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LIPSKY SPEECH ATTACKING "NINE NO-NO's"

CURRENT ANTITRUST DIVISION VIEWS
ON PATENT LICENSING PRACTICES

REMARKS OF

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The topic of this panel invites consideration of two notoriously complex and controversial legal subjects, each of which would require several written volumes to treat exhaustively. I therefore long ago abandoned any hope of providing even the broadest outlines of Division policy with respect to all matters potentially within the mandate for discussion by this group. However, Bill Baxter has already described our basic approach to the application of antitrust law to transnational arrangements, and will elaborate those ideas in a speech to be delivered later today. This suggests that I might usefully treat the other half of the topic--patent and know-how licensing. Although the time limitation has forced me to deal only with patent questions, the implications of that analysis for the know-how field should be more or less readily discernable to this group.

For the better part of the last decade, Division enforcement policy toward patent licensing has been advertised using a list of forbidden practices commonly known as the "Nine No-No's." 1/ Each of these practices is thought to be especially deserving of antitrust condemnation by virtue of some inherently anticompetitive feature. I will discuss these practices and their allegedly anticompetitive aspects in a moment.

Let me first point out, however, that intimations of doubt had already been expressed before the advent of the current Administration concerning the validity of the Nine No-No's, at least insofar as they are intended to be statements of sensible antitrust enforcement policy. While the precise dimensions of this recent skepticism are difficult to discern, the best clue is found in a speech given by my predecessor in 1979. 2/ What I propose to do, therefore, is to reexamine his articulation of Division attitudes, and to indicate where the current Division leadership expects to agree and disagree with those ideas and their implications for antitrust policy toward specific licensing practices.

That speech identified two basic policy assumptions thought to underlie all analysis performed at the patent/ antitrust interface. The first such assumption is that there is nothing inherently wrong or anticompetitive about the market power conferred by a patent grant. Given the existence of the standards that must be met in order for this monopoly to be obtained, it is safe to presume that whatever market power may arise from possession of the exculsive right to make, use, or sell has been earned by useful inventive activity. While it is possible to debate the wisdom of the congressional decision to reward invention in this way, it is indisputable that Congress has made this choice, and that antitrust analysis therefore is bound to accept the legality of the patent holder's monopoly position.

The second assumption identified is that the value of the patent monopoly arises from the patentee's ability to exploit his patent-based market power. It is only where market power is collusively obtained or exploited--that is, by means other than individual inventive effort--that a true antitrust problem arises. These two basic assumptions seem to lie beyond the realm of useful debate.

The antitrust implications drawn by my predecessor from these two basic assumptions also seem fundamentally sound. These are, first, that it can be competitively abusive to obtain the patent monopoly through means other than inventiveness. The most obvious illustration of this principle is found in situations involving fraud on the patent office, a la Walker Process. 3/ Second, the antitrust legality of the means chosen for exploitation of a patent ought to be subject to the same general antitrust standards as other commercial transactions. Finally, my predecessor identified "[t]he most important single concern of the Antitrust Division in this area, namely, whether one or more licenses are being used as part of a broader conspiracy to restrain significant actual or potential competition among affected firms . . . ." I would enthusiastically endorse this last conclusion in particular.

Where I depart from my predecessor, however, is in his assertion that the nine no-no's have much independent validity as economically rational antitrust rules logically following from the premises stated. When one makes the analysis, one finds that the nine no-no's, as statements of rational economic policy, contain more error than accuracy. I therefore propose to go through the nine no-no's in some detail, and highlight the inconsistencies between the basic theories that seem to underlie previous Division statements concerning the legality of these practices, and the analysis that seems to be compelled by my

1/ "Department of Justice Luncheon Speech Law on Licensing Practices: Myth or Reality?" Remarks by Bruce Wilson (Jan. 21, 1975).

2/ "Antitrust Enforcement and the Patent Laws," Remarks of Ky P. Ewing, Jr. (May 5, 1979).

3/ Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp., 382 U.S. 172 (1965).

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predecessor's creditable exposition of the basic topology of the patent/antitrust interface.

As many of you may already suspect, my analysis will bear a strong thematic resemblance to previous Division statements regarding prevalent judicial attitudes toward various nonpatent practices collectively referred to as vertical arrangements or distributional restraints. This is no coincidence. In most respects, the intellectual property protected by a patent represents an input to a productive process. As such, it must be combined with numerous other inputs before assuming the form of an article of commerce that can be traded for money because it has value to its consumer. Even where the patented item is a product that does not become recongizable until a relatively late stage in the chain of manufacture, that item must still be packaged, distributed, transported, insured, advertised, retailed, financed, and sold, perhaps subject to warranties or other promises of post-sale performance and the availability of maintenance or other assistance.

