKY: I can jump in. Mike, I
wouldn't say my thoughts have completely spun out
on this. But I think the considerations are
somewhat different. In many respects the
question of whether to impose a tie-out ought to
be addressed almost in terms of merger law.

If we don't want to create distorted
incentives for downstream vertical integration,
we're going to have to appreciate that there are
a lot of valid reasons why an intellectual
property owner would only want to enlist help.
And whatever the purpose of the license was, whatever the purpose of the sale was, be it distribution or manufacturing or some other complementary activity or some other activity in the chain of commerce, if you will, there are going to be a lot of circumstances where the intellectual property owner should be entitled to in a sense the complete loyalty of the partners -- of the other partner.

It's very similar to the rationales you find for exclusive dealing in the ordinary vertical context apart from considerations of intellectual property, although I think the problems probably have a better relationship than is widely appreciated.

There are corner solutions. There are situations where you're basically facing a Lorain Journal type of situation.

But there's also one other important problem that I think should at least be noted. And that is there is a kind of schizophrenia I
think in the way that antitrust has tended to
treat these kinds of relationships and the use of
this kind of restriction.

Picture if you will a situation where
somebody has come up with a real breakthrough
innovation, something that is really going to do
a lot of competitive displacement in the
industry.

On the one hand efficiency seems to
suggest that the intellectual property ought to
be licensed to everybody, that the technology in
a sense ought to take over the world.

But on the other hand if you go ahead
and get that solution, then you're going to have
cases like Microsoft where there are going to be
monopolization-type allegations against the
process of taking over the world.

But what's the alternative? You say,
well, half the world is allowed to have this
intellectual property, and the other half is not
in the hopes it will preserve some potential
And I remember when the Microsoft case first started I found myself standing on a platform in Palo Alto arguing to an audience much like this one that maybe what the government ought to do is be forced to state at the outset of the case, you know, will you require that some of the hardware manufacturers be disabled from licensing the Microsoft operating system to leave them out there as a competitive fringe so that they can take Apple's operating system or some other future competitive operating system.

I think that is one of the problems at the root of the question of the legality of tie-outs. And I don't know what the solution is, but I think it's a problem that needs to be thought about.

MICHAEL KATZ: Then we will now take a short break for about 15 minutes. And when we come back, we will talk about patent extension.

(Recess.)
MICHAEL KATZ: What we're going to do up until noon for the remainder of this morning's session is talk about patent extension. And the format is going to be that Rebecca Dick is going to make a presentation and then David Sibley and Joe Farrell are each going to have some comments from economists' perspectives on these issues as well.

Rebecca practices antitrust law at Swidler Berlin where she handles both merger and civil conduct matters and specializes in the intersection between intellectual property and antitrust.

Prior to entering private practice two years ago she served for twenty years in the Antitrust Division where she held a variety of positions including director of civil non-merger enforcement. We're very pleased to have her today. Rebecca?

REBECCA DICK: Thank you, Michael.

I'm going to touch on a number of ways in which
IP holders have tried to extend the value of their rights.

The variety though is infinite and as David Sibley's talk illustrated in terms of long-term contracts, that's one way. There are many, many others. But I would like to go through some of the main categories at least.

The value of a patent or copyright can decline for either of two reasons. Either its term expires or new competitive IP becomes available that diminishes any market power that the earlier IP may have commanded.

Companies use a variety of techniques to try to extend the useful life of their intellectual property. But their ability to do this is really quite limited in most circumstances.

Most patents and copyrights expire on time effectively and pass into the public domain or they are displaced even before that time in the marketplace by newer and better innovations.
But nevertheless companies have devised a number of schemes to try to extend the useful life of their IP. And some of the schemes have been quite inventive. A number of them really are only applicable in a particular set of circumstances, either a particular industry or a particular regulatory scheme.

One is the use of trade secrets which has no term instead of a copyright or patent. One is incentive sales schemes. I'll discuss a couple that have been the subject of litigation recently. Another is restrictions built in a joint venture can limit the innovation from at least certain other parties to the venture.

Package or pool licenses which we've discussed some this morning already, acquisitions under some circumstances, and Hatch-Waxman is a sort of specialized area unto itself where there's been particular problems.

And finally seeking legislation, which has been popular recently. First we can look at
trade secrets. It has no fixed term of course, and it operates entirely outside the patent/copyright regime.

This was thought to be true for many years, and finally the Supreme Court said so definitively in 1974. The benefit obviously of relying on trade secret information is that there's no expiration of the rights as long as they are not disclosed into the public domain.

The Uniform Trade Secrets Act provides some guidance about what constitutes know-how and how rights to it can be enforced. But there are variations in the various state schemes and some states haven't adopted the act in any form.

Coca-Cola is really the firm that has been able to use trade secrets as successfully as anyone. It has protected its secret formula for over a century through the use of trade secret protection. But it has done so at the cost of eternal vigilance really to keep that formula secret.
Very few other firms have been able to protect their trade secrets to such an extent and for such a period of time. Usually the trade secrets leak out into the public domain over time. And this was the defendant’s problem in the Pilkington case.

Pilkington had once held patents on a process for making flat glass. It was called the float process. So you hear the case referred to either as the float glass case or the flat glass case. Either way is correct.

During the life of the patent they set up a worldwide licensing regime with exclusive territories. Each licensee had a particular area that was exclusively theirs to practice the patent.

The principal U.S. patents however on the process had expired by the early 1980s. And nevertheless Pilkington continued to enforce worldwide licensing schemes with exclusive territories now based solely on the licensing of
The Department of Justice in 1994 challenged this scheme. Interestingly enough, it did not allege that the know-how was completely gone, that there was no secret know-how that Pilkington still held. It did allege, however, that to the extent secrets remained, they consisted of engineering solutions with no substantial value over equally efficacious engineering alternatives.

Essentially the Department argued that the scheme had become -- the licensing of the know-how had simply become a device for implementing a cartel. So one of the issues when you look at a possibly anticompetitive use of trade secrets is whether or not trade secrets are genuine, is the claim that the trade secrets are being licensed -- is that really a sham. And then a second question certainly
raised by the Pilkington case is whether or not
you're going to ask is the strength of secrets
weighed against the anticompetitive effects of
the licensing agreement.

Since the Pilkington case was settled,
this issue wasn't litigated. There is no
precedent for this notion of weighing the
strength of the IP versus the competitive effects
of the licensing scheme.

There's no precedent for it in trade
secret law. There is some related precedent in
copyright law which can look under certain
circumstances to how thin or strong copyright
rights are.

And I think it's possible to develop
policy arguments both for and against the notion
that there should be such a weighing process.

It's hard to imagine how it would be done except
in extreme circumstances, and certainly how it
could be predicted in terms of counseling
clients.
But when you have a situation like the Pilkington case where there were -- the markets involved were enormous. The markets both for constructing the plants to build the -- to manufacture the glass and then the markets for the glass itself, the markets were 600 million and 15 billion respectively annually.

To have an international cartel of unlimited duration based on such flimsy IP is certainly something that was a competitive concern. And I think you can certainly understand why the Division looked for a way to try to attack that.

Are there other Pilkington cases out there, or is this really an unusual situation?

My own view is that there are not a lot of other Pilkington cases out there. I understand that patent holders frequently try to insert provisions for licensing of know-how in their proposed license agreements.
expired its separate royalties for know-how are
almost always dropped in the course of
negotiations over the agreements.

The next device I'd like to talk about are incentive sales agreements. One of the cases currently in litigation involving this issue is a lawsuit against Monsanto which has held the patent on the active ingredient in the herbicide Roundup which has been an enormously successful product for them.

A competing herbicide company, Chemical Products Technologies, filed a lawsuit alleging that in the waning months of the term of the patent, Monsanto went around to distributors who sell most of the herbicides that are sold. It's very hard to market allegedly to users, direct market to users in this business.

So Monsanto is alleged to have gone around to distributors and offered them volume discount and rebate arrangements that spanned the period of time from the last months of the life
of the patent into the months and even years beyond the expiration of the patent.

And allegedly under the incentive sales arrangements distributors could earn credits depending on the volume of Roundup they purchased. But they wouldn't actually be paid for the credits unless they continued to buy high volumes after the expiration of the patent.

And if they failed to do so during the post-patent period, they could actually forfeit some of the credits they had earned prior to expiration.

There are elements of this case that are reminiscent of the LaPage's versus 3M case that was mentioned earlier this morning but with sort of an IP twist. This litigation is in its early stages. Not much of the issues have been addressed substantively by the court yet.

And of course the issue raised directly by the case is does calculating a total discount based on purchases both pre-and post expiration improperly extend the term of the
And because the court has not begun to address this, there are a number of factors you can imagine the court weighing, the existence of competing IP. If Roundup was one of five affected herbicides out there all going around trying to get dealers' loyalty, some kind of incentive sales arrangement like this might be of significantly less concern. And then just weighing the amounts, what is the amount of pre-expiration credit that's at risk if the post-expiration sales fall below volume levels. And what are those volume levels; how large are they? And then are there any efficiencies in this licensing scheme? Presumably Monsanto will have a story to tell there that it will present. I'd like to talk next about joint venture restrictions. Of course joint ventures frequently involve agreements between the parties
to the venture that they will not compete against
the venture, that they will devote all -- in the
area of industrial effort that the joint venture
is pursuing, that neither party to the venture
will independently compete against it, that its
undivided loyalty will be devoted to the venture.

And non-compete agreements often
extend to IP that either is dedicated to the
venture by one of the parties pre-existing IP or
IP that the venture may develop on its own.

But in a circumstance where the other
entity to the venture is a likely competitor, and
in an extreme case this could lead to competitive
problems, one of which is illustrated in the
Department's LSL Biotechnologies case.

There was a joint venture aimed at
developing a new tomato with a long shelf life.
The goal was to develop a tomato that could be
sold fresh in the markets in the wintertime that
would taste a lot better than the tasteless
rubber that's available now.

The joint venture developed such
tomato, but the partners in this joint venture could not get along and the venture dissolved.

But in the course of their disputes with one another during the brief life of the venture, they signed a perpetual non-compete.

This was permanent. It had no term. It continued post the termination of the joint venture and then was going to continue forever.

The Department's complaint alleged that the two former partners had divided the world between them with each agreeing never to engage in the development of any type of long shelf life tomato seeds for sale or use in the other party's exclusive territory.

The agreement of this kind wasn't necessary to protect against infringement because you can do DNA testing of a tomato and if one of the former partners was marketing a tomato that the other suspected infringed on the joint venture's IP they could test the tomato and get a definitive answer about their suspicions.

And in any event the non-compete as
written allegedly survives the expiration of the patent on the joint venture's IP on the joint venture's tomato.

The Department's complaint alleges that the party that's foreclosed from selling in the United States, developing seeds for tomatoes to be grown and sold in the United States, is one of the firms worldwide most likely to develop an effective product.

It is a market in which there are very few competitors, a great deal of expertise is required, and the non-compete is having an actual effect on competition today. The case has not fared well in the courts however.

The District Court in Arizona dismissed the allegations relating to the sales of seeds in the United States for failure to properly allege the product in geographic markets, although the court did say that this part of the case was dismissed without prejudice and the court observed that it was likely that the Department could draft a complaint with
appropriate market definitions.

The court dismissed with prejudice the portion of the complaint that addressed the agreement's restriction on development of seeds for use in Mexico with the notion in the complaint that the resulting tomatoes would be imported into the United States.

And the court held that that provision had no direct substantial and foreseeable effect on competition on the sales of tomatoes in the United States citing the statutory standard.

The Department has now asked the court to dismiss the entire case with prejudice so that it can appeal although it hasn't definitively said it will appeal. Presumably that's what's coming next. And that motion is pending.

If you look at a joint venture agreement I'd like to emphasize that most of these non-competes are going to be perfectly legal. One issue though to look at is is the competitive restriction really ancillary.
That is, is it reasonably necessary
to effectuate the purposes of the joint venture.
Are there less restrictive, effective alternatives?

And is it appropriate to weigh the procompetitive effects of the venture against the anticompetitive effects of the restriction? Is the venture very narrow in scope and the restriction enormous in scope?

Turning now to package or pool licenses, as has been mentioned, it can be a very efficient means for transferring IP rights. But it can also offer opportunities to extend IP rights, valuable IP rights.

It can kind of disguise the important IP among a number of patents and make it hard for licensees to either invent around or to determine if the patent that they really need permission to practice is about to expire.

One way in which a patent holder can try to extend his patent's useful life is to
incorporate in a pool unnecessary but later running patents. Assume a company obtains a patent for a new product, develops standards for that product, and licenses the rights freely and it becomes widely used.

And then as that company develops standards for later generations of the product, it incorporates newer patents that it owns with later expiration dates even though it could have chosen alternative unpatented technology.

And the effect of this is to artificially extend the period of time during which it can earn royalties from the firms that use its standardized products.

In the late 1990s the Department issued a series of three similar business review letters relating to patent pools. And these letters addressed a variety of issues. But one element of them was the Department approved the use of an independent expert to verify the essentiality of the patents in the pool.
These were pools created by a number of different IP holders. Now, the requirement of having an independent expert doesn't fully address the problem because it examines only the necessity of the patent for making the product as the standard requires that it be made. It doesn't look at the underlying design decision. But it does ensure that at least the patents named in the pool are necessary for making the product as designed.

Another way to use patent pools is to bundle -- as I mentioned at the outset here, is to bundle important IP with other patents and then refuse to provide licensees with a list of the covered products. And this is alleged in the Echostar case against Gemstar which is currently pending. It's one of several pieces of litigation pending between those two companies. But Echostar alleges that Gemstar has many, many patents, some important, and many that
are not, refuses to give licensees a list of what
those patents are, and in fact even refuses to
tell licensees which Gemstar affiliate holds the
rights to particular patents.

And Echostar alleges that the
practical effect of this is that licensees have
to expect to pay royalties forever because they
will never know when the patent that they really
need has expired.

One question in this whole area is the
intractability of this issue to litigation. Does
asking the questions about which patents are
included in a pool really involve courts in
product and process design decisions that they
are not qualified to address? On the other hand,
does not asking create an unwarranted exemption?

I think one conclusion you can draw is
that as a practical matter courts are only going
to be willing to look at this kind of issue in
fairly extreme and rare situations because it
is to some extent intractable in terms of the
litigation process.

It's somewhat outside the scope of this talk, but several of the cases I'm mentioning here did involve in addition to the other claims, claims that the defendant had acquired additional patents to augment or extend rights over a particular process or product. Acquisitions of IP are generally treated like other acquisitions. If the H-S-R levels are met and it's an exclusive license, it's H-S-R reportable. And agencies will consider what are the alternatives and the likelihood that someone could enter the market by inventing around.

Both the Gemstar case that I just mentioned and the Biovail case which I'm going to mention in a moment contain claims that there was anticompetitive acquisition of patents, in the Echostar case allegedly a pattern of acquisitions of a lot of patents, and in the Biovail case allegedly anticompetitive acquisition of a single
strategic patent.

It's the standard merger analysis if the transaction rises to the level that it's reportable and if it involves IP for which there are few substitutes, you define the market. You look at competitive effects, and you look at the possibility or likelihood of entry.

One of the issues that's often raised is in terms of grantbacks. Does acquisition of improvement patents enable the patent holder to leverage expired core patents into control of later generation product standards?

Again I think this is a difficult issue for the courts because as a practical matter many patent holders are unwilling to license their rights unless they get grantbacks on improvements.

And if the policy goal is to encourage licensing, this is likely to be an outcome that is a cost of that policy in favor of licensing.

I'd like to touch briefly on the
Hatch-Waxman cases. These really are to some extent a creation of the -- well, to a complete extent a creation of the statutory and regulatory scheme governing the marketing of generic -- new generic drugs.

The Hatch-Waxman Act was intended to promote development and sale of generic drugs.

And to some extent it has been successful. But it has been subject to manipulation by parties. And the FTC has filed what it calls two generations of cases. There has also been some private litigation.

The first generation cases involve -- well, let me first summarize the statute. No new drug can be sold without FDA approval. Even if it's functionally similar to an already approved drug and it doesn't infringe on an existing patent, you still need FDA approval. Under the Hatch-Waxman scheme, once a generic has applied for FDA approval a patent holder can allege infringement. And then there's
a waiting period of up to 30 months while the parties litigate the infringement issue. After 30 months if it's unresolved the FDA goes ahead. And if the litigation is resolved prior to the 30 months -- it obviously depends who wins the infringement litigation. If the generic wins, it's free to go ahead and sell once it has FDA approval.

Then there is a second period. Once the 30 months has passed, the generic is able to proceed and it has received FDA approval, it then as a reward for having gone through the infringement litigation in part is entitled to a 180-day head start.

And the economics of sales of generic drugs is that a significant part of the profits that are made are made in the days immediately after a generic is introduced in the market. The price starts high at the patent level, at the monopoly level, and declines. But it doesn't drop in a straight
line. It drops at an angle. And so the first
generic captures a lot of the higher part of the
price decline. And so the 180-day period really
does provide something of an incentive.

And after the 180 days other generics
that get permission can go and sell, and the
price normally continues to decline

significantly.

In the first cases the FTC brought

against two different pharmaceutical companies,
each one faced a generic that was claiming to
compete with one of its leading patented drugs.
Each filed infringement litigation. Each then
reached an agreement with the generic.

