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ABSTRACT

The recent increased awareness of the importance to our economy of innovation and the development of new technologies has been coupled with the crafting of new legislation to increase the level of intellectual property protection available to innovators. Because one of the key methods of encouraging the efficient use of intellectual property is through licensing, it is crucial that our laws not unnecessarily discourage such licensing. Bills seeking to foster procompetitive licensing arrangements such as H.R. 557 and S. 438, as well as administration proposals such as those included in Title III of H.R. 1155 and S. 539, are intended to reassure American firms that the licensing of intellectual property will not receive hasty and harsh treatment under antitrust laws. H.R. 557 assures that only licensing arrangements proven to be anticompetitive will be held unlawful, while H.R. 1155 goes further to clarify and reform the doctrine of patent misuse and to clarify laws governing license challenges to patent validity. This legislation would strike a better balance between the rights of the patent owner and the rights of the licensee and give them greater freedom to negotiate terms that suit their needs, thus reducing the uncertainties that may now be deterring procompetitive licensing. (KM)

# Department of Justice





STATEMENT

OF

ROGER B. ANDEWELT
DEPUTY ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE THE

SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

CONCERNING

H.R. 557
INTELLECTUAL PROPERTY LICENSING LEGISLATION

ON

APRIL 30, 1987

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before the Subcommittee today to present the views of the Department of Justice on H.R. 557 and related proposals designed to encourage the development of new technologies by ensuring that procompetitive licensing of technologies is not unreasonably discouraged. This legislation is very important. If adopted, it should significantly benefit our economy.

Over the last 6 years there has been an increased awareness of the importance to our economy of innovation and the development of new technologies. Indeed, new technologies help address some of the most important economic issues of our time--productivity, inflation, unemployment and our international balance of payments. Advances in technology bring dramatic increases in productivity that permit products to be made at a fraction of their old cost. With lower costs comes also a tempering of inflation. Indeed, even during the 1970s, high technology industries such as electronics bucked the trend of runaway inflation by providing equivalent products at ever-decreasing costs. With respect to unemployment, new technology has resulted in the creation and growth of new industries that were not previously envisioned. For example, millions of people are presently employed in computer-related fields which were not even in existence 20 years ago. With respect to our balance of payments, which is of such significant concern today, the development of new technologies can have a dramatic effect in improving the ability of U.S. firms to compete in foreign markets.

Indeed, the ability of our industry consistently to produce major innovations is a major advantage that the U.S. has in the international marketplace. The combination of a tremendously creative citizenry with a free-market economic system that encourages those citizens to devote their resources to innovation has produced an economy with an unsurpassed ability to discover and develop new technologies.

During the past 6 years this Administration and the Congress have been very active in crafting new legislation to increase the level of intellectual property protection available to innovators. By making such protection available, we encourage increased investment in R&D and hence increased innovation.

In our free-market, profit-oriented economy, the amount a firm will invest in developing new technologies typically will depend upon the perceived financial rewards from its investment--the higher the perceived rewards, the greater the R&D investment. The anticipated rewards from any particular

R&D investment can diminish significantly, however, if once the new technology is brought into the marketplace, others are free to use it in competition with the creator. If potential creators of new technologies expect substantial diversion of profits due to uncompensated use of the technology by others, the expected economic reward of R&D investments will be lessened, the incentive to make such investments will be reduced, fewer technological breakthroughs by American firms will occur, American competitiveness will suffer, and consumers will face fewer choices and higher prices. Intellectual property protection addresses this problem by restricting the unauthorized use of a new technology developed by others. It thereby promotes innovation and results in consumers and firms having access to inventions and technologies that otherwise would not have been discovered.

The modification of the scope of intellectual property protection that has occurred in recent years does not eliminate all existing counterproductive disincentives to invest in innovation. In addition to assuring that the scope of available intellectual property protection is adequate to promote innovation, it also is crucial that the law encourage the efficient use of the intellectual property that has been created. This is an area that is ripe for legislative improvement and that is appropriately addressed by H.R. 557 and other pending bills.

One of the key methods of encouraging the efficient use of intellectual property is through licensing arrangements. Licensing has the potential for significant procompetitive benefits. The creator of a new technology often will not be in the best position to commercialize the technology to the maximum extent desirable in all possible fields. For example, others may have superior manufacturing or distribution capabilities. This is particularly likely to occur in instances where the creator of the new technology is a small firm or an individual. Licensing permits the owner of the technology in effect to convey part of his proprietary right in the technology for fair value, thus combining his assets with the manufacturing or distribution assets of others and encouraging the development and utilization of the technology in the most efficient way possible. When licensing leads to more efficient use of technology, it improves the competitiveness of American firms and benefits consumers. And by permitting the owner of a patent or other intellectual property to realize such efficiencies, licensing increases the perceived value of the patent and thereby increases the incentive to invest in the procompetitive development of new technologies.

