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(出國類別：研究)

競爭法對專利授權適用性之研究

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內容摘要: 公平交易法是在靜態的智慧財產權保護之外,建立動態平衡的公平競爭規範,兩者之間是否具有衝突對立的緊張關係,尤其為學者及實務所長期關注。另一方面,專利權在智慧財產權的領域之中,尤其具有代表性,專利在高科技產業幾乎就等於技術創新的代名詞,如能善用專利權,不僅在積極方面可以建構事業的技術核心,創造商品的高附加價值,在消極方面更可以阻絕競爭者的追擊,而專利的授權更是專利權的與競爭最重要的介面,它決定了專利權人與垂直與水平的競爭關係,所以競爭法與專利授權行為可說有密切關聯。面對複雜多變的市場競爭,競爭法如何追求執法的精確與穩定度,其難度極高,但也正足展現競爭法規範的生命力。鑒於我國競爭法主管機關雖於民國九十年訂有「審理技術授權協議案件處理原則」,但執法經驗尚淺,實務上不論飛利浦光碟案乃至於微軟案,一再顯示專利及其他智慧財產權的授權,將成為競爭法之執法重心。回顧美國競爭法對專利授權的規範與論析,當然可以肯定美國競爭法對於專利授權行為之適用並不是採取例外或豁免的態度,這與我國的基本執法原則是相符合的。然而由於專利授權,特別是關涉科技產業的專利授權,連相關事業都難以精確地描述系爭眾多專利技術究竟是替代還是互補,競爭法主管機關只憑有限的調查結果,當然在論辨市場界定的時候,顯得有點力有未逮。但市場與競爭關係之釐清,正是專利授權案件的核心,競爭法主管機關必須因應科技發展的趨勢,才能有效地執行競爭

本文電子檔已上傳至出國報告資訊網

競爭法對專利授權適用性之研究

【摘要】

公平交易法是在靜態的智慧財產權保護之外，建立動態平衡的公平競爭規範，兩者之間是否具有衝突對立的緊張關係，尤其為學者及實務所長期關注。另一方面，專利權在智慧財產權的領域之中，尤其具有代表性，專利在高科技產業幾乎就等於技術創新的代名詞，如能善用專利權，不僅在積極方面可以建構事業的技術核心，創造商品的高附加價值，在消極方面更可以阻絕競爭者的追擊，而專利的授權更是專利權的與競爭最重要的介面，它決定了專利權人與垂直與水平的競爭關係，所以競爭法與專利授權行為可說有密切關聯。面對複雜多變的市場競爭，競爭法如何追求執法的精確與穩定度，其難度極高，但也正足展現競爭法規範的生命力。

鑒於我國競爭法主管機關雖於民國九十年訂有「審理技術授權協議案件處理原則」，但執法經驗尚淺，實務上不論飛利浦光碟案乃至於微軟案，一再顯示專利及其他智慧財產權的授權，將成為競爭法之執法重心。回顧美國競爭法對專利授權的規範與論析，當然可以肯定美國競爭法對於專利授權行為之適用並不是採取例外或豁免的態度，這與我國的基本執法原則是相符合的。然而由於專利授權，特別是關涉科技產業的專利授權，連相關事業都難以精確地描述系爭眾多專利技術究竟是替代還是互補，競爭法主管機關只憑有限的調查結果，當然在論辨市場界定的時候，或顯得有點力有未逮。但市場與競爭關係之釐清，正是專利授權案件的核心，競爭法主管機關必須因應科技發展的趨勢，才能有效地執行競爭法。

競爭法對專利授權適用性之研究

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壹、緒論

一、背景說明

傳統與現代經濟的最大分野，並不在於產業的種類，也不在於區域與國界的劃分，而是現代產業以知識與科技為基礎，無須使用大量生產要素與自然資源，就能形成源源不絕的經濟動力。所以各國智慧財產權法律，無不提供創新者相當的排他性權能，以有效誘引企業充分投入研究發展，這已成為知識經濟體制下，財產法律最重要的法則之一。然在另一方面，正由於知識產業跨越國際與資本藩籬的發展潛能，較之傳統產業更能迅速穿透時空，掌握經濟發展的樞紐，而公平交易法作為自由經濟的基本遊戲規則，必須確保競爭的自由與公平，透過市場機制有效分配資源，滿足消費者的最佳福祉，不能坐視少數私人壟斷經濟的渠道，亦不能放縱競爭者以不公平競爭的方法，掠取他人努力的成果。

換言之，公平交易法是在靜態的智慧財產權保護之外，建立動態平衡的公平競爭規範，兩者之間是否具有衝突對立的緊張關係，特別為學者及實務所長期關注。另一方面，專利權在智慧財產權的領域之中，尤其具有代表性，專利的申請與防禦，在高科技產業幾乎就等於技術創新的代名詞，如能善用專利權，不僅在積極方面可以建構事業

的技術核心，創造商品的高附加價值，在消極方面更可以阻絕競爭者的追擊，而專利的授權更是專利權的與競爭最重要的介面，它決定了專利權人與垂直與水平的競爭關係，所以競爭法與專利授權行為可說有密切關聯。面對複雜多變的市場競爭，競爭法如何追求執法的精確與穩定度，其難度極高，但也正足展現競爭法規範的生命力。

二、研究經過及觀摩參訪之過程與心得

本計畫之執行，獲美國華盛頓州大學法學院(University of Washington, School of Law)之許可，得以訪問學者(visiting scholar)之身分赴該校研修六個月。期間除與該校相關領域之學者廣泛研討，並同時修習智慧財產權與競爭法相關領域之課程，並參與相關之研討會等學術活動。

另於九十二年九月下旬至十月上旬，赴紐約、華府及波士頓三地觀摩實習，除參訪紐約哥倫比亞大學、波士頓哈佛大學等知名學術機構外，亦配合我公平交易委員會於是年與美國聯邦交易委員會(Federal Trade Commission)及司法部反托拉斯署(Department of Justice, Antitrust Division)共同召開之台美競爭法主管機關第三次雙邊會議，參與該項會議之會談。智慧財產權與競爭法之互動關係，正為該雙邊諮商會議工作層級會議之會談重點，故得以藉此與美方主事官員交換

意見，以期全盤瞭解美方對該項議題之看法，進而有助於本計畫之遂行。

貳、研究成果與心得

—美國競爭法¹對專利授權行為之適用性之論析

一、 法制背景與原則

智慧財產目前實際上已經取代有體財產權成為國家財富的基礎。對聯邦競爭法主管機關而言，沒有任何事，比在智慧財產權領域內，審慎準確地適用競爭法來得更重要。這並非易事，尤其智慧財產權可能由大公司的研發部門所發展，也有可能就僅是個體戶的發明者在自己家的車庫裡創造出來的。然而發明家或許只因為另外一個發明者，在終點線前一步之遙的領先，多年的心血就全部付諸東流²；有些發明也有可能在實驗室裡看起來具體可行，但因生產成本的因素，始終無法在市場上成功量產，使得辛苦創造的成果，只能淪為紙上談兵。而這種種的風險，使得智慧財產權法制必須提供足夠的獎賞，才能激勵有志者願意投入大量的財力與智慧。

如果社會公眾可以任意使用或推展他人努力的成果，將嚴重減損投入發明的誘因。所以專利的保障，就賦予專利權人剝奪他人任意使用

¹ 競爭法是國際上目前一般對各國公平交易法的通稱，主要的核心規範，當然在於獨占、結合與水平及垂直的限制競爭，在美國這樣的法律規範，就稱之為反托拉斯法(antitrust law)，所以在本文於美國法的領域，通常直接以反托拉斯法代稱競爭法。

² 美國專利法所採取的是先發明先保護的制度(first-to-invent)，與其他國家先申請先保護(first-to-file)的制度是迥然不同。See 35 U.S.C. §102 (g).

的機會，但另一方面也就使得利用現有技術繼續創新的動力，因專利而受到限制，也使得專利技術無法自由運用，嘉惠公眾。競爭法的目標，無疑的就是必須在鼓勵創新以及技術流通的兩難間求取平衡。

從鼓勵創新的角度來看，保障智慧財產權必須要達到相當的程度，才能使發明者真正因為他的努力而受惠。如果別人可以搭便車分享智慧財產，卻不需要分擔研究與發展的風險與成本，勢必使得除了國家的投資之外，沒有任何私人願意投入研究。所以具有排他性質的專利或其他智慧財產權的保護，顯然是法律所必須提供的。

然而這樣的保護也必須小心，不宜使智慧財產權的保護逾越必要的限度，如果因為授與專利的範圍過於廣泛，以致後來發明創造的成果，可能被先前的專利權所霸佔或掠取，也同樣會變相阻礙後起的發明者從事創造的動力。

當然從另一方面——促進科技快速流通的角度來看，專利制度已做了相當的設計。專利法允許專利權人藉由授權他人而獲利，進而達到經濟規模，可以因被授權人的給付而分散研究與發展的固定成本，同時也允許專利權人在授權條件上設限，以極大化其利益，否則專利權人將因授權利益稀釋而降低其授權的誘因。在另一方面專利法也要求專

利權人必須公開其發明創造的成果，以進一步促進科技的創新³

與保護智慧財產權同樣重要的，是藉由保護競爭的市場機制來確保科技的快速流通，新產品或製程的發明者，或許總希望能控制創新科技流通公開的速度，維持相當的價格，以充分因獨占而獲利。但不能忘記的是，或許就會有同樣聰明的發明家，或者是擁有同樣財力實驗室，會發展出功能超越的產品或是更有效的製程。競爭法的功能，就在於確保通路或供應商不會不公平地拒絕交易，或是與既有的業者共謀，排除新進者進入市場，或者阻礙競爭者獲得生產或財務上的支持。

二、競爭法與專利法之調和

在維護競爭的前提下，美國聯邦反托拉斯法依然適用於智慧財產權的領域，並不單純因為專利法上合法，就可以不管所引發的反托拉斯法爭議。固然這兩套法制背後所蘊含的政策意義，某種程度上並不一致，但一般而言，競爭法與專利法與其說是處於相衝突的狀態，毋寧說兩者是互補的法制。從長期的角度，兩者都在藉由鼓勵競爭的基

³所以有學者形容專利是專利權人與公眾間訂定的契約，專利權人以完整揭露其發明創造來換取公眾賦予其排他的權利。MARTIN J. ADELMAN ET AL., PATENT LAW, 438 (2nd Ed. 2003). 尤有甚者，美國專利法不僅要求申請者提供書面文件，以完整、清晰、簡明及精確的文字，描述製造與使用專利的方法與程序，更進一步要求，必須揭露發明者所知最佳運用專利的模式。35 U.S.C. § 112 後者的要求幾乎已經進入發明者主觀認知的領域。See, *Chemcast Corp. v. Arco Industries Corp.* 913 F.2d 923, 16 U.S.P.Q.2d 1033 (Fed. Cir. 1987).

本動力—創新，以達到極大化消費者福祉的目的。

然而在過去美國反托拉斯法執法的歷史，或許是因為執法者（特別是法院）誤解，對智慧財產權領域的適用，並非總是以互補的態度來看待。因為傳統上智慧財產權會被認為是法律所賦予的獨占，而競爭法最基本的原則，就是不樂見人為獨占的發生，出於這樣的觀點，有學者即認為智慧財產權的立法目的，就是與競爭法背道而馳的⁴。在二十世紀初期，某些美國法院根本認為專利權或其他智慧財產權是反托拉斯法的例外，依照專利法行使專利權的行為，就可以免除反托拉斯法的審查⁵。

從另一種觀點，專利是受法律保障的排他性權利，也可以說就該項專利發明的確是法律允許的獨占，但這與在經濟上反托拉斯法要嚴格檢視的相關市場所擁有的獨占地位，兩者是不同的概念，某些法院卻將兩者相混淆，因而在二十世紀的大部分時間，有些美國法院常直接把反托拉斯法當作限制專利保護範圍的途徑。

⁴ See e.g., Stephen Calkins, *Patent Law: The Impact of the 1998 Patent Misuse Reform Act and Noerr-Pennington Doctrine on Misuse Defenses and Antitrust Counterclaim*, 38 DRAKE L. REV. 175, 176 n. 1 (1989)(noting this conflict).

⁵ See e.g. *United States v. General Electric Co.* 272 U.S. 476, 490 (1926). 美國最高法院於本案認為專利權人可以在授權上加上任何合理的限制，以獲取最大的利益，這個案子是對於專利產品的轉售價格限制，最高法院認為 General Electric 應該被允許對製造其專利產品的 Westinghouse 之銷售價格加以控制，並認為價格控制(price fixing)通常就是確保專利的適當報酬本質上所必須。不過首席大法官 Taft（也就是曾任總統的 Taft），或許是意識到問題並非如此簡單，加上了「在報酬的合理範圍」(reasonably-within-the-reward) 的標準。See also, Furth, *Price-Restrictive Patent Licenses Under the Sherman Act*, 71 HARV. L. REV. 815, 816 (1958).

典型的方式就是逕行認定某種特定態樣的專利授權就是違法，美國最高法院就曾在 *International Salt Co. v. United States* 一案中⁶，將專利保護視同為經濟上的獨占，進而推論該項專利導致違法的搭售行為⁷，所以法院在沒有考慮是否有其他品牌的替代產品，也沒有考慮專利權人的市場占有率，更沒有考慮競爭的存在與否，就逕行判定專利權人要求授權製鹽機的專利，被授權者必須附帶向專利權人買鹽的授權方式是違法的。

此一案例美國最高法院採取的判決理由，以現在的通說來看是有缺陷的，雖然專利的確在法律上是一種獨占，但並不必然在經濟的觀點上是一項獨占⁸。要之，專利權人固然可以排除他人使用他的專利，但專利權人無從排除他人發展或銷售較該項專利更優越，或至少可替

⁶ 332 U.S. 392 (1947). 而且這並不是單一的案例，類似直接推定專利權人具有獨占力的案件，歷來不乏其例。 See, e.g., *Jefferson Parish Hosp. Dist. v. Hyde*, 466 U.S. 2 (1984); *United States v. Loew's, Inc.*, 371 U.S. 38 (1962); see also *Digidynev. Date General Corp.*, 734 F.2d 1336 (9th Cir. 1984), cert. denied 473 U.S. 908 (1985).

⁷ 觀念上必須要說明的，搭售行為在美國反托拉斯法中，是可能同時涉及薛曼法第一條，克萊登法第三條及聯邦交易委員會法第五條。但如果搭售者具有足夠的市場力量（market power 實務上幾乎是獨占的同義語），那麼會構成薛曼法下的當然違法的類型。See *Jefferson Parish Hospital No. 2 v. Hyde*, 466 U.S. 2, 12(1984). 概念上與我國公平交易法第十九條第六款的情形，似乎有不同的解釋方式，通常被認為必須以合理原則分析，而非當然違法，但如果考慮到公平交易法第十條與第十九條的競合情形，美國與我國實務論析的結果，應該沒有多大出入。

⁸ See e.g., HEBERT HOVENKAMP, *ECONOMICS AND FEDERAL ANTITRUST LAW*, 219 (1985); ROBERT P. MERGES ET AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE*, 998 (3rd ed. 2003); William Montgomery, *Note, The Presumption of Economic Power For Patented and Copyrighted Products in Tying Arrangement*, 85 COLUM. L. REV. 1140, 1156(1985). 而這也形成了 1995 年司法部與聯邦交易委員會發布的「反托拉斯法對智慧財產權授權處理原則」的基本原則之一，See U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property*, § 2.2 (1995) [hereinafter IP Guidelines], available at <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm>.

代的技術或產品，而一旦有替代品存在，專利權人就無從得到市場力量或者是獨占力的庇蔭。

不過這種過往對專利與反托拉斯法相衝突的觀念，仍然繼續影響法院的判決，而在法律案例課本中，這些案例也依然被引用，而且最高法院也從未明白地推翻過。另一方面，對法院來說，縱使學者已經發表了許多深具洞察力的論述，聯邦主管機關更在 1995 年發布了處理原則，如何界定何時對專利權的保護已經逾越適當的程度，而開始對消費者福祉造成傷害，對競爭法主管機關依然是十分困難。

三、反托拉斯法對高科技產業適用之迷思

隨著二十一世紀的到來，世界上的主要經濟體，都愈來愈倚重茁壯中的高科技產業，而這些產業實際上就是立足在各式各樣的智慧財產權之上，而新的智慧財產權與反托拉斯法的爭議，不論在法庭中或是公共論壇都正方興未艾。質言之，在反托拉斯法的立法的時代，經濟還是由煙囪林立的重工業所支配，強調的是企業的規模與地理市場的大小。這種時代的法律真的適於動態的、創新為基礎的新經濟嗎？真的適用於例如傳播、生化、電腦軟硬體等等，以智慧財產權為關鍵的產業嗎⁹？

⁹ See Robert Pitofsky, *Challenges of the New Economic: Issues the Intersection of Antitrust and*

論者有以為，以現在市場的快速變動，將使「市場進入障礙」一語，變得沒有意義，而反托拉斯法的執法也歸於徒然；論者也指出，大型的研究發展計畫，往往需要業者的通力合作，然而薛曼法傳統對與競爭者間合作的傳統看法，將有礙於技術創新；更有人引據時新的網絡效應（Network Effects）¹⁰，認為反托拉斯法的執法不僅無益甚或有害。例如錄影帶 VHS 規格打敗 Betamax，微軟相對於其他作業系統的競爭者的優勢，或許都成因於網絡效應，而反托拉斯法若積極執法，是否會賠上消費者的利益？然而具有支配地位的企業遭遇反托拉斯法的訴訟似乎不可避免，而訴訟所致的損失，甚或更糟的，被判決必須付出高額賠償獲罰金，甚或或分割事業，這均有可能摧毀一個有效率的科技產業¹¹。

不過這些反托拉斯法所面臨的困境，雖然十分難解，但在現實上卻不是最重要的問題。因為就算是鼓吹自由放任最力的純理論者，恐怕也都還沒有準備好，支持任何所謂對高科技產業應給予全面的反托

Intellectual Property, presented at American Antitrust Institute Conference: An Age for Antitrust in the 21st Century (2000), at <http://www.ftc.gov/speeches/pitofsky/000615speech.htm>.

¹⁰ 關於網絡效應或網絡經濟的討論，*See, e.g.*, STAN LIEBOWITZ, RE-THINKING THE NETWORK ECONOMY: THE TRUE FORCES THAT DRIVE THE DIGITAL MARKETPLACE, 3-4 (2002).

¹¹ JOHN H. SHENEFIELD & IRWIN M. STELZER, THE ANTITRUST LAWS-A PRIMER, 90 (4th ed.2001). 但也有以為，正是因為所謂的網絡效應，造成高科技產業成為贏者全拿(winner-take-all)的局面，對於既存的網絡優勢業者，新進業者很難與之競爭，因而獨占者之市場力量反而因網絡效應增強。William J. Baer, *Antitrust Enforcement and High Technology Markets*, Remarks before the American Bar Association Section of Business Law, Litigation, Tort and Insurance Practice (Nov. 12, 1998), at <http://www.ftc.gov/speeches/other/ipat6.htm>

拉斯法豁免的說法¹²。所以實際的問題，恐怕不是要不要於新經濟體制下執行競爭法，而是該怎麼執行！

實際上反托拉斯法向來都保有一定的彈性，本來在實際案例處理上就會考量會特定產業的屬性與特質，高科技產業亦然。例如薛曼法在實務上對於研發方面的共同投資所衍生的行為，就抱著比較寬容的態度¹³。又如獨占地位的取得是基於網絡效應的結果，當然不會因此構成反托拉斯法的違法。換言之，重要的是個別案例事證是否足以證明違法的存在，而非事業究竟是否為高科技產業¹⁴。

當然科技的迅速變化及技術的複雜，競爭法執法者因而需要更高超的執法技能與效率，而在追訴違法的裁量適切性上也同樣受到挑戰。無疑的，新的科技發展不論對法院、陪審團乃至於執法機關而言，都形成嚴峻的挑戰。然而更重要的是，如何即時作成一項正確的決定或裁判，也就是在科技版圖或市場情勢變動之前，適時地建制好競爭

¹² See e.g., Richard M. Brunell, *Appropriability in Antitrust: How Much is enough?*, 69 ANTITRUST L. J. 1 (2001); Richard J. Gilbert & Willard K. Tom, *Is Innovation King at the Agency? The Intellectual Property Guidelines Five Years Later*, 69 ANTITRUST L. J. 43 (2001).

¹³ See U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for Collaborations among Competitors*, § 4.3 (2000), available at <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf>.

¹⁴ 就有人對所謂高科技產業的說法提出質疑，例如現任的聯邦交易委員會委員 Leary 氏就曾提到，他在七〇年代工作於通用汽車公司，大概在現代不會把汽車產業歸類為高科技產業，但實際上所運用的高科技遠超過一般人的想像。Thomas B. Leary, *The Patent-Antitrust Interface*, based on a speech before the American Bar Association's Section of Antitrust Law Program, "Intellectual Property and Antitrust: Navigating the Minefield," Philadelphia, PA, May 3, 2001, at <http://www.ftc.gov/speeches/leary/ipspeech.htm>.

的遊戲規則，這才是競爭法體制最基本而又不能逃避的挑戰。

四、智慧財產權領域的市場界定

當然如一般所知的，在智慧財產權領域適用競爭法的第一項問題，也是最基本的分析，仍然是相關市場的界定。通常牽涉到三個可能的相關市場，也就是產品市場、技術市場以及在特定領域的研究與發展市場，有時稱之為創新市場。而這也是美國司法部與聯邦交易委員會 1995 年「反托拉斯法對智慧財產權授權處理原則」對智慧財產權授權協議會影響的相關市場的基本界定¹⁵。

所謂的產品市場在智慧財產權的範疇，一般是指可能受到智慧財產權影響之產品，包括使用該項智慧財產權的中間及最終產品，以及製造前述中間或最終產品所需的零組件等之上游產品。處理原則也宣示，產品市場佔有率的計算標準，將依 1992 年公布的水平結合處理原則(Horizontal Merger Guidelines)第一點的規定，來加以認定¹⁶。

要界定傳統的產品市場或者是商品市場，一般來說並沒有爭議。例如，購併競爭者的智慧財產權，就有可能減損產品市場的競爭，因

¹⁵ IP Guidelines § 3.2. 公平交易委員會九十年一月二十日訂定的「審理技術授權協議案件處理原則」第四點第二款明白表示採取相同的市場界分方法，或許就是繼承於美國司法部與聯邦交易委員會的規定。

¹⁶ IP Guidelines § 3.2.1.

為將使競爭者製造該項專利產品的能力遭到剝奪，而該項專利產品可能就是購併者產品的替代品。又如授權的契約或合意，也有可能限制被授權者就特定產品的銷售活動，比如說限制銷售區域或其他銷售條件。

所謂的技術市場是由用來授權的智慧財產權及可以替代該智慧財產權的其他技術所組成的。當專利產品與專利本身是可以分開來銷售時，主管機關就可以特別針對該項專利的技術市場分析其授權行為的競爭效果¹⁷。

技術市場的分析，相對而研究比較困難，事業通常在技術市場中，事業就是在技術移轉、授權或是使用智慧財產權等行為上發生競爭關係。所以技術的購併或授權，有可能降低該技術市場的競爭程度。

但更複雜的問題是，競爭法主管機關以及部分企業近年所關切所關切的研究發展的市場，也就是所謂的創新市場¹⁸。可以想像在研發的領域內，有一些競爭行為將會實質地降低市場競爭的程度，但事實上相關的科技都還僅在發展階段，並沒有任何人取得智慧財產權。近年來美國競爭法主管機關所處理的高科技公司的購併案件，就足以為

¹⁷ IP Guidelines § 3.2.2.

¹⁸ IP Guidelines § 3.2.3.

例，如聯邦交易委員會曾對涉及基因療法一項結合案發出改善的命令（類似我國附條件的許可），理由是該結合案將導致基因療法的研究發展市場競爭降低而基於維護該技術創新市場的競爭程度，聯邦交易委員會要求主導購併的公司，必須承諾將來必須提供必要的、非排他性的技術授權給其他公司，也就是說實際的產品發展在購併的階段，根本就不存在，但主管機關仍然基於維護所謂的相關研究發展市場之競爭，而對該項結合案發出命令¹⁹。但由此即可發現爭議所在—高科技產業無時無刻不在快速地創新發展，然競爭法主管機關仍希望能對創新發展過程有所監控，面對如此快速多變的市場動態，迫使主管機關必須更頻繁而且迅速地作成決定。

五、合理原則與當然違法之適用

當相關市場的選定之後，在智慧財產權領域的反托拉斯法分析模式，並不令人陌生。大多數的爭點仍然運用合理原則(rule of reason)。就專利授權協議而言，將衡量其對於競爭的利益是否超越對競爭所形成的負擔或限制；除此之外，也會衡量是否以對競爭更少限制的方法，來達成對競爭相同的利益²⁰。在個案中這樣的分析如何窮盡，又相關的市場何在，往往必須緊密地依循個案具體事實才能決定。涉及

¹⁹ *In the Matter of CIBA-Geigy Limited et al*, FTC File, DKT No. C-3725, available at <http://www.ftc.gov/os/1997/04/c3725.do.htm>

²⁰ IP Guidelines, § 3.4.

智慧財產權的結合案件的分析，則是對有利於競爭的影響(effects)與效能(efficiencies)必須超越對競爭所造成的不利影響(injury)。

某些特定的垂直限制行為，例如轉售價格的限制(resale price-fixing)或不當搭售(tying)，將會以較嚴格的標準審查，因為這樣的行為幾乎可以確定將貶損競爭，而且缺乏增進效能的正當理由，所以會快速簡易地被推定是當然違法的。在這樣的標準之下，主管機關只會對據稱的一些正當理由進行有限度的審查，以判斷是否足以降低反競爭的風險。如果不足以降低反競爭風險，主管機關就會在當然違法原則(*per se rule*)的前提下，起訴這樣的案件。

此外，某些一般在反托拉斯法上被認定為當然違法的行為，在智慧財產權領域亦沒有不同的看法。例如赤裸裸的水平價格聯合以及市場劃分行為，就被認定為當然違法，不需要理會當事人提出的任何所謂促進競爭的藉口。

六、安全區域 (safe zone)

在光譜的另一端，一九九五年聯邦司法部與聯邦交易委員會所訂定的處理原則，則提供了有限的安全區域(safe zone)，在這個範圍內的行為，主管機關將不會進行審查。首先，不可以是任何一種以當然

違法處理的行為；其次，在授權者與被授權者在相關被權影響的市場的占有率，合計不超過百分之二十。如果能滿足上述兩項標準，主管機關將不進一步處理相關案件。然而上述的「安全港」條款(safe-harbor provisions)，只適用於智慧財產權授權協議與智慧財產權的行使行為，而不適用於涉及智慧財產權的取得，不論是以排他性授權取得或是以買斷方式取得皆然²¹。

必須強調的是，本文固然以專利權及其授權行為為關心的對象，也是在專利的範圍裡進行分析。但具體個案中，違反反托拉斯的分析或其違法判斷，通常是不因為個別智慧財產權的特質而受影響，也就是說不論專利、商標、著作權或營業秘密，原則上在反托拉斯法上的處遇是相同的。

七、專利權的取得行為(Acquisition)

一般而言，智慧財產權的取得行為，並不常受到反托拉斯法的關注，尤其對專利來說，能夠自由轉讓或許是使發明能夠商業化，進而為社會運用的重要途徑。因為發明家或許長於創新，但卻拙於生產行銷，如果不許專利權或其他智慧財產權轉讓，許多創新的技術或產品，只能敝帚自珍，無從廣為流傳。就算專利權人是基於詐欺而取得

²¹ IP Guidelines § 4.3

專利--也就是說專利局如果不是因錯誤的資料而受誤導，根本不會核發專利，即便如此，也不構成反托拉斯法上的違法，充其量只是在專利法上足以成為撤銷專利的事由²²。也就是說，絕大多數的智慧財產權的取得與轉讓，根本是稀鬆平常的事。

但如果系爭取得或轉讓的智慧財產權，在相關市場是相當重要的要素，將因取得或轉讓造成獨占或限制競爭，那就是另一回事。例如法院或許會認定刻意攫取相關領域所有專利的行為，是意圖排除競爭，有可能違反薛曼法第二條規定。同樣的，如果行使基於詐欺所取得的專利權，其目的也在於藉此保持獨占或企圖取得獨占地位，在專利訴訟中的對造，將可以違反薛曼法第二條為由予以抗辯，阻止其專利權的行使²³。不過這都是相當罕見的案例，每天都有無數的智慧財產權移轉，幾乎都不會觸動反托拉斯法的審查。

八、專利權的行使行為(enforcement)

專利是藉由提起專利侵害的訴訟來行使其權利²⁴，在專利侵害訴訟中，反托拉斯法的主張，是由涉嫌侵權的一方以反訴方式提出²⁵。

²² JOHN H. SHENEFIELD & IRWIN M. STELZER, *supra* note 11, at 94.

²³ *Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.* 382 U.S. 172 (1965).

²⁴ 在美國法上的討論，提到智慧財產權的行使(enforcement of intellectual property)，指的就是提起侵害訴訟，沒有其他方式，即使是寄發警告信函(cease-and-desist letter)，也都只是侵害訴訟的一部分或先行行為。

²⁵ Clayton Act § 4, 15 U.S.C.S. § 15; *Kobe, Inc. v. Dempsey Pump Co.*, 198 F.2d 416 (10th Cir. 1952).

如果該反訴成功，行使專利權的一方，就可能會蒙受金錢損失，因為反訴的一方可依據克萊登法第四條請求三倍的損害賠償²⁶，所以任何提起專利侵害訴訟者，都必須要考慮對方提出反托拉斯法抗辯所造成的風險與嚴重性。

一般的反托拉斯法反訴，不一定會把專利侵害訴訟，也當作違反反托拉斯法行為的一部份。也就是說，反托拉斯法反訴可能完全基於專利權人在侵害訴訟之外反競爭行為，諸如反托拉斯法上常見的不法行為——不當獨占、不當搭售及其他反托拉斯法的違法行為，都可以在專利侵害訴訟中提出來當作反訴理由。舉例而言，實務上曾有原告聲稱其（使用於礦業）旋轉碎石機之專利遭到侵害，而被告反訴原告以授權專利之際，同時要求購買非專利的環氧樹脂，因而構成違反薛曼法第一條的不法搭售行為²⁷。雖然這樣的反托拉斯法訴訟，當然可以另行起訴，但以反訴形式一併訴請審理，不僅可控訴他方違反反托拉斯法，同時亦可形成對抗原告專利侵害訴訟的有力工具。

如果不是單獨的反托拉斯法違法行為，而是以原告對被授權者提出專利侵害訴訟一事，逕行當作反托拉斯法反訴的訴訟標的，這樣的反訴，必須要由提出反訴的一方，證明原告是惡意(in bad faith)提起

²⁶ The Clayton Act § 4, 15 U.S.C. 15.

²⁷ *Rex Chainbelt Inc. v. Harco Products, Inc.*, 512 F.2d. 993 (9th Cir. 1975).

專利侵害訴訟²⁸，要不是系爭專利之取得就是基於詐欺，不然就是該專利侵害訴訟客觀上沒有基礎(objectively baseless)。

所謂專利侵害訴訟客觀上沒有基礎，指的是該訴訟基於其訴訟理由，完全沒有合理期待可能贏得訴訟。這種濫用訴訟的行為，無非意圖利用公權力程序直接干擾競爭者的商業交易，有可能進一步要承擔民事賠償責任。

雖然通常的訴訟中，即使主張他方惡意提起訴訟的一方，能證明專利權人是基於詐欺取得專利，或者能證明該專利侵害訴訟客觀上沒有基礎，惡意提起專利侵害訴訟者，也很少因此需擔負損害賠償責任。另一方面，反托拉斯法基本而最重要的要件，證明專利權人在相關市場具有市場力，仍然是反托拉斯的反訴中最重大的障礙。

正由於要證明專利權人在相關市場具有市場力是相當困難的，於是激發專利侵害訴訟中的被告發展出一套新的抗辯方式，也就是以聯邦或州的「不公平競爭」條款，作為單獨或併行的反訴理由，也就是說這些抗辯並非基於反托拉斯法，而是基於州法或聯邦的 Lanham Act 所規範的不公平競爭²⁹。

²⁸ “[T]he right of a patentee afforded by patent to assert that a competitor is engaged in wrongful conduct with respect to the patent requires that a complaining competitor allege and prove bad faith for each such claim.” *Zenith Electronics Corp. v. Exzec Inc.*, 182 F.3d. 1340, 1355(Fed. Cir. 1990).

²⁹ 與我國將不公平競爭與反托拉斯法共治於公平交易法不同，美國法上的不公平競爭(unfair

重要的是，不公平競爭的抗辯，並不需要證明專利權人有市場力或其他反托拉斯法上的要件。不過依然要求必須能證明原告是惡意提出專利訴訟。不公平競爭的反訴同樣可以請求金錢的損害賠償，因而對被指稱為專利侵害的一方，由於反托拉斯法的反訴不一定能成功，實務上愈來愈常見以不公平競爭作為反訴理由。

九、專利濫用原則與反托拉斯法

另一個專利侵害訴訟中與反托拉斯法反訴息息相關的抗辯方式，是所謂的專利濫用原則(the patent misuse doctrine)的抗辯，質言之，此一抗辯係主張案關涉及被侵害的專利已遭濫用，或者其行使方法違反專利法、反托拉斯法或者任何相關法政策 (legal policy)³⁰。雖然專利濫用原則通常是以專利行使造成反競爭效果為典型，例如說就專利商品對外轉售的價格予以限制，但該原則的適用並不以行為實際違反反托拉斯法為要件，只要符合有反競爭之虞的低度標準即可，不過近年法院有提高標準的趨勢，使得專利濫用原則的適用愈來愈接近反托拉斯法的審查³¹。

competition)，主要關注於商標或其他表徵或表示的遭到仿製或誤導，聯邦法律的規定，在統一商法典的第十五章的 1051 到 1141n 節(15 U.S.C. §§1051~1141n)，法律體系與理論背景與反托拉斯法截然不同，學術或實務的討論也通常都當作是不同的領域來看待。

³⁰ 有些學者是以違反公共政策(public policy)一語來描述專利濫用行為，see e.g., ROBERT P. MERGES ET AL., *supra* note 8, at 284.

³¹ 國會從來就不滿意法院對專利濫用原則的界定，1952 年就曾經修正專利法，增訂 35 U.S.C.

第一個採用建立專利濫用原則的最高法院案例，是 1917 年的 *Montion Picture Patents Company v. Universal Film Manufacturing Company et al.*³²，該案原告聲稱被告等三家公司侵害其使用於動畫放映機器裝置影片的一項專利，然而原告授權下游生產使用其專利之機器時，規定其售價不得低於原告規定的價格，尤有甚者，契約亦規定，任何銷售的放映機器，不得僅能使用曾具有另一專利權之影片，但該影片之專利已告屆期。最高法院認為上述限制是無效的，宣示專利權的界限，僅限於專利的範圍(claims)，法院指摘原告意圖擴張專利的獨占範圍至專利已失效的影片上，並宣示專利法目的在於鼓勵創新，而非增進私有財產，特別是當專利授權契約的約款，如果會嚴重傷害公共利益時，並不受專利法保護。

有趣的是，反托拉斯法正是在十九世紀末、二十世紀初開始制定（薛曼法，1890 年；克萊登法，1914 年），是否意味著最高法院受到反托拉斯法立法的影响？此外儘管專利濫用原則排除的專利授權行為與反托拉斯法大體相同，然而專利濫用的範疇卻比反托拉斯法廣泛

§271(d)(1)-(3)，1988 年更通過所謂專利濫用改革法案(the Patent Misuse Reform Act, PMRA)，同樣修正 35 U.S.C. §271，內容幾乎使專利濫用與反托拉斯法規範的行為更加重疊。聯邦第七巡迴法院法官 Posner（著名的反托拉斯法與法律經濟學學者）就主張兩者範圍應該相同，也就是說除非違反反托拉斯法，不會構成專利濫用，同時也必須以傳統的反托拉斯法原則加以分析適用。See, *USM Corp. v. SPS Tech.*, 694 F.2d 505 (7th Cir. 1982), cert. denied, 462 U.S. 107 (1983).
³² 243 U.S. 502(1917).

³³。尤有甚者，反托拉斯法需要證明市場地位以及對於競爭或市場供需的影響，專利濫用原則適用時，並沒有這樣的限制³⁴。

也就是因為專利濫用並不等於違反反托拉斯法，所以專利濫用在訴訟上即使成功，也只是使專利權人無法對被告實行專利權，並不提供遭濫用的一方金錢的損害賠償³⁵。這有助於理解專利濫用原則與反托拉斯法雖有重疊，但並不同。

正由於提起專利侵害訴訟有可能引發反托拉斯法的追究，所以許多專利侵害訴訟是以和解收場，或尋求不再對訴訟他方行使專利權，授權或集中授權(patent pools)等授權安排，正是雙方合意以交互授權，用以解決專利授權爭議的常見方法。此種授權安排透過產品互補零組件的整合可以增進經濟效率，否則產品的生產可能受阻於其他封鎖性的專利(blocking patents)，甚至某單一的产品可能需要運用多種分屬不同權利人的專利，始能加以生產。然而即便是這種促進技術合作或整合授權協議，也不能豁免反托拉斯法的審查。一旦發現藉著雙方的專利授權協議，包括失效的專利，或者企圖加強締約者的市場力

³³如前所述，違反公共政策的事由，不僅以違反反托拉斯法為限。筆者 2003 年秋季於 Univ. of Washington 法學院修習智慧財產權課程，筆者以下的方式表述此一觀點：「違反公共政策不一定違反反托拉斯法，但違反反托拉斯法一定是違反公共政策。」授課教授 Dan Laster 就表示相當同意。國內學者錢遠霖亦有相類見解，氏著，光儲存媒體技術聯合授權反壟斷問題之探討—以美國法制為例，智慧財產權月刊 62 期，頁三五，民 93 年 2 月。

³⁴ ROBERT P. MERGES ET AL., *supra* note 8, at 284.

³⁵ See, MARTIN J. ADELMAN ET AL., *supra* note 3, at 1074-75.

量，以排除其他未獲得授權的競爭者，極有可能被認定為違反反托拉斯法。例如兩家處方藥生產商 A、B 達成和解，合意由 A 業者給付四千萬元，換取 B 業者同意將聲稱侵害專利藥專利的學名藥（與專利藥具有競爭關係），延遲在美國境內付諸量產上市，雖然名目上或是表面上這是一項專利侵權和解，或是專利授權協議，但實際上是合意減損相關市場的競爭，即有可能以違反薛曼法第一條及第二條遭到起訴。

類似的情形是，反托拉斯法主管機關曾認為如果壓迫專利權人不得行使其專利權，也有可能違反反托拉斯法，近年聯邦交易委員會對英特爾公司所提出的反托拉斯訴訟一案的重點即為此。該案英特爾公司（Intel Corp.）藉由停止供應，或者威脅停止供應全功能微處理晶片的必要技術資訊給特定的交易相對人，壓迫這些廠商放棄已對英特爾公司提出的侵權訴訟，並且授權其智慧財產權（通常是專利）給英特爾公司，聯邦交易委員會認為這樣的行為違反聯邦交易委員會法（the Federal Trade Commission Act）第五條規定。該案聯邦交易委員會發出命令，要求英特爾公司不得停止提供進一步的技術資訊予任何對英特爾公司主張智慧財產權的交易相對人，特別是該交易相對人在爭議中原有收到英特爾公司的資訊，該公司接受該命令的裁決而達成

和解³⁶。

十、專利授權之相關議題

(一) 概論

專利權人一旦取得專利權，隨之即得以排除他人製造、使用、銷售該項發明，專利權人可以藉由其專利追求財物上、商業上及私人的利得，正是此種獲利的動機，吸引專利權人將其專利授權與他人，以追求最大的利得。

專利授權的安排，正如其他牽涉到專利權的契約或合意，通常是促進市場競爭的，因為經由授權有助於新技術的流通。只有在罕見的獨占或限制競爭的情形，才會成為反托拉斯法查處的對象。法院判決先例（雖然尚在發展之中）³⁷以及主管機關的處理原則中的意見³⁸，都認為專利授權協議的案例審理的時候，應該適用合理原則(rule of reason)。少數的當然違法的例外案件，通常是專利授權協議只是用來作為共謀價格僵固、分割市場或是其他赤裸裸的限制競爭行為的偶然

³⁶ *In the matter of Intel Corp.*, FTC DKT. No. 9228 (file June 1998), Consent Order (August 6, 1999), available at <http://www.ftc.gov/os/adjpro/d9288/index.htm> 該案以雙方達成和解收場，不過委員 Orson Swindle 認為缺乏足夠的理由認定英特爾公司違反聯邦交易委員會法第五條，所以提出不同意見，at <http://www.ftc.gov/os/1998/08/swindleintel.htm>.

³⁷ See generally, *FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447 (1986); *NCAA v. Board of regents of the Univ. of Okla.*, 468 U.S. 85 (1984).

³⁸ See, IP Guidelines, § 3.4. ¶ 1.

工具(incidental instruments)。

(二) 反托拉斯法對專利授權行為之區分

反托拉斯法對專利授權行為的分析，首要工作即是對行為予以區別分類，這關係到將如何適用反托拉斯法。首先反托拉斯法對於對於競爭者間關係的規範，不同於賣方與最終消費者的規範，而且前者遠較後者嚴格。其次，競爭者間專利授權問題，也可以區分為水平以及垂直的關係。競爭者間的專利授權協議，如果用意在於建立共同行為例如有瓜分市場或價格聯合的情事，無疑的就會被認為是水平的行為，也就是說在反托拉斯法上是用較嚴格的規範。另一方面，專利授權協議如果在事業間如果形成互補的關係，例如以研究發展為業的公司與以製造生產為業的公司之間的協議，就會屬於垂直性質。

另外一項須於授權案件分析中予以區別分類的是案關授權協議是屬於專屬性或是非專屬性的。有些專利權人會授權予他方專屬的、獨家的授權，也就是說允許被授權人等同於專利權人的地位行使該專利權，由於被授權人因而取得對專利控制的程度遠高於一般授權，因而通常也必須給付高額的權利金。另一方面，專利權人也可能選擇對多數的交易相對人，締結非專屬的專利授權協議，此種協議固然容許被授權人使用該專利發明並據以產銷相關產品，但並不允許被授權人

行使專利權對抗侵權者。當然這樣非專屬的授權協議能收取的權利金數額是相對較低³⁹。

（三） 排他性授權條款

專利授權即便是排他性的授權，亦無不合法可言，事實上專利法就明白規定容許專利權人以專屬授權的方式讓與專利權作為行使專利的方式⁴⁰，專屬授權只有在專利購併的情形可能會引起反托拉斯法的關切，例如說，系爭專利的授權者與被授權者正好互為競爭者或潛在競爭者。非專屬性的授權一般來說相對更為安全，但是某些情形也會引起反托拉斯法的關切，例如說，假設實際的授權操作形成事實上的專屬授權而且具有一定的反競爭效果。例如說 1994 年司法部就主張某一項授權予某家用殺蟲劑的領導廠商的非專屬授權，事實上是專屬的授權，以保護被告在美國市場的支配地位，並排除外國廠商競爭參進。該案由於授權人是家用殺蟲劑市場潛在的新進競爭者，授權人給予被授權人對專利技術排他性控制及同意拒絕其他請求授權的邀約，取代授權人自己進入市場，所以司法部認為有違反反托拉斯法

³⁹ *Waterman v. Mackenzie*, 138 U.S. 252, 255-56 (1891). 學者因此區分成讓與(assignment)以及授權(license)兩種形式，See, MARTIN J. ADELMAN ET AL., *supra* note 3, at 1056.

⁴⁰ 35 U.S.C. § 261. See also, *Waterman v. Mackenzie*, “[T]he patentee or his assigns may, by instrument in writing, assign, grant, and convey, either (1) the whole patent, comprising the exclusive right to make use and vend the invention throughout the United States; or (2) an undivided part or share of that exclusive right, or (3) the exclusive right under the patent within and throughout a specified part of the United States....” *id* at 255.

之虞⁴¹。

(四) 權利金條款

在專利授權的行為本身之外，授權的某些主要條款或許也具有反托拉斯法的意義。以專利授權的權利金而言，一般而言專利權人會收取市場能夠忍受最高程度的權利金，典型的權利金計算方式，基本上是以專利產品的銷售量為基礎來計算。但如果權利金的計算是基於某些無關於專利效用的基準，就有可能是一種專利濫用而有違法之虞。微軟公司的第一個被控違反反托拉斯法的案件，司法部即是指控此一軟體巨人對電腦公司要求每生產一台電腦，就必須給付微軟公司軟體授權的費用，不論電腦銷售時實際上是否裝置微軟的軟體，這等於是對裝置微軟以外軟體的電腦，要求支付雙重的費用—除了要支付實際裝置的軟體費用，還要支付未曾裝置的微軟軟體費用⁴²。也就是說微軟公司等於在其他軟體公司進入市場的道路上，藉由權利金收取的方式豎立路障，阻止其他人參與競爭。這樣的權利金收取就不能說是正當的專利權行使，當然還是有違反反托拉斯法之虞。

(五) 限制轉售價格條款

⁴¹ *United States v. S.C. Johnson & Son, Inc.*, 1995-1 Trade Cases (CCH) ¶ 70,842 (D. Ariz. 1994)(consent decree).

⁴² *United States v. Microsoft Corp.*, 1995-2 Trade Cases (CCH) ¶ 71,096 (D.D.C. 1995).

授權協議也有可能藉授權為條件，以限制被授權者銷售產品之價格，這種運作方式通常被認為與維持轉售價格(resale price maintenance)有關，但正當化的理由是專利授權人如果自己產銷專利產品，就可以訂定其專利獨占的價格，所以認為並非不可要求被授權人依其約定的價格出售，同樣的邏輯與理由，也被用來支持專利權人約定轉售價格的上限與下限。

不過這樣的維持轉售價格限制是充滿爭議的，最高法院在 *United States v. General Electric Co.* 一案雖然認可了這樣的見解⁴³，但這是相當古老的判決，有幾次幾乎都快要被推翻，聯邦司法部反托拉斯署多年來一直以之為目標，都因為一些無關的瑣事而功敗垂成，不過此一判決先例雖然岌岌可危卻仍然有效，只是適用上受到嚴格限制⁴⁴。例如說如果專利授權人只賣給被授權人非專利產品，而沒有賣給被授權人專利產品，那就不能就被授權人銷售的專利產品限制其轉售價格；同樣的，如果專利授權人同時產製而且銷售專利產品，也不能藉由僅授權銷售但未授權產製專利產品的授權協議，來限制下游廠商就專利產品的轉售價格⁴⁵。

⁴³ 272 U.S. 476 (1926).

⁴⁴ See, *Zenith Radio Corp., v. Hazeltine Research, Inc.*, 395 U.S. 100 (1969).

⁴⁵ JOHN H. SHENEFIELD & IRWIN M. STELZER, *supra* note 11, at 102-03.

所以維持轉售價格在智慧財產權領域，一如其他領域的反托拉斯法案件是充滿疑慮的，質言之，任何授權協議一旦涉及價格的限制，都將引起競爭法主管機關執法上高度的敵意，而且進行嚴格的檢視。以下兩個規則對專利權人而言，是相對較為清楚的：首先關於價格的約定，不宜適用於非專利的產品，甚且法院也認為不得延伸價格限制的約定到被授權人轉售給消費者的價格。其次，如果授權協議於系爭專利過期之後仍然收取權利金，通常法院也會加以非難。

（六）區域限制條款

所有關於專利正當行使的反托拉斯法原則，其實都出自於下列觀點，就是說專利法會賦予專利權人相當豐厚的權益，但相對的，這些權益必須限於專利的產品、製程乃至於程序所能涵蓋的範圍，才能夠正當行使。這種專利正當行使的臨界線，同樣存在於專利的區域授權問題，專利權人是可以限制被授權人不得於特定區域銷售，即使該區域有被授權人的競爭對手（也就是說直截了當地以授權契約限制競爭），或者限制被授權人專利產品的交易對象。同樣的專利用途的限制條款，例如限制被授權人只能於一定的範圍內就特定用途或特定產品使用專利，這樣的限制通常也被認為合法。

不過專利授權區域限制的條款仍然有其限度，如果可以認定案關專利的授權協議是作為劃分市場或是交易對象的方式，而專利本身在協議中只扮演微不足道的角色，那麼仍然會適用反托拉斯法的當然違法原則⁴⁶。可以想像的例子是，如果有一個專利權人與同質性的專利權人交換授權（例如兩者的專利權都可以製造出彼此具替代性的內燃機），但附帶的約定是甲業者只在 A 區產銷，乙業者則在其他區域經營，不進入 A 區。可以推斷由於雙方專利具替代性，所以彼此並不構成進一步產銷的瓶頸，這樣的交換授權反而更是赤裸的市場區域劃分。

（七）回頭授權條款

專利授權協議也可能包含回頭授權的約款，也就是說專利權人授權時附帶一項條件，約定被授權人將來基於該向授權所發展的任何技術創新，必須回頭授權給原始的授權人⁴⁷。回頭授權的約款一般而言也是對競爭有利的，因為有助於技術的流通與交換，但只有回頭授權產生遏阻創新的網路效應時，法院才會介入而去否定這樣的授權，例如回頭授權的約款是排他性的，也就是說不僅要求被授權人必須回頭授權，而且授權人取得獨家授權，那麼對被授權人而言，由於將來只

⁴⁶ IP Guidelines, § 5.1 ¶ 2

⁴⁷ IP Guidelines §5.6 ¶ 1.

能對原授權人授權，可以預期不會有豐厚的權利金或其他專利利得，就會缺乏足夠的誘因去進一步發明創新，在這樣的情形之下，等於競爭與鼓勵創新的機制都因為獨家回頭授權的約款而受到壓抑，即有可能構成反托拉斯法的違反，惟法院及主管機關依然是適用合理原則進行反托拉斯法的分析與審查⁴⁸。

智慧財產權授權協議有時也會包括一些優惠約款，要求被授權人在進行專利有關的模具採購時，必須給予授權人優先的交易地位。這或許形成是一種獨家交易的安排，也或許是一種搭售的行為。

一如反托拉斯法對其他領域的態度，關涉智慧財產權的獨家交易安排，如果不具有具體的反競爭效果，並不會被認為是惡性(malign)的行為。但在另一方面，如果授權人挾優勢的市場力量在相當的期間以此方式行使專利權，而造成反競爭的效果，依然有可能受到反托拉斯法的非難，前述微軟公司 1995 年的案件即為適例⁴⁹。

(八) 搭售與包裹授權

有時專利授權人會試圖在專利授權協議中訂定有關搭售的條款，要求被授權人必須購買非專利或專利必須的物品，以換取專利授

⁴⁸ IP Guidelines §5.6, *see also* R. Hewitt Pate, *Antitrust and Intellectual Property*, addressed before American Intellectual Property Association (January 24, 2003).

⁴⁹ *Supra* note 42.

權的機會或獲授權產銷專利產品。傳統上法院認為專利權、著作權或其他智慧財產權當然在反托拉斯法的分析上，可以用以推定權利人具有相當的市場地位⁵⁰也就是說幾乎可以推定該搭售協議是不合法的。然而時至今日，上述的推論已經不是自明之理，證明有專利權或其他智慧財產權存在，不過是在不當搭售行為的違法性論斷的道路上踏出第一步，而主管機關的智慧財產權授權處理原則，更進一步要求整個專利授權協議其對競爭的影響，都必須以合理原則加以衡量⁵¹。

對於包裹授權(package licensing)的分析也可能是同樣的過程與結果，所謂的包裹授權指的是一組專利以套裝或集合銷售的方式進行授權，這也有可能被認定為不合法的搭售行為。

當然最知名的案例或許就是聯邦政府近年對微軟公司所提出的反托拉斯法訴訟，司法部主張微軟公司以極為成功的作業系統 Windows 綁住較不受歡迎的網際網路瀏覽器 IE Explorer，進行不當的搭售，相對而言，微軟公司一直主張沒有所謂的搭售，因為根本就不存在兩種不同的產品，Windows 與 IE Explorer 是一項整合瀏覽器型的作業系統。承審的地方法院初步認定，瀏覽器與作業系統對交易相對人而言是外觀上就可以區分的，而且微軟公司整合兩者一併銷售，

⁵⁰ *Supra* note 6,當然類此行為也被認為是專利濫用的行為，*see Morton Salt Co. v. G. S. Suppiger Co.* 314 U.S.448 (1942).

⁵¹ IP Guidelines § 3.4

與其說是出自於技術上所必須或者商業上所必要，不如說是「以處心積慮的設計壓抑可能發生的競爭」(“deliberate and purposeful choice to quell incipient competition”)所以特區法院認為微軟公司的市場力量及具體的市場封鎖效應可認定，違反薛曼法的規定⁵²。

不過在上訴階段，法院並沒有採用當然違法的分析方式，而是對是否構成違法搭售行為進行實質的審查。而由於反托拉斯法欠缺足夠的經驗去處理軟體的套裝銷售，以及認定這樣的「整合」是否為功能所需，所以上訴法院認為至少在軟體平台的技術整合方面，是有適用合理原則之餘地⁵³。

(九) 專利集中授權(patent pools)⁵⁴

在傳統的授權協議之外，多數同一產業的企業可能會從事更複雜的專利授權協議，一般稱之為專利集中授權，專利權人往往會運用專利集中授權的手段，來緩和特定產品因封鎖性專利(blocking patents)或產業標準(industry standards)所造成的的授權問題。

⁵² *United States v. Microsoft Corp.*, Civil Action No. 98-1232 (TPJ) (D.C. April 3, 2000), at <http://www.usdoj.gov/atr/cases/f4400/4469.htm>

⁵³ 253 F.3d 34 (D.C.Cir. 2002)

⁵⁴ Patent pools 的中文翻譯相當多樣，從直譯的專利池、專利庫，到專利集管、專利聯合等部下十餘個名稱，可參見，何愛文，「論專利法制與競爭法制之關係—從保護專利權之正當性談起」，國立台灣大學博士論文，頁二二四，民九二年二月；蔡宜芯，「專利集中授權之法律規範—以競爭法為中心」，國立台灣大學碩士論文，頁七一八，民九二年六月。

專利集中授權是依循合理原則加以審查，而且通常會被判定為合法⁵⁵。但排他性的專利集中授權就有可能導致以當然違法來處斷⁵⁶，因為專利集中授權的美意將會因排他性的協議而蕩然無存。如果兩家公司分別就特定產品的技術擁有封鎖性的專利，以交互授權的方式，清除彼此的專利封鎖幾乎可判定為完全合法，因為若無這樣的交互授權，技術創新將遭受阻礙。同樣的，如果專利集中授權的成因，是為了解決新的產業標準固有的問題，也就是說專利集中授權的範圍均是符合該產業標準所必須的，正常情形下也不會產生反托拉斯法的爭議。例如，一九八八年司法部發出的商業審查函(business review letter)，就肯認一項 DVD 專利權人所形成的專利集中授權，整體而言並沒有潛在的反托拉斯法問題，因為其中所包含的專利，皆是如欲生產符合 DVD 規格產業標準的產品所必須之專利⁵⁷。

進一步言，專利集中授權的協議並不當然要求參與的成員必須接納每一個競爭者，但另一方面，如果專利集中授權協議已經具有市場力量，而且其加入已經是相關市場競爭所必須，那麼就必須接納所有的競爭者⁵⁸。

⁵⁵ IP Guidelines § 5.5 ¶ 1

⁵⁶ IP Guidelines § 5.5 ¶ 4.

⁵⁷ Letter from Joel I. Klein, Assistant Attorney General, U.S. Department of Justice, Antitrust Division (Dec. 18, 1998), at <http://www.usdoj.gov/atr/public/busreview/2121.htm>

⁵⁸ IP Guidelines §5.5 ¶ 4, cf. *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284 (1985).

(十) 拒絕授權

即便對一般產業而言專利授權有如家常便飯，專利權人還是可以拒絕對外授權，甚至是於專利有效期間內始終不對外授權。但由於拒絕授權正是專利法律所賦予的權利，所以即使專利權人在專利產品的相關市場處於獨占地位，也不會因此違反反托拉斯法。但如前所述，如果相互拒絕授權是競爭者間的合意，就不是單純的拒絕授權，而會受到反托拉斯法的審查與非難。

(十一) 小結

可以明顯地看出來，在智慧財產權一如專利權，如須分析對競爭秩序的影響或是否其授權行為有反托拉斯法的適用，其考量與專利權的情形相當類似。另一方面或許必須強調，智慧財產權權人也擁有專屬的權利，這是法律所賦予的，而且權利人可依照個人的意願來安排其權利的行使，只有在智慧財產權成為限制競爭行為的掩護，才會有反托拉斯法的介入。

不過另一方面，如果智慧財產權已經形成參與某特定市場競爭的必要因素，在這樣情形下，或許就形成所謂的樞紐設施(bottleneck facilities，或譯為瓶頸設施)。微軟公司的視窗作業系統或許是其一，

英特爾公司的電腦作業晶片或許是另一個，一旦形成樞紐設施，而權利人又濫用其智慧財產權，法院或執法機關就有可以命令權利人授權以消除所造成的競爭障礙，這或許是也是一種援用反托拉斯法調和或緩衝專利權的型態⁵⁹。

⁵⁹ 或許會進一步引伸出強制授權(compulsory licensing)的問題，但在美國法院實務對強制授權頗為謹慎，認為這在專利制度上極為罕見(“Compulsory licensing is a rarity in our patent system”)，*Dawson Chen Co. v. Rohm & Haas Co.* 448 U.S. 176, 215 (1980).