And the terms of these agreements vary
to some extent. But in each case the generic
agreed not to sell its own product until certain
future events had taken place. And in the
meantime the patent holder agreed to pay the
generic millions of dollars.

Because the generic first in line had
applied for FDA approval, it was first in line under the Hatch-Waxman scheme. But because under these agreements it didn't start selling its product in the market, the 180-day head start period never started. So by virtue of this agreement the first in line generic and the monopoly and the patent holder were able to prevent any other generics from entering the market, not indefinitely, but for a period of potentially many months. And the FTC in the year 2000 challenged two of these arrangements. Both cases settled, one I believe right away and the other somewhat later. And there has since been a third case against Schering-Plough. The FTC has said that it looks for three things when it's looking at these infringement settlements in cases involving a patent holder and generic. First of all, it looks for reverse
payments, payments from the patent holder to the
generic. One of the issues that's difficult for
defendants to answer in this situation is why the
patent holder who has claimed infringement is
suddenly paying money to the alleged infringer.

Normally you would expect the payments
to be going the other way if there had been any
merit whatsoever to the infringement claim. And
it's difficult to understand the basis on which
the patent holder would be paying -- a legitimate
basis on which the patent holder would be paying

the generic.

And then the FTC also looks for
limitations on the generic's ability to sell
non-infringing products. Typically these
agreements prohibit the generic from selling so
that the 180-day period will not start.

And then simply the FTC looks for
limits on a generic's ability to waive or assign
its rights to the 180-day period which it
otherwise can contract away.
The second generation cases involve the FDA's Orange Book. I'll just allude to these. These have to do with listing of drugs in the FDA's Orange Book. If a drug listed there has blocking potential over other drugs, the FDA will not approve it.

And the FTC has recently alleged that Biovail and other companies have filed -- have knowingly filed and falsely listed products in the Orange Book to prevent generic entry.

The issue of whether or not this constitutes protected conduct under the First Amendment has been just litigated in the Southern District of New York which held that it was not protected.

And FTC chairman Tim Muris has recently testified on the Hill about all of these cases. And his testimony is on the FTC website and is very useful on this issue.

And then finally I'd like to mention legislation. Certainly the safest from an
The grounds really had to do with whether or not this is rewarding original works or is it rewarding works that have already been rewarded, are no longer original, and is it really rewarding progress in the useful arts or the status quo.

In terms of the future, certainly more cases to come. And I think particularly because
IP is becoming an increasingly important part of our economy, our increasingly technology driven economy, some IP has become enormously valuable. Because none of these cases have been litigated fully as yet, there really is not yet a consistent theoretical framework for analysis and we haven't seen really the full development of the kinds of defenses that I think are likely ultimately to emerge. But I do think this will be an area for the future. Thank you.

MICHAEL KATZ: Thank you.

(Applause.)

MICHAEL KATZ: Without further ado, David Sibley has offered some comments, and I've asked him to cut his comments down considerably.

So I will apologize to him for that, but thank you for agreeing.

DAVID SIBLEY: I'll talk a bit about long-term contracts, something that Becky mentioned but not in detail. This by the way is an issue in at least one of the Gemstar/Echostar
Suppose there is an incumbent and an entrant may be due in the future but an incumbent signs buyers up to contracts which extend past the point where its patent expires and entry then becomes possible.

And suppose that entry involves a fixed cost or some type of economy of scale where the entrant has to sign up enough customers in order to make entry viable.

Now, in this setting, a long-term exclusive contract or partially exclusive contract, by limiting the number of customers available to the entrant, might possibly be anticompetitive.

Now, this is kind of like the argument made in United Shoe and Posner and Bork and others have made the excellent counterpoint that they don't see anticompetitive harm here because in order for the incumbent to sign up a customer to a contract going past the patent expiration
date presumably he would have had to give the
customer a good enough deal to make it worth the
customer's while to not wait.

Now, this view, although it's
certainly part of the truth, ignores a factor
that's gotten a lot of play in the recent
economics literature, the fairly recent paper
by Aghion and Bolton in 1987 and the much more
recent paper by Segal and Whinston in the
March 2000 AER, pointing out that there are
externalities between buyers which can cause
problems here.

That is, if I sign up to a contract
perhaps as a result of a great inducement by the
IP monopolist, my signing up means I am excluded
from being a customer of the entrant.

Thereby my doing that, by making entry
less likely, I'm imposing a negative externality,
and negative effects on customers that have not
been signed up. As a result other buyers will
have to accept higher prices.
And a seller in fact can exploit this negative externality to extract more from other customers. To give an example, suppose there are fifteen buyers. The monopolist makes a profit of three dollars per buyer without entry. The gain to a customer of having entry would be five dollars.

And let's suppose that the entrant has -- let's suppose that the incumbent if he signs up five of the fifteen can exclude entry. Now, in this setting is exclusion profitable? Well, yes.

The incumbent makes three dollars profit for the fifteen buyers. That's forty-five. He has to get five of the them to sign up for a long-term exclusive contract. And to do that he has to pay them five dollars each which is there prospective gain from entry.

He ends up making a profit of twenty. Now, exclusion won't always be profitable. We can cook up cases where it wouldn't. But note in
this case the five who signed long-term contracts did exactly what Posner and Bork said they should do.

They got paid off enough to make it worthwhile their signing up and forgoing the possibility of dealing with the entrant. However, this buyer versus buyer externality comes into play here because the ones that didn't sign up then have to pay higher prices without this payoff as a result of the first five having signed up.

Anyway, there are several papers that go over this sort of story in a general way. And it's clear that in principle long-term contracts extending past patent expiration date can be anticompetitive.

MICHAEL KATZ: Joe?

JOSEPH FARRELL: Well, I think a lot of economists wonder what the legal restriction on patent extension is all about because there's another well known paper in the economics
literature by my colleagues Rich Gilbert and Carl Shapiro that argues -- they argue this in the context of intellectual property design rather than IP holder practices -- argues that it's good to have a long but small stream of royalties rather than a short and large stream of royalties because that collects the same IP rent with the same incentives for innovation but at a lower deadweight loss than the system we have.

And so that I think has led a number of economists to wonder what the lawyers think they are doing coming down on patent extension.

Now, David Sibley just described kind of a contrary modern view which is that there's such a thing as not just extension in the Gilbert-Shapiro sense where you're taking the same rents but over a longer period of time, but what I would call some version of leverage whereby taking them over a longer period of time you actually increase the total amount that you get in an anticompetitive way.
And without taking the time to give
all the links, I will step to my second point
which I assure you is related.

Professor Shapiro more recently has
suggested in the context of settlements to
IP litigation that a good rule is to allow
settlements if and only if they leave consumers
unharmed relative to the but-for world in which
the litigation continues.

And from an antitrust point of view
that seems like a very natural proposal. But
let me suggest a slightly different perspective
coming back to this IP extension question.

Suppose that you have an IP settlement
of the kind perhaps attacked by the FTC. And
suppose you believe that the FTC was right that
that was a nakedly anticompetitive deal ex post.

That is, there were no efficiency
benefits from whatever else they were doing. It
was just effectively extending the intellectual

property term from the statutory period to the
statutory period plus.

Well, if you treat that as of the date of agreement, which I think is what Carl's suggestion would encourage you to do, then it's basically creating an, if you like, monopoly. I think in those cases it would be a monopoly for an additional X years. That's pretty clear I think how a competition agency ought to view that.

However, there is a different way of viewing it which I hinted at in my earlier presentation. And this perhaps relates to the questions about the Sonny Bono act.

Suppose you view it not as an isolated incident unforeseen by anyone, but as an instance or the beginnings perhaps of a general tendency whereby the life of certain categories of intellectual property is extended from the existing statutory period to the statutory period plus X years.

Now, if you think that's going to be
taken into account by potential innovators, then
that's equivalent not just to the creation of an
additional X years of some sort of monopoly.
It's equivalent to Congress having made a
somewhat different choice in its choice of the
statutory IP period.
And if that is taken into account
enough to have the effects on innovation
incentives as well as on ex post market power,
then you're really asking would it have been bad
for Congress to make that alternative choice
instead.
And one view is, well, Congress made
the choice it did for a reason, so, yes, it would
have been bad. And I think that may be about the
best view we can take although certainly easily
attacked.
But economists are fond of pointing
out that hills are flat on top. And so if you
have a relatively modest extension of IP rights
that is fully foreseen at the time of potential
innovation, the overall social losses from that
extension are not measured by the ex post
increase in market power.

They are measured by what to an
economist is at least for a modest increase a
second order variation in the basic IP policy
trade-off.

And I don't really now how to resolve
this. I think there are elements of both the
ex post X years of unnecessary monopoly, and the
ex ante change in the IP policy trade-off.

And I think it's going to be very
important for the consumers of these hearings to
develop a coherent view on whether we're doing
antitrust ex post and say you have that monopoly
now stop because any further monopoly is totally
unjustified, or whether we're integrating it with
IP policy in which case you're really looking
more at that second order effect.

MICHAEL KATZ: Thank you, all three of
you. Let me -- I think we're running out of time
and this is a city where it's important to have
your power lunches, let me just summarize a few
things -- perhaps not as much a summary as my
view on some of the economics of this issue and
then just summarize the day which will be very
brief indeed.

The following view I think is an
oversimplification. But I think if you're going
to start somewhere it is probably the right
oversimplification which is a lot different than
the way a lot of people think about these things.

But I think it is what we've heard
from the economists which is throwing extra
things in a package of licenses or IP that's not
needed or an agreement to extend the royalty
payments beyond the life of the patent.

None of those things increase the
bargaining power of the patent holder vis-a-vis a
single licensee. Now, I think that's important
because of an awful lot of at least complaints
one hears. And I suspect the private litigation
is that a single licensee claims that somehow
this has disadvantaged that licensee.

They are forced to pay for things they
didn't really want or somehow this is dragging out. And while one can construct at least theoretically situations where there are problems, I think in fact those are quite delicate and fairly subtle theories.

And I think what we're hearing today is the things that really matter, at least that economics would identify, are the effects on third parties.

So it arises either because there are multiple licensees and the actions of one licensee can affect the other, or because even if you have a single licensee you may still have consumers of the product that uses the patent. And they certainly can be harmed.

And that's where one then gets into issues such as is intellectual property being just used as a cover or a sham for supporting a cartel. And that also is where one could be concerned about having running royalties that extend beyond the patent.

Because if what you have is the
licensor and the licensee are competitors in a downstream product market, then the fact that you're charging this running royalty is going to elevate the price to the ultimate consumers because even -- one reason is fairly obvious. The licensee of course is paying the royalty and that's a cost and that's going to tend to raise their price. But also the licensor is going to recognize, at least if it has economists somewhere nearby, that it should raise its price too because it's competing with someone to whom it's selling its intellectual property and it should take that back into account that if it wins sales away from the licensee it's actually forgoing some license revenue. So both of those effects will tend to push then both firms' prices up and consumers will be harmed. So there are good reasons to be concerned here, and there are issues to address. But I think they typically are not the ones that are the most widely stated, the notion
that somehow the single buyer is being exploited

or forced to buy things it doesn't want.

And even in the case where it's

said that by having the package it's either

diminishing the incentives to invent around or

diminishing the incentives to challenge validity

or enforceability, at least work I've done and

others have done suggests that actually is very

delicate.

I think Joe may disagree with me on

how delicate it is. I believe he skipped over a

slide where he talked about that. But it comes

down to an issue of timing and commitment. And

it's far from obvious -- I think Joe probably

will agree with me on that.

It's far from obvious that the package

licensing does have the effects that are claimed

and there's really a lot more work to do there

which will turn me to summary for the day. I

think we probably have agreement across the panel

and the audience that these are difficult issues
There is an appreciation for the efficiency benefits of sophisticated licensing practices including bundling which has been developed over the years.

And certainly the IP guidelines issued by the two agencies, you know, if nothing else they were putting down a marker to say, look, rule of reason is the way to think about these things because there clearly can be efficiency benefits.

But also recognize that there can be harms. For better or worse it seems that we're largely stuck in a world of rule of reason. And I'll finish on an upbeat note which is to say these are difficult problems and there are certainly times when all of us have made a mess of them. But I think there is reason to believe we are getting better at muddling through.

And the thoughts of the people such as on this panel and the other panels we have had in
the IP hearings I think are pushing us forward.

And as I say, these are going to remain difficult issues.

But at least I think the more egregious errors are going away and we're going to be worrying about narrower and narrower issues. So let me ask you all to join me in thanking the panelists today. I will remind you we will reconvene with a different moderator at 1:30. Thank you.

(Lunch recess.)
AFTERNOON SESSION

(1:30 p.m.)

WILLIAM STALLINGS: Good afternoon and welcome. We're very glad that you have joined for what we expect will be another interesting session of these hearings. My name is Bill Stallings. I'm a trial attorney here at the Antitrust Division.

We're here today to discuss how to handle antitrust analysis when dealing with disputed or uncertain intellectual property rights. This subject is particularly important to the agencies as IP issues are arising in antitrust investigations with more and more frequency.

As Professor Shapiro stated, a compelling case can be made that intellectual property disputes are increasingly important in
determining just which firms can compete in which markets and on what terms.

At the agencies we often find ourselves faced with difficult issues about whether and how to take into account the quality, strength, or scope of underlying IP right when is making decision about a transaction's competitive effects.

These issues arise from many contexts.

For example, imagine a relevant market where only two firms compete. Firm A says that its patents block the field and that its rival, firm B, is in the market only because it is illegally infringing these patents.

A is suing B for infringement, which B defends by claiming that the patents are invalid or that it simply does not infringe. Now, let's say that the two firms decide to merge. How should the agencies analyze the competitive effects of such a transaction, especially those effects that arise from disputed patent rights?
A will likely argue that competition is not lessened because the only competition taking place was illegal competition that the antitrust law should not protect. Yet B was competing notwithstanding the infringement allegations. How should the agencies value such competition?

As another example, patent license agreements often contain terms restricting competition between the parties. Such restraints may as the guidelines state serve procompetitive ends by allowing the licensor to exploit its property as efficiently and effectively as possible. Yet they may also raise antitrust concerns if they harm competition that would have occurred absent the license. How should the agencies assess competitive relationships between the parties with the strength of the underlying patents in dispute? The agencies may be concerned that the
parties are agreeing to terms that fall outside the scope of the patent right or that a, quote, unquote, weak patent, if there is such a thing, is being used to justify a cartel arrangement.

Definitional issues also arise in patent pooling arrangements where a key fact is whether the pooled patents are blocking patents.

This is important to ensure that the pools contain complementary IP rights and not substitute IP rights.

It seems clear that a mere assertion the patents are blocking should not indemnify a combination for antitrust scrutiny. The question though is how far must the agencies go in conducting a full scale review of scope and validity to assess antitrust risk from combining patents.

In analyzing these types of transactions several common questions arise that warrant discussion today. For example, when should parties to a license, merger, or other
agreement be treated as horizontal competitors if
IP rights are in dispute?
How should the agencies take into
account a patent's presumption of validity?
Should the agencies even question the relative
strength of a patent portfolio? If so, using
what standards? What is the impact on incentives
to innovate from scrutinizing agreements
involving disputed IP?
How do we balance that impact
against the incentives of parties to use such
arrangements to achieve a potentially undeserved
cartel outcome? And finally as a matter of
resources what steps should the agencies take
to resolve these issues?
Joining me in representing the
agencies is John Hoven from the division's
economic analysis group, Suzanne Michel, counsel
for intellectual property at the FTC, and Edward
Polk, an assistant solicitor at the U.S. Patent
and Trademark Office.
Now for some brief introductions of the members of our panel in order of their appearance. I refer you to the handout that provides complete biographies. I'll just give abbreviated ones.

Doug Melamed is a partner in the Washington, D.C. office of Wilmer, Cutler & Pickering. He serves as cochair of the firm's antitrust and competition practice group.

Prior to returning to Wilmer, he worked in the Antitrust Division for four-and-a-half years, serving first as principal deputy assistant attorney general and then as acting assistant attorney general.

Joseph Kattan is a partner in Gibson, Dunn & Crutcher's Washington, D.C. office. His practice focuses on antitrust litigation, counseling, and agency representation.

Molly S. Boast is a litigation partner with Debevoise and Plimpton in New York. Ms. Boast served in the Bureau of Competition of
the FTC from 1999 through 2001, first as senior
deputy director and then as director.

Joseph Farrell is professor
of economics at the University of
California-Berkeley where he's also chair of the
competition policy center and an affiliate
professor of business. Professor Farrell was
recently deputy assistant attorney general for
economics in the Antitrust Division.

Gregory Vistnes is a vice president
at Charles River Associates in Washington, D.C.
where he specializes in the economic analysis of
antitrust and competition issues.

He recently was the deputy director
for antitrust in the FTC's Bureau of Economics.
Before that he was an assistant chief in the
economic analysis group at the Antitrust
Division.

M. J. Moltenbrey is as of today a
partner in the Washington, D.C. office of
Freshfields, Bruckhaus Deringer. Until March
2002 she was director of civil non-merger enforcement at the U.S. Department of Justice Antitrust Division. She was at the Antitrust Division in a number of capacities before that.

Salem Katsh is a partner with Shearman & Sterling in New York where his practice involves counseling and litigating intellectual property issues.

And finally Joseph Miller is an assistant professor of law at the Lewis & Clark Law School. He is formerly a trial attorney with the Antitrust Division where he worked on numerous cases involving the intersection of antitrust and intellectual property.