Because of the importance of intellectual property licensing to competition and competitiveness, it is crucial that our laws not unnecessarily discourage such licensing. Towards this end, bills seeking to foster procompetitive licensing arrangements have been introduced with strong bipartisan support in both the House and the Senate. H.R. 557, introduced by Congressman Fish, with Congressmen Frank, Moorhead, Synar, Lungren, Hyde and Dannemeyer as co-sponsors, and S. 438, introduced by Senator Leahy, with Senators Hatch, Thurmond and Humphrey as co-sponsors, both improve legal treatment of intellectual property licensing by assuring that licensing arrangements receive full and proper consideration under the antitrust laws. The Administration has submitted a very similar proposal to clarify the antitrust treatment of licensing arrangements and related proposals that would similarly assure that other bodies of law do not deter or inhibit procompetitive licensing arrangements. These Administration proposals are part of Title III of H.R. 1155, introduced by Congressman Michel with 25 co-sponsors, and S. 539, introduced by Minority Leader Dole with Senators Simpson and Cochran as co-sponsors.

Licensing and the Antitrust Laws

H.R. 557 and the similar proposals I have mentioned are intended to reassure American firms that the licensing of intellectual property will not receive hasty and harsh treatment under the antitrust laws. Through the years, there unfortunately has been a widespread and incorrect perception that intellectual property protection is inherently inimical to antitrust competition policy. This misperception is derived from two sources. First, there is extensive dicta in certain court opinions suggesting this conflict. 1/ Second, during the 1970s, officials in the Department of Justice gave a series of speeches which warned that certain types of intellectual property licenses would be viewed with considerable hostility under the antitrust laws. 2/

For the reasons I have explained previously, however, we have come to recognize that the intellectual property laws and the antitrust laws do not conflict. In fact, they are complementary. When properly interpreted, both promote competition, thereby benefiting consumers and the competitiveness of American firms.

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1/ For example, the Supreme Court has called patents "monopolies" that should be limited. See, e.g., United States v. Line Material Co., 333 U.S. 287 (1948).

2/ See, e.g., Remarks by Deputy Assistant Attorney General Bruce Wilson, "Department of Justice Luncheon Speech Law on Licensing Practices: Myth or Reality?" (January 21, 1975). Practitioners outside the Justice Department have continued to suggest a conflict between the antitrust and patent laws. Only a few years ago, the Antitrust Section of the ABA held a National Institute on patent licensing, at which one of the authors began with the bald assertion that "[t]he antitrust and patent laws conflict at their interface." Sobel, The Antitrust Interface with Patents and Innovation: Acquisition of Patents, Improvement Patents and Grant-Backs, Non-Use, Fraud on the Patent Office, Development of New Products and Joint Research, 53 Antitrust L.J. 681 (1985).

Types of intellectual property, such as patents, really are not monopolies; they simply create property rights. 3/ Property rights, in turn, are the cornerstone of an efficient free-market economy. They create the incentive for private investment in productive activity by providing the investor with the means to appropriate the returns from his efforts free from undue interference by third parties.

The rights conveyed by a patent grant are really no different from the rights of the owner of a tangible asset, such as a factory. The owner of each has the right to exclude others from using it without his or her consent. It is relatively easy to prevent the unauthorized use of tangible property. It is not as easy to control a piece of technology embodied by a patent because it is intangible--it is information. A patent, in effect, converts the information into property like the factory--the patent grant provides a government-enforced recognition that once the patentee has publicly disclosed the information, it has a right to exclusive use of the patented technology.

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3/ Some court decisions have recognized this basic point. See, e.g., Schenck v. Norton Corp., 713 F.2d 782, 786 n.3 (Fed. Cir. 1983). As recently as 1984, however, the Supreme Court in dictum referred to "the patent monopoly" and "the market power it confers," see Jefferson Parish Hospital District No. 2 v. Hyde, 466 U.S. 2, 16 (1984). Four Justices in concurring in the Court's decision described the notion that a patent necessarily conveys market power as "a common misconception." Id. at 37 n. 7 (O'Connor, J., concurring).