參、 結論與建議

一、 公平交易委員會實務—從飛利浦案談起

本案可說是公平交易委員會近年最受矚目的案件之一⁶⁰，被處分的對象是：荷蘭商·皇家飛利浦電子股份有限公司、日本·新力股份有限公司（Sony Corporation）及日商·太陽誘電股份有限公司（Taiyo-Yuden Co., Ltd. ），被處分的行為有三：其一、以聯合授權方式，共同合意決定 CD-R 光碟片專利之授權內容及限制單獨授權，違反公平交易法第十四條規定。其二、利用聯合授權方式，取得 CD-R 光碟片技術市場之獨占地位，在市場情事顯著變更情況下，仍不予被授權人談判之機會，及繼續維持其原授權金之計價方式，屬不當維持授權金之價格，違反公平交易法第十條第二款規定。其三、利用聯合授權方式，取得 CD-R 光碟片技術市場之獨占地位，拒絕提供被授權人有關授權協議之重要交易資訊，並禁止專利有效性之異議，為濫用市場地位之行為，違反公平交易法第十條第四款規定。

事實上該案原來在九十年一月二十日，已經公平交易委員會（九

⁶⁰公處字第 0 九一 0 六九號處分書。本案目前經行政院訴願決定維持，行政訴訟目前正繫屬於台北高等行政法院。相關的論述，可參見劉孔中，公平交易法，頁六二至六八，民九二年十月。

十)公處字第0二一號處分書予以處分。被處分人等不服向行政院提起訴願，經行政院分別於九十年十一月十六日台九十訴字第0六七二六六號、九十年十一月二十六日台九十訴字第0五九四四三號及台九十訴字第0六七四0一號訴願決定書撤銷原處分，由原處分機關另為適法之處分。

行政院撤銷原處分之四點理由概略如下：

1. 原處分機關卷附資料似無與現階段市場上其他類似儲存媒介產品之比較，足以支持其推論 CD-R 光碟產品與其他光學儲存產品間，在目前市場供需、價格及技術功能上，為唯一具市場地位之可錄一次型光碟產品，並以 CD-R 可錄式光碟授權技術市場界定為特定市場之資料，本部分證據論證容有補強之必要？
2. 被處分人等訴稱曾提供被授權人單獨授權之要約及條件供被授權人選擇，被授權人有選擇聯合授權一次取得三專利權人授權或單獨取得被處分人授權之自由，渠等聯合授權雖對市場供需造成影響，至於約定權利金縱使過高亦屬契約自由，為應訴諸民事法院之問題云云，所稱曾提供被授權人單獨授權之要約及條件供其選擇，是否實情？若本案檢舉人等係自行選擇以聯合授權方式支付權利金，是否仍屬公平交易法規範之範疇？
3. CD-R 技術之所有重要專利為飛利浦等三家廠商所擁有，全球任何 CD-R 之製造、銷售均須取得該等廠商對於 CD-R 擁有技術之授權，取得其一專利權人之專利尚無法製造 CD-R，則渠等間是否具有水平競爭關係？
4. 飛利浦公司、日本新力及太陽誘電分別罰鍰八百萬元、四百萬元及二百萬元之依據如何？

行政院的理由的確觸及了專利授權案件的若干核心爭議，至少包括市場界定、競爭關係的認定與專利權利金之競爭規範等問題，公平交易委員會再次處分時，的確也就這些問題有特別的著墨。

在市場界定方面，公平交易委員會指出：

目前主要光儲存產品種類，可分為唯讀型光碟片及寫錄型光碟片，由於 CD-R 可寫一次光碟片具有不能改寫、永久保存及無法塗改的特性，故被廣泛應用在歷史資料的備份儲存，此外，CD-R 光碟片更適用於僅登錄一次，便不再修改的資料記錄…

由於 CD-R 光碟片無法重覆記錄的缺點，相關廠商另發展出具可重覆寫錄功能的 CD-RW 光碟片，故唯讀型光碟片、CD-R 及 CD-RW 在各別技術市場的供需及技術功能上，即具有單獨可分的區隔性。CD-R、CD-RW、DVD 光碟片，以及 MD、DCC 產品，在目前市場供需、價格及技術功能上，仍有區隔，彼此並無法相互依存，故可單獨被界定為特定市場…

至於技術市場，本案自簽約之日（八十六年）起至檢舉之日（八十八年），當時我國 CD-RW 光碟片之生產技術尚在萌芽中，就目前而言，拿生產 CD-RW 之生產技術去生產 CD-R 光碟片亦非市場常態；另 DVD 光碟片、MD、DCC 因與 CD-R 光碟片生產技術更無法相容…

其次在競爭關係方面，理由是：

被處分人對於系爭 CD-R 可錄式光碟專利技術，以「聯合授權」方式對國內廠商進行授權行為，在 CD-R 光碟片技術市場上被處分人等各自擁有之專利技術，均為 CD-R 光碟產品製造所必須使用到，則對於擬被授權人（即需求者）而言，必須一一尋求渠等三家事業的各別授權，始可製造完成 CD-R 產品，缺一不可…

被處分人目前所提供之專利技術縱使因共同制定規格而不具替代性，然被處分人同為 CD-R 之技術提供者及製造者，對於其他被處分人所擁有之專利技術，仍然可以透過迴避專利範圍之方式，研發具有類似功能之替代性技術，與其他被處分人就 CD-R 技術授權進行競爭。是以，專利權人所擁有之專利，縱均為製造某種商品所必要，主張該等專利具有互補性，仍無礙渠等事業繫屬同一產銷階段，具有水平競爭關係之認定。

在權利金之收取涉及聯合行為部分：

日本新力及太陽誘電對於該標準授權合約內容，包括所共同約定之權利金數額，確實擁有相當的影響力或決定力，並且務須獲得渠等同意，始得使用。是故飛利浦公司及日本新力與太陽誘電等為具有競爭關係之事業，已合致公平交易法第七條之聯合行為....

聯合授權（Patent pool）可非難之處不在其本身，而是當事人藉由聯合授權限制價格、劃分市場或限制自由發展項目，而影響市場競爭機能的發揮，被處分人等擁有之專利權國家並不相同，如檢舉人所稱，日本新力在我國及歐洲並未擁有製造 CD-R 光碟片之必要專利，渠等聯合授權行為已造成其不當擴充其專利版圖，並排除其他競爭者的加入，有違公平交易法之聯合行為禁制規定....

在權利金收取涉及濫用獨占地位方面：

按飛利浦公司以「淨銷售價格三%或日幣十圓中，以較高者準。」做為權利金之計算方式...

比較被處分人等實際權利金收益與預期權利金收益而言，依據工研院經資中心資料，八十五年全球 CD-R 光碟片的平均出廠價格尚可達每片七美元；八十六年已快速滑落為一點六五美元；八十七年在軟體與音樂複製需求大幅成長刺激下，使得 CD-R 光碟片價格下跌幅度稍趨緩和，平均出廠價格維持在一美元左右；八十八年上半年平均每片 CD-R 光碟片之出廠價格維持在零點七至零點八美元，下半年最低報價則已出現零點五美元；八十九年平均每片 CD-R 光碟片將低於零點五美元，但在經過製造廠商間重整，及出廠價格已接近成本邊緣情況下，九十年起 CD-R 光碟片的價格競爭已趨緩....

假設飛利浦公司預估回收相關研發成本，係以八十六年全球 CD-R 光碟片出貨量的淨銷售價格百分之三，或每片日幣十圓較高者計算的話，則因 CD-R 出貨量以遠超出預期的大幅成長下，而在所有製造銷售 CD-R 的廠商，均必須取得被處分人等對於系爭專利技術之授權，並簽立合約支付其權利金的情況下，其八十九年度飛利浦公司的權利金收益，估計為八十六年度的二十至六十倍.... 復若以 CD-R 光碟片淨銷售價格與權利金金額的比例計算，在 CD-R 光碟片價格大幅下跌的情況下，其權利金金額倘仍維持每片十日圓計算，如以目前平均出廠價格每片美金零點五元（現折算約五十六日圓）為準，將達到出廠價格的百分之

十七點八，遠超過被授權人可以負擔的範圍，而被授權人屢次向被處分人等反映亦均未能獲得善意回應，使授權金金額無法做即時有效之變更並反映正常之市場需求....

被處分人等在 CD-R 光碟片技術市場，利用聯合授權方式，取得 CD-R 光碟片技術市場之獨占地位，在全球 CD-R 市場規模遠超出預期的大幅成長之市場顯著情事變更情況下，仍不予被授權人談判之機會，及繼續維持其原授權金之計價方式，未能做有效之變更，以因應市場需求，違反公平交易法第十條第二款有關獨占事業禁制行為之規定。

另外也認定因未揭露相關專利授權資訊，而濫用其獨占地位：

按技術授權協議授權人基於授權協議契約之本旨，對於其所為授權協議標的內容、範圍或其所有之專利有效期限等基本資料，應即提供給被授權人，以踐行契約履行之主要義務。...又被授權人給付權利金，當然要以取得合法有效的專利為目的，既然專利已有瑕疵，即不應強求被授權人接受此種限制約款的拘束，授權人所為此種拒絕提供重要交易資訊及限制約款等行為，涉有濫用市場優勢地位....

飛利浦公司對於擬被授權人所提問題，並有具體回覆，僅傳真部分專利清單，實際上並未清楚揭露授權專利的資料，有關在網路上雖可查詢專利的內容，但日本專利只能查到簡要說明，且不能證明何處侵害其專利，以及授權專利與橘皮書規格之相容關係，另外，各專利在各國的對應關係，即專利家屬，亦無法從網路上查詢得到，必須付出相當成本，飛利浦公司主張可輕易按圖索驥，透過電腦資料庫或網際網路獲悉授權專利之詳細資料，其說詞顯不合理。復經參照系爭專利授權合約第一·0 九條之規定，飛利浦公司所授權專利內容及範圍，應包括附表 B1 至 B5 所示與可錄式光磁碟產品之相關專利清單，惟該附表專利清單 B1 至 B5 約有一百零九件專利，卻僅載明系爭專利於美國及日本之專利號碼及技術名稱，其中 B4 至 B5 部分之專利有效期間更付諸闕如。復查被處分人等迄今僅分別就其中少數專利內容提出說明；對於系爭授權專利與授權產品間的必要性疑慮，亦未提供詳實說明或證明，有關授權合約中所包括之專利與該標準規格，即與橘皮書之對應關係，及飛利浦公司、日本新力及太陽誘電各自擁有之專利數目，迄今仍未提出完整說明，是飛利浦公司等公司並未詳細告知被授權廠商相關專利之內容、範圍及有效期限等重要交易資訊內容....

(一) 結論—從比較法與案例分析提出對實務的 建議

回顧美國競爭法對專利授權的規範與論析，當然可以肯定美國競爭法對於專利授權行為之適用並不是採取例外或豁免的態度，這與我國的基本執法原則是相符合的。當然上述案例的妥適性，學界並不乏檢討與批評的聲音⁶¹，本文無意一一辯證與論駁，但本案正確與否固有仁智之見，但與美國法比較分析時，我競爭法的實務是有值得探討與省思之處。

其一，本案再度證明市場界定是競爭法最優先而且最重要的工作⁶²，我們可以看出公平交易委員會在智慧財產權領域的市場界定，沿襲了與美國 1995 年處理原則的市場分類方式，將本案界定在技術市場，縱使這也是最受批評的地方，但必須說這樣的界分是正確而值得鼓勵的，唯有如此，也才能正確說明飛利浦公司的市場力量。

然而由於專利授權，特別是像本案關涉科技產業的專利授權，連檢舉人是位處下游產業的相關事業，都難以精確地描述系爭眾多專利技

⁶¹ 參見黃銘傑，專利集管(patent pool)與公平交易法，月旦法學雜誌第八十七期，頁一二二，民八九年八月，氏對本案有極嚴厲的批評。蔡宜芯，前揭註五四，頁二四九至二七一。

⁶² THE WORK BANK & OECD, A FRAMEWORK FOR THE DESIGN AND IMPLEMENTATION OF COMPETITION LAW AND POLICY, 10 (1998).

術究竟是替代還是互補，競爭法主管機關只憑有限的鑑定報告，當然在論辨市場範圍的時候，顯得有點力有未逮。但必須強調，這正是專利授權案件的核心，如果競爭法主管機關無力因應科技發展的趨勢，也就難以有效地執行競爭法。

其二，與美國法相較，公平交易委員會以權利金收取逾越必要的限度，毋寧說是相當大膽的嘗試。正如前面論述的，美國法一再強調專利權人極大化其利益，只要在專利有效容許的範圍，競爭法不能擅加干預。本案專利權人似乎很難說有超出專利範圍收取權利金，公平交易委員會對其額度的合理性提出挑戰，固然有相當的事實基礎，畢竟等於對權利人的定價自由予以限制。公平交易法第十條第二款當然賦予公平交易委員會這樣的權責，但必須說節制獨占力最佳的途徑，並不是限制其定價自由，而是改變市場結構，導入自由競爭來改善不當的定價行為。

最後，本案直接涉及一項專利集中授權，公平交易委員會明白表示專利集中授權本身並不值得非難，值得非難的是藉由專利集中授權運作的卡特爾行為。這樣的論述固然是正確而值得肯定的，但如前所述，專利集中授權值得肯定之處，在於納入專利授權的各項專利，必

須是為互補的，而且不含過期或無效的專利，這在美國司法部歷年就專利集中授權所發布的商業審查信函中，是不斷強調的⁶³。公平交易委員會如果能強調，系爭的專利集中授權含有互補或無效的專利，相信必能消弭外界的批評與疑慮⁶⁴。

⁶³ Supra note 57; 參見何愛文，前揭註五四，頁二二八至二三四；蔡宜芯，前揭註五四，頁一〇九至一二三。

⁶⁴ 何愛文，前揭註五四，頁二七二。事實上筆者九十二年九月廿九日參與台美競爭法主管機關第三次會議時，美方代表及直率地對本案涉及專利集中授權表達相當的疑慮，但在我方說明本案的專利集中授權含有替代及無效的專利，美方當即表示理解。

附錄一：

美國司法部與聯邦交易委員會—反
托拉斯法對專利授權之處理原則



Antitrust Guidelines for the Licensing of Intellectual Property

**Issued by the
U.S. Department of Justice*
and the
Federal Trade Commission**

April 6, 1995

* These Guidelines supersede section 3.6 in Part I, "Intellectual Property Licensing Arrangements," and cases 6, 10, 11, and 12 in Part II of the U.S. Department of Justice 1988 Antitrust Enforcement Guidelines for International Operations.

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1. Intellectual property protection and the antitrust laws

1.0 These Guidelines state the antitrust enforcement policy of the U.S. Department of Justice and the Federal Trade Commission (individually, “the Agency,” and collectively, “the Agencies”) with respect to the licensing of intellectual property protected by patent, copyright, and trade secret law, and of know-how.¹ By stating their general policy, the Agencies hope to assist those who need to predict whether the Agencies will challenge a practice as anticompetitive. However, these Guidelines cannot remove judgment and discretion in antitrust law enforcement. Moreover, the standards set forth in these Guidelines must be applied in unforeseeable circumstances. Each case will be evaluated in light of its own facts, and these Guidelines will be applied reasonably and flexibly.²

In the United States, patents confer rights to exclude others from making, using, or selling in the United States the invention claimed by the patent for a period of seventeen years from the date of issue.³ To gain patent protection, an invention (which may be a product, process, machine, or composition of matter) must be novel, nonobvious, and useful. Copyright protection applies to original works of authorship embodied in a tangible medium of expression.⁴ A copyright protects only the expression, not the underlying

¹ These Guidelines do not cover the antitrust treatment of trademarks. Although the same general antitrust principles that apply to other forms of intellectual property apply to trademarks as well, these Guidelines deal with technology transfer and innovation-related issues that typically arise with respect to patents, copyrights, trade secrets, and know-how agreements, rather than with product-differentiation issues that typically arise with respect to trademarks.

² As is the case with all guidelines, users should rely on qualified counsel to assist them in evaluating the antitrust risk associated with any contemplated transaction or activity. No set of guidelines can possibly indicate how the Agencies will assess the particular facts of every case. Parties who wish to know the Agencies' specific enforcement intentions with respect to any particular transaction should consider seeking a Department of Justice business review letter pursuant to 28 C.F.R. § 50.6 or a Federal Trade Commission Advisory Opinion pursuant to 16 C.F.R. §§ 1.1–1.4.

³ See 35 U.S.C. § 154 (1988). Section 532(a) of the Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4809, 4983 (1994) would change the length of patent protection to a term beginning on the date at which the patent issues and ending twenty years from the date on which the application for the patent was filed.

⁴ See 17 U.S.C. § 102 (1988 & Supp. V 1993). Copyright protection lasts for the author's life plus 50 years, or 75 years from first publication (or 100 years from creation, whichever expires first) for works made for hire. See 17 U.S.C. § 302 (1988). The principles stated in these Guidelines also apply to protection of mask works fixed in a semiconductor chip product (see 17 U.S.C. § 901 *et seq.* (1988)), which is analogous to copyright protection for works of authorship.

ideas.⁵ Unlike a patent, which protects an invention not only from copying but also from independent creation, a copyright does not preclude others from independently creating similar expression. Trade secret protection applies to information whose economic value depends on its not being generally known.⁶ Trade secret protection is conditioned upon efforts to maintain secrecy and has no fixed term. As with copyright protection, trade secret protection does not preclude independent creation by others.

The intellectual property laws and the antitrust laws share the common purpose of promoting innovation and enhancing consumer welfare.⁷ The intellectual property laws provide incentives for innovation and its dissemination and commercialization by establishing enforceable property rights for the creators of new and useful products, more efficient processes, and original works of expression. In the absence of intellectual property rights, imitators could more rapidly exploit the efforts of innovators and investors without compensation. Rapid imitation would reduce the commercial value of innovation and erode incentives to invest, ultimately to the detriment of consumers. The antitrust laws promote innovation and consumer welfare by prohibiting certain actions that may harm competition with respect to either existing or new ways of serving consumers.

2. General principles

2.0 These Guidelines embody three general principles: (a) for the purpose of antitrust analysis, the Agencies regard intellectual property as being essentially comparable to any other form of property; (b) the Agencies do not presume that intellectual property creates market power in the antitrust context; and (c) the Agencies recognize that intellectual property licensing allows firms to combine complementary factors of production and is generally procompetitive.

⁵ See 17 U.S.C. § 102(b) (1988).

⁶ Trade secret protection derives from state law. See generally *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470 (1974).

⁷ “[T]he aims and objectives of patent and antitrust laws may seem, at first glance, wholly at odds. However, the two bodies of law are actually complementary, as both are aimed at encouraging innovation, industry and competition.” *Atari Games Corp. v. Nintendo of America, Inc.*, 897 F.2d 1572, 1576 (Fed. Cir. 1990).

2.1 Standard antitrust analysis applies to intellectual property

The Agencies apply the same general antitrust principles to conduct involving intellectual property that they apply to conduct involving any other form of tangible or intangible property. That is not to say that intellectual property is in all respects the same as any other form of property. Intellectual property has important characteristics, such as ease of misappropriation, that distinguish it from many other forms of property. These characteristics can be taken into account by standard antitrust analysis, however, and do not require the application of fundamentally different principles.⁸

Although there are clear and important differences in the purpose, extent, and duration of protection provided under the intellectual property regimes of patent, copyright, and trade secret, the governing antitrust principles are the same. Antitrust analysis takes differences among these forms of intellectual property into account in evaluating the specific market circumstances in which transactions occur, just as it does with other particular market circumstances.

Intellectual property law bestows on the owners of intellectual property certain rights to exclude others. These rights help the owners to profit from the use of their property. An intellectual property owner's rights to exclude are similar to the rights enjoyed by owners of other forms of private property. As with other forms of private property, certain types of conduct with respect to intellectual property may have anticompetitive effects against which the antitrust laws can and do protect. Intellectual property is thus neither particularly free from scrutiny under the antitrust laws, nor particularly suspect under them.

The Agencies recognize that the licensing of intellectual property is often international. The principles of antitrust analysis described in these Guidelines apply equally to domestic and international licensing arrangements. However, as described in the 1995 Department of Justice and Federal Trade Commission Antitrust Enforcement Guidelines for International Operations, considerations particular to international operations, such as jurisdiction and comity, may affect enforcement decisions when the arrangement is in an international context.

⁸ As with other forms of property, the power to exclude others from the use of intellectual property may vary substantially, depending on the nature of the property and its status under federal or state law. The greater or lesser legal power of an owner to exclude others is also taken into account by standard antitrust analysis.

2.2 Intellectual property and market power

Market power is the ability profitably to maintain prices above, or output below, competitive levels for a significant period of time.⁹ The Agencies will not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner. Although the intellectual property right confers the power to exclude with respect to the *specific* product, process, or work in question, there will often be sufficient actual or potential close substitutes for such product, process, or work to prevent the exercise of market power.¹⁰ If a patent or other form of intellectual property does confer market power, that market power does not by itself offend the antitrust laws. As with any other tangible or intangible asset that enables its owner to obtain significant supracompetitive profits, market power (or even a monopoly) that is solely “a consequence of a superior product, business acumen, or historic accident” does not violate the antitrust laws.¹¹ Nor does such market power impose on the intellectual property owner an obligation to license the use of that property to others. As in other antitrust contexts, however, market power could be illegally acquired or maintained, or, even if lawfully acquired and maintained, would be relevant to the ability of an intellectual property owner to harm competition through unreasonable conduct in connection with such property.

2.3 Procompetitive benefits of licensing

⁹ Market power can be exercised in other economic dimensions, such as quality, service, and the development of new or improved goods and processes. It is assumed in this definition that all competitive dimensions are held constant except the ones in which market power is being exercised; that a seller is able to charge higher prices for a higher-quality product does not alone indicate market power. The definition in the text is stated in terms of a seller with market power. A buyer could also exercise market power (e.g., by maintaining the price below the competitive level, thereby depressing output).

¹⁰ The Agencies note that the law is unclear on this issue. *Compare Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2, 16 (1984) (expressing the view in dictum that if a product is protected by a patent, “it is fair to presume that the inability to buy the product elsewhere gives the seller market power”) *with id.* at 37 n.7 (O’Connor, J., concurring) (“[A] patent holder has no market power in any relevant sense if there are close substitutes for the patented product.”). *Compare also Abbott Laboratories v. Brennan*, 952 F.2d 1346, 1354–55 (Fed. Cir. 1991) (no presumption of market power from intellectual property right), *cert. denied*, 112 S. Ct. 2993 (1992) *with Digidyne Corp. v. Data General Corp.*, 734 F.2d 1336, 1341–42 (9th Cir. 1984) (requisite economic power is presumed from copyright), *cert. denied*, 473 U.S. 908 (1985).

¹¹ *United States v. Grinnell Corp.*, 384 U.S. 563, 571 (1966); *see also United States v. Aluminum Co. of America*, 148 F.2d 416, 430 (2d Cir. 1945) (Sherman Act is not violated by the attainment of market power solely through “superior skill, foresight and industry”).

Intellectual property typically is one component among many in a production process and derives value from its combination with complementary factors. Complementary factors of production include manufacturing and distribution facilities, workforces, and other items of intellectual property. The owner of intellectual property has to arrange for its combination with other necessary factors to realize its commercial value. Often, the owner finds it most efficient to contract with others for these factors, to sell rights to the intellectual property, or to enter into a joint venture arrangement for its development, rather than supplying these complementary factors itself.

Licensing, cross-licensing, or otherwise transferring intellectual property (hereinafter “licensing”) can facilitate integration of the licensed property with complementary factors of production. This integration can lead to more efficient exploitation of the intellectual property, benefiting consumers through the reduction of costs and the introduction of new products. Such arrangements increase the value of intellectual property to consumers and to the developers of the technology. By potentially increasing the expected returns from intellectual property, licensing also can increase the incentive for its creation and thus promote greater investment in research and development.

Sometimes the use of one item of intellectual property requires access to another. An item of intellectual property “blocks” another when the second cannot be practiced without using the first. For example, an improvement on a patented machine can be blocked by the patent on the machine. Licensing may promote the coordinated development of technologies that are in a blocking relationship.

Field-of-use, territorial, and other limitations on intellectual property licenses may serve procompetitive ends by allowing the licensor to exploit its property as efficiently and effectively as possible. These various forms of exclusivity can be used to give a licensee an incentive to invest in the commercialization and distribution of products embodying the licensed intellectual property and to develop additional applications for the licensed property. The restrictions may do so, for example, by protecting the licensee against free-riding on the licensee's investments by other licensees or by the licensor. They may also increase the licensor's incentive to license, for example, by protecting the licensor from competition in the licensor's own technology in a market niche that it prefers to keep to itself. These benefits of licensing restrictions apply to patent, copyright, and trade secret licenses, and to know-how agreements.

Example 1¹²

Situation: ComputerCo develops a new, copyrighted software program for inventory management. The program has wide application in the health field. ComputerCo licenses the program in an arrangement that imposes both field of use and territorial limitations. Some of ComputerCo's licenses permit use only in hospitals; others permit use only in group medical practices. ComputerCo charges different royalties for the different uses. All of ComputerCo's licenses permit use only in specified portions of the United States and in specified foreign countries.¹³ The licenses contain no provisions that would prevent or discourage licensees from developing, using, or selling any other program, or from competing in any other good or service other than in the use of the licensed program. None of the licensees are actual or likely potential competitors of ComputerCo in the sale of inventory management programs.

Discussion: The key competitive issue raised by the licensing arrangement is whether it harms competition among entities that would have been actual or likely potential competitors in the absence of the arrangement. Such harm could occur if, for example, the licenses anticompetitively foreclose access to competing technologies (in this case, most likely competing computer programs), prevent licensees from developing their own competing technologies (again, in this case, most likely computer programs), or facilitate market allocation or price-fixing for any product or service supplied by the licensees. (See section 3.1.) If the license agreements contained such provisions, the Agency evaluating the arrangement would analyze its likely competitive effects as described in parts 3–5 of these Guidelines. In this hypothetical, there are no such provisions and thus the arrangement is merely a subdivision of the licensor's intellectual property among different fields of use and territories. The licensing arrangement does not appear likely to harm competition among entities that would have been actual or likely potential competitors if ComputerCo had chosen not to license the software program. The Agency therefore would be unlikely to object to this arrangement. Based on these facts, the result of the antitrust analysis would be the same whether the technology was protected by patent, copyright, or trade secret. The Agency's conclusion as to likely competitive effects could differ if, for example, the license barred licensees from using any other inventory management program.

¹² The examples in these Guidelines are hypothetical and do not represent judgments about, or analysis of, any actual market circumstances of the named industries.

¹³ These Guidelines do not address the possible application of the antitrust laws of other countries to restraints such as territorial restrictions in international licensing arrangements.

3. Antitrust concerns and modes of analysis

3.1 Nature of the concerns

While intellectual property licensing arrangements are typically welfare-enhancing and procompetitive, antitrust concerns may nonetheless arise. For example, a licensing arrangement could include restraints that adversely affect competition in goods markets by dividing the markets among firms that would have competed using different technologies. *See, e.g.*, Example 7. An arrangement that effectively merges the research and development activities of two of only a few entities that could plausibly engage in research and development in the relevant field might harm competition for development of new goods and services. *See* section 3.2.3. An acquisition of intellectual property may lessen competition in a relevant antitrust market. *See* section 5.7. The Agencies will focus on the actual effects of an arrangement, not on its formal terms.

The Agencies will not require the owner of intellectual property to create competition in its own technology. However, antitrust concerns may arise when a licensing arrangement harms competition among entities that would have been actual or likely potential competitors¹⁴ in a relevant market in the absence of the license (entities in a “horizontal relationship”). A restraint in a licensing arrangement may harm such competition, for example, if it facilitates market division or price-fixing. In addition, license restrictions with respect to one market may harm such competition in another market by anticompetitively foreclosing access to, or significantly raising the price of, an important input,¹⁵ or by facilitating coordination to increase price or reduce output. When it appears that such competition may be adversely affected, the Agencies will follow the analysis set forth below. *See generally* sections 3.4 and 4.2.

3.2 Markets affected by licensing arrangements

Licensing arrangements raise concerns under the antitrust laws if they are likely to affect adversely the prices, quantities, qualities, or varieties of goods and services¹⁶ either currently or potentially available. The competitive effects of licensing arrangements often can be

¹⁴ A firm will be treated as a likely potential competitor if there is evidence that entry by that firm is reasonably probable in the absence of the licensing arrangement.

¹⁵ As used herein, “input” includes outlets for distribution and sales, as well as factors of production. *See, e.g.*, sections 4.1.1 and 5.3–5.5 for further discussion of conditions under which foreclosing access to, or raising the price of, an input may harm competition in a relevant market.

¹⁶ Hereinafter, the term “goods” also includes services.

adequately assessed within the relevant markets for the goods affected by the arrangements. In such instances, the Agencies will delineate and analyze only goods markets. In other cases, however, the analysis may require the delineation of markets for technology or markets for research and development (innovation markets).

3.2.1 Goods markets

A number of different goods markets may be relevant to evaluating the effects of a licensing arrangement. A restraint in a licensing arrangement may have competitive effects in markets for final or intermediate goods made using the intellectual property, or it may have effects upstream, in markets for goods that are used as inputs, along with the intellectual property, to the production of other goods. In general, for goods markets affected by a licensing arrangement, the Agencies will approach the delineation of relevant market and the measurement of market share in the intellectual property area as in section 1 of the U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines.¹⁷

3.2.2 Technology markets

Technology markets consist of the intellectual property that is licensed (the “licensed technology”) and its close substitutes—that is, the technologies or goods that are close enough substitutes significantly to constrain the exercise of market power with respect to the intellectual property that is licensed.¹⁸ When rights to intellectual property are marketed separately from the products in which they are used,¹⁹ the Agencies may rely on technology markets to analyze the competitive effects of a licensing arrangement.

Example 2

Situation: Firms Alpha and Beta independently develop different patented process technologies

¹⁷ U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (April 2, 1992) (hereinafter “1992 Horizontal Merger Guidelines”). As stated in section 1.41 of the 1992 Horizontal Merger Guidelines, market shares for goods markets “can be expressed either in dollar terms through measurement of sales, shipments, or production, or in physical terms through measurement of sales, shipments, production, capacity or reserves.”

¹⁸ For example, the owner of a process for producing a particular good may be constrained in its conduct with respect to that process not only by other processes for making that good, but also by other goods that compete with the downstream good and by the processes used to produce those other goods.

¹⁹ Intellectual property is often licensed, sold, or transferred as an integral part of a marketed good. An example is a patented product marketed with an implied license permitting its use. In such circumstances, there is no need for a separate analysis of technology markets to capture relevant competitive effects.

to manufacture the same off-patent drug for the treatment of a particular disease. Before the firms use their technologies internally or license them to third parties, they announce plans jointly to manufacture the drug, and to assign their manufacturing processes to the new manufacturing venture. Many firms are capable of using and have the incentive to use the licensed technologies to manufacture and distribute the drug; thus, the market for drug manufacturing and distribution is competitive. One of the Agencies is evaluating the likely competitive effects of the planned venture.

Discussion: The Agency would analyze the competitive effects of the proposed joint venture by first defining the relevant markets in which competition may be affected and then evaluating the likely competitive effects of the joint venture in the identified markets. (See Example 4 for a discussion of the Agencies' approach to joint venture analysis.) In this example, the structural effect of the joint venture in the relevant goods market for the manufacture and distribution of the drug is unlikely to be significant, because many firms in addition to the joint venture compete in that market. The joint venture might, however, increase the prices of the drug produced using Alpha's or Beta's technology by reducing competition in the relevant market for technology to manufacture the drug.

The Agency would delineate a technology market in which to evaluate likely competitive effects of the proposed joint venture. The Agency would identify other technologies that can be used to make the drug with levels of effectiveness and cost per dose comparable to that of the technologies owned by Alpha and Beta. In addition, the Agency would consider the extent to which competition from other drugs that are substitutes for the drug produced using Alpha's or Beta's technology would limit the ability of a hypothetical monopolist that owned both Alpha's and Beta's technology to raise its price.

To identify a technology's close substitutes and thus to delineate the relevant technology market, the Agencies will, if the data permit, identify the smallest group of technologies and goods over which a hypothetical monopolist of those technologies and goods likely would exercise market power—for example, by imposing a small but significant and nontransitory price increase.²⁰ The Agencies recognize that technology often is licensed in ways that are not readily quantifiable in monetary terms.²¹ In such

²⁰ This is conceptually analogous to the analytical approach to goods markets under the 1992 Horizontal Merger Guidelines. Cf. § 1.11. Of course, market power also can be exercised in other dimensions, such as quality, and these dimensions also may be relevant to the definition and analysis of technology markets.

²¹ For example, technology may be licensed royalty-free in exchange for the right to use other technology, or it may be licensed as part of a package license.

circumstances, the Agencies will delineate the relevant market by identifying other technologies and goods which buyers would substitute at a cost comparable to that of using the licensed technology.

In assessing the competitive significance of current and likely potential participants in a technology market, the Agencies will take into account all relevant evidence. When market share data are available and accurately reflect the competitive significance of market participants, the Agencies will include market share data in this assessment. The Agencies also will seek evidence of buyers' and market participants' assessments of the competitive significance of technology market participants. Such evidence is particularly important when market share data are unavailable, or do not accurately represent the competitive significance of market participants. When market share data or other indicia of market power are not available, and it appears that competing technologies are comparably efficient,²² the Agencies will assign each technology the same market share. For new technologies, the Agencies generally will use the best available information to estimate market acceptance over a two-year period, beginning with commercial introduction.

3.2.3 Research and development: innovation markets

If a licensing arrangement may adversely affect competition to develop new or improved goods or processes, the Agencies will analyze such an impact either as a separate competitive effect in relevant goods or technology markets, or as a competitive effect in a separate innovation market. A licensing arrangement may have competitive effects on innovation that cannot be adequately addressed through the analysis of goods or technology markets. For example, the arrangement may affect the development of goods that do not yet exist.²³ Alternatively, the arrangement may affect the development of new or improved

²² The Agencies will regard two technologies as "comparably efficient" if they can be used to produce close substitutes at comparable costs.

²³ *E.g.*, *Sensormatic*, FTC Inv. No. 941-0126, 60 Fed. Reg. 5428 (accepted for comment Dec. 28, 1994); *Wright Medical Technology, Inc.*, FTC Inv. No. 951-0015, 60 Fed. Reg. 460 (accepted for comment Dec. 8, 1994); *American Home Products*, FTC Inv. No. 941-0116, 59 Fed. Reg. 60,807 (accepted for comment Nov. 28, 1994); *Roche Holdings Ltd.*, 113 F.T.C. 1086 (1990); *United States v. Automobile Mfrs. Ass'n*, 307 F. Supp. 617 (C.D. Cal. 1969), *appeal dismissed sub nom. City of New York v. United States*, 397 U.S. 248 (1970), *modified sub nom. United States v. Motor Vehicles Mfrs. Ass'n*, 1982-83 Trade Cas. (CCH) ¶ 65,088 (C.D. Cal. 1982).

goods or processes in geographic markets where there is no actual or likely potential competition in the relevant goods.²⁴

An innovation market consists of the research and development directed to particular new or improved goods or processes, and the close substitutes for that research and development. The close substitutes are research and development efforts, technologies, and goods²⁵ that significantly constrain the exercise of market power with respect to the relevant research and development, for example by limiting the ability and incentive of a hypothetical monopolist to retard the pace of research and development. The Agencies will delineate an innovation market only when the capabilities to engage in the relevant research and development can be associated with specialized assets or characteristics of specific firms.

In assessing the competitive significance of current and likely potential participants in an innovation market, the Agencies will take into account all relevant evidence. When market share data are available and accurately reflect the competitive significance of market participants, the Agencies will include market share data in this assessment. The Agencies also will seek evidence of buyers' and market participants' assessments of the competitive significance of innovation market participants. Such evidence is particularly important when market share data are unavailable or do not accurately represent the competitive significance of market participants. The Agencies may base the market shares of participants in an innovation market on their shares of identifiable assets or characteristics upon which innovation depends, on shares of research and development expenditures, or on shares of a related product. When entities have comparable capabilities and incentives to pursue research and development that is a close substitute for the research and development activities of the parties to a licensing arrangement, the Agencies may assign equal market shares to such entities.

²⁴ See Complaint, *United States v. General Motors Corp.*, Civ. No. 93-530 (D. Del., filed Nov. 16, 1993).

²⁵ For example, the licensor of research and development may be constrained in its conduct not only by competing research and development efforts but also by other existing goods that would compete with the goods under development.

Example 3

Situation: Two companies that specialize in advanced metallurgy agree to cross-license future patents relating to the development of a new component for aircraft jet turbines. Innovation in the development of the component requires the capability to work with very high tensile strength materials for jet turbines. Aspects of the licensing arrangement raise the possibility that competition in research and development of this and related components will be lessened. One of the Agencies is considering whether to define an innovation market in which to evaluate the competitive effects of the arrangement.

Discussion: If the firms that have the capability and incentive to work with very high tensile strength materials for jet turbines can be reasonably identified, the Agency will consider defining a relevant innovation market for development of the new component. If the number of firms with the required capability and incentive to engage in research and development of very high tensile strength materials for aircraft jet turbines is small, the Agency may employ the concept of an innovation market to analyze the likely competitive effects of the arrangement in that market, or as an aid in analyzing competitive effects in technology or goods markets. The Agency would perform its analysis as described in parts 3–5.

If the number of firms with the required capability and incentive is large (either because there are a large number of such firms in the jet turbine industry, or because there are many firms in other industries with the required capability and incentive), then the Agency will conclude that the innovation market is competitive. Under these circumstances, it is unlikely that any single firm or plausible aggregation of firms could acquire a large enough share of the assets necessary for innovation to have an adverse impact on competition.

If the Agency cannot reasonably identify the firms with the required capability and incentive, it will not attempt to define an innovation market.

Example 4

Situation: Three of the largest producers of a plastic used in disposable bottles plan to engage in joint research and development to produce a new type of plastic that is rapidly biodegradable. The joint venture will grant to its partners (but to no one else) licenses to all patent rights and use of know-how. One of the Agencies is evaluating the likely competitive effects of the proposed joint venture.

Discussion: The Agency would analyze the proposed research and development joint venture using an analysis similar to that applied to other joint ventures.²⁶ The Agency would begin by defining the relevant markets in which to analyze the joint venture's likely competitive effects.

²⁶ See, e.g., U.S. Department of Justice and Federal Trade Commission, Statements of Enforcement Policy and Analytical Principles Relating to Health Care and Antitrust 20–23, 37–40, 72–74 (September 27, 1994). This type of transaction may qualify for treatment under the National Cooperative Research and Production Act of 1993, 15 U.S.C.A §§ 4301–05.

In this case, a relevant market is an innovation market—research and development for biodegradable (and other environmentally friendly) containers. The Agency would seek to identify any other entities that would be actual or likely potential competitors with the joint venture in that relevant market. This would include those firms that have the capability and incentive to undertake research and development closely substitutable for the research and development proposed to be undertaken by the joint venture, taking into account such firms' existing technologies and technologies under development, R&D facilities, and other relevant assets and business circumstances. Firms possessing such capabilities and incentives would be included in the research and development market even if they are not competitors in relevant markets for related goods, such as the plastics currently produced by the joint venturers, although competitors in existing goods markets may often also compete in related innovation markets.

Having defined a relevant innovation market, the Agency would assess whether the joint venture is likely to have anticompetitive effects in that market. A starting point in this analysis is the degree of concentration in the relevant market and the market shares of the parties to the joint venture. If, in addition to the parties to the joint venture (taken collectively), there are at least four other independently controlled entities that possess comparable capabilities and incentives to undertake research and development of biodegradable plastics, or other products that would be close substitutes for such new plastics, the joint venture ordinarily would be unlikely to adversely affect competition in the relevant innovation market (*cf.* section 4.3). If there are fewer than four other independently controlled entities with similar capabilities and incentives, the Agency would consider whether the joint venture would give the parties to the joint venture an incentive and ability collectively to reduce investment in, or otherwise to retard the pace or scope of, research and development efforts. If the joint venture creates a significant risk of anticompetitive effects in the innovation market, the Agency would proceed to consider efficiency justifications for the venture, such as the potential for combining complementary R&D assets in such a way as to make successful innovation more likely, or to bring it about sooner, or to achieve cost reductions in research and development.

The Agency would also assess the likelihood that the joint venture would adversely affect competition in other relevant markets, including markets for products produced by the parties to the joint venture. The risk of such adverse competitive effects would be increased to the extent that, for example, the joint venture facilitates the exchange among the parties of competitively sensitive information relating to goods markets in which the parties currently compete or facilitates the coordination of competitive activities in such markets. The Agency would examine whether the joint venture imposes collateral restraints that might significantly restrict competition among the joint venturers in goods markets, and would examine whether such collateral restraints were reasonably necessary to achieve any efficiencies that are likely to be attained by the venture.

3.3 Horizontal and vertical relationships

As with other property transfers, antitrust analysis of intellectual property licensing arrangements examines whether the relationship among the parties to the arrangement is primarily horizontal or vertical in nature, or whether it has substantial aspects of both. A licensing arrangement has a vertical component when it affects activities that are in a complementary relationship, as is typically the case in a licensing arrangement. For example, the licensor's primary line of business may be in research and development, and the licensees, as manufacturers, may be buying the rights to use technology developed by the licensor. Alternatively, the licensor may be a component manufacturer owning intellectual property rights in a product that the licensee manufactures by combining the component with other inputs, or the licensor may manufacture the product, and the licensees may operate primarily in distribution and marketing.

In addition to this vertical component, the licensor and its licensees may also have a horizontal relationship. For analytical purposes, the Agencies ordinarily will treat a relationship between a licensor and its licensees, or between licensees, as horizontal when they would have been actual or likely potential competitors in a relevant market in the absence of the license.

The existence of a horizontal relationship between a licensor and its licensees does not, in itself, indicate that the arrangement is anticompetitive. Identification of such relationships is merely an aid in determining whether there may be anticompetitive effects arising from a licensing arrangement. Such a relationship need not give rise to an anticompetitive effect, nor does a purely vertical relationship assure that there are no anticompetitive effects.

The following examples illustrate different competitive relationships among a licensor and its licensees.

Example 5

Situation: AgCo, a manufacturer of farm equipment, develops a new, patented emission control technology for its tractor engines and licenses it to FarmCo, another farm equipment manufacturer. AgCo's emission control technology is far superior to the technology currently owned and used by FarmCo, so much so that FarmCo's technology does not significantly constrain the prices that AgCo could charge for its technology. AgCo's emission control patent has a broad scope. It is likely that any improved emissions control technology that FarmCo could develop in the foreseeable future would infringe AgCo's patent.

Discussion: Because FarmCo's emission control technology does not significantly constrain AgCo's competitive conduct with respect to its emission control technology, AgCo's and FarmCo's emission control technologies are not close substitutes for each other. FarmCo is a consumer of AgCo's technology and is not an actual competitor of AgCo in the relevant market for superior emission control technology of the kind licensed by AgCo. Furthermore, FarmCo

is not a likely potential competitor of AgCo in the relevant market because, even if FarmCo could develop an improved emission control technology, it is likely that it would infringe AgCo's patent. This means that the relationship between AgCo and FarmCo with regard to the supply and use of emissions control technology is vertical. Assuming that AgCo and FarmCo are actual or likely potential competitors in sales of farm equipment products, their relationship is horizontal in the relevant markets for farm equipment.

Example 6

Situation: FarmCo develops a new valve technology for its engines and enters into a cross-licensing arrangement with AgCo, whereby AgCo licenses its emission control technology to FarmCo and FarmCo licenses its valve technology to AgCo. AgCo already owns an alternative valve technology that can be used to achieve engine performance similar to that using FarmCo's valve technology and at a comparable cost to consumers. Before adopting FarmCo's technology, AgCo was using its own valve technology in its production of engines and was licensing (and continues to license) that technology for use by others. As in Example 5, FarmCo does not own or control an emission control technology that is a close substitute for the technology licensed from AgCo. Furthermore, as in Example 5, FarmCo is not likely to develop an improved emission control technology that would be a close substitute for AgCo's technology, because of AgCo's blocking patent.

Discussion: FarmCo is a consumer and not a competitor of AgCo's emission control technology. As in Example 5, their relationship is vertical with regard to this technology. The relationship between AgCo and FarmCo in the relevant market that includes engine valve technology is vertical in part and horizontal in part. It is vertical in part because AgCo and FarmCo stand in a complementary relationship, in which AgCo is a consumer of a technology supplied by FarmCo. However, the relationship between AgCo and FarmCo in the relevant market that includes engine valve technology is also horizontal in part, because FarmCo and AgCo are actual competitors in the licensing of valve technology that can be used to achieve similar engine performance at a comparable cost. Whether the firms license their valve technologies to others is not important for the conclusion that the firms have a horizontal relationship in this relevant market. Even if AgCo's use of its valve technology were solely captive to its own production, the fact that the two valve technologies are substitutable at comparable cost means that the two firms have a horizontal relationship.

As in Example 5, the relationship between AgCo and FarmCo is horizontal in the relevant markets for farm equipment.

3.4 Framework for evaluating licensing restraints

In the vast majority of cases, restraints in intellectual property licensing arrangements are evaluated under the rule of reason. The Agencies' general approach in analyzing a licensing restraint under the rule of reason is to inquire whether the restraint is likely to have anticompetitive effects and, if so, whether the restraint is reasonably necessary to achieve procompetitive benefits that outweigh those anticompetitive effects. *See Federal Trade Commission v. Indiana Federation of Dentists*, 476 U.S. 447 (1986); *NCAA v. Board of Regents of the University of Oklahoma*, 468 U.S. 85 (1984); *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979); 7 Phillip E. Areeda, *Antitrust Law* § 1502 (1986). *See also* part 4.

In some cases, however, the courts conclude that a restraint's "nature and necessary effect are so plainly anticompetitive" that it should be treated as unlawful per se, without an elaborate inquiry into the restraint's likely competitive effect. *Federal Trade Commission v. Superior Court Trial Lawyers Association*, 493 U.S. 411, 433 (1990); *National Society of Professional Engineers v. United States*, 435 U.S. 679, 692 (1978). Among the restraints that have been held per se unlawful are naked price-fixing, output restraints, and market division among horizontal competitors, as well as certain group boycotts and resale price maintenance.

To determine whether a particular restraint in a licensing arrangement is given per se or rule of reason treatment, the Agencies will assess whether the restraint in question can be expected to contribute to an efficiency-enhancing integration of economic activity. *See Broadcast Music*, 441 U.S. at 16–24. In general, licensing arrangements promote such integration because they facilitate the combination of the licensor's intellectual property with complementary factors of production owned by the licensee. A restraint in a licensing arrangement may further such integration by, for example, aligning the incentives of the licensor and the licensees to promote the development and marketing of the licensed technology, or by substantially reducing transactions costs. If there is no efficiency-enhancing integration of economic activity and if the type of restraint is one that has been accorded per se treatment, the Agencies will challenge the restraint under the per se rule. Otherwise, the Agencies will apply a rule of reason analysis.

Application of the rule of reason generally requires a comprehensive inquiry into market conditions. (*See* sections 4.1–4.3.) However, that inquiry may be truncated in certain circumstances. If the Agencies conclude that a restraint has no likely anticompetitive effects, they will treat it as reasonable, without an elaborate analysis of market power or the justifications for the restraint. Similarly, if a restraint facially appears to be of a kind that

would always or almost always tend to reduce output or increase prices,²⁷ and the restraint is not reasonably related to efficiencies, the Agencies will likely challenge the restraint without an elaborate analysis of particular industry circumstances.²⁸ See *Indiana Federation of Dentists*, 476 U.S. at 459–60; *NCAA*, 468 U.S. at 109.

Example 7

Situation: Gamma, which manufactures Product X using its patented process, offers a license for its process technology to every other manufacturer of Product X, each of which competes world-wide with Gamma in the manufacture and sale of X. The process technology does not represent an economic improvement over the available existing technologies. Indeed, although most manufacturers accept licenses from Gamma, none of the licensees actually uses the licensed technology. The licenses provide that each manufacturer has an exclusive right to sell Product X manufactured using the licensed technology in a designated geographic area and that no manufacturer may sell Product X, however manufactured, outside the designated territory.

Discussion: The manufacturers of Product X are in a horizontal relationship in the goods market for Product X. Any manufacturers of Product X that control technologies that are substitutable at comparable cost for Gamma's process are also horizontal competitors of Gamma in the relevant technology market. The licensees of Gamma's process technology are technically in a vertical relationship, although that is not significant in this example because they do not actually use Gamma's technology.

The licensing arrangement restricts competition in the relevant goods market among manufacturers of Product X by requiring each manufacturer to limit its sales to an exclusive territory. Thus, competition among entities that would be actual competitors in the absence of the licensing arrangement is restricted. Based on the facts set forth above, the licensing arrangement does not involve a useful transfer of technology, and thus it is unlikely that the restraint on sales outside the designated territories contributes to an efficiency-enhancing integration of economic activity. Consequently, the evaluating Agency would be likely to challenge the arrangement under the per se rule as a horizontal territorial market allocation scheme and to view the intellectual property aspects of the arrangement as a sham intended to cloak its true nature.

²⁷ Details about the Federal Trade Commission's approach are set forth in *Massachusetts Board of Registration in Optometry*, 110 F.T.C. 549, 604 (1988). In applying its truncated rule of reason inquiry, the FTC uses the analytical category of "inherently suspect" restraints to denote facially anticompetitive restraints that would always or almost always tend to decrease output or increase prices, but that may be relatively unfamiliar or may not fit neatly into traditional per se categories.

²⁸ Under the FTC's *Mass. Board* approach, asserted efficiency justifications for inherently suspect restraints are examined to determine whether they are plausible and, if so, whether they are valid in the context of the market at issue. *Mass. Board*, 110 F.T.C. at 604.

If the licensing arrangement could be expected to contribute to an efficiency-enhancing integration of economic activity, as might be the case if the licensed technology were an advance over existing processes and used by the licensees, the Agency would analyze the arrangement under the rule of reason applying the analytical framework described in this section.

In this example, the competitive implications do not generally depend on whether the licensed technology is protected by patent, is a trade secret or other know-how, or is a computer program protected by copyright; nor do the competitive implications generally depend on whether the allocation of markets is territorial, as in this example, or functional, based on fields of use.

4. General principles concerning the Agencies' evaluation of licensing arrangements under the rule of reason

4.1 Analysis of anticompetitive effects

The existence of anticompetitive effects resulting from a restraint in a licensing arrangement will be evaluated on the basis of the analysis described in this section.

4.1.1 Market structure, coordination, and foreclosure

When a licensing arrangement affects parties in a horizontal relationship, a restraint in that arrangement may increase the risk of coordinated pricing, output restrictions, or the acquisition or maintenance of market power. Harm to competition also may occur if the arrangement poses a significant risk of retarding or restricting the development of new or improved goods or processes. The potential for competitive harm depends in part on the degree of concentration in, the difficulty of entry into, and the responsiveness of supply and demand to changes in price in the relevant markets. *Cf.* 1992 Horizontal Merger Guidelines §§ 1.5, 3.

When the licensor and licensees are in a vertical relationship, the Agencies will analyze whether the licensing arrangement may harm competition among entities in a horizontal relationship at either the level of the licensor or the licensees, or possibly in another relevant market. Harm to competition from a restraint may occur if it anticompetitively forecloses access to, or increases competitors' costs of obtaining, important inputs, or facilitates coordination to raise price or restrict output. The risk of anticompetitively foreclosing access or increasing competitors' costs is related to the proportion of the markets affected by the licensing restraint; other characteristics of the relevant markets, such as concentration,

difficulty of entry, and the responsiveness of supply and demand to changes in price in the relevant markets; and the duration of the restraint. A licensing arrangement does not foreclose competition merely because some or all of the potential licensees in an industry choose to use the licensed technology to the exclusion of other technologies. Exclusive use may be an efficient consequence of the licensed technology having the lowest cost or highest value.

Harm to competition from a restraint in a vertical licensing arrangement also may occur if a licensing restraint facilitates coordination among entities in a horizontal relationship to raise prices or reduce output in a relevant market. For example, if owners of competing technologies impose similar restraints on their licensees, the licensors may find it easier to coordinate their pricing. Similarly, licensees that are competitors may find it easier to coordinate their pricing if they are subject to common restraints in licenses with a common licensor or competing licensors. The risk of anticompetitive coordination is increased when the relevant markets are concentrated and difficult to enter. The use of similar restraints may be common and procompetitive in an industry, however, because they contribute to efficient exploitation of the licensed property.

4.1.2 Licensing arrangements involving exclusivity

A licensing arrangement may involve exclusivity in two distinct respects. First, the licensor may grant one or more *exclusive licenses*, which restrict the right of the licensor to license others and possibly also to use the technology itself. Generally, an exclusive license may raise antitrust concerns only if the licensees themselves, or the licensor and its licensees, are in a horizontal relationship. Examples of arrangements involving exclusive licensing that may give rise to antitrust concerns include cross-licensing by parties collectively possessing market power (*see* section 5.5), grantbacks (*see* section 5.6), and acquisitions of intellectual property rights (*see* section 5.7).

A non-exclusive license of intellectual property that does not contain any restraints on the competitive conduct of the licensor or the licensee generally does not present antitrust concerns even if the parties to the license are in a horizontal relationship, because the non-exclusive license normally does not diminish competition that would occur in its absence.

A second form of exclusivity, *exclusive dealing*, arises when a license prevents or restrains the licensee from licensing, selling, distributing, or using competing technologies. *See* section 5.4. Exclusivity may be achieved by an explicit exclusive dealing term in the license or by other provisions such as compensation terms or other economic incentives. Such restraints may anticompetitively foreclose access to, or increase competitors' costs of obtaining, important inputs, or facilitate coordination to raise price or reduce output, but they

also may have procompetitive effects. For example, a licensing arrangement that prevents the licensee from dealing in other technologies may encourage the licensee to develop and market the licensed technology or specialized applications of that technology. *See, e.g.*, Example 8. The Agencies will take into account such procompetitive effects in evaluating the reasonableness of the arrangement. *See* section 4.2.

The antitrust principles that apply to a licensor's grant of various forms of exclusivity to and among its licensees are similar to those that apply to comparable vertical restraints outside the licensing context, such as exclusive territories and exclusive dealing. However, the fact that intellectual property may in some cases be misappropriated more easily than other forms of property may justify the use of some restrictions that might be anticompetitive in other contexts.

As noted earlier, the Agencies will focus on the actual practice and its effects, not on the formal terms of the arrangement. A license denominated as non-exclusive (either in the sense of exclusive licensing or in the sense of exclusive dealing) may nonetheless give rise to the same concerns posed by formal exclusivity. A non-exclusive license may have the effect of exclusive licensing if it is structured so that the licensor is unlikely to license others or to practice the technology itself. A license that does not explicitly require exclusive dealing may have the effect of exclusive dealing if it is structured to increase significantly a licensee's cost when it uses competing technologies. However, a licensing arrangement will not automatically raise these concerns merely because a party chooses to deal with a single licensee or licensor, or confines his activity to a single field of use or location, or because only a single licensee has chosen to take a license.

Example 8

Situation: NewCo, the inventor and manufacturer of a new flat panel display technology, lacking the capability to bring a flat panel display product to market, grants BigCo an exclusive license to sell a product embodying NewCo's technology. BigCo does not currently sell, and is not developing (or likely to develop), a product that would compete with the product embodying the new technology and does not control rights to another display technology. Several firms offer competing displays, BigCo accounts for only a small proportion of the outlets for distribution of display products, and entry into the manufacture and distribution of display products is relatively easy. Demand for the new technology is uncertain and successful market penetration will require considerable promotional effort. The license contains an exclusive dealing restriction preventing BigCo from selling products that compete with the product embodying the licensed technology.

Discussion: This example illustrates both types of exclusivity in a licensing arrangement. The license is exclusive in that it restricts the right of the licensor to grant other licenses. In

addition, the license has an exclusive dealing component in that it restricts the licensee from selling competing products.

The inventor of the display technology and its licensee are in a vertical relationship and are not actual or likely potential competitors in the manufacture or sale of display products or in the sale or development of technology. Hence, the grant of an exclusive license does not affect competition between the licensor and the licensee. The exclusive license may promote competition in the manufacturing and sale of display products by encouraging BigCo to develop and promote the new product in the face of uncertain demand by rewarding BigCo for its efforts if they lead to large sales. Although the license bars the licensee from selling competing products, this exclusive dealing aspect is unlikely in this example to harm competition by anticompetitively foreclosing access, raising competitors' costs of inputs, or facilitating anticompetitive pricing because the relevant product market is unconcentrated, the exclusive dealing restraint affects only a small proportion of the outlets for distribution of display products, and entry is easy. On these facts, the evaluating Agency would be unlikely to challenge the arrangement.