Before we get started into the discussion, there are a couple of brief housekeeping details. Our location here today in the Great Hall creates certain security concerns. The basic rule is that if you are not a DOJ employee you must be escorted around the building.
Antitrust Division paralegals who are wearing name tags highlighted in green escorted you into the Great Hall and they are available at the back of the room to escort you back out of the building should you need to leave the session, to the restroom, or upstairs to the seventh floor where you can make a phone call if you need to.

To compensate for the inconvenience we do have coffee, soda, and water at the back of the room.

This afternoon's session will be a combination of presentations and discussion. We will hear presentations from each of the panelists in groups of two with discussion periods following thereafter. We'll also have a fifteen-minute break in the middle of the session.

And because we want to leave plenty of time for discussion and because we have a large panel today, we have asked that each of the
panelists limit their presentations to ten
minutes. Now let's turn to our first
presentation from Doug Melamed.

DOUGLAS MELAMED: Thanks, Bill. I
don't know how I was selected to speak first, but
I think it's probably fitting because I really
have more questions than answers and more
problems than solutions to talk about.

My view which was I guess first
implemented when I was actually acting AAG and
asked M. J. Moltenbrey to chair a working group
at the division to think about the intersection

of antitrust and intellectual property issues.

For the most part those issues are not
conceptually novel.

That is to say, when you can assume
the intellectual property to be property, I think
as the guidelines say as a general matter the
antitrust analysis is the same of that kind --
with respect to that kind of property as it is
with respect to any other kind of property,
mindful of course of the particular factual differences because all antitrust investigations and inquiries obviously have to be attentive to factual differences.

I know there's a dispute about whether that similarity between IP and other kinds of property really applies in the case of unconditional unilateral refusals to deal. But with that possible exception I think it does apply.

The difficult issue, the really novel issue in my view that the intellectual property poses for antitrust enforcement arises however in the increasingly frequent circumstances in which there is a bona fide dispute about the scope or validity of the intellectual property that is material to the competitive analysis.

And as Bill pointed out correctly, this can come up in a variety of ways. It can come up in contracts, litigation settlements, joint ventures, mergers, pooling arrangements,
cross license arrangements, and you name it.

And it has the common feature that if

the intellectual property is what the holder of

the property claims it to be, then there is no

lawful competition being eliminated by the

horizontal agreement.

If however the intellectual property

is not what it is claimed to be because it has a

problem of validity or a problem of scope, then

under many circumstances there would be

competition that could not lawfully be prohibited

by the intellectual property, and if the

agreement serves to eliminate that competition

it obviously raises competitive questions.

The problem is exacerbated by the fact

that often the parties to the agreement have an

anticompetitive incentive to prevent the

resolution of the underlying question or

uncertainty about the intellectual property.

They have that because if let's say

the party who is calling into question the
validity or scope of the intellectual property is somehow unusually or uniquely situations to do so, either because it has unique access to information that might enable it to challenge the patent or copyright, or because in, for example, the Hatch-Waxman circumstances, it has unique incentive by reason of being a unique opportunity to compete.

Then it and the intellectual property holder have a common interest in preventing a resolution of the underlying uncertainty because if the intellectual property is found to be invalid or so narrow in scope as not to block the field, then not only the challenger but potentially numerous other challenges could compete, and there could be no supercompetitive profits for anyone to take in that particular market.

If on the other hand the intellectual property is not challenged and is deemed to be valid, there may well be supercompetitive profits
to be earned, and both the putative challenger and the intellectual property holder might agree it is in their interest to share those profits and put an end to the intellectual property dispute. 

So I think it's a conceptually serious and difficult problem. Based on my experience at the Division and some experience since then, I think it's one that has real impact in real markets because mergers are done where one party says the acquired firm couldn't have competed against me because of the strength of my patents, and one doesn't know if that's true. 

Litigation is settled. Contracts are entered into on similar arguments and one doesn't know whether it's true. 

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Now, the easy case which has been the subject of the Abbott, Geneva, and Schering-Plough cases brought by the FTC is a case in which the agreement between the parties, in those cases litigation settlements, eliminates
more competition than could have been lawfully prohibited even assuming the validity of the intellectual property claimed.

In that case of course one could argue using analogies to traditional antitrust doctrines that the agreement is more restrictive than necessary to achieve whatever legitimate purposes one might think there is to repose and settlement of intellectual property disputes. And one could condemn the agreement on that ground without having to grapple with the hard question of was the intellectual property holder entitled by reason of his IP to prevent at least some of the competition that was prevented by the private agreement.

Another case that may be easy if the facts are right is a case in which the fact finder can comfortably conclude that in the absence of the private arrangement between the parties there would have been competition, pending some resolution of the intellectual
property claimed either because the putative infringer sort of dares the IP holder to bring a lawsuit, or because in fact there is pending litigation and they would have litigated it. But in the meantime, they would have competed. In that situation it seems to me it's fairly easy to say, gee, the agreement eliminated competition; what's the justification for that. And maybe at this point some of the ideas that Joe Miller suggested in his paper -- I don't want to steal his thunder -- come into play and that is at the very at least you put on the IP holder the burden of demonstrating something like the showing that he has to make to get a preliminary injunction with respect to the likely strength and validity of his intellectual property. Or you make the acquired firm or the would be challenger do something akin to the failing firm defense to show that in fact there wouldn't have been competition. But that's a
dispute about the facts where the parties are really saying, no, there wouldn't have been competition in the absence of this agreement.

And again if you assume that the fact finder concludes there would be competition, it seems to me there's little justification to let the parties by a private agreement eliminate that competition on the ground that maybe they were entitled to eliminate it because of the intellectual property.

To state this however does not it seems to me give much comfort that there's a way to solve many of these problems because I think it's going to be an unusual case where one can prove there actually would have been competition in the absence between these parties in the absence of their agreement.

For one thing, well counseled parties in most situations can avoid that by consummating their merger or consummating their agreement before there's been a history of competition.
under the cloud of the IP dispute and before therefore there is a sufficient factual basis to make a confident prediction that if the IP dispute stayed clouded competition would nevertheless ensue.

So the hard question -- the hard case and the likely case I think is a case where there is a private agreement that eliminates competition that one suspects might have taken place, but you can't prove it actually would have taken place, although you think that if the IP were plainly invalid it would take place, and if the IP claim were upheld of course the parties wouldn't be entitled to the competition.

And there are it seems to me several unsatisfactory alternatives for dealing with this.

One is simply to say let the would be antitrust plaintiff prove that the intellectual property is not in fact sufficiently valid or properly -- the scope of it is properly construed
to be sufficiently broad to entitle one of the
parties legally to prevent the competition from
the other party.

I think that's an unsatisfactory
solution because in that situation the parties
who probably have the best information and the
best incentive to know the truth of the matter
about the underlying intellectual property would
be aligned against the government.

They would be the IP claimant and the
putative infringer who now have a common interest
to defend their agreement and argue that the IP
is valid because it seems to me that you are now
making an antitrust plaintiff prove not only an
antitrust case but a challenge to a patent or a
copyright at well.

And that strikes me as raising the
bar to effective antitrust enforcement very high.

Another way to do it is simply to say we're going
to deem the intellectual property to be valid.

After all it is presumed to be valid in the case
of patents under the patent law. End of the
matter.

That has the obvious disadvantage of
course of allowing weak, flimsy, barely plausible
intellectual property claims to escape scrutiny
because the IP holder can pay off the would-be
challengers with some kind of a transaction which
enables them to share in the market power.

And the third party like the
government would not be able to challenge it.
The alternative of course would be to say
intellectual property is never deemed to be valid
until it's upheld in a court.

And the premise of this of course is
that our intellectual property system as everyone
knows to some extent depends on litigation for a
final resolution of the validity of patents, and
it assumes that the initial grant of the patent
will be no more than a presumption of its
validity.

The problem with this of course is
that it prevents legitimate settlements and
legitimate transactions whether there is an
intellectual property cloud. It probably tilts
too far away from the interests of repose and
efficient marketplace transactions.

Let me suggest then as my final
unhappy resolution of all this an approach that
may help in some cases to navigate through this
what I regard as a difficult conundrum.

I would imagine an antitrust rule that
might say that an agreement that eliminates a
real prospect in a potential competition sense or
in the sense of materially basing entry barriers,
a real prospect of competition would be illegal
even if there were a claim that the electric --
that there were intellectual property that
entitled the parties to eliminate their
competition, if the following three conditions
are met.

First, the other elements of an
antitrust claim are satisfied. That is to say,
there was injury to competition in the market as
a whole and so forth.
Secondly, one of the parties to the transaction, the one I called here the putative infringer, is in an almost unique position to challenge the intellectual property. So the resolution not only eliminates the prospect of that they will compete, but materially reduces the likelihood that invalid intellectual property will in fact be found to be invalid.

And here as I suggested earlier there might be a circumstance where someone has a unique ability to challenge it because of its position in the industry, or a unique incentive to challenge it because of its uniqueness in the potential entry sense I suppose, capacity to compete against the IP holder.

And the legal analogy for that element would be the potential competition cases or vertical foreclosure cases where one basically says you can't buy off someone who's uniquely positioned to create a likelihood of competition in this marketplace.
And the third element is that you examine the agreement between them rather than the underlying IP which the premise of this proposal is the agencies aren't equipped to evaluate IP even in a probabilistic sort of Carl Shapiro-like sense.

Instead you look at the agreement between the parties and you ask the question do we have reason to believe that this agreement between the parties entails a sharing of supercompetitive profits.

The easy case here is where the IP holder pays the infringer to go away. One would not expect under very unusual situations -- I'm sure Joe Farrell with some game theories can imagine. One would not ordinarily expect in that situation at least where the payment exceeds the expected litigation or transaction costs.

One would not expect to see that happen unless the IP holder were in effect acquiring insurance against the fact that its IP claim would be found to be invalid.
And ordinarily of course parties
can't buy off potential competitors as insurance
against their rivalry. Now, it's easy to state
in the so-called wrong way payment cases
like that.

It's harder to know how one would
determine by examining an agreement whether it
involved the sharing of supercompetitive profits
from this particular market if the agreement
were more complex and there were a variety of
situations going ways or if it were a merger and
one were trying to extract from the complete
aggregation of assets the particular overlap
involving the IP.

But it seems to me that asking that
question and focusing on that issue might at
least enable the antitrust agencies to bring a
coherent antitrust case in some instances without
the necessity to prove -- resolve the underlying
intellectual property claim. Thank you.

WILLIAM STALLINGS: Now we'd like to
hear from Joe Kattan.
JOSEPH KATTAN: Like Doug I think that we have a problem for which we only have unsatisfactory solutions. I think that there are solutions that are more satisfactory perhaps though then the solution -- or the non-solution -- should I just go down there?

WILLIAM STALLINGS: It would probably be easier.

JOSEPH KATTAN: But I think there are solutions that are less unsatisfactory than the ones that we've opted for as a default matter. And that's what I'd like to discuss. So I'm going to skip the slide about the problem because I think Doug has described it.

And I'll talk about the non-solution that we live with today. And the non-solution is that we assume that any two parties that compete are legitimate competitors, and that until an injunction has been issued that stops the infringer from continuing with the infringement the two parties ought to continue to compete.
And we subject them to exactly the same antitrust analysis process to which we would submit any two parties. And there are two rationales for that. There is a typo there. A is the one that should be getting enjoined, not B.

There are two basic rationales for that. One is we say, look, antitrust is already complicated enough without getting it bogged down with IP issues; the antitrust agencies don't have the expertise to deal with the complexities of IP disputes after all.

A patent case may last many, many years, and how do you compress a patent case into the life span of a short antitrust case? And this is particularly true in the context of mergers where how do you take a five-year patent case and compress it to the four or five months of the Hart-Scott-Rodino review period?

And second of all, consumers should have the benefit of competition until we get the
injunction. And I guess I fundamentally disagree
with those premises.

The notion that we don't have the
institutional expertise and therefore shouldn't
get bogged down in IP disputes reminds me of the
joke about the economist who is looking for a key
under a street light when in fact the key was
misplaced somewhere else where it's a little
bit darker.

And the economist is asked why are
you looking for the key here, and the answer is,
well, because I can see better over here. So the
fact that we can see the antitrust issues better
than the IP issues doesn't mean that we can just
sidestep them.

We do a lot of other things in
antitrust analysis that are very complicated. We
do very complicated econometrics, particularly in
merger cases in recent years.

So I don't think that that's an
answer. And giving consumers the benefit of
competition until final resolution of the IP
dispute assumes that there is an entitlement to
competition.

I think if we take the extreme case of
the people who will sell you a copy of Windows XP
for two dollars on the streets of Hong Kong, I
think everybody would agree that that is not
legitimate competition. And that's not the
competition that we ought to give consumers the
benefit of until there's an injunction issued.

Obviously the cases which the
antitrust authorities are called to act upon are
a little bit more complicated than that. They
are not as clearcut as that.

But if we believe that there is a type
of competition which is not legitimate because
it's founded on misappropriation of somebody's
trade secrets or infringement of fundamental
patents -- and obviously the importance of the
patent itself is another complicated factor --
then I think it's a copout to say, well, let's
just give consumers the benefit of competition.

Now, the fact is that there are different dynamics in merger and non-merger cases. I think in non-merger cases the parties have a much better chance to try to turn the -- or to bring the IP case into the antitrust case.

I know that when we litigated the Intel case against the FTC we wanted to bring in some patent issues because the FTC was taking the position that certain patents were valid and infringed.

And we ultimately got a stipulation from the FTC that we would not litigate the patent issues if they would not take the position that certain patents were valid and had been infringed.

I think in merger cases it is a lot harder to force the agencies to deal with the IP issues. You're racing against the clock. And if the agencies don't want to deal with the IP issues and are not going to be persuaded by them,
then your next stop is a District Court. And it's pretty hard to convince the District Court judge that a PI hearing under Section VII should now also be turned into a minitrial on patent issues.

But having been there, having told -- clients who have said to me but they've built their business around my stolen trade secrets or on my patents, it's very frustrating to say to the client, well, I see your point, but it's very unlikely that you will be able to persuade the agencies. There is another complicating issue here because the alleged infringer isn't going to be willing to come in to say to the agency, well, I admit it; I really infringed; it's a valid patent and I know that I infringed it. They know that if the deal goes south even if there was a claim that there was intellectual property that the patent is invalid. So the parties can't even present the united
The one practical suggestion that I have -- and it's worked once. Who knows if the stars will ever align again for that kind of solution to work?

It was where the infringing party agreed to waive attorney-client privilege vis-a-vis the agency, let the agency look at its files, and presumably be in a case where its lawyers have told it that it infringes and the patent is invalid.

And if the acquirer stipulates that it's not going to claim a waiver of the attorney-client privilege on that basis and there is no risk that a third party would claim waiver, that's potentially a way to get around this problem. But, as I said, the stars have to align and they very seldom do.

My imperfect solution is that the agencies need to get better IP capabilities.

Litigate to the death can't be the only solution.
It's ironic because judges just absolutely hammer litigants to settle their disputes. And then they come before the agencies, and the agencies evince hostility toward any kind of resolution that enables the parties to share in the value over which they are fighting.

And my bottom line is this. Particularly in merger cases the agencies are engaged in a predictive exercise. And it's a predictive exercise that has many uncertain dimensions. Bringing in predictions about the resolution of an IP dispute complicates the picture to be sure. But it certainly is something that's going to lead the agencies at least in the direction of making the right decision more often. I'm not talking about a full-blown trial of patent cases. I realize that is impractical. But to the extent that the cases bolster their IP capabilities, hire people who
understand patent cases, who know how to litigate patent cases, know how to evaluate patent claims, part of the predictive exercise can be evaluating the strength of the patents, the strength of the infringement claims, the strength of the claims of invalidity, and reaching some prediction about how the litigation would wind up if the parties were to litigate to the death.

There are lots of other complicated issues that I have glossed over, things like not all patents where there is a determination of a valid patent that has been infringed result in an injunction. Lots of patent cases are resolved with licenses, where the licenses have been ones with running royalties or lump sum royalties. Maybe the parties would have entered into a cross-license that would have enabled both of them to compete. Those are all legitimate questions for the enforcement agencies to ask in questioning whether the settlement through an acquisition is the only resolution.
But the current non-solution which is
to say we're not even going to concern ourselves
with the IP issues I think is something that
needs to be looked at. And by augmenting the
agencies' resources with IP counsel, perhaps we
will get a better handle on the problem than we
have today.

(Applause.)

WILLIAM STALLINGS: Thank you. During

the discussion period if panelists want to make a
point, just raise up your tags like that and we
can recognize you. Probably to lead it off
I think that both Doug and Joe mentioned
probabilities and predictive exercises.

I think a lot of you know that
Professor Gilbert and Professor Shapiro earlier
in these hearings have put forth models trying to
look at the probability of patents being held
valid and the agencies relying on that type of
theory. I was wondering if there was any
reaction to how such type of theories work in
DOUGLAS MELAMED: My reaction is it is probably easier to litigate a patent case and let the Judge decide than it is to determine in the absence of a decision what the probability is that the Judge will decide your way.

And then in any event, I don't know how you go to a Judge and say we're asking you to make a decision about what the probabilities are as to the truth of a matter in dispute.

So I just don't see it as either really economizing on the problem here which is scarce capacity to evaluate the IP claim or as lending itself in any easy way to the normal litigation models that I think we apply in the Antitrust Department.