As we have pointed out with respect to distributional arrangements, the purveyor of any product has a strong economic interest in seeing that all of these functions are provided in the right combination, in appropriate magnitude, and at the least cost. For this reason, there is no inherent competitive significance to the decision of a single seller to select the number of outlets for his product, their location and methods of doing business, or the prices and terms on which trade occurs. In order for a decision as to any of these matters to be anticompetitive, it must somehow implicate that seller's relations to other sellers, and in particular, it must constitute or facilitate a collusive arrangement. This is just a fancy way of saying that in order to be illegal under the antitrust laws, a business transaction must be anticompetitive because of its horizontal consequences.

This same general discussion applies with equal if not greater force to the patent field. While the antitrust analyst is at liberty outside the patent field to dabble in such issues as whether the market power of the seller was lawfully or unlawfully acquired, or whether the extent of that market power is or ought to be of independent competitive concern, the patentee comes to judgment with those questions settled according to constitutional and congressional instructions. To repeat an earlier point of agreement between this and previous Antitrust Division spokesmen, we are bound to concede the competitive legitimacy of the existence and unilateral exploitation of a lawfully acquired valid patent. Thus, the independent decisions of the patentee regarding the means by which an invention is to be combined with other productive inputs ought to be regarded as having no inherent anticompetitive import.

Before discussing the nine no-no's, I would also like to state with all the emphasis at my command that the legality of particular patent licensing practices is ultimately determined by the federal courts, not by the Antitrust Division. Therefore, to the extent that my remarks may be heard as differing explicitly or implicitly from the teachings of the case law, they ought to be ignored--and by ignored I sincerely mean utterly disregarded --in advising clients with respect to any matter other than the current thinking and likely enforcement policy of the Antitrust Division.

With all the preliminaries disposed of, let me now go through the nine no-no's in individual detail. No-no Number 1: "It is clear that it is unlawful to require a licensee to purchase unpatented materials from the licensor." As a statement of the current law, this formulation may be valid, although there is some hope, based on recent judicial decisions, that it will be relied on less automatically in the future. As a statement of a rule that ought to be followed, it is largely balderdash. It has long been recognized by the courts that where unpatented and patented articles are used in close conjunction, and where the two must be technically compatible to assure efficient operation or use of the patented product, such a tie-in is legal. 4/ But aside from this, the broader rule ought to be abandoned. The practice often appears in circumstances that strongly suggest its utility for two valid purposes: First, it allows the patentee to charge the licensee an amount that is a closer approximation to the value of the license than would be attainable by forcing the patentee to measure that value by other less direct or more costly means. Second, it may provide licensees with the incentive to practice the patent by using unpatented inputs in correct proportions with the patented item. Forcing the patentee to extract all economic rents from only the patented item would lead to inefficient substitution of unpatented inputs in the face of lawful monopoly charges imposed on the patented item alone. Both of these purposes are generally consistent with enhancement of consumer welfare. Thus, while it is conceivable that patent tie-ins might be anticompetitive under peculiar conditions, a general rule prohibiting them is almost certainly counterproductive.

Undoubtedly, some will say that this reasoning flies in the face of hallowed judicial precedent finding patent tie-ins to be outside the scope of the patent monopoly. Most often, however, when a court says that a particular practice is beyond the scope of the patent monopoly, it is usually just phrasing its legal conclusion, necessarily arrived at on other grounds. Obviously, any consensual bargain that the licensee can be induced to enter in return for the right to practice the patent must be within the scope of the patent monopoly in the sense that the licensee, by accepting the license terms, has demonstrated his willingness to adhere to the bargain in return for his licensed rights. Thus, if the courts are to prohibit some aspect of the bargain, they must find an independent policy reason for doing so. Consider, for example, a rule that forbids the license of a patent in return for the licensee's promise to rob a bank. This rule is based on an independent social policy that discourages bank robbery, and quite properly so, even though the consideration for the license is not beyond the scope of the patent monopoly in the sense I have described. The policy reason one must find in fashioning antitrust-based prohibitions on licensing is that the practice restricts competition and worsens resource allocation. The first no-no does not qualify as a generally valid prohibition on this ground.