Unfortunately, there clearly exists the perception in the business community that the antitrust laws are hostile to certain forms of licensing arrangements, and this perception appears to be deterring procompetitive licensing arrangements. This is not surprising. Antitrust suits are expensive to litigate, very expensive to lose and should be avoided.

Faced with a similar perception concerning the antitrust status of research and development joint ventures, Congress in 1984 passed the National Cooperative Research Act (NCRA). 4/ Based on the recognition that joint R&D ventures are generally procompetitive and fully consistent with the antitrust laws, that legislation sought to encourage such ventures. It did so by providing that such ventures would not be deemed illegal *per se* under the antitrust laws but instead would be evaluated under the antitrust rule of reason, and that in certain circumstances any antitrust recovery against a joint R&D venture that proved anticompetitive would be limited to single damages rather than the customary treble damages. 5/ Among the activities included within joint R&D ventures eligible for such rule of reason evaluation and single damages is "the granting

4/ Pub. L. No. 98-462, 98 Stat. 1815 (codified at 15 U.S.C. §§ 4301-4305).

5/ 15 U.S.C. § 4303.

of licenses for results of such venture." 6/ The NCRA thus was intended to reassure firms that joint R&D ventures will not be hastily condemned under the antitrust laws.

But joint R&D is a minor part of all R&D. Far more important than modifying the incentive structure in the area of joint R&D is modifying the structure for single firm R&D, which constitutes the vast majority of all R&D.

H.R. 557 is directed toward that end and takes an approach that is similar to the approach taken in the NCRA with respect to joint R&D ventures. H.R. 557 (as well as S. 438 and H.R. 1155) would assure that licensing arrangements covering a variety of types of intellectual property will not be evaluated under the *per se* doctrine, but instead will be evaluated under the antitrust rule of reason, which permits the licensee to explain to the court any procompetitive benefits that result from the challenged activity. This bill thereby will help assure that courts will consider the business justifications and procompetitive aspects of all suspect licensing arrangements in antitrust cases, and that only arrangements that are proven to be anticompetitive will be held unlawful. Significantly, this legislation would not render lawful any

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6/ See 15 U.S.C. § 4301(a)(6).

anticompetitive licensing scheme. Rather it would merely assure that courts hear all relevant evidence on the probable economic effects of a challenged practice. Anticompetitive licenses would remain illegal.

In assuring that all intellectual property licensing arrangements are evaluated under the rule of reason, H.R. 557 is a natural outgrowth of the NCRA, which assures rule of reason analysis for the licensing of intellectual property that is developed through joint R&D ventures. The Department believes that there is no reason to treat the licensing of intellectual property that is independently developed more harshly than the licensing of intellectual property that is the result of a joint R&D venture.

H.R. 557 (as well as S. 438 and H.R. 1155) also recognizes that the trebling of damages generally provided under the antitrust laws may well be overdeterring procompetitive licensing arrangements that allow American firms to realize fully their investments in innovative R&D. Accordingly, this legislation also provides for single damage recovery in antitrust cases based on intellectual property licensing arrangements instead of treble damages. Here, too, H.R. 557 follows the approach of the NCRA in seeking to avoid deterring procompetitive activity.

## Licensing and Misuse

H.R. 557 does not, however, go far enough to solve the licensing problem. With respect to many forms of competitive activity, the sole concern of firms is the reach of the antitrust laws. In the intellectual property area, however, the concern also extends to the reach of the patent misuse doctrine. Misuse is a judicially created doctrine founded in the courts' equitable powers and is used to attack patent licensing practices that are alleged to be undesirable from a public policy standpoint.

The claim of misuse by one who has used or would like to use another's patent rights without adequate compensation is a powerful weapon. The sanction for misuse is harsh; the patent is unenforceable against anyone, not just a party allegedly injured by such misuse, until the misuse has been eliminated and its effects purged from the marketplace. Therefore, patent owners can be expected to avoid entering into patent licensing arrangements that they fear may be deemed to constitute patent misuse. In order to reassure creators of new technology that the courts will not interfere with procompetitive patent licensing, we must assure that the misuse doctrine is not applied in a manner that condemns competitively desirable licensing.