WILLIAM STALLINGS: Salem?

SALEM KATSH: Well, I don't have a comment on the two papers, so.

WILLIAM STALLINGS: We'll come back to you.
JOSEPH FARRELL: I think Doug

obviously has a point. It's not going to be easy
to get probability based on assessment into the
Judge's head or into the record if you can't get
a decision.

I think there are circumstances where
you can get evidence about the parties' beliefs
about the probabilities out of their behavior.
And you can then put those probabilities into
some sort of rule of reason.

Sometimes you can do that. Sometimes

you can't do that. I suspect more often you
can't. But I don't think we should give up on
the possibility you can. But subject to that I
mean I think agree with Doug's core point there.

WILLIAM STALLINGS: Are you thinking
that you would look at some type of evidence of
intent of what the parties subjectively --

JOSEPH FARRELL: No. I'm thinking
partly of the kind of situation that I've seen
where a party continues to compete in the
marketplace despite claims of infringement and
is willing to indemnify its customers.

Or perhaps that's not an essential
element if the customers are aware of the claim.

And that gives you some bound on the competitors’
and/or the customers' estimate of the probability
that the patent will be found to be valid and
infringed.

Now, whether you need to take that
estimate out and plug it into a different formula
or whether you can say in a qualitative way
competition with indemnification is legitimate

competition, I don't know. You have to think
about that in a particular case.

WILLIAM STALLINGS: Salem?

SALEM KATSH: I just have a couple of
comments on very good presentations. One is that
I think it's important in terms of settlements of
litigation to distinguish between that context
and the merger context. You can prevent two
ongoing companies from merging and they are left
where they are.

If you prevent the settlement from going through, then where are you? The defendant in many, many cases wants to settle because he can't afford the cost of litigation, because he's not in a sufficient -- his cost of capital is too high. He does not want to litigate.

And one of the problems I see in the proposals that are being put forward is the assumption that if a settlement is found to be anticompetitive that somehow the defendant can be imposed upon to continue to fight. And that is not -- that's not in my experience very normally the case.

In terms of Joe's mention of the attorney-client privilege, as somebody that has split his career between antitrust and patents and the last fifteen was focused on patents, I think the opinion that he mentioned, if it was an opinion by defendant's counsel that his client had a bad case, it's maybe the only such patent
opinion that's been written in history.

There is no such thing as a written opinion given to a putative defendant that tells him he's in a dangerous position of infringement. And the reason for that is that those opinions are always written to ward off the possibility of willful infringement. They are always written that there's no infringement, that there's no invalidity. If they can't find a grounds for saying that it's not valid, they will leave it out of the opinion. And if they can't find anything to say, they won't say anything.

JOSEPH KATTAN: You're right.

SALEM KATSH: So I think the prospect of finding opinions is illusory.

JOSEPH KATTAN: That was actually a real case.

SALEM KATSH: And I take it there are exceptions to every rule. And finally I would just like to underscore that I agree that conduct
evidence, conduct evidence in my experience is very probative. And I completely disagree with the Federal Circuit's treatment of the pretext issue in the Kodak case.

I think that the way a company comports itself with respect to its intellectual property rights says a lot about how it thinks about those in the ordinary course of business and how it talks to investors and how it views it in terms of its shareholders and its capital value.

And when you have a flip-flop on that suddenly in the context of litigation, I think that's worth examining and may be probative.

WILLIAM STALLINGS: One thing I forgot to mention to the panelists, if you can make sure you pull a microphone towards you, the acoustics here are not very good, and especially with some noises. Molly?

MOLLY BOAST: I'd like to just make a practical comment in response to Joe's point
about the difficulties of dealing with this in a
merger context and then throw a question back
to him.

The practical comment is that at the
Commission at least we did not turn a blind eye
to the relative validity or strength of the
patent -- the party's position in the patent
dispute. We did in fact usually take a look at
it. We were often unable to get a final answer.

But in at least one case that I can
remember we told the parties what our take on
the likelihood that they would prevail was and
suggested that if they disagreed with that they
seek mediation and resolve their dispute and come
back to us with the results.

And they did that in the space of

And it turned out that the mediator
agreed with us. And we then went forward and,
you know, that was an effective market for
purposes of the merger.

And I mention it simply because it
might not work in every instance. But it's at least one more approach to consider putting in your tool bag when you're dealing with a merger with disputed intellectual property rights.

Moving away from the practical, the question back to Joe is that as I understand it in the case of the pirate infringer the patent holder will be made whole through the damages system. I mean that is theoretically what happens. Why under those circumstances is it not appropriate -- what is the social cost of permitting what you label the legitimate competition if the patent holder is made whole at the end of the day in the face of the pirate?

JOSEPH KATTAN: Well, I think that the assumption that the patent holder will be made whole at the end of the day is not necessarily a valid one. There are lots of companies whose business is built around other people's IP and who go out of business without being able to make
the other party whole.

The other thing that you are avoiding is years of litigation. And there is a social value in avoiding the years of litigation. I understand that the agencies take the position that they would -- the agencies would like certainty on the antitrust side of the ledger. And that is something that is a legitimate consideration for an enforcement agency.

On the other side of the ledger the parties themselves value certainty, the ability to go about your business knowing who your competitors are, whether you're going to have to confront this party that you think is a pirate which may or may not be a pirate, or whether you're going to have the what you thought was the twenty-year monopoly that the patent granted you, assuming again that we are talking about a fundamental patent.

There's a huge value in certainty
to parties that are in the business world. And that's what they are seeking when they enter into settlement. That's the main driver for settlement.

MOLLY BOAST: I would have thought you might have also been concerned about reduced incentives. If you really have a pirate and they are allowed to compete for an extended period of time, what does that do to innovation incentives over the long term?

JOSEPH KATTAN: I don't think private parties are concerned with innovation incentives. I think they are concerned with their bottom line. So I wouldn't presume to suggest that any of my clients were concerned with preserving the incentives to innovate when they sued somebody for infringement.

MOLLY BOAST: No. But I was talking about the social costs in the broader context.

WILLIAM STALLINGS: Professor Farrell?

JOSEPH FARRELL: Well, let me pick up
and be almost a little pedantic if I might about Joe Kattan's Windows example. He mentioned Windows offered for two dollars on the streets of Hong Kong. And, first of all, let me say of course I agree assuming that happens it is illegitimate competition.

But I think the question for the enforcement agencies is not so much is it illegitimate competition, because that one is a case in which that's easy to see. And there are a lot of cases where that's hard to see.

So it seems to me the question might be given that you have -- you can't really condition the rule on whether it's easy to tell that this is illegitimate or not, is it okay for Microsoft if its attempts to enforce its intellectual property in other ways fail to go to these street vendors and pay them off to stop competing.

That would be something that given our knowledge of this illegitimate competition we
would think I assume would be okay. But that
would raise hackles based on the extrapolation to
cases in which it's a little less clear that the
competition is illegitimate.

And it seems to me the panel's reaction to that slightly harder case -- or let's
take -- you know, I don't know what a slightly harder case still would be.

But imagine that you are not quite 100 percent sure that the competition is illegitimate and you see the dominant firm going to these competitors which it claims are illegitimate and doing something, let's say, that would be nakedly illegal such as paying them to shut down were it not for that.

If that makes us uncomfortable, then I think it's difficult to say the rule should be, oh, you should shut down or not try to preserve that kind of competition once you step outside the street vendor hawking an illegal copy. And I wonder if you have a reaction to that or
others do.

JOSEPH KATTAN: Yes. They are clearly hard cases. And the preponderance of cases are going to be difficult cases.

The question is then do we just make the assumption that all competition is legitimate and that an acquisition of an alleged infringer to the extent that standard antitrust analysis fully divorced from the IP dispute would tell us it's problematic should not be allowed?

Or should agencies at least internally try to make an effort to get a better handle on the parameters of the IP dispute and to try to make a cut as to whether there is a reasonable probability that the patent is valid, that it is infringed, and that the competition is, if you will, illegitimate, just as they make a prediction as to the likely effects of an increase in concentration on prices and innovation in a market?

Those predictions very often turn out to be incorrect. Much of the time they turn out
to be correct, and that's the nature of a 
prediction.

So I don't know why you would exclude 
something which is fundamental to the analysis. 
It is a central part of the analysis. Why would 
you exclude that from the analysis simply because 
we say, well, it's too hard to do and we don't 
know how to do it very well, therefore let's bury 
our heads in the sand?

WILLIAM STALLINGS: I think we're now 
going to hear a presentation from Molly Boast. 

MOLLY BOAST: Thank you, Bill. Well, 
this entire intersection, if you will, is an area 
of keen interest obviously within the Bar, but 
to me personally as well since the Commission's 
Hatch-Waxman settlement challenges were developed 
and brought during my tenure there. 
And since I've been away from the 
government for slightly under a year, I've had 
the opportunity to consider some of the arguments 
that were made surrounding those cases that I 
think have broader applicability and have finally
come up with some tentative thoughts.

I will give myself the protection of saying that I'm not sure I even agree with what I'm about to say. But at least for purposes of this discussion what I'd like to do is raise some of the questions that were -- that we considered internally and some of the arguments that were made to us and give you my responses as of today.

And as I said, I think these are applicable outside the Hatch-Waxman context. So the points should be considered general points unless I narrow them.

The first is a question that I think can be readily disposed of, and that is do the positions that the FTC and Department of Justice guidelines for licensing intellectual property take on potential competition foreclose a challenge to parties where there is the absence of proving infringement.

Section 3.3 of the guidelines is much cited, and it says for analytical purposes the agencies ordinarily will treat a relationship
between a licensor and licensee or between licensees as horizontal when they would have been actual or likely potential competitors in a relevant market in the absence of a license.

And this is thrown up often as a statement that agencies really must go out and prove the infringement or non-infringement, validity or invalidity of the patent.

First of all, this passage occurs in the guideline sections that are really addressing relationships that have both horizontal and vertical components.

And the question there is how do you weigh the overall effects of these various arrangements; how do you assess the overall competitive effects. And I don't mean to be taking the position that that language ought to have no role in looking at a purely horizontal relationship.

But I certainly think that it has been given much more emphasis than what was intended when that language was included in the guidelines
just by mere placement of where the passage occurred.

Secondly, the language by itself speaks to probabilities. The section says the parties will be treated as likely potential competitors.

There is no suggestion that this should impose some rule of certainty on the agencies in the guidelines themselves. And it would be a mistake I think to elevate it to something more than that.

And the third thing is the guidelines are what they purport to be. They are guidelines. They don't and they shouldn't trump actual facts.

I think everyone who has been heard on the point at this point agrees that actual conduct, what we see in the parties' behavior, what we see in their recorded records of their behavior, is much more valuable than abstracting some -- elevating some kind of principle like this into the analysis as dispositive.
And they certainly -- the guidelines shouldn't be used to cabin prosecutorial discretion in this area, particular where there's a large potential for consumer harm.

A second question that was confronted and alluded to again by others is what role in the agencies' antitrust analysis should be played by the presumptive validity of a patent. And my answer to that is almost none.

The presumption applies in infringement lawsuits. It is a procedural device. It is not evidentiary in the courts. It's simply a burden shifting tool and by no means provides a final answer about patent validity or not.

And there is no presumption of infringement. Even with the presumption of validity operating in its favor, the patentee still bears the ultimate burden of persuasion on infringement claims.

And second suggesting somehow that
derived presumption should require the government
to give some additional layer of deference to
disputed IP rights when it's making an
enforcement judgment really makes no sense to me.
It's simply adding a layer of
defferece where the courts have already done
that. And that would I think unduly constrain
antitrust enforcement.
And I guess we are perhaps also
influenced or at least I am in my view here
by data that suggests that the significant
proportion of issued patents are ultimately
determined to be invalid in any event.
So the presumption wouldn't actually
apply in all instances anyway. The third
question and the issue that was confronted is
can the agencies challenge a licensing
arrangement that takes place within the life of
the scope of the patent.
Doug made the point at the beginning
that the Hatch-Waxman cases were perhaps the easy
cases because the conduct or at least a portion

of it really was outside the scope of the patent.

And indeed if you look at the series
of decisions that have come out in private
litigation in this Hatch-Waxman context, you will
see that the courts are often very focused on
things like the manipulation of the exclusivity
that the Hatch-Waxman statute affords.

The premise of this argument that the
agencies ought not to be concerned about conduct
that takes place within the life and the scope of
the patent is that the patent gives the power to
exclude for the duration of the patent. So
anything less than that can't be anticompetitive.

And the problem with this approach it
seems to me is that it elevates the presumption
of validity into certainty or near certainty.

The power to exclude -- and this is one of the
points that Professor Shapiro has made -- is
really no greater than the strength and breadth
of the patent itself.

And that may indeed be quite uncertain. And so for this reason I think there ought to be little room for the argument frankly that I was pushing Joe on, that a potential infringer is competing illegally.

As I understand it -- and I am not the IP lawyer that he and Salem are -- the patentee has no right to exclude an infringer who is competing unless and until the infringement is proven. That is what the system is set up for. And I completely take his point that there are costs to the parties in terms of their need for certainty and the likelihood that they won't see this through to resolution.

But I don't see in the law or on any policy basis a reason why somebody should have something greater than the power to exclude once you have proven your right to it. And finally the power to exclude gives the patentee the unilateral right to refuse to
license its intellectual property but does not
give it the right to insulate a horizontal
agreement on the timing of entry, for example,
whether that takes place within or without the

It seems to me that the analytical
process ought not to change even if the agreement
is reached within the scope of the patent.
And the fourth question is in some respects a
variation on this and again one that others have
alluded to: does the antitrust plaintiff have to
prove the but-for world.
This is the argument of course that
the plaintiff must litigate the patent case to
prove that a competitive relationship existed.
Or put otherwise, it must show that the agreement
was more anticompetitive than the outcome of the
litigation would be.
Now, in the Hatch-Waxman cases this
is made relatively easy because the statutory
framework essentially treats the pioneer firm and
the generic firm as competitors by requiring that bioequivalency be shown before the generic firm can pursue the abbreviated new drug application. Outside that context I would readily concede it can be more difficult. But from a litigator's point of view frankly the argument doesn't make practical sense and I don't think that courts -- they haven't and I don't think they are likely to embrace it. By definition a settlement or license means that there will be no judicial determination on a validity or infringement situation. So to impose this requirement post hoc on an antitrust plaintiff is a very circuitous judicial route to evaluating an agreement. And as I said, the courts have not done this thus far. The several decisions that have come out surrounding the pharmaceutical cases, every court that I am aware of that has been asked to
address this question straight up has either
rejected the argument or found another way to
analyze the problem that prevented it from having
to move in that direction.

In a settlement context the parties
often argue that the settlement in fact reflects
their assessment of litigation risk and therefore
the plaintiff must prove the but-for world. Show
us why this isn't in fact appropriate given how
we assess the litigation. This is just a
variation on this same point.

But at least in the cases where
monopoly profits are being shared I would
suggest that the negotiating incentives can be
sufficiently skewed that there is really no
reason to assume that the settlement in fact
reflects an assessment of litigation risk.

It's not necessarily a proxy for that.

And I think that it would be very risky to
operate from that assumption and indeed the
agencies haven't.
This also raises of course the practical problem of how to read behind the parties' motives when internal assessments of the strengths of their patents except for Joe's waiver of attorney-client privilege are likely to be withheld under privilege claims.

And this is something that in a merger setting I think is more likely that you would counsel considering, parties considering sharing a privileged assessment.

Once you are outside the merger setting I dare say it would never happen because there is almost always going to be private litigation following non-merger government litigation. The plaintiff's bar tends not to pursue the mergers.

In any event from the government's point of view I think it is also risky to think that access to counsel's opinions would necessarily give you any greater degree of certainty about the likelihood that the
settlement accurately reflected the outcome of
the litigation if you believe as some seem to
have suggested that these opinions could be
capable of manipulation.
If you believe that there are
anticompetitive incentives that can drive toward
a settlement, why wouldn't that trickle down into
positioning the opinions in the same way?

So those are my practical year old,
year later thoughts on some of the tough
questions we addressed, and I look forward to
people's responses.

WILLIAM STALLINGS: Thank you.

Professor Farrell?

(Applause.)

JOSEPH FARRELL: I want to talk about
an issue that came up several times this morning
and that I think is central to the whole
IP/antitrust issue, not by any means the only
question, but I think it is a central question
and it is a very difficult question.
And that is the question of incentives to challenge intellectual property. So, for example, Carl Shapiro, as someone has already mentioned this afternoon, has put forward the view I'm sure others have talked about too that intellectual property and patents in particular are not really rights to exclude; they are tickets to sue.

This perhaps is particularly crucial if we suspect as many do that there may be a lot of weak and invalid intellectual property rights granted in the sense of -- given at an earlier stage.

My colleague, Mark Lemley, has a paper where he engages in some back of the envelope cost/benefit analysis and suggests that when you take into account subsequent litigation test of intellectual property, it may actually be quite rational for the initial patent examination to be relatively cursory.

So all this suggests that patent
challenge, intellectual property challenge and
defense, and resolution is really an important
part of the system, that it's completely wrong to
think about it as taking place essentially at the
Patent Office and after that it's just fighting.
My colleague Rich Gilbert suggested
earlier here that antitrust agencies might take
it upon themselves to challenge intellectual
property in a few cases and yet suggested that
those cases should be the ones where spillovers
are most marked and therefore where the private
incentive to challenge intellectual property is
most likely to be inadequate.