4.2 Efficiencies and justifications

If the Agencies conclude, upon an evaluation of the market factors described in section 4.1, that a restraint in a licensing arrangement is unlikely to have an anticompetitive effect, they will not challenge the restraint. If the Agencies conclude that the restraint has, or is likely to have, an anticompetitive effect, they will consider whether the restraint is reasonably necessary to achieve procompetitive efficiencies. If the restraint is reasonably necessary, the Agencies will balance the procompetitive efficiencies and the anticompetitive effects to determine the probable net effect on competition in each relevant market.

The Agencies' comparison of anticompetitive harms and procompetitive efficiencies is necessarily a qualitative one. The risk of anticompetitive effects in a particular case may be insignificant compared to the expected efficiencies, or vice versa. As the expected anticompetitive effects in a particular licensing arrangement increase, the Agencies will require evidence establishing a greater level of expected efficiencies.

The existence of practical and significantly less restrictive alternatives is relevant to a determination of whether a restraint is reasonably necessary. If it is clear that the parties could have achieved similar efficiencies by means that are significantly less restrictive, then the Agencies will not give weight to the parties' efficiency claim. In making this assessment, however, the Agencies will not engage in a search for a theoretically least restrictive alternative that is not realistic in the practical prospective business situation faced by the parties.

When a restraint has, or is likely to have, an anticompetitive effect, the duration of that restraint can be an important factor in determining whether it is reasonably necessary to achieve the putative procompetitive efficiency. The effective duration of a restraint may depend on a number of factors, including the option of the affected party to terminate the arrangement unilaterally and the presence of contract terms (e.g., unpaid balances on minimum purchase commitments) that encourage the licensee to renew a license arrangement. Consistent with their approach to less restrictive alternative analysis generally, the Agencies will not attempt to draw fine distinctions regarding duration; rather, their focus will be on situations in which the duration clearly exceeds the period needed to achieve the procompetitive efficiency.

The evaluation of procompetitive efficiencies, of the reasonable necessity of a restraint to achieve them, and of the duration of the restraint, may depend on the market context. A restraint that may be justified by the needs of a new entrant, for example, may not have a procompetitive efficiency justification in different market circumstances. *Cf. United States v. Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).

4.3 Antitrust “safety zone”

Because licensing arrangements often promote innovation and enhance competition, the Agencies believe that an antitrust “safety zone” is useful in order to provide some degree of certainty and thus to encourage such activity.²⁹ Absent extraordinary circumstances, the Agencies will not challenge a restraint in an intellectual property licensing arrangement if (1) the restraint is not facially anticompetitive³⁰ and (2) the licensor and its licensees collectively account for no more than twenty percent of each relevant market significantly affected by the restraint. This “safety zone” does not apply to those transfers of intellectual property rights to which a merger analysis is applied. *See* section 5.7.

Whether a restraint falls within the safety zone will be determined by reference only to goods markets unless the analysis of goods markets alone would inadequately address the effects of the licensing arrangement on competition among technologies or in research and development.

²⁹ The antitrust “safety zone” does not apply to restraints that are not in a licensing arrangement, or to restraints that are in a licensing arrangement but are unrelated to the use of the licensed intellectual property.

³⁰ “Facially anticompetitive” refers to restraints that normally warrant per se treatment, as well as other restraints of a kind that would always or almost always tend to reduce output or increase prices. *See* section 3.4.

If an examination of the effects on competition among technologies or in research development is required, and if market share data are unavailable or do not accurately represent competitive significance, the following safety zone criteria will apply. Absent extraordinary circumstances, the Agencies will not challenge a restraint in an intellectual property licensing arrangement that may affect competition in a technology market if (1) the restraint is not facially anticompetitive and (2) there are four or more independently controlled technologies in addition to the technologies controlled by the parties to the licensing arrangement that may be substitutable for the licensed technology at a comparable cost to the user. Absent extraordinary circumstances, the Agencies will not challenge a restraint in an intellectual property licensing arrangement that may affect competition in an innovation market if (1) the restraint is not facially anticompetitive and (2) four or more independently controlled entities in addition to the parties to the licensing arrangement possess the required specialized assets or characteristics and the incentive to engage in research and development that is a close substitute of the research and development activities of the parties to the licensing agreement.³¹

The Agencies emphasize that licensing arrangements are not anticompetitive merely because they do not fall within the scope of the safety zone. Indeed, it is likely that the great majority of licenses falling outside the safety zone are lawful and procompetitive. The safety zone is designed to provide owners of intellectual property with a degree of certainty in those situations in which anticompetitive effects are so unlikely that the arrangements may be presumed not to be anticompetitive without an inquiry into particular industry circumstances. It is not intended to suggest that parties should conform to the safety zone or to discourage parties falling outside the safety zone from adopting restrictions in their license arrangements that are reasonably necessary to achieve an efficiency-enhancing integration of economic activity. The Agencies will analyze arrangements falling outside the safety zone based on the considerations outlined in parts 3–5.

The status of a licensing arrangement with respect to the safety zone may change over time. A determination by the Agencies that a restraint in a licensing arrangement qualifies for inclusion in the safety zone is based on the factual circumstances prevailing at the time of the conduct at issue.³²

³¹ This is consistent with congressional intent in enacting the National Cooperative Research Act. See H.R. Conf. Rpt. No. 1044, 98th Cong., 2d Sess., 10, *reprinted in* 1984 U.S.C.C.A.N. 3105, 3134–35.

³² The conduct at issue may be the transaction giving rise to the restraint or the subsequent implementation of the restraint.

5. Application of general principles

5.0 This section illustrates the application of the general principles discussed above to particular licensing restraints and to arrangements that involve the cross-licensing, pooling, or acquisition of intellectual property. The restraints and arrangements identified are typical of those that are likely to receive antitrust scrutiny; however, they are not intended as an exhaustive list of practices that could raise competitive concerns.

5.1 Horizontal restraints

The existence of a restraint in a licensing arrangement that affects parties in a horizontal relationship (a “horizontal restraint”) does not necessarily cause the arrangement to be anticompetitive. As in the case of joint ventures among horizontal competitors, licensing arrangements among such competitors may promote rather than hinder competition if they result in integrative efficiencies. Such efficiencies may arise, for example, from the realization of economies of scale and the integration of complementary research and development, production, and marketing capabilities.

Following the general principles outlined in section 3.4, horizontal restraints often will be evaluated under the rule of reason. In some circumstances, however, that analysis may be truncated; additionally, some restraints may merit per se treatment, including price fixing, allocation of markets or customers, agreements to reduce output, and certain group boycotts.

Example 9

Situation: Two of the leading manufacturers of a consumer electronic product hold patents that cover alternative circuit designs for the product. The manufacturers assign their patents to a separate corporation wholly owned by the two firms. That corporation licenses the right to use the circuit designs to other consumer product manufacturers and establishes the license royalties. None of the patents is blocking; that is, each of the patents can be used without infringing a patent owned by the other firm. The different circuit designs are substitutable in that each permits the manufacture at comparable cost to consumers of products that consumers consider to be interchangeable. One of the Agencies is analyzing the licensing arrangement.

Discussion: In this example, the manufacturers are horizontal competitors in the goods market for the consumer product and in the related technology markets. The competitive issue with regard to a joint assignment of patent rights is whether the assignment has an adverse impact on competition in technology and goods markets that is not outweighed by procompetitive efficiencies, such as benefits in the use or dissemination of the technology. Each of the patent owners has a right to exclude others from using its patent. That right does not extend, however, to the agreement to assign rights jointly. To the extent that the patent rights cover technologies that are close substitutes, the joint determination of royalties likely would result in higher royalties and higher goods prices than would result if the owners licensed or used their technologies independently. In the absence of evidence establishing efficiency-enhancing integration from the joint assignment of patent rights, the Agency may conclude that the joint marketing of competing patent rights constitutes horizontal price fixing and could be challenged as a per se unlawful horizontal restraint of trade. If the joint marketing arrangement results in an efficiency-enhancing integration, the Agency would evaluate the arrangement under the rule of reason. However, the Agency may conclude that the anticompetitive effects are sufficiently apparent, and the claimed integrative efficiencies are sufficiently weak or not reasonably related to the restraints, to warrant challenge of the arrangement without an elaborate analysis of particular industry circumstances (*see* section 3.4).

5.2 Resale price maintenance

Resale price maintenance is illegal when “commodities have passed into the channels of trade and are owned by dealers.” *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 408 (1911). It has been held per se illegal for a licensor of an intellectual property right in a product to fix a licensee's *resale* price of that product. *United States v. Unis Lens Co.*, 316 U.S. 241 (1942); *Ethyl Gasoline Corp. v. United States*, 309 U.S. 436 (1940).³³

³³ *But cf. United States v. General Electric Co.*, 272 U.S. 476 (1926) (holding that an owner of a product patent may condition a license to manufacture the product on the fixing of the *first* sale price

Consistent with the principles set forth in section 3.4, the Agencies will enforce the per se rule against resale price maintenance in the intellectual property context.

5.3 Tying arrangements

A “tying” or “tie-in” or “tied sale” arrangement has been defined as “an agreement by a party to sell one product . . . on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that [tied] product from any other supplier.” *Eastman Kodak Co. v. Image Technical Services, Inc.*, 112 S. Ct. 2072, 2079 (1992). Conditioning the ability of a licensee to license one or more items of intellectual property on the licensee's purchase of another item of intellectual property or a good or a service has been held in some cases to constitute illegal tying.³⁴ Although tying arrangements may result in anticompetitive effects, such arrangements can also result in significant efficiencies and procompetitive benefits. In the exercise of their prosecutorial discretion, the Agencies will consider both the anticompetitive effects and the efficiencies attributable to a tie-in. The Agencies would be likely to challenge a tying arrangement if: (1) the seller has market power in the tying product,³⁵ (2) the arrangement has an adverse effect on competition in the relevant market for the tied product, and (3) efficiency justifications for the arrangement do not outweigh the anticompetitive effects.³⁶ The Agencies will not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner.

of the patented product). Subsequent lower court decisions have distinguished the *GE* decision in various contexts. See, e.g., *Royal Indus. v. St. Regis Paper Co.*, 420 F.2d 449, 452 (9th Cir. 1969) (observing that *GE* involved a restriction by a patentee who also manufactured the patented product and leaving open the question whether a nonmanufacturing patentee may fix the price of the patented product); *Newburgh Moire Co. v. Superior Moire Co.*, 237 F.2d 283, 293–94 (3rd Cir. 1956) (grant of multiple licenses each containing price restrictions does not come within the *GE* doctrine); *Cummer-Graham Co. v. Straight Side Basket Corp.*, 142 F.2d 646, 647 (5th Cir.) (owner of an intellectual property right in a process to manufacture an unpatented product may not fix the sale price of that product), *cert. denied*, 323 U.S. 726 (1944); *Barber-Colman Co. v. National Tool Co.*, 136 F.2d 339, 343–44 (6th Cir. 1943) (same).

³⁴ See, e.g., *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 156–58 (1948) (copyrights); *International Salt Co. v. United States*, 332 U.S. 392 (1947) (patent and related product).

³⁵ Cf. 35 U.S.C. § 271(d) (1988 & Supp. V 1993) (requirement of market power in patent misuse cases involving tying).

³⁶ As is true throughout these Guidelines, the factors listed are those that guide the Agencies' internal analysis in exercising their prosecutorial discretion. They are not intended to circumscribe how the Agencies will conduct the litigation of cases that they decide to bring.

Package licensing—the licensing of multiple items of intellectual property in a single license or in a group of related licenses—may be a form of tying arrangement if the licensing of one product is conditioned upon the acceptance of a license of another, separate product. Package licensing can be efficiency enhancing under some circumstances. When multiple licenses are needed to use any single item of intellectual property, for example, a package license may promote such efficiencies. If a package license constitutes a tying arrangement, the Agencies will evaluate its competitive effects under the same principles they apply to other tying arrangements.

5.4 Exclusive dealing

In the intellectual property context, exclusive dealing occurs when a license prevents the licensee from licensing, selling, distributing, or using competing technologies. Exclusive dealing arrangements are evaluated under the rule of reason. *See Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961) (evaluating legality of exclusive dealing under section 1 of the Sherman Act and section 3 of the Clayton Act); *Beltone Electronics Corp.*, 100 F.T.C. 68 (1982) (evaluating legality of exclusive dealing under section 5 of the Federal Trade Commission Act). In determining whether an exclusive dealing arrangement is likely to reduce competition in a relevant market, the Agencies will take into account the extent to which the arrangement (1) promotes the exploitation and development of the licensor's technology and (2) anticompetitively forecloses the exploitation and development of, or otherwise constrains competition among, competing technologies.

The likelihood that exclusive dealing may have anticompetitive effects is related, inter alia, to the degree of foreclosure in the relevant market, the duration of the exclusive dealing arrangement, and other characteristics of the input and output markets, such as concentration, difficulty of entry, and the responsiveness of supply and demand to changes in price in the relevant markets. (*See* sections 4.1.1 and 4.1.2.) If the Agencies determine that a particular exclusive dealing arrangement may have an anticompetitive effect, they will evaluate the extent to which the restraint encourages licensees to develop and market the licensed technology (or specialized applications of that technology), increases licensors' incentives to develop or refine the licensed technology, or otherwise increases competition and enhances output in a relevant market. (*See* section 4.2 and Example 8.)

5.5 Cross-licensing and pooling arrangements

Cross-licensing and pooling arrangements are agreements of two or more owners of different items of intellectual property to license one another or third parties. These arrangements may provide procompetitive benefits by integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation. By promoting the dissemination of technology, cross-licensing and pooling arrangements are often procompetitive.

Cross-licensing and pooling arrangements can have anticompetitive effects in certain circumstances. For example, collective price or output restraints in pooling arrangements, such as the joint marketing of pooled intellectual property rights with collective price setting or coordinated output restrictions, may be deemed unlawful if they do not contribute to an efficiency-enhancing integration of economic activity among the participants. *Compare NCAA* 468 U.S. at 114 (output restriction on college football broadcasting held unlawful because it was not reasonably related to any purported justification) *with Broadcast Music*, 441 U.S. at 23 (blanket license for music copyrights found not per se illegal because the cooperative price was necessary to the creation of a new product). When cross-licensing or pooling arrangements are mechanisms to accomplish naked price fixing or market division, they are subject to challenge under the per se rule. *See United States v. New Wrinkle, Inc.*, 342 U.S. 371 (1952) (price fixing).

Settlements involving the cross-licensing of intellectual property rights can be an efficient means to avoid litigation and, in general, courts favor such settlements. When such cross-licensing involves horizontal competitors, however, the Agencies will consider whether the effect of the settlement is to diminish competition among entities that would have been actual or likely potential competitors in a relevant market in the absence of the cross-license. In the absence of offsetting efficiencies, such settlements may be challenged as unlawful restraints of trade. *Cf. United States v. Singer Manufacturing Co.*, 374 U.S. 174 (1963) (cross-license agreement was part of broader combination to exclude competitors).

Pooling arrangements generally need not be open to all who would like to join. However, exclusion from cross-licensing and pooling arrangements among parties that collectively possess market power may, under some circumstances, harm competition. *Cf. Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284 (1985) (exclusion of a competitor from a purchasing cooperative not per se unlawful absent a showing of market power). In general, exclusion from a pooling or cross-licensing arrangement among competing technologies is unlikely to have anticompetitive effects unless (1) excluded firms cannot effectively compete in the relevant market for the good incorporating the licensed technologies and (2) the pool participants collectively possess market power in the relevant market. If these circumstances exist, the Agencies will evaluate

whether the arrangement's limitations on participation are reasonably related to the efficient development and exploitation of the pooled technologies and will assess the net effect of those limitations in the relevant market. *See* section 4.2.

Another possible anticompetitive effect of pooling arrangements may occur if the arrangement deters or discourages participants from engaging in research and development, thus retarding innovation. For example, a pooling arrangement that requires members to grant licenses to each other for current and future technology at minimal cost may reduce the incentives of its members to engage in research and development because members of the pool have to share their successful research and development and each of the members can free ride on the accomplishments of other pool members. *See generally United States v. Mfrs. Aircraft Ass'n, Inc.*, 1976-1 Trade Cas. (CCH) ¶ 60,810 (S.D.N.Y. 1975); *United States v. Automobile Mfrs. Ass'n*, 307 F. Supp. 617 (C.D. Cal 1969), *appeal dismissed sub nom. City of New York v. United States*, 397 U.S. 248 (1970), *modified sub nom. United States v. Motor Vehicle Mfrs. Ass'n*, 1982-83 Trade Cas. (CCH) ¶ 65,088 (C.D. Cal. 1982). However, such an arrangement can have procompetitive benefits, for example, by exploiting economies of scale and integrating complementary capabilities of the pool members, (including the clearing of blocking positions), and is likely to cause competitive problems only when the arrangement includes a large fraction of the potential research and development in an innovation market. *See* section 3.2.3 and Example 4.

Example 10

Situation: As in Example 9, two of the leading manufacturers of a consumer electronic product hold patents that cover alternative circuit designs for the product. The manufacturers assign several of their patents to a separate corporation wholly owned by the two firms. That corporation licenses the right to use the circuit designs to other consumer product manufacturers and establishes the license royalties. In this example, however, the manufacturers assign to the separate corporation only patents that are blocking. None of the patents assigned to the corporation can be used without infringing a patent owned by the other firm.

Discussion: Unlike the previous example, the joint assignment of patent rights to the wholly owned corporation in this example does not adversely affect competition in the licensed technology among entities that would have been actual or likely potential competitors in the absence of the licensing arrangement. Moreover, the licensing arrangement is likely to have procompetitive benefits in the use of the technology. Because the manufacturers' patents are blocking, the manufacturers are not in a horizontal relationship with respect to those patents. None of the patents can be used without the right to a patent owned by the other firm, so the patents are not substitutable. As in Example 9, the firms are horizontal competitors in the relevant goods market. In the absence of collateral restraints that would likely raise price or reduce output in the relevant goods market or in any other relevant antitrust market and that are

not reasonably related to an efficiency-enhancing integration of economic activity, the evaluating Agency would be unlikely to challenge this arrangement.

5.6 Grantbacks

A grantback is an arrangement under which a licensee agrees to extend to the licensor of intellectual property the right to use the licensee's improvements to the licensed technology. Grantbacks can have procompetitive effects, especially if they are nonexclusive. Such arrangements provide a means for the licensee and the licensor to share risks and reward the licensor for making possible further innovation based on or informed by the licensed technology, and both promote innovation in the first place and promote the subsequent licensing of the results of the innovation. Grantbacks may adversely affect competition, however, if they substantially reduce the licensee's incentives to engage in research and development and thereby limit rivalry in innovation markets.

A non-exclusive grantback allows the licensee to practice its technology and license it to others. Such a grantback provision may be necessary to ensure that the licensor is not prevented from effectively competing because it is denied access to improvements developed with the aid of its own technology. Compared with an exclusive grantback, a non-exclusive grantback, which leaves the licensee free to license improvements technology to others, is less likely to have anticompetitive effects.

The Agencies will evaluate a grantback provision under the rule of reason, *see generally* *Transparent-Wrap Machine Corp. v. Stokes & Smith Co.*, 329 U.S. 637, 645–48 (1947) (grantback provision in technology license is not per se unlawful), considering its likely effects in light of the overall structure of the licensing arrangement and conditions in the relevant markets. An important factor in the Agencies' analysis of a grantback will be whether the licensor has market power in a relevant technology or innovation market. If the Agencies determine that a particular grantback provision is likely to reduce significantly licensees' incentives to invest in improving the licensed technology, the Agencies will consider the extent to which the grantback provision has offsetting procompetitive effects, such as (1) promoting dissemination of licensees' improvements to the licensed technology, (2) increasing the licensors' incentives to disseminate the licensed technology, or (3) otherwise increasing competition and output in a relevant technology or innovation market. *See* section 4.2. In addition, the Agencies will consider the extent to which grantback provisions in the relevant markets generally increase licensors' incentives to innovate in the first place.

5.7 Acquisition of intellectual property rights

Certain transfers of intellectual property rights are most appropriately analyzed by applying the principles and standards used to analyze mergers, particularly those in the 1992 Horizontal Merger Guidelines. The Agencies will apply a merger analysis to an outright sale by an intellectual property owner of all of its rights to that intellectual property and to a transaction in which a person obtains through grant, sale, or other transfer an exclusive license for intellectual property (i.e., a license that precludes all other persons, including the licensor, from using the licensed intellectual property).³⁷ Such transactions may be assessed under section 7 of the Clayton Act, sections 1 and 2 of the Sherman Act, and section 5 of the Federal Trade Commission Act.

Example 11

Situation: Omega develops a new, patented pharmaceutical for the treatment of a particular disease. The only drug on the market approved for the treatment of this disease is sold by Delta. Omega's patented drug has almost completed regulatory approval by the Food and Drug Administration. Omega has invested considerable sums in product development and market testing, and initial results show that Omega's drug would be a significant competitor to Delta's. However, rather than enter the market as a direct competitor of Delta, Omega licenses to Delta the right to manufacture and sell Omega's patented drug. The license agreement with Delta is nominally nonexclusive. However, Omega has rejected all requests by other firms to obtain a license to manufacture and sell Omega's patented drug, despite offers by those firms of terms that are reasonable in relation to those in Delta's license.

Discussion: Although Omega's license to Delta is nominally nonexclusive, the circumstances indicate that it is exclusive in fact because Omega has rejected all reasonable offers by other firms for licenses to manufacture and sell Omega's patented drug. The facts of this example indicate that Omega would be a likely potential competitor of Delta in the absence of the licensing arrangement, and thus they are in a horizontal relationship in the relevant goods market that includes drugs for the treatment of this particular disease. The evaluating Agency would apply a merger analysis to this transaction, since it involves an acquisition of a likely potential competitor.

³⁷ The safety zone of section 4.3 does not apply to transfers of intellectual property such as those described in this section.

6. Enforcement of invalid intellectual property rights

The Agencies may challenge the enforcement of invalid intellectual property rights as antitrust violations. Enforcement or attempted enforcement of a patent obtained by fraud on the Patent and Trademark Office or the Copyright Office may violate section 2 of the Sherman Act, if all the elements otherwise necessary to establish a section 2 charge are proved, or section 5 of the Federal Trade Commission Act. *Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.*, 382 U.S. 172 (1965) (patents); *American Cyanamid Co.*, 72 F.T.C. 623, 684–85 (1967), *aff'd sub. nom. Charles Pfizer & Co.*, 401 F.2d 574 (6th Cir. 1968), *cert. denied*, 394 U.S. 920 (1969) (patents); *Michael Anthony Jewelers, Inc. v. Peacock Jewelry, Inc.*, 795 F. Supp. 639, 647 (S.D.N.Y. 1992) (copyrights). Inequitable conduct before the Patent and Trademark Office will not be the basis of a section 2 claim unless the conduct also involves knowing and willful fraud and the other elements of a section 2 claim are present. *Argus Chemical Corp. v. Fibre Glass-Evercoat, Inc.*, 812 F.2d 1381, 1384–85 (Fed. Cir. 1987). Actual or attempted enforcement of patents obtained by inequitable conduct that falls short of fraud under some circumstances may violate section 5 of the Federal Trade Commission Act, *American Cyanamid Co.*, *supra*. Objectively baseless litigation to enforce invalid intellectual property rights may also constitute an element of a violation of the Sherman Act. See *Professional Real Estate Investors, Inc. v. Columbia Pictures Industries, Inc.*, 113 S. Ct. 1920, 1928 (1993) (copyrights); *Handgards, Inc. v. Ethicon, Inc.*, 743 F.2d 1282, 1289 (9th Cir. 1984), *cert. denied*, 469 U.S. 1190 (1985) (patents); *Handgards, Inc. v. Ethicon, Inc.*, 601 F.2d 986, 992–96 (9th Cir. 1979), *cert. denied*, 444 U.S. 1025 (1980) (patents); *CVD, Inc. v. Raytheon Co.*, 769 F.2d 842 (1st Cir. 1985) (trade secrets), *cert. denied*, 475 U.S. 1016 (1986).

附錄二：

美國聯邦交易委員會—促進創新：競爭法與專利其法律及政策之適當平衡



To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy

A Report by the Federal Trade Commission
October 2003



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The Commission thanks the Competition Policy Center and the Berkeley Center for Law and Technology at the University of California at Berkeley for providing facilities to allow some of the Hearings to be held on the West Coast.

Cover:

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Patents: Front Cover

Patent No. 549,160 - Selden Road Engine

Patent No. 4,779, 268 - Frame Decoding for Digital Signal Transmission

Patents: Back Cover

Patent No. 4,302,281 - Method for Producing Pulp

Patent No. 4,805,654 - Sun Shield for Automobiles

TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY

EXECUTIVE SUMMARY

Innovation benefits consumers through the development of new and improved goods, services, and processes. An economy's capacity for invention and innovation helps drive its economic growth and the degree to which standards of living increase.¹ Technological breakthroughs such as automobiles, airplanes, the personal computer, the Internet, television, telephones, and modern pharmaceuticals illustrate the power of innovation to increase prosperity and improve the quality of our lives.

Competition and patents stand out among the federal policies that influence innovation. Both competition and patent policy can foster innovation, but each requires a proper balance with the other to do so. Errors or systematic biases in how one policy's rules are interpreted and applied can harm the other policy's effectiveness. This report by the Federal Trade Commission (FTC) discusses and makes recommendations for the patent system to maintain a proper balance with competition law and policy.² A second joint report, by

the FTC and the Antitrust Division of the Department of Justice (DOJ) (forthcoming), will discuss and make recommendations for antitrust to maintain a proper balance with the patent system.

Competition and Patent Law and Policy Promote Innovation and Benefit the Public.

Competition through free enterprise and open markets is the organizing principle for most of the U.S. economy. Competition among firms generally works best to achieve optimum prices, quantity, and quality of goods and services for consumers. Antitrust law, codified in the Sherman Act, the FTC Act, and other statutes, seeks "to maximize consumer welfare by encouraging firms to behave competitively."³

Competition can stimulate innovation. Competition among firms can spur the invention of new or better products or more efficient processes. Firms may race to be the first to market an innovative technology. Companies may invent lower-cost manufacturing processes, thereby increasing their profits and enhancing their ability to compete. Competition can prompt firms to identify consumers' unmet needs and develop new products or services to

¹ Federal Reserve Board Vice Chairman Roger W. Ferguson, Jr., Patent Policy in a Broader Context, Remarks at 2003 Financial Markets Conference of the Federal Reserve Bank of Atlanta (April 5, 2003), at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030407/default.htm>.

² The Federal Trade Commission issues reports pursuant to Section 6(f) of the Federal Trade Commission Act, 15 U.S.C. § 46(f).

³ PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶100a at 4 (2000).

satisfy them.

Patent policy also can stimulate innovation. The U.S. Constitution authorizes Congress “[t]o promote the Progress of Science and useful Arts, by securing for limited Times to . . . Inventors the exclusive Right to their respective . . . Discoveries.”⁴ To obtain a patent, an invention (that is, a product, process, machine, or composition of matter) must be novel, nonobvious, and useful. Moreover, a patentee must clearly disclose the invention. A patent confers a right to exclude others from making, using, or selling in the United States the invention claimed by the patent for twenty years from the date of filing the patent application.

This property right can enable firms to increase their expected profits from investments in research and development, thus fostering innovation that would not occur but for the prospect of a patent. Because the patent system requires public disclosure, it can promote a dissemination of scientific and technical information that would not occur but for the prospect of a patent.

Like competition policy, patent policy serves to benefit the public. “The basic quid pro quo contemplated by the Constitution and the Congress for granting a patent monopoly is the benefit derived by the public from an invention with substantial utility.”⁵ The public disclosure of scientific

⁴ U.S. CONST. art. I, § 8. Other sections of this constitutional provision authorize copyright law.

⁵ *Brenner v. Manson*, 383 U.S. 519, 534-35 (1966). The consideration an inventor gives in return for a patent “is the benefit which he confers upon the public by

and technical information is part of the consideration that the inventor gives the public.”⁶

Competition and Patents Must Work Together in the Proper Balance.

Competition and patents are not inherently in conflict. Patent and antitrust law “are actually complementary, as both are aimed at encouraging innovation, industry, and competition.”⁷ Patent law plays an important role in the property rights regime essential to a well-functioning competitive economy. For example, firms may compete to obtain the property rights that patents convey. Patents do not necessarily confer monopoly power on their holders,⁸ and most business conduct with respect to patents does not unreasonably restrain or serve to monopolize markets. Even when a patent does confer monopoly power, that alone does not create an antitrust violation. Antitrust law recognizes that a patent’s creation of monopoly power can be

placing in their hands a means through the use of which their wants may be supplied.” 1 WILLIAM ROBINSON, *THE LAW OF PATENTS FOR USEFUL INVENTIONS* § 22 at 305 (1890), cited in ROBERT P. MERGES & JOHN F. DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* 361 (3d ed. 2002).

⁶ See James E. Rogan, *Prepared Remarks of James E. Rogan, Under Secretary of Commerce for Intellectual Property and Director of the United States Patent and Trademark Office* (2/6/02) 2, at <http://www.ftc.gov/opp/intellect/rogan.htm>.

⁷ *Atari Games Corp. v. Nintendo of Am.*, 897 F.2d 1572, 1576 (Fed. Cir.1990).

⁸ ROBERT L. HARMON, *PATENTS AND THE FEDERAL CIRCUIT* § 1.4(b) at 21 (5th ed. 2001) (“Patent rights are not legal monopolies in the antitrust sense of the word. Not every patent is a monopoly, and not every patent confers market power.”).

necessary to achieve a greater gain for consumers.

Analogously, the Supreme Court has recognized the importance of competition to the patent system.⁹ “[F]ree competition” is “the baseline” on which “the patent system’s incentive to creative effort depends.”¹⁰ By limiting the duration of a patent, “[t]he Patent Clause itself reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition without any concomitant advance in the ‘Progress of Science and useful Arts.’”¹¹ The patentability requirements for novelty and nonobviousness “are grounded in the notion that concepts within the public grasp, or those so obvious that they readily could be, are the tools of creation available to all.”¹²

A failure to strike the appropriate balance between competition and patent law and policy can harm innovation. For example, if patent law were to allow patents on “obvious” inventions, it could thwart

competition that might have developed based on the obvious technology. *See* Box 1. Conversely, competition policy can

Box 1. *An Invalid Patent on an Obvious Invention Can Harm Competition.*

In 1895, George Selden obtained a U.S. patent with a claim so broad that “it literally encompass[ed] most automobiles ever made.” Yet the basic invention covered by that claim – putting a gasoline engine on a chassis to make a car – was so obvious that many people worldwide thought of it independently as soon as the most primitive gasoline engines were developed. The association that licensed the Selden patent collected hundreds of thousands of dollars in royalties – raising costs and reducing the output of automobiles – before Henry Ford and others challenged the patent, and the patent claim was judicially narrowed in 1911. *See* MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 644-46.

undermine the innovation that the patent system promotes if overzealous antitrust enforcement restricts the procompetitive use of a valid patent. *See* Box 2.

The FTC/DOJ Hearings Examined the Balance of Competition and Patent Law and Policy.

To examine the current balance of competition and patent law and policy, the FTC and the DOJ held Hearings from February through November 2002. The Hearings took place over 24 days, and involved more than 300 panelists, including business representatives from large and small firms, and the independent inventor community; leading patent and antitrust organizations; leading antitrust and patent practitioners; and leading scholars in

⁹ *See Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989) (federal patent laws embody “a careful balance between the need to promote innovation and the recognition that imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy.”).

¹⁰ *Id.* at 156.

¹¹ *Id.* at 146.

¹² *Id.* at 156.

Box 2. Overzealous Antitrust Enforcement Can Undermine the Innovation that Patents Promote.

In the 1970's, antitrust enforcers viewed grantbacks (*e.g.*, when a licensee has improved patented technology, it "grants back" to the original patentee access to the improvement) as automatically illegal. More recently, antitrust enforcers recognize that "[g]rantbacks can have procompetitive effects," for example, by encouraging a patentee to license its patent in the first place, thereby enabling the licensee's improvement. Antitrust enforcers now evaluate likely procompetitive and anticompetitive effects of grantbacks. Past antitrust rules may have deterred some procompetitive grantbacks, however, thus deterring some innovations using patented technology. *See* U.S. Department of Justice and Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property § 5.6 (Apr. 6, 1995), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,132, *available at* <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm>.

economics and antitrust and patent law.¹³ In addition, the FTC received about 100 written submissions. Business representatives were mostly from high-tech industries: pharmaceuticals, biotechnology, computer hardware and software, and the Internet.¹⁴ This report discusses Hearings testimony and independent research, and explains the

¹³ The Commission thanks the DOJ and the Patent and Trademark Office for participating in many of the panels at the Hearings and for recommending many of the participants in the Hearings. For providing facilities to allow some of the Hearings to be held on the West Coast, the Commission thanks the Competition Policy Center and the Berkeley Center for Law and Technology at the University of California at Berkeley.

The Commission wishes to note the expertise and time contributed by Hearings participants. For all of their contributions, the Commission conveys its thanks.

¹⁴ *See* Appendices A and B.

Commission's conclusions about and recommendations for the patent system.

CONCLUSIONS AND RECOMMENDATIONS

I. Although Most of the Patent System Works Well, Some Modifications Are Needed to Maintain A Proper Balance of Competition and Patent Law and Policy.

The patent system does, for the most part, achieve a proper balance with competition policy. The statutory standards of patentability appear largely compatible with competition; properly interpreted, they tend to award patents only when necessary to provide incentives for inventions, their commercial development, or their disclosure. Congress has enacted new statutes that protect competition by, among other things, facilitating disclosures of patent applications. The Court of Appeals for the Federal Circuit, the sole court for most patent law appeals, has brought stability and increased predictability to various elements of patent law. This has reduced legal uncertainty and facilitated business planning. The Patent and Trademark Office (PTO) has implemented initiatives to deal with new types of patents and has released a Strategic Plan for the 21st Century to improve patent quality (*i.e.*, reduce errors) and streamline procedures.¹⁵ Hearings participants found much to praise in the current patent system.

¹⁵ *See* United States Patent and Trademark Office, The 21st Century Strategic Plan, *at* www.uspto.gov/web/offices/com/strat21/index.htm.

Nonetheless, many participants in and observers of the patent system expressed significant concerns that, in some ways, the patent system is out of balance with competition policy. Poor patent quality and legal standards and procedures that inadvertently may have anticompetitive effects can cause unwarranted market power and can unjustifiably increase costs. Such effects can hamper competition that otherwise would stimulate innovation. This report makes several recommendations for the legal standards, procedures, and institutions of the patent system to address such concerns.

II. Questionable Patents Are a Significant Competitive Concern and Can Harm Innovation.

A poor quality or questionable patent is one that is likely invalid or contains claims that are likely overly broad. Hearings participants raised concerns about the number of questionable patents issued.¹⁶ Such patents can block competition, *see* Box 3, and harm innovation in several ways.

¹⁶ For example, software firms raised concerns about patents that they believed should not have been granted, because the inventions were obvious based on preceding work in the area. While praising patents as the basis for their industry, biotech firms also raised concerns that some overbroad patents may discourage further innovation in some biotech areas. *See generally* Chs. 2 and 3.

A. Questionable Patents Can Deter or Raise the Costs of Innovation.

One firm's questionable patent may lead its competitor to forgo R&D in the areas that the patent improperly covers. For example, firms in the biotech industry reported that they avoid infringing questionable patents and therefore will refrain from entering or continuing with a particular field of research that such patents

Box 3. *Blocking Patents*

The patents of others can block a patentee's ability to exploit its own invention. For example:

"[S]uppose that Admiral Motors obtains a patent on an internal combustion engine for use in automobiles. Later, Betty Beta purchases an automobile marketed by Admiral Motors that embodies the patented invention. Beta experiments with her new car and develops a dramatically improved fuel injector useable only in the patented Admiral Motors engine. Even if Beta patents her improved fuel injector, she cannot practice that technology without infringing Alpha's basic patent. . . . Unless one of the parties licenses the other, Beta must wait until Admiral Motors' patent expires before practicing her own patented improvement invention."
ROGER E. SCHECHTER & JOHN R. THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS* § 20.1.1 at 462 (2003). If the blocking patent is invalid or overbroad, then no public benefits exist to justify its effects on follow-on innovation.

appear to cover.¹⁷ Such effects deter market entry and follow-on innovation by

¹⁷ *See, e.g., FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy, David J. Earp Testimony Feb. 26, 2002*, at pages 290-91, 238 (hereinafter, citations to transcripts of these Hearings state the speaker's last name, the date of testimony, and relevant page(s)); Blackbum 2/26 at 296; Caulfield 3/19 at 161.

competitors and increase the potential for the holder of a questionable patent to suppress competition.

If a competitor chooses to pursue R&D in the area improperly covered by the questionable patent without a license to that patent, it risks expensive and time-consuming litigation with the patent holder. If the competitor chooses to negotiate a license to and pay royalties on the questionable patent, the costs of follow-on innovation and commercial development increase due to unjustified royalties.

Another option is to find a legal means to invalidate the patent. PTO procedures allow only very limited participation by third parties, however. A lawsuit in federal court may not be an alternative, because a competitor may not sue to challenge patent validity unless the patent holder has threatened the competitor with litigation. If the competitor is not on the verge of marketing an infringing product, the patent holder may have no reason to threaten litigation. In these circumstances, as one biotech representative complained, “there are these bad patents that sit out there and you can’t touch them.”¹⁸ If litigation does take place, it typically costs millions of dollars and takes years to resolve. This wastes resources.

B. In Industries with Incremental Innovation, Questionable Patents Can Increase “Defensive Patenting” and Licensing Complications.

¹⁸ Blackburn 2/26 at 295-96.

In some industries, such as computer hardware and software, firms can require access to dozens, hundreds, or even thousands of patents to produce just one commercial product. One industry representative from a computer hardware firm reported that more than “90,000 patents generally related to microprocessors are held by more than 10,000 parties.”¹⁹ Many of these patents overlap, with each patent blocking several others. This tends to create a “patent thicket” – that is, a “dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology.”²⁰

Much of this thicket of overlapping patent rights results from the nature of the technology; computer hardware and software contain an incredibly large number of incremental innovations. Moreover, as more and more patents issue on incremental inventions, firms seek more and more patents to have enough bargaining chips to obtain access to others’ overlapping patents.²¹ One panelist asserted that the time and money his software company spends on creating and filing these so-called defensive patents, which “have no . . . innovative value in and of themselves,” could have been better spent on developing new

¹⁹ Detkin 2/28 at 667-68.

²⁰ Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting*, in *1 INNOVATION POLICY AND THE ECONOMY* 119, 120 (Adam Jaffe et al. eds., 2001).

²¹ The forthcoming FTC/DOJ joint report will discuss the proper antitrust evaluation of licensing techniques used in such situations.

technologies.²²

Questionable patents contribute to the patent thicket. In the context of a patent thicket, questionable patents can introduce new kinds of licensing difficulties, such as royalties stacked one on top of another, and can increase uncertainty about the patent landscape, thus complicating business planning. Questionable patents in patent thickets can frustrate competition by current manufacturers as well as potential entrants. Because a manufacturer needs a license to all of the patents that cover its product, firms can use questionable patents to extract high royalties or to threaten litigation.²³ For example, a questionable patent that claims a single routine in a software program may be asserted to hold up production of the entire software program. This process can deter follow-on innovation and unjustifiably raise costs to businesses and, ultimately, to consumers.

C. Recommendations to Improve Patent Quality and Minimize Anticompetitive Costs of the Patent System.

One recent article argues persuasively that because most patent applications involve claims of little

²² Greenhall 2/27 at 377, 420.

²³ “Large and small companies are increasingly being subjected to litigation (or its threat) on the basis of questionable patents.” *United States Patent and Trademark Office Fee Modernization Act of 2003: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the House Comm. on the Judiciary*, 108th Cong. 2 (2003) (Statement of Michael K. Kirk, Executive Director, American Intellectual Property Law Association), available at <http://www.aipla.org/html/Legislative/108/testimony/FeeLeg.htm>.

economic significance, “it is much cheaper for society to make detailed [patent] validity determinations in those few cases [in which patents are challenged] than to invest additional resources examining patents that will never be heard from again.”²⁴

Accordingly, the FTC’s recommendations focus first on procedures and presumptions used in challenging questionable patents, because such challenges are more likely to involve patents of competitive significance.

Recommendation 1:

As the PTO Recommends, Enact Legislation to Create A New Administrative Procedure to Allow Post-Grant Review of and Opposition to Patents.

The PTO discusses patent applications only with the patent applicant. Until recently, third parties could only bring certain relevant documents to the attention of, and, in limited circumstances, file a written protest with, an examiner or to request the PTO Director to reexamine a patent. To address this situation, Congress passed legislation to establish limited procedures that allow third parties to participate in patent reexaminations. Recent amendments have improved those procedures, but they still contain important restrictions and disincentives for their use. Once a questionable patent has issued, the most effective way to challenge it is through litigation. Litigation generally is extremely

²⁴ Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 NW. L. REV. 1495, 1497 (2001).

costly and lengthy,²⁵ and is not an option unless the patent owner has threatened the potential challenger with patent infringement litigation.

The existing procedures attempt to balance two perspectives. On the one hand, third parties in the same field as a patent applicant may have the best information and expertise with which to assist in the evaluation of a patent application, and therefore might be useful participants in the process of deciding whether to grant a patent. On the other hand, the limited involvement of third parties in the issuance and reexamination of patents reflects genuine concern to protect patent applicants from harassment by competitors. This remains an important goal. To continue to protect against the possibility of competitors harrasing patent applicants, any new procedure should be available only after a patent issues.

Because existing means for challenging questionable patents are inadequate, we recommend an administrative procedure for post-grant review and opposition that allows for meaningful challenges to patent validity short of federal court litigation. To be meaningful, the post-grant review should be allowed to address important patentability issues.²⁶ The review petitioner should be required to make a suitable threshold showing. An administrative patent judge

²⁵ A biotechnology case, for example, can cost between five and seven million dollars and take two or three years to litigate. See Ch. 3.

²⁶ At a minimum, patent challengers should be able to raise issues of novelty, nonobviousness, written description, enablement, and utility.

should preside over the proceeding, which should allow cross-examination and carefully circumscribed discovery, and which should be subject to a time limit and the use of appropriate sanctions authority. Limitations should be established to protect against undue delay in requesting post-grant review and against harassment through multiple petitions for review. The authorizing legislation should include a delegation of authority permitting the PTO's conclusions of law to receive deference from the appellate court. Finally, as is the case with settlements of patent interferences, settlement agreements resolving post-grant proceedings should be filed with the PTO and, upon request, made available to other government agencies.

Recommendation 2:

Enact Legislation to Specify that Challenges to the Validity of a Patent Are To Be Determined Based on a "Preponderance of the Evidence."

An issued patent is presumed valid. Courts require a firm that challenges a patent to prove its invalidity by "clear and convincing evidence." This standard appears unjustified. A plethora of presumptions and procedures tip the scales in favor of the ultimate issuance of a patent, once an application is filed. In addition, as many have noted, the PTO is underfunded, and PTO patent examiners all too often do not have sufficient time to evaluate patent applications fully. These circumstances suggest that an overly strong presumption of a patent's validity is inappropriate. Rather, courts should require only a "preponderance of the evidence" to rebut the presumption of validity.

The PTO works under a number of disadvantages that can impede its ability to reduce the issuance of questionable patents. Perhaps most important, the courts have interpreted the patent statute to require the PTO to grant a patent application unless the PTO can establish that the claimed invention does not meet one or more of the patentability criteria. Once an application is filed, the claimed invention is effectively presumed to warrant a patent unless the PTO can prove otherwise.

The PTO's procedures to evaluate patent applications seem inadequate to handle this burden. The patent prosecution process involves only the applicant and the PTO. A patent examiner conducts searches of the relevant prior art,²⁷ a focal point of the examination process, with only the applicant's submissions for assistance. The patent applicant has a duty of candor to the PTO, but that duty does not require an applicant to search for prior art beyond that about which the applicant already knows.²⁸ If the patent applicant makes assertions or files documentary evidence regarding certain

facts, the PTO does not have facilities with which to test the accuracy or reliability of such information.

Moreover, presumptions in PTO rules tend to favor the issuance of a patent. For example, "[i]f the examiner does not produce a *prima facie* case [of obviousness], the applicant is under no obligation to submit evidence of nonobviousness."²⁹ Similarly, "[o]ffice personnel . . . must treat as true a statement of fact made by an applicant in relation to [the asserted usefulness of the invention], unless countervailing evidence can be provided that shows that one of ordinary skill in the art would have a legitimate basis to doubt the credibility of such a statement."³⁰ Likewise, "[t]here is a strong presumption that an adequate written description of the claimed invention is present when the application is filed."³¹

The PTO's resources also appear inadequate to allow efficient and accurate screening of questionable patent applications. Patent applications have doubled in the last twelve years and are increasing at about 10% per year.³² With yearly applications approximating 300,000,

²⁷ "Prior art" consists of materials – often patents and publications, although affidavits and testimony also may present prior art – that reflect one or more of the features or elements of the claimed invention. An invention is "obvious" if it does not represent a sufficient step beyond the prior art.

²⁸ The PTO's Manual of Patent Examining Procedure (MPEP) states that the agency "does not investigate" duty of disclosure issues and "does not . . . reject" applications on that basis. See United States Patent and Trademark Office, *Manual of Patent Examining Procedure* § 2010 (8th edition 2001) (explaining that such PTO determinations "would significantly add to the expense and time involved in obtaining a patent with little or no benefit to the patent owner or any other parties with an interest"), available at <http://www.uspto.gov/web/offices/pac/mpep/mpep.htm> (hereinafter MPEP).

²⁹ MPEP § 2142.

³⁰ United States Patent and Trademark Office, *Utility Examination Guidelines*, 66 Fed. Reg. 1092, 1098-99 (2001).

³¹ United States Patent and Trademark Office, *Guidelines for Examination of Patent Applications under the 35 U.S.C. 112 ¶ 1, "Written Description" Requirement*, 66 Fed. Reg. 1099, 1105 (2001).

³² Lerner 2/20 at 157; James Langenfeld, *Innovation, Competition, and Intellectual Property: Providing an Economic Framework* (2/20/02) (slides) at 6, at <http://www.ftc.gov/opp/intellect/langenfeld.pdf>.

they arrive at the rate of about 1,000 each working day.³³ A corps of some 3,000 examiners must deal with the flood of filings.³⁴ Hearings participants estimated that patent examiners have from 8 to 25 hours to read and understand each application, search for prior art, evaluate patentability, communicate with the applicant, work out necessary revisions, and reach and write up conclusions. Many found these time constraints troubling.³⁵ Hearings participants unanimously held the view that the PTO does not receive sufficient funding for its responsibilities.

Finally, the PTO grants patents based only on the “preponderance of the evidence.” This standard applies in the context of an underlying presumption that the patent should be granted unless the PTO can prove otherwise. It does not seem sensible to treat an issued patent as though it had met some higher standard of patentability.

Defenders of the application of the “clear and convincing” evidence standard urged that a finding of patent validity by a neutral government agency using a knowledgeable examiner justifies placing a heavy burden on those who challenge a patent’s validity. We disagree. Presumptions and procedures that favor the

grant of a patent application, combined with the limited resources available to the PTO, counsel against requiring “clear and convincing evidence” to overturn that presumption. We believe the “clear and convincing evidence” burden can undermine the ability of the court system to weed out questionable patents,³⁶ and therefore we recommend that legislation be enacted to amend the burden to a “preponderance of the evidence.”

Recommendation 3:

Tighten Certain Legal Standards Used to Evaluate Whether A Patent Is “Obvious.”

Patent law precludes patenting if the differences between the claimed invention and the prior art³⁷ are such that “the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art.”³⁸ “Nonobviousness asks whether a development is a significant enough technical advance to merit the award of a patent.”³⁹ A proper application of this statutory requirement is crucial to prevent the issuance of questionable patents, including trivial patents and patents on inventions essentially already in the public domain. The courts have developed a variety of tests to evaluate the obviousness of a claimed invention. Two in particular –

³³ Chambers 2/8 (Patent Law for Antitrust Lawyers) at 86 (hereinafter 2/8 (Patent Session)).

³⁴ Chambers 2/8 (Patent Session) at 84.

³⁵ See, e.g., Dickinson 2/6 at 64-65 (“Patent examiners need more time to examine.”); Kirschner 2/26 at 242-43 (time available “clearly inadequate” for a meaningful examination of a biotech patent application); Kesan 4/10 at 100 (time constraints do not allow adequate search for software prior art).

³⁶ See T.S. Ellis 7/11 at 119-20.

³⁷ See *supra* note 25.

³⁸ 35 U.S.C. § 103.

³⁹ See MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 644.

the “commercial success test” and “the suggestion test” – require more thoughtful application to weed out obvious patents.

- a. ***In applying the “commercial success” test, 1) evaluate on a case-by-case basis whether commercial success is a valid indicator that the claimed invention is not obvious, and 2) place the burden on the patent holder to prove the claimed invention caused the commercial success.***

The Supreme Court has advised that, in some circumstances, courts may consider the commercial success of a claimed invention to indicate that it was not obvious. For example, in some cases early in the twentieth century, courts found the commercial success of an invention that satisfied a long-felt need that had resisted the efforts of others to solve the problem tended to show the claimed invention was not obvious.

Commercial success can result from many factors, however, some of which have nothing to do with the claimed invention. For example, marketing, advertising, or an incumbent’s unique advantages may cause commercial success. An undue reliance on commercial success to show nonobviousness can raise a number of competitive concerns. Commercially successful inventions may be more likely than others to occur even without the prospect of a patent. Patents on commercially successful products are more likely to confer market power than those on less successful products.

Certain patent experts and other Hearings participants expressed concern that courts and juries sometimes fail to use a

sufficiently searching inquiry when they conclude that commercial success demonstrates a claimed invention is not obvious. Under current standards, if the patent holder shows that the claimed features of the patent are coextensive with those of a successful product, then it is presumed that the invention – rather than other factors – caused the commercial success. The burden shifts to the challenger to present evidence to rebut that presumption.⁴⁰

This test fails to ask, first, whether factors other than the invention may have caused the commercial success. By contrast, the PTO properly requires that commercial success be “directly derived from the invention claimed” and not the result of “business events extraneous to the merits of the claimed invention.”⁴¹ Second, the judicial standard too easily shifts the burden to the challenger. The patent holder is the best source of information on what has caused the commercial success of its product and should be required to show that, in fact, the claimed invention caused the commercial success.

- b. ***In applying the “suggestion” test, assume an ability to combine or modify prior art references that is consistent with the creativity and problem-solving skills that in fact are characteristic of those having ordinary skill in the art.***

If the prior art already would have suggested the claimed invention, then the

⁴⁰ See HARMON, PATENTS AND THE FEDERAL CIRCUIT at 169-70.

⁴¹ MPEP § 716.03(b).

claimed invention is obvious. If not, then the claimed invention is not obvious. The “suggestion test” thus asks a helpful question – that is, to what extent would the prior art “have *suggested* to one of ordinary skill in the art that this process should be carried out and would have a reasonable likelihood of success.”⁴² The Federal Circuit justifiably has sought to protect inventors from findings of obviousness based purely on hindsight. “Good ideas may well appear ‘obvious’ after they have been disclosed, despite having been previously unrecognized.”⁴³ The Federal Circuit also has sought to ensure that the PTO provides an administrative record susceptible to judicial review.

Hearings participants expressed concern, however, with some recent applications of the suggestion test. To show that a claimed invention is obvious, some cases seem to require the PTO to point to particular items of prior art that concretely suggest how to *combine* all of the features of a claimed invention. Such an application of the suggestion test may have found that the claimed invention of the Selden patent – that is, putting a gasoline engine on a carriage – was not obvious, because there was no document that suggested that combination. The invention likely was obvious, however; “[e]verybody seemed to know that if you got a new engine of any kind, you would put it on a carriage.”⁴⁴

⁴² *Brown and Williamson Tobacco Corp. v. Philip Morris*, 229 F.3d 1120, 1124 (Fed. Cir. 2000) (emphasis added).

⁴³ *Arkie Lures, Inc. v. Gene Larew Tackle, Inc.*, 119 F.3d 953, 956 (Fed. Cir. 1997).

⁴⁴ Duffy 7/10 at 132-33.

It is important to protect against the issuance of obvious patents that may confer market power and unjustifiably raise costs. Requiring concrete suggestions beyond those actually needed by a person with ordinary skill in the art,⁴⁵ and failing to give weight to suggestions implicit from the art as a whole and from the nature of the problem to be solved, is likely to result in patents on obvious inventions and is likely to be unnecessarily detrimental to competition. The Federal Circuit’s most recent articulations of the suggestion test seem to signal greater appreciation of these issues and would better facilitate implementation of the test in ways sensitive to competitive concerns.

Recommendation 4:

Provide Adequate Funding for the PTO.

Participants in the Hearings unanimously expressed the view that the PTO lacks the funding necessary to address issues of patent quality. Presidential patent review committees have long advocated more funding for the PTO to allow it to improve patent quality.⁴⁶ As recently as 2002, the Patent Public Advisory Committee stated that the PTO “faces a crisis in funding

⁴⁵ *Cf.* Barr 10/30 at 53-54 (arguing that current obviousness standards fail to reflect the skill of his company’s engineers, who “every day” independently invent things that have been deemed nonobvious).

⁴⁶ *E.g.*, THE ADVISORY COMMISSION ON PATENT LAW REFORM, REPORT TO THE SECRETARY OF COMMERCE (Aug. 1992), available at <http://world.std.com/obi/USG/Patents/overview>; REPORT OF THE INDUSTRIAL SUBCOMM. FOR PATENT AND INFORMATION POLICY OF THE ADVISORY COMM. ON INDUSTRIAL INNOVATION, REPORT ON PATENT POLICY (1979).

that will seriously impact . . . the quality of . . . issued patents.”⁴⁷ The FTC strongly recommends that the PTO receive funds sufficient to enable it to ensure quality patent review.

Recommendation 5:

Modify Certain PTO Rules and Implement Portions of the PTO’s 21st Century Strategic Plan.

- a. Amend PTO regulations to require that, upon the request of the examiner, applicants submit statements of relevance regarding their prior art references.*

Some Hearings participants asserted that, far from holding back information, patent applicants tend to provide an examiner with numerous prior art citations, resulting in lots of “information,” but little “knowledge.”⁴⁸ The 2002 version of the PTO’s 21st Century Strategic Plan proposed requiring applicants that cited more than 20 prior art references to provide statements to explain the relevance of references, but the PTO has now withdrawn that proposal.⁴⁹ The FTC’s proposal is more modest than the PTO’s original proposal; it would require relevance statements only when the

examiner requests them. These statements could materially enhance examiners’ ability to provide quality patent examinations by drawing more fully on the patent applicant’s knowledge base to identify the most relevant portions of prior art references.

- b. Encourage the use of examiner inquiries under Rule 105 to obtain more complete information, and reformulate Rule 105 to permit reasonable follow-up.*

PTO Rule 105 permits examiners to request “such information as may be reasonably necessary to properly examine or treat the matter [under examination].”⁵⁰ The Commission recommends that the PTO make a concentrated effort to use examiner inquiries more often and more extensively. As one panelist emphasized, “to get better quality and shrink the amount of work,” there is a need to seek more knowledge in the possession of applicants, who typically “know more about the technology than the examiner does, and [know] where you might find something that might be relevant.”⁵¹ To be fully effective, however, Rule 105 should be amended so that applicants who reply that they do not know the answer to the examiner’s inquiry, or that the necessary information “is not readily available to the party or parties from which it was requested” are *not* accepted as a complete reply,⁵² as they are now, but rather are treated as responses on which the examiner may follow up.

⁴⁷ PATENT PUBLIC ADVISORY COMMITTEE, ANNUAL REPORT 6 (Nov. 29, 2002), available at <http://www.uspto.gov/web/offices/com/advisory/acrobat/ppaannual12-05-02.pdf>.

⁴⁸ *E.g.*, Kesan 10/25 at 60-61.

⁴⁹ United States Patent and Trademark Office 21st Century Strategic Plan, *Mandatory Information Disclosure Statements (IDS)*, P-09 at 3 (June 3, 2002). See The 21st Century Strategic Plan, available at www.uspto.gov/web/offices/com/strat21/index.htm.

⁵⁰ 37 C.F.R. § 1.105.

⁵¹ Kushan 4/11 at 89.