No-no Number 2: "[T]he Department views it as unlawful for a patentee to require a licensee to assign to the patentee any patent which may be issued to the licensee after the licensing

4/ <u>See</u> Fortner Enterprises Inc. v. United States Steel Corp., 394 U.S. 495 (1969).

arrangement is executed." Again, this may be a rough statement of existing law. Whether such a rule ought to be followed is more difficult to determine than for other rules on the list. The troublesome aspect of this practice is its tendency to reduce the incentives of licensees to engage in their own inventive activity, and to guarantee the licensor that its licensee-competitors will obtain no unique advantage over it. Let me first discuss the practice in its most inoffensive form: a license between parties not otherwise in actual or potential competition, where the grantback is limited to improvements made possible by practice of the patent, and where the grantback is nonexclusive. In this situation, other competitors remain subject to the incentives to invent, and even the licensee retains the incentive to discover new technology that would free him from his dependence on the patentee. The other extreme would involve an exclusive grantback provision in licenses granted to all or most significant actual or potential competitors of the patentee, or to trivial licensee-competitors of an industry-dominating patentee, with all technology in the field subject to grantback, regardless of whether practice of the patent was necessary to the improvement. In these situations, the practice would be clearly objectionable. Between the extremes, our approach must necessarily constitute a fact-sensitive and careful evaluation of the risk that the incentives to invent have been sacrificed to a degree unnecessary for adequate exploitation of the patentee's monopoly rights.

No-no Number 3: "The Department believes it is unlawful to attempt to restrict a purchaser of a patented product in the resale of that product." Again, as a statement of current law, this statement is not manifestly inaccurate. As a statement of a sensible rule that ought to be followed, it is likely to be mischievous. This practice can be subjected to analysis that closely parallels that applied to other vertical practices. The seller's incentive is to ensure that he achieves the maximum economic return from his intellectual property. He cannot increase his own lawful monopoly power by restricting the methods by which his product is distributed, transported, insured, sold, and so forth, unless his choice somehow decreases the options available to his competitors. This analysis is no less valid where the product is patented. Restrictions on resale ought to be judged by the same general standards as those that ought to be in use outside the patent field. This no-no derives, historically, from the same ancient prohibition against restraints on alienation that animated the Schwinn 5/ decision and was wisely put aside in GTE Sylvania. 6/

No-no Number 4: "[A] patentee may not restrict his licensee's freedom to deal in the products or services not within the scope of the patent." Let me first dispose of this last phrase: I assume that in this context "products or services not within the scope of the patent" means products or services other than those subject to the patent. So understood, the analysis of this practice should start with an attempt to determine whether the relationship between the patentee and licensee is vertical or horizontal. Where the relationship is vertical, the analysis should proceed on the same basis as the analysis of vertical exclusive arrangements outside the patent field. Unless the practice threatens to preempt an entire rung in the distribution ladder, and unless the patentee's advantage is so overwhelming as to make this a credible threat, there is no competitive reason to prohibit exclusive distribution arrangements.

While the phrasing of this rule suggests strongly that it was fashioned with vertical practices in mind, I should at least mention that the practice could occur in a setting that portends horizontal impact. Where the licensee is actually or potentially in competition with the patentee, one can imagine an exclusive arrangement of this nature that requires the licensee to forego his own opportunities to provide competition for the product or service of the patentee. By eliminating the potential competition of the licensee, or by reducing the licensee's incentives to invent a competitive art, it might be argued that an anticompetitive effect is present. While I have some difficulty imagining a case of this nature, I cannot rule it out, and will therefore leave this discussion with that tenuous caveat to the conclusion that the fourth no-no appears to have no general validity, at least with respect to the category of restraints to which it was apparently intended to apply.

No-no Number 5: "[T]he Department believes it to be unlawful for a patentee to agree with his licensee that he will not, without the licensee's consent, grant further licenses to any other person." Again, while one can imagine situations in which the use of such a restriction might be anticompetitive, the rule as stated has no general procompetitive tendency. A licensee's exploitation of a patent may depend on a considerable investment in R&D the fruits of which may not be patentable, in plant, goodwill, and marketing capability. That investment will be justified only if the licensee expects some level of return, and the number of other licensees or the character or field of their practice of the patent can critically affect that return. It would therefore be totally unsurprising to discover that licensees will not undertake the practice of some patents without assurances that the level of activity by other licensees will not rise to the point where the licensee's return falls below that required to justify his investment. It is therefore easy to imagine situations in which the imposition of this fifth rule will prevent the procompetitive exploitation of inventions.

No-no Number 6: "[T]he Department believes that mandatory package licensing is an unlawful extension of the patent grant." In a world of perfect information and zero transaction costs, the best way for a patentee to maximize the return from two patents is to charge each licensee the maximum amount that will just induce the acceptance of licenses for both patents. This is surely the dream of every profit-maximizing patentee, and the law would clearly allow this type of behavior. In the real world, however, information is costly to obtain, and transactions are costly to execute. One licensee may be willing to pay more for patent A than for patent B, while for another licensee the reverse may be the case. Even where all licensees value both patents identically, it would be costly to negotiate separate arrangements for each license.