Following along the same idea that
there may be inadequate private incentives to
challenge intellectual property, Joe Miller
suggests in a paper that was circulated for this
meeting that perhaps there should be some kind of
bounty system for successful challenge to
intellectual property.

So all of this is just some -- these
are just some of the reasons why it seems to me that challenge is essential to understand.

And just to give you a very brief -- or at least my understanding of why one might well think and I tend to think that private incentives to challenge intellectual property may be badly inadequate.

End users, final consumers typically benefit in the ex post sense, that is once the invention has already been made, typically benefit from a successful challenge to intellectual property, but are relatively unlikely to be in a position to bring a challenge.

More often a challenge is brought by somebody downstream from the intellectual property holder but not in fact an end user. And in those circumstances where there are a number of competing such potential licensees if one of them successfully challenges the intellectual property then the intellectual
property is invalid as to all potential licensees.

That as I understand it is the Supreme Court decision in the Blonder-Tongue case. And what that means is since competition is largely a relative performance scheme that the successful challenger reaps only a part and quite possibly only a small part of the benefits.

Other parts go to its rivals and perhaps the biggest parts goes to final users or to downstream participants.

So even leaving aside anticompetitive incentives to settle, there are reasons to think that incentives to challenge are a lot less than the incentive to challenge that you would think arises if you think of a single licensee who in economic incidence terms, that is really -- and not just according to the checkbook is paying the licensees.

However, that does not necessarily mean as we might think that the private
incentives to challenge are too low because
in order to understand whether the private
incentives to challenge are too low you have to
not only understand whether they are lower than
you might think.
You also have to understand what the
right incentives to challenge are. So how would
an economist set about understanding what is the
correct, what is the right, what is the efficient
incentive to challenge a disputable piece of
intellectual property?
Well, the natural way for an
economist to set about thinking about incentives
to challenge is to ask what's the benefit, the
net benefit from a successful challenge, because
if you can say what the net benefit from a
successful challenge is both to the challenger
and to society as a whole, then you'll get the
comparison between incentives to fight for that
result.
So we can certainly say that if we
take an invention as given, if we take the
invention as having been made, then the social
gain from successfully challenging a piece of
intellectual property -- and let's look at just
the simple case where it's a single product, the
patent does confer monopoly, and there's no
cumulative investment incentives or anything
like that.

The social value is either you
save the loss of the deadweight loss from that
monopoly. That's if you take a total surplus
standard. Or if you take a consumer surplus
standard you save the deadweight loss plus the
monopoly profits.

And it's possible to stop there. And
you could compare that against the benefit which
any individual licensee might get privately from
a successful challenge.

And then I think you would find very
often that the private incentive to challenge is
too low. However, my main point for today is
that that may be the wrong place to stop because on the one hand you can't take the view that, look, here's this invention whether correctly patentable or not. It's been made.

The patent system has some rules for whether it's appropriate to reward that with a period of exclusivity. And it turns out that the answer is, no, it doesn't. It isn't appropriate. And discovering that seems like a good thing, and how good a thing.

Well, you're saving this monopoly power that otherwise was being gratuitously given to the intellectual property holder. That's one point of view. I think it's got something to it, but I think it's not completely right.

And the other point of view that I'd like to put forward for consideration has something to it as well. And that's the following: that any colorable claim to intellectual property, if that's rewarded there's likely to be some effect on innovation
incentives.

Maybe more, maybe less. That's going to depend on a lot of things. But there's likely to be some effect. And if there's some effect, then there's going to be some effect on future innovation.

And that ought to be taken into account too. So if a piece of intellectual property or a piece of asserted intellectual property is successfully challenged, on the one hand you save what you might call the overcharges for this product.

On the other hand, inevitably you're going to influence future innovators' expectations to some degree about how much reward they're going to get from their innovation.

And so the second, different contracting approach -- the first approach, remember, was, well, this invention has happened, and now the question is, is the IP holder illegitimately extracting exclusivity.
The second approach is to try to integrate it more with intellectual property policy as a whole and to ask not only what's the effect given the invention that's happened, but what's the effect on investors' expectations of future rewards to future innovation. And I think it's important that this has to operate through expectations. Obviously this invention has already happened whether it was patentable or not. So the question is if you challenge -- if you successfully challenge that and the patent is overturned what happens to future expectations. Is this challenge to intellectual property linked in the minds of future innovators to the treatment of their efforts? And that's by the way a different question potentially from can lawyers distinguish and say, no, no, this was decided on this grounds and that's not going to apply to your more legitimate invention. It seems to me that competition policy
needs to take on as a job conveying to potential innovators as well as others what's going on. So if innovators are mistaken as to the link, you know, that's something that needs to be taken into account.

So what potential intellectual property is weakened by a decision that removes claimed intellectual property?

So one special case which might be interesting to think about is can there be cases where there's no innovation effect, where the original approach of saying, no, the social benefit to overturning this weak intellectual property is just that you save the deadweight loss or the deadweight loss and the profits.

Well, basically what you're saying here is there needs to be no spillover from this successful challenge to future innovative efforts and thus no effect on future innovation. This is a pretty strong condition.

Invalidity or certain forms of
invalidity are really not enough for this. So suppose you take an invention that has -- where there was some contribution but not a large enough contribution to rise to the level of patentable.

What does that say? Well, it says that Congress thought or the Congress and the courts have thought that the trade-off between giving and not giving protection to this innovation should be resolved in favor of not giving it.

But that doesn't mean that there's no contribution, and it doesn't mean that in thinking about a program of innovation somebody won't be influenced by the treatment of this kind of innovation.

So the special case where there's no innovation effect is going to be I think fairly special. A second, perhaps more provocative special case is where there's a uniform innovation effect. What do I mean by that?
What I mean by that is think about a successful challenge as causing potential innovators to think, okay, the probability that I can successfully sustain intellectual property has just gone down a bit. And it's that same bit for all future potential innovators. So of the long history of intellectual property policy and decisions, this is a part. It fractionally reduces that probability.

Now, fractionally reducing the probability that you can sustain an intellectual property claim, it turns out if you write down the economic formulae to be a lot like fractionally reducing the lifetime of intellectual property.

And so just like patent extension techniques, including perhaps settlements, certain settlements, you can think of it as varying the effective lifetime away from the statutory lifetime.
In the case of successful challenges, varying it by reducing it. In the case of successful extensions, varying it by increasing it. So what about things that are like changing patent life? So here is where I want to combine two of economists' favorite tools, a diagram and an assumption.

I'm going to assume a diagram which actually should be over there, and then I'm going to give some thoughts by comparing what's going on to Congress's judgment.

I apologize if it's not very readable. I tried to do this in PowerPoint, but I haven't yet figured out all the twists and turns in there.

So in this picture on the horizontal axis I've put the effective length and strength of intellectual property. And on the vertical axis is the total social benefit of the intellectual property system as a whole.

And what I have here is an inverted
U-shaped curve. And the goal of intellectual property policy should be to choose a length and/or strength to put us at the peak of that curve.

Now, if you think about some technique of patent life extension that increases the effect of patent life from the statutory life -- call it A -- to something a little longer -- call it A-prime -- if A is indeed at the peak, then A-prime by definition is lower but only a bit lower because if you're at the peak things don't fall off very quickly as you move away from the peak.

It's true that if Congress had chosen too strong an intellectual property protection system so that we were not starting from A but from B here on the right of the curve where it's already falling, then extending to B-prime would be seriously bad.

But it's also true that if we were on the left part of the curve starting at C where the curve is still increasing, then extending
from C to C-prime is actually good. So what do
we do given that we don't really know where we
are on this curve?

Well, I don't know, but in some sense
it's not clear that we can do much other than
assume that Congress didn't predictably get it
wrong, in which case a patent extension of this
kind involves a loss.

But the loss is not the whole
deadweight loss or deadweight loss plus profits.

It's rather the trade-off between that and the
increased intellectual property protection.

So this, remember, is the case where
we have uniform effect, not the case where we
have no effect. And of course it's not a more
complicated case because I can't handle that.

If we think about a successful
challenge, that's running in the other direction.

So a successful challenge takes us perhaps from
A-prime to A, perhaps from C-prime to C, or
perhaps from B-prime to B. And depending on
where we think we are on the curve, that's going
to give you different effects.

So my bottom line here is in thinking about the incentive to challenge which as I say I think is a very important challenge in this intersection of antitrust and intellectual property, it's not clear that we're getting enough of the picture if we just look at the ex post effect in the market that we're talking about.

It's not clear that we shouldn't try to integrate this with intellectual property policy. Unfortunately if you do that the results are a lot less clearcut. So let's step back and say do we really have to do that integrating.

We don't have to do the integrating if we're willing to say in some rather absolute sense that we had the right intellectual property policy and so marginal extensions may be marginal but they're still bad.

You don't have to do it if you think that there is no effect, as you might think if this is an unpredictable extension of patent.
Or perhaps most interestingly you don't have to think, well, all of these curves are all very well. But they don't really deal -- and I think this is right. They don't really deal with the fact that this is not a change in overall policy. And an increase in effective intellectual property protection as a change in overall policy might be one thing. This is not that. It's the private parties deciding that they are going to grab more protection in this particular case. So I think that's an appealing argument, but I also don't know -- you know, suppose it is that. But suppose you have a pattern that allows that to happen. In what substantive way exactly is that different from policy change? Or to put it another way, the policy change might itself be rules onsetsments, on other policies that allow this kind of thing to happen. So like Doug I have a lot more questions than answers here. It just seems to me
that, A, we need to think more about incentives
to challenge. And, B, I think it's a good idea
to think about it in an integrated context rather
than separately.

(Appause.)

WILLIAM STALLINGS: Thank you. I
think right now we'll take a short break, and
then we'll pick up on the other presentations and
some more discussion after the break. If we
could, reconvene at 3:10. Thank you.

(Recess.)

WILLIAM STALLINGS: I think we'll
start back up with a presentation from Greg
Vistnes.

GREGORY VISTNES: Normally I don't
like to speak after so many others have spoken on
the same subject in a panel like this because I'm
afraid they will have taken all the good
questions and good issues.

But fortunately on a panel talking
about practical problems in IP there are
certainly enough problems to go around for
everyone. So I think there will hopefully be at
least some new things for me to be talking about.

What I want to talk about is -- and
I've been evolving very much since I started
trying to put together. To put it in the context
of what Joe was saying earlier with the economist
searching around for the keys, I am very much
thinking that with some of these IP problems
we're very much groping around in the dark.

It's just tough to find the keys out
there. And I certainly don't want to go so far
as to say we should move on over to where the
lamp post is just because the light is
better there.

But at the same time I think we need
to recognize that it is so dark with some of the
issues having to do with IP determination that we
need to do something more in order to shed
some light.

And certainly I have no disagreement
with Joe that anything we can do to shed light to
get more expertise at the agencies to be able to

But at the same time I think that
	hat's going to be a pretty dim candle at the

towards the end of the day and that somehow we need to be

worrying about how can we search more effectively

in the dark to try to get at some of the answers

for the IP issues.

Clearly the uncertainty having to

do with IP affects all different manners of

antitrust investigations whether we're talking

about patent pools, whether we're talking about

mergers between firms that may or may not be

rivals depending on the validity of their

patents, having to do with likelihood of entry,

all sorts of patent/IP type issues.

What I want to be discussing and far

less today than when I first started out to be

advocating a move towards rules, but to be at

least discussing the possibility of implementing
additional rules to try to help us find some
light in this dark area.

I guess my basic tenet is that having
been through at least a few of these both on the
side of the government and on the other side
although of course still with the government's
end goals is that I don't think the agencies are
well situated to determine the status of IP
claims.

And that has nothing to do with the
skills or the tenacity or the abilities of agency
individuals. But it's simply that the agencies
are responsible for far too many industries to be
able to build up sufficient skill in this area.

I think that there far too often
especially in the context of mergers substantial
time constraints which preclude any significant
light being shed on some of these issues.

And there are obviously going to be
some significant information constraints which
will prevent them from coming to the best
determination on IP issues.

Clearly at the end of the day an agency decision is going to require some very subjective determinations. And as others have pointed out, everything the agencies do has some subjectivity about it.

But I think looking forward in the area of patent or -- I keep calling it patent, but IP validity involves much more subjectivity than usual. Current IP status is not always relevant even to what's going on depend on the type of case.

It may be important to figure out what the parties thought at the time they entered into an agreement which could have been two or three years in the past and try to figure out information on that. That old information will be even more difficult to do.

Some of the issues regarding the agency determinations on IP status is any agency decision about status on IP is going to pose
some problems. First of all, any decision, any
determination the agencies come to is very
clearly going to be subject to future challenges.

Any IP determinations on even private

contexts outside of the agencies coming to a
decision is often subject to challenge. It's
even more likely that what the agencies do will
be subject to challenge when they have to do it
under such time and information constraints.

Certainly once the agency makes its
decision as time marches forward more information
will come to light that additional information
will likely affect the decisions that would be
made which makes the challenge of an agency
determination even more ripe. It makes it almost
certain that challenges will come about.

I'm not so sure that those subsequent
challenges of agency determinations on IP are
necessarily good things for the agencies to the
extent that their decisions on IP if they are
continuously challenged and often overturned,
I think that takes away a certain amount of legitimacy of the agencies when they are acting in this area, especially if they are trying to break new ground.

And finally the question emerges how will agency determinations on IP status affect any parallel litigation that's going on outside the agency context, being in private litigation or in the patent dispute. Certainly decisions can be made on what I'm calling here expected values or probabilistic values. Basically, hey, we take the best information we have and sort of you pay your money you take your chances. We figure that the patent validity is maybe 40 percent. And we've put it into, whether explicitly or not, some sort of a probabilistic perspective. Yeah, we can do that. But there's so much barrier that's going to be associated that I don't think that's going to solve many of the problems.
So what I was at least thinking originally is to what extent can we be substituting rules for individual IP assessments. And clearly that's easier said than done. There are clearly certain benefits of rules. It reduces cost; it's for everybody.

It increases certainty about the process. It increases speed of resolution. And hopefully it will avoid some parallel litigation of IP issues. Again there are also costs associated with implementing rules. Sometimes you are going to get an ex post bad call. That's clear under a per se type rule even. You always have to admit the possibility of a bad call.

The rules will generally not even utilize all the available information. And defining rules may be very difficult given the complexity and the variety of the issues at hand. So like I said, easier said than done. There are certainly some goals that can be considered in trying to figure out how to
implement a rule.

And one is recognizing the rules involve significant trade-offs, basically trying to balance the harm from allowing bad conduct versus preventing the blockading of preventing good conduct.

You need to balance those two types of errors. The other balance that's going to be is in timing of any type of decision on how the rule works in that the longer you defer a decision the greater the information that you're likely to have. And that will more likely let you achieve a better decision.

A deferred decision is not necessarily a better decision overall though. Justice delayed is justice denied I think is the saying. The question arises is market power more likely in markets with IP. And this goes towards how you want to be setting up a rule and what sort of things should rule be focusing on.

There is a question that if you think
that anticompetitive mischief is more likely,
perhaps in designing a rule you want to be more
conservative or more aggressive. I'm not sure
what the right adjective is. But you want to be
more inclined towards blocking behavior because
you think it's simply more likely.
You may want to focus on rules that
somehow reduce the uncertainty associated with

IP issues. And that is, as you think of rules
having two possible end results. One is you can
either go for the grand slam and try to get the
rule that gets the right answer every time or at
least most of the time.
Alternatively you can try to come up
with rules that basically reduce the uncertainty,
in essence sort of focus the area of searching
underneath the street lamp.
And maybe the best example I can think
of here is when we're talking in the context of
Hatch-Waxman cases where one of the rules is, for
example, we don't like reverse payments.
Well, if you implement a rule we don't like reverse payments, then one way of getting around that rule is to say, well, let's sort of cloud the whole issue by having all sorts of side payments. In other words, it won't be a payment purely to stay out, but we'll trade other sorts of licenses back and forth, just kind of muck up the whole water so you can't really tell if there's a reverse payment.

Well, the rule there if you reduce some of the uncertainty may be that in any situation where there is a patent involved and some uncertainty that a payment with respect to the patent has to be patent specific. In essence you can't muck up the water with all these other side payments. I'm not sure that's going to be an implementable rule or a good rule, but at least it should hopefully give the concept of what I'm trying to get here.

A very important point which is quite
obvious is that I'm afraid often not fully taken
into a context, a rule has been resistant to
gaming. Any rule you can come up with, there are
going to be some huge incentives to get around
that rule.
And again I'll go back to the example
of a rule that says thou shalt not do reverse
payments or backwards payments, whatever the
language is on some of these patents in
Hatch-Waxman.

Well, if that's the rule, it's fairly
easy to get around by, as I said, throwing in
some other parts to the bargain so it's no longer
so obvious that there is a reverse payment

going on.

To the extent you can base your rules
upon unambiguous conditions, that should be a
useful guideline in trying to come up with rules,
and again focus the rules on areas that are
classified by the greatest uncertainty.

Go where the bang for the buck is
greatest. Try to use the rules to again -- back
to the street lamp example. Use the rules to
push you to where you're then most likely to be
able to find things using the candle that you
have left available to you.