⁵² See 37 C.F.R. § 1.105.

c. *Implement the PTO's recommendation in its 21st Century Strategic Plan that it expand its "second-pair-of-eyes" review to selected areas.*

Second-pair-of-eyes review allows the PTO quickly to flag issues that need further attention by the examiner or the examiner's supervisor. The PTO first used this method to improve the quality of business method patents, and it received good reviews from participants in the patent system. The Commission believes that expanding this program to fields with substantial economic importance, such as semiconductors, software, and biotechnology, as well as other new technologies as they emerge, could help to boost patent quality in areas where it will make the most difference.

d. *Continue to implement the recognition that the PTO "forges a balance between the public's interest in intellectual property and each customer's interest in his/her patent and trademark."*⁵³

The PTO functions as a steward of the public interest, not as a servant of patent applicants. The PTO must protect the public against the issuance of invalid patents that add unnecessary costs and may confer market power, just as it should issue valid patents to encourage invention, disclosure, and commercial development.

⁵³ United States Patent and Trademark Office, *FY2002 Corporate Plan 28* (2001) (describing role of PTO Under Secretary and Director), at <http://www.uspto.gov/web/offices/com/corplan/fy2002/index.html>.

Recommendation 6:

Consider Possible Harm to Competition – Along with Other Possible Benefits and Costs – Before Extending the Scope of Patentable Subject Matter.

Section 101 of the Patent Act states, "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent."⁵⁴ Despite this broad mandate, courts have long held certain types of inventions unpatentable. Traditional common law exceptions include phenomena of nature, abstract intellectual concepts, mental steps, mathematical algorithms with no substantial practical application, printed matter, and, for many years, business methods.

Over the past twenty-five years, however, the scope of patentable subject matter has expanded significantly. For example, the Supreme Court, through two landmark decisions in 1980, held that both man-made, living organisms and computer software constitute patentable subject matter pursuant to Section 101. In 1999, the Federal Circuit ruled that business methods can be patented. Some Hearings participants claimed that patents on computer software and business methods are not necessary to spur the invention, commercial development, or public disclosure of

⁵⁴ 35 U.S.C. § 101.

software or business methods.⁵⁵ Others disagreed. Some Hearings participants contended that software and business method patents can raise significant competitive concerns and deter innovation, especially because so much of the innovation in those fields builds incrementally on preceding work. This may raise the potential for thickets of patents to hinder, rather than accelerate, innovation and commercial development.

The constitutional intention that patents “promote the Progress of Science and useful Arts” should be taken into account in interpreting the scope of patentable subject matter under Section 101. Decisionmakers should ask whether granting patents on certain subject matter in fact will promote such progress or instead will hinder competition that can effectively spur innovation. Such consideration is consistent with the historical interpretation of patentable subject matter, which implicitly recognizes that granting patent protection to certain things, such as phenomena of nature and abstract intellectual concepts, would not advance the progress of science and the useful arts. For future issues, it will be highly desirable to consider possible harms to competition that spurs innovation – as well as other possible benefits and costs – before extending the scope of patentable subject matter.

III. Other Patent Laws and Procedures Also Raise Competitive Concerns.

⁵⁵ See generally Ch. 3. See also Robert M. Hunt, *You Can Patent That? Are Patents on Computer Programs and Business Methods Good for the Economy?*, Q1 BUSINESS REVIEW 5, 14 (2001).

In addition to questionable patents, other portions of the patent system raise competitive concerns. This section briefly describes each issue and the Commission’s recommendation(s) to address it.

Recommendation 7:

Enact Legislation to Require Publication of All Patent Applications 18 Months After Filing.

Until relatively recently, patents were published only when issued; patent applications were not published. During the time that would pass between the filing of a patent application and the issuance of a patent, an applicant’s competitor could have invested substantially in designing and developing a product and bringing it to market, only to learn, once the patent finally issued, that it was infringing a rival’s patent and owed significant royalties. This scenario disrupts business planning, and can reduce incentives to innovate and discourage competition.

A relatively new statute requires that most patent applications – all except those filed only in the United States – be published 18 months after filing. Patent applicants are protected from copying of their inventions by statutory royalty rights, if the patent ultimately issues. This new procedure appears to have increased business certainty and promoted rational planning, as well as reduced the problem of unanticipated “submarine patents” used to hold up competitors for unanticipated royalties. For these reasons, Hearings participants advocated expanding the 18-month publication requirement to include patents filed only domestically, because such

patents may well have competitive significance. Protection from copying similar to that already available for other published applications should be extended to those filing domestic patent applications as well, and any necessary protections for independent inventors also should be considered in terms of their likely costs and benefits.

Recommendation 8:

Enact Legislation to Create Intervening or Prior User Rights to Protect Parties from Infringement Allegations That Rely on Certain Patent Claims First Introduced in a Continuing or Other Similar Application.

After publication of its patent application, an applicant may continue to amend its claims. Through this claim amendment process, a patent that states broader claims than those published at 18 months can still emerge. If the applicant uses procedures such as continuing applications to extend the period of patent prosecution, the potential for anticompetitive hold up increases. Indeed, several panelists asserted that some applicants keep continuing applications pending for extended periods, monitor developments in the relevant market, and then modify their claims to ensnare competitors' products after those competitors have sunk significant costs in their products. Patent reform efforts have long focused on how to remedy opportunistic broadening of claims to capture competitors' products.

Legitimate reasons exist to amend claims and use continuing applications. Any

proposed remedy for the opportunistic broadening of claims should also protect such legitimate uses. Creating intervening or prior use rights would most directly achieve this balance; it would cure potential competitive problems without interfering with legitimate needs for continuations. Such rights should shelter inventors and users that infringe a patent only because of claim amendments following a continuation or other similar application,⁵⁶ provided that the sheltered products or processes are developed or used (or the subject of substantial preparation for use) before the amended claims are published.

Recommendation 9:

Enact Legislation to Require, As a Predicate for Liability for Willful Infringement, Either Actual, Written Notice of Infringement from the Patentee, or Deliberate Copying of the Patentee's Invention, Knowing It to Be Patented.

A court may award up to three times the amount of damages for a defendant's willful infringement of a patent – that is, the defendant knew about and infringed the patent without a reasonable basis for doing so. Some Hearings participants explained that they do not read their competitors' patents out of concern for such potential treble damage liability. Failure to read competitors' patents can jeopardize plans for a noninfringing business or research strategy, encourage wasteful duplication of effort, delay follow-on innovation that could

⁵⁶ See *infra* Ch. 4(II)(C)(1) for a description of the types of filings that should be covered.

derive from patent disclosures, and discourage the development of competition.

It is troubling that some businesses refrain from reading their competitors' patents because they fear the imposition of treble damages for willful infringement. Nonetheless, infringers must not be allowed to profit from knowingly and deliberately using another's patented invention due to a low likelihood that the patent holder can afford to bring suit or obtain substantial damages. The FTC's recommendation would permit firms to read patents for their disclosure value and to survey the patent landscape to assess potential infringement issues, yet retain a viable willfulness doctrine that protects both wronged patentees and competition.

Recommendation 10:

Expand Consideration of Economic Learning and Competition Policy Concerns in Patent Law Decisionmaking.

The Supreme Court has made clear in several decisions that there is room for policy-oriented interpretation of the patent laws.⁵⁷ Indeed, to find the proper balance between patent and competition law, such policy-oriented interpretations are essential. Over the past twenty-five years, the incorporation of economic thinking into antitrust has provided significant insights that have substantially improved the development of antitrust law and competition policy. The Federal Circuit and the PTO may also benefit from much greater

⁵⁷ See, e.g., *supra* notes 10-12; *Graham v. John Deere Co.*, 383 U.S. 1 (1966).

consideration and incorporation of economic insights in their decisionmaking.

IV. The FTC Will Pursue Steps to Increase Communication between Antitrust Agencies and Patent Institutions.

Many Hearings participants expressed concern that the patent and competition communities appear to exist in separate worlds, interacting infrequently at best. Patent practitioners and scholars further expressed concern that patent institutions do not always fully understand or accommodate economic learning or competition concerns. Increased interaction appears desirable to foster better understanding and communication between the patent and competition communities.

The FTC wishes to do its part to improve communication between the competition and patent communities. Accordingly, the FTC will pursue the steps listed below.

A. The FTC Will Increase its Competition Advocacy Role through Filing Amicus Briefs in Appropriate Circumstances.

The Commission will renew its commitment to the filing of amicus briefs in important patent cases that can affect competition, as well as in cases at the intersection of patent and antitrust law. When such cases have high stakes for the public, the Commission can serve the public interest by filing amicus briefs to present its perspectives regarding the implications of certain issues for consumer welfare.

B. In Appropriate Circumstances, the FTC Will Ask the PTO Director to Reexamine Questionable Patents that Raise Competitive Concerns.

A collective action problem may frustrate business challenges to questionable patents. Instead of challenging a patent's validity, many firms may simply license it, because no single firm has the incentive to finance an expensive legal challenge that would benefit all of the affected firms, not just the challenger. An enforcement agency, however, can consider the cost of a questionable patent to an entire industry and to consumers and can solve this coordination problem. In appropriately narrow circumstances, the FTC will do so.

C. The FTC Will Encourage Increased Communication between Patent Institutions and the Antitrust Agencies.

One means of improving interagency communication would be the establishment of a Liaison Panel between the FTC and the DOJ's Antitrust Division (collectively, the Antitrust Agencies) and the PTO. Such a panel could function as a practical, policy-oriented group designed to permit the exchange of views on important issues as they arise. Another means would be to establish an Office of Competition Advocacy within the PTO. Such an office could, when appropriate, advise PTO policymakers about the likely competitive impact and economic consequences of policy decisions. A final means would be to request that Congress amend the membership categories of the Patent Public Advisory Committee ("P-PAC") to include competition experts and economists.

V. Conclusion

Both patents and competition make significant contributions to innovation, consumer welfare, and our nation's prosperity. We recognize the importance of the patent system; the recommendations in this Report are designed to increase the likelihood that the valid patents are issued and upheld. There is broad consensus on the significant role that these patents can play to spur innovation and to encourage the disclosure and commercial development of inventions.

The importance of competition as a spur to innovation also should be recognized. More patents in more industries and with greater breadth are not always the best ways to maximize consumer welfare. A questionable patent can raise costs and prevent competition and innovation that otherwise would benefit consumers. The FTC looks forward to working closely with the PTO and other patent organizations to increase communication and include all parties in discussion and implementation of the FTC's recommendations.

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CHAPTER 1 INTRODUCTION AND BACKGROUND

Innovation benefits consumers through the development of new and improved goods and services, and spurs economic growth. An economy's capacity for invention and innovation helps drive its economic growth and the degree to which standards of living increase.¹ Indeed, the United States economy and the economies of other countries have enjoyed "huge productivity gains from the development and rapid adoption of new information and communication technologies."² The technological breakthroughs that introduced "automobiles, airplanes, radio, television, space travel, telephones, internet, modern pharmaceuticals, and the like" illustrate how innovation improves the quality of our lives in ways that are hard to measure and underscore the importance of stimulating innovation.³

The federal government has a profound impact on R&D in the U.S. First, the federal government funds certain R&D. In FY 2003, federal investment in R&D hit a new record of \$117 billion, a 13.8 percent increase over FY 2002 and the largest dollar increase in history.⁴ Many government

agencies contribute to R&D funding, especially in national defense, health, and space.⁵ Second, the federal government sets policies that influence how businesses and individuals invest many more billions of dollars in R&D. Tax and environmental policies, for example, all can influence which R&D companies undertake and how much they spend.

Competition and patents stand out among the federal policies that influence private R&D.⁶ Competition among firms prods inventors to be first in the market with a new product or service at a price and quality that consumers want. Patent policy encourages prospective inventors to invest time and money in inventions, because a patent's grant of the exclusive right to make, sell, and use the invention for a certain period of time can allow inventors to realize

Science 1 (2003), at <http://www.aaas.org/spp/rd/ca03.pdf>.

⁵ For example, the Department of Defense (DOD) accounts for half the total federal R&D portfolio. Support for R&D makes up 97 percent of the budget of the National Institute of Health (NIH). The National Science Foundation (NSF) accounts for about 20 percent of federal support to academic institutions for basic research. The National Aeronautics and Space Administration (NASA) spends two-thirds of its budget (excluding the Space Shuttle program) on R&D. See Koizumi & Turner, *Congressional Action on Research and Development in the FY 2003 Budget* at 11-16; NFS website <http://www.nsf.gov/home/programs>; AAAS R&D Funding Update, *FY 2003 Omnibus Bill Complete NIH Doubling Plan; Large Increases for Bioterrorism R&D and Facilities 1, 3* (Feb. 25, 2003), at <http://www.aaas.org/spp/rd/nih03f.pdf>.

⁶ In the Hearings, panelists focused on patents and not other forms of intellectual property. Most of the antitrust cases involving intellectual property involve patents in particular. See, e.g., 1 HERBERT HOVENKAMP ET AL., *IP AND ANTITRUST: AN ANALYSIS OF ANTITRUST PRINCIPLES APPLIED TO INTELLECTUAL PROPERTY LAW* § 1.3c at 1-14 (2002) (hereinafter HOVENKAMP ET AL., *IP AND ANTITRUST*).

¹ Federal Reserve Board Vice Chairman Roger W. Ferguson, Jr., Patent Policy in a Broader Context, Remarks at 2003 Financial Markets Conference of the Federal Reserve Bank of Atlanta (April 5, 2003), at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030407/default.htm>.

² *Id.*

³ American Bar Association Section of Antitrust Law, *The Economics of Innovation: A Survey* (Public Comment) 2, at <http://www.ftc.gov/opp/intellect/0207salabasrvy.pdf> (hereinafter ABA (Economics stmt)).

⁴ Kei Koizumi & Paul W. Turner, *Congressional Action on Research and Development in the FY 2003 Budget*, American Association for the Advancement of

returns sufficient to encourage the initial investments.⁷

Competition and patent policy are bound together by the economics of innovation and an intricate web of legal rules that seek to balance the scope and effect of each policy. Errors or systematic biases in the interpretation or application of one policy's rules can harm the other policy's effectiveness. For example, patent law precludes the patenting of an "obvious" invention. If, however, patent law sets the bar for "obviousness" too low, and erroneously allows patents on "obvious" inventions, then patent law can thwart competition that otherwise might have developed based on the obvious technology. Conversely, competition policy – as implemented through antitrust law – prohibits only anticompetitive business conduct. If antitrust enforcement erroneously condemns efficient, welfare-enhancing conduct with respect to a valid patent, then antitrust enforcement can undermine the incentives the patent system creates to encourage innovation. A challenge for both policies is to find the proper balance of competition and patent protection.⁸

⁷ See generally *infra* Ch. 2(I).

⁸ See *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989) ("From their inception, the federal patent laws have embodied a careful balance between the need to promote innovation and the recognition that imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy."); Richard Posner, *Antitrust in the New Economy*, 68 ANTITRUST L.J. 925, 927 (2001) ("The patent and copyright laws try to strike the output-maximizing balance by giving the creator of intellectual property some but not complete protection from competition."); I HOVENKAMP ET AL., IP AND ANTITRUST § 1.3b at 1-14 (patents can limit the reach of antitrust law, and antitrust constrains what a patentee can do with its

To understand better the current relationship between competition and patent law and policy, and whether it strikes the proper balance, the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice (DOJ) held a series of Hearings from February through November 2002. The Hearings took place over 24 days, with more than 300 panelists, including experienced business representatives from large and small firms, representatives from the independent inventor community, all of the leading patent and antitrust organizations, many of the leading antitrust and patent practitioners, and scholars in economics and antitrust and patent law. Care was taken to solicit all points of view, and the transcripts of the Hearings provide a wide spectrum of well-considered experience with and perspectives on patent and competition-related issues. In addition, written comments were solicited; the FTC received about 100 written submissions.

The FTC took the lead in examining the issues addressed in this report, which discusses what the FTC has learned and, as appropriate, makes recommendations for changes to patent law and policy to achieve a better balance with competition policy. The DOJ and the FTC worked together developing the record for a forthcoming joint report that will examine antitrust's approach to maintaining the proper balance with the patent system.

patent).

I. THE RELATIONSHIP OF COMPETITION AND PATENT LAW AND POLICY

A. Each Policy Reflects Fundamental Assumptions about How Best to Organize an Economy and Encourage Innovation

1. Competition Policy and Antitrust Law

Competition through free enterprise and open markets is the organizing principle for most of the U.S. economy.⁹ The United States generally has chosen antitrust law (rather than regulation) to provide the governing rules for competition. For the last twenty years, antitrust law has recognized enhancing consumer welfare as the single unifying goal of competition policy.¹⁰ To serve that objective, competition policy and antitrust enforcement use a framework based on sound economics.¹¹

Economics affirms that “[c]ompetition is good for a variety of reasons. Basic economics teaches that firms

⁹ See, e.g., 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3a at 1-10 (“[A] fundamental principle of our economic system is the proposition that free market competition will best ensure an efficient allocation of resources in the absence of market failure.”).

¹⁰ See, e.g., IIA PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 401 (2d. ed. 2002).

¹¹ See, e.g., HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE § 2.3a (2d ed. 1999).

in competition will produce more and price lower than monopolists. Monopolists not only take money away from consumers by raising prices, but they impose a ‘deadweight loss’ on society by reducing their output below the level which consumers would be willing to purchase at a competitive price.”¹² Thus, economics informs us that effective competition is the best mechanism for achieving the optimum mix of products and services in terms of price, quality, and consumer choice. Moreover, economic learning focuses on the importance of competition in enhancing consumer welfare not only with respect to existing products, but also the development of new and improved products and services.¹³ Monopolists can have fewer incentives to innovate than do competitive firms.¹⁴

Antitrust law protects competition and the competitive process “by preventing certain types of conduct that threaten a free market.”¹⁵ Antitrust evaluates agreements among firms to determine whether they

¹² 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.2 at 1-5 through 1-6. See also William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 991 (1981).

¹³ See generally *infra* Ch. 2(II)(A).

¹⁴ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.2 at 1-6. Others emphasize that, depending on the circumstances, monopolists also can have greater incentives to innovate. See *infra* at Ch. 2(II)(A)(3).

¹⁵ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.2 at 1-5. See also *Northern Pacific Railway v. United States*, 356 U.S. 1, 4 (1958) (“The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade.”).

“unreasonably restrain trade.”¹⁶ For example, antitrust prohibits naked agreements among competitors on the price they will charge or which customers each will serve. For most other agreements, antitrust evaluates likely procompetitive and anticompetitive effects.¹⁷ Antitrust law also constrains the creation of market power through mergers,¹⁸ and prohibits monopolization and attempts and conspiracies to monopolize.¹⁹

In recognizing consumer welfare as its proper goal, antitrust law has relinquished earlier doctrines that sought to protect competitors rather than competition. Indeed,

¹⁶ Sherman Act of 1890 § 1, 15 U.S.C. § 1; *Standard Oil Co. v. United States*, 221 U.S. 1, 59-69 (1911); see also Federal Trade Commission Act of 1914 § 5, 15 U.S.C. § 45.

¹⁷ *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1, 8 (1979). See generally Federal Trade Commission and U.S. Department of Justice, Antitrust Guidelines for Collaborations Among Competitors § 2 (April 2000), available at <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf>.

¹⁸ Clayton Act of 1950 § 7, 15 U.S.C. § 18; 15 U.S.C. § 45. Market power arises when the “defendant (1) can profitably set prices well above its costs and (2) enjoys some protection against a rival’s entry or expansion that would erode such supracompetitive prices and profits.” IIA AREEDA & HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 501 at 90. See also *United States v. E.I. duPont de Nemours & Co.*, 351 U.S. 377 (1956); Federal Trade Commission and U.S. Department of Justice, Horizontal Merger Guidelines § 1.1 (1992), available at <http://www.ftc.gov/bc/docs/horizmer.htm>; *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy*, William E. Kovacic Testimony Feb. 8, 2002 (*Antitrust Law for Patent Lawyers*), at page 33 (hereinafter, citations to transcripts of these Hearings state the speaker’s last name, the date of testimony, and relevant page(s)). Antitrust does not constrain all exercises of market power, however. See *infra* Ch. 1(I)(B).

¹⁹ 15 U.S.C. § 2.

the Supreme Court has held that the purpose of the antitrust laws is to protect competition, not competitors.²⁰ Thus, antitrust enforcement has ceased protecting individual firms in favor of protecting consumer welfare, because protecting individual firms often served to harm consumers by protecting firms from competition.²¹ Antitrust’s focus on consumer welfare also reveals that governmental impediments to, or exemptions from, competition can be as harmful to consumers as private business restraints.²²

2. Patent Policy and Law

The U.S. economy also reflects the belief that limited exclusive rights in intellectual property – as distinguished from tangible property – can encourage innovation, which also benefits consumers.²³ Article I, Section 8 of the Constitution authorizes Congress “[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and

²⁰ *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977) (“The antitrust laws, however, were enacted for the protection of *competition*, not *competitors*” (internal citations omitted)).

²¹ See generally I PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶100 at 3-7 (2d ed. 2000).

²² See, e.g., HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE § 18.1a at 680.

²³ ROBERT L. HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.2 at 11 (5th ed. 2001) (noting that the exclusive right granted by a patent “was for the national purpose of advancing the useful arts – the process today called technological innovation[.]” and serves “the public interest in technological advancement.” (Footnotes omitted)).

Inventors the exclusive Right to their respective Writings and Discoveries.”²⁴ The patent statute²⁵ confers a right to exclude others from making, using, or selling in the United States the invention claimed by the patent for twenty years from the date of filing the patent application.²⁶

To obtain a patent, an invention (that is, a product, process, machine, or composition of matter) must be novel, nonobvious, and useful, and must meet certain requirements for the description of the invention.²⁷ A patentee must disclose the invention clearly enough so that one skilled in that art can make and use it without undertaking a great deal of experimentation;²⁸ must highlight or

Box 1-1. Two of the Basics of the Patent Document

A patent contains a great deal of information. Among the most important are the patent’s “specification” and “claims.” The specification must provide a “written description of the invention, and of the manner and process of making and using it,” and must disclose the “best mode” known to the inventor of carrying out the invention. 35 U.S.C. §§ 111, 112.

The patent’s “claims” are “the portion of the patent document that defines the patentee’s rights.” *Markman v. Westview Instruments, Inc.*, 517 U.S. 370, 372 (1992). Since the claims essentially articulate the “metes and bounds” of the patentee’s intellectual property, they are one of the most important parts of the modern patent document. See generally ROBERT MERGES & JOHN DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS 25-26 (3d ed. 2002).

describe what the inventor claims so that others can easily discern the boundaries of the patent;²⁹ and must tell the public the inventor’s “best mode” – most effective method – for practicing the invention.³⁰ See also Box 1-1.

Patent law reflects certain differences between intellectual property and tangible property. Problems of copying by third parties make it generally more difficult for holders of intellectual property to exclude others from its use than it is for holders of

²⁴ U.S. CONST. art. I, § 8 also authorizes Congress to establish the copyright system.

²⁵ The first U.S. patent statute was passed by the first U.S. Congress; it has been substantially revised from time to time. See generally ROBERT PATRICK MERGES & JOHN FITZGERALD DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS 1-13 (3d ed. 2002) (reviewing history of patent law); ROGER E. SCHECHTER & JOHN R. THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARKS § 13.2 at 283-87 (2003) (reviewing history of patent law).

²⁶ 35 U.S.C. § 154(a)(2).

²⁷ 35 U.S.C. §§ 101-103, 112.

²⁸ See 35 U.S.C. § 112; *J.E.M. Ag Supply, Inc. v. Pioneer Hi-Bred Int’l, Inc.*, 534 U.S. 124, 142 (2001) (“The disclosure required by the Patent Act is the ‘quid pro quo of the right to exclude’” (internal citations omitted)); MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 262; James E. Rogan, *Prepared Remarks of James E. Rogan, Under Secretary of Commerce for Intellectual Property and Director of the United States*

Patent and Trademark Office (2/6/02) 2 (disclosure for right to exclude is a “remarkable trade-off”), at <http://www.ftc.gov/opp/intellect/rogan.htm> (hereinafter Rogan (stmt)).

²⁹ 35 U.S.C. § 112. HARMON, PATENTS AND THE FEDERAL CIRCUIT § 5.4 at 218 (“The inquiry under § 112¶ 2 focuses on whether the claims, as interpreted in view of the written description, adequately perform their function of notifying the public of the patentee’s right to exclude.”); MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 262.

³⁰ 35 U.S.C. § 112; MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 263.

tangible property to do so.³¹ Once third parties have learned about an invention, they may copy and use it.³² Intellectual property is also “non-rivalrous” – that is, many people may use innovative technology, and they all may use it without diminishing others’ ability to use it.³³ Many people may employ an innovation without depletion, and it is hard to identify and prevent those who will not pay for its use from using it.³⁴ In such circumstances, inventors are unlikely to have sufficient incentives to pursue and produce their inventions.³⁵

To preserve incentives to invent, patent policy protects inventors from such misappropriation. “The principal basis for intellectual property protection in the United States is the utilitarian or economic incentive framework. That is, intellectual property in the United States is fundamentally about incentives to invent and

³¹ See 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.1 at 1-2.

³² 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.1 at 1-3 through 1-4; see also Thomas 2/8 (Patent Session) at 14-15.

³³ HAL VARIAN, MICROECONOMIC ANALYSIS 414-415 (3d ed. 1992); 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.1 at 1-2; see also DonPaul Olshove, *Comments Regarding Competition & Intellectual Property* (Public Comment) 3, at <http://www.ftc.gov/os/comments/intelpropertycomments/olshovedonpaul.htm>.

³⁴ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.1 at 1-3 through 1-4. See generally, Thomas 2/8 (Patent Session) at 14-15.

³⁵ SCHECHTER & THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARK § 13.4.1 at 288 (noting that, if inventions can easily be duplicated or exploited by free riders, “[t]he resulting inability of inventors to capitalize on their inventions would lead to an environment where too few inventions are made.” (Footnote omitted.)).

create.”³⁶ Patent policy serves consumer interests in innovation through other means as well.³⁷ By requiring disclosure of the patented invention in an issued patent,³⁸ the patent system can encourage further innovations if inventors forego keeping their inventions as trade secrets and instead disclose their inventions.³⁹ The patent system also can encourage further innovation by facilitating investment in the research, development, and marketing necessary to commercialize a product.⁴⁰ One

³⁶ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.1 at 1-2.

³⁷ See generally *infra* Ch. 2(I)(A)(2), (I)(A)(3).

³⁸ See 35 U.S.C. § 112.

³⁹ See MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 259 (explaining that by the late eighteenth century, many viewed the primary benefit of the patent system as “the technological know-how behind the inventor’s patent. . . . This was a major change in the economic role of patents, for it shifted the emphasis from the introduction of finished products into commerce to the introduction of new and useful information to the technical arts[.]” (emphasis in original)); R. Levin 2/6 at 100 (research has shown the disclosure requirement is “quite procompetitive”); SCHECHTER & THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS § 13.4 .1 at 288 (noting that “[t]rade secrets do not enrich the collective knowledge of society, . . . , nor do they discourage others from engaging in duplicative research.”); Donald S. Chisum, *Comment: Anticipation, Obviousness, Enablement: An Eternal Golden Braid*, 15 AIPLA Q.J. 57 (1987) (explaining that primary purpose of disclosure requirement is to “put[] the invention in full possession of the public so the invention may be freely made and used after expiration of the patent”).

But see *infra* Ch. 2(II)(A)(2) (firms sometimes favor trade secrecy over patents as an appropriation mechanism) and Ch. 3(IV)(D) (firms sometimes obtain patents only when they view trade secrecy as impossible).

⁴⁰ HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.2 at 11; SCHECHTER & THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS § 13.4.1 at 289. See *infra* Ch. 2 (I)(A).

patent scholar has described the public purposes of the patent grant as “an incentive to invention, investment, and disclosure.”⁴¹

B. Competition and Patent Policy Both Promote Consumer Welfare Over Time, and Competition and Patent Policy Generally Work Well Together

Patent and antitrust law “are actually complementary, as both are aimed at encouraging innovation, industry, and competition.”⁴² In introducing these hearings, FTC Chairman Muris emphasized that “properly understood, IP law and antitrust law both seek to promote innovation and enhance consumer welfare.”⁴³ Then-Assistant Attorney General Charles James similarly noted that “intellectual property and antitrust law share the common purpose of promoting dynamic competition and thereby enhancing consumer welfare.”⁴⁴ Likewise, Under

Secretary of Commerce for Intellectual Property and Director of the United States Patent and Trademark Office James Rogan stated that “patent law and competition law . . . are highly compatible and serve many similar ends.”⁴⁵ Others have also observed that antitrust and patent law “are complementary efforts to promote an efficient marketplace and long-run, dynamic competition through innovation.”⁴⁶ Both doctrines can function to promote consumer welfare.⁴⁷

<http://www.usdoj.gov/atr/public/speeches/10162.htm>
(hereinafter *Opening Day Comments*).

⁴⁵ Rogan (stmt) 3.

⁴⁶ 1 HOVENKAMP, JANIS, & LEMLEY, IP AND ANTITRUST § 1.3 at 1-12 through 1-13. *See also* M. Thompson 2/25 at 7; American Bar Association Section of Antitrust Law, *Statement 6-7*, at <http://www.ftc.gov/opp/intellect/020628busey.pdf> (hereinafter ABA Antitrust Section (stmt)); Sheila F. Anthony, *Antitrust and Intellectual Property Law: From Adversaries to Partners*, 28 AIPLA Q.J. 1 at 1, 7 (2000), at <http://www.ftc.gov/speeches/other/aipia.htm>.

Antitrust and patent law show similarities and differences in each’s consideration of short and long run effects on consumer welfare. “Patent law and the incipency elements of antitrust law are similar in that they both are ultimately based on inherently uncertain predictions of what is going to happen in the future. The difference is that in the antitrust regime, we sometimes are concerned about conduct that in the short term may be benign or even helpful to consumers, but that may be harmful in the long run, whereas in the patent regime we are willing to tolerate immediate consumer harm [e.g., monopoly pricing] in the expectation that in the long run it will benefit consumers by encouraging innovation.” Thomas B. Leary, *The Patent-Antitrust Interface*, Remarks before the ABA Section of Antitrust Law Program, Philadelphia, Pennsylvania 3-4 (May 3, 2001), at <http://www.ftc.gov/speeches/leary/ipspeech.htm>.

⁴⁷ WARD S. BOWMAN, JR., PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL, 2-3 (1973); 1 HOVENKAMP, JANIS, & LEMLEY, IP AND ANTITRUST § 1.3 at 1-11 (“[W]hen one departs from the static view of markets and takes a longer-run approach, it is even plausible that intellectual property and the antitrust laws share a common goal”).

⁴¹ HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.4(b) at 22.

⁴² *Atari Games Corp. v. Nintendo of Am.*, 897 F.2d 1572, 1576 (Fed. Cir.1990). *See also* R. Hewitt Pate, *Refusals to Deal and Intellectual Property Rights*, 10 GEO. MASON L. REV. 429, 429 (2002) (“Intellectual property and antitrust laws share a common objective – to encourage innovation, industry, and competition.”).

⁴³ Timothy J. Muris, *Competition and Intellectual Property Policy: The Way Ahead*, Before American Bar Association Antitrust Section, Fall Forum 2 (Nov. 15, 2001), at <http://www.ftc.gov/speeches/muris/intellectual.htm> (hereinafter *The Way Ahead*).

⁴⁴ Charles A. James, *Opening Day Comments, Joint DOJ-FTC Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* 1 (Feb. 6, 2002), at

In most cases, competition and patent policy work in tandem toward this goal.⁴⁸ Competition advocates understand that “an effective legal regime defining and protecting property rights is essential to a well-functioning competitive economy[,]” and that “[patent] law plays an important role in this overall property rights regime.”⁴⁹ The patent system spurs competition to innovate, because it can increase the potential rewards to successful innovators by limiting the competition that may arise from the innovation. As the Supreme Court has noted, “free competition” is “the baseline” on which “the patent system’s incentive to creative effort depends.”⁵⁰ Moreover, patents protect intellectual property that firms use as inputs to compete. Thus, as a general matter, competition spurs the creation of patents, and patents protect inputs that firms use in the competitive process.

Analogously, patent policy recognizes the value of competition. The Supreme Court has pointed out that, by

⁴⁸ See, e.g., American Intellectual Property Law Association (AIPLA), *AIPLA Testimony* (Public Comment) 2-4 (“we view the two sets of laws as fully sharing common, not conflicting, goals and acting together in balance”), at <http://www.ftc.gov/os/comments/intelpropertycomments/aipla.pdf> (hereinafter AIPLA (stmt)).

⁴⁹ Muris, *The Way Ahead* at 2; see also American Bar Association Section of Antitrust Law and Section of International Law and Practice, *Comments and Recommendations on the Competition Elements of the Doha Declaration*, Before the United States Trade Representative 12 (2003) (noting that a “functional system for the definition, protection and exchange of common forms of tangible and intangible property (including intellectual property)” is necessary for a “successful market economy” based on competition), at <http://www.abanet.org/antitrust/comments/doha.doc>.

⁵⁰ *Bonito Boats*, 489 U.S. at 156.

limiting the duration of a patent, “[t]he Patent Clause itself reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition without any concomitant advance in the ‘Progress of Science and useful Arts.’”⁵¹ The patentability requirements for novelty and nonobviousness “are grounded in the notion that concepts within the public grasp, or those so obvious that they readily could be, are the tools of creation available to all.”⁵² Thus, patent policy recognizes that certain limits on patents are necessary to avoid unnecessarily restraining competition.⁵³

Competition and patent policy approach these issues through different means to achieve their congruent goals, however.⁵⁴ Antitrust concerns about harm to competition typically flow from the creation or exercise of monopoly power in a relevant antitrust market.⁵⁵ “Intellectual property,

⁵¹ *Bonito Boats*, 489 U.S. at 146.

⁵² *Bonito Boats*, 489 U.S. at 156.

⁵³ See, e.g., HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.2 at 12 (“It should not be supposed, however, that there are no public costs associated with the right to exclude. These include inflated prices (invariably absorbed by the consumer), which frequently accompany exclusive rights, and overinvestment. The patent system seeks to maintain an efficient balance between incentives to create and commercialize and the public costs engendered by these incentives.” (Footnotes omitted)).

⁵⁴ BOWMAN, PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL at 2; HOVENKAMP ET AL., IP AND ANTITRUST § 1.3b at 1-13.

⁵⁵ Although cases under Sections 1 and 2 of the Sherman Act may distinguish between “monopoly power” and “market power,” this report uses the terms interchangeably, because the distinction is not important for present purposes. The creation or exercise of monopoly power does not always violate the antitrust laws. See *infra* Ch. 1(I)(B).

while it does not generally create a monopoly, may in some cases permit or even encourage monopoly in order to give incentives for invention.⁵⁶ As Judge Pauline Newman noted, “[p]atents are directed at innovation. That’s their purpose, and of course they affect competition. That’s how they work. That’s the only way they work, and that’s why we’re here today.”⁵⁷ The existence of a patent may enable a firm to charge monopoly prices or otherwise limit competition.⁵⁸

Patents do not always or even frequently confer monopoly power on their owners.⁵⁹ Indeed, most patents do not confer monopoly power on their holders,⁶⁰ and most business conduct with respect to patents does not “unreasonably restrain” or serve to monopolize markets. Even when a patent does confer monopoly power, that alone does not create an antitrust violation. Antitrust law recognizes that a patent’s

⁵⁶ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3b at 1-13.

⁵⁷ Newman 2/6 at 38. See also 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3a at 1-9 through 1-10 (“Indeed, in order for the intellectual property laws to succeed in giving authors and inventors an incentive to create, the law *must* give them some power over price.” (emphasis in original)).

⁵⁸ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3a at 1-10.

⁵⁹ HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.4(b) at 21 (“Patent rights are not legal monopolies in the antitrust sense of the word. Not every patents is a monopoly, and not every patent confers market power.” (Footnote omitted.)). See also ABA Antitrust Section (stmt) 11-12; Kovacic 2/8 (Antitrust Law for Patent Lawyers) at 32-33 (hereinafter Antitrust Session); Tom 2/8 (Antitrust Session) at 50.

⁶⁰ AIPLA (stmt) 21; Cohen 2/20 at 63; Dickinson 2/6 at 52-53; Pitofsky 2/6 at 29-30.

creation of monopoly power can be necessary to achieve a greater gain for consumers.⁶¹ Moreover, antitrust law does not outlaw monopoly in all circumstances. For example, monopoly achieved solely with “superior skill, foresight, and industry” does not violate the antitrust laws.⁶²

C. Tension Can Arise Between Competition and Patent Law and Policy in Certain Limited Circumstances

Nevertheless, there are opportunities for tension between competition and patent law and policy. Broadly speaking, this tension most typically arises in two settings. The first involves the grant of a patent; the second involves business conduct with respect to a patent. Competition and patent policymakers may reach different conclusions about whether each policy has adequately accommodated the other’s concerns.

1. Grant of a Patent

Competition policy asks two questions in connection with the grant of a patent. The first question is whether the patent is warranted. Patent policy, of course, as set through statutes and decisional law, also seeks to ensure that the Patent and

⁶¹ BOWMAN, PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL at 3, n. 2.

⁶² *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 430 (2d Cir. 1945) (“The successful competitor, having been urged to compete, must not be turned upon when he wins.” *Id.*). See also *U.S. v. Grinnell Corp.*, 384 U.S. 563, 571 (1996) (the offense of monopoly is distinct from “growth or development as a consequence of a superior product, business acumen, or historic accident”); ABA Antitrust Section (stmt) 12.

Trademark Office (PTO) does not grant, and the courts do not uphold, invalid patents. The second question is whether the patent conveys market power. The patent system does not ask this question. We introduce each question here and discuss the issues in more depth throughout this report.

a. Is the Patent Warranted?

The PTO must issue a patent unless it can establish a *prima facie* case for rejection of the patent application.⁶³ Patent law establishes the standards of patentability against which the PTO measures a patent application. These standards ask whether the claimed invention is patentable subject matter⁶⁴ that is novel,⁶⁵ nonobvious,⁶⁶ and useful,⁶⁷ and whether the application meets the disclosure requirements.⁶⁸

⁶³ *In re Warner*, 379 F.2d 1011, 1016 (C.C.P.A. 1967), *cert. denied*, 389 U.S. 1057 (1968).

⁶⁴ 35 U.S.C. § 101 (basically, processes, machines, manufactures, and compositions of matter).

⁶⁵ 35 U.S.C. § 102. “The invention must . . . not be wholly anticipated by the so-called ‘prior art,’ or public domain materials such as publications and other patents.” SCHECHTER & THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS* § 13.1 at 282 (footnote omitted).

⁶⁶ 35 U.S.C. § 103. “The nonobviousness requirement is met if the invention is beyond the ordinary abilities of a skilled artisan knowledgeable in the appropriate field.” SCHECHTER & THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS* § 13.1 at 282 (footnote omitted).

⁶⁷ 35 U.S.C. § 101. “An invention is judged as useful if it is minimally operable towards some practical purpose.” SCHECHTER & THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS* § 13.1 at 282 (footnote omitted).

⁶⁸ 35 U.S.C. § 112. “Patent applications must include a specification that so completely describes the invention that skilled artisans are enabled to practice it

Competition policy and economic perspectives would ask a somewhat different question, one that focuses on whether and how the patent is necessary to encourage innovation. For example, one could ask whether the claimed invention would have emerged in roughly the same time frame “but for” the prospect of a patent. Judge Posner articulated this view as follows:

[I]f a court thinks an invention for which a patent is being sought would have been made as soon or almost as soon as it was made even if there were no patent laws, it must pronounce the invention obvious and the patent invalid.⁶⁹

Analogously, one could ask whether other measures through which patent law can encourage innovation – disclosure or commercial development of an invention⁷⁰ – would have occurred as soon “but for” the patent.⁷¹

This question asks whether a patent is necessary to achieve one of the means through which the patent system encourages innovation. If not, then, in theory, a patent

without undue experimentation. The patent application must also contain distinct, definite claims that set out the proprietary interest asserted by the inventor.” SCHECHTER & THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHT, PATENTS AND TRADEMARKS* § 13.1 at 282 (footnotes omitted).

⁶⁹ *Roberts v. Sears, Roebuck & Co.*, 723 F.2d 1324, 1346 (7th Cir. 1983) (Posner, J., dissenting from judgment remanding for a new trial rather than finding the claimed invention obvious as a matter of law).

⁷⁰ See *supra* Ch. 1(I)(A)(2) and *infra* Ch. 2(I)(A) (discussing purposes of the patent law).

⁷¹ See generally *infra* Ch. 2(I), (II) (discussing purposes of patent law from economic perspective).

should not be granted, because patents can impose costs on the public.⁷² By disallowing a patent if it is not necessary to elicit an invention (or disclosure or commercial development of the invention), this “but for” approach would leave room for competition policy to spur innovation and provide consumers with what they want at optimal prices, quantity, and quality.⁷³

From a theoretical perspective, the “but for” approach represents the right way to assess whether to grant a patent.⁷⁴ It is not usually possible, however, to use a “but

⁷² See, e.g., 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3a at 1-10 (“Because intellectual property rights impose costs on the public, the intellectual property laws can be justified by the public goods argument *only to the extent that the laws on balance encourage enough creation and dissemination of new works to offset those costs.*” (Emphasis added.)); see also HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.2 at 12 (costs to the public can include inflated prices); see *infra* Ch. 1(IV)(B)(5) (discussing process costs and costs of uncertainty to businesses).

⁷³ The Supreme Court’s decision in *Bonito Boats* provides an analogy. There, a unanimous Supreme Court held a Florida statute offering patent-like protection for a boat hull molding process to be preempted by the Supremacy Clause. “By offering patent-like protection for ideas deemed unprotected under the present federal scheme, the Florida statute conflicts with the ‘strong federal policy favoring free competition in ideas which do not merit patent protection.’” *Bonito Boats*, 489 U.S. at 168, citing *Lear, Inc. v. Adkins*, 395 U.S. 653, 656 (1969). A “but for” approach analogously would protect free competition in areas where a patent was not necessary to elicit the invention (or its disclosure or commercial development).

⁷⁴ Many view the perspective that patents should be granted only if the invention would not have emerged “but for” the patent system as the “defining proposition” for standards of patentability. See, e.g., Merges 2/28 at 579; Greenhall 2/27 at 421-22; Farrell 2/28 at 596-97; Musacchia 4/9 at 25-26; Scherer 7/10 at 54; Lunney 7/10 at 97-104; Wamsley 7/10 at 139; Gambrell 10/25 at 41; Stoner 10/30 at 37; Kitch 10/30 at 50-51 (“but for” inquiry the right thing to think about as a matter of “metatheory”); Barr 10/30 at 53.

for” approach to analyze whether individual patents should be granted.⁷⁵ For example, any property rights system must be administrable; finding the answer to the “but for” question in most individual cases would not be administrable.⁷⁶ Instead, the more manageable standards of the patent statute have evolved to serve as the means by which to measure when to grant a patent. Nonetheless, for conceptual purposes, one way to assess the alignment between competition and patent law and policy, and to assess policy choices for an appropriate blend of competition and patents, is to examine whether the patent system’s standards of patentability ask questions likely to produce results similar to those obtained by asking the “but for” question.⁷⁷

b. Does the Grant of the Patent Confer Market Power on the Patentholder or Unnecessarily Increase Transaction Costs?

If an unwarranted patent confers market power on a patentholder, it can deprive consumers of the benefits of competition without compensating value.⁷⁸ Moreover, even if an unwarranted patent

⁷⁵ Most concede that the “but for” standard, although conceptually correct, cannot practically be applied in individual cases. See generally *infra* Ch. 4(II)(A)(2).

⁷⁶ In many cases, it is likely unknowable whether the claimed invention would have emerged in roughly the same time frame absent the prospect of a patent. Even if knowable, the costs of examining that question would generally far outweigh any benefits from obtaining a more precise measure of whether a patent should be granted.

⁷⁷ See generally *infra* Ch. 4(II)(A)(2) (discussing standards of patentability in relation to “but for” question).

⁷⁸ The issuance of invalid patents that do not confer market power may also raise societal costs even if they do not raise competition issues.

does not confer market power, a proliferation of trivial patents can harm competition.

The patent system, quite properly, does not examine whether the grant of a patent would likely create market power. As Under Secretary of Commerce for Intellectual Property and Director of the USPTO James Rogan pointed out on the first day of the Hearings, “[p]atent examination does not include an analysis of the potential commercial impact of the patent. It does not determine the relevant market in which the invention may be marketed or sold. No patent examiner projects the economies of scale to be achieved through the invention.”⁷⁹ In other words, patent examination does not include an assessment of the likely competitive significance of a patent.⁸⁰

This is as it should be, especially given the early point at which patent applications typically are filed.⁸¹ At that point, any attempt to assess the likely competitive significance of a patent would usually devolve into mere speculation. Nonetheless, the likelihood of market power problems may be greater in some areas of the economy than others, and that increased likelihood may justify closer scrutiny of patent applications in those areas.⁸²

⁷⁹ Rogan (stmt) 2.

⁸⁰ *Id.*

⁸¹ Hughes 2/28 at 611-12, 618.

⁸² See *infra* Chs. 3 (II), (IV) and 4 (II)(E) (business method patents; semiconductors (patent thicket)). But see *supra* Ch. 1(I)(B) (antitrust does not object to patent that conveys market power if the patent is necessary to elicit an invention that otherwise would likely not have

In addition, the issuance of unwarranted patents can injure competition even if they do not confer market power. A proliferation of trivial patents can be detrimental. Innovators “must expend resources both in searching such patents to avoid infringement and in negotiating patent licenses to use the technology. For patents covering significant developments, it may be assumed that those additional social costs are relatively small compared to the social benefits associated with the advance in the art. But that assumption becomes less plausible if the advance is relatively trivial. . . . Thus, in aggregate, the search and transaction costs associated with numerous trivial patents may outweigh the relatively small benefits associated with such patents.”⁸³

2. Business Conduct with Respect to a Patent

Patent policy generally asks two questions about antitrust enforcement in connection with a patent. The first question is whether antitrust enforcement is warranted, or erroneously condemns welfare-enhancing conduct that should be permitted. Antitrust enforcers, of course, are also very concerned to ensure that antitrust enforcement properly distinguishes between anticompetitive and procompetitive conduct. The second question is whether antitrust enforcement limits the rights conferred by a patent to undermine the incentives that the patent system creates. This is a question that also concerns antitrust enforcers. We introduce each question and discuss both

issued at all or as soon).

⁸³ MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 647.

more thoroughly throughout the report.

a. *Is Antitrust Enforcement Warranted?*

Antitrust law can constrain what a patentee can do with its patent, depending on the conduct at issue.⁸⁴ A patentee may use a patent to obtain unwarranted market power⁸⁵ or interfere with competition in a variety of ways.⁸⁶ The question for antitrust policymakers is how best to distinguish between procompetitive and anticompetitive conduct with respect to patents. A proper answer depends in part on understanding the role of patents in innovation and competition in particular industries. As this report will discuss, patents play different roles in different industries.⁸⁷ Moreover, to avoid errors, antitrust enforcement needs to understand the efficiencies that businesses may realize through particular types of patent-related conduct. The Antitrust Agencies have addressed this in part by issuing *Antitrust Guidelines for the*

⁸⁴ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3b at 1-14. See also *United States v. Microsoft Corp.*, 253 F.3d 34, 63 (2001) (The court rejected appellant's assertion that because intellectual property rights have been lawfully acquired, their subsequent use cannot result in antitrust liability. *Id.* "That is no more correct than the proposition that use of one's personal property, such as a baseball bat, cannot give rise to tort liability." *Id.*); Tom 2/8 (Antitrust Session) at 53-54.

⁸⁵ This description does not capture all of the possible anticompetitive conduct, of course. For example, certain limited conduct with respect to a patent may be summarily condemned, without an examination of market power, due to its obvious anticompetitive effects. See Second Report (forthcoming).

⁸⁶ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3b at 1-13. See Second Report (forthcoming).

⁸⁷ See generally *infra* Ch. 2(II)(A)(2) and Ch. 3.

*Licensing of Intellectual Property.*⁸⁸ The Guidelines outline a framework for antitrust analysis of licensing practices and identify some of the efficiencies that businesses may seek through particular licensing practices.⁸⁹

b. *Does Antitrust Enforcement Undermine the Incentives Created by the Patent System?*

Antitrust scrutiny is more likely if business conduct involves a patent that confers market power on the patentholder than if the patent does not confer market power. A patent that confers market power, however, can fulfill precisely the goals of the patent system: to preserve incentives to innovate.⁹⁰ Patents thus present an additional concern to antitrust enforcers: mistaken antitrust enforcement may undermine the incentives the patent system creates. If patentees find that antitrust enforcement unwarrantedly limits their conduct with respect to their patents, then such enforcement may reduce incentives to invent. Thus, patent perspectives emphasize the need for antitrust enforcement to take care in distinguishing anticompetitive from procompetitive conduct, particularly when the patent confers market power.

⁸⁸ U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property* (Apr. 6, 1995), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,132, available at <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm> (hereinafter IP Guidelines).

⁸⁹ *Id.* at § 3.3. How these Guidelines are working in practice will be discussed in the second, forthcoming report.

⁹⁰ See *supra* Ch. 1(B).

3. Enhancing Consumer Welfare Requires a Proper Balance of Competition and Patent Law and Policy

The Hearings record provides ample evidence of both the tensions and the potential for greater congruence between competition and patent law and policy. On the one hand, panelists noted antitrust's increased appreciation of the role of patents in fostering innovation and increased understanding of the efficiencies to be gained through patent licensing and other practices.⁹¹ On the other hand, economists also emphasized that ever greater intellectual property protection is not necessarily socially beneficial.⁹² Among other things, stronger intellectual property protection carries the potential for less price competition.⁹³ From a broad policy perspective, policymakers can maximize consumer welfare at a level of IP protection certainly greater than zero, but less than absolute.⁹⁴ Because both competition and intellectual property protection may foster innovation, these policy tools must be blended to achieve consumer welfare.⁹⁵

⁹¹ See, e.g., James, *Opening Day Comments* at 1-2; Pitofsky 2/6 at 29-30; Tom 2/8 (Antitrust Session) at 47-50.

⁹² See, e.g., Farrell 2/28 at 596-97; Langenfeld 2/20 at 10-13, 64.

⁹³ See, e.g., HARMON, PATENTS AND THE FEDERAL CIRCUIT § 1.2 at 12.

⁹⁴ See generally James Langenfeld, *Intellectual Property and Antitrust: Steps Toward Striking a Balance*, 52 CASE W. RES. L. REV. 91, 96-98 (2001); William Landes & Richard Posner, *An Economic Analysis of Copyright Law*, 18 J. LEGAL STUD. 325 (1989).

⁹⁵ See generally *infra* Ch. 2(II), (III).

II. VIEWS ON HOW BEST TO BALANCE COMPETITION AND PATENTS TO ACHIEVE CONSUMER WELFARE HAVE VARIED WIDELY OVER TIME

A. For Much of the Twentieth Century, Patent and Antitrust Law Have Traded Ascendancy with Each Other

Despite the common goals of patent and antitrust law, the doctrines historically have traded ascendancy between each other.⁹⁶ Broadly speaking, throughout much of the twentieth century, courts and federal agencies considered patents to confer monopoly power and, correspondingly, viewed antitrust as always opposed to monopoly power.⁹⁷ Some have argued that this perceived conflict led courts to believe that, in any given case, they had to find that either patents or antitrust took precedence.⁹⁸ In general, when courts were favoring patents, they were usually disfavoring antitrust, and vice versa. A variety of factors appear to have shaped these shifts, including perceptions about the power of big business,

⁹⁶ I HOVENKAMP ET AL., IP AND ANTITRUST at § 1.3c at 1-15.

⁹⁷ See, e.g., *Crown Die & Tool Co. v. Nye Tool & Mach. Works*, 261 U.S. 24, 37 (1923), citing *Continental Paper Bag Co. v. Eastern Paper Bag Co.*, 210 U.S. 405 (1908) (patents as monopolies); R. Hewitt Pate, *Antitrust and Intellectual Property*, Before the American Intellectual Property Association, 2003 Mid-Winter Institute (Jan. 24, 2003), at <http://www.usdoj.gov/atr/public/speeches/200701.pdf>.

⁹⁸ Anthony, 28 AIPLA Q.J. at 4.

the competitive significance of various patent licensing practices, the nature and role of patents, and the best ways to achieve economic and technological growth.

1. 1890-1930: Patents Receive Little Antitrust Scrutiny

Passage of the Sherman Act in 1890 – one hundred years after passage of the first Patent Act in 1790 – set the stage for courts to begin construing how these two doctrines should interact. Although both patent and antitrust have antecedents dating back farther than the enactment of those two statutes,⁹⁹ courts did not give significant attention to the intersection of patents and antitrust until the early 1900s.¹⁰⁰ Early court opinions generally refrained from subjecting patent-related conduct to antitrust

⁹⁹ Robert Merges and John Duffy point out that Aristotle discussed (and rejected) a proposal for a patent-like system in the fourth century B.C.; they trace the history of the core concepts of patent law from that time through the present. See MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 1-13. One can also find ‘abuse of patent’ cases in England going back to 1600. 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3c at 1-14 & n. 10, citing Lewis Edmonds, THE LAW AND PRACTICE OF LETTERS PATENT FOR INVENTIONS 7-8 (1890) (relating a case in which two people were stripped of patents and imprisoned for abusing their patent in the seventeenth century). Analogously, English courts wrestled with competition law early on, and, for example, rejected a monopoly granted by Elizabeth I. The Case of Monopolies, 11 Co. Rep. 84b, 77 Eng. Rep. 1260 (1603). Other competition law issues, such as restraint of trade cases, with parties demonstrating cartel behavior, were brought as contract cases. Courts in England and the United States refused to uphold such contracts, long before the Sherman Act was written. See generally John E. Lopatka, *The Case for Legal Enforcement of Price Fixing Agreements*, 38 EMORY L.J. 1 (1989).

¹⁰⁰ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3c at 1-14 through 1-15.

scrutiny,¹⁰¹ most typically because the “very object of these [patent] laws is monopoly. . . .”¹⁰² Courts often seemed “to immunize from antitrust scrutiny the conduct of firms holding patents,”¹⁰³ even including patent pools with outright price fixing.¹⁰⁴ Some contend that patent owners engaged in “what was arguably rather substantial overreaching” during this time by seeking to impose restrictions beyond the first sale of a patented product.¹⁰⁵

2. 1930-1980: Antitrust Is Generally Ascendant

An antitrust backlash began in 1917,¹⁰⁶ when the Supreme Court rejected on antitrust and patent misuse grounds certain licensing restrictions that movie exhibitors had imposed.¹⁰⁷ By the 1930s, a stronger role for antitrust, and a correspondingly weaker role for patents, were emerging. During that time, some saw

¹⁰¹ See, e.g., *Bement v. National Harrow Co.*, 186 U.S. 70 (1902); *Heaton-Peninsular Button-Fastner Co. v. Eureka Specialty Co.*, 77 F. 288 (6th Cir. 1896); *Strait v. National Harrow Co.*, 51 F. 819 (N.D.N.Y. 1892).

¹⁰² *Bement v. National Harrow Co.*, 186 U.S. at 91. See also *Strait v. National Harrow Co.*, 51 F. 819 (N.D.N.Y. 1892); Tom 2/8 (Antitrust Session) at 38.

¹⁰³ Anthony, 28 AIPLA Q.J. at 5.

¹⁰⁴ Anthony, 28 AIPLA Q.J. at 5 (citing *Bement v. National Harrow Co.*, 186 U.S. 70 (1902)).

¹⁰⁵ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3c at 1-15.

¹⁰⁶ *Id.*

¹⁰⁷ *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502 (1917). Movie exhibitors mandated that their patented film projection equipment only be resold at a specified price, and that the projectors only be used with the licensor’s patented film.

patent procedures as favoring “the powerful and the unscrupulous,” noting, among other things, the potential for “dragnet” patent applications, through which firms could amend their patent claims during lengthy procedures at the patent office and thereby capture competitors’ most recent developments.¹⁰⁸ Others attacked patents more broadly.¹⁰⁹ Although not all commentary was anti-patent,¹¹⁰ an “anti-business” tenor of the times apparently contributed to antitrust’s more active role in constraining patent-related conduct.¹¹¹

Another significant factor was the state of economic learning. Courts limited the scope of any exemption from antitrust for patent-related conduct. The Supreme Court ruled there was no exemption from antitrust “beyond the limits of the patent

monopoly.”¹¹² As this quotation and other cases made clear, courts generally continued to view patents as automatic sources of monopoly power.¹¹³

Around the same time, courts also weakened patent rights, “most notably by imposing a high standard of ‘invention’ as a condition of patentability.”¹¹⁴ For example, in *Cuno Engineering Corp. v. Automatic Devices Corp.*, the Supreme Court reversed a lower court’s judgment that respondent had a valid patent that was infringed, reasoning that “the new device, however useful it may be, must reveal *the flash of creative genius*, not merely the skill of the calling. If it fails, it has not established its right to a private grant on the public domain.”¹¹⁵ The anti-patent posture of the Supreme Court at that time led one dissenting U.S. Supreme Court Justice to observe that “the only patent that is valid is one which this Court has not been able to get

¹⁰⁸ Alfred E. Kahn, *Fundamental Deficiencies of American Patent Law*, 30 AM. ECON. REV. 475, 485-86 (1940). See *infra* Ch. 4(II)(C)(1), for a discussion of the current competitive significance of continuation procedures at the PTO. See also FRITZ MACHLUP, AN ECONOMIC REVIEW OF THE PATENT SYSTEM, SUBCOMM. ON PATENTS, TRADEMARKS, & COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY, 85TH CONG., 2D SESS. 40-42 (Comm. Print 1957) (discussing charges that “the patent system operates in favor of economic concentration and bigness”) (hereinafter MACHLUP, AN ECONOMIC REVIEW OF THE PATENT SYSTEM).