Unfortunately, patent misuse has been applied as a per se doctrine prohibiting conduct that careful analysis demonstrates is not necessarily anticompetitive and, in fact, often is procompetitive. 7/ Indeed, the U.S. Court of Appeals for the Federal Circuit, which has jurisdiction and expertise on a variety of intellectual property matters, has questioned the rationale appearing in Supreme Court opinions dealing with misuse, 8/ but has regarded itself as "bound . . . to adhere to existing Supreme Court guidance in the area until otherwise directed by Congress or the Supreme Court." 9/

Congress should provide that guidance, and make clear that licensing conduct is to be condemned as misuse on competitive grounds only when antitrust analysis demonstrates the conduct

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7/ Two basic lines of patent misuse cases have developed. The primary line involves alleged efforts to use the patent to control commerce outside the scope of the patent claims. The secondary line of misuse cases involves decisions of the patent owner as to whether or not to license a particular party and, if so, at what royalty. A more detailed discussion of the development of the misuse doctrine and analysis of the case law is contained in my Remarks before the Patent, Trademark and Copyright Section of the Bar Association for the District of Columbia, "Competition Policy and the Patent Misuse Doctrine" (Nov. 3, 1982).

8/ See Windsurfing International, Inc. v. AMF, Inc., 782 F.2d 995, 1001-02 n. 9 (Fed. Cir. 1986), cert. denied, 106 S. Ct. 3275 (1986).

9/ Senza-Gel Corp. v. Seiffhart, 1986-2 Trade Cas. (CCH) ¶ 67,307 at p. 61,573 n. 5 (Fed. Cir. 1986).

to be anticompetitive. Specifically, since the antitrust laws are the appropriate vehicle for separating conduct having anticompetitive effect from conduct that is not harmful to competition, allegedly anticompetitive conduct should not be condemned as patent misuse unless that conduct is deemed unlawful based on an antitrust analysis. 10/

Section 3105 of H.R. 1155 would clarify and reform the doctrine of patent misuse so as to ensure that it does not deter procompetitive licensing arrangements. Section 3105 provides that licensing arrangements will not be condemned on grounds related to competition unless an evaluation of the competitive effects of the conduct demonstrates a violation of the antitrust laws. Section 3105 lists several patent licensing practices that cannot be the basis for a finding of

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10/ This is not to say that there are no situations short of an antitrust violation where courts, in the exercise of their equitable jurisdiction, properly should refuse to enforce a valid patent. For example, courts have refused to enforce a valid patent where the patentee engaged in inequitable conduct before the Patent Office. _See, e.g._, J. P. Stevens & Co. v. Lex-Tex Ltd., 747 F.2d 1553, (Fed. Cir. 1984), _cert. denied_, 106 S. Ct. 73 (1985). Such decisions, however, are based on an independent public policy; it is alleged that unless patent applicants are held to a high level of ethical conduct, the ex parte patent examination process will be unacceptably unreliable. However, it is crucial that whenever courts decline to enforce a valid patent, there should be such a clear and definite public need to do so. Any other course of action will tend to devalue the patent and interfere with the incentive structure envisioned in the patent laws, to the ultimate detriment of consumers and American competitiveness.

misuse unless such practices, in the circumstances in which they are employed, violate the antitrust laws. The first five practices listed are categories of conduct that have, at least in some instances, been hastily condemned under the misuse doctrine. In addition to these specific categories of practices, section 3105 also lists "otherwise [using] the patent allegedly to suppress competition" among the conduct to be evaluated under the antitrust laws. Under section 3105, courts still would have the discretion to refuse to enforce a valid, infringed patent on competitive grounds whenever the challenged conduct violates the antitrust laws, as well as on grounds not related to competition (e.g., fraud on the Patent Office).

Licensee Challenges to Patent Validity

Section 3106 of H.R. 1155 would clarify the law governing what happens when a licensee decides to challenge the validity of a patent. Section 3106 contains two important provisions. First, it would codify the well-established holding of Lear v. Adkins 11/ that a licensee under a patent cannot be estopped by agreement or otherwise from contesting the validity of a patent to which it is licensed. Second, section 3106 would make clear that beyond the estoppel issue, the parties are free to

11/ Lear, Inc. v. Adkins, 395 U.S. 653 (1969).

negotiate relevant terms concerning what happens if the licensee challenges validity, including whether the license can be terminated and whether the licensee is obliged to continue to pay royalties during the course of any such challenge.

This change is necessary to encourage procompetitive licensing of patents. The Lear decision itself assures that licensees are not placed in a comparatively disadvantageous position. In its freedom to challenge the patent, the licensee is in the same position as any non-licensee. If it discovers information that suggests that the patent is invalid, it can proceed to challenge the patent. If the licensee prevails, it can practice the patent without paying any further royalties even if the license agreement obligated it to pay royalties.