So in summary, the agencies I think
should very much try to limit their role as much
as possible in determining individual IP status.
Again the more they can do to figuring it out the
better. But I just don't ultimately have that
much confidence they will get too far.

And then try to design rules that
address the inherent uncertainty associated with
markets. Again anticipate strategic responses to
any type of rule design.

And then the last question -- and I
certainly don't have the answer -- is will the
drawbacks associated with trying to implement
some of these rules be greater than the benefit
of the rules themselves. It's going to depend a
lot on just exactly what the rules look like.
Thank you.

(Applause.)

WILLIAM STALLINGS: M. J. Moltenbrey?

M. J. MOLTENBREY: I find myself in large agreement with a fair amount of what Greg said. But I'm going to try not to repeat it too much. I think we've already had this afternoon a pretty good explanation of what the likely problems are that we are looking for solutions to.

Since this is supposed to be a panel that focuses on the practical side of things, I'm just going to make a few points about what I see as approaches that make sense for the agency drawing mostly on my experience as an enforcer and looking at some of these problems and trying to figure out where resources should go and how we should approach the problem.

The first thing I want to say is that because we're looking at least in part for practical responses, there doesn't have to be a...
single answer. The question whether there should be -- for example, whether there should be rules that can be applied to simplify the analysis may make sense.

I don't think that -- I actually believe that there are some rules that can be applied that will simplify the analysis in some circumstances. But I don't take from that that the agency should never undertake their own independent analysis of the IP.

The basic problem that comes about here is -- the reason for the problems that we have here are that we rely -- our whole system relies on private agreements and private negotiation and private enforcement to limit the scope of patents and to prevent them from being used anticompetitively.

The problem comes up because the private incentives, the incentives of various private parties who are involved in various disputes are not aligned with those of consumers.
Often times what we have in other areas of law where we have a public policy we want enforced, a private party's incentives aren't going to line up perfectly as we have a public agency that's responsible for stepping into consumers' shoes and doing the enforcement. Certainly that's what we have on the antitrust side with respect to at least certain problems. We know that private enforcement is not going to be a substitute for public enforcement. To the extent the agencies can do it, can get the expertise, can get the resources and can challenge IP that is -- IP claims that are unduly restrictive to competition, I think they should do that and are perhaps in the best position right now of any agency or any system we have to have someone speak on behalf of consumers and represent their interests. But recognizing that that's not an immediate and perfect solution, the next step is
to think about how antitrust rules and how -- how we should analyze certain agreements among IP holders and other parties, recognizing what their private incentives are, and trying to find a way to maximize those incentives towards serving the public good and deterring use of IP for anticompetitive purposes.

We talked today mostly about two different types of agreements. One is -- two types of issues. One is how to deal with uncertainty of IP rights in the merger context. And I'm actually not going to offer too much there. I'm not sure that I have a lot of constructive solutions on that side. I think it's the trickiest problem. What I'm going to talk about instead are agreements between parties short of merger.

I think it's important to keep in mind that we tend to get distracted by this whole notion of settlements of lawsuits. There is no particular magic about an agreement between
parties being in settlement of a lawsuit in terms of what the competitive effects are, what the incentives are, and what the analysis is.

If I come up with evidence that I believe -- and decide that I'm in a position to perhaps enter a market by challenging either the validity of someone's patent or the scope of the claims that they have been making and thinking that I can compete, but I go to them and say, look, I've been thinking about entering this market; I'm not sure whether I need a license or not; perhaps you'd like to give me one on really favorable terms, and they enter into a license agreement that in some way is beneficial to both parties, I'm not sure that that should be looked at any differently than if they had first either started to manufacture the product and been sued or had gone in and sought declaratory judgment that the patent was invalid.

The basic competitive issues are the same in both cases. The fact that the one
agreement might be reached in settlement of a
lawsuit and the other might be reached -- the
same agreement might be reached before the
dispute really becomes choate doesn't seem to
be that important to me.

And when you think about it in those
ways you understand two different things. One,
this concern comes up much more broadly than just
in -- worrying about patent settlements is a
broad enough topic. But in fact the same
concerns apply to almost any kind of licensing
agreement or could apply to it.

So we're talking about more and more
types of transactions that you might worry about
here. But the second is that perhaps when you
go about analyzing them we've been looking too
broadly and been asking too hard of a question

about what the agreement is that we should be
challenging.

What I mean by that is it seems to me
that people say perhaps one of the things we need
to do is do we need to ask the but-for question:

But for this settlement would there be competition in the end, with the notion being that -- what the agencies will then be trying to figure out is if they enjoin the settlement will ultimately this litigation be resolved in favor of the patent holder or the alleged infringer.

Perhaps the but-for question we should be asking is: But for the payment of certain incentives, but for the sharing of monopoly profits would this case be settled.

And we don't have to answer the ultimate question as to how the litigation would come out. It seems to me an appropriate rule in the context of agreements to license intellectual property or agreements not to produce potentially infringing products.

That rule has to be carefully constructed not to disincentivize settlements of litigation.
infringers, on potential challenges, on new
entrants to require them to challenge patents, to
require them to challenge validity to say, no,
you're not allowed to decide you're going to duck
this particular problem and not take on the
burden of defending consumer interests.

If you want to have a rule that
says -- so that means that you don't want to
ever have a rule that says you can't settle
litigation; you're not allowed to get out of this
litigation.

The question you then want to ask is
why are they getting out of this litigation.
If the only reason they are getting out of the
litigation is because they are being compensated
with a share of monopoly profits and that but for
the sharing of those monopoly profits the answer
continue the plight.

What the public agencies want to do

is say you can't have that payment, not you can't
have that settlement. And so what you want to do
is separate those two out.

I agree with Greg that that buys a whole different set of practical problems. Yes, it is often going to be hard to determine whether or not a payment has taken place.

We've had some very obvious examples, and everyone is probably learning from those even as we speak that if you're going to pay an alleged infringer not to compete with you, you better do it in more disguised terms.

I don't think that having a rule that says you can't have such payments in certain circumstances solved every problem.

But I do think that in many circumstances the agencies are going to be better equipped to sort out those issues than they are to sort out the full underlying IP disputes that are going on, that sitting down and looking at a division of -- you know, at what the economic terms of a particular licensing agreement is

something more within the agencies' expertise
than doing the full-blown patent analysis

So where that leads me is that with respect to agreements that are between parties that lessen competition where you have disputed IP rights is I'd ask a series of questions.

The first is: Is this an area where we have market power? If there's no market power involved, obviously whatever types of settlements go on we should assume are not being motivated for anticompetitive purposes and are in the public interest.

The second is one that Doug mentioned: Are there relatively few challenges. I would probably broaden that somewhat simply to point out that when you decide how many challenges are out there in a market I think it's important to bear in mind the realities of IP litigation.

And even if you have multiple parties who are situated or perhaps have an incentive to perhaps challenge the validity of IP they may not
be temporally equivalent.

If you have someone who's on the verge
of going to trial who settles a case and there
are three pending cases by -- three challenges by
other parties out there but they are years away
from resolution, I think there's a lot of
potential harm there, notwithstanding the fact
that the issues may ultimately be litigated.

And so I would look not only at who
is a challenger but who is a challenger in the
immediate term. And then I would look for a
payment of -- a sharing of monopoly profit.
One of the issues that I've toyed with a little
bit -- I'm not sure that it works very well.

But it's to take those thoughts and
put them into some kind of legal construct and
say, gee, what is the legal analysis that leads
to this result.

And I think there's an interesting
lesson that can be learned by looking at
conspiracy to monopolize a law. If you look at
the analysis of agreements under section 2, the
analysis is a little different.

And I think a lot of it leads you to

exactly that type of inquiry, which is do you see

two parties who have an incentive to monopolize

this market, and is that what this agreement is

about, or is it really simply an agreement to

avoid litigation. Those are my practical

thoughts on some of the issues that came up

today.

(Appause.)

WILLIAM STALLINGS: Well, I've heard

from four panelists. I'd like to just open

up the floor for discussion based on the

presentations we heard earlier, if anyone has

any comments.

SALEM KATSH: I'd like to ask M. J.

a question about whether the market sharing of

monopoly profits would be a -- whatever, red

flag, yellow flag.

If one assumes that the plaintiff

or the patent owner has a valid and infringed

patent, why does it make a difference if he
decides to exploit it by sharing it with a
licensee on terms and conditions that are
acceptable to the patentee.

He may lack some capacity. He may not
other things. Why would that -- why is that a
solution rather than a sort of circular kind of
problem?

M. J. MOLTENBREY: Well, my answer
would be it goes back to the question that you're
asking which is -- the question is but for that
payment would the licensee be challenging the
scope or validity of the patent.

And if the answer is yes, then the
payment is not a payment to distribute the
product, not a payment to produce it. It's a
payment not to challenge the validity of patent.

And that's what I would enjoin.

If the answer is I've chosen to share
this and but for this payment I wouldn't be in a
lawsuit with this person trying to prove this
patent is invalid, I'd be out distributing
someone else's product, then I don't think you
have any concern whatsoever about it.

I don't mean to be too dismissive of the difficulties of making those factual determinations in any given context. I just think that they may be easier determinations to make than the ultimate validity or scope of patent determinations.

WILLIAM STALLINGS: Joe Kattan?

JOSEPH KATTAN: The thing that worries me about rules is that they tend to be mechanisms by which enforcers shift the burden of proof to defendants.

When the IP guidelines talk about agreements raising antitrust concerns when they eliminate or reduce competition that would have taken place in the absence of the agreement, I think they are not simply stating an enforcement policy by which the government is going to be bound in litigation.

I think they are also stating the state of the law on the issue, which is that the plaintiff in an antitrust case has the burden of
showing that the agreement has created anticompetitive effects.

If one wants to look at a rules regime in the IP context, one can look at the technology transfer block exemption the European Commission has adopted.

And I would ask the panelists here, particularly those who have spoken about rules, whether a regime like that which to me seems unduly rigid and has a lot of results that I think most people at this table would at least in some cases question as preferable to the rule of reason approach that we use here.

WILLIAM STALLINGS: Doug?

DOUGLAS MELAMED: I have a brief comment on what Joe said and then I want to go back to answer the question that was put to M. J. in a way that probably violates the subject of this conference which is to be practical.

I agree with Joe about rules. I think that if rules, whatever that means, are going to be attractive in this area what they should be
are ideas about how to think about the facts, to
draw appropriate inferences from the facts in a
rule of reason context.

They should not be formalistic rules for the reasons Joe has said. But I don't think
that, you know, a rule or a notion that says if
you identify parties that have -- to pick up on
what M. J. said, parties that have market power,
there is a bona fide uncertainty about the
intellectual property.

And there's something fishy -- I'll
come back to what that means in a minute -- about
the nature of the deal between them that you
can't from that infer that there is a sufficient
harm to competition that you meet the
requirements of the rule of reason.

I don't think that's a rule. I think
that's simply a way of thinking about the facts.

Now, for whatever it's worth it seems to me one
way of looking at M.J.'s notion or at least my
understanding of M.J.'s notion of is there market
whether it be a merger or a settlement agreement
or a license agreement or whatever between the
IP claimant and the putative infringer.
To think of it almost as an
exclusionary agreement of the type in which a
party with market power either induces an input
supplier not to furnish that input to anybody
else -- and here the analogy would be to pursue
the IP litigation in a way that reduces entry
barriers to everybody, and if you strike down or
reconstrue the scope of the patent.
Or simply bribe them not to compete,
you know, a BRI kind of case, kind of agreement.
And it seems to me what you do there is you ask
does this agreement have efficiency enhancing
properties. Here you'd be saying did it simply
economize on litigation costs.
Or you would be asking did it in fact
increase the efficiency of the exploitation of
the intellectual property because the licensee
really is much better able to build the machine
or to distribute the product or whatever it

might be.

And then you ask the other question or
maybe it's the default to say maybe it doesn't
increase efficiency. Maybe all it does is bribe
the input supplier not to facilitate entry by
others or the would be rival not to compete.

And you identify that bribe by saying
we don't think efficiencies could possibly
explain the consideration in this contract after
looking at the facts; we don't see that enhanced
exploitation of the IP. We don't see that a
zillion dollars in consideration is simply
avoiding litigation cost.

And then you can infer if you
otherwise think the defendant has market power
that what he's doing is he's using some of that
market power to bribe the rival of the input
supplier not to facilitate or to provide
competition.
And by analogy to these vertical
exclusionary cases or potential entry cases or
market allocation cases, you can say that's an
illegal agreement.

SUZANNE MICHEL: Let me ask a question. If one were to accept this concept that the antitrust plaintiffs might have a burden to show the but-for world, or if one were even interested in taking on the task of showing the probabilities that the patent was valid and infringed, what is the real question that we're trying to get at in that context?

And by that I mean are we trying to show outcome of particular litigation? Are we trying to show some more general -- make some more general determination of whether a particular patent is invalid from first principles, and infringed?

MOLLY BOAST: I will take a stab at that. I think I may well be wrong, but I think it flows really from Doug's point. And I think
what you are answering there is the question of
whether there's an efficiency in the agreement.

That is to say, is the licensing arrangement on whatever terms, you know, more

efficient than the outcome of the litigation?

SALEM KATSH: I would answer it this way. If you get in a position of asking that question, I think you're asking the wrong question because it can't be answered.

SUZANNE MICHEL: And by that question do you mean the question on the outcome of the particular litigation?

SALEM KATSH: Right. The ability to quantify or on a qualitative basis assess the outcome of a patent case is impossible. Now, you can get a feel for it. Sure.

But I think to go back to Doug's point and M.J.'s, if you have an agreement that appears clearly to be in restraint of trade whether because it falls within the category of sharing market power or otherwise is subject to some
traditional antitrust principle, that is where --
that is the question that should be asked it
seems to me.
And then I would say that although the
division does have the burden of proof I think

that to say that a but-for -- I think that's more
in the way of an affirmative defense than it is
an element of the government's claim.
And I think that in that respect this
entire discussion of presuming competition to be
illegal, and that's something that the defendant
has to establish, is striking from my point of
view.

SUZANNE MICHEL: Would you say that
the but-for world then is even a viable defense
if you're talking about trying to show the
outcome of particular litigation?

SALEM KATSH: It's a theoretical
defense. But there are so many ins and outs with
a patent you can't imagine what it's going to
look like when it gets finished, and the process
of going up and down and how many years it's
going to take, where the industry is going to go,
what other products are going to come in.

Right now you have an agreement.

Now, if the agreement is distributing -- private
agreement distributing incentives for production

and marketing and it's being justified on the
basis of the defendant is an illegal competitor,
I just find that something that would be
inherently suspicious to me. And I'd want
really convincing proof.

WILLIAM STALLINGS: M. J.?

M. J. MOLTENBREY: I guess I would
answer the question about what is it that
you're -- what is the but-for world to say it
might in different circumstances be any one
of those.

But what happens is that your relief
is different. The relief that you are seeking
and that you would be entitled to get is going to
be different.
I can imagine circumstances where you would be able to show -- and just to take an extreme, simple example, that a patent holder goes out and pays -- simply goes out and pays one of the few other firms that has underlying technology in the area and just walks in and says we're going to pay you a lot of money and you agree that you'll never challenge our patents. And as long as you do that we're going to pay you a lot of money. And if that circumstance I can imagine challenging that. There the challenge is to the payment, and it is to the agreement not to challenge. And you're not making any determination about the validity or scope of the patent. I can imagine circumstances -- they may be rare -- where in fact you could not only as a theoretical -- on a theoretical level but on a practical level get evidence of the likely outcome of a particular case. It may be very difficult and it might
depend a lot -- just to draw on some practical experience, it's a little harder to do that when you are looking at the early stages of litigation with years of discovery yet to go than it is when you're looking at a case that's been briefed on appeal and the issue that is raised on appeal is a very narrow legal one.

You may very well be able to make a determination about the likelihood of success there. And in that case again if you challenge that the relief you're getting may well be that particular agreement.

Whether or not that particular -- if it's the scope of the patent it will be whether that particular infringer is violating or not.

You may also have circumstances where the only alternative is to try the entire case, to put in the evidence. And the outcome is that the patent is invalid. The consequences and relief that you get from that are much, much broader. And obviously it is a much more
difficult case.

But I don't think there is any reason to narrow it down and say there's only one way to get at it. I think you just -- you are challenging something slightly different and you're seeking slightly different relief in each case.

SUZANNE MICHEL: If our goal is to take on the -- or to try to show the likely outcome of particular litigation, to what extent then do we need to get into factors like who are the lawyers and who was the judge and what were his propensities and is this really a doable thing?

SALEM KATSH: Why is this different than where the defendant raises the defense of a natural monopoly, that nobody else can exist in this market, and the defendant agrees? Why you would put the burden on those parties to prove that, I don't see why this is any different.

And you would approach that with a
fair amount of skepticism. Now, I would modify my prior remarks by saying if the patent has a history of being successfully enforced and, you know, that would be a factor.

And in this connection, the so-called secondary consideration under the patent law, you know, long felt need, penicillin, breakthrough discoveries, commercial success, prior judgments, sure. You know, that kind of case is different.

But if you're talking about untested patents, then I think you're in a very difficult situation to ask the but-for question up front.

WILLIAM STALLINGS: I recognize Ed Polk.

EDWARD POLK: I guess I agree with what was said there as far as the situation where it's just a payment itself and not so much where the underlying patent needs to be challenged.