¹⁰⁹ See MACHLUP, AN ECONOMIC REVIEW OF THE PATENT SYSTEM at 28-29 (quoting from various articles attacking patents to one degree or another). Machlup’s report also outlines many arguments in favor of patents.

¹¹⁰ See, e.g., JOHN BATES CLARK, ESSENTIALS OF ECONOMIC THEORY 360 (1927) (describing why inventors need patents to maintain incentives to innovate), cited in MACHLUP, AN ECONOMIC REVIEW OF THE PATENT SYSTEM at 37.

¹¹¹ See MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 10.

¹¹² *United States v. Line Material Co.*, 333 U.S. 287, 308 (1948). See also *Morton Salt Co. v. G. S. Suppiger Co.*, 314 U.S. 488, 492 (1942).

¹¹³ See, e.g., MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 1349 (“During the middle part of the twentieth century, the courts tended to associate patents with monopolies, and hence to view them as narrow exceptions to the nation’s antitrust laws. This view [was] especially prominent in the Supreme Court cases from the 1930s until the 1960s, . . .”).

¹¹⁴ 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.3c at 1-16; see also SCHECHTER & THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS § 17.3.1 at 376 (“The anti-monopoly sentiments that arose during the Depression era did not bode well for the patent system. Courts began to apply an increasingly stringent ‘invention’ standard that found most patents wanting.”).

¹¹⁵ 314 U.S. 84, 91 (1941) (emphasis added); see also Gerald Sobel, *Patent Scope and Competition: Is the Federal Circuit’s Approach Correct?*, 7 VA. J. OF LAW & TECH. 3, 16-17 (2002).

Box 1-2. REPORT OF THE PRESIDENT'S COMMISSION ON THE PATENT SYSTEM (1966) "TO PROMOTE THE PROGRESS OF . . . USEFUL ARTS"

In 1965, President Johnson established a Commission on the Patent System, which examined the patent system in light of six objectives: raising the quality and reliability of U.S. patents; shortening the period of patent pendency; accelerating the public disclosure of technological advances; reducing the expense of obtaining and litigating a patent; harmonizing the U.S. patent system with that of other major countries; and preparing the patent system to cope with future technological developments.

In 1966, the Commission issued its report containing 35 recommendations that addressed a wide range of subject areas. Two areas of recommendation are particularly noteworthy as they underscore society's ongoing efforts to increase the value of patent disclosures and to decrease the possibility the system could be gamed so as to undermine the value of those disclosures.

Publication. The Commission concluded that early publication of patent applications "could prevent needless duplication of the disclosed work, promote additional technological advances based on the information disclosed, and apprise entrepreneurs of their potential liability." They recommended publication of all pending applications "eighteen to twenty-four months after its earliest effective filing date. . . ."

Continuations. Continuations are one means by which claims can be broadened after publication. The difficulty continuations pose is that "unclaimed disclosures in a published application . . . might be protected by broader claims in [a] subsequently issued patent." The Commission believed an absolute bar on continuations was not feasible but, instead, recommended the imposition of certain limits on an applicant's ability to file continuations.

its hands on."¹¹⁶

Congress responded to these judicial trends by passing the Patent Act of 1952, which limited the doctrine of patent misuse and strengthened the patent system.¹¹⁷ Congress issued a lengthy study in 1957 on "The Patent System and the Modern Economy,"¹¹⁸ consisting of reports prepared by a variety of experts. Most references to the study note only the conclusion of economist Fritz Machlup that insufficient empirical economic evidence exists to justify either abolishing or creating a patent system, but Machlup also provided useful insights about how patents and competition

each might function to achieve the purposes of the patent system.¹¹⁹ A 1966 Presidential Commission on the Patent System endorsed patents as offering a "unique service," although the Commission also recommended 35 changes to the patent system. See Box 1-2 (1966 Presidential Commission). Also in 1966, the Supreme Court articulated an objective test for nonobviousness, based on Section 103 of the Patent Act of 1952, which, over time, has replaced the more subjective "invention"

¹¹⁶ *Jungerson v. Ostby & Barton Co.*, 335 U.S. 560, 572 (1949) (Jackson, J., dissenting).

¹¹⁷ 35 U.S.C. §§ 1 et seq.

¹¹⁸ STUDY OF THE SUBCOMM. ON PATENTS, TRADEMARKS, AND COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY, 84TH CONG., 2D SESS. (1957).

¹¹⁹ See MACHLUP, AN ECONOMIC REVIEW OF THE PATENT SYSTEM at 80 ("If we did not have a patent system, it would be irresponsible, on the basis of our present knowledge of its economic consequences, to recommend instituting one. But since we have had a patent system for a long time, it would be irresponsible, on the basis of our present knowledge, to recommend abolishing it."); *id.* at 76-79 (discussing rationales for patent system, such as providing incentives to invent, disclose, or invest, and comparing theories suggesting that competition alone could serve those purposes with theories that patents are necessary in some cases to achieve those purposes); Merges 2/28 at 577-79.

approach the Court had used earlier.¹²⁰

Overall, however, antitrust dominated and patents were disfavored during the 1960s and 70s.¹²¹ “Most litigated patents were held invalid during this period.”¹²² Courts of appeal “diverged widely both as to doctrine and basic attitudes toward patents.”¹²³ Some contend that, for that reason, “industry downplayed the significance of patents.”¹²⁴ Overzealous antitrust enforcement culminated in the Department of Justice’s “Nine No-Nos,” a list of nine licensing practices that the Justice Department generally viewed as automatically illegal.¹²⁵ Most now believe that antitrust’s ascendancy during this period

¹²⁰ See SCHECHTER & THOMAS, THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS, § 17.3.2 at 377-80 (discussing *Graham v. John Deere Co.*, 383 U.S. 1 (1966) in relation to 35 U.S.C. § 103 (1952)); HARMON, PATENTS AND THE FEDERAL CIRCUIT § 4.2(a) at 137-39 (same).

¹²¹ See, e.g., Pate, Antitrust and Intellectual Property at 6.

¹²² I HOVENKAMP ET AL., IP AND ANTITRUST § 1.3c at 1-16. In 1971, the Second Circuit reported that appeals courts found more than 80% of the patents reviewed to be invalid. *Carter-Wallace, Inc. v. Davis-Edwards Pharmacal Corp.*, 443 F.2d 867, 872 (2d Cir. 1971), cert. denied, 412 U.S. 929 (1973). See also MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 10 (during 1960s and early 1970s, “[i]t was difficult to get a patent upheld in many federal courts”).

¹²³ MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 10-11. See *infra* Ch. 6(II)(A).

¹²⁴ MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 11.

¹²⁵ See Bruce B. Wilson, Deputy Assistant Attorney General, Antitrust Division, Remarks before the Michigan State Bar Antitrust Law Section (September 21, 1972), reprinted in 5 CCH Trade Reg. Rep. 50,146 (transfer binder) (DOJ official’s speech articulating what came to be called the “Nine No-Nos”).

lacked both a sound economic foundation and a sufficient appreciation of the incentives for innovation that patents and patent licensing can provide.¹²⁶

B. 1980-1990: Congress and the Courts Strengthen Patents, and Antitrust Incorporates an Updated Economic Framework

By the late 1970s, two factors were converging to reverse the cycle of antitrust’s dominance and patents’ weakness. First, general concern about industrial stagnation and a lack of significant technological innovation spurred reassessments of the patent system. Second, scholars, many associated with the “Chicago School of Economics,” spurred a general rethinking of antitrust, including its approach to patents. Although these two factors were not the only ones that influenced trends in the 1980s, each played a central role.

1. Congress and the Courts Strengthen Patents

a. Congress Creates the Court of Appeals for the Federal Circuit

In 1978, President Carter appointed an Advisory Committee to perform a domestic review of industrial innovation. See Box 1-3 (1979 Commission report on patents). Government officials and policymakers had grown concerned with an overall weakening of R&D and other signs

¹²⁶ See, e.g., Muris, The Way Ahead at 1; Pate, Antitrust and Intellectual Property at 7; Pitofsky 2/6 at 29-30 (“‘Nine No-Nos . . .’ a far, far cry from where we are today”).

Box 1-3. REPORT OF THE INDUSTRIAL SUBCOMMITTEE FOR PATENT AND INFORMATION POLICY OF THE ADVISORY COMMITTEE ON INDUSTRIAL INNOVATION: REPORT ON PATENT POLICY (1979)

In 1978, President Carter appointed an Advisory Committee to perform a domestic review of industrial innovation. In 1979, the Patent and Information Policy Subcommittee (Subcommittee) of the Advisory Committee issued its REPORT ON PATENT POLICY. The report had five key proposals, four of which (at pages 153-55) are relevant to this report:

Proposal I. Upgrade the Patent and Trademark Office. The Subcommittee observed that the quality of the patent system depends on the quality of the underlying PTO examination, which in turn depends upon "the search of the prior art by the examiner." The Subcommittee recommended the PTO be "given the funds and resources to improve its examination procedure. . . ."

Proposal II. Provide for Reexamination of Patents. The Subcommittee recognized the need for a "fast, inexpensive method for increasing the certainty as to the enforceability and scope of patents over prior art not considered by the PTO." Under the proposal, any party could request reexamination during the life of the patent. The proposed system would provide for the submission of written arguments by interested parties and expedited review by the PTO to provide a "simple, inexpensive method" to improve the quality of patents with demonstrated commercial value.

Proposal III. Provide a Specialized Appellate Court for Patent Cases. The Subcommittee advocated, "a centralized national court with exclusive appellate jurisdiction (subject to Supreme Court review) over patent-related cases as a vehicle for insuring more uniform interpretation of the patent laws."

Proposal IV. Reduce Cost of Patent Litigation. The Subcommittee concluded that decreasing "the cost and time involved in resolving patent infringement and validity disputes through litigation" would improve the patent system. The Subcommittee urged, among other things, that Federal courts "exercise a high degree of control over the conduct of patent litigation, with particular concern for the time and expense of discovery."

of economic trouble. One question for the Advisory Committee was whether, and to what extent, patent policies contributed to these circumstances. Judge Newman, a member of the Advisory Committee, recalled the "low point" at which they found the U.S. economy: "Investment in basic science in applied research had disappeared . . . Our production in the United States was no longer competitive. Old technologies were stagnant. New [technologies] were dormant. . . ."127 Among other problems, Committee members attributed these conditions to "a diminished patent incentive" in the U.S..128

The *Report on Patent Policy* that emerged recommended "a centralized national court with exclusive appellate jurisdiction (subject to Supreme Court review) over patent-related cases as a vehicle for insuring more uniform interpretation of the patent laws."¹²⁹ Committee members concluded that increased uniformity and reliability in patent decisions would "contribute meaningfully to decisions to file patent applications and to commercialize invention, thereby improving industrial innovation[.]"¹³⁰ During the 1970s, others also discussed the problem of

¹²⁷ Newman 2/6 at 39-42.

¹²⁸ *Id.*

¹²⁹ REPORT OF THE INDUSTRIAL SUBCOMM. FOR PATENT AND INFORMATION POLICY OF THE ADVISORY COMM. ON INDUSTRIAL INNOVATION, REPORT ON PATENT POLICY 155 (1979).

¹³⁰ *Id.*

Box 1-4. Congressional Activity.

Congress has actively legislated in the field of patent law since 1980. Congress passed amendments to the Patent Act in 1980 that required the payment of maintenance fees (35 U.S.C. § 154), made provision for third parties to cite prior art to the PTO (35 U.S.C. § 301) and created reexamination procedures (35 U.S.C. § 302). In 1982, Congress created the Court of Appeals for the Federal Circuit (35 U.S.C. § 141, 28 U.S.C. § 1295). Two years later, Congress passed the Hatch Waxman Amendments which, among other things, permitted an extension of patent term to compensate for delay in securing FDA approval to sell new drugs for humans (35 U.S.C. § 156) and consolidated the Boards of Patent Appeals and Interferences into a single Board of Patent Appeals and Interferences (35 U.S.C. § 141). In 1988, Congress passed the Patent Misuse Reform Act, which governs the application of certain patent misuse defenses to patent infringement claims (35 U.S.C. § 271(d)). In 1994, Congress passed the Uruguay Round Agreements Act which, among other reforms, changed the patent term to 20 years from the earliest date on which the application was filed (35 U.S.C. § 154) and allowed the filing of provisional applications (35 U.S.C. § 111). Congress passed the American Inventors Protection Act in 1999, which made multiple changes to patent law, such as requiring that patent applications be published after 18 months where equivalent applications are published abroad (35 U.S.C. § 122), creating an *inter partes* reexamination procedure (35 U.S.C. §§ 311-313), and granting a prior user right for business method patents (35 U.S.C. § 273). Congress reformed certain features of the *inter partes* reexamination procedure in 2002.

significant inconsistency in patent decisions and the idea that a centralized appellate court for patent matters might ease that problem.¹³¹

In 1982, Congress created the Court of Appeals for the Federal Circuit.¹³² The Federal Circuit has exclusive jurisdiction of all appeals from final district court decisions in civil actions “arising under any Act of Congress relating to patents.”¹³³ “[T]he

¹³¹ See, e.g., MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 11 (during 1970s, idea of a single, unified court of appeals for patent cases discussed as “way to return patents to a more central position in the commercial world”).

¹³² 28 U.S.C. § 1295. The United States Court of Appeals for the Federal Circuit was created through the merging of two specialized courts of limited subject matter but nationwide jurisdiction – the U.S. Court of Claims and the U.S. Court of Customs and Patent Appeals.

¹³³ 28 U.S.C. § 1338(a). The Supreme Court has interpreted the “arising under” clause to require a determination of whether the patent allegation forms part of the “well-pleaded complaint,” in that patent law either (1) “creates the cause of action” (generally referred to as “arising under” jurisdiction), or (2) is a “necessary element

creation of the Federal Circuit was a watershed event in the history of the U.S. patent system.”¹³⁴ Most commentators find that, as a general matter, the Federal Circuit strengthened patent rights significantly,¹³⁵ upholding patent validity

of one of the well-pleaded claims,” such that “plaintiff’s right to relief necessarily depends on resolution of a substantial question of federal patent law” (generally referred to as “substantial question” jurisdiction). *Christianson v. Colt*, 486 U.S. 800 (1988). In *Holmes Group, Inc. v. Vornado Air Circulation Systems, Inc.*, 535 U.S. 826 (2002), the Supreme Court concluded that “arising under” jurisdiction does not give jurisdiction to the Federal Circuit, when only a patent counterclaim exists, and the complaint does not assert any claim arising under federal patent law. See generally *infra* Ch. 6(II)(B)(1)(a).

¹³⁴ MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 11.

¹³⁵ “Since the creation of the Federal Circuit, . . . [i]t is also much easier to get an injunction against an infringer. And money damages have soared too, both on average and in the highest-visibility cases.” MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 11. Cf. ROBERT L. HARMON, PATENTS AND THE FEDERAL CIRCUIT 147, 161 (Supp. 2002) (original assessment of Federal Circuit as pro-patentec; more recently, court is moving toward “a more neutral position”).

“more frequently than in the anti-patent era of the 30s to the 70s.”¹³⁶

b. The Supreme Court Interprets Patentable Subject Matter Broadly

In *Diamond v. Chakrabarty*,¹³⁷ the Supreme Court held that a live, human-made microorganism was patentable subject matter under 35 U.S.C. § 101.¹³⁸ In reaching this decision, the Court noted that the Committee Reports accompanying the 1952 Patent Act “inform us that Congress intended statutory subject matter to ‘include anything under the sun that is made by man.’”¹³⁹ The Court distinguished “laws of nature, physical phenomena, and abstract ideas,” which have been held not patentable,¹⁴⁰ from the patentee’s “new bacterium with markedly different

characteristics from any found in nature and one having the potential for significant utility.”¹⁴¹ “His discovery is not nature’s handiwork, but his own; accordingly it is patentable subject matter under § 101.”¹⁴² The description of patentable subject matter as “anything under the sun that is made by man” conveyed a broad sense of the potential scope of patents and, in particular, provided a significant boost to the biotech industry. Indeed, Hearings participants from the biotech industry generally credited the Court’s decision in *Chakrabarty* as the beginning of their industry, without which genetic engineering would not have made nearly as much progress.¹⁴³

In the 1981 case, *Diamond v. Diehr*,¹⁴⁴ the Supreme Court held that a process claim that included use of a computer program was patentable subject matter, concluding that “a claim drawn to subject matter otherwise statutory does not become nonstatutory simply because it uses a mathematical formula, computer program,

¹³⁶ “Since the creation of the Federal Circuit, patents have been held valid more frequently than in the anti-patent era of the 30s to the 70s.” MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 11 (footnotes omitted). See also Robert P. Merges, *Commercial Success and Patent Standards: Economic Perspectives on Innovation*, 76 CAL. L. REV. 803, 820-21 (comparing pre- and post-Federal Circuit era statistics); John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q. J. 185 (1998) (providing a statistical survey of validity decisions from 1989-1996). See generally *infra* Ch. 6(II)(C).

¹³⁷ 447 U.S. 303 (1980).

¹³⁸ Section 101 states that “[w]hoever invents or discovers any new or useful process, machine, manufacture, or composition of matter, or any new or useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.” 35 U.S.C. § 101 (emphasis added).

¹³⁹ 447 U.S. at 309, citing S. REP. NO. 82-1979, at 5 (1952); H.R. REP. NO. 82-1923, at 6 (1952).

¹⁴⁰ 447 U.S. at 309. “[A]n application of a law of nature or mathematical formula to a known structure or process may well be deserving of patent protection[.]” however. *Diamond v. Diehr*, 450 U.S. 175, 187 (1981).

¹⁴¹ 447 U.S. at 310.

¹⁴² *Id.* The Court’s decision was 5-4, with Justice Brennan writing the dissent, which described the patent laws as “attempt[ing] to reconcile this Nation’s deep-seated antipathy to monopolies with the need to encourage progress[.]” and argued that both congressional intent and public policy militated against finding that living organisms could be patentable subject matter. *Id.* at 318-19.

¹⁴³ Kirschner 2/26 at 239; Beier 2/26 at 322; Chen 2/28 at 628; American Bar Association Section of Intellectual Property Law, *Statement of Robert P. Taylor on Behalf of Section of Intellectual Property Law American Bar Association on Competition and Intellectual Property Law and Policy In the Knowledge-Based Economy* (7/11/02) 7, at <http://www.ftc.gov/opp/intellect/020711robertptaylor.pdf>.

¹⁴⁴ 450 U.S. 175 (1981).

or digital computer.”¹⁴⁵ The Court “view[ed] the patentees’] claims as nothing more than a process for molding rubber products and not as an attempt to patent a mathematical formula.”¹⁴⁶ The Court repeated the observation that patentable subject matter can “include anything under the sun that is made by man,”¹⁴⁷ and once again conveyed a broad sense of the potential scope of patents.

2. Antitrust Incorporates an Updated Economic Framework

During the 1970s, change was brewing in antitrust as well. Debates took place between those who focused primarily on market structure and market power, and those who, broadly speaking, saw more efficiencies than market power in the U.S. economy.¹⁴⁸ The new economic learning, associated with many of those who were called “Chicago School” economists and lawyers, brought an updated economic framework to antitrust that, among other things, emphasized the importance of seeking to understand the efficiencies, as

¹⁴⁵ *Id.* at 187. Once again, the decision was 5-4, with the dissent by Justice Stevens noting, among other things, that it was not at all clear that patent protection was essential for the growth of the software industry. *Id.* at 217. For discussion of the ongoing controversy about the role of patents in the computer industry, see *infra* Ch. 3(III), (IV).

¹⁴⁶ 450 U.S. at 191. The dissenting justices viewed the case as having greater implications for the patentability of computer programs generally and would have adopted a much narrower rule for when a program-related invention could constitute patentable subject matter. *Id.* at 219.

¹⁴⁷ *Id.* at 182.

¹⁴⁸ See generally Harold Demsetz, *Two Systems of Belief about Monopoly*, in *INDUSTRIAL CONCENTRATION: THE NEW LEARNING* 164-84 (Harvey J. Goldschmid et al. eds. 1974).

well as possible anticompetitive effects, associated with particular business conduct. Over time, the courts and agencies have largely adopted this updated economic framework.¹⁴⁹

New economic learning led to a more complex and pro-patent understanding of how antitrust should view conduct with respect to patents. In 1981, Antitrust Division Deputy Assistant Attorney General Abbott B. Lipsky, Jr., renounced the Nine No-Nos as “contain[ing] more error than accuracy,” and reviewed in some detail the possible efficiency justifications for each licensing practice that the Nine No-Nos previously had condemned automatically.¹⁵⁰ The then-Chief of the Intellectual Property Section of the Antitrust Division, Roger Andewelt described how patents can benefit competition:

The availability of exclusive patent rights increases the possible reward for R&D. It thereby results in the development of some inventions that otherwise would not have been discovered or developed at all or, at least, not nearly as early as they were. For such inventions it is illogical to talk in terms of the patent

¹⁴⁹ See generally William E. Kovacic & Carl Shapiro, *Antitrust Policy: A Century of Economic and Legal Thinking*, 14 J. ECON. PERSPECTIVES 43, 54-55 (2000). One of the first decisions to use the new learning was *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), which upheld a supplier’s restriction on the geographic area in which its distributor could sell. The Supreme Court found that consumers would benefit from a restriction on competition that prevented competitors from “free riding” on a firm’s promotional efforts. *Id.* at 54-55.

¹⁵⁰ Abbott B. Lipsky, Jr., *Current Antitrust Division Views on Patent Licensing Practices*, 50 ANTITRUST L.J. 515, 517-24 (1981).

grant conflicting with a competitive economic system. If there were no patent grant these inventions would not have reached the marketplace; therefore, the availability of a patent served only to benefit competition – to make additional or less expensive choices available to consumers.¹⁵¹

In 1985, Deputy Assistant Attorney General for Antitrust Charles F. Rule commented on prior failures of the courts and the Department of Justice “to recognize some fundamental facts about the nature of intellectual property and the beneficial role that technology licensing plays in a healthy, competitive economy.”¹⁵² The 1988 DOJ *Antitrust Enforcement Guidelines for International Operations* elaborated on these earlier policy statements with a section on intellectual property licensing arrangements that outlined consumer benefits from intellectual property licensing¹⁵³ and specifically adopted a rule of reason approach to intellectual property licensing issues, absent sham.

¹⁵¹ Roger B. Andewelt, Basic Principles to Apply at the Patent-Antitrust Interface, Remarks to the Houston Patent Law Association 4-5 (Dec. 3, 1981).

¹⁵² Charles F. Rule, Technology Licensing and the Second American Revolution: Storming the Ramparts of Antitrust and Misuse, Before the John Marshall Law School 5 (Feb. 22, 1985). Rule emphasized the role of patents in preventing free riding: “Unless the ‘free rider’ problem is somehow addressed, those who might otherwise undertake risky and expensive R&D will not do so. Fewer technologies will be developed and consumers will face higher prices and fewer choices.” *Id.* at 6. See also Charles F. Rule, The Antitrust Implications of International Licensing: After the Nine No-No’s, Remarks before the Legal Conference sponsored by the World Trade Association and the Cincinnati Patent Law Association (Oct. 21, 1986), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,131.3, 1981.

¹⁵³ 1988 International Guidelines at §§ 3.6, 3.61.

Thus, by the end of the 1980s, congressional and court-driven changes had significantly strengthened patents. Antitrust’s incorporation of updated economic thinking led to a generally more favorable view of how conduct with respect to patents influences competition. This incorporation of economics held the potential for both competition and patent policy to develop a greater integration and balance.

III. COMPETITION AND PATENT POLICY CONTINUE TO SEEK A PROPER BALANCE, AND GROWTH OF THE KNOWLEDGE-BASED ECONOMY ADDS NEW CHALLENGES

A. Antitrust and Patent Policy Have Worked to Achieve Better Balance

1. Antitrust Policy Has Continued to Implement New Economic Learning in Addressing the Intersection of Antitrust and Patents

Antitrust policymakers and enforcers continue to apply the new economic learning that gained precedence in the 1980s. In 1995, the Antitrust Division of the Department of Justice and the Federal Trade Commission jointly issued *Antitrust Guidelines for the Licensing of Intellectual Property (IP Guidelines)*. Like the 1988 Guidelines, the 1995 IP Guidelines identify and discuss potential efficiencies associated with many licensing practices and

emphasize that the vast majority of licensing practices are analyzed under the rule of reason.¹⁵⁴

The IP Guidelines “embody three general principles[.]”¹⁵⁵ The first is that “for the purpose of antitrust analysis, the Agencies regard intellectual property as being essentially comparable to any other form of property[.]”¹⁵⁶ Some have expressed concern that this statement may mean that antitrust sees no difference between intellectual property and other types of property.¹⁵⁷ The IP Guidelines themselves belie this characterization, explaining that:

[i]ntellectual property has important characteristics, such as ease of misappropriation, that distinguish it from many other forms of property. These characteristics can be taken into account by standard antitrust analysis, however, and do not require the application of fundamentally different principles. [footnote omitted]¹⁵⁸

¹⁵⁴ The 1995 IP Guidelines superceded the 1988 International Guidelines. The 1988 International Guidelines specified that “[b]ecause they hold significant procompetitive potential, unless the underlying transfer of technology is a sham, the Department analyzes restrictions in intellectual property licensing arrangements under a rule of reason [footnote omitted].” § 3.62. The 1995 Guidelines provide for a slightly greater possibility of *per se* treatment, see IP Guidelines § 3.4, but still make clear that the Agencies use the rule of reason “[i]n the vast majority of cases.” IP Guidelines § 3.4.

¹⁵⁵ IP Guidelines § 2.0.

¹⁵⁶ *Id.*

¹⁵⁷ See, e.g., Langenfeld 2/20 at 6-8.

¹⁵⁸ IP Guidelines § 2.1. See Tom 2/8 (Antitrust Session) at 50-52. The IP Guidelines further note that the power to exclude others from the use of intellectual

Second, “the Agencies do not presume that intellectual property creates market power in the antitrust context[.]”¹⁵⁹ This observation eliminates the automatic conflict between patents and antitrust that courts perceived by assuming that patents always create monopoly power in the hands of the patent holder. As noted earlier, patents may enable the holder to exercise market power,¹⁶⁰ but the Antitrust Agencies do not assume that is necessarily the case.

Third, “the Agencies recognize that intellectual property licensing allows firms to combine complementary factors of production and is generally procompetitive.”¹⁶¹ The IP Guidelines explicitly recognize the efficiencies that firms can gain through intellectual property licensing, which can “benefit[] consumers through the reduction of costs and the introduction of new products.”¹⁶² Further, the IP Guidelines note that, “[b]y potentially increasing the expected returns from intellectual property, licensing also can increase the incentive for its creation and thus promote greater investment in research and development.”¹⁶³ Similarly, the IP Guidelines note that “various forms of

property may vary substantially, and that “[t]he greater or lesser legal power of an owner to exclude others is also taken into account by standard antitrust analysis.” IP Guidelines § 2.1, n. 9.

¹⁵⁹ IP Guidelines § 2.0.

¹⁶⁰ See *supra* Ch. 1(I)(C)(1).

¹⁶¹ IP Guidelines § 2.1.

¹⁶² *Id.* § 2.3.

¹⁶³ *Id.*

exclusivity”¹⁶⁴ can give a licensee the incentive to invest in commercializing and distributing products that embody the intellectual property by “protecting the licensee against free-riding on the licensee’s investments by other licensees or by the licensor.”¹⁶⁵ Overall, the 1995 IP Guidelines, like the *1988 International Guidelines*, signal an approach that is far more positive toward patent licensing than earlier antitrust perspectives.

In the same vein, since 1997, the Antitrust Division of the Department of Justice has issued four Business Review Letters that analyze the antitrust issues raised by the proposed patent pools and discuss the features that reduce competitive concerns about those pools.¹⁶⁶ Each letter explicitly recognizes that patent pools can provide competitive benefits by promoting

the dissemination of technology.¹⁶⁷ In each case, based on the descriptions of the patent pools the parties provided, the Antitrust Division declined to initiate enforcement action.¹⁶⁸

The FTC challenged one patent pool; the allegations were resolved through a consent order that bars continuation of the pooling arrangement.¹⁶⁹ The FTC’s challenge elicited controversy, especially with regard to what the facts actually showed, but the FTC’s complaint provides a useful comparison to the types of arrangements reviewed by the Antitrust Division to reveal which types of patent pools are more likely to pose significant antitrust concerns.¹⁷⁰ Once again, the Antitrust Agencies have viewed patent pools that offer legitimate efficiencies far more favorably than in the past.

¹⁶⁴ The guidelines give as examples field-of-use and territorial restrictions. IP Guidelines § 2.3.

¹⁶⁵ *Id.*

¹⁶⁶ See Letter from Joel I. Klein, Acting Assistant Attorney General, Antitrust Division, Department of Justice, Letter to Garrard R. Beeney, Esq. (June 26, 1997), at <http://www.usdoj.gov/atr/public/busreview/1170.htm> (hereinafter MPEG Pool Letter); Letter from Joel I. Klein, Assistant Attorney General, Antitrust Division, Department of Justice, to Garrard R. Beeney, Esq. (Dec. 16, 1998), at <http://www.usdoj.gov/atr/public/busreview/2121.htm> (hereinafter Phillips DVD Pool Letter); Letter from Joel I. Klein, Assistant Attorney General, Department of Justice, to Carey R. Ramos, Esq., counsel to Hitachi, Ltd. (June 10, 1999), at <http://www.usdoj.gov/atr/public/busreview/2485.htm> (hereinafter Hitachi DVD Pool Letter); Letter from Charles A. James, Assistant Attorney General, Antitrust Division, Department of Justice, to Ky P. Ewing, Esq. (Nov. 12, 2002), at <http://www.usdoj.gov/atr/public/busreview/200455.htm>. See also James, *Opening Day Comments* at 2.

¹⁶⁷ See MPEG Pool Letter at 5; Phillips DVD Pool Letter at 5; Hitachi DVD Pool Letter at 5.

¹⁶⁸ See MPEG Pool Letter at 9-10; Phillips DVD Pool Letter at 9; Hitachi DVD Pool Letter at 10.

¹⁶⁹ See *In re Summit Tech., Inc. & VISX, Inc.*, No. 9286 (FTC Mar. 24, 1998) (complaint), available at <http://www.ftc.gov/os/1998/03/summit.cmp.htm> (Summit Complaint); *In re Summit Tech., Inc. & VISX, Inc.*, No. 9286 (FTC Aug. 21, 1998) (Agreement Containing Consent Order To Cease And Desist As To Summit Tech., Inc.), available at <http://www.ftc.gov/os/1998/08/d09286suagr.htm>; *In re Summit Tech., Inc. & VISX, Inc.*, No. 9286 (FTC Aug. 21, 1998) (Agreement Containing Consent Order To Cease And Desist As To VISX, Inc.), available at <http://www.ftc.gov/os/1998/08/d09286viagr.htm>.

¹⁷⁰ See Anthony, 28 AIPLA Q.J. at 18-19.

2. **Patent Policy Has Implemented Certain Reforms and Rules that Can Lessen Anticompetitive Conduct and Increase Competition**

a. ***Congress Enacted the American Inventors Protection Act of 1999 (AIPA)***

(i). **Disclosure of Most Patent Applications after Eighteen Months Can Reduce Opportunistic Hold Ups through Submarine Patents**

Over the years, companies have complained about problems caused by “submarine patents.” The basic scenario is that a patent applicant allows its application to languish in the PTO while watching another company make substantial investments in a technology or product that will infringe the yet-to-be-issued patent. Once the other company’s sunk costs are large, the patent applicant obtains the patent, asserts infringement, and “holds up” the other company, demanding supra-competitive royalties for a license to the “submarine patent.”¹⁷¹ The company must agree to supra-competitive royalties or forego its production or innovation. As a result, consumers will either pay higher prices for the company’s goods, or will never get the benefit of the innovation that the company had to abandon.¹⁷²

Partly in response to problems

¹⁷¹ See, e.g., Shapiro 11/6 at 15-16, 175-76; see also *infra* Ch. 2(B)(3)(b)(1) (discussing hold up in the context of patent thickets) and Second Report (forthcoming).

¹⁷² See *infra* at Ch. 2(B)(3)(b)(1) (discussing this scenario in more detail).

created by submarine patents, and partly to conform U.S. practice to international practice, the AIPA now requires publication of a patent application eighteen months after filing, unless the applicant certifies that the invention will not be the subject of any foreign or international application in jurisdictions that provide for eighteen-month publication.¹⁷³ The PTO reports that roughly 90 percent of all pending patent applications are published at eighteen months.¹⁷⁴ This new publication requirement can assist inventors and businesses to some extent in avoiding hold up and making more informed decisions about where (and where not) to spend R&D resources.¹⁷⁵ As several

¹⁷³ 35 U.S.C. § 122. See John Love 2/28 at 647 (18-month publication part of AIPA is response to problem of submarine patents); MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 62-63 (AIPA brings United States into conformity with many other countries that require publication of application eighteen months after filing).

¹⁷⁴ John Love 2/28 at 647.

¹⁷⁵ Gable 3/20 at 118-19 (describing how AIPA can “go a long way” to prevent plight of individual small inventors who “put a lot of money and a lot of effort into this process and two or three years down the line, typically, in the course of the prosecution of their own patent they found out another patent has issued that covers their invention and they’re barred from using it.”); John Love 2/28 at 647 (AIPA gives businesses “an idea of what patent applications are pending and . . . an indication of where the technology is going also.”); Ronald Myrick, *FTC/DOJ Hearings on IP and Antitrust: Testimony of Ronald Myrick* (3/19/02) 20 (eliminating the right to opt-out of application publication at eighteen months would “partially eliminate the potential for ‘surprise’ or ‘hold up’ about which some have expressed concern.”), at <http://www.ftc.gov/opp/intellect/020319ronmyrickpreparedtestimony.pdf>. But see Thomas 4/10 at 192-93 (asserting that the AIPA provides no benefit, because it requires only the publication of patent applications that already are published in Europe at the same time; may “save[] a translation fee on occasion”); Katsh 4/10 at 193 (noting that 18-month publication does not give notice of what additional claims will be sought in continuation practice; 18-month publication does not give complete notice and

panelists noted, patent disclosures may stimulate competition to design around a patent.¹⁷⁶

(ii). Patent Quality: Reexaminations of Questionable Patents

Patent prosecutions – that is, the administrative procedures through which a patent application becomes a patent – take place *ex parte*. At the PTO, only the patent applicant and the patent examiner(s) discuss the patent application; no third parties are involved in that discussion.¹⁷⁷ In 1980, Congress established an *ex parte* reexamination procedure¹⁷⁸ intended to “strengthen[] investor confidence in the certainty of patent rights by creating a system of administrative reexamination of doubtful patents.”¹⁷⁹ Congress hoped this reexamination procedure would allow an efficient resolution of questions of patent validity and thus would obviate to some extent the need for lengthy and costly patent litigation.¹⁸⁰ This *ex parte* reexamination procedure affords little opportunity for

participation by third parties, however;¹⁸¹ for the most part, it is conducted *ex parte* in the same manner as the initial patent examination. It has not become a substitute for patent litigation, and some argue that it has been used as frequently by patentees to strengthen their patents as by challengers to weed out invalid patents.¹⁸²

To afford a greater opportunity for third-party participation in the reexamination process, Congress enacted an *inter partes* reexamination system as part of the AIPA.¹⁸³ See also Box 1-5 (1992 Advisory Commission on Patent Law Reform). Due to certain limitations, however, third parties had used the procedure only four times since its enactment, as of the date of the Hearings.¹⁸⁴ In the fall of 2002, Congress revised the procedure in hopes that third parties would use it more frequently.¹⁸⁵ Some remain skeptical that the revisions were sufficient to encourage greater use of the procedure because one important disincentive to its use remains.¹⁸⁶ Nevertheless, the availability of

leaves uncertainty).

¹⁷⁶ See, e.g., Banner 10/30 at 70-71 (discussing design-around competition that disclosure of issued patents spurs); see generally *infra* at Ch. 3(III)(D)(1)(b) and Ch. 5(II)(C)(4) for discussion of limitations on the role of patent application disclosures at eighteen months and disclosures of issued patents in facilitating business planning and encouraging design-around competition.

¹⁷⁷ See *infra* Ch. 5(II)(B).

¹⁷⁸ 35 U.S.C. §§ 302-07.

¹⁷⁹ H.R. REP. NO. 96-1307, at 3, *reprinted in* 1980 U.S.C.C.A.N. 6460, 6462.

¹⁸⁰ H.R. REP. NO. 96-1307, at 3, *reprinted in* 1980 U.S.C.C.A.N. at 6463.

¹⁸¹ 35 U.S.C. §§ 304, 307 (if a third party has requested the reexamination, it has a right to reply to the patentee’s opening statement on the reexamination issue, but no right to participate beyond that).

¹⁸² See Mowery 2/27 at 408; Hall 2/28 at 760-61; Merrill 10/25 at 123; See MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 1210-11 (“the confirmation of a patent in reexamination is accorded a great deal of respect by courts, and hence a reexamination can bolster the ‘strength’ of a patent.”).

¹⁸³ 35 U.S.C. §§ 311-18.

¹⁸⁴ See Kunin 7/10 at 70.

¹⁸⁵ 35 U.S.C. § 315(b) (as amended Nov. 2, 2002).

¹⁸⁶ See *infra* Ch. 5(III)(A), (B)(1).

Box 1-5. THE ADVISORY COMMISSION ON PATENT LAW REFORM: A REPORT TO THE SECRETARY OF COMMERCE (1992)

In 1990, Secretary of Commerce Robert Mosbacher established an Advisory Commission regarding the state of the patent system and the need for any reform. In 1992, the Commission issued its report containing recommendations in three areas:

(1) Harmonization-Related Issues. The Commission recommended publication of all patent applications within 24 months from the earliest priority date claimed by the applicant, along with certain protections for patentees.

(2) Patent Enforcement-Related Issues. *Litigation*. The Commission recognized that “an essential relationship [exists] between the value of patent rights [] and the cost of patent litigation.” More specifically, the Commission sought “to ensure that transactional costs do not prejudice the rights of patentees or the rights of the public through the process of patent enforcement.” The Commission also noted that “[i]ncreased quality of examination will strengthen the presumption of validity, which in turn will decrease the number of unwarranted challenges to patent validity. This will also increase the confidence of the courts in applying the statutory presumption of validity.”

Alternatives to Litigation. The Commission advocated modifications to the reexamination system “to provide third parties with a greater opportunity to participate.” For example, it recommended that the basis and scope of reexamination include all aspects of 35 U.S.C. § 112 (i.e., written description, enablement, claim definiteness), except best mode.

(3) Unique Issues Facing the Patent System. This series of recommendations addressed issues ranging from the protection of computer-related inventions to PTO funding through user fees. Recommendations relevant to the FTC/DOJ Hearings are addressed elsewhere in this report.

inter partes reexamination adds a new mechanism through which to address competition concerns about the validity of patents associated with market power.¹⁸⁷

b. *The Federal Circuit Has Increased Business Certainty and Has Noted Competition Concerns in Certain Contexts*

Many panelists at the Hearings agreed that the Federal Circuit has increased consistency in the application of many aspects of patent law.¹⁸⁸ This trend has

¹⁸⁷ See also *infra* Ch. 5(III)(B), (C) for discussion of pros and cons of reexamination and post-grant opposition proceedings as means to address questionable patents.

¹⁸⁸ See, e.g., *Mossinghoff* 2/6 at 76-78 (adds certainty and consistency); *Myrick* 3/19 at 17 (credits Federal Circuit with uniformity and certainty of patent

important implications. Consistency in the application of the law can reduce the costs of business uncertainty and can facilitate business planning about how best to compete.

In addition, in different contexts, the Federal Circuit has interpreted the statute in ways that support the “notice function” of patents¹⁸⁹ – that is, the requirement that a

law); *Ambrecht* 3/19 at 54-55 (informal poll of members of Industrial Research Institute found general agreement that the Federal Circuit has brought greater stability and predictability to the patent process across industries); *Weil* 7/11 at 150-51 (Federal Circuit has brought consistency to many areas of patent law). *But see generally* Ch. 6(II)(C) (discussion of areas in which some argue that the Federal Circuit has increased uncertainty or other costs of the litigation process).

¹⁸⁹ See, e.g., *Athletic Alternatives, Inc. v. Prince Manufacturing, Inc.*, 73 F.3d 1573, 1581 (Fed. Cir. 1996) (“Where there is an equal choice between a broader and

patent's "specification shall conclude with one or more claims particularly pointing out and distinctly claiming the subject matter which the applicant regards as his invention."¹⁹⁰ The notice function serves an important purpose in the framework of competition: "The object of the patent law in requiring the patentee [to distinctly claim his invention] is not only to secure to him all to which he is entitled, but to apprise the public of what is still open to them."¹⁹¹ Accurate notice of the scope of a patent's claims can encourage competition in the area not covered by the patent. Although the Supreme Court in one context has found that the interest in ensuring appropriate incentives for innovation can override the notice function,¹⁹² the Federal Circuit's

narrower meaning of a claim, and there is an enabling disclosure that indicates that the applicant is at least entitled to a claim having the narrower meaning, we consider the notice function of the claim to be best served by adopting the narrower meaning.").

¹⁹⁰ 35 U.S.C. § 112.

¹⁹¹ *McClain v. Ortmyer*, 141 U.S. 419, 424 (1891) (emphasis added). See also *General Electric Co. v. Wabash Appliance Corp.*, 304 U.S. 364, 369 (1938) (primary purpose of notice is "to guard against unreasonable advantages to the patentee and disadvantages to others arising from uncertainty as to their [respective] rights.").

¹⁹² In *Festo v. Shoketsu Kinzoku Kogyo Kabushiki*, 535 U.S. 722 (2002), the Court reviewed a case involving the doctrine of equivalents, under which "[t]he scope of a patent is not limited to its literal terms but instead embraces all equivalents to the claims described." *Festo*, 535 U.S. at 732. In that case, the Court conceded that "the doctrine of equivalents renders the scope of patents less certain [and that it] may be difficult to determine what is, or is not, an equivalent to a particular element of an invention. If competitors cannot be certain about a patent's extent, they may be deterred from engaging in legitimate manufactures outside its limits, or they may invest by mistake in competing products that the patent secures. In addition the uncertainty may lead to wasteful litigation between competitors, suits that a rule of literalism might avoid." *Id.* The Court noted, however, that "[t]hese

general attentiveness to the role of notice in ensuring that competitors know what a patent does and does not protect serves to encourage and protect competition outside the scope of a valid patent.

c. ***The PTO Has Implemented Certain Reforms that Can Aid Competition***

(i). Utility Guidelines

A claimed invention must be "useful" to receive a patent. From time to time, some have raised concerns about whether patents have been granted for research "too close to the laboratory bench" – that is, basic research not yet "useful" enough to deserve a patent.¹⁹³ During the 1990s, some raised this concern with regard to biotech patents in particular.¹⁹⁴ The PTO responded by issuing and then revising a set of Utility Examination Guidelines,¹⁹⁵ which, ultimately, have been generally well-

concerns with the doctrine of equivalents . . . are not new. Each time the Court has considered the doctrine, it has acknowledged this uncertainty as the price of ensuring the appropriate incentives for innovation, and it has affirmed the doctrine over dissents that urged a more certain rule." *Id.* See also *Festo v. Shoketsu Kinzoku Kogyo Kabushiki*, No. 95-1066, 2003 U.S. App. LEXIS 19867 (Fed. Cir. Sept. 26, 2003).

¹⁹³ Thomas 2/8 (Patent Session) at 42.

¹⁹⁴ See, e.g., Arti K. Rai, *Regulating Scientific Research: Intellectual Property Rights and the Norms of Science*, 94 NW. U. L. REV. 77, 106-07, 138 (1999); Rebecca S. Eisenberg & Robert P. Merges, *Opinion Letter as to the Patentability of Certain Investigations Associated with the Identification of Partial cDNA Sequences*, 23 AIPLA Q. J. 1, 4-20 (1995).

¹⁹⁵ United States Patent and Trademark Office, *Utility Examination Guidelines*, 66 Fed. Reg. 1092 (2001), revising interim guidelines published at 64 Fed. Reg. 71440 (1999), which in turn superseded an earlier version, 60 Fed. Reg. 36263 (1995).

received.¹⁹⁶ Well-considered PTO guidelines can prevent invalid patents that capture basic ideas and research and thus thwart competition in emerging fields.¹⁹⁷

(ii). Business Methods Patent Initiatives

In *State Street Bank & Trust v. Signature Financial Group*,¹⁹⁸ the Federal Circuit ruled that business methods can be patented. This decision has generated a fair amount of controversy, as has the PTO's subsequent issuance of hundreds of business method patents.¹⁹⁹ From a competition standpoint, one could ask whether and, if so, when a business method should be patented; for example, a patented business method may stand in the way of Internet competition in some circumstances.²⁰⁰ In addition, it is often very difficult to locate and identify all relevant prior art with respect to a claimed business method invention, because much of the relevant prior art does not exist in the patent literature, the traditional source of relevant prior art.²⁰¹ Prior art is the primary way that patent examiners determine whether a claimed invention is nonobvious,

one of the requirements of the patent statute.

The PTO responded to concerns about the possible issuance of many questionable business method patents by undertaking the "Business Method Initiative."²⁰² The primary goals of this initiative were to identify sources of non-patent prior art and to create mandatory fields of search for examiners.²⁰³ In addition, the PTO adopted another level of review for business method patents; this level of review involves a "second pair of eyes" – that is, a more senior examiner or an examination panel takes a look at each business method patent application.²⁰⁴ Since the PTO introduced this program, the allowance rate for business method patents has decreased, and the PTO believes that this decreased allowance rate indicates improved PTO searches for prior art.²⁰⁵ Such PTO action can prevent the issuance of invalid patents that may contribute to market power and restrain competition in unwarranted ways.

¹⁹⁶ See *infra* Ch. 4(II)(D)(1).

¹⁹⁷ See generally Ch. 4(II)(D)(1) for further discussion of the PTO's Utility Guidelines.

¹⁹⁸ 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 525 U.S. 1093 (1999).

¹⁹⁹ See *infra* Ch. 4(II)(E).

²⁰⁰ See, e.g., Musacchia 4/9 at 24-25; Young 4/11 at 61, 63-64; Thomas 4/11 at 59-60; Richard C. Levin, *Testimony* (2/6/02) 2, at <http://www.ftc.gov/os/comments/intelpropertycomments/levinrichardc.htm>; Langenfeld 2/20 at 18; Kushan 4/11 at 114.

²⁰¹ See Thomas 4/11 at 111; see *infra* Ch. 4(II)(E)(2).

²⁰² John Love 2/27 at 467-68.

²⁰³ *Id.*

²⁰⁴ *Id.* at 470.

²⁰⁵ *Id.* at 470-71. See generally *infra* at Ch. 4(II)(E) for discussion of issues surrounding business method patents.

B. The Growth of the Knowledge-Based Economy Creates Ongoing Controversy and Challenges Competition and Patent Policy to Continue Seeking a Better Balance

As discussed above, both antitrust and the patent system have responded to the challenges posed by the knowledge-based economy and sought to improve the balance between competition and patent policy. Nonetheless, the Hearings revealed that much controversy remains about whether competition and patent policy have yet responded adequately to the knowledge-based economy or found a proper balance. The joint FTC/DOJ report (forthcoming) will address the issues related to the balance between antitrust law and policy and patents that were raised at the Hearings. This report discusses issues related to the balance between patent law and policy and competition that were raised at the Hearings.

The growth of the knowledge-based economy presents several challenges to the patent system. One is the sheer number of patents sought and received. As Under Secretary of Commerce for Intellectual Property and Director of the USPTO James Rogan stated at the outset of these Hearings, there is an “unprecedented explosion of patent applications” today.²⁰⁶ Other aspects of the knowledge-based economy also render the PTO’s mission more difficult. For example, pendency may assume particular importance in fast-moving technologies (such as software); prior art may be more difficult to locate for

²⁰⁶ Rogan (stmt) 3.

technologies that were previously unpatented or unpatentable (such as business methods); and increasingly complex technologies (such as biotechnology) must be evaluated.

Many panelists at the Hearings raised concerns that the patent system is not keeping up with these challenges. They asserted that dubious patents, and costly patent procedures and litigation to determine whether such patents are valid or infringing, are stifling competition unnecessarily. Panelists observed that issues of patent quality seem to arise more frequently than is desirable.²⁰⁷ In recent testimony before the House Judiciary Committee's Subcommittee on Courts, the Internet, and Intellectual Property, the AIPLA stated that “[l]arge and small companies are increasingly being subjected to litigation (or its threat) on the basis of questionable patents.”²⁰⁸ As noted earlier, invalid patents that confer market power unnecessarily thwart competition. *See also* Box 1-6 (blocking patents).

Panelists pointed out that a number of factors determine patent quality. Substantive standards of patent law determine whether the PTO and the courts evaluate the validity and scope of patents under proper standards. Procedures and presumptions at the PTO and in the courts

²⁰⁷ *See, e.g., infra* Chs. 3(II), (IV) and Ch. 5(I).

²⁰⁸ *United States Patent and Trademark Office Fee Modernization Act of 2003: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the House Comm. on the Judiciary*, 108th Cong. 2 (2003) (Statement of Michael K. Kirk, Executive Director, American Intellectual Property Law Association), available at <http://www.aipla.org/html/Legislative/108/testimony/FeeLog.htm>.

Box 1-6. Blocking Patents

The patents of others can block a patentee's ability to exploit its own invention without a license to the others' patents. Schechter and Thomas provide an example:

"[S]uppose that Admiral Motors obtains a patent on an internal combustion engine for use in automobiles. Later, Betty Beta purchases an automobile marketed by Admiral Motors that embodies the patented invention. Beta experiments with her new car and develops a dramatically improved fuel injector useable only in the patented Admiral Motors engine. Even if Beta patents her improved fuel injector, she cannot practice that technology without infringing Alpha's basic patent. . . . Unless one of the parties licenses the other, Beta must wait until Admiral Motors' patent expires before practicing her own patented improvement invention." SCHECHTER & THOMAS, *THE LAW OF COPYRIGHTS, PATENTS & TRADEMARKS* § 20.1.1 at 462.

If the alleged blocking patent is questionable, business costs, which ultimately may be passed on to consumers, can increase unjustifiably, with the owner of an improvement patent forced to choose between paying royalties on a questionable patent or engaging in expensive patent litigation. *See generally infra* Ch. 5(III).

further affect the ability to weed out unwarranted patents either before or after they are granted. Panelists raised several issues concerning patent quality and how it affects the proper balance between competition and patent policy. We identify a few.

1. Follow-On Innovation, Product Commercialization, and Patent Proliferation

The simplest economic model of the patent system assumes that innovation is a "one-time" event.²⁰⁹ Of course, in the real world, innovation is an ongoing process, with one invention frequently providing a building block for the next. The ongoing nature of innovation poses difficult questions about how best to preserve adequate incentives for an initial innovator and maintain adequate incentives for competition to become the next innovator. These questions implicate substantive standards for determining the proper breadth

²⁰⁹ *See generally infra* Ch. 2(I).

of patent claims.

The real world adds other complexities as well. In a simple economic model of innovation and patents, each invention requires access to only one or a few patents to commercialize the patented product. Certain industries, such as pharmaceuticals, have tended to follow this model.²¹⁰ Some suggest, however, that more and more industries are moving toward the model in which, for commercialization, a product requires access to many patents – dozens, hundreds, or even thousands.²¹¹ Reports indicate that this phenomenon can increase transactions costs substantially and lead to additional problems such as royalty

²¹⁰ *See, e.g.*, Browder 3/19 at 174; Gregory J. Glover, *Competition in the Pharmaceutical Marketplace* (3/19/02) 8, at <http://www.ftc.gov/opp/intellect/020319gregoryjglover.pdf>.

²¹¹ *See, e.g.*, R. Levin 2/6 at 98-99; Cohen 2/20 at 29.

stacking and patent thickets.²¹² These issues have implications for both patent and competition policy. *See also* Box 1-7 (difficulties in claim drafting and interpretation).

2. Procedures that Third Parties Can Use to Challenge Questionable Patents

Procedures that third parties can use to challenge questionable patents may be insufficient.²¹³ Third parties rarely use *inter partes* reexamination procedures;²¹⁴ moreover, participants in the patent system generally view patent litigation as too costly and time consuming. Substantial concerns about patent quality, however, have led to calls for improving existing or developing new procedures through which third parties can challenge questionable patents. These issues, including their relationship to

²¹² Royalty stacking describes the phenomenon whereby disparate owners of complementary technologies demand higher aggregate royalties than they would if they acted as a group. *See infra* Ch. 2(III)(C)(3). A patent thicket is a “dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology.” Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting*, in 1 *INNOVATION POLICY AND THE ECONOMY* 119, 120 (Adam Jaffe et al. eds., 2001). *See infra* Ch. 2(III)(C) (describing economics of patent thickets); *see generally* Ch. 3(II)(D)(4) (describing instances of royalty stacking and patent thickets).

²¹³ *See generally infra* Ch. 5(I), (III).

²¹⁴ *See generally infra* Ch. 5(III).

competition policy, are discussed in depth in this report.²¹⁵

Box 1-7. Complexities Added by the Difficulty of Drafting and Interpreting Claims

When a firm determines whether it needs access to one or more patents held by others, it evaluates its planned business activities in relation to the rights established in others’ patents. Each patentee’s exclusive rights are based upon the invention, as recited in the claims of the patent. Each claim consists of one sentence that verbally portrays a method, product or process; a patent may contain one or many claims. Sometimes, a patent may contain claims that overlap other claims in that patent, or that overlap claims in other patents.

The inquiring firm reviews the claims set forth in patents it believes it might infringe without a license. A firm’s activities may infringe only one, many, or all of the claims of the patent. In some cases, a review of the claims in others’ patents may yield uncertain answers. Although drafting claims sounds straightforward, experience has shown that it is often a very difficult task. As a corollary, issues can arise with some frequency regarding how claims should be interpreted. *See generally* SCHECTER & THOMAS, *THE LAW OF COPYRIGHTS, PATENTS & TRADEMARKS* § § 18.2 and 20.2 at 404-20, 474-75. Claim interpretation issues can add to the complexity that firms may confront in determining whether their planned activities would infringe absent licenses to use others’ patents.

3. Patent Prosecutions and Examinations within the PTO

A variety of pressures that arise from the nature of recent technological change and innovation confront the PTO. Sometimes these pressures may conflict; for example, pressure to reduce the pendency of patent applications may conflict with pressure to provide additional time for examinations of particularly complex patent applications. Indeed, patent applicants in different industries may take different views

²¹⁵ *See generally infra* Ch. 5(I), (III).

of which of these issues is most important.²¹⁶

Increasing Complexity and Limited Time for Patent Examiners. Throughout the Hearings, panelists lamented the PTO's inability to provide examiners with sufficient time to undertake their review.²¹⁷ The increasing complexity of patents compounds this challenge. One panelist noted, for example, that typically new examiners have 25 hours, and more experienced examiners have 20 hours, to examine a biotechnology patent. He felt these time constraints were "clearly inadequate given the complexity and difficulty of biotechnology patents. . . ."²¹⁸ This panelist recommended not only that the PTO double the time allocated for such patent examinations, but also that the PTO provide examiners with more training.²¹⁹ Expertise comes not only from education but also from experience.²²⁰

²¹⁶ See generally *infra* Ch. 3(III)(D)(2), (V)(B) (compare biotech representatives expressing views that more thorough examinations are more important than reducing pendency times with software representatives expressing concern that patents emerge only after they no longer have any commercial value).

²¹⁷ See, e.g., Dickinson 2/6 at 64; Gable 3/20 at 121.

²¹⁸ Kirschner 2/26 at 243.

²¹⁹ Kirschner 2/26 at 244.

²²⁰ The PTO has sometimes suffered from a "crippling attrition rate," due to more experienced examiners going to higher paying private sector jobs; more recently, the attrition rate at the PTO has been falling. See *Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary*, 107th Cong. 2 (2002) (Statement of James E. Rogan, Under Secretary of Commerce for Intellectual Property and Director, United States Patent and Trademark Office), available at <http://www.uspto.gov/web/offices/com/speeches/househrg2002.htm>. See also Robert P. Merges, *As Many as Six*

Opportunities to Broaden Claims.

Some believe that an opaque process for patent prosecution at the PTO can allow firms unfairly to disadvantage their competitors. For instance, some assert that applicants can anticompetitively game patent continuations to capture subject matter already developed by a competitor.²²¹ This raises significant issues for both patent and competition policy.