For these reasons, package licensing may allow the patentee to maximize the net return on both patents, given the constraints on his state of knowledge concerning the value of the patents to different licensees, and on the ease with which he can negotiate separate licenses for each patent. In any event, his return is

5/ U.S. v. Arnold, Schwinn Co., 388 U.S. 365 (1967).

6/ Contintental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

necessarily limited to the maximum amount that he could extract lawfully in the world of perfect information and zero transaction costs. Thus, the practice of package licensing ought not be subjected to any general prohibition on antitrust grounds.

No-no Number 7: "[T]he Department believes that it is unlawful for a patentee to insist, as a condition of the license, that his licensee pay royalties in an amount not reasonably related to the licensee's sales of products covered by the patent--for example, royalties on the total sales of products of the general type covered by the licensed patent." This rule is troublesome because it contains a hidden assumption. Since the patentee's natural and legitimate aspiration is to extract the maximum return from each license, the relationship between sales of the patented item and the royalty should not necessarily be regarded as paramount. Rather, what is important is the reasonableness of the patentee's choice of method for metering or approximating the value of the license. Sales may be a reasonable method, but it may not in some circumstances. A royalty will discourage any activity that triggers the obligation to pay. This disincentive can be used to inhibit competitive activity, and should therefore raise some concern where the patentee and licensee are horizontal competitors. In that situation, a rule of reason approach must be employed to ensure an optimal trade-off between the requirements of the patentee's metering needs, and the risk of unnecessary cartelization. However, to the extent that the seventh no-no contemplates patentee/licensee relationships that are purely vertical, it sweeps too broadly.

No-no Number 8: "[I]t is pretty clearly unlawful for the owner of a process patent to attempt to place restrictions in his licensee's sales of products made by the use of the patented process." I am compelled to speak with some restraint here, since this proposition is at issue in a pending government case. 7/ What I can say is that the rule makes sense to the extent that it prohibits the patentee from attaining monopoly or cartel control of something not necessarily subject to that control by virtue of the patent grant. On the other hand, there is little point in worrying about the process/product distinction to the extent that control of the process necessarily confers control over the product or in circumstances in which no effective control over extra-patent items is threatened. In those instances, to deny the patentee the means to exploit his legitimate monopoly by the most convenient means, simply because those means take the form of restraints on transactions involving the unpatented product, is not only excessively formalistic, but is potentially destructive of consumer welfare.

No-no Number 9: "[T]he Department of Justice considers it unlawful for a patentee to require a licensee to adhere to any specified or minimum price with respect to the licensee's sale of the licensed products." Again, we would reject this formulation and rely instead upon the same analysis employed with respect to distributional practices, at least where the relationship between the patentee and licensee is vertical. When that relationship is horizontal, a far more agonizing choice is presented, because the opportunities for establishing or enhancing cartel control reaching beyond the subject matter of the patent may be significantly enhanced through the setting of resale price, or through the exchange of information necessary to monitor and enforce the licensing arrangement. There appears to be no clearly superior alternative to a fact-sensitive rule of reason approach where trade-offs of this nature are encountered. It would be constructive to face this inevitable quandary directly, rather than to pretend that it can be resolved by quick reference to a simple rule.

Having buried the nine no-no's individually, let me now perform a partial collective resurrection: I have analyzed each of these rules, and have found in almost every instance that they are overinclusive or contain at least some element of economic irrationality. Nevertheless, each practice might be condemned in the type of complex multi-party, multi-patent context that seems so typical of this field. However, the analysis of those situations will not be aided, I submit, by using simple rules whose validity might be unquestionable in occasional isolated circumstances. To seek reassurance in one situation from rules valid in another would be akin to taking your map of Washington, D.C. to assist you in finding your way around Tokyo. Directions that will get you from your home to your office in Washington will always be useful in Washington and virtually never in Tokyo.

In the antitrust world, and at the patent/antitrust interface, the basic point is to prevent collusive activity unnecessary to the exploitation of a lawful monopoly. In many situations, the decision will be wonderfully ambiguous. However, there is little sense in pretending that easy resolutions exist where in fact they do not. To the extent that I have made it harder to pretend, I will count this occasion as a success.

7/ United States v. Studiengesellschaft Kohle, m.b.H., 1978-2 Trade Cas. (CCH) ¶ 62,291 (D.D.C 1978).

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