But if you have a situation where it is about the underlying patent and you are in a case where maybe but for that patent there
wouldn't be a market there, it seems to me that
if you are just putting in rules where you don't
want to undertake that analysis you're trying to
get a speedier result possibly at the cost of the
truth of what really are the facts of that
situation.

Maybe it would be a good thing to
actually go with that analysis, to come with the
truthful result rather than the quick result.

WILLIAM STALLINGS: Joe Kattan?
JOSEPH KATTAN: It seems to me that to

answer your question you need to ask the ultimate
question which is what is the question we're
trying to answer in an antitrust case, and that
is whether the agreement creates, maintains,
upgrades, preserves, or -- creates or preserves
market power, and not whether the agreement is
contributing to efficiency.

And the only way that you can
determine whether the agreement is creating or
maintaining market power is to look at what the
but-for world would have been like. And if in
the but-for world you would not have had two
parties competing with each other, I don't see
how you can get to that ultimate result.

Now, it just so happens that a lot
of patent cases get settled after you have had
a Markman hearing. And after you have had the
Markman hearing you frequently have a pretty good
idea, not a dispositive idea, not something that
you can take to the bank.

But you have a pretty good idea of
where the case is going to wind up because the

Judge has basically told you now here's how I'm
going to be interpreting the claims of the
patent.

And once you've got the claims of the
patent interpreted, the rest of it is relatively
speaking fairly mechanical. So it's a difficult
issue.

But I think if we begin by saying are
you contributing to efficiencies, then you're
saying defendant prove to me that you have had
a good reason for entering into this agreement
rather than, plaintiff, prove to me that this
agreement creates market power, preserves market
power, prevents its erosion.

WILLIAM STALLINGS: Doug?

DOUGLAS MELAMED: I think Ed's comment
and maybe Joe's as well implicitly surface a
critical premise in this discussion. I say
premise. We can disagree about the premise.
Both of those comments it seems to me
assume the correctness of a pitch that was made
by a lawyer who came before the Division when I

was there with a merger in which the acquiring
firm had a passel, to say the least, of patents
and bought a competitor, a firm where the two
were actually competing.

They claimed that one or more of all
of this mess of patents entitled it to prevent
the acquired firm from continuing to compete with
it. And the lawyers said, look, if the patents
are valid there's no lawful competition here. If
the patents are invalid, there's no other entry
barrier. There's no competitive concern.
So either way you guys should go away.
And if one accepts the notion that a patent is
either valid or invalid and that the matter --
the increase should be as to the truth of the
matter, I think there's something to that
analysis.
There's another way of thinking of
patent law which I think has been alluded to by
several people this morning but I think it ought
to be surfaced.
And that is that the truth of the

matter is that a patent gives you certain
presumptive rights to act as if you own property.
But you don't own that property until after the
litigation process if any is completed and it is
determined what the proper scope and validity of
that patent is.
And if that -- if therefore the truth
of the matter is that you don’t own a patent
prior to the resolution of the litigation -- I
mean you don’t own a definitive right to exclude
would-be rivals prior to the end of the
litigation, then the but-for world or the truth
of the matter that is pertinent might well be
that there would have been competition or a
likelihood of competition notwithstanding the
patent claim and prior to the possible future
resolution of its validity.

And that competition, it seems to me
if you accept the premise that the intellectual
property laws do not assume either validity or
invalidity but rather assume uncertainty until a
resolution, that competition is competition that

the antitrust laws ought to be concerned about.

WILLIAM STALLINGS: I recognize Salem
Katsh who is going to make a presentation.

SALEM KATSH: It just shows that
eventually competition does induce innovation
because this was done on a Macintosh and now it's
being shown on a PC. I want to run through the slides because I want to make sure I pick up on the points that may not have been covered. The first point I wanted to make -- and this goes to the question of whether we should start with a but-for test -- is to consider historically the relative importance and weight given to the patent laws and the antitrust laws. And I think to the extent the agencies are waking up to this field today, they may well benefit from looking at what was considered axiomatic law when I started practicing sometime during the pendency of the IBM/Government case.

I don't want to tell you exactly how old I am. The patent clause in the Constitution doesn't say anything about licenses. It doesn't say anything about assignments. All it says is that the owner shall have the exclusive right to his discoveries. The antitrust laws and the FTC act are
broad based commerce laws, powers, that were
enacted to regulate contracts. The patent laws
contain no provisions for balancing the relative
innovative value of a patent to its competitive
costs.

Every patent is of equal validity once
it issues from the Patent Office regardless of
whether it meets the margin of patentability by
an inch or by fifteen yards.

The degree to which it passes the
bar of patentability may be completely out of
proportion to the amount of market power it
lends itself to.

I'm not going to read these, but if
you look at the Kodak/Goodyear case of the
Federal Circuit, the SEM/Xerox case, and the
FTC/DOJ guidelines, you'll see a completely
different philosophy of enforcement theory.

The Federal Circuit was saying it
didn't matter who owned the patent. The fact was
that if the patent had not been transferred it
five still could have been used to exclude

six competition.

seven So they were assuming a hypothetical

eight infringement action that would have been brought

nine that would have been successful whether or not

ten that would in fact have been the case.

eleven I think that -- and I've tried to

twelve carefully look at the cases since these chestnuts

thirteen back in the forties. I don't think the law has

fourteen changed in terms of Supreme Court pronouncements

fifteen about the relative status of the antitrust laws

sixteen and the patent laws.

seventeen The contract which M. J. may have

eighteen alluded to comes before the court. If it does in

nineteen fact lend itself to the interpretation that it's

twenty in restraint of trade, it comes -- the patent

twenty-one aspect is subject to that principle of general

twenty-two law and does not override it.


So there are many cases where the

Supreme Court has struck down pooling

arrangements, cross-licensing arrangements
without regard to whether the patents were valid or invalid.

It is true that as a matter of relief or subsequently the patents could have been enforced. But that would have been on their own merits. The agreements that parties reach privately should not be subject to the control of a subsidiary body of jurisprudence.

Now, I used that little clip art thing to try and illustrate what to me is a practical reality that many may not completely understand. The black spider-type thing up with the little red dots, if you can make them out, going into the funnel is meant to represent the patent.

Now, there's been a lot of discussion about patents conferring market power. But in reality it's a firm that will have market power, a firm with plant, property, equipment, employees, know-how, trade secrets, and so forth.

A patent is one component of the
firm's overall assets. And it is, as has been
mentioned, simply a cause of action. One can
call it a property right if one wants to, but all
it means is that you can bring a lawsuit.

The patent lawyers are fond of always
emphasizing that a patent does not give you the
right to practice your own invention because
there could be a patent that blocks you. All it
gives you is a right to bring a cause of action.

And the misuse doctrine to the extent
it still exists -- and there's maybe something
left of it -- was a doctrine that was adopted by
the Supreme Court based on the fact that the
patent owner was appealing to the court of equity
to exclude other people.

And the Court held that equitable
principles -- irrespective of whether there was
an antitrust violation, equitable principles came
into play in terms of whether that patent would
not be enforced.

I mention here that there are other
situations beyond the patent case where defenses have relied upon private property rights, that the government was attempting to reallocate private wealth.

And they were subject to various defenses such as ruinous competition, failing company. There was the Fashion Originators Guild case where the owners of creative designs got together to police against pirating.

All of those were struck down -- I mean that case in particular was struck down as per se illegal because it was a resort to self-help.

And some of the arguments you hear about the presumptive legality and value of patents sound like similar arguments that have been treated with some skepticism by the agencies.

Now, the Xerox case in the Federal Circuit has thoroughly complicated the situation confronting both the private bar and the agencies.
and does present a unique opportunity for the United States as a plaintiff, or the Federal Trade Commission, to take action so that their cases will not come before the Federal Circuit for review.

And I think this is a point that the Federal Circuit has basically adopted the syllogism that because the patent gives you the right to exclude, almost any condition that you attach to giving a license is immune from antitrust attack.

No weighing, no attempt to look at the but-for. The license agreement is per se valid unless you meet the requirements of Professional Real Estate and sham litigation, unless there is an enormous fraud on the Patent Office, or unless there is a tying arrangement.

Why the court threw in tying arrangement I'm not sure. It was in one portion of its opinion and it's not in many other articulations by the Federal Circuit where they've allowed only sham and fraud as the two
grounds for challenging a patent suit or a patent agreement.

Think about how the Supreme Court would have treated the argument in Aspen or Lorraine Journal if in Aspen they put forward as a defense that the ski company had a patent on the chair lifts used on Highlands Mountain. Anybody who thinks that the result would have been any different I think is wrong. Aspen owned the three mountains and it was obliged to open its -- it was obliged to waive its right to sue for trespass. That is what antitrust courts do when there are found to be serious antitrust violations even in a single firm context.

In Lorraine Journal, the Journal established a policy of not carrying the advertisements of anybody who advertised with the new entrant, the radio station. Suppose the Journal had gotten a business method patent on how it ran advertisements? So but for the infringement of the
patent -- in other words, they would have the
absolute right to refuse to license their patent.
And that would be somehow different from what
they did which was to refuse to deal and share
their property.

Now, the antitrust laws have always
had difficulty regulating single firm conduct.
It's no different today than it was in the days
of the IBM cases that involved access to trade
secret or copyrighted interface data.

The U.S. gave up on that. The
European Commission did require certain
compulsory licensing of vertical integration
cases where a single firm takes action that has
the potential of excluding competition in the
primary market because it will require other
competitors to vertically integrate into two
markets.

In most of the Supreme Court cases
involving patents -- and one of the last of the
string was Blacksaw -- the Court again did not
pay attention so much to the issue of patent
validity as to what the agreements were intended
to do.

And when the Xerox court in the
Federal Circuit says it's not going to consider
scienter, it's not going to consider an objective
intent, it's not going to consider the memos
which talk about why a firm has entered into an
agreement, they are basically immunizing from
antitrust examination the bread and butter of
antitrust cases where one does look to motive,
one does look to intent, not as Phil or Rita used
to say, because the chairman of IBM has bad
thoughts about destroying competition, but no.

Was the company motivated to enter
into this agreement because it felt that the
other party was in fact violating the patents?

Or does the discovery show other considerations,
a fear of attack on the patents, sharing of
monopoly power to buy off attack? Those issues
would appear to be out of consideration as far as
the Federal Circuit is concerned.

Now, on the settlement question -- and
I really wanted to get to this -- there is a big, big problem which nobody's mentioned. And maybe I'm missing something. But Professional Real Estate does say that if you bring a lawsuit you cannot be accused of violating the antitrust laws unless it's shown to be objectively baseless.

Now, that's going to be a very hard thing to show in virtually all cases. A settlement that is based on wanting to resolve a presumptively valid lawsuit is going to be hard to challenge it seems to me, despite whatever the settlement agreement says, if the defendant wants out of the litigation.

And the court is bound to find that the litigation was proper exercise of the patent owner's First Amendment rights. And I find this a real curve ball. In terms of examining license agreements there could be litigation. And then you'd be into a direct PRE situation where there is litigation, and you're in that.

So I think this is an area where a lot of work and thought needs to be devoted to
overcoming that if some of these agreements are
to be challenged. Thank you very much.

(AppAUSE.)

WILLIAM STALLINGS: I'd just like to

note quickly that all these presentations will be

on the FTC's website I think today. And we also

have hard copy presentations of Joe Miller's

paper in the back which is a good lead-in to

recognizing Joe Miller.

JOSEPH MILLER: Thank you. And thank

you for inviting me to talk to you all today. My

idea is sort of that this is a good news, bad

news situation when we ask what standards are we

going to use when we're trying to examine the

antitrust status of certain patent license

settlement agreements.

Let me start with the bad news. It's

good to get that out of the way first. The bad

news is that I think resort to patent law

standards is at some level ineradicable.

You are never going to get to a point
merits of an underlying assertion about the
scope of patent rights including validity or
infringement, whichever is more important in
any particular case.

I think it's true from first
principles. The guidelines seem to suggest
this is the case.

And I think more importantly the
Business Review letters that people have alluded
to that have dealt with patent pool issues, all
three of which emphasize the importance of the
role of an independent patent expert who is going
to pass on the essentiality of patents, of given
patents for the pool technology, emphasizes an
acknowledgement that the merits of patent claims
are important at some very basic level.

The good news is that patent law
isn't merely a big pain in the neck for antitrust
enforcement authorities. Patent law actually I
think contains some important principles that the
antitrust enforcement agencies could use to their advantage when they are examining and perhaps

then challenging certain patent license arrangements.

I've thought about two in particular, but I don't mean to suggest that these are the only two. I'm sure there are many more that people more creative and intelligent than I am will think of later.

I do think it's worth spending some mental energy on this though to try and come up with as many as one can. Let me mention the two that occurred to me.

One is the presumption of validity has been alluded to many times today. And Molly Boast quite correctly emphasized that the presumption of validity is merely a procedural device. And it's a procedural device of somewhat limited utility.

An important instance where it does not apply is when a patentee is seeking
preliminarily to enjoin rather than permanently
to enjoin someone from competing with them in the
marketplace.

So when a patentee wants peremptorily
to remove someone from the marketplace, they bear
the burden showing that their patent will be
sustained against the attacks that the defendant
has signaled might be in the offing.
It seems to me that the antitrust
agencies can and should be able to make the case
that they ought to be no worse off with respect
to someone who wants peremptorily to remove a
competitor with a license than they would be if
the person sought peremptorily to remove a
competitor with a preliminary injunction.
There has also been a lot of talk
today about shifting burdens. And I sense a
distaste for it in certain respects, shifting the
burden onto the parties who come forward with
these arrangements.
But I do think they need to bear a lot
19 more of the burden, especially if they want to
20 forestall much more drastic measures, about which
21 more in a moment.
22
22 The other procedural principle that

1 I think is worth considering is the adverse
2 inference that is drawn in patent infringement
3 cases when a party who has been found to infringe
4 is defending against the charge that their
5 infringement was willful, that it was done with
6 reckless disregard for the other person's
7 patents.
8
8 Of course, when the person's intent
9 about the patent rights becomes an issue, the
10 natural thing for them to rely on is advice of
11 counsel: I had a good faith basis for believing
12 I didn't infringe or that the patent was invalid,
13 therefore I did not act with reckless disregard;
14 I acted with appropriate regard; I had good
15 advice; it happened to be wrong, but don't sock
16 me with treble damages.
17 It seems to me that there is an
argument to be made and it has several steps. I would commend the paper to you for it in detail.

But there is an analogy to be made here through the failing firm defense that the accused infringer who says, look, I had to give

in; I had to give my independence to the patent holder because I couldn't possibly compete lawfully, ought to be forced to disclose the good faith basis for that belief or suffer the same adverse inference, that they had no good faith basis for that belief.

Now, the point has been made that these legal opinions if they are negative opinions, if they are opinions that suggest that someone would be held liable for infringement of a valid patent, that they will not be written down.

My experience as a patent litigator indicates the truth of that statement that's been made by others. It almost certainly wouldn't be written down.
That doesn't mean it can't be disclosed. Conversations I'm sure would be had. They have to be had because companies need competent legal advice on how to proceed given the circumstances they are under. And the substance of those conversations could be relayed. Again if someone decides they don't want to, there is always an adverse inference to draw and I would recommend heartily that it be drawn.

Again, these are two procedural rules from patent law itself that I think the antitrust authorities could usefully deploy. I'm sure there are others.

But the complaint could rightly be made when one talks about these sorts of ideas that -- pick whichever cliche you like, nibbling around the edges, rearranging deck chairs on a sinking ship.

And I take those criticisms to heart.

I think they have great merit. The reason that I
think they have great merit is because they don't
attack the fundamental structural difficulty that
we're confronting that Joe Farrell has alluded
to, that Doug Melamed has alluded to and I think
others have as well.

And that is the consequence of the
legal rule that's been with us since a Supreme
Court case called Blonder-Tongue that once a
patent has been held invalid as to one person
it's invalid as to the rest of the world.

That means that patent challenges have
a public goods quality much like innovation
itself. So if we're convinced that innovation
needs patents because it will be undersupplied
otherwise, we're probably equally likely to be
convinced that patent challenges need some sort
of boost or they're likely to be undersupplied.

I need to think a lot more about Joe
Farrell's very, very provocative and important
remarks here today about whether we can
confidently state that the level of patent
challenges really is below the place we need it
to be according to some particular social wealth
or standard.

What I'm not going to wait to say
though is some ideas about how we might change
the law if we conclude it is below where it needs
to be. What practical things might we do? Well,
I think that at a bare minimum you would want to

even out the patent law fee shifting regime.
Right now when you want to shift fees,
when you want to make sure that someone who has
one meritorious case gets their attorney fees
compensated, it's very tilted toward the patentee
who's successful and tilted very far away from
the accused infringer who's successful.
It seems to me that if you thought
that patent challenges were being undersupplied
by the current set of legal rules that's the
first place you would look. At least the legal
fees, make the patentee pay them in other words,
when an accused infringer successfully
invalidates a patent.

That would be particularly appropriate when they do so on grounds that the patentee could have avoided if he or she only took a little bit more time and care in figuring out whether the invention was patentable in the first place.

But what might you do that's even more bold than that? I think we have a laboratory for what you might do. It's the Hatch-Waxman Act.

Now, the Hatch-Waxman Act is not popular. It's especially not popular in a room full of antitrust lawyers, for good reason, because it has a lot of pernicious aspects to it that have been manipulated with real abandon on the part of the main pharmaceutical manufacturers.