Patent Pendency. Faster technology evolution and shorter product life cycles have increased the pressure on the PTO to reduce pendency times.²²² As the U.S. House of Representatives Committee on Science/Subcommittee on Technology recognized: "In a growing number of industries - such as computer hardware and software . . . - the pace of advancement has begun to challenge the ability of the patent office to process applications in a time frame that is functionally useful to the inventor."²²³ In fast moving fields, such as electronics,

Impossible Patents Before Breakfast: Property Rights for Business Concepts and Patent System Reform, 14 BERKELEY TECH. L.J. 577, 607-8 (1999). See also Gable 3/20 at 121 ("There is a very significantly high turnover in the examiners particularly . . . in the biotech area as well as the software, method of doing business area.")

²²¹ See generally *infra* Ch. 4(II)(C)(1).

²²² Cf. FTC Staff Report, *Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace*, Ch. 6 at 15 (May 1996) ("Competition to be first on the market has resulted in shortening product life cycles, at least in high-tech industries."), available at http://www.ftc.gov/opp/global/report/gc_v1.pdf.

²²³ *The Patent System and Modern Technology Needs: Meeting the Challenges of the 21st Century, Hearing Charter Before the Subcomm. on Technology of the House Comm. on Science*, 104th Cong. (1996), available at <http://www.house.gov/science/patchrt.htm>.

semiconductor, and telecommunications, patents granted years after filing may be of “little value.”²²⁴

4. Patent Quality and Patentable Subject Matter

Many at the Hearings noted the continuing expansion of what can constitute patentable subject matter.²²⁵ The transition of subject matter from a status of “generally open to free competition” to a status in which an inventor may obtain a patent on it can raise questions for competition policy.²²⁶ In addition, panelists explained that the expansion of patentable subject matter can cause difficult transition periods for patent policy. The courts and the PTO must determine how best to apply existing patent doctrines to the newly patentable subject matter.

²²⁴ Michael Kirk, *AIPLA/FICPI Colloquium on Pendency Reduction* 9-10 (2001), at <http://www.aipla.org/html/ficpi/2001/ficpi1119.pdf>. Though not addressing the pendency issue explicitly, one panelist discussed the consequences of increasing technological change and the value of intellectual property protection as a practical matter. Burk 3/20 at 141 (If a product has a “very, very short life,” then “some intellectual property protections, as they now exist, just are not terribly helpful in your business plan.” Instead, such companies sell the product “for six months until our competitors copy it” and then sell something else.).

²²⁵ See generally *infra* Ch. 4(II)(E)(3).

²²⁶ See generally *infra* Ch. 4(II)(E) (discussion of business method patents).

IV. THE HEARINGS EXAMINED THE CURRENT BALANCE OF COMPETITION AND PATENT LAW AND POLICY IN FOSTERING INNOVATION

As noted earlier, the growth of the knowledge-based economy means that increasingly complex questions confront antitrust enforcers, and increasingly numerous and challenging patent applications and patent issues confront the patent system. Some claim that these challenges have led to problems in the patent system that cause unnecessary harm to competition and may even require antitrust solutions. Others assert that these challenges have confounded antitrust and require even greater deference to patents. The FTC and the Antitrust Division of the Department of Justice convened these Hearings to learn more about these and other questions.

A. The Hearings Did Not Address Certain Fundamental Questions or Issues with International Ramifications

The Hearings did not address certain fundamental questions. For example, the Hearings did not ask whether there should be a patent system. Some panelists noted a correlation between a strengthened patent system during the 1980s and subsequent robust performance of the U.S. economy; they suggested a causal link between those

events.²²⁷ Regardless of whether and to what extent such a link exists, there is no gainsaying the innovation that businesses report that the patent system has spurred.²²⁸

The Hearings also did not ask whether the duration of a patent is optimal; Congress and international organizations have recently spoken on the legal length of patents.²²⁹ Similarly, the Hearings did not address various questions – such as whether to use a first-to-file or first-to-invent standard – that are in discussion among the United States and other countries in international fora.²³⁰

B. The Hearings Examined the Appropriate Balance of Competition and Patent Law and Policy from a Competition and Economic Perspective

The Hearings addressed questions about the appropriate balance of competition, antitrust, and patent law and

policy. The joint FTC/DOJ report will address the appropriate balance of antitrust law and policy with patents. This report applies a competition and economic perspective to identify the following policy goals for a proper balancing of patent law and policy with competition concerns.

1. The Legal System Should Provide Efficient Incentives for All Types of Innovation, Including Both Single-Stage and Follow-On Innovation

Single-stage Innovation. Efficient incentives for innovation begin with assuring adequate appropriability for single-stage innovation. By conferring a right to exclude, the patent system can enhance appropriability and increase incentives to innovate.²³¹ Patents also may be important bases for attracting financial support, particularly for small, new firms without tangible assets and reliable cash flow.²³² Patents can thereby facilitate entry and innovation.²³³ The relative importance of patents for appropriability, however, varies

²²⁷ See, e.g., Newman 2/6 at 40-41, 49; see also Pate, Antitrust and Intellectual Property at 16.

²²⁸ See generally *infra* Ch. 3.

²²⁹ To comply with the Agreement on Trade-Related Aspects of Intellectual Property Rights (the TRIPS Agreement), the United States in 1995 enacted the Uruguay Round Agreement Act, providing, among other things, a patent term of twenty years from the patent application's filing date. See 35 U.S.C. § 154(a)(2); see also SCHECHTER AND THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS § 13.3.3 at 288.

²³⁰ See, e.g., Adam I. Hasson, *Domestic Implementation of International Obligations: The Quest for World Patent Law Harmonization*, 25 B.C. INT'L & COMP. L. REV. 373 (2002).

²³¹ See, e.g., Thomas 2/8 (Patent Session) at 13-15; Langenfeld 2/20 at 7-8; Stoner 2/26 at 108; Taylor 2/27 at 489-90; Duffy 7/10 at 107; Chambers 10/25 at 30; ABA (Economics stmt) 17-18; Intellectual Property Owners Association, *Comments on the Joint Hearings of the Federal Trade Commission and the Department of Justice Regarding Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (Public Comment) 4, at http://www.ftc.gov/os/comments/intelpropertycomments/ip_o.pdf (hereinafter IPO (stmt)).

²³² See, e.g., Merges 2/28 at 577-78; Scherer 7/10 at 53; Hoerner 7/11 at 54; Barton 2/26 at 212.

²³³ See, e.g., Lerner 2/20 at 186; Hall 2/26 at 179, 183, 191; Ziedonis 3/20 at 17-18, 87-88.

from industry to industry.²³⁴

Follow-on Innovation. Innovation often is a cumulative process, with each stage building on its predecessors. To the extent that follow-on innovation flows from sources independent of the initial innovator, it is vital that efficient incentives to innovate exist for the original and for follow-on innovators.²³⁵

2. Safeguard the Patent System's Disclosure Function

In exchange for receiving a patent, a patentee must disclose the nature of the invention; disclosure is the basic *quid pro quo* of the system.²³⁶ Disclosure can provide the public with knowledge that otherwise might have been kept a trade secret.²³⁷ The public may apply that knowledge in non-

²³⁴ See *infra* Ch. 2(II)(A)(2). Testimony indicated that patents are likely to have greatest significance as appropriability mechanisms when R&D costs are high relative to the size of the market, and imitation is quick and easy. See *id.*

²³⁵ See Scotchmer 2/26 at 128-29. See generally *infra* Ch. 2(III) for a discussion of different theories about how best to address this issue. *Design-around innovation.* Some stress that the patent system directs R&D away from imitative and toward innovative efforts by forcing competitors to design around patents. Others respond that design-around may be technically impossible or economically impractical and may entail costly efforts essentially to duplicate the patentee's invention. See *infra* Ch. 2(III)(B)(1) for a discussion of design-around innovation.

²³⁶ See, e.g., Rogan 2/6 at 21; Cohen 2/20 at 35; Myrick 3/19 at 18. See generally Stoner 2/26 at 109-10. Indeed, some viewed disclosure as the system's central feature. See Myrick 10/30 at 25 (describing focus on disclosure as "really what the patent system is all about").

²³⁷ But see *infra* Ch. 3 (Hearings record mixed on whether businesses use patents when they can keep inventions as trade secrets instead).

infringing uses, and, after the patent expires, the invention becomes part of the public domain:

3. The Patent System Should Avoid Creating or Upholding Unwarranted Patents that Confer Market Power

"We should be wary of creating unwarranted market power by granting unwarranted patents."²³⁸ Unwarranted market power can produce supracompetitive pricing, deter competition to spur innovation, and cause other harms to consumers.²³⁹ From a patent perspective, an unwarranted patent is one that does not meet the statutory standards for patentability. From an economic perspective, however, unwarranted market power can arise from unwarranted patents – that is, patents for inventions that would have emerged in roughly the same time frame, and for which disclosure and commercial development would have occurred, even without the prospect of a patent.²⁴⁰

²³⁸ R. Levin 2/6 at 102. Recognition of potential market power effects was a theme echoed by many other participants. See, e.g., ABA (Economics stmt) 11 (describing the exercise of market power as a possible cost of patent protection); Langenfeld 2/20 at 10-13; Stoner 2/26 at 108-09; Hall 2/26 at 181, 184; Farrell 2/28 at 596; Katsh 4/10 at 25-26; Gambrell 10/25 at 38-39.

²³⁹ See, e.g., *infra* Ch. 2(I)(B).

²⁴⁰ As noted earlier, many view this perspective – that patents should be granted only if the invention would not have emerged "but for" the patent system – as the "defining proposition" for standards of patentability. See Merges 2/28 at 579. Most concede, however, that the "but for" standard cannot practically be applied in individual cases. See generally *infra* Ch. 4(II)(A).

4. The Patent System Should Rely on Substantive Standards and Procedures that Minimize the Sum of Error and Process Costs and the Detrimental Effects of Uncertainty

All legal regimes should consider the extent to which they are subject to error – that is, false negatives and false positives.²⁴¹ In the antitrust context, this translates into under-enforcement (failing to challenge anticompetitive conduct) versus over-enforcement (erroneously condemning efficient, welfare-enhancing conduct).²⁴² In the patent context, this translates into denying a patent that should have been granted versus granting an unwarranted patent.²⁴³ Legal systems also should consider the extent to which they create or minimize costs or business uncertainty through the use of specific procedures and presumptions.²⁴⁴ Among other problems, uncertainty can thwart effective business planning and increase costs of capital for

²⁴¹ See generally Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

²⁴² See, e.g., CHARLES J. GOETZ & FRED S. MCCHESENEY, *ANTITRUST LAW: INTERPRETATION AND IMPLEMENTATION* 67-69 (2nd ed. 2002) (discussing approach of antitrust law to Type I (false positive) and Type II (false negative) error); Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 15-16 (1984).

²⁴³ See Erik S. Maurer, *An Economic Justification for a Broad Interpretation of Patentable Subject Matter*, 95 NW. U. L. REV. 1057, 1094-96 (2001) (arguing that analysis of Type I and Type II errors supports broader scope for patentable subject matter).

²⁴⁴ See generally Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

business investments.²⁴⁵ Trade-offs may be necessary among the accuracy, transparency, and manageability of substantive standards²⁴⁶ and the error rates and process and uncertainty costs of different approaches toward quality control.²⁴⁷ The goal is to minimize the sum of error and process costs and the detrimental effects of uncertainty.

C. Organization of the Report

We begin with what economics can teach us about the relationship of competition and patent policy to innovation and then review business testimony about specific industries. We next examine patent approaches that may ameliorate perceived

²⁴⁵ See, e.g., Teece 2/26 at 202-04 (“the greater the ambiguity around intellectual property rights the less likely that the market will be able to work”); Friedman 2/27 at 411-12 (patent uncertainties undermine R&D planning, add to risks, and frustrate innovation incentives); Quillen 3/19 at 29 (patent uncertainty raises innovation capital costs); IPO (stmt) 3 (uncertainty adds costs and impairs business planning).

²⁴⁶ See, e.g., Dreyfuss 7/10 at 142-43; Pooley 10/30 at 55-57; see generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557 (1992).

²⁴⁷ See, e.g., Taylor 10/25 at 51-52; F. Scott Kieff, *Summary of Proposed Testimony* (Public Comment), at <http://www.ftc.gov/os/comments/intelpropertycomments/harvardlaw.pdf>; see generally Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEG. STUDIES 399 (1973). Issues could include whether a patent challenger should need “clear and convincing evidence” to rebut a patent’s presumption of validity (the presumption of validity can save process costs, but may erroneously protect invalid patents) or whether cases should be decided by only one specialized court or by numerous regional courts of appeal (use of one specialized court may save process costs and may contribute to stability in the law, but may lead to more errors in the development of the case law, which has not had the benefit of as many different perspectives on and insights into the issues at hand).

problems. We conclude with a discussion of recommendations for antitrust and patent institutions.

patent terms (App. C), and a list of selected federal statutes (App. D).

The following chapters discuss these issues:

- Chapter 2: What can we learn from theoretical and empirical economics about the general relationship between competition policy, patents, and innovation?
- Chapter 3: What can we learn from the examination of individual industries about areas in which the balance between competition and patents seems to be working well or, conversely, might be off-kilter?
- Chapter 4: What suggestions for substantive patent law reform might address problematic issues raised at the Hearings?
- Chapter 5: What suggestions for procedural patent law reform might address problematic issues raised at the Hearings?
- Chapter 6: What suggestions might facilitate greater interaction between antitrust and patent institutions about the issues discussed in this report?

In four appendices, we also provide a list of contributors to the Hearings (App. A), a list of public comments (App. B), a glossary of

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CHAPTER 2

THE ROLE OF COMPETITION AND THE PATENT SYSTEM IN SPURRING INNOVATION

Introduction. Competition and patent policy play complementary roles in enhancing economic welfare over time.¹ This chapter explores the economic learning – based on economic theory and empirical economic evidence – about the effects that patent policy and competition can have on innovation and economic welfare.²

Patents and Stand-Alone Innovation. It is easy to see how patent awards affect *stand-alone* innovations, and the discussion below begins with that clear case.³ The

award of patent rights can spur stand-alone innovations by limiting free riding, facilitating commercialization of innovations, and encouraging disclosure of new ideas.⁴ Pharmaceutical companies, for example, rely on patents to prevent free riding, recoup their R&D investments, and learn about new technological breakthroughs, according to many panelists.⁵ Biotechnology start-ups rely on their ability to patent their innovations to attract investment and continue innovating, some panelists stated.⁶

Awarding patent rights, however, is not costless. An innovator whose patent confers market power can raise prices or depress output⁷ (and, as developed below, broad initial patent rights can sometimes interfere with follow-on innovation⁸). These effects may be the price of progress, if the promise of a patent grant is necessary to elicit an invention, its disclosure, or investment in it. If invention, disclosure, or investment would have occurred even without the promise of a patent award, however, these costs hurt consumers

¹ See *supra* Ch. 1(I)(B). See also JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 390-92, 400 (1988) (discussing different incentives for innovation).

² The scope of the inquiry here is limited and omits some of the complexities of different types of innovation and regulation. For example, the discussion does not distinguish between “process” and “product” innovation. (The former term refers to changing the production process to reduce the costs of making a product, and the latter involves improving the quality of the product itself. See, e.g., American Bar Association Section of Antitrust Law, *The Economics of Innovation: A Survey* (Public Comment) 4 (reporting that more than three-fourths of R&D expenditure in the United States is on product innovation), at <http://www.ftc.gov/opp/intellect/0207salabasrvy.pdf> (hereinafter ABA (Economics stmt)). Similarly, this discussion does not elaborate upon the important point that – in addition to granting intellectual property rights – the U.S. government takes other steps to increase innovation. See *supra* Ch. 1. Nor does this chapter discuss the optimal length of patent protection. See, e.g., ABA (Economics stmt) 14-15 (summarizing literature on the optimal patent length). (The current patent term of twenty years from the filing of the patent application, see *supra* Ch. 1(I)(A)(2), derives from statutorily implemented international obligations.)

³ See *infra* Ch. 2(I) (discussing patents’ effects on stand-alone innovation). Patent policies can also affect follow-on innovation, to be sure. For ease of exposition, however, this chapter focuses first on the simpler case of stand-alone innovation. For a discussion of other effects that patent policies have on follow-on innovations, see

infra Ch. 2(III).

⁴ See *infra* Ch. 2(I)(A) (discussing how patents can spur stand-alone innovation).

⁵ See *infra* Ch. 3(II)(C). More information about this and other real-world illustrations of the economic phenomena described in this chapter follow, in Chapter 3.

⁶ See *infra* Ch. 3(III)(D).

⁷ See *infra* Ch. 2(I)(B) (discussing costs of patents).

⁸ See *infra* Ch. 2(III) (discussing patents’ effects on follow-on innovation).

unjustifiedly.⁹

Competition and Initial and Follow-On Innovation. Like patent policy, competition also affects innovation. On the one hand, competition can spur innovation in a wide variety of ways. As an initial matter, competition to win a patent right may drive a race to innovate. Indeed, firms competing to innovate may approach research problems differently, increasing the chances of successful innovation. Moreover, in some circumstances, an innovator may reap the benefits of its work simply by exploiting its head start on its competitors. For example, empirical studies have demonstrated that in the semiconductor and communications equipment industries, patents are less important than other means of exploiting innovation, means such as maintaining secrecy, taking advantage of lead time, investing in complementary manufacturing processes, and offering complementary sales and services.¹⁰ This chapter explores these and other ways in which competition can drive innovation.¹¹

On the other hand, competition alone is not a perfect engine of innovation. As noted above, competition, standing alone, does little to limit free riding on others' innovations,¹² and competition-driven

⁹ See *infra* Ch. 2(I)(B) (discussing costs and limits of patents' power to spur stand-alone innovation); Ch. 2(III) (discussing patents' effects on follow-on innovation).

¹⁰ See *infra* Ch. 2(II)(A)(2) (discussing these studies).

¹¹ See *infra* Ch. 2(II)(A) (discussing competition's power to spur innovation).

¹² See *infra* Ch. 2(II)(B)(1) (discussing appropriability problems).

innovation races can generate duplicative research, which some deem wasteful.¹³

Patents and Follow-On Innovation. The analysis concludes with a discussion of the effects of patent grants on *follow-on* innovation.¹⁴ Admittedly, the categories of initial and follow-on innovation are hardly hermetically sealed. The progression of innovation is often continuous. Today's follow-on innovation often becomes the foundation for a future advance.¹⁵ In keeping with much of the scholarly analysis and for ease of exposition, however, this chapter analyzes initial and follow-on innovation separately and discusses the various issues in the context in which they have the greatest significance.

Some at the Hearings argued that broad initial patent grants facilitate follow-on innovation by allowing the *patentee* to organize research flowing from its innovation.¹⁶ By contrast, others contended that broad initial patent rights can sometimes impede follow-on innovation that would otherwise emerge from entities *independent of* the patentee. A patentee's refusal to license an initial patent on technology needed for follow-on research can hinder

¹³ See *infra* Ch. 2(II)(B)(2) (discussing costs of duplication of efforts).

¹⁴ See *infra* Ch. 2(III) (analyzing patents' effects on follow-on innovation).

¹⁵ See, e.g., *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy*, Suzanne Andersen Scotchmer *Testimony Feb. 26, 2002*, at page 170 (hereinafter, citations to transcripts of these Hearings state the speaker's last name, the date of testimony, and relevant page(s)).

¹⁶ See *infra* Ch. 2(III)(A)(1) (discussing follow-on innovation organized by the initial innovator).

follow-on innovation, according to some. Others, however, stressed the potential benefits of design-around activities and the availability of licenses.¹⁷ For example, the fact that the ulcer-treating drug Tagamet was patented forced others to design around it, leading to the development of another successful product, Zantac, according to some Hearing testimony.¹⁸

Some panelists expressed concern that researchers who require access not just to a single patent but to *multiple* patents may find their work impeded by high transaction costs,¹⁹ royalty stacking,²⁰ hold up in patent thickets,²¹ and oligopolists seeking to bar new entry.²² Panelists made clear that these are not merely hypothetical concerns. For example, some panelists noted that the plethora of patents in the computer hardware industry makes it “virtually impossible to search all potentially relevant patents, review the claims,” and evaluate the infringement risk;²³ and panelists from the software industry complained of the risk of

¹⁷ See *infra* Ch. 2(III)(B)(1) (discussing design-around innovation); Ch. 2(III)(B)(3) (discussing licenses).

¹⁸ See *infra id.* (discussing examples of design-around innovation).

¹⁹ See *infra* Ch. 2(III)(C)(1) (discussing transaction costs).

²⁰ See *infra* Ch. 2(III)(C)(3) (discussing royalty stacking and the Cournot complements problem).

²¹ See *infra* Ch. 2(III)(C)(2) (discussing hold up in the patent thicket).

²² See *infra* Ch. 2(III)(C)(4) (discussing oligopoly and group boycotts).

²³ Robert Barr, *Statement* (2/28/02) I, at <http://www.ftc.gov/opp/intellect/barrrobert.doc> (hereinafter Barr (stnt)).

hold up, noting that the owner of any one of the multitude of patented technologies constituting a software program can hold up production of innovative new software.²⁴

In short, panelists noted that both competition and patent grants can spur innovation, but both can have adverse effects on innovation as well. This chapter aims to outline the costs and benefits of each approach to enhancing economic welfare.

I. PATENTS' EFFECTS ON STAND-ALONE INNOVATION

A. Patents Can Spur Stand-Alone Innovation

As noted in Chapter 1, intellectual property is particularly susceptible to misappropriation, also known as “free riding.” Patents can limit free riding and also facilitate commercialization of the intellectual property the patent protects. This chapter addresses each of these scenarios below. It also explores how patent policy encourages disclosure, and how that disclosure can stimulate further innovation.²⁵

²⁴ See *infra* Ch. 3(V)(E).

²⁵ Patents, like other property rights, can also serve as an underpinning of competition and thereby spur innovation. For example, firms may use patent rights, like other property rights, to compete with each other on innovation. *Cf.* U.S. Department of Justice and Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property § 1.0 (Apr. 6, 1995), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,132 (“The intellectual property laws provide incentives for innovation and its dissemination and commercialization by establishing enforceable property rights for the creators of new and useful products [and of] more efficient processes.”), *available at* <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm>.

1. Internalize Externalities and Protect Against Free Riding

Economists recognize that without patent protection, “innovators [that produce intellectual property] cannot appropriate the full benefits of their innovation; some of the benefits go to ‘free riders’ without payment.”²⁶ If innovators know that they cannot exclude imitators and appropriate the fruits of their R&D efforts, then they may lack sufficient incentives to undertake the innovation in the first place.²⁷ The problem is especially acute when the original innovator’s efforts entail substantial fixed costs, and the imitators can copy the innovation cheaply.²⁸ Patent rights mitigate this problem by granting exclusive rights in

²⁶ ABA (Economics stmt) 10-12 (discussing “invention motivation” rationale for patent protection); *see also* Stoner 2/26 at 108. Even with a patent, patent holders may be unable to appropriate the full benefits of their innovation because patent protection is limited. For instance, others can learn of the invention and make use of the knowledge as long as they do not infringe the patent claims.

²⁷ *See, e.g.*, Alstadt 3/19 at 39 (noting that his client will not pursue concept for new alloy unless patent protection is available). Langenfeld 2/20 at 8 (“[i]f you have an idea and you can’t protect it adequately, other people will steal it and use it and that, obviously, deters your incentive to develop those ideas yourself.”); Duffy 7/10 at 107 (discussing inventors’ disincentives to innovate absent assurances that they can recover R&D costs); Chambers 10/25 at 30 (noting that his clients have foregone pursuing “areas or . . . products” because of lack of assurance that “they were going to have a clear ownership right”).

²⁸ *See, e.g.*, Scherer 7/10 at 52 (stating that patents are most likely to be important when R&D costs are “high relative to the size of the potential market but imitation can be quick and easy, that is, with imitator R&D costs much lower than those incurred by the innovator”); Taylor 2/27 at 489-90 (patent system is “absolutely essential” for industries in which firms must expend “high front-end costs” and in which “their products are easily copied and attract[] free riders”).

innovations, enhancing appropriability.²⁹ Economic theory suggests that by conferring such rights to exclude, the patent system increases incentives to innovate.³⁰

²⁹ ABA (Economics stmt) 10-12 (discussing “invention motivation” rationale for patent protection); *see also* Stoner 2/26 at 108-09; Thomas 2/8 (Patent Session) at 15, Intellectual Property Owners Association, *Comments on the Joint Hearings of the Federal Trade Commission and the Department of Justice Regarding Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (Public Comment) 4, at http://www.ftc.gov/os/comments/intelpropertycomments/ip_o.pdf.

Panelists discussed the degree to which such protection from free riding helps entrants. *Compare* Greenstein 2/20 at 143-47 (discussing entrant’s ability to use patent to prevent imitation by incumbent); Hall 2/26 at 179, 183, 191 (patents may facilitate entry by helping with securing financing and by allowing firm to exploit its innovation), Hall 2/26 at 190-91 (patents facilitate vertical disintegration and entry by firms with only intangible assets); Arora 2/25 at 72 (patents permit small firms to compete in R&D without having extensive downstream assets); Merges 2/28 at 578 (in the raising of capital, the marginal importance of patent grows as size of business declines); Nydegger 2/27 at 525-26 (smaller firms acquire patents to protect innovative technologies and “hopefully put them on a somewhat level playing field with larger competitors”); Scherer 7/10 at 53 (patents important to small, new firms without reliable internal cash flow); Taylor 2/27 at 490 (reward essential to attract capital); Hoerner 7/11 at 54 (patents particularly important for start-ups needing financing) *with* Cohen 10/30 at 78 (with imperfect capital markets for investment in legal resources, small firms and entrants may have less ability to enforce their patents); Barton 2/26 at 213 (small firms often cannot afford to litigate). *Cf.* Liebowitz 2/20 at 233-34 (contrasting this traditional goal of patent ownership with other goals).

³⁰ It is unlikely that there is too much innovation from the viewpoint of economic welfare. Innovation often generates “large positive spillovers” that the inventor cannot appropriate; as a result, there is a general “underinvestment in innovative activities.” Thomas M. Jorde & David J. Teece, *Rule of Reason Analysis of Horizontal Arrangements: Agreements Designed to Advance Innovation and Commercialize Technology*, 61 ANTITRUST L.J. 579, 584 (1993); *see also id.* at 583-88 (summarizing empirical evidence showing that “the social returns to innovation are markedly greater than the private returns”); Dennis Carlton, *Antitrust Policy Toward Mergers When Firms Innovate: Should Antitrust Recognize the Doctrine of Innovation Markets?*, Testimony

This view of the role of patents assumes that invention is “a one-time stationary phenomenon, not a cumulative process whereby inventions build on each other.”³¹ When innovation is not cumulative, enhancing appropriability raises few concerns about any “offsetting retardation of innovation that could come from the increased risk of infringement by followers in the cumulative chain.”³² When innovation is cumulative, however, allowing the initial innovator to appropriate more of the rewards from its invention may hinder independent follow-on innovation. Independent firms seeking to build on the initial innovation would have to bear the risk of infringement or the cost of negotiating and paying for licenses. Thus, the granting of strong patent rights may carry costs.³³

Appropriability mechanisms other than patents – such as trade secrecy, first-mover advantages, and learning-curve advantages – may also protect the innovator from free riding. Indeed, a number of studies have shown that such measures typically are more important than patents for protecting

Before the FTC Hearings on Global and Innovation-Based Competition 6 (Oct. 25, 1995) (noting that the “social rate of return [on innovation] exceeds the private one, suggesting that more R&D would be desirable”), at <http://www.ftc.gov/opp/global/carlton.htm>; Richard J. Gilbert & Steven C. Sunshine, *Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets*, 63 ANTITRUST L.J. 569, 593-94 n. 60 (1995) (noting evidence that “the private return to R&D is much less than the social return”).

³¹ Stoner 2/26 at 108-109.

³² *Id.*

³³ See *infra* Ch. 2(III) (discussing patents’ effects on follow-on innovation).

appropriability in many industries.³⁴ In other industries, however, these alternatives may be less readily available.

2. Facilitate Commercialization

Some inventions lack commercial capability at first. Only substantial development can turn them into commercially viable products. Economic theory posits that patent rights make it easier for inventors to develop relationships with others to invest in that development.³⁵ Patents can make information a tradeable commodity by reducing transaction costs and enabling licensing negotiations.³⁶ Without patent rights, inventors might have to rely on secrecy to prevent free-riding on their innovation; by shielding inventors from such free-riding, patents allow them to discuss their work with other firms that can help commercialize the invention.³⁷ If firms had to rely on trade secrets to protect their inventions, it would be “very difficult to . . . efficiently transfer information from the

³⁴ See *infra* Ch. 2(II)(A)(2) (discussing races to innovate); see also Cohen 2/20 at 25-26; Scherer 7/10 at 51-52. In particular, Prof. Teece has noted that problems in the patent system are sometimes the reason that firms use non-patent means of appropriating value from their innovations. See Teece 2/26 at 206.

³⁵ See generally ABA (Economics stmt) 12.

³⁶ See, e.g., Bronwyn H. Hall, *Patents and Innovation* (2/26/02) (slides) at 8 (patents allow trade in knowledge), at <http://www.ftc.gov/opp/intellect/020226bronwynhall.pdf>. Other kinds of intellectual property, such as trade secrets, can likewise facilitate trade in information. See, e.g., ROGER M. MILGRIM, 2 MILGRIM ON TRADE SECRETS § 9.01[4], 9-13-9-24 (2003) (noting that trade secrets may be licensed).

³⁷ See, e.g., Kitch 2/20 at 84 (patents enable contracting to transfer information); Arora 2/25 at 72 (patents “enhance the efficiency of knowledge transfer”).

inventor or even the investor to . . . the entity that [is] best able to exploit and develop it.”³⁸ As one panelist put it, without patent rights,

[y]ou can imagine the basic problem. An independent inventor goes to a large firm [and says,] ‘Hey, I’ve got a great invention.’ And the large firm says, ‘Well, what is it?’ Well, without a property right the conversation might stop.³⁹

Rendering innovation a tradeable commodity also helps foster specialization. A small firm that has invented something need not do alone all the things necessary – from the advertising and warranties to sales and service – to bring the invention to market.⁴⁰ Instead, it can license or sell its invention to another firm, which can then do whatever tasks are needed to develop and market the invention.⁴¹ In these ways, the patent system facilitates the commercialization of inventions.

3. Encourage Disclosure

The patent system also promotes innovation, some panelists noted, by demanding disclosure. Patent law requires applicants to disclose the inventions for

³⁸ Kobak 7/11 at 60.

³⁹ Thomas 2/8 (Patent Session) at 17 (noting further that contracts and nondisclosure agreements are imperfect).

⁴⁰ See, e.g., Thomas 2/8 (Patent Session) at 18; Teece 2/26 at 201 (patents allow small firms to specialize in invention).

⁴¹ See, e.g., Thomas 2/8 (Patent Session) at 18-19 (discussing how patent system reduces need for vertical integration).

which they receive patents.⁴² This disclosure obligation is a quid pro quo for obtaining the right to exclude others from making, using, offering for sale, or selling an invention.⁴³ The purpose of the disclosure obligation is to foster further innovation by enabling a person skilled in the particular art to learn from another’s invention.⁴⁴ Thus, an issued patent “communicates a considerable amount of information that can help other would-be inventors, including rival firms.”⁴⁵ Although some questioned whether the

⁴² See *infra* Ch. 4(II)(B) (describing statutory requirements). See also Rogan 2/6 at 21 (the quid pro quo for receiving patent rights is disclosure); Myrick 3/19 at 18-19 (stating that “[p]atenting . . . serves the public interest by encouraging still more innovation, which in turn must be publicly disclosed to be entitled to patent protection”). Since 1999, patent law has also required the publication of certain patent applications 18 months after they are filed, see *infra* Ch. 4(II)(C)(1); however, through the use of continuations, a patent may issue that contains broader claims than publication initially revealed, see *id.*

⁴³ See Rogan 2/6 at 21; J.E.M. Ag Supply, Inc. v. Pioneer Hi-Bred Int’l, Inc., 534 U.S. 124, 142 (2001) (“The disclosure required by the Patent Act is the ‘quid pro quo of the right to exclude’” (internal citations omitted)); Merges & Duffy, Patent Law and Policy: Cases and Materials at 262.

⁴⁴ See, e.g., R. Levin 2/6 at 100 (stating that disclosure function is important and pro-competitive); Cohen 2/20 at 23, 34-35 (noting that patent policy aims through disclosure to promote innovation); Kushan 10/25 at 131 (stating that disclosure promotes innovation); Thomas 2/8 (Patent Session) at 15; Merges 2/28 at 577; Frankel 4/10 at 6; Scotchmer 4/10 at 65 (noting that disclosure obviates need for reverse engineering); Chambers 10/25 at 177 (arguing that patents permit inventor to talk more freely about invention); Chambers 2/8 (Patent Session) at 83-84 (patents encourage less trade secrecy); cf. Dreyfuss 7/10 at 197 (if society makes it really hard to get patents, there will be more trade secrecy).

⁴⁵ Kenneth W. Dam, *The Economic Underpinnings of Patent Law*, 23 J. LEGAL STUDIES 247, 267 (1994); see also Newman 2/6 at 39 (describing patents as “the major if not the only source of technical information” in “virtually all fields of technology”); Armbrecht 3/19 at 51-52.

disclosures that patent law demands are adequate,⁴⁶ others noted that their adequacy might vary by industry.⁴⁷ In Japan, patents are reportedly a more significant source of new technical information than in the United States.⁴⁸

⁴⁶ Arora 2/25 at 73 (concern over whether disclosures are adequate).

⁴⁷ See, e.g., Kahin 10/25 at 133 (arguing that patents induce meaningful disclosure in pharmaceuticals industry but not in software industry); Friedman 2/27 at 354-55 (contending that patent disclosures are too slow to be of use in software industry); Thomas 10/30 at 184-85 (in many post-industrial fields, the claim is an abstract behavioral protocol and there is not much worth learning from the description). See also *infra* Ch. 4(II)(B)(3) (questions about whether software disclosures are adequate, because no requirement to disclose source code).

⁴⁸ See Cohen 2/20 at 36-39; Wesley M. Cohen, *Patents: Their Effectiveness and Role* (2/20/02) (slides) at 24, at <http://www.ftc.gov/opp/intellect/cohen.pdf> (hereinafter Cohen Presentation), Cohen 10/30 at 84-85, 123-24 (finding patents to be the most important R&D information source in Japan but just "in middle of pack" in the United States); Wesley Cohen et al., *R&D Spillovers, Patents and the Incentives to Innovate in Japan and the United States*, 31 RESEARCH POLICY 1349, 1355-56 (2002) (survey findings suggest that patents more effectively serve the information disclosure function in Japan than in the U.S.); Janusz Ordovery, *A Patent System for Both Diffusion and Exclusion*, 5 J. OF ECON. PERSP. 43, 45 (1991) (stating that the Japanese patent system is designed to induce earlier disclosure than the American patent system). The Japanese patent system apparently induces disclosure by a variety of means. For example, it awards patent rights to those who file first, inducing innovators to disclose their inventions in patent applications earlier than does the American system of awarding patent rights to the first to invent. See, e.g., Ordovery, 5 J. OF ECON. PERSP. at 45; Cohen 10/30 at 123. Moreover, Japan's patent system also generally grants narrower patents, such that there are "more patents per product" – fostering more cross licensing and related negotiations and information sharing – than in the United States. Cohen 2/20 at 37; see also Cohen et al., 31 RESEARCH POLICY at 1356-62; Ordovery, 5 J. OF ECON. PERSP. at 48. Two other explanations that affected survey results – Japan's pre-grant opposition system and its publication of patent applications 18 months after filing, see Cohen 10/30 at 123; Cohen et al., 31 RESEARCH POLICY at 1356; Ordovery, 5 J. OF ECON. PERSP. at 45-46 – may no longer be relevant. Japan has abandoned pre-grant opposition, and the United States has begun publishing

B. Costs Of, and Limits To, Patents' Power to Spur Stand-Alone Innovation

Most patents do not confer market power on their holders,⁴⁹ but when they do, they carry costs. For example, an innovator whose patent confers market power can cause prices of goods and services to be above (and quantities to be below) competitive levels. The creation of a patent monopoly can "lead[] to restriction of production, a supracompetitive price, and what economists call an efficiency or deadweight loss."⁵⁰

most patent applications 18 months after filing.

⁴⁹ See *infra* Ch. 1(III)(A)(1). See also Edmund W. Kitch, *Elementary and Persistent Errors in the Economic Analysis of Intellectual Property*, 53 VAND. L. REV. 1727, 1729-38 (2000).

⁵⁰ Dam, 23 J. LEGAL STUDIES at 248; see also Langenfeld 2/20 at 10-13, 64-66 and James Langenfeld, *Innovation, Competition, and Intellectual Property: Providing an Economic Framework* (2/20/02) (slides) at 4 (arguing that strong IP rights reduce price competition, and that partial IP protection would maximize economic welfare), at <http://www.ftc.gov/opp/intellect/langenfeld.pdf>; Farrell 2/28 at 596 (stating that IP rights can come at the cost of monopoly price); Kushan 10/25 at 131 (inventors pursue patents to try to "exploit exclusivity to a commercial advantage"). Many other participants recognized such potential market power effects. See, e.g., ABA (Economic stmt) 11 (describing the exercise of market power as a possible cost of patent protection); Stoner 2/26 at 108-09; Hall 2/26 at 181, 184; Farrell 2/28 at 596; Katsh 4/10 at 25-26; MacKie-Mason 5/1 at 171; Gambrell 10/25 at 38-39; Farrell 11/6 at 109-11; Ordovery 11/6 at 114; Hans Lennros, *Question Regarding Competition & Intellectual Property* (Public Comment) 1, at <http://www.ftc.gov/os/comments/intelpropertycomments/kenros/hans.htm>; see also Louis Kaplow, *The Patent-Antitrust Intersection: A Reappraisal*, 97 HARV. L. REV. 1813, 1821-23 (1984) (noting that "the patentee's reward is made possible through monopolistic restrictions" and discussing the difficulty of striking a balance between rewarding patent holders and limiting anticompetitive harm).

Moreover, in the rational exercise of its self-interest, a patentee may sue would-be rivals for infringement, deterring entry to compete. Patentee suits against entrants for infringement can “tax” entry.⁵¹ The threat of being sued for infringement by an incumbent – even on a meritless claim – may “scare . . . away” venture capital financing.⁵² Likewise, according to panelists, a patentee may prolong its market power by precluding access to technology necessary for the next generation of products to emerge.⁵³

To the extent that the promise of patent protection is necessary to stimulate invention, disclosure, or investment, then society accepts these costs as necessary to maximize long-term economic welfare.⁵⁴ If the promise of patent protection is not necessary for those purposes, however, then the costs – which may include higher prices or retarded follow-on innovation – may

cause unjustified injury to consumers.⁵⁵ “[T]his economy is founded on the privilege to compete. That is the fundamental, bedrock principle of our capitalist economy. . . . [W]e simply must be very concerned when we manipulate our markets to restrain competition.”⁵⁶ For these reasons, one panelist cautioned that “[w]e should be wary of creating unwarranted market power by granting unwarranted patents.”⁵⁷

II. COMPETITION’S EFFECTS ON INITIAL AND FOLLOW-ON INNOVATION

Like patent policy, competition plays an important role in spurring the development of technologies and sequences of related, follow-on technology.⁵⁸ This section discusses how a greater level of competition can affect the level of innovation, holding patent policy constant.

Panelists noted that competition can spur innovation in several ways, but that economic theory and empirical evidence suggest that the effect of an increase in competition on innovation will vary from

⁵¹ Lerner 2/20 at 158-61, 187; *see also* Weinstein 2/27 at 451-52 (discussing patents as barriers to entry); Stoner 10/30 at 9 (discussing patents as potential entry barriers); Stallman 4/9 at 21, 38 (arguing that patents can exclude firms from standards); Josh Lerner, *Patenting in the Shadow of Competitors*, 38 J. LAW & ECON. 463, 465, 489-490 (1995) (finding that high litigation costs deter biotechnology firms from seeking patents when rivals already hold patents).

⁵² Lerner 2/20 at 189.

⁵³ *See* Arrow 2/25 at 59-61, 64-65; *see also infra* Box 2-1.

⁵⁴ *See, e.g.*, Hall 2/26 at 181 (noting the trade-off between short-term monopoly in return for incentive to innovate and disclose); Lunney 7/10 at 97-98 (noting that traditional trade-off balances incentives to innovate against monopoly deadweight loss). *See also supra* Ch. 1(I)(C)(1)(a) (recognizing that statutory standards for patentability govern, and that in any event, it would not usually be possible to use a “but for” test for patentability).

⁵⁵ *See, e.g.*, Farrell 11/6 at 109-11 (noting that costs of temporary monopoly become a matter for concern if the patents in some sense are not valid or deserved); Farrell 2/28 at 596-97 (because protecting intellectual property is a “costly way” to stimulate innovation since it sometimes allows monopoly pricing, IP protection should be used “judiciously”).

⁵⁶ Thomas 4/11 at 56.

⁵⁷ R. Levin 2/6 at 102.

⁵⁸ *See, e.g.*, Partha Dasgupta & J.E. Stiglitz, *Uncertainty, Industrial Structure and the Speed of R&D*, 11 BELL J. ECON. 1, 25 (1980) (finding that competition in research and development raises the level of R&D).

one context to another.⁵⁹ For example, some panelists stated that firms in a competitive market generally have greater incentives to innovate than a monopolist who does not face the threat of entry.⁶⁰ Likewise, competition may drive a race to innovate, spurring invention faster. The firm that innovates first may gain a patent that allows it to exclude others, or may reap the benefits of its work by taking advantage of its competitive lead (at least when, among other things, copying the innovation is expensive or time-consuming).⁶¹ Some panelists critiqued – and others defended – the so-called Schumpeterian hypothesis that large firms innovate more than small firms, and that firms in concentrated markets innovate more than firms in competitive markets.⁶² Finally, some noted that firms competing to innovate will approach research problems differently, increasing the chances of successful innovation.⁶³ There are costs and limits, however, to competition’s power to spur innovation. Patent grants are sometimes crucial to avoiding the kind of free riding that could erode incentives to innovate.⁶⁴ Moreover, the innovation races that competition can incite can lead firms to

⁵⁹ See, e.g., Nelson 2/20 at 123-36 (summarizing the literature and concluding that “there is no simple relationship”).

⁶⁰ See *infra* Ch. 2(II)(A)(1) (discussing cannibalization).

⁶¹ See *infra* Ch. 2(II)(B)(2) (discussing races to innovate).

⁶² See *infra* Ch. 2(II)(B)(3) (discussing Schumpeterian hypothesis and its critics).

⁶³ See *infra* Ch. 2(II)(A)(4) (discussing diversity of R&D efforts).

⁶⁴ See *infra* Ch. 2(II)(B)(1) (discussing appropriability problems).

duplicate each others’ research, which some believe to be a wasteful process.⁶⁵ Each point is addressed in turn below.

A. Competition Can Spur Innovation, Whether Initial or Follow-On

1. Cannibalization

Competition can drive innovation, and its power to do so may depend on market structure. To be sure, even a monopolist that faces no competition has an incentive to innovate to expand the demand for its products and to reduce its costs. Other things being equal, however, a monopolist that does not face the threat of entry has less incentive to engage in costly R&D to develop new products than does a firm facing competition, some contend. To the extent that new products would cannibalize the monopolist’s existing sales, the monopolist would be less likely to find R&D expenditures worthwhile, they maintain.⁶⁶ By contrast, firms in a competitive market have incentives to innovate in hopes of acquiring market power, some argue.⁶⁷ Similarly, the monopolist that does face a threat of entry may have more incentive to invest in R&D

⁶⁵ See *infra* Ch. 2(II)(B)(2) (discussing duplication of effort).

⁶⁶ See generally Kenneth J. Arrow, *Economic Welfare & the Allocation of Resources for Invention*, in THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 609, 619 (1962), Nelson 2/20 at 126.

⁶⁷ See, e.g., Shane Greenstein, *Market Structure and Innovation: A Brief Synopsis* (2/20/02) (slides) at 2, at <http://www.ftc.gov/opp/intellect/greenstein.pdf> (hereinafter Greenstein Presentation).

than a prospective entrant would have, because the monopolist may have more to lose from entry than a potential entrant has to gain.⁶⁸

2. Races to Innovate

The role of competition in stimulating R&D expenditures is perhaps most obvious when there is a race to patent, as, for example, when two companies are attempting to solve the same problem and the one that solves it first can win a patent and exclude the other from the market. Lured by this possibility, potential inventors may race to innovate.⁶⁹

A number of studies have examined different settings where competitors race to achieve innovations and have concluded that the results vary by context. For example, analyses indicate that the effects of competition on innovation will vary according to the nature of the inventive process⁷⁰ and a firm's efficiency level

relative to that of its rivals.⁷¹ One commentator who has studied the disk drive industry has concluded that its patterns regarding competition and innovation show that "firms that trail the leader innovate more."⁷² On the other hand, some state that races to innovate may lead to wasteful expenditures and risky cutting of corners, and they are not necessarily efficient.⁷³

Some panelists observed that when imitation is costly or time-consuming, a firm can reap substantial benefits from innovation by exploiting its head start on competitors to further develop the innovation and the means to market it. It might enjoy a short-term monopoly on the innovation until other firms can copy it, and even after they enter, the innovator's established position may help it maintain market share.⁷⁴ In some industries, it is enough if an innovation "permit[s] the firm to reach the market first with a product (or in most industries a new

⁶⁸ See, e.g., Greenstein 2/20 at 140-141; Greenstein Presentation at 2; FTC Staff Report, *Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace*, Ch. 6, p. 12, n. 54 (May 1996) (summarizing testimony of Prof. Carlton that monopolists who fear the loss of their monopoly profits have an even greater incentive to innovate than a competitive firm), available at http://www.ftc.gov/opp/global/report/gc_v1.pdf.

⁶⁹ See, e.g., GEORGE E. FROST, THE PATENT SYSTEM AND THE MODERN ECONOMY, STUDY OF THE SUBCOMM. ON PATENTS, TRADEMARKS, AND COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY, 84TH CONG., 2D SESS. 34 (Comm. Print 1957).

⁷⁰ Compare Richard J. Gilbert & David M. G. Newbery, *Preemptive Patenting and the Persistence of Monopoly*, 72 AM. ECON. REV. 514, 515-17 (1982) (arguing that when invention follows without uncertainty from investment, a monopolistic incumbent has an incentive to out-bid entrants in a race to invent) with

Jennifer Reinganum, *Uncertain Innovation and the Persistence of Monopoly*, 73 AM. ECON. REV. 741 (1983) (arguing that with uncertainty in the relationship between investment and the success of innovation efforts, potential entrants have greater incentives than incumbents to seek "drastic" (revolutionary) innovations).

⁷¹ See, e.g., Jan Boone, *Competitive Pressure: The Effects on Investments in Product and Process Innovation*, 31 RAND J. ECON. 549 (2000).

⁷² Josh Lerner, *An Empirical Exploration of a Technology Race*, 28 RAND J. ECON. 228 (1997).

⁷³ See *infra* Ch. 2(II)(B)(2).

⁷⁴ See, e.g., Edwin Mansfield, *Patents and Innovation: An Empirical Study*, 32 MGMT. SCIENCE 173, 176 (1986) (noting that patents might not seem worthwhile in industries in which imitation is costly or difficult); Stoner 2/26 at 111 (noting that a simple head start on a product can yield large profits); Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP. 93, 105-07 (1994).

feature of an established product); other firms are sure to follow, but only after the time required for copying or reverse engineering.”⁷⁵

Empirical study has shown that in some industries, firms often innovate to exploit first-mover advantages, learning-curve advantages, and other advantages, not to gain patent protection. One early study showed that in only two of the twelve surveyed industries – pharmaceuticals and chemicals – did the firms believe patents to be essential for developing or introducing thirty percent or more of the inventions.⁷⁶ “[I]n office equipment, motor vehicles, rubber, and textiles, the firms were unanimous in reporting that patent protection was not essential for the development or introduction of any of their inventions during this period.”⁷⁷ By contrast, pharmaceutical industry participants reported that 60% of inventions would not have been developed and 65% would not have been commercially introduced absent patent protection.⁷⁸ A later study found that lead time, learning curve advantages, complementary sales or service efforts, and secrecy were all more effective means of protecting the competitive advantages of new processes

than patents were.⁷⁹ With regard to new products, patents ranked ahead of secrecy but behind the other three mechanisms.⁸⁰ Again, the results showed substantial variation among industries, with patents proving particularly useful with regard to pharmaceutical drugs, pesticides, and industrial organic chemicals.⁸¹

The most recent study confirms the earlier findings; it found that patents trailed secrecy, lead time, investments in complementary manufacturing capabilities, and investments in complementary sales and services as appropriability mechanisms that businesses preferred.⁸² “[P]atents are unambiguously the least central of the major appropriability mechanisms overall,” the study concludes.⁸³ Again, patent significance varied sharply by industry. For example, in the medical equipment and pharmaceutical drug industries patents were effective appropriability mechanisms for more than 50% of all product innovations, but for semiconductors and communications equipment patents were effective less than

⁷⁹ See Richard C. Levin et al., *Appropriating the Returns from Industrial R&D*, in *BROOKINGS PAPERS ON ECONOMIC ACTIVITY* 783 (1987). This study analyzed survey responses from 650 R&D managers representing 130 lines of business.

⁸⁰ *Id.* at 794-95.

⁸¹ *Id.* at 795-96.

⁸² See W.M. COHEN ET AL., *PROTECTING THEIR INTELLECTUAL ASSETS: APPROPRIABILITY CONDITIONS AND WHY U.S. MANUFACTURING FIRMS PATENT (OR NOT)* (National Bureau of Econ. Research Working Paper No. 7552, 2000), at <http://papersdev.nber.org/papers/w7552> (hereinafter COHEN ET AL., *PROTECTING THEIR INTELLECTUAL ASSETS*).

⁸³ *Id.* at 9 (discussing product innovations), Figures 1 and 2 (reporting similar results for product and process innovations).

⁷⁵ Dam, 23 *J. LEGAL STUDIES* at 263.

⁷⁶ See Edwin Mansfield, *Patents and Innovation: An Empirical Study*, 32 *MGMT. SCIENCE* 173 (1986). This study involved a random sample of 100 firms (excluding very small firms) from twelve broadly defined industries from 1981-1983.

⁷⁷ *Id.* at 174.

⁷⁸ *Id.* at 175.

Box 2-1. Competition for monopoly. Allowing price to rise above marginal cost through a succession of temporary monopolies can spur dynamic competition, some have asserted. Some analysts argue that rapid innovation, increased importance of declining average costs, and network externalities have created conditions ideal for “dynamic” competition for monopoly, in which temporary monopolies rise and fall in the rhythms of rapid entry and exit. See, e.g., Janusz A Ordover, *Antitrust for the New Economy or New Economics for Antitrust* (2/20/02) 5, at <http://www.ftc.gov/opp/intellect/020220januszordover.pdf> (hereinafter Ordover (stmt)); Richard A. Posner, *Antitrust in the New Economy*, 68 ANTITRUST L.J. 925, 929-30 (2001). This type of competition can increase innovation, according to some observers. Low barriers to entry are critical to many of these analyses. As noted above, several observers have stated that a monopolist threatened by entry has more to lose than any potential entrant has to gain and will therefore invest more in innovation. See Greenstein 2/20 at 140-141; DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 538-40 (3rd ed. 1999). See generally Dasgupta & Stiglitz, 11 BELL J. ECON. at 25 (finding that the threat of entry may lead a monopolist to increase the pace of research). Another panelist explained that an incumbent monopolist can create barriers to entry by acquiring broad patents on critical technology. The very existence of such barriers to entry may have offsetting effects, however, because the value of winning the better-protected monopoly rises and the prospect of successful entry becomes more attractive. Kenneth Arrow, *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (2/25/02) 1, at <http://www.ftc.gov/opp/intellect/020225kennethjarrow.pdf>; Arrow 2/25 at 64-65.

27% of the time.⁸⁴

These points do not suggest that patents are unimportant. Research regarding the relationship between patent effectiveness and R&D investments indicates that “[w]hile patents are not as featured as other mechanisms, they do stimulate R&D broadly, though more in some industries than others.”⁸⁵ These three studies do suggest, however, that competition also plays an important role in spurring innovation.⁸⁶

⁸⁴ *Id.* at Table 1.

⁸⁵ Cohen 2/20 at 43. See ASHISH ARORA ET AL., *R&D AND THE PATENT PREMIUM* 35 (National Bureau of Econ. Research Working Paper No. 9431, 2003), at <http://www.nber.org/papers/w9431>. For evidence of a strong correlation between R&D investment and patenting activity, see Zvi Griliches, *Patent Statistics as Economic Indicators: A Survey*, 28 J. OF ECON. LITERATURE 1661, 1673-74 (1990); see also Evenson 2/20 at 51-52 (surveying international data).

⁸⁶ *Cf.* Hoerner 7/11 at 54 (stating that many companies would engage in the same level of R&D even without the patent system, because they must innovate to continue offering products that attract consumers away

3. Schumpeterian Hypothesis and its Critics

Panelists debated the hypothesis, originally espoused by Joseph Schumpeter, that “large and often monopolistic enterprises” are “the principal engines of technological progress.”⁸⁷ Participants discussed two dimensions of Schumpeter’s hypothesis: larger firms innovate more than smaller firms, and firms in concentrated markets innovate more than firms in competitive markets.⁸⁸ Economists developing Schumpeter’s ideas have noted that

from nvals).

⁸⁷ See JOSEPH SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* (1942); see also DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 532-33 (3rd ed. 1999); Jennifer Reinganum, *The Timing of Innovation: Research, Development, and Diffusion*, in 1 *HANDBOOK OF INDUSTRIAL ORGANIZATION* 849 (Richard L. Schmalensee & Robert D. Willig, eds. 1989).

⁸⁸ ABA (Economics stmt) 29.

economies of scale may make innovation less costly for a large firm.⁸⁹ Specifically, they contend, large firms sponsoring considerable R&D can reduce the marginal costs of innovation by using “more specialized resources;” can spread the fixed costs of any R&D over a wider base of output; can spread the risk of unsuccessful R&D efforts by sponsoring many R&D projects simultaneously; and have access to inexpensive investment capital, drawn from the firm itself or from capital markets.⁹⁰ Moreover, some commentators state that large firms benefit from their own innovative efforts more than smaller firms do: large firms can apply their process innovations to large production operations, gaining greater savings; the chances that an innovation will be useful to one of their many businesses is greater; and their abilities to market their innovations to others may be greater.⁹¹ Studies also have revealed a positive correlation between concentration and industry R&D/sales ratios, although that correlation may break down at high levels of concentration.⁹²

Some panelists critiqued the Schumpeterian hypothesis directly. They noted, for example, that venture capital breaks the link between innovation and the financial resources of a firm, undermining the argument that large firms have unique

access to investment capital.⁹³ Moreover, a number of studies have found that R&D spending rises proportionally to firm size in most industries, but that R&D spending by large firms generates less innovation per dollar than does spending by smaller firms.⁹⁴ And some have stated that the weight of economic theory and evidence shows that there is a non-linear, inverted-U-shaped relationship between concentration and innovation. In their view, low concentration may not be conducive to innovation, but “very high concentration has a positive effect only in rare cases, and more often it is apt to retard progress by restricting the number of independent sources of initiative and by dampening firms’ incentive to gain market position through accelerated R&D.”⁹⁵ Under this view, “[w]hat is needed for rapid technical progress is a subtle blend of competition and monopoly, with more emphasis in general on the former than the latter, and with the role of monopolistic elements diminishing when rich technological opportunities exist.”⁹⁶

⁸⁹ *Id.*

⁹⁰ *Id.* at 29-30.

⁹¹ *See, e.g., Id.* (summarizing these arguments).

⁹² *See, e.g., F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 646 (3d ed. 1990). For a discussion of the possible implications of Schumpeterian theories for dynamic competition for monopoly, *see* Box 2-1.

⁹³ *See, e.g., Teece* 2/26 at 195; SCHERER & ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* at 630, 652 (noting that growth of a venture capital industry in United States that can “channel[] investment into new high-technology firms shows that past monopoly profits are no *sine qua non* for supporting innovation”).

⁹⁴ *See* Wesley Cohen & Steven Klepper, *A Reprise of Size and R&D*, 106 *ECON. J.* 925, 927-30 (summarizing prior research), 947 (suggesting that large firms may have greater incentives to undertake marginal research projects) (1996); *see also* Shelanski 2/25 at 25-36 (critiquing Schumpeter theory and noting lack of good empirical support).

⁹⁵ SCHERER & ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* at 660.