Some recent decisions interpreting Lear, however, have tipped the equilibrium much further in favor of the licensee; so much so that it seriously discourages efficient licensing in the first place. These decisions have refused to enforce provisions in the patent license that permit the licensor to terminate the license after the licensee challenges validity and have permitted the licensee to place royalties in escrow during the pendency of the patent challenge despite a contractual obligation to pay the royalties to the licensor. 12/ These decisions are not dictated by Lear and are economically counterproductive. Moreover, the licensee faces less stringent sanctions if he loses the patent challenge than does a non-licensee.

The essential thrust of Lear is that licensees should not be forced to pay royalties on invalid patents because of "the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain." 395 U.S. at 670. The policy behind Lear is therefore satisfied as long as licensees are not estopped from challenging the validity of patents. A licensee can contest the validity of the patent and, if victorious, abrogate its responsibilities under its license.

But the policy behind Lear does not dictate going further. The parties should be free to negotiate concerning whether the licensor can terminate the license or at least insist on

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12/ See Precision Shooting Equipment Co. v. Allen, 646 F.2d 313 (7th Cir.), cert. denied, 454 U.S. 964 (1981); Atlas Chemical Industries, Inc. v. Moraine Products, 509 F.2d 1 (6th Cir. 1974). Cf. Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 488-89 (1974) (dicta). The Federal Circuit has now found this result both unfair and not required by Lear. Cordis Corp. v. Medtronic, Inc., 780 F.2d 991 (Fed. Cir. 1985), cert. denied, 106 S. Ct. 1971 (1986). The Second and Eighth Circuits are in accord. Warner-Jenkinson Co. v. Allied Chemical Corp., 567 F. 2d 184 (2d Cir. 1977); Nebraska Engineering Corp. v. Shivvers, 557 F. 2d 1257 (8th Cir. 1977).

payment of royalties until a decision on validity is made. Significantly, even if a license were terminated, the licensee would not necessarily be precluded from continuing to use the patented invention during the course of the suit. The licensee would simply be in the same position as any other alleged infringer. Injunctions against such alleged infringers are granted only where it appears reasonably certain that in fact the patent is valid and the patentee will prevail in the suit. 13/

The incorrect post-*Lear* decisions simply put a licensor in an untenable position. It cannot be assured royalty payments for even one day; the day after the license is entered the licensee can cease paying royalties. Moreover, a licensee is in a far better position than any other firm that in good faith challenges the validity of a patent, because if the patent is found valid, it retains its license and, having never infringed the patent, it owes the licensor nothing more than the royalties it has agreed to pay. 14/ Thus, potential infringers are encouraged to enter into bad faith negotiations for a

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13/ Smith Internat'l, Inc. v. Hughes Tool Co., 718 F.2d 1573, 1577-79 (Fed. Cir.), *cert. denied*, 464 U.S. 996 (1983).

14/ If a non-licensee uses the patented invention and then unsuccessfully challenges the validity of the patent, it can be enjoined from using the patent and liable to the licensor for lost profits.

license when their clear intention is simply to challenge the validity of the patent. These incentives distort the negotiating process and discourage the efficient licensing of patents.

Section 3106 of H.R. 1155 would seek to put the licensor and licensee in a better equilibrium. It would permit the patent owner and licensee to agree, in advance, what rules would govern in the event that the licensee decides to challenge the patent. Allowing the parties to negotiate terms to govern in the event of a challenge permits both parties better to define their contractual relationship and negotiate terms that suit their particular circumstances. Royalties could be negotiated with some assurance that they would be paid for at least some period of time, and the amount could be set accordingly. Most importantly, uncertainty would be reduced somewhat and licensors would be encouraged to enter procompetitive licensing arrangements that may be discouraged by current case law.

In sum, the legislation would strike a better balance between the rights of the patent owner and the rights of the licensee. While the licensee would still be free to challenge the validity of the patent, the hands of the patent owner would not be completely tied. The patent holder could negotiate terms giving him some recourse in the event the licensee challenged the patent. The legislation would also give patent owners and their licensees greater freedom to negotiate terms that suit their needs and reduce the uncertainties that may now be deterring procompetitive licensing.

## Conclusion

A healthy R&D environment is crucial to the continued success of our economy. Enactment of the NCRA went part of the way toward improving that environment, but at least equally important is enacting new statutes that encourage procompetitive licensing of intellectual property. We encourage prompt attention to the pending legislation.

That concludes my prepared remarks. I would be happy to answer any questions at this time.



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