But it also has this very, very interesting suggestion for a device that might work quite well.

The 180-day semiexclusivity period,
this is a period that allows the first person who
steps up to challenge the drug patent a six-month
period after they succeed where they will be able
to sell into the market and their only competitor
will be the name manufacturer.

The other generics will have to wait.

Now, the problem with this procedure as
Hatch-Waxman enacted it was that it allowed the
first generic to put a cork in the bottle and
trap every generic behind it and sit around and
wait and not really even enter.

If that got fixed -- and it seems that
it is being fixed in some ways and might be fixed
even more dramatically with some legislation
that's on the Hill right now. If that were fixed
I think what we'd see is here is a bounty being
paid to the first challenger and only the first
challenger.

Why is that important? Because it's
a benefit that they will get that their
competitors, who will also reap some benefits
from the invalidation of an invalid patent, will
never get.

So they get a reward that others won't
get that's an incentive to undertake the
challenge. It's sounding a lot like the patent
regime itself, right? You reward someone in a
way that won't be appropriated by people who are
similarly situated.

So I think we have to think seriously
about bounties that we give to people who
successfully challenge invalid patents. I

propose at the end of my paper an especially
outrageous bounty. So I like to think big,
right?

So my outrageous bounty is that the
accused infringer receive the disgorged profits,
all of them, that the patentee has earned under
the patent to date.

This really evens the playing field
considerably and it eliminates the very mechanism
which people have referred to repeatedly here
today, this structural defect where the patentee can co-opt the accused infringer, align its incentives with the patentee's against the public.

If the accused infringer may be able to get all the profits, you offering to cut them in on a third or a half doesn't sound so great. They might decide, well, you know what, I'd rather shoot for the moon and get all your profits.

And so I think we need to think about a bounty system, how that might correct this market failure in patent challenges as a way to really attack central problems at the IP/antitrust intersection rather than sort of nibble here and nibble there with this or that procedural innovation.

As useful as those might be, I think they're not nearly as satisfying as something like the bounty proposal would be. Thanks.

(Applause.)
WILLIAM STALLINGS: Some reaction out of Professor Farrell?

JOSEPH FARRELL: Well, I think if one decided to take the view that one shouldn't incorporate incentives to innovate into the calculations of the gain from overturning invalid IP -- and as I discussed, it's not clear whether one should decide that.

But if one did decide that, then far from being outrageous your bounty would perhaps be inadequate because it only includes the profits and not the deadweight loss which is also harm caused by the illegitimate monopolization.

And that of course in addition to getting the incentives to bring the suit, to bring the challenge a little higher, probably only a little higher, would also make it even more impossible for someone to offer part of the profits in return.

Let me take the opportunity to make a couple of general comments in response to
Mr. Katsh's observations. It seems to me that there are two fallacies floating around that he kind of mentioned I think in the spirit of attacking, but I would like to hear attacked more vigorously, and so I'll do it myself. The first is that if there's no obligation to do X, then there shouldn't be limits on how you do X. I think this is a pretty well understood fallacy. I don't have to hire an employee, but if I do hire an employee there are limits on what I can do, even things I can do that are disclosed to potential employees up front. I don't have to enter a market, but if I do enter a market I'm not allowed then to collude with incumbents. There are lots of ways in which the syllogism you don't have to do X, therefore the law can't limit how you do X, is rejected. The second widespread fallacy is in dismissing too quickly intent evidence. And this
is something I think antitrust practitioners are particularly fond of. It's certainly true that middle managers and perhaps others like to make loose statements about crushing the competition and so on.

And it's certainly true that we shouldn't base antitrust enforcement on those kinds of loose statements.

On the other hand, if you want to know what the real expected effects of a practice or a merger or a settlement are, I think it's likely to be pretty informative to find out the best considered opinion of those in the firm who know the most about that aspect of the business.

And just because we want to throw out cases based on these inflammatory kill the competition memos does not mean and shouldn't mean that we throw out the use of evidence about the most careful thinking within the firms, who know a lot more about it than we do.

JOSEPH MILLER: I've rarely been
accused of not sufficiently aggressively stating

my position. I accept your additions.

JOSEPH FARRELL: Thank you. I've rarely been accused by the way for those who have been here this morning of being to the right of Greg Sidak. But he mentioned that.

DOUGLAS MELAMED: This is a small comment maybe only in the nature of a clarification about the bounty proposal. But I wanted to note something and maybe ask a question about it.

What Joe has focused on in his bounty proposal is the enhanced incentive to the challenger of the intellectual property. But of course the bounty I take it is supposed to come from the patentee. And therefore it imposes a cost on the patentee.

And we want to be careful I suppose that we don't by imposing such a cost deter the patentee from engaging in socially desirable conduct.
So my question or clarification is this: I take it you do not mean by your bounty proposal to require forfeiture of all profits from the patentee's exploitation of the technology putatively covered by the patent, but rather simply those profits attributable to his now in hindsight wrongful assertion of a patent right to exclude rivals.

Otherwise it seems to me that you would be deterring procompetitive conduct if your bounty is paid by the patentee rather than the Treasury.

WILLIAM STALLINGS: Joe?

JOSEPH MILLER: I think I would agree with the second characterization that the profit would be the profit attributable to the wrongful reliance on the patent. I suspect however that in practice that the first would be the proxy for the second.

It would be difficult to disentangle the profit attributable to the misassertion of
the patent from profits attributable merely to practicing the technology.

The reason I went to patentee profits in the first place -- perhaps that would be helpful to lay on the table -- is a problem you confront in designing any bounty system, which is how big shall the bounty be.

That's just a design problem, right?

And it seems to me that fixing any sum certain -- let's make it 100,000, let's make it 5,000 -- is always going to have real underinclusive and overinclusive problems. So the better thing to do is to try and calibrate it directly to the value of the technology at issue in the case.

And so that's why I think you have to go to patentee profits measured somehow. But I accept your clarification. And it relates in a sense to Joe Farrell's comment about whether or not we want to include the incentive to innovate in the way we think about whether these things are over- or underencouraged.
I certainly think we ought to try to incorporate the incentive to innovate in the way we think about whether these things are under or oversupplied. I would say this however in addition, that we should also try to incorporate all ways that people can protect their investments in innovations.

It is not merely the case that you have patents or copyrights or nothing at all. Many firms don't ever get any patents or have any copyrights. What they do is they rely on their lead time in the marketplace.

And there's been quite a bit of research about the different ways that firms recoup their investments in innovation. And I think that if a bounty proposal were employed in the patent system it might reduce the amount of patent seeking but I don't think it would reduce innovation seeking that is protected by other mechanisms.

So that would also need to be part of
this very complex story that we should try to
work out for the reasons that you stated earlier.

WILLIAM STALLINGS: Molly?

MOLLY BOAST: This is a little off
point, the bounty point. But just as I sit and
listen to this entire conversation and a fair
degree of unanimity -- certainly there are people
who don't agree.

But there's a growing number of people
that seem to share a consensus that if we let too
many abstract rules get in the way we will engage
in underdeterrence in antitrust enforcement in
this area, or alternatively put, perhaps we're
already engaging in underdeterrence.

And that happens to be my own view.

But I think in the search for rules and clarity
and principles, that also propels us toward
seeking more enforcement activity. It is not an
appropriate approach it seems to me to stumble
over some of these hard questions and then not go
forward.
It is better to take those to the courts. That's where the rules get made in this system. That's what antitrust enforcement is in this country. It's not a regulatory regime. It's a law enforcement regime. And we ought to be encouraging agencies to go forward.

WILLIAM STALLINGS: Salem?

SALEM KATSH: I just had one thought in listening to Professor Farrell. I'm wondering how he deals with that.

And this is the fact that before the Federal Circuit in '82 under the exact same legal standard, which is the Graham test of the Supreme Court in '65, between '65 and '82 somewhere around 70 percent of patents that came before the various Circuit Courts of Appeals were held invalid or not infringed.

After 1982 again under the same legal standard the percentages have reversed. And one of the problems I think that everybody here is confronting in terms of whether the system can be
tinkered with or whether some truly structural reform is necessary, is the question of how to deal with the uncertainty that now pervades the system when you're dealing with one court that will get every patent case if it has a discrete patent claim, and not only will it in general at the end of the day uphold 70 percent of the patents, but it will in the interim reverse almost 50 percent of the Markman determinations. Which to Joe's point prevents the parties from relying on the Markman determination to get certainty before -- because if that were a real final resolution of the claim construction in 90 percent of the cases it would have a tremendous impact, a procompetitive impact. But with the Court it's a brand-new ballgame, almost 60/40. So it's impossible for you to tell a client, look, you've lost in the District Court; now you better fold it in. It's quite the contrary.

WILLIAM STALLINGS: Joe, do you want to respond?
JOSEPH FARRELL: Well, to be honest I'm not quite sure what the question is here. I mean one thing I would say about the fraction to winners on each side is that's very apt of be a feature of the set of cases that get brought to that tribunal. And so although I assume you can infer something from a big shift like that you have to be very careful about what you're inferring; that is, you're looking at a very selective sample.

I think what you're saying is settlements are made more difficult by the uncertainty that goes along with a dramatic change in policy, assuming there is such a change, and made more difficult also by the disrespect that's given to the Markman results. I think it's true there's probably discouraged settlement. But I'm not sure what you're asking beyond that.

JOSEPH MILLER: I guess I was thinking out loud for a minute to M. J.'s point about profit sharing. If the uncertainty is so great,
confronting both parties as to what the final
outcome will be, doesn't that just complicate the
antitrust enforcement decision in terms of
whether the way the case is settled is a fair
allocation of risk even though it may amount a
certain amount of profit or power sharing?

JOSEPH FARRELL: Yes. I think it
does. I've never been an advocate for the
antitrust agencies trying to judge whether a
settlement is fair. I think one way to phrase
what you're saying though is it makes it harder
still to find triggers for thinking that a
settlement is really a division of monopoly
profits rather than a true settlement of the
litigation risks.

I suppose it does because it does tell
you that there is a bigger spectrum of agreements
that might look good to both sides if they are
taking different views about uncertainty.

The uncertainty in itself by the way
has very little to do with difficulty of reaching
settlements or any of those things. It's
difference of views that makes settlements hard to reach, not sheer uncertainty.

And certainly as matter of economic theory you have to ask how does the uncertainty create difference of views? I think in practice that's less of a point than it is in theory.

But I agree. There is one tool that you might have hoped could get you somewhere in analyzing and that maybe can't get you as far as you might have hoped. I guess I was never all that hopeful myself.

WILLIAM STALLINGS: If we can shift topics for one minute, we have heard some references to whether the Antitrust Division and the FTC have the resources to look at these issues.

I'm wondering about the panel's viewpoints on whether the agencies could work with the PTO in some manner in terms of re-examination procedures or other types of mechanisms to utilize the resources there. Joe?

JOSEPH MILLER: I think certainly in
the context of re-examination procedure -- and
now we're really getting into some finer points
of Patent Office administration which is what
we're think about, because as I said, I think we
need to as antitrust enforcement people -- or
people who are involved in antitrust issues need
to start thinking in a much more detailed way
about substantive patent rules and procedural
patent rules.

And so thinking about PTO procedure is
a good way to start to do that. In the context
of re-examination it is the case that the
commissioner of the Patent Office is statutorily
authorized to request re-examinations.

In fact it might even be to direct
that there be a re-examination. I would have to
go back and look. So re-examination is not
merely something that a private party can
instigate.

Now, it's true that the statute also
creates a standard. There has to be a, quote,
substantial new question of patentability. So
it's not like this is something you can just go
do because you feel like it on a whim. You have
to have a reason to do so.

But I think that if the agencies or
one of the agencies went to the commissioner and
said in this context there's all sorts of
evidence that would suggest a substantial new
question of patentability here; do you think that
there is some ground for re-examination.

And if in the antitrust enforcement
context it seemed to be useful and beneficial to
really get to the heart of the matter I don't see
why you should be shy about doing so, going to
the patent office and asking for just that
procedure.

M. J. MOLTENBREY: I think that
promise underlying that question is an assumption
that the agencies' difficulties in dealing with
the IP issues stem solely from a lack of patent
lawyers. I think the real situation is more
complicated than that.
And it goes really to what is the question that the agencies have to answer. And if the agency had an unlimited number of patent lawyers and made a determination on the scope and validity of the patent, how should that play into the antitrust analysis? Does the agency's own determination become the final determination?

I think the really hard question is the uncertainty of the IP rights, and in fact the nature of the IP rights and the but-for question presented. And is it even possible to get at those questions rather than solely a lack of patent lawyers?

WILLIAM STALLINGS: Salem?

SALEM KATSH: As somebody who's cut my teeth on patent law and technology without a technical background, which is why I infuriate the patent bar so much, the Federal Trade Commission and the Antitrust Division unquestionably can come to a qualitative decision about a patent within a matter of days or a
You guys know industries. You look at products. So it's not technology that's your problem. It's patent law. And I know from my own background that it's very intimidating to for whatever reasons to say that you're going to have to pick up some patent law.

But patent law is not rocket science. And the actual analysis of whether a claim is strong in terms of prior art, of whether it's going to get a broad or lean interpretation, whether there's going to be a strong or mixed range of equivalents, those are issues where qualitative judgment can be made, yes.

A final determination on a but-for case, no. I don't think that's something that the agencies can shoot for. But, you know, I think that to have the expertise within the house and incorporate it in, it's just another body of law. It's not that bizarre.
acknowledgement that we can't get at that but-for world, is where does the antitrust analysis go from there?

And that's the hard question I think when people talk about the agency not being able to come to a determination, that that's really more the heart of the matter than the inability to make the qualitative analysis that you talked about.

SALEM KATSH: But again, why is that different from being confronted with a natural monopoly defense or a failing company defense or some efficiency defense?

M. J. MOLTENBREY: Well, I think that's an interesting question in the sense that those defenses place the burden on the parties and not on the agency.

And much along the lines of what Joe
was talking about, the question might come down
to who carries the burden because no one's going
to be able to meet it anyway. And it becomes a
default rule, which may be just the answer. I
don't know.

WILLIAM STALLINGS: Doug?

DOUGLAS MELAMED: It seems to me there's a legal problem too here. If you accept
the premise of the last couple of minutes that
the but-for world that we might be having to
investigate -- it involves a resolution of the
question is the patent valid.

If the antitrust laws require the
resolution of that question, there's no way it
seems to me to decide the antitrust question
without resolving that question in a patent
litigation because if the antitrust rule says
patentee is entitled to exclude the competition
if the patent is valid, then you have to make a
determination.

It doesn't matter what the antitrust
agency thinks. It doesn't even matter what the antitrust court thinks, unless it has proper jurisdiction over the patent issue. It seems to me that unless you want antitrust to have to resolve all those issues in a proper patent case, that's another reason to look for decision tools, antitrust modes of analysis, that enable you to resolve a lot of competition questions without having to resolve that but-for world.

WILLIAM STALLINGS: Joe Kattan with the last comment?

JOSEPH KATTAN: I think that a very wise person said that a lot of antitrust law gets made not by litigation or doctrine these days, but by prosecutorial discretion. And in the exercise of that prosecutorial discretion, it seems to me that the agencies can make the qualitative judgments that at least in certain cases and certainly in the merger context we're not going to bring a case,
which is based on a prediction of what the world would look like if the merger were to go forward or what the world would have looked like absent the agreement, when we have ability to make the qualitative judgment as to whether competition would have existed between the parties,

WILLIAM STALLINGS: Well, you've heard a lot today. The last thing, we've asked Joe Miller to try to wrap it up and put it all in context.

JOSEPH MILLER: And talk about dreaming the impossible dream. How would we summarize this? I think that some themes have emerged.

The notion that there is a particular structural problem with the very nature of patent challenges that sets off certain dynamics and has certain conclusions, that we need to think more about and try to struggle with because that may
be where the big payoffs are for increasing the
amount of competition that should be taking place
in the marketplace.

I think the theme that figuring out
what the but-for world is, how to analyze it
correctly, is a daunting challenge. You've heard
a lot of different views about whether it's even

something that's necessary to do.

And I'm probably at the other end of
the spectrum which is I don't see how one can
avoid doing it frankly. So this is still very
much a contested question.

But I think what's not contested is
that economic theory honed by experiences like
the Hatch-Waxman Act cases are indicating to us
plenty of contexts where even if we assume the
patents are fully valid and fully infringed by a
particular party, that the arrangement in
question is anticompetitive and we need to push
the forefront of that boundary, get it back as
far as we can, so that we reduce the number of
instances where we do have to take on the merits of the underlying patent issues.

And also again, to sort of plug my own idea since I have the floor, is that we do have to start to think through on the assumption that we will not be able to eliminate the need to look at the merits of patent scope at the end of the day. Let's assume we just will never get there where we can eliminate it.

Let's embrace the thorn, the nettle, whatever, and say, okay, let's assume we're not going to be able to and let's start talking patent law seriously. Does this body of law have anything that will help us? If we're going to be playing on this field let's start learning what it's like to be playing on it.

And so I think that's why you've heard a number of people suggest that the agencies really could profitably invest in building some patent law expertise to try to deal with these issues in those terms as well. That's my
summary.

WILLIAM STALLINGS: Joe, thank you very much. I'd like to thank all the panelists. I appreciate your time and effort. Thank you all for coming.

(Adjournment.)