⁹⁶ *Id.*

Other panelists contended that the Schumpeterian hypothesis is true for some industries and markets but not true in others. For example, one panelist stated that industry conditions are so varied that it would be surprising to find a “simple Schumpeterian relationship” across all industries.⁹⁷ Likewise, another panelist stated that “result[s] vary a lot depending on the structure and nature of the industry.”⁹⁸ Indeed, two studies that controlled for inter-industry differences found reason to question various facets of the Schumpeterian hypothesis.⁹⁹ In a similar vein, some have suggested that policymakers examine “the relationship between concentration, R&D activity, and innovation” in particular industries, because “industries probably vary too much for one theory to fit all.”¹⁰⁰

Statistical cross-section studies examining multiple industries have not identified any clear relationship between

concentration and innovation.¹⁰¹ To the contrary, many studies seem to suggest that the effect of concentration on innovation depends on many factors.¹⁰² For example, some statistical evidence suggests that the existence of an inverted-U relationship between concentration and innovation depends on industry characteristics.¹⁰³ Some

⁹⁷ Nelson 2/20 at 132-36.

⁹⁸ Rubinfeld 2/25 at 20.

⁹⁹ See Wesley Cohen et al., *Firm Size and R&D Intensity: A Re-examination*, 35 J. INDUS. ECON. 543, 543-544 (1987) (questioning linkage between firm size and intensity of R&D); P.A. Geroski, *Innovation, Technological Opportunity, and Market Structure*, 42 OXFORD ECON. PAPERS 586, 586 (1990) (finding, based on data from the United Kingdom and a variety of measures of market structure, “fairly strong evidence against the hypothesis that increases in competitive rivalry decrease innovativeness”).

¹⁰⁰ DENNIS W. CARLTON & ROBERT H. GERTNER, *INTELLECTUAL PROPERTY, ANTITRUST AND STRATEGIC BEHAVIOR* 14 (National Bureau of Econ. Research Working Paper No. 8976, 2002), at <http://www.nber.org/papers/w8976>.

¹⁰¹ See, e.g., Gilbert 2/25 at 12-14; SCHERER & ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* at 645-51 (noting that some statistical evidence points to a positive relationship between industry concentration and R&D/sales ratios, although that correlation may break down at high levels of concentration); Richard J. Gilbert & Steven C. Sunshine, *Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets*, 63 ANTITRUST L.J. 569 (1995) (stating that firm- and industry-specific factors complicate the relationship between concentration and innovation); Richard Rapp, *The Misapplication of the Innovation Market Approach to Merger Analysis*, 64 ANTITRUST L.J. 19 (1995) (citing the inconclusive economic literature on the relationship between concentration and innovation); Richard J. Gilbert & Steven C. Sunshine, *The Use of Innovation Markets: A Reply to Hay, Rapp, and Hoerner*, 64 ANTITRUST L.J. 75, 76-77 (1995) (suggesting that industry-specific factors obscure the statistical relationships); Shelanski 2/25 at 32 (stating that the “empirical data do not resolve any of the ambiguity in the relationship between competition and innovation,” and that the “empirical evidence is really quite ambivalent”).

¹⁰² See, e.g., Gilbert & Sunshine, 64 ANTITRUST L.J. at 76-77 (stating that “many factors influence the incentive to invest in the development of new products and processes”).

¹⁰³ See, e.g., SCHERER & ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* at 645-51 (noting that including variables such as R&D performed outside the industry, the pace of innovation, and the strength of appropriation mechanisms weakens the inverted-U relationship in some industries, which points to the importance of firm and industry effects in qualifying the relationship), Nelson 2/20 at 128 (noting potential data and statistical problems with at least some of the studies that have found inverted-U relationships). For a recent working paper finding inverted-U relationships in data involving United Kingdom firms, see PHILIPPE AGHION ET AL., *COMPETITION AND INNOVATION: AN INVERTED U RELATIONSHIP* (National Bureau of Econ. Research Working Paper No. 9269, 2002) (describing the inverted-U

Box 2-2. Additional Pricing Strategies. Panelists described a number of non-patent pricing strategies that firms may use to recoup fixed costs, including R&D spending.

Long-run average costs. One panelist noted that firms with declining average costs will not price at marginal cost because they must recover their substantial fixed costs. Ordovery (stmt) 2. Another panelist echoed that a firm charging a flat price must set it higher than marginal cost if it has returns to scale. Varian 2/25 at 76. One panelist suggested that long-run average costs may be a useful analytical benchmark, but added that it is difficult to determine which of a firm's fixed costs correspond to individual products and that some temporary returns in excess of that benchmark may be necessary for adequate incentives to innovate. See Ordovery (stmt) 3.

Price discrimination. Some maintain that, rather than use constant per-unit prices, firms have begun to adopt more "sophisticated" models of pricing – such as volume or loyalty discounts, bundling, and self-selective price discrimination – as a means of covering substantial up-front investments, such as R&D spending. See Varian 2/25 at 76-79.

industry case studies indicate that competition drives innovation in particular industries.¹⁰⁴

relationship), at <http://nber.org/papers/w9269.pdf>.

¹⁰⁴ See, e.g., Lemcr, 28 RAND J. ECON. at 244 (empirical study of the computer disk drive industry showing that "the greatest innovative activity is shown by firms that follow the leader"); Gilbert 2/25 at 12 (noting that the correlation between competition promoting innovation characterizes "almost any [sector of] the software industry," including operating systems and Internet browsers, as well as semiconductors); Gilbert & Sunshine 63 ANTITRUST L.J. at 580-81 (noting evidence and industry case studies that "support the stronger conclusion that protection from competition [i]s inimical to technological progress"); MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 143 (1990) ("[R]ivalry has a direct role in stimulating improvements and innovation").

4. Diversity of R&D Efforts

Several panelists discussed the importance of diverse research efforts in producing innovation. One panelist noted that when many firms devote R&D efforts to tackling the same problem, the public benefits.¹⁰⁵ Likewise, another panelist noted that "if you have fewer innovators [and] less diversity, you are likely to have less innovation or higher prices or lower quality products."¹⁰⁶ He illustrated his point by discussing a proposed merger that, he stated, might have stifled innovation in a market "where the strategy of innovation is highly unpredictable [and where] path-breaking innovations . . . are made by niche players and not by the leading incumbents."¹⁰⁷ Indeed, some commentators have observed that under certain conditions, rates of innovation are positively correlated with rates of entry.¹⁰⁸ Nevertheless, others suggested that the ability of diverse R&D efforts to affect innovation depends on a key industry

¹⁰⁵ See Arrow 2/25 at 58-59 (stating that "diversity is good" with respect to "differing sources of R&D"); see also Thomas M. Jorde & David J. Teece, *Innovation and Cooperation: Implications for Competition and Antitrust*, 4 J. ECON. PERSPECTIVES 75, 81 (1990) (acknowledging that "horizontal cooperation" in research "may reduce diversity").

¹⁰⁶ Rubinfeld 2/25 at 19.

¹⁰⁷ Rubinfeld 2/25 at 22-23; see also Daniel Rubinfeld & John Hoven, *Innovation and Antitrust Enforcement*, in DYNAMIC COMPETITION AND PUBLIC POLICY 65, 87-88 (Jerry Ellig, ed. 2001) (noting need for diversity of innovation).

¹⁰⁸ See James Bessen & Eric Maskin, *Sequential Innovation, Patents, and Imitation* (Public Comment) 13-15, at <http://www.ftc.gov/os/comments/intelpropertycomments/jimbessencricmaskin.pdf> (hereinafter Bessen & Maskin (stmt)).

characteristic: the predictability of subsequent R&D paths.¹⁰⁹

B. Costs Of, and Limits To, Competition's Power to Spur Innovation

1. Appropriability Problems

As discussed above, however, panelists noted that competition cannot serve as the sole driver of innovation. Inventors sometimes cannot appropriate value from the invention without the grant of a patent, making patents an important incentive for innovation in such settings.¹¹⁰

2. Duplication of Effort

Some analysts have underscored one of the costs of competition to innovate: duplication of effort involved in parallel research efforts.¹¹¹ "Independent research activities often proceed down identical or near-identical technological paths," making a policy of encouraging diversity in R&D paths unhelpful, in their view.¹¹² They argue that excess efforts at innovation generate "wasteful patent race[s] to be the first

successful inventor."¹¹³

Yet what some deem wasteful duplicative efforts is what others deem useful competition.¹¹⁴ Firms compete via their R&D efforts, and such competition generates better consumer products and lower prices, benefits that may outstrip any social loss from the patent race, some observe.¹¹⁵ Some have noted that the benefits accruing from diverse efforts at innovation may outweigh the waste involved in competitive innovation.¹¹⁶ They argue that the potential wastefulness of parallel R&D efforts should not influence public policy decisions:

[W]e do not normally consider the opening of a new gasoline station or grocery store near an existing one to be an example of waste, or at least not one with which public policy should be concerned, even though we believe that only one can survive and we know that some economic rent of location may accrue to the survivor. Rather, we consider the competition induced by the new entrant to lead to a better outcome

¹⁰⁹ See *infra* Ch. 2(III)(A)(1).

¹¹⁰ See *supra* Ch. 2(I)(A) (discussing patents' power to internalize externalities and protect against free riding). For a discussion of non-patent pricing strategies that firms may use to recover fixed research and development costs, see Box 2-2.

¹¹¹ Cf. William M. Landes & Richard A. Posner, *Trademark Law: An Economic Perspective*, 30 J. LAW & ECON. 265, 267-68 (1987) (arguing that rent seeking is as wasteful as having many parties search for lost treasure).

¹¹² Jorde & Teece, 4 J. ECON. PERSPECTIVES at 81.

¹¹³ *Stoner 2/26* at 108-09; see also Mark F. Grady & Jay I. Alexander, *Patent Law and Rent Dissipation*, 78 VA. L. REV. 305, 308 (1992) (positing that competition to be the first to develop pioneer and follow-on innovations causes overinvestment that "dissipates," or eliminates, the benefit to society of the innovation or its improvement).

¹¹⁴ See, e.g., Dam, 23 J. LEGAL STUDIES at 263 (making this point).

¹¹⁵ See, e.g., Dam, 23 J. LEGAL STUDIES at 252, 263.

¹¹⁶ See Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839, 873, 877 (1990).

than would accrue through legal protection of the exiting firm. So, too, we cannot have much confidence that some of the natural alternatives to competition in R&D would increase social welfare.¹¹⁷

III. PATENTS' EFFECTS ON FOLLOW-ON INNOVATION

Finally, it is appropriate to address the effects of patent grants on *follow-on* innovation. Innovation is often an ongoing, cumulative process, with each generation of innovations building on what came before.¹¹⁸ For example, knowledge gained through basic research may serve as a foundation for subsequent applied activities; new products or services may go through multiple generations of improvements and extensions of use; initial research may produce tools – from laser technology through specialized software programs and isolated, purified genetic material – that follow-on research then applies to develop products and services for end-use consumers. In each case, the question arises whether policies and laws suitable for fostering a single generation of inventions also maximize welfare in the more dynamic, cumulative innovation settings actually observed. This section explores these issues.

First, this section identifies the relative strengths and weaknesses of follow-

on innovation organized by the initial innovator versus that conducted by independent innovators. On the one hand, some argued that strong initial patent rights can facilitate follow-on innovation by, or under the management of, the initial innovator. For example, some have contended that broad initial patent grants can allow the original patentee to organize its licensees' research into the patent's prospects, avoiding wasteful patent races.¹¹⁹ Others, however, disagreed, stating that subsequent researchers acting independently of the original inventor and competing against each other may foster greater innovation – and may have less market power in any resulting innovation.¹²⁰

Second, this section considers the implications for independent follow-on innovation of a single, blocking, initial patent. Sometimes the follow-on innovator will seek to design around the initial patent, potentially generating new technologies, but also incurring R&D costs.¹²¹ Other times the follow-on innovator will license the patented technology. This section examines the division of rewards between initial and follow-on innovators through such licensing and considers some of the impediments that might interfere with achieving licensing arrangements that adequately reward both generations of innovators.¹²²

¹¹⁷ Dam, 23 J. LEGAL STUDIES at 263.

¹¹⁸ See, e.g., ABA (Economics stmt) 20, 24; Lemley 2/25 at 37; Scotchmer 2/26 at 128-29; Suzanne Scotchmer, *Standing on the Shoulders of Giants: Cumulative Research and the Patent Law*, 5 J. ECON. PERSP. 29 (1991).

¹¹⁹ See *infra* Ch. 2(III)(A)(1) (discussing follow-on innovation organized by the initial innovator).

¹²⁰ See *infra* Ch. 2(III)(A)(2) (discussing follow-on activities by independent follow-on innovators).

¹²¹ See *infra* Ch.2(III)(B)(1) (discussing design-around innovation).

¹²² See *infra* Ch.2(III)(B)(2)-(3) (discussing division of rewards and licensing).

Finally, this section considers implications for follow-on innovation in the face of multiple existing patents. Sometimes, the need to attain access to multiple existing patents in the hands of multiple patentees can pose difficulties for independent follow-on innovators. This problem may flow just from the transaction costs of negotiating multiple licenses.¹²³ Moreover, the necessary patents may be too numerous to identify and license; follow-on innovators may almost inevitably risk suit for infringement once they sink costs into their research or production efforts.¹²⁴ An additional problem may affect the level of the multiple royalties: the patentees, acting independently, may seek a higher total royalty than would a single patentee charging a package price.¹²⁵ Furthermore, some argue that oligopolists holding a collection of necessary patents can injure and block follow-on innovation by refusing to license, or charging high royalty rates, to entrants.¹²⁶ A patentee may use multiple patents on near substitutes for its original work to retard independent follow-on innovation and impede entry, some contend.¹²⁷ Finally, some suggest that, under certain conditions, the initial innovator's rivals might use multiple patents on trivial variants to constrain the initial

¹²³ See *infra* Ch.2(III)(C)(1) (discussing transaction costs).

¹²⁴ See *infra* Ch.2(III)(C)(2) (discussing hold up in the patent thicket).

¹²⁵ See *infra* Ch.2(III)(C)(3) (discussing royalty stacking and the Cournot complements problem).

¹²⁶ See *infra* Ch.2(III)(C)(4) (discussing oligopoly and group boycotts).

¹²⁷ See *infra* Ch.2(III)(C)(5) (discussing patent fences).

innovator's future development efforts and force it to license away its technology.¹²⁸ Each point is discussed in turn below.

A. The Roles of Managed and Independent Follow-On Innovation

Panelists discussed follow-on innovation from the perspective of two general models. Under one model, follow-on innovation proceeds under the control and management of the initial innovator. That innovator might conduct follow-on activities itself. It also might effectively "hire" others to do some of the follow-on work, licensing them to use its technology for follow-on research and development. Both mechanisms are forms of "managed" follow-on innovation. Alternatively, follow-on activity may proceed independently of the initial innovator's coordination or control, with an array of outside researchers each seeking to build upon prior discoveries, a model that this Report terms "independent follow-on innovation." When a prior discovery is patented, an independent follow-on innovator may need a license, and the patentee may or may not wish to grant it.

1. Follow-On Innovation Organized by the Initial Innovator

In some instances, an initial innovator with a broad patent covering future development opportunities might pursue, or organize others to pursue, the follow-on innovations. Professor Edmund Kitch emphasized several advantages of such arrangements. Broad, initial patent

¹²⁸ See *infra* Ch.2(III)(C)(6) (discussing patent flooding).

rights can protect appropriability, not just for initial inventions but for the full range of follow-on activities needed to bring products to market. Broad initial patent rights enable the innovator to provide efficient, central management of the subsequent development efforts, avoiding unnecessary duplication of R&D activity and wasteful racing for follow-on patent rights. Broad initial patent rights permit innovators to disclose information without fear of free riding, thereby facilitating access to financing, complementary technology, and specialized supplies.¹²⁹

These considerations are key elements of what has come to be known as the “prospect theory” of patent rights. The prospect theory focuses on exploration of technological opportunities, referred to as “prospects.”¹³⁰ It emphasizes the effect of patents on commercialization, as opposed to a view that emphasizes the effect of patents on incentives to invent. Its perspective is forward looking, focusing on the efficient coordination of, and incentives for, follow-on activities.¹³¹

Several panelists identified potential shortcomings of this prospect theory. Some

¹²⁹ See Kitch 2/20 at 79-87; Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J. LAW & ECON. 265 (1977). According to Professor Kitch, a broad patent places its owner in a position “to coordinate the search for technological and market enhancement of the patent’s value so that duplicative investments are not made and so that information is exchanged among the searchers.” *Id.* at 276. Broad patents also permit the owner “to make investments to maximize the value of the patent without fear that the fruits of the investment will produce unpatentable information appropriable by competitors.” *Id.* at 276.

¹³⁰ See Kitch, 20 J. LAW & ECON. at 266.

¹³¹ See *id.*; Scotchmer 2/26 at 129.

questioned whether initial innovators are likely to provide effective central management;¹³² no one decision maker may have the range of knowledge necessary to choose the best follow-up opportunities or to select the ideal follow-up researchers.¹³³ Others noted that the theory depends on efficient licensing of follow-on opportunities, but that licensing negotiations may be lengthy and costly or break down due to differences in valuations.¹³⁴ Still others stressed that the efficiencies realized may be private, not social – arguing that follow-on patent races, although costly, may benefit consumers by yielding products sooner and with more certainty, and that coordination may eliminate desirable

¹³² See, e.g., Lemley 2/25 at 37-38 (central management by initial innovator an unwise “gamble” when innovation is likely to be cumulative); Frederick M. Scherer, *The Economics of Human Gene Patents*, 77 ACADEMIC MEDICINE 1348, 1362 (2002).

¹³³ See, e.g., Rubinfeld 2/25 at 20 (“very hard ex ante to know who is going to be successful”); see also Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 TEX. L. REV. 989, 1048-52 (1997); Merges & Nelson, 90 COLUM. L. REV. at 873 (“[N]o one knows for sure what possible inventions are in the technological pool. . . . The only way to find out what works and what does not is to let a variety of minds try.”); Rebecca S. Eisenberg, *Patents and the Progress of Science: Exclusive Rights and Experimental Use*, 56 U. CHI. L. REV. 1017, 1066-69 (1989) (arguing that central management by an initial innovator is least likely to be successful when follow-on research is likely to “lead[] down unexpected paths” and when it “depends on insights and creativity that may differ from one investigator to the next,” and concluding from this that the prospect theory may work better in contexts involving applied, rather than basic, research).

¹³⁴ See, e.g., O’Rourke 2/20 at 98; Hall 2/26 at 182-83; Merges & Nelson, 90 COLUM. L. REV. at 874-75 (noting the “steep transaction costs of technology licensing”); see also *infra* Ch. 2(III)(B)(3). Professor Kitch acknowledged these concerns but argued that the fact that negotiation sometimes breaks down or proves costly does not reveal how well the process works as a whole. Kitch 2/20 at 109.

competition in the market for follow-on products.¹³⁵

2. Follow-On Activities by Independent Follow-On Innovators

Follow-on innovation often proceeds through the activities of inventors independent of the initial innovator.¹³⁶ Independent follow-on innovation has all of the potential benefits identified *supra* in Ch. 2(II)(A), discussing the role of competition in spurring innovation. Competition may prod follow-on innovation efforts to proceed more quickly.¹³⁷ It may foster greater diversity of R&D activity, providing broader range for identifying research opportunities, designing and pursuing research paths, and recognizing and acting upon the implications of research results.¹³⁸ It may overcome biases in the initial innovator's choice of follow-on research projects attributable to its firm-specific skills or investments in

¹³⁵ See Scotchmer 2/26 at 136-39; Suzanne Scotchmer, *Competition Policy and Innovation: The Context of Cumulative Innovation* (2/26/02) (slides) at 7, at <http://www.ftc.gov/opp/intellect/020226suzanneandersonscotchmer.pdf> (hereinafter Scotchmer 2/26 Presentation); Bessen & Maskin (stmt) 4 ("increasing the number of firms in pursuit of a solution raises the probability that *someone* will succeed") (emphasis in original).

¹³⁶ Indeed, one analyst finds independent follow-on efforts the predominant pattern. See Scherer, 77 *ACADEMIC MEDICINE* at 1362 ("It is more the norm than the exception in the history of technology for the firms introducing significant derivatives of and improvements upon a basic discovery to be other than the original discoverer.").

¹³⁷ See Scotchmer 2/26 at 137-38.

¹³⁸ See, e.g., Arrow 2/25 at 58-59; Barton 2/26 at 172-73.

complementary assets.¹³⁹ When research is complete and follow-on products enter the market, their derivation from independent lines of development may result in less market power than when the initial innovator controls follow-on innovation.¹⁴⁰

Independent follow-on innovation, of course, might entail substantial duplication of effort.¹⁴¹ Some scholars condemn this duplication as wasteful, rent-seeking activity. Professor Mark Grady, for example, explains that when an initial innovation signals opportunities for follow-on inventions, hopeful inventors may "redundantly waste efforts to find and capitalize on that method of improvement."¹⁴² Others caution, however, that what to the firms involved is wasteful duplication of effort may have social benefit.¹⁴³ As Professor Suzanne Scotchmer explained, coordinating follow-on activities

¹³⁹ See generally Gilbert & Sunshine, 63 *ANTITRUST L.J.* at 577; Merges & Nelson, 90 *COLUM. L. REV.* at 873 ("Once a firm develops and becomes competent in one part of a 'prospect,' it may be very hard for it to give much attention to other parts, even though in the eyes of others, there may be great promise there.").

¹⁴⁰ Scotchmer 2/26 at 136-39 and Scotchmer 2/26 Presentation at 7.

¹⁴¹ See Stoner 2/26 at 112-13; Kitch, 20 *J. LAW & ECON.* at 276. See also *supra* Ch. 2(II)(B)(2).

¹⁴² Grady & Alexander, 78 *VA. L. REV.* at 308. The authors argue that many aspects of patent law can be explained as reflecting a desire to limit rent dissipation. *Id.* at 308-10. They note, though, that this effort may prove complex: a system that awards a broad initial patent to discourage wasteful follow-on races could unintentionally encourage duplicative efforts to win the initial patent. *Id.* at 308 ("The obvious compromise is to grant protection broad enough to prevent a race to improve . . . but not so broad as to create wasteful races for other patent goldmines.").

¹⁴³ See *supra* Ch. 2(II)(B)(2).

by eliminating patent races may increase the research firms' profits but harm consumers. "[T]ypically, the patent race will get us the product sooner, and may get us the product with higher probability," she stated.¹⁴⁴ Over all, the debate suggests that duplication may entail elements of both social benefit and undesirable waste.¹⁴⁵

B. Follow-On Innovation in the Face of a Single Blocking, Initial Patent

The Hearings identified two distinct sets of issues that the patent system raises for independent follow-on innovation. First, initial innovation may give rise to individual patents that block certain follow-on activities. This section discusses two potential responses: (i) directing follow-on innovation around the blocking patent or (ii) negotiating with the initial patentee for a license to permit the follow-on activities to go forward. Second, in some settings, follow-on activities may require numerous, distinct pieces of patented technology to proceed; the special problems this may pose here are analyzed *infra* in Chapter 2(III)(C).

¹⁴⁴ Scotchmer 2/26 at 137 (terming this "a conflict between the private incentives to cut back on R&D and the social incentives").

¹⁴⁵ A focus on duplicative research efforts reveals both facets. On the one hand, Professor Rebecca Eisenberg finds merit in overlapping research, arguing that "different investigators are likely to make different observations and have different ideas for follow-up experiments, improving the chances for serendipitous discoveries" and that "[e]ven completely duplicative research efforts may serve a valuable function by confirming research results and enhancing the likelihood that a discovery will be noticed." See Eisenberg, 56 U. CHI. L. REV. at 1068-69. On the other hand, Professor Kitch finds unnecessary waste when initial research is kept secret and follow-on researchers must tread the same ground without knowing of or learning from the prior failed efforts. See Kitch, 20 J. LAW & ECON. at 276.

1. Design-Around Innovation

Several panelists stressed that a significant benefit of the patent system is its role in directing R&D away from imitation by forcing competitors to design around existing patents. In the long run, they argued, re-directing R&D toward more innovative goals encourages greater technological progress.¹⁴⁶ One panelist, for example, explained that patent protection of the ulcer-treating drug Tagamet forced design-around efforts that led to the development of another successful drug, Zantac;¹⁴⁷ others cited Xerox's photocopying technology, which developed out of an effort to design around Kodak's silver halide photography patents and which, in turn, gave impetus to design-around research that generated ink-jet technology.¹⁴⁸

Other panelists pointed to the design-around theory's limits. In some settings design-around may be technically impossible.¹⁴⁹ In other settings, such as

¹⁴⁶ See, e.g., Myrick 3/19 at 20 and 10/30 at 40-42; Frankel 4/10 at 7; Banner 10/30 at 71; Frederick J. Telecky, *Statement of Frederick J. Telecky, Jr., Senior Vice President and General Patent Counsel, Texas Instruments: FTC/DOJ Hearings on "Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy"* (2/28/02) 3, at <http://www.ftc.gov/opp/intellect/020228telecky.pdf> (hereinafter Telecky (stmt)).

¹⁴⁷ See Armitage 3/19 at 230.

¹⁴⁸ See Varian 2/25 at 94; Sobel 7/10 at 175.

¹⁴⁹ See, e.g., Barr 10/30 at 90 (broad patents can prevent design-around); Detkin 2/28 at 668 ("unavoidable overlap of IP" in semiconductor technology); Richard Stallman, *The Danger of Software Patents Speech by Richard Stallman at Cambridge University, March 25 2002* (Public Comment) 4 ("no way around that patent. . . . nothing else you could do like that"), at <http://www.ftc.gov/os/comments/intelpropertycomments/st>

when the patented technology is needed to conform to a standard or consumers are otherwise locked in or when the infringing approach is already built into a competitor's product before the patent issues, design-around may be economically impossible.¹⁵⁰ In still other contexts the design-around may add little value, merely requiring that competitors "work harder to get to the same place."¹⁵¹ Indeed, analysts emphasize that design-around is not costless, but rather consumes resources that, absent the initial patent, might be more fruitfully employed.¹⁵² Without a clear basis for assessing the net value of design-around activity, general conclusions are difficult.

2. Division of Rewards

Rather than designing around an initial patent, an independent follow-on innovator may acquire a license to the patented technology and proceed with development of products or processes within the patent's coverage. In such cases, the division of rewards between the initial and follow-on innovators becomes crucial, because it determines the level of incentives for each generation of innovation. The

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¹⁵⁰ See, e.g., Stallman 4/9 at 19, 88-89; Barr 10/30 at 79.

¹⁵¹ See Stallman 4/9 at 38; cf. F. M. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 446 (2d ed. 1980) (noting both "examples and counterexamples" of valuable and essentially duplicative design-around research).

¹⁵² See *id.*; Kitch, 20 J. LAW & ECON. at 278-79. Stated differently, the design-around process may re-introduce some of the same duplications of effort *outside* the scope of an initial patent that are discouraged *within* the patent's coverage.

initial innovation provides a benefit to the follow-on innovator, and the full social benefit of the initial innovation includes a portion of the follow-on benefits that it confers. Consequently, providing the initial innovator some share in the returns from the follow-on activity may be efficient.¹⁵³

Optimal sharing arrangements, however, may prove elusive, for shifting rewards from one generation to another may reduce incentives at the disadvantaged generation. "The challenge is to reward early innovators for the technological foundation they provide to later innovators, but to reward later innovators adequately for their improvements and new products as well."¹⁵⁴

Royalty payments from the follow-on innovator are a means for implementing the sharing arrangements. Standards of patentability, discussed in Chapter 4, shape the backdrop against which licensing

¹⁵³ See Scotchmer 2/26 at 128-29; Scotchmer, 5 J. ECON. PERSP. at 31 ("First innovators will have correct incentives to invest only if they receive some of the social surplus provided by second generation products."). Of course, as already noted, innovation may be continuous, so that the "follow-on" innovator at one stage in the cycle becomes the "initial" innovator at the next. See Scotchmer 2/26 at 170.

¹⁵⁴ Scotchmer, 5 J. ECON. PERSP. at 30. Substantial additional literature explores the economically optimal division of profit between initial and follow-on innovators. See, e.g., HUGO A. HOPENHAYN & MATTHEW F. MITCHELL, *INNOVATION FERTILITY AND PATENT DESIGN* (National Bureau of Econ. Research Working Paper No. 7070, 1999), at <http://www.nber.org/papers/w7070.pdf>; Suzanne Scotchmer, *Protecting Early Innovators: Should Second-Generation Products be Patentable*, 27 RAND J. ECON. 322 (1996); Jerry R. Green & Suzanne Scotchmer, *On the Division of Profit in Sequential Innovation*, 26 RAND J. ECON. 20 (1995); Howard Chang, *Patent Scope, Antitrust Policy, and Cumulative Innovation*, 26 RAND J. ECON. 34 (1995).

negotiations occur. When the initial innovator obtains a narrow patent, so that the follow-on innovation does not infringe, the initial innovator will receive no royalty. It may still benefit if the follow-on innovation is a complement that increases the value of the initial innovation, but the initial innovator will suffer without compensation if the follow-on innovation is a substitute. If instead the initial innovator receives a broad patent, so that the follow-on innovation infringes, the initial innovator can force the follow-on innovator to take a license for the initial technology and share some of the follow-on benefits through the ensuing royalties.¹⁵⁵ If the follow-on innovator garners a patent on its improvement, it may have some negotiating leverage of its own; the patents are mutually blocking, and if the initial innovator wants access to the improvement, it will need to give as well as take.¹⁵⁶

3. Licensing

The timing of negotiations affects whether licensing arrangements will adequately reward both initial and follow-on innovation. Results are most likely to be problematic when licensing occurs *ex post*, that is, after the follow-on innovator has incurred the sunk costs of its R&D efforts. At that point, the follow-on innovator is

¹⁵⁵ See, e.g., Green & Scotchmer, 26 RAND J. ECON. at 21 (“Because the breadth of the first patent determines whether a product infringes, it thus determines the division of profit.”).

¹⁵⁶ See, e.g., O’Rourke 2/20 at 103-04 (describing the mutual infringement situation as the “blocking patent doctrine”); American Intellectual Property Law Association (AIPLA), *AIPLA Testimony* (Public Comment) 3, at <http://www.ftc.gov/os/comments/intelpropertycomments/aipla.pdf>.

exposed: it must secure a license now, after its investments are sunk. Faced with opportunistic demands, the follow-on innovator may not receive rewards adequate for its contribution.¹⁵⁷ If this were the established pattern, socially efficient levels of independent follow-on innovation could not be sustained.¹⁵⁸

Negotiation is more likely to divide rewards to support efficient follow-on activity if licensing occurs *ex ante*, that is, before the follow-on innovator makes its sunk investments.¹⁵⁹ Although incentives to enter *ex ante* licenses often may be present,¹⁶⁰ the Hearings and related scholarship suggested reasons that licensing may not occur *ex ante* in some circumstances.¹⁶¹

¹⁵⁷ See, e.g., Scotchmer 2/26 at 135; Rai 4/10 at 19; Green & Scotchmer, 26 RAND J. ECON. at 21, 23-24. Nevertheless, the initial innovator generally would not have an incentive to charge a royalty so high that the follow-on company would exit.

¹⁵⁸ Of course, follow-on innovation that is very valuable, and patent-protected, may still be profitable. See Green & Scotchmer, 26 RAND J. ECON. at 25. Thus, some panelists argued that when improvements are significant and adequate information is available, awarding a blocking position to the follow-on innovator may sufficiently protect that innovator even when licensing negotiations are conducted *ex post*. See Parkhurst 4/10 at 93-94; Kieff 4/10 at 163-64.

¹⁵⁹ See Stoner 2/26 at 118-19; Scotchmer 2/26 at 135.

¹⁶⁰ See, e.g., Kieff 4/10 at 163 (“let’s assume I have no idea where the big commercial utility is – I want to license everyone in the room in the hope that they find a commercial utility, because then I get a piece of that pie”); Blackburn 2/26 at 264-65 (“when you cannot predict ahead of time the incentive is there to broadly license”).

¹⁶¹ For full discussion of many of the possible licensing impediments, see Lemley, 75 TEX. L. REV. at 1050-61; Eisenberg, 56 U. CHI. L. REV. at 1073-74.

Some analysts stress the potential licensee's exposure in bringing a follow-on idea to the initial innovator. In an *ex ante* context, *before* the follow-on innovator has made its R&D investment, the follow-on idea would not be patent-protected, and the initial innovator might misappropriate it. Contracts to protect against such conduct may prove inadequate.¹⁶²

Some analysts suggest that transaction costs of *ex ante* licensing may prove high.¹⁶³ The negotiations may be fraught with uncertainty because the subject matter entails research that has not yet been conducted.¹⁶⁴ There may also be substantial uncertainty regarding the validity and scope of the initial innovator's patent rights.¹⁶⁵

Divergent views regarding the relative value of initial and follow-on contributions may prevent reaching

agreement.¹⁶⁶ One analyst highlights the potential for bargaining stalemates when the initial innovation involves basic research with little commercial value itself and the follow-on innovations require substantial investment.¹⁶⁷

In some circumstances, the initial innovator may not have a private incentive to license. Some panelists cautioned that firms may be reluctant to license others who may eventually prove to be competitors. When in-house development works to enhance or maintain market power, the initial innovator may serve its self-interest by forgoing socially beneficial licensing.¹⁶⁸

Others responded that transaction costs and the effects of uncertainty usually can be overcome, that the holder of an upstream patent has the incentive to assure that downstream products reach the market,¹⁶⁹ and that if licensing to follow-on innovators

¹⁶² See Lemley, 75 TEX. L. REV. at 1051; Scotchmer, 5 J. ECON. PERSP. at 36 n.11; Eisenberg, 56 U. CHI. L. REV. at 1063, 1073. The argument is an illustration of the point that patents facilitate efficient transfers of information. See *infra* Ch. 2(I)(A)(2).

¹⁶³ See, e.g., O'Rourke 2/20 at 98; Lemley, 75 TEXAS L. REV. at 1053-55; Merges & Nelson, 90 COLUM. L. REV. at 874.

¹⁶⁴ See, e.g., Lemley, 75 TEXAS L. REV. at 1053 ("if it is hard to value an invention that has already been made, it is well-nigh impossible to value one that might be made in the future"); Eisenberg, 56 U. CHI. L. REV. at 1073.

¹⁶⁵ See, e.g., Teece 2/26 at 202-04, 210 (observing that unclear boundaries "foul up" the market for know-how, but concluding that solutions to licensing problems eventually emerge); see *infra* Ch. 5(I).

¹⁶⁶ See, e.g., Rai 4/10 at 19. One mechanism for resolving uncertainties and divergent views regarding the likely value of follow-on research involves the use of licenses with reach-through royalties, that is, royalties measured as a percentage of the sales of the follow-on product or service. For discussion of the use of reach-through royalties in biotechnology contexts, see *infra* Ch. 3(II)(E)(1). For discussion of some of the legal and economic issues posed by reach-through royalties, see Second Report (forthcoming).

¹⁶⁷ See e.g., Scherer 7/10 at 56 (noting the combination of technical and market uncertainty); Scherer, 77 ACADEMIC MEDICINE at 1362.

¹⁶⁸ See, e.g., Rubinfeld 2/25 at 19-20 (discussing "in-house bias"); Cohen 10/30 at 151-52; Shapiro 11/6 at 164; McFalls 11/6 at 182-83.

¹⁶⁹ See, e.g., Blackburn 2/26 at 264.

Box 2-3a. Patent Thickets. The potential economic problems associated with patent thickets are diverse. First, in a patent thicket where innovation depends on having access to existing patents held by many different owners, the transaction costs of access can rise substantially because of the costs of negotiating with each of many individual patentees. *See infra* Ch. 2(III)(C)(1). Second, in some situations, the transaction costs of learning about and individually licensing all existing relevant patents are high enough to significantly undermine the economic incentive to develop follow-on innovation and production. In other situations, uncertainty surrounding pending patents hampers reaching licensing agreements. Unless a firm can mitigate the problem, it may have to choose between the risk of being sued for infringement after it sinks costs into its invention or production, or dropping its innovative or productive efforts altogether. *See infra* Ch.2(III)(C)(2). Third, a follow-on innovator in a patent thicket generally needs to access multiple patentees' intellectual property to develop his invention. Following Cournot's prediction, each patentee will demand a higher royalty than its patent would command if it were licensed as part of a package. *See infra* Ch. 2(III)(C)(3). Finally, in patent thickets in which follow-on innovation depends on having access to many patents held by a group of oligopolists, the oligopolists may use the patents to prevent entry. *See infra* Ch. 2(III)(C)(4).

would be beneficial, it is likely to occur.¹⁷⁰ Prof. David Teece, for example, explained that although there may be "battles around patents" in the early days of an industry, "what tends to happen is that these problems get solved."¹⁷¹ Anecdotal information and case studies point in both directions.¹⁷²

C. Follow-On Innovation in the Face of Multiple Existing Patents

In some circumstances, the need for access to multiple existing patent-protected technologies may also hinder subsequent

innovative work.¹⁷³

Indeed, in some industries, there has been a proliferation of patents.¹⁷⁴ Commentators have noted five factors that contribute to patent proliferation. First, the technology developed in industries such as semiconductors, computer hardware, and software can contain a large number of

¹⁷³ *See infra* Ch. 3(III)(D)(4), (IV)(E)(2) and (V)(E)(2). For a summary of problems of the patent thicket and techniques for mitigating it, *see* Boxes 2-3a and 2-3b.

¹⁷⁴ *See* Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting*, in 1 *INNOVATION POLICY AND THE ECONOMY* 119, 120 (Adam Jaffe et al. eds., 2001) (hereinafter *Navigating the Patent Thicket*); Mowery 2/27 at 427; Stallman 4/9 at 20; Burk 3/20 at 149; Greenhall 2/27 at 375-76; Detkin 2/28 at 667-68 and Peter N. Detkin, *A Semiconductor Patent Survey (2/28/02)* (slides) at 5, at <http://www.ftc.gov/opp/intellect/020228peterndetkin.pdf>. The introduction of patent maintenance payments may help somewhat to clear patent thickets because a significant number of patent holders do not maintain their patents for the full term. *See* Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 *Nw. U. L. REV.* 1494, 1503-04 (2001) (50 percent of patents gone by twelfth year). Many of the patents so eliminated may never have had commercial significance, however. *See* Lemley, 95 *Nw. U. L. REV.* at 1503 ("Most of these [lapsed] patents aren't litigated or licensed during the short time they are in force.").

¹⁷⁰ *See, e.g.*, Teece 2/26 at 210-11; Kieff 4/10 at 159-60, 199-200; *cf.* Arora 2/25 at 88-89 (transaction costs generally are not large enough to prevent licensing provided that the proper incentives are present).

¹⁷¹ Teece 2/26 at 210.

¹⁷² For example, *compare* O'Rourke 2/20 at 98 and Rai 4/10 at 19 (both citing Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 *COLUM. L. REV.* 839 (1990), for its case studies of breakdowns in licensing opportunities) *with* Boulware 10/30 at 175-76 (citing two broad, basic biotech patents that have been widely licensed).

incremental innovations.¹⁷⁵ One panelist from the software industry noted that programs can contain millions of lines of code and include “potentially hundreds of thousands” of patentable inventions.¹⁷⁶ The complex nature of such technology creates a technology thicket over which a patent thicket develops.¹⁷⁷

Box 2-3b. Mitigating the Patent Thicket.

Techniques that companies use for handling the patent thicket include assuring mutual destruction, *see infra* Ch. 2(III)(C)(2)(b), patent pooling, cross-licensing, and package licensing, *see infra* Ch. 2(III)(C)(3).

Second, in their research, Hall and Ziedonis contend that a “pro-patent” shift in the U.S. legal environment in the 1980s was the stimulus for patent proliferation.¹⁷⁸ The authors believe that a series of congressional reforms in the early 1980s – including the creation of the Court of Appeals for the Federal Circuit, which “put in place a

¹⁷⁵ See Detkin 2/28 at 669-70, 710-11; Poppen 2/28 at 684, 712; Barr 2/28 at 713-14; Fox 2/28 at 714; Mowery 2/27 at 427; Armbrrecht 3/19 at 54; Cohen 10/30 at 91.

¹⁷⁶ See Kohn 2/27 at 351-52; Pooley 2/27 at 382.

¹⁷⁷ See Teece 2/27 at 500 (“the right question to ask is not whether or not there’s a patent thicket, but whether or not the patent thicket, if there is one, is undergirded by a technology thicket”).

¹⁷⁸ Bronwyn H. Hall & Rosemarie Ham Ziedonis, *The Patent Paradox Revisited: An Empirical Study of Patenting in the U.S. Semiconductor Industry, 1979-1995*, 32 RAND J. OF ECON. 101, 105 (2001). See also Jeffrey T. Macher, David C. Mowery & David A. Hodges, *Semiconductors, in U.S. INDUSTRY IN 2000: STUDIES IN COMPETITIVE PERFORMANCE 279-81* (1999), at <http://www.nap.edu/books/0309061792/html/245.html>.

number of procedural and substantive rules that collectively strengthened the rights of US patent owners¹⁷⁹ – produced this shift. Hall and Ziedonis also identified two events that arose out of the “pro-patent” shift and signaled the strength of the new patent regime: (i) Polaroid’s patent infringement suit against Kodak, which resulted in almost \$1 billion in damages and an injunction against Kodak’s participation in the instant-film camera business,¹⁸⁰ and (ii) higher royalty rates obtained by Texas Instruments from an aggressive licensing strategy, which demonstrated to other firms the revenue potential of mining a large patent portfolio.¹⁸¹

Third, in the semiconductor, computer hardware, and software industries, defensive patenting strategies can drive firms to patent even more. As more patents issue, the likelihood of “unintentional and sometimes unavoidable patent infringement” increases.¹⁸² Some firms respond to this by “fil[ing] hundreds of patents each year” themselves, patents they can use defensively against firms threatening infringement actions.¹⁸³ The result of this, of course, is

¹⁷⁹ Rosemarie Ham Ziedonis & Bronwyn H. Hall, *The Effects of Strengthening Patent Rights on Firms Engaged in Cumulative Innovation: Insights from the Semiconductor Industry* 12 (June 2001), at <http://emlab.berkeley.edu/users/bhall/papers/HallZiedonis01%20libecap.pdf> (draft version).

¹⁸⁰ Hall & Ziedonis, 32 RAND J. OF ECON. at 109.

¹⁸¹ *Id.*

¹⁸² Barr 2/28 at 677.

¹⁸³ *Id.*; see also Detkin 2/28 at 668 (“there’s an unavoidable overlap of IP . . . people are tripping over each other’s patents right and left”); Hart 4/9 at 42-42; Hall 2/28 at 661; Hall & Ziedonis, 32 RAND J. OF ECON. at 125.

yet more patenting.

Fourth, in some industries, increased patenting levels may reflect increases in R&D activity.¹⁸⁴ Finally, the issuance of unwarranted patents may be a contributing factor to patent proliferation.¹⁸⁵ One panelist cited interviews conducted with participants in the semiconductor industry in which the participants voiced concern regarding the patenting of “very trivial inventions.”¹⁸⁶

1. High Transaction Costs

a. Stemming From Number of Patents

When follow-on innovation depends on having access to patents held by many different owners, the transaction costs of access can rise substantially. In industries with incremental innovation, such as the software industry, innovation often depends on access to many patents.¹⁸⁷ There can be “potentially dozens or hundreds of patents covering individual components of a product” in such an industry.¹⁸⁸ One panelist’s experience illustrates the concern: in searching the patent landscape surrounding a particular patent relevant to

¹⁸⁴ See, e.g., Ziedonis 3/20 at 13-14 and Rosemarie Ziedonis, *The Role of Patents in Semiconductors: Insights from Two Recent Studies* (3/20/02) (slides) at 3, at <http://www.ftc.gov/opp/intellect/020320rosemarieziedonis.pdf>; Telecky 2/28 at 711 (increasing patents reflect increasing research budgets); Mossinghoff 2/6 at 82-83 (pharmaceutical R&D expenditures have increased at a greater rate than pharmaceutical patents).

¹⁸⁵ See Ziedonis 3/20 at 15-16.

¹⁸⁶ See Ziedonis 3/20 at 15-16.

¹⁸⁷ See Telecky (stmt) 3; Tecce 2/27 at 500.

¹⁸⁸ Mowery 2/27 at 427.

his business, he found 120 patents that appeared to overlap each other.¹⁸⁹ The cost of access rises in such situations because of the costs of negotiating with each of many individual patentees.¹⁹⁰

b. Stemming from Lack of Benchmarks

Moreover, transaction costs may be greater where bargainers lack benchmarks for the deal they are trying to reach. In general, incomplete or asymmetrical information in bilateral bargaining situations raises transaction costs by lengthening negotiations.¹⁹¹ Many licensing agreements are kept confidential, panelists noted,¹⁹² and in any event, different transactions may involve unique elements that make comparisons difficult. As a result, when two parties wish to create a licensing agreement,

¹⁸⁹ See Greenhall 2/27 at 375-76.

¹⁹⁰ Some have called this problem an aspect of the “tragedy of the anticommons.” See, e.g., Michael Heller & Rebecca Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCIENCE 698, 699 (1998); Hall 2/26 at 182-83; cf. Dickinson 2/6 at 61-62 (referring to this transaction cost concern as “patent layering”). For a description of the tragedy of the anticommons and business panelists’ perceptions of whether it actually occurs, see *infra* Ch. 3(III)(D)(4).

¹⁹¹ See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 68-69 (5th ed. 1998) (using example of litigation settlement to demonstrate the transaction costs incurred by incomplete information, arguing that a potential litigant who does not know the price at which its counterpart would prefer litigation to settlement will find it expensive to determine the correct settlement terms, and will expend “much time and resources” trying to bargain once it has determined its counterpart’s price “range”); Joseph Farrell, *Information and the Coase Theorem*, 1 J. ECON. PERSP. 113, 115 (1987) (sketching the difficulties that incomplete information raises for bilateral bargaining).

¹⁹² See, e.g., Pooley 2/27 at 436-37.

they may lack “a market-driven assessment of the value of the patent” in question, according to one panelist,¹⁹³ and that ignorance can raise transaction costs. Indeed, some would-be licensors feel the need to threaten litigation in order to have access to others’ confidential licensing terms,¹⁹⁴ further heightening transaction costs.

2. Hold Up in the Patent Thicket

a. Hold Up

Sometimes, follow-on innovation and production depends on having access to patents that are economically infeasible to license because they are too numerous to license individually or even to learn about. In other situations, uncertainty surrounding pending patents hampers the reaching of licensing agreements. Unless downstream actors – whether innovators or manufacturers – can mitigate the problem, they may have to choose between the risk of being sued for infringement after they sink costs into invention or production, or dropping innovative or productive efforts altogether. Either option can injure economic welfare. Below is a discussion of the economic theories behind these

¹⁹³ Friedman 2/27 at 439 (noting that knowledge of others’ licensing terms would be of limited use, since “markets with few people in it are extraordinarily inexact”); *see also* Pooley 2/27 at 437 (noting that if would-be licensees could review confidential terms of other licensing agreements, they could get an objective sense of the worth of the patent by evaluating not just the royalty rate but who the licensees were, how much “they are actually paying when weighed against other contributions that they’re making or obligations they are taking,” and the like).

¹⁹⁴ *See, e.g.*, Pooley 2/27 at 437-38 (suggesting that discovery in litigation could disclose such information).

concerns.

In some situations, the transaction costs of learning about and individually licensing all existing relevant patents are high enough to undermine significantly the economic incentive to develop follow-on innovation and production.¹⁹⁵ For example, one panelist noted that in industries such as semiconductors in which the ratio of patents to products is high, a firm cannot make a new product “without infringing hundreds if not thousands of patents.”¹⁹⁶ Another commentator concurred: participants in the semiconductor industry receive “thousands of patents . . . each year and manufacturers can potentially infringe on hundreds of patents with a single product.”¹⁹⁷ Another panelist observed that “the large number of issued patents in [the computer hardware industry] makes it virtually impossible to search all potentially relevant patents, review the claims, and evaluate the possibility of an infringement claim or the need for a license.”¹⁹⁸

In other situations, secrecy

¹⁹⁵ High transaction costs can render licensing from multiple intellectual-property holders economically infeasible. *See, e.g.*, *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979) (determining that blanket license warranted review under the rule of reason). Some have called transaction costs *the* problem of the “patent thicket.”

¹⁹⁶ *See* Lemley 2/25 at 37-39 (noting that in such industries, patents are awarded on “inventions [that] are small changes in process, they are small changes in product, they are circuit design innovations, they are little pieces of the innovation,” and that in such industries with high ratios of patents to products, “hold-up problems are much greater than they are in other industries”).

¹⁹⁷ Shapiro, *Navigating the Patent Thicket* at 125.

¹⁹⁸ Barr (stmt) 1; *see also* Barr 2/28 at 676-7.

surrounding a patent makes it very difficult for downstream actors to avoid it. Indeed, the holder of a yet-unpublished patent can (once it issues) use it to hold up follow-on innovators and producers who unknowingly infringed it.¹⁹⁹ One panelist stated that “the long delays in the patent office work to [some firms’] benefit by keeping the eventual coverage of their patents indefinite while others produce products.”²⁰⁰ Some noted that improving “information [available] at an earlier stage about patents likely to issue” could help ameliorate hold up,²⁰¹ but hold up may persist because of uncertainty about the scope of claims that eventually will issue.²⁰²

If an innovator or producer learns that it has infringed a patent only after it has committed sunk costs to its innovation and production – and thus locked in to the effort – the patentee may be in a position to demand supra-competitive royalty rates. If, before lock in, the downstream actor had known about the patent and could have designed its product or innovation around it, then the firm might have used the opportunity to adopt alternative designs as leverage for seeking a competitive royalty

¹⁹⁹ See Barr 2/28 at 676.

²⁰⁰ Barr (stmt) 2; see also Ch. 4(II)(C)(1) (discussing continuations).

²⁰¹ See, e.g., Shapiro, *Navigating the Patent Thicket* at 126. For example, ninety percent of patent applications are now published within 18 months, pursuant to the requirements of the American Invention Protection Act; and a 1995 patent term change from 17 years after issuance to twenty years after filing may reduce incentives to prolong examinations. See *infra* Ch. 4(II)(C)(1). Some panelists believed that these developments can mitigate hold up; others pointed out that they would not completely cure the problem. *Id.*

²⁰² Barr 2/28 at 676; see also *infra* Ch. 4.

rate. But after lock in, the downstream actor no longer has that option. Redesigning a product after significant costs have been sunk may not be economically viable.²⁰³ And the cost of being preliminarily enjoined is high: as one industry participant noted, losing a motion for a preliminary injunction in an infringement lawsuit “would be detrimental to a firm if it means shutting down a high-volume manufacturing facility [since the] loss of one week’s production alone can cost millions of dollars.”²⁰⁴

Hold up can injure innovation and competition. First, such a demand for payment after lock in can compel the downstream actor to pay the patentee a “far greater” royalty rate.²⁰⁵ That higher rate, one scholar noted, can be passed along to consumers in the form of higher prices.²⁰⁶ Second, the threat of hold up may reduce overall levels of innovation, because some companies will “refrain from introducing certain products for fear of holdup.”²⁰⁷

²⁰³ See, e.g., Shapiro, *Navigating the Patent Thicket* at 125; Barr (stmt) 2-3; Rosemarie Ziedonis, *When the Giants’ Shoulders are Crowded: Fragmented Rights and Patent Strategies in Semiconductors* 8-9 (July 2002) (unpublished manuscript), at <http://www.isnie.org/ISNIE02/Papers02/ziedonis.pdf>.

²⁰⁴ Hall & Ziedonis, 32 *RAND J. OF ECON.* at 109 (paraphrasing the statement of an industry participant whom they interviewed).

²⁰⁵ Shapiro, *Navigating the Patent Thicket* at 125.

²⁰⁶ See *id.* at 126; see also Poppen 2/28 at 690.

²⁰⁷ Shapiro, *Navigating the Patent Thicket* at 126; see also Peter C. Grindley & David J. Tecce, *Managing Intellectual Capital: Licensing and Cross-Licensing in Semiconductors and Electronics*, 39 *CAL. MGMT. REV.* 8, 20 (1997).

b. Strategies to Mitigate

(i). Mitigation Strategy of Amassing Patents and Assuring Mutual Destruction

To mitigate such hold up in the context of a patent thicket, some firms in certain industries have accumulated large patent portfolios.²⁰⁸ Panelists noted that a firm with a large patent portfolio is in a better position to raise patent infringement counterclaims against a firm that tries to hold it up.²⁰⁹ It is also better able to force others to license their patents (or perhaps portfolios of patents),²¹⁰ or to demand that other firms agree not to assert blocking patents against it (often called “non-assertion agreements”).²¹¹ The prospect of mutually assured destruction (or “MAD”)

²⁰⁸ See, e.g., Hall & Ziedonis, 32 RAND J. OF ECON. at 104 (describing semiconductor industry); Ziedonis, *When the Giants’ Shoulders are Crowded: Fragmented Rights and Patent Strategies in Semiconductors* at 4 (describing semiconductor industry); Barton 2/26 at 150 (predicting evolution of mutual-assured-destruction strategy in financial services industry and biotech industry, and noting that such strategies are “not going to be an uncommon situation”).

²⁰⁹ See, e.g., COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS at 26-27 (stating that one of the most important uses of patents across all industries is to prevent infringement lawsuits); Hall 2/28 at 662 (“Basically we pile up a lot of patents because the other guy has a lot of patents and that, when we, if we, do get threatened, we can engage in a cross-licensing negotiation.”); League for Programming Freedom, *Against Software Patents* (Public Comment) 6, at <http://www.ftc.gov/os/comments/intelpropertycomments/lp f.pdf>.

²¹⁰ See, e.g., COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS at 20-24 (stating that one reason firms in complex product industries obtain patents is to strengthen their position in cross-licensing negotiations).

²¹¹ Non-assertion agreements are discussed in Second Report (forthcoming).

ensures detente, and design freedom, for such firms.²¹² Each firm takes into account that, if it tried to extract excessive royalties or impede the other’s innovation efforts through threats of patent infringement litigation, the other firm could retaliate by suing it for patent infringement and enjoining its production. This leads the firms to reach licensing agreements with each other, often portfolio cross-licensing agreements.²¹³ Such agreements can give each firm the freedom to design and operate without fear of being sued by the other.²¹⁴

(ii). Costs and Limits of MAD Mitigation Strategy

(A). Costly Arms Race

Amassing patent portfolios may mitigate hold up, but it also carries costs. It is, as one commentator noted, a “rather costly arms race.”²¹⁵ It generates a “lot of resource waste,” some panelists noted,²¹⁶ since firms spend “a significant amount on legal bills to apply for patents” to use in

²¹² See Hall 2/28 at 662; Hall & Ziedonis, 32 RAND J. OF ECON. at 109; Friedman 2/27 at 356 (describing one goal of amassing large patent portfolios as maintaining detente). MAD strategies apply only to firms that are vulnerable; those that are not are discussed below, see *infra* Ch. 2(III)(C)(2)(b)(ii)(B) (discussing undeterred NPEs).

²¹³ See, e.g., Cohen 2/20 at 63-64.

²¹⁴ See, e.g., *id.* See also Second Report (forthcoming) (discussing portfolio cross-licensing agreements).

²¹⁵ Cohen 2/20 at 33-34.

²¹⁶ Hall 2/26 at 178-79 (reporting semiconductor patent executives’ views).

these MAD strategies.²¹⁷ One panelist issued a directive to his company's staff requiring that they "reallocate roughly 20 to 35 percent of [their] developer's resources and sign on two separate law firms to increase [their] patent portfolio."²¹⁸ The engineers' time dedicated to assisting in the filing of patents, which "have no . . . innovative value in and of themselves," could have been spent on developing new technologies, the panelist noted.²¹⁹

(B). NPEs Undeterred

In addition to being expensive, MAD strategies are not always effective. Firms cannot use their patent portfolios defensively against companies referred to as non-practicing entities (NPEs).²²⁰ NPEs are firms that are, for a variety of reasons, invulnerable to a countersuit for patent infringement. They may be design firms that patent their inventions but do not practice them or patent assertion firms that buy patents from other companies (particularly bankrupt ones) not to practice

but to assert against others.²²¹ Since NPEs are not vulnerable to an infringement counter attack, MAD strategies threatening infringement actions do little to constrain their willingness to seek high royalty rates from locked-in downstream actors.²²² Thus, NPEs can threaten other firms with patent infringement actions, which, if successful, could inflict substantial losses, without fear of retaliation.²²³ In short, MAD strategies do nothing to mitigate NPE hold up.²²⁴

One panelist hypothesized that NPEs' invulnerability may create a competitive problem if it prevents the type of cross-licensing that has evolved as a "safety valve" due to the prevalence of overlapping and cumulative patents.²²⁵ Under this theory, a cross-licensing "safety valve" may be necessary for markets to work efficiently when there are large numbers of overlapping and cumulative patents. If the market-created safety valve relies on *all*

²¹⁷ Barton 2/26 at 177-78.

²¹⁸ Greenhall 2/27 at 376.

²¹⁹ *Id.* at 377, 420.

²²⁰ Participants in the Hearings also used the terms "non-vertically integrated" intellectual property holders and "trolls" to refer to NPEs. For purposes of clarity, this Report uses the neutral term "NPE." See Poppen 2/28 at 685-88; Detkin 2/28 at 672; Carl Shapiro, *The FTC's Challenge to Intel's Cross-Licensing Practices*, Institute of Business and Economic Research Competition Policy Center Paper CPC02-029, at 7 (2002), at <http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1028&context=iber/cpc>; see also *infra* Ch. 3(IV)(E) (noting view that NPEs are merely exercising legitimate patent rights).

²²¹ See, e.g., Poppen 2/28 at 685-88; Detkin 2/28 at 672.

²²² See, e.g., Rhoden 2/28 at 723-24 ("There's nothing that they need that you have and so they're basically in the position where they have something perhaps that you need. Since there's no mutually assured destruction . . . they can come in and assert and shut your business down and you have no option against them."); McCurdy 3/20 at 72 (you cannot negotiate reasonable royalties from NPEs because "there is no counterassertion capacity."); cf. Ziedonis 3/20 at 71-72 ("The Lemelson Foundation, I think, has made a very successful business from setting licensing fees so that balancing payment, you set it low enough to where it's below the cost of actually going to court or the managerial time that it would take to basically fend off the lawsuit.").

²²³ See Poppen 2/28 at 685-89; Detkin 2/28 at 671-72; Hall & Ziedonis, 32 RAND J. OF ECON. at 109.

²²⁴ See *infra* Ch. 3(IV)(E)(2)(c) for a description of the recent rise in NPE activity.

²²⁵ Farrell 11/6 at 174-75.

parties wishing to bring products to the market, then a patent holder that is not vulnerable to countersuit for infringement may “gum[] up the safety valve.”²²⁶

3. Royalty Stacking and Cournot’s Complements Problem

In addition, the so-called “complements problem” can raise costs for innovators who depend on access to multiple patents. First identified in 1838 by Antoine Cournot and echoed by subsequent observers, the complements problem refers to the welfare loss stemming from individual monopolists each selling complementary goods for a given use.²²⁷ Profit maximizing behavior will lead each producer to extract a monopoly price for his good, resulting in cumulative monopoly rents proportional to the number of complements.²²⁸ In contrast, if a single firm controlled the production of all complementary inputs, it would extract a single monopoly rent, and the price would be lower than the aggregate of individual monopoly prices.²²⁹ This is because the firm would take into account the effect that the

prices of complementary products have on each other’s sales, and would set a package price that would maximize total profit.²³⁰ Thus, if monopolistic producers of complementary products packaged their products and extracted a single monopoly rent, prices would fall, output would increase, and profits would rise.²³¹

The complements problem is relevant to the problem of blocking patents, one panelist argued. A follow-on innovator frequently needs to access multiple patents to develop his invention. When acting alone, patent holders – like individual monopolists of complementary technology or information inputs – will demand higher aggregate royalties than they would if they acted as a group.²³² Such behavior imposes a financial burden on prospective licensees that might deter further innovation.²³³

Indeed, some have argued that over-generous granting of patent rights in the biomedical industry has resulted in follow-

²²⁶ *Id.* at 175.

²²⁷ See generally ANTOINE COURNOT, RESEARCHES INTO THE MATHEMATICAL PRINCIPLES OF THE THEORY OF WEALTH (1838), tr. Nathaniel Bacon (1895); cf. Shapiro, *Navigating the Patent Thicket* at 145 n.6 (noting assumption that the complementary inputs are used in fixed quantities and cannot substitute for each other).

²²⁸ See Shapiro, *Navigating the Patent Thicket* at 149 (applying economic theory to show that the aggregate monopoly “markup” of competing complement producers is equal to the number of producers multiplied by the markup for a single product).

²²⁹ See, e.g., *id.* at 123 (observing that prices would be lower and profits higher if a single producer controlled all complements than if each were controlled by individual monopolists).

²³⁰ See Carl Shapiro, *Theories of Oligopoly Behavior*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 339 (Richard L. Schmalensee & Robert D. Willig eds. 1989) (noting that competing monopolists of complementary goods would not take “negative externalities” into their pricing decisions).

²³¹ See, e.g., Shapiro, *Navigating the Patent Thicket* at 123 (noting that “monopolist suppliers will find it in their joint interests to offer a package price that is less than the[] two components sold for when priced separately”); Nirvikar Singh & Xavier Vives, *Price and Competition in a Differentiated Duopoly*, 15 RAND J. OF ECON. 546, 547 (1984) (showing that rational firms supplying complementary goods will cooperate to offer a high enough quantity to “reinforce” one another’s market).

²³² See Shapiro, *Navigating the Patent Thicket* at 123 (applying general Cournot theory of complements to blocking patents).

²³³ See *id.* at 124.

on innovators' under-utilization of existing research. Biomedical researchers face a maze of overlapping patents in the hands of different owners, the critics state.²³⁴ They argue that these conditions can raise to prohibitive levels the cost of licensing all of the relevant patents for a useful advance.²³⁵ Perversely, it can also divert research to unpromising areas that are relatively barren of patents.²³⁶ One commentator states that this situation provides an example of Cournot's complements problem: each biotechnology patent holder, acting in its own self-interest, holds royalty rates inefficiently high, raising the costs of further innovation.²³⁷

One panelist has suggested that an "impleading" mechanism could help cure the Cournot problem. Under a system similar to the one governing stakeholder lawsuits, a follow-on innovator could offer a "reasonable" royalty rate to all of the holders

²³⁴ See Heller & Eisenberg, 280 *SCIENCE* at 698 (discussing rising number of patents granted in biomedical research). The authors have deemed this an aspect of the "tragedy of the anticommons." See *id.* at 699. For a description of the tragedy of the anticommons, see *infra* Ch. 3(III).

²³⁵ See Heller & Eisenberg, 280 *SCIENCE* at 698-99, 701 (describing the disincentive to follow-on innovation created by overlapping patents). The authors also noted that individual patent holders tend to overestimate the likelihood that their patent will be used in the final invention, which induces some to charge a higher royalty rate than their patent deserves, raising the direct costs of licensing for follow-on innovations. See *id.* at 701

²³⁶ See *id.* at 699 (describing distortionary effects of the anticommons problem).

²³⁷ See Shapiro, *Navigating the Patent Thicket* at 124 (linking tragedy of the anticommons to the complements problem).

of relevant intellectual property.²³⁸ Another commentator has suggested that patent pooling, cross-licensing, and package licensing can ameliorate the complements problem: when two or more patent holders predict that other firms might wish licenses to their patents, they can organize patent pools or package licenses to facilitate orderly transfer of intellectual property at lower combined royalty rates and higher combined profits.²³⁹ Such mechanisms serve a similar function to the impleading proposal by allowing producers of complementary goods to set a mutually beneficial price. Such packages might also reduce the transaction costs faced by prospective follow-on innovators.²⁴⁰

4. Oligopoly/Group Boycott

When follow-on innovation depends on having access to many patents held by a group of oligopolists, the oligopolists can use the patents to prevent entry. Specifically, some argued that patentees can foster "MAD oligopolies" that deter entry. They noted that a group of patentees, each fearing an infringement counterclaim from the other, can tacitly agree not to sue each other for infringement.²⁴¹ The patentees could "give each other at least a tacit license [or an] explicit license with some kind of

²³⁸ See Pooley 2/27 at 415-16 (also noting industry consortia or government intervention as potential solutions to the problem).

²³⁹ See Shapiro, *Navigating the Patent Thicket* at 123 (calling such solutions an "ideal outcome" under the right circumstances).

²⁴⁰ See *supra* Ch. 2(III)(C)(1)(a).

²⁴¹ See, e.g., Barton 2/26 at 151; see also Barton, 65 *ANTITRUST L.J.* at 464.

formal cross-license.”²⁴² The group could deter entry either by refusing to license the new entrant or by charging the entrant high royalty rates.²⁴³ For example, one panelist noted that “in Japan, . . . the leading firms in the industry . . . agglomerate[d] huge portfolios which they were swapping with each other, but which they were unwilling to trade with the outside players.”²⁴⁴

On the other hand, what looks like a MAD oligopoly may really be a pro-competitive way of rewarding those who took the initial risks, some observed,²⁴⁵ or of cutting through patent thickets.²⁴⁶ Moreover, cross-licensing arrangements in the semiconductor industry appear not to have slowed innovation, one panelist argued.²⁴⁷

5. Patent Fences and Patent Extensions

Hearing discussion raised some of

²⁴² Barton 2/26 at 151.

²⁴³ *Id.* at 152 (noting that patentee group could charge outsiders royalty rates “that were not simply enough to cover a reasonable share of the research costs and so forth, but [were] so big as to knock everybody else out of the industry”).

²⁴⁴ Ordover 11/6 at 105.

²⁴⁵ See, e.g., Teece 2/26 at 176-77 (arguing that often, patentees cross-license “as a way to extract a fee. So the latecomers who didn’t . . . incur a lot of those early expenses end up . . . having to pay something, and you seem to me that you’ve solved the classic sort of free-rider problem”).

²⁴⁶ See, e.g., Barton 2/26 at 152 (noting that some cross-licensing agreements are “appropriate because we have zillions of mutually-blocking patents”); Shapiro 11/6 at 111. See generally *supra* Ch. 2(III)(C)(2)(b) (discussing MAD strategies).

²⁴⁷ See Teece 2/26 at 177.

the potential strategic uses of multiple patents. One branch of the discussion focused on an initial innovator’s efforts to accumulate patents to buttress a threatened position of market power. Thus, an initial innovator may seek to build a “fence” around its position by securing additional patents on near substitutes, thereby blocking follow-on innovators from designing around the initial patent or raising their R&D costs.²⁴⁸ Under a pure “fence” strategy, the patentee would have no intention either to license the substitute patent technologies or to develop them on its own; the only goal would be to keep rivals out.²⁴⁹ Some analysts suggest that preemptive patenting of this type is likely to be a useful strategy only in exceptional circumstances, given the costs and the potential for multiple routes to entry.²⁵⁰ Nonetheless, some recent survey evidence suggests that “fence” strategies may be frequently employed in “discrete products” industries – which entail relatively few patents per commercial product – in which individual patents fail to prevent

²⁴⁸ See Cohen 2/20 at 31; COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS at 22, 25; Richard J. Gilbert, *Patents, Sleeping Patents and Entry Deterrence*, printed in STRATEGY, PREDATION, AND ANTITRUST ANALYSIS 223-25 (S. Salop ed. 1981); SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE at 451 (1980).

²⁴⁹ See Cohen 2/20 at 32; COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS at 22, 25.

²⁵⁰ See Gilbert & Newbery, 72 AMER. ECON. REV. at 514-15; Gilbert, *Patents, Sleeping Patents and Entry Deterrence* at 227 (observing that if there are many patentable alternatives at comparable development costs, then “the use of preemptive patenting to fence in a monopoly is about as effective as holding back a flood with a sieve”), 268-69.

imitation or substitution.²⁵¹

Panelists did not suggest that patent fences developed by a firm's own research are, or should be, antitrust violations.²⁵² Some scholarship, however, raises concerns regarding the effects of patent fences on follow-on innovation and efficiency. Some commentators suggest that using patents to build fences departs from traditional patent goals; rather than securing a defined reward for beneficial innovation, it expands that initial reward by broadening the zone of exclusivity – and the possible impact on entry and independent follow-on innovation – without conferring additional social benefits through new products or processes.²⁵³ Other analysts have contended that socially wasteful expenditures of resources flow from fencing activities.²⁵⁴

A related strategy, which might be designated “patent extensions,” involves efforts to extend patent protection beyond the life of an initial patent by accumulating

²⁵¹ See Cohen 2/20 at 32 and Cohen Presentation at 14 and 15; COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS at 22-25 (treating as indicative of a fence strategy survey responses that reported blocking, but not negotiating or licensing, as among the motives for patenting and finding such responses 44-45% of the time in discrete product industries).

²⁵² Building a fence through acquisitions of patents, however, could raise issues under Section 7 of the Clayton Act, 15 U.S.C. § 18. See, e.g., McFalls 11/6 at 183-84.

²⁵³ See COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS at 28; cf. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE at 451-52 (1980) (patent fencing a way “to extend and pyramid . . . monopoly power”).

²⁵⁴ See HOPENHAYN & MITCHELL, INNOVATION FERTILITY & PATENT DESIGN at 4.

patents on improvements. During the Hearings, Professor F.M. Scherer argued that Xerox's strategy for photocopying illustrated this approach, stating that “by amassing this continuing portfolio of improvement patents, Xerox was going to monopolize the industry, not for 17 years, but forever.”²⁵⁵ For the strategy to be effective however, there must be some reason to expect that, following expiration of the initial patent, competitors offering the no-longer-patent-protected core product would not adequately constrain pricing of the improved version.²⁵⁶

6. Patent Flooding

Efforts to build a sufficient patent portfolio to induce others to share their technology through cross licenses may shade into more aggressive strategies. When rivals obtain patents on trivial variants of an initial innovation, “patent flooding” becomes possible. Under this strategy, “[t]he flooder ‘surrounds’ a competitor’s patent or technology . . . so that over time, the competitor finds itself ‘unable to maneuver.’”²⁵⁷ Lacking the breathing room

²⁵⁵ Scherer 7/10 at 180. Professor Scherer's textbook cites a similar prolongation of control through a series of improvement patents on the electric light bulb. See SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE at 451-52 (1980).

²⁵⁶ See Sheila F. Anthony, Riddles and Lessons from the Prescription Drug Wars: Antitrust Implications of Certain Types of Agreements Involving Intellectual Property, Before the American Bar Association Program on “Antitrust and Intellectual Property: The Crossroads” (June 1, 2000) (analyzing analogous issues raised by Eli Lilly's acquisition of an exclusive license from Sepracor), at <http://www.ftc.gov/speeches/anthony/sfip000601.htm>.

²⁵⁷ Sri Krishna Sankaran, *Patent Flooding in the United States and Japan*, 40 IDEA 393, 394 (2000), quoting Dan Rosen & Chikako Usui, *The Social Structure*

to develop improvements or to find new uses for its invention, the initial innovator eventually must accede to demands that it share its technology through a cross license with the flooder.²⁵⁸ Critics of patent flooding argue that these cross licenses are one-sided, extracting valuable intellectual property from the targets and undermining initial innovators' incentives to innovate without contributing significant follow-on benefits.²⁵⁹ Typically they point to examples in Japan, where the patent system appears more conducive to flooding strategies than in the United States.²⁶⁰ The hearing record does not suggest that patent flooding is currently a widespread practice in this country.²⁶¹

of Japanese Intellectual Property Law, 13 UCLA PAC. BASIN L. J. 32, 44 (1994); Jeffrey A. Wolfson, *Patent Flooding in the Japanese Patent Office: Methods for Reducing Patent Flooding and Obtaining Effective Patent Protection*, 27 GEO. WASH. J. INT'L L. & ECON. 531 (1994).

²⁵⁸ See, e.g., Wolfson, 27 GEO. WASH. J. INT'L L. & ECON. at 533 (describing cross-licensing as the flooder's typical goal).

²⁵⁹ See, e.g., *id.* at 533, 554-55.

²⁶⁰ See, e.g., Sankaran, 40 IDEA at 399-404 (emphasizing that patent applicants in Japan may defer examination for up to seven years, allowing them to assert the claimed rights coercively for a prolonged period without ever having to demonstrate patentability). Several analysts note the perception of a proclivity in Japan to issue narrow patents to initial innovators and to grant patents on relatively minor variations on prior inventions; they argue that this would increase the potential for flooding. See, e.g., John Gladstone Mills III, *A Transnational Patent Convention for the Acquisition and Enforcement of International Rights*, 84 J. PAT. & TRADEMARK OFFICE SOC'Y 83, 110-11 (2002); Sankaran, 40 IDEA at 395; Wolfson, 27 GEO. WASH. J. L. & ECON. at 539-41; Ordovery, 5 J. ECON. PERSP. at 48.

²⁶¹ See Kunin 7/11 at 181-83 (describing patent flooding as a product of the Japanese patent system). Even an analyst who argues that patent flooding may have occurred in the United States identifies at most a handful of

Conclusion. Competition policy and patent policy enhance economic welfare in complementary ways. Yet neither competition nor patent policy can, alone, promote innovation fully. Competition alone is not a perfect tool for fostering innovation. For example, the award of patents is often necessary to remedy free riding on others' innovations. But patent policy alone also is not a perfect tool for fostering innovation. Indeed, patent rights can in some circumstances hinder follow-on innovation and competition. Rather, the two means of promoting innovation must work in tandem with each other.

The balance of this Report explores how they can best do so. Chapter 3 provides extensive real-world illustrations of the economic phenomena as voiced by business representatives from the pharmaceutical, biotechnology, computer hardware, and software/Internet industries. Chapters 4 and 5 translate the core economic concerns into a detailed examination of patent system standards and procedures.

instances in which it has been alleged. See Sankaran, 40 IDEA at 411-17. As discussed below, the patent law's obviousness doctrine, which deals with the size of inventive step necessary for obtaining a follow-on patent, affects opportunities to employ flooding strategies. See *infra* Ch. 4(II)(A)(1). In the United States, some aspects of this doctrine work against flooding. Cf. Merges 2/26 at 162-64 (explaining that the double patenting doctrine in the United States gives initial innovators greater ability than improvers to patent what would otherwise be obvious variations).

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CHAPTER 3

BUSINESS TESTIMONY: CURRENT INNOVATION LANDSCAPE IN SELECTED INDUSTRIES

I. SUMMARY

Over six days of Hearings, business representatives from four high-tech industries discussed the drivers of innovation in their industries. Representatives from the pharmaceutical, biotechnology, Internet, and computer hardware and software industries described their real-world experience with how patents and competition affect incentives to innovate. Their discussions confirmed many of the principles summarized in Chapter 2 and sometimes shed additional light and offered new perspectives on the topics. They highlighted both the benefits and costs of current patent and antitrust policies applied in their industries. This chapter discusses the diverse views presented by the panelists, and also incorporates the results of business surveys and other industry-specific scholarship.

The panelists identified various attributes that characterized innovation in the different industries. Panelists discussed whether innovation in their industries tends to be discrete or cumulative, building incrementally on prior discoveries. Panelists also addressed sources and amounts of capital required for entry, barriers to entry, the extent to which industries are vertically integrated, and difficulties in commercializing new products. They raised issues of fixed cost recovery, alternative appropriability mechanisms, and relationships between initial and follow-on innovation, adding business insights and practical experience to the analysis of Chapter 2. According to both panelists and academics, factors such as these shape the

role of competition and patents in spurring or discouraging innovation in their industries.

Pharmaceutical and biotechnology representatives testified that strong patent protection is essential to innovation in their industries. Business representatives characterized innovation in these industries as costly and unpredictable, requiring significant amounts of pioneering research to discover and test new drug products. By preventing rival firms from free riding on discoveries, patents allow pharmaceutical firms to recoup the substantial capital investments made to discover, test, and obtain regulatory approval of new drug products. Biotech representatives emphasized that patent protection is critical to attract the capital necessary to fund this high-risk investment. Indeed, firms believed that the biotech industry would not exist but for patents. One concern involved patents on the research tools used to assist in the discovery of new drug products. Biotech representatives expressed concern that such patents could obstruct the commercialization of new products, thereby hindering follow-on innovation. To date, however, evidence suggests that such problems have not emerged.

Pharmaceutical and biotech representatives testified that they use patent information disclosures required by the patent statutes to direct their research and development (R&D) into areas not claimed by the patents. Representatives from generic pharmaceutical firms discussed how patent disclosures guide their efforts to “design-around” patents, so that they can develop

non-infringing generic versions of brand-name drug products.

By contrast, computer hardware and software industry representatives generally emphasized competition to develop more advanced technologies as a driver of innovation in these rapidly changing industries. These representatives, particularly those from the software industry, described an innovation process that is generally significantly less costly than in the pharmaceutical and biotech industries, and they spoke of a product life cycle that is generally much shorter. Some software representatives observed that copyrights or open source code policies facilitate the incremental and dynamic nature of software innovation. They discounted the value of patent disclosures, because they do not require the disclosure of a software product's underlying source code.

Computer hardware manufacturers noted that they often use trade secrets, rather than patents, to protect their inventions, because it is difficult to discover whether a rival firm has infringed a patented manufacturing invention. Computer hardware manufacturers generally would rather keep the invention secret than publicly disclose it and risk third party misappropriation of patent rights that they will be unable to discover. By contrast, computer hardware firms that specialize solely in hardware design and have no manufacturing responsibilities valued patent protection as a way to raise venture capital.

Representatives from both the computer hardware and software industries observed that firms in their industries are obtaining patents for defensive purposes at

rapidly increasing rates. They explained that the increased likelihood of firms holding overlapping intellectual property rights creates a "patent thicket" that they must clear away to commercialize new technology. They discussed how patent thickets divert funds away from R&D, make it difficult to commercialize new products, and raise uncertainty and investment risks. Some computer hardware and software representatives highlighted their growing concern that companies operating in a patent thicket are increasingly vulnerable to threats to enjoin their production from non-practicing entities that hold patents necessary to make the manufacturer's product.

A global concern that representatives from each of the four industries described was that poor patent quality (*e.g.*, a patent for which there is invalidating prior art, or a patent broader than was enabled) can blunt incentives to innovate. They described the costly nature of litigation to invalidate these patents, both in terms of dollars and resources diverted from R&D. They also discussed how a timely, less costly mechanism to review poor quality patents would enhance innovation in their industries.

These representatives also described how each industry has developed licensing practices to extract value from their patents or, in some cases, to obviate some of the problems raised by patent thickets. They raised concerns that uncertainty about the parameters of antitrust enforcement may be hindering the use of certain methods to extract patent value. For example, biotech

representatives noted that antitrust concerns have contributed to uncertainty about the propriety of using reach-through royalty provisions in research tool licenses.

Firms in the computer hardware and software industries indicated that antitrust concerns may be inhibiting joint discussions of licensing terms during the standard-setting process. They noted that antitrust has traditionally been suspicious of joint discussions of licensing terms arising prior to the adoption of a standard. Some panelists suggested, however, that such conduct is necessary for the efficient establishment of new standards because some companies are using patents strategically.

Box 3-1. Independent Inventors and the FTC's Invention Promotion Cases

One cross-industry concern raised by a specific sub-group was the vulnerability of independent inventors to fraudulent practices as they seek patents and offer licenses on those patents. This problem has been, and continues to be, a matter of FTC concern. Two panelists representing the independent invention community mentioned the defrauding of inventors by invention promotion firms. *See Udell 2/28 at 568-69* ("the FTC has done a magnificent job of not only educating inventors, but also getting the scam organizations that have been bleeding inventors for decades out of the pockets of the poor inventors in America."); *Hayes-Rines 3/19 at 61-62* (urging enhanced FTC enforcement efforts).

In 1997, the FTC launched a consumer education program and a law-enforcement sweep entitled "Project Mousetrap" because a "number of firms in the invention promotion industry are perpetrating a massive fraud" against independent inventors. As a result of this sweep and other enforcement actions, the Commission brought eight cases against invention promoters during the 1990s. The complaints have named 41 defendants, consisting of 21 companies and 20 individuals. In some cases, the Commission alleged that the defendants represented that they would obtain patents for their customers' inventions without clarifying that these would be design patents, which typically have less commercial value than utility patents. The Commission generally alleged that the defendants represented that their research and marketing services were likely to secure profitable licenses for their customers' inventions. The Commission further alleged that, in fact, the defendants were rarely successful at securing licensing agreements, and that the few licenses that the defendants did secure seldom resulted in appreciable income for the inventors.

In six cases, the Commission obtained consent orders that required the defendants to pay consumer redress and to make affirmative disclosures to prospective customers about the promoters' past success rates. One case is still in litigation and the eighth case was dismissed after the U.S. Attorney's office filed criminal charges. More recently, the Commission has expanded its consumer education program, in cooperation with the PTO, to include rights available to inventors under the American Inventors Protection Act of 1999. Further details on the Commission's consumer education efforts and enforcement actions are available at <http://www.ftc.gov/bcp/conline/edcams/invention/> and <http://www.ftc.gov/opa/1997/07/mouse.htm>.

II. THE PHARMACEUTICAL INDUSTRY

A. Introduction

Representatives from the pharmaceutical industry stated that patent protection is indispensable in promoting pharmaceutical innovation for drug products containing new chemical entities. The sunk cost of engaging in research projects aimed toward the development of these drugs is extremely high. By preventing rival firms from free riding on the innovating firms' discoveries, patents can enable pharmaceutical firms to cover their fixed costs and regain the capital they invest in R&D efforts. Moreover, the patenting process requires disclosure of the underlying invention covered by the patent, potentially encouraging further innovation. Generic drug companies report they use disclosed patents as a basis on which to "invent-around" patented, brand-name products in order to develop generic variations.

The panelists who represented pharmaceutical firms or organizations at the Hearings were Robert A. Armitage, representing Eli Lilly and Company; Monte R. Browder, representing Ivax Corporation; David Coffin-Beach, representing Torpharm, Inc.; Gregory J. Glover, Counsel to Pharmaceutical Research and Manufacturers of America; Nancy J. Linck, representing Guilford Pharmaceuticals; and Ross Oehler, representing Aventis Pharmaceuticals Inc. One scholar, Edward A. Snyder, from the University of Chicago, and one attorney, Rochelle K. Seide, from Baker Botts, LLP, also participated in a business perspective panel on the pharmaceutical industry.

B. Industry Description

R&D in the pharmaceutical industry generally produces two main types of innovation: (1) discrete innovation, which means, in general terms, that the invention might be improved, but does not point the way to wide-ranging, subsequent discoveries of new chemical entities (NCEs);¹ and (2) incremental innovation, which describes the development of improvements to existing drug products, often referred to as product line-extensions.² Obviously, innovation can occur at many points along the continuum, from discrete to incremental, but these categories are useful in identifying certain characteristics associated with innovation in the pharmaceutical industry.

1. Discrete Research and Development for NCEs

Discrete R&D in the pharmaceutical industry focuses on the discovery and development of new chemical or molecular

See Robert P. Merges & Richard R. Nelson, On the Complex Economics of Patent Scope, 90 COLUM. L. REV. 839, 880 (1990) (discussing types of innovation); *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy*, Mark Lemley Testimony Feb. 25, 2002, at page 37 (hereinafter, citations to transcripts of these Hearings state the speaker's last name, the date of testimony, and relevant page(s)); Richard C. Levin, *Testimony of Richard C. Levin, President, Yale University* (2/6/02), at <http://www.ftc.gov/os/comments/intelpropertycomments/levinrichardc.htm> (hereinafter R. Levin (stmt)). *But cf.* Browder 3/19 at 174 (noting the potential need for progression from generic compound to specific compound to unique formulation).

² For an overview of the different types of pharmaceutical patents, see Box 3-2.

entities to make small molecule drug products.³ The discovery of a chemical molecule that is both efficacious and safe for human usage can result in a totally new drug product. Such discoveries typically require significant amounts of pioneering research, and both fixed costs and risks of failing to develop a marketable product, consequently, are very high. Brand-name companies spend a substantial amount in development costs over the course of 10 to 15 years to bring a product involving an NCE to market from the initial research stage.⁴ The brand-name companies' trade association reports that most newly marketed drugs do not cover their average development costs.⁵ Brand-name companies typically rely on a small number of "blockbuster" drugs to recoup

³ This contrasts with the biotechnology industry, which focuses instead on cells and large biological molecules (such as DNA and proteins). See Beier 2/26 at 248.

⁴ See Gregory J. Glover, *Competition in the Pharmaceutical Marketplace* (3/19/02) 3 (stating that the average cost to develop a new drug is \$802 million), at <http://www.ftc.gov/opp/intellect/020319gregoryjglover.pdf> (hereinafter Glover (stmt)); Armitage 3/19 at 127-28; see also Bureau of Economics Staff Report, Federal Trade Commission, *The Pharmaceutical Industry: A Discussion of Competitive and Antitrust Issues in an Environment of Change* (Mar. 1999) (discussing development risk), available at <http://www.ftc.gov/reports/pharmaceutical/drugrep.pdf> (hereinafter BE Staff Report, *The Pharmaceutical Industry*); Arthur D. Little, *Examining the Relationship Between Market-Based Pricing and Bio-Pharmaceutical Innovation* (Public Comment) 3, at <http://www.ftc.gov/os/comments/intelpropertycomments/litlearthur2.pdf>.

⁵ See Pharmaceutical Research and Manufacturers of America, *Delivering on the Promise of Pharmaceutical Innovation: The Need to Maintain Strong and Predictable Intellectual Property Rights* (Public Comment) 9, at <http://www.ftc.gov/os/comments/intelpropertycomments/phrma020422.pdf> (hereinafter PhRMA (stmt)); see also Glover (stmt) 4; Armitage 3/19 at 129; BE Staff Report, *The Pharmaceutical Industry* (discussing market risk).

Box 3-2. *Pharmaceutical Patents*

Pharmaceutical patents are issued for four different categories: drug substance, method of use, formulation, and process. Drug substance patents cover the compound or active ingredient in the drug product, such as fluoxetine hydrochloride, which is the active ingredient in Prozac. Method of use patents cover the use of the product to treat certain health problems, such as depression or asthma. Formulation patents cover the physical composition or delivery mechanism of the drug product, such as an extended release tablet or capsule. Process patents generally cover the procedure used to make the active ingredient. For further details on pharmaceutical patents, see Federal Trade Commission, *Generic Drug Entry Prior to Patent Expiration: An FTC Study* (July 2002) (hereinafter, FTC, *Generic Drug Study*), at <http://www.ftc.gov/os/2002/07/genericdrugstudy.pdf>.

their overall investment in innovation, including R&D costs for failed products.⁶

Relatively few patents are required to protect a product with an NCE.⁷ One panelist noted that an actual drug product can be based on between four and 15 patents.⁸ The low number of patents contained in a pharmaceutical product

⁶ See The National Institute for Health Care Management, *Changing Patterns Of Pharmaceutical Innovation* 4 (2002), at <http://www.nihcm.org/innovations.pdf> (hereinafter *NIHCM Innovation Report*); IMS Health, *IMS HEALTH Data Reveal Dramatic Growth in Megabrands*, at <http://secure.imshealth.com/public/structure/discontent/1,2779,1362-1362-143992,00.html>; PhRMA (stmt) 11.

⁷ One panelist defined discrete product industries as those that require relatively few patents to protect a product, and complex product industries as those that require a relatively large number. See Cohen 2/20 at 30 and Wesley M. Cohen, *Patents: Their Effectiveness and Role* (2/20/02) (slides) at 13, at <http://www.ftc.gov/opp/intellect/cohen.pdf>.

⁸ See Browder 3/19 at 174.

means that, as panelists noted, the development of patent thickets is generally not a concern.⁹ Although brand-name companies may compete with each other in the same therapeutic class, such as anti-depressants or blood-pressure-lowering drugs, and may seek to obtain a number of patents in a particular area to ensure freedom to operate, such behavior has not given rise to so many overlapping sets of patent rights as to hinder the commercialization of new technologies.¹⁰ From 1989 to 2000, the Food and Drug Administration (FDA) approved 1,035 New Drug Applications (NDAs), 361 of which were for NCEs.¹¹ The remaining 674 NDAs that FDA approved during this period were incrementally modified drugs (IMDs).¹²

2. The Demanding Nature of the NCE Development Process

Panelists provided an overview of the two-stage process to determine whether an NCE is safe and efficacious to market – a process that is time-consuming, uncertain,

and expensive.¹³ The first stage involves the identification of chemical compounds that might treat an indication or disease.¹⁴ In general, the brand-name companies' trade association reported, "only 20 in 5,000 compounds that are screened enter preclinical testing," which involves laboratory and animal testing.¹⁵

The second stage begins when the company sponsoring the drug submits an NDA to the FDA. Three phases of clinical testing then follow, which the drug-sponsoring company undertakes and the FDA's Center for Drug Evaluation and Research oversees. Brand-name companies conduct Phase I clinical studies on healthy human beings to determine side effects and gather preliminary evidence of effectiveness. Phase II studies "are designed to obtain data on the effectiveness of the drug for a particular indication or indications in patients with the disease or condition."¹⁶ Phase III studies are expanded controlled and uncontrolled trials and can involve thousands of patients. These clinical trials are often very resource and time-intensive.¹⁷

⁹ See Glover (stmt) 8.

A patent thicket is a "dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology." Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting*, in 1 *INNOVATION POLICY AND THE ECONOMY* 119, 120 (Adam Jaffe et al. eds., 2001) (hereinafter *Navigating the Patent Thicket*).

¹⁰ See Glover (stmt) 6, 8; Armitage 3/19 at 230.

¹¹ See *NIHCM Innovation Report* at 3.

¹² See *NIHCM Innovation Report* at 3. IMDs are drugs which rely on an active ingredient present in a drug already approved for the U.S. market, or a closely related chemical derivative of such an ingredient, that has been modified by the manufacturer. *Id.* at 5.

¹³ See Armitage 3/19 at 127-28.

¹⁴ See *id.* "Indication" means disease, illness, or disorder.

¹⁵ See Glover (stmt) 3; Armitage 3/19 at 127.

¹⁶ Tufts Center for the Study of Drug Development, *How New Drugs Move through the Development and Approval Process* (2001), at <http://csdd.tufts.edu/NewsEvents/RecentNews.asp?newsid=4>.

¹⁷ See Glover (stmt) 3.

3. The Implications of Clinical Trials for Effective Patent Term of NCEs

The time-consuming nature of clinical trials to evaluate a drug product's safety and efficacy may limit the length of effective patent term that brand-name companies can realize. Panelists testified that brand-name companies seek to obtain patents early in the R&D process – usually before clinical trials have commenced.¹⁸ One panelist stated that the initial patent(s) to be issued for a totally new drug product are on the drug substance (*i.e.*, the NCE or molecule).¹⁹ This panelist contended that drug substance patents are typically the most valuable for the brand-name company, because they are much more difficult for potential competitors (including generic companies) to design around than formulation or method of use patents.²⁰

In the Hatch-Waxman Amendments to the Federal Food, Drug and Cosmetic Act, Congress provided for restoration of a portion of the patent term that elapses while clinical trials and FDA review are under way.²¹ The Hatch-Waxman Amendments can restore patent term up to a maximum of five years, depending on how long clinical trials and FDA review take. Total effective patent term may not exceed more than 14

years from the date of FDA approval.²² Pharmaceutical companies report, however, that by the time clinical trials are complete and a drug product is ready to market, the effective patent life for a drug patent – even with patent term restoration – is typically about 11 years,²³ substantially shorter than the 20-year statutory patent term.²⁴ Congress also has provided other market exclusivity periods for brand-name

²² 35 U.S.C. § 156 (c)(3). Another approach to restoring the patent term that elapses during FDA review would be to reduce FDA approval time. One study has found that reductions in regulatory approval times are somewhat more effective in increasing cash flow for a brand-name company, because such reductions add years to the less heavily discounted beginning of the product life cycle, rather than the end. See James W. Hughes et al., "Napsterizing" Pharmaceuticals: Access, Innovation, and Consumer Welfare (Public Comment) 8-9, at http://www.ftc.gov/os/comments/intelpropertycomments/sn_ydermoorehughes.pdf.

²³ See PhRMA (stmt) 9-10 (stating that "the [average] effective patent life for drugs introduced from 1984-1995 that received patent term restoration, including such restoration, was only about 11 years" and citing Sheila R. Shulman et al., *Patent Term Restoration The Impact of the Waxman-Hatch Act on New Drugs and Biologics Approved 1984-1995*, 2 J. BIOLAW AND BUS. 63, 66 (1999)); see also Linck 4/9 at 97; Browder 3/19 at 174-75; Seide 3/19 at 176; Armitage 3/19 at 176-77. But see NIHCM Foundation Issue Brief, *Prescription Drugs and Intellectual Property Protection: Finding the Right Balance Between Access and Innovation* 1, 3 (Aug. 2000) (arguing that the effective patent term has increased by at least 50% since the passage of the Hatch-Waxman Amendments), at <http://www.nihcm.org/prescription.pdf>.

²⁴ A patent's term is 20 years from the date of filing the application. Due to the time-consuming nature of the patent examination process, most patents are unlikely to have an effective patent term of 19 or 20 years. See 35 U.S.C. § 154(a)(2), as amended by the Uruguay Round Agreements Act of 1994, Pub. L. No. 103-465, which changed patent term from 17 years measured from date of a patent's issuance to 20 years measured from date of filing the patent application.

¹⁸ See Glover 3/19 at 172-74; Armitage 3/19 at 176-77.

¹⁹ See Armitage 3/19 at 178.

²⁰ See *id.*; McCurdy 3/20 at 36-37.

²¹ Drug Price Competition and Patent Restoration Act of 1984, Pub. L. No. 98-417, 98 Stat. 1585 (1984) (codified as amended 21 U.S.C. § 355 (1994)).

companies.²⁵

Box 3-3. Generic Drug Entry Prior to Patent Expiration: An FTC Study

In light of the questions its various generic drug investigations raised, the Commission began an industry-wide study of generic drug competition in October 2000. The Generic Drug Study focused solely on the procedures used to facilitate generic drug entry *prior to* expiration of the patent(s) that protect the brand-name drug product. The Commission issued nearly 80 special orders - pursuant to Section 6(b) of the FTC Act - to brand-name companies and to generic drug manufacturers, seeking information about certain practices. The Commission staff compiled the information received to provide a factual description of how the 180-day marketing exclusivity and 30-month stay provisions affect the timing of generic entry prior to patent expiration. Based on this data, the Commission made two primary recommendations concerning the 30-month stay provision and the 180-day exclusivity to mitigate the possibility of abuse that deters more generic drugs from becoming available. The Generic Drug Study is *available at* <http://www.ftc.gov/os/2002/07/genericdrugstudy.pdf>.

4. Incremental Innovation for the Development of IMDs

The other main type of innovation in the pharmaceutical industry consists of enhancing known chemical entities by formulating new dosage forms or additional methods of use for existing chemical entities. This type of innovation is generally described as “incremental,” which, in general terms, means that “today’s advances

²⁵ For example, the safety and efficacy data for a product may not be relied upon by another company for five years if the product contains an NCE and for three years if the product involves a new use of an existing compound. 21 U.S.C. § 355(c)(3)(D)(ii). A drug product also can obtain an additional six months of market exclusivity if it conducts studies showing the product is safe and effective for children. 21 U.S.C. § 355a.

build on and interact with many other features of existing technology.”²⁶ In the pharmaceutical industry, incremental innovation generally falls into one of three categories. The modified product may use a new formulation, such as a transdermal patch instead of a pill, may combine two previously approved active ingredients, or may use a new salt or ester, which is a more purified form of the original chemical entity.²⁷ Several panelists suggested that brand-name companies have responded to effective patent term reduction and the increasing cost of discovering and developing NCEs by implementing product life-cycle management, including the use of IMDs.²⁸ Some have noted that IMDs “provide a high return on investment.”²⁹

Participants in the Hearings expressed differing views about the benefits of these modified drugs. Some testified that IMDs benefit consumers by providing more convenient dosing or “superior therapeutic

²⁶ See Merges & Nelson, 90 COLUM. L. REV. at 881.

²⁷ See *NIHCM Innovation Report* at 5; Armitage 3/19 at 217.

²⁸ See Linck 4/9 at 97-98; Aventis Pharmaceuticals Inc., *Comments of Dr. Nahed Ahmed, Vice President, Productivity, Portfolio & Project Management Drug Innovation & Approval Aventis Pharmaceuticals Inc.* (Public Comment) 3-4 (contending that there are strong economic incentives for brand-name companies to implement IMDs, because they are “safer, faster, and more cost effective for the development as an incremental improvement rather than an original product.”), at <http://www.ftc.gov/os/comments/intelpropertycomments/aventis.pdf> (hereinafter *Aventis (stmt)*); Armitage 3/19 at 216-218; Snyder 3/19 at 224; *NIHCM Innovation Report* at 3.

²⁹ *NIHCM Innovation Report* at 4; see also *Aventis (stmt)* 4.

properties than the original formulation,³⁰ or by serving certain patient populations better than the original product.³¹ The brand-name companies' trade association stated that if physicians and consumers choose IMDs in preference to generic alternatives of the original brand-name product, the modified drug is warranted.³² In contrast, a generic drug manufacturer suggested that IMDs might be a tactic employed by brand-name companies "to extend patent monopolies beyond the patent expiry of the new chemical entity . . . by a matter of years, not days or weeks or months."³³ This panelist also argued that the PTO issues too many questionable patents, which create a gridlock of patent litigation in the district court system and thereby delay generic entry.³⁴ The FTC's Generic Drug Study found that over time, for blockbuster products, brand name companies are suing for infringement on more patents, and those suits take longer on average than suits involving a single patent.³⁵ Others have reported that "the FDA view[s] the vast majority of IMDs as providing no significant

clinical improvement."³⁶

C. The Role of Patents In Spurring Pharmaceutical Innovation

Panelists reported that patent protection promotes innovation in the pharmaceutical industry by creating incentives for brand-name companies to innovate, and by disclosing inventions, thereby encouraging generic companies to innovate by designing around brand-name company patents.

Participants in the Hearings overwhelmingly expressed the view that patent rights for pharmaceuticals are essential for brand-name companies to prevent free riding and recoup their significant investments in research and development of NCEs.³⁷ One panelist noted that patents are particularly important in the pharmaceutical industry, because the Hatch-Waxman Amendments permit generic applicants to rely on the brand-name company's proprietary data demonstrating the safety and efficacy of the brand-name drug product.³⁸

³⁰ Glover (stmt) 7.

³¹ See Snyder 3/19 at 224.

³² See PhRMA (stmt) 29-30; *see also* Glover (stmt) 7.

³³ Coffin-Beach 3/19 at 201-05, 212-213 (suggesting that brand-name companies time their incremental modifications to maximize their product's franchise, for example, by waiting 10 years to develop a sustained-release version of an NCE).

³⁴ Coffin-Beach 3/19 at 204-205.

³⁵ See FTC, *Generic Drug Study* at 47-48.

³⁶ *NIHCM Innovation Report* at 7; *see also* Coffin-Beach 3/19 at 201-05 (stating that IMDs may have "questionable therapeutic merit.").

³⁷ See PhRMA (stmt) 10-13; Glover (stmt) 2, 4 (describing the cost of new drug development and generic entry); Linck 4/9 at 48-49; Armitage 3/19 at 165; *see supra* Ch. 2(B)(1)(b) (discussing economic studies on the role of patents in protecting against free riding in different industries).

³⁸ See Armitage 3/19 at 133, 165. The FDA considered retesting of generic drugs to be wasteful if the underlying drug is safe and effective. Moreover, such retesting is unethical because it requires that some sick patients take placebos and be denied treatment known to be

Patent law requires applicants to disclose the inventions for which they seek patents. The purpose of the disclosure obligation is to foster further innovation by enabling a person skilled in the particular art to learn from another's invention.³⁹ This disclosure obligation is a trade-off for obtaining the right to exclude others from making, using, offering for sale or selling an invention.⁴⁰ Several panelists observed that the disclosure requirement fosters innovation in the pharmaceutical industry by enabling both brand-name and generic companies to discern the development plans and scientific development of rival companies.⁴¹ One panelist reported that patent literature is an important source of information on technological advances for the pharmaceutical industry, whereas scientific literature, much of which is enabled by patents, is more important in the biotechnology industry.⁴²

One way in which a generic company can compete with a particular brand-name product prior to the expiration of the patents

effective. See H.R. REP. NO. 98-857, Part I at 16 (1984), reprinted in 1984 U.S.C.C.A.N. 2647, 2649. The ability of other companies to rely on that data and develop bioequivalent generic versions of NCEs at much lower costs significantly reduces the profits for the branded product. One panelist stated that once a certain drug has a generic counterpart, the result is a "more rapid decline in the pioneer share of the market" because pharmacy benefit managers and formulary managers require that physicians and patients use generic drugs, as opposed to the more expensive branded drugs. See Glover 3/19 at 171.

³⁹ See *supra* Ch. 2(1)(A)(3).

⁴⁰ Rogan 2/6 at 21.

⁴¹ See Coffin-Beach 3/19 at 212; Glover 3/19 at 224-25; Seide 3/19 at 226; Browder 3/19 at 238; Oehler 2/26 at 319.

⁴² See Blackburn 2/26 at 319-20.

that cover the drug product is to design around those patents.⁴³ Representatives of generic companies observed that the process of designing around brand-name patents can give rise to innovation.⁴⁴ In some circumstances a generic company may obtain a patent for its design-around innovations.⁴⁵

D. The Role of Competition in Spurring Pharmaceutical Innovation

Panelists described competition among brand-name companies and the role of the Hatch-Waxman Amendments in fostering competition and innovation in the pharmaceutical industry. One panelist observed that the granting of a pharmaceutical patent does not necessarily confer a "monopoly on the treatment of any specific disease;" brand-name companies may compete with each other in the same therapeutic class, such as drugs that reduce cholesterol.⁴⁶ Moreover, according to the brand-name companies' trade association, competition among brand-name companies is increasing, because the period of market exclusivity between the introduction of breakthrough medicine and competing innovators has been consistently shrinking

⁴³ For further details, see FTC, *Generic Drug Study*. For discussion of design-around innovation by brand-name companies, see Armitage 3/19 at 230.

⁴⁴ See, e.g., Browder 3/19 at 228.

⁴⁵ See Coffin-Beach 3/19 at 225.

⁴⁶ See Glover (stmt) 6. But see *NIHCM Innovation Report* at 3 (suggesting that price competition among several new drugs products in a therapeutic class is limited.).

since 1965.⁴⁷ None of the panelists believed, however, that competition alone could generate sufficient innovation in the pharmaceutical industry.⁴⁸

One of the unique aspects of the pharmaceutical industry is how the regulatory structure governing the approval of new brand-name and generic drug products has spurred additional competition and innovation. In this case, the Hatch-Waxman Amendments sought to balance incentives for continued innovation by research-based pharmaceutical companies and opportunities for market entry by generic drug manufacturers. The streamlined approval process gives generic drug applicants the opportunity to obtain FDA approval of their generic drug products prior to patent expiration.⁴⁹ By removing

⁴⁷ See Glover (stmt) 7; PhRMA (stmt) 28. But see Sal Ricciardi, *Comments Re: Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy Public Hearings, Spring and Summer, 2002* (Public Comment) 10 (discussing restraints on secondary market competition), at <http://www.ftc.gov/os/comments/intelpropertycomments/pda.pdf>.

⁴⁸ Panelists disagreed on the extent to which innovation would occur in the pharmaceutical industry absent patent protection, although all believed that it would decline markedly. Professor Snyder, who has conducted research into this particular issue, cited findings indicating that in the absence of patent protection for pharmaceuticals, innovation would decrease by approximately 60%. Armitage disagreed with Snyder, asserting that the absence of patents would eliminate innovation in the pharmaceutical industry. Compare Snyder 3/19 at 170 with Armitage 3/19 at 180.

⁴⁹ Brand-name companies must provide the FDA with information regarding patents that cover their drug products, which the FDA then lists in a publication commonly known as the "Orange Book." See 21 U.S.C. § 355(j)(7)(A) and FTC, *Generic Drug Study* at Ch. 3. Generic drug companies who seek FDA approval prior to patent expiration must give notice to brand-name companies stating that the listed patents are invalid or not

obstacles to generic competition, the Hatch-Waxman Amendments "stimulated the development of a generic pharmaceutical industry in the United States. Since the law's passage, the generic industry's share of the prescription drug market has jumped from less than 20 percent to almost 50 percent today."⁵⁰ The Hatch-Waxman Amendments have fostered significant price competition in those markets with generic entry.⁵¹ The generic competition spurred by Hatch-Waxman has forced brand-name firms to come up with new products to replenish their revenue streams.⁵² Brand-name companies often have introduced IMDs for which they can seek patent protection to lessen the impact of this generic competition.⁵³

Congress also encouraged generic

infringed by the generic product.

⁵⁰ See Glover (stmt) 7; see also Ashoke Bhattacharjya, *FTC Health Care Workshop: Panel on Branded and Generic Pharmaceuticals* 5 (stmt presented at the FTC's Healthcare Workshop Sept. 10, 2002), at <http://www.ftc.gov/ogc/healthcare/bhatta.pdf>; FTC, *Generic Drug Study* at (i) (identifying these figures as shares of prescriptions filled).

⁵¹ Studies indicate that the first generic typically enters the market at 70 to 80 percent of the price of the corresponding brand and rapidly secures as much as a two-thirds market share. See, e.g., Congressional Budget Office, *How Increased Competition from Generic Drugs Has Affected Prices and Returns in the Pharmaceutical Industry* 28 (July 1998), at <http://www.cbo.gov/showdoc.cfm?index=655&sequence=0>; DAVID REIFFEN & MICHAEL R. WARD, *GENERIC DRUG INDUSTRY DYNAMICS* (Federal Trade Commission Bureau of Econ. Working Paper No. 248, 2002), at <http://www.ftc.gov/be/econwork.htm>; see also BE Staff Report, *The Pharmaceutical Industry*.

⁵² See, e.g., Glover 3/19 at 146 (noting that "even major companies must develop a blockbuster every two to three years or face massive financial contraction").

⁵³ Browder 3/9 at 227-28.

entry by granting 180 days of marketing exclusivity to the first generic applicant to file an application for a generic drug product that does not infringe the brand-name product or that challenges the validity of the brand-name company's patents.⁵⁴ The 180-day exclusivity period increases the economic incentives for a generic company to be the first to file, because the generic applicant has the potential to reap the reward of marketing the only generic product (and, thus, to charge a higher price until more generic products enter). Through this 180-day provision, the Amendments provide an increased incentive for companies to challenge patents and develop alternatives to patented drugs.⁵⁵ Indeed, one generic panelist reported that competition among generic companies for the 180 days of exclusivity has become "acute."⁵⁶

Once a brand-name company is notified of the filing of such a generic application, it has a 45-day window in which to sue the generic applicant for patent infringement. The initiation of the patent infringement suit triggers a 30-month stay of FDA approval of the generic drug application. According to the legislative history, the stay allows for the commencement of a lawsuit and takes into account the patent owner's rights while still encouraging generic entry.⁵⁷

⁵⁴ For a fuller discussion of the effect of the 180-day marketing exclusivity provision on competition, see FTC, *Generic Drug Study* at Ch. 3.

⁵⁵ See *Granutec, Inc. v. Shalala*, 139 F.3d 889, 891 (4th Cir. 1998).

⁵⁶ Coffin-Beach 3/19 at 239.

⁵⁷ H. REP. NO. 98-857, at 27 (1984).

E. The FTC's Pharmaceutical Industry Enforcement Actions and Generic Drug Study

The Commission has pursued numerous antitrust enforcement actions affecting both brand-name and generic drug manufacturers when it had reason to believe that a company abused its patent rights in violation of the antitrust laws. The Commission has addressed conduct that it alleged would have the effect of delaying generic entry, including certain patent settlement agreements between brand-name companies and generic applicants,⁵⁸ a brand-name company's acquisition of an exclusive license to a particular patent,⁵⁹ the purported

⁵⁸ *Abbott Laboratories*, No. C-3945 (FTC May 22, 2000) (consent order), available at <http://www.ftc.gov/os/2000/05/c3945.do.htm>. *Geneva Pharmaceuticals*, No. C-3946 (FTC May 22, 2000) (consent order), available at <http://www.ftc.gov/os/2000/05/c3946.do.htm>. *Hoechst/Andrx*, No. 9293 (FTC May 8, 2001) (consent order), available at <http://www.ftc.gov/os/2001/05/hoechstdo.htm>. In another matter, *Schering-Plough*, the Commission resolved all claims against one of three respondents, American Home Products (AHP), by issuing a final consent order. *Schering-Plough Corp.*, No. 9297 (FTC Apr. 2, 2002) (consent order as to AHP), available at http://www.ftc.gov/os/2002/04/scheringplough_do.htm.

The case against the other two respondents is in litigation before the Commission. See *Schering-Plough Corp.*, No. 9297 (FTC July 2, 2002) (Initial Decision), available at <http://www.ftc.gov/os/2002/07/scheringinitialdecisionp1.pdf>.

⁵⁹ *Biovail Corp.*, No. C-4060 (FTC Oct. 2, 2002) (consent order), available at <http://www.ftc.gov/os/2002/10/biovaildo.pdf>.

use of sham litigation,⁶⁰ and an agreement between generic drug manufacturers.⁶¹ It also has addressed conduct that the Commission contended would eliminate a potential competitor for an NCE in the merger context.⁶²

Over the past few years the Commission also has observed through its investigations, law enforcement actions, and Generic Drug Study that some brand-name and generic drug manufacturers may have “gamed” the 180-day marketing exclusivity and the 30-month stay provisions, attempting to restrict competition beyond what the Hatch-Waxman Amendments intended.⁶³ The Commission has undertaken two main types of enforcement activities in this area. It has addressed patent settlement agreements between brand-name companies and generic applicants that the Commission alleged had delayed the entry of one or more generic applicants through manipulation of the 180-day exclusivity period.⁶⁴ It also has

addressed allegations that individual brand-name manufacturers have delayed generic competition through the use of improper Orange Book listings⁶⁵ that trigger the Hatch-Waxman provision prohibiting the FDA from approving a generic applicant for 30 months.⁶⁶

Brand-name companies previously could obtain additional 30-month stays by obtaining additional patents that claimed their brand-name products. There were opportunities for “gaming” the 30-month stay because the FDA does not oversee whether these additional patents meet the requirements for listing with the FDA, and there is no private right of action for a court to make such a determination. Not surprisingly, given the amount of revenue at stake, the FTC found in its Generic Drug Study that some brand-name companies have “gamed” the 30-month stay provision, and that it had the potential to be “gamed” in the future, absent reform.⁶⁷ The FDA changed its rule to prevent brand-name companies from obtaining additional 30-month stays. This rule change was based

⁶⁰ *Bristol-Myers Squibb*, No. C-4076 (FTC Mar. 7, 2003) (consent order), available at <http://www.ftc.gov/os/2003/03/bristolmyersconsent.pdf>.

⁶¹ *Biovail Corp. and Elan Corp. PLC*, No. C-4057 (FTC Aug. 20, 2002) (consent order), available at <http://www.ftc.gov/os/2002/06/biovailendo.pdf>.

⁶² *In the Matter of Glaxo Wellcome plc, and SmithKline Beecham PLC*, No. C-3990 (FTC Jan. 31, 2001) (consent order) (requiring divestiture of certain intellectual property rights on NCEs), available at <http://www.ftc.gov/os/2001/01/glaxosmithkline.do.pdf>.

⁶³ For further details on the Generic Drug Study see Box 3-3.

⁶⁴ *Abbott Laboratories*, No. C-3945 (FTC May 22, 2000) (consent order), available at <http://www.ftc.gov/os/2000/05/c3945.do.htm>. *Geneva Pharmaceuticals*, No. C-3946 (FTC May 22, 2000) (consent order), available at <http://www.ftc.gov/os/2000/05/c3946.do.htm>.

⁶⁵ The Commission first raised concerns about the potential anticompetitive impact of improper Orange Book listings in *American Bioscience, Inc. v. Bristol-Myers Squibb Co.*, No. CV-00-08577 (C.D. Cal. Sept. 7, 2000). See Brief of Amicus Curiae Federal Trade Commission, *Am. Bioscience, Inc. v. Bristol Myers Squibb Co.*, 2000 U.S. Dist. LEXIS 21067 (No. CV-00-08577), available at <http://www.ftc.gov/os/2000/09/amicusbrief.pdf>.

⁶⁶ *Biovail Corp.*, No. C-4060 (FTC Oct. 2, 2002) (consent order), available at <http://www.ftc.gov/os/2002/10/biovaildo.pdf>; *Bristol-Myers Squibb*, No. C-4076 (FTC Mar. 7, 2003) (consent order), available at <http://www.ftc.gov/os/2003/03/bristolmyersconsent.pdf>.

⁶⁷ See FTC, *Generic Drug Study* at (ii)-(iv) and Ch. 3.

largely on the FTC's recommendation.⁶⁸

F. Conclusion

Representatives from the pharmaceutical industry emphasized that patents are critical for promoting pharmaceutical innovation of NCEs. Brand-name companies depend on patents to recoup their substantial investment in the discrete innovation that leads to the development of new drug products. Also, brand-name companies make and patent incremental improvements to their products to manage them on a life-cycle basis. Panelists differed as to the extent to which such IMDs benefit consumers.

Competition in the pharmaceutical industry occurs in two primary ways: between brand-name companies that have products in the same therapeutic class and between brand-name and generic companies. Competition between and among brand-name companies and generics can foster innovation, as well as other benefits of competition. Patent disclosure requirements can enable brand-name and generic competitors to design around some patents covering brand-name drug products in order to bring competing products to market. The Commission has brought enforcement actions in the pharmaceutical industry to protect competition, including incentives to innovate.

The innovation that the patent system

spurs for the discovery and commercialization of NCEs in the pharmaceutical industry in many ways showcases the patent system's benefits. Such innovation entails the high fixed research costs, relative ease of imitation, and free riding problems that patent protection effectively manages. Fewer patent thicket issues arise in the pharmaceutical context than in industries where innovation is less discrete and individual products are covered by many patents. Subsequent sections examine how the roles of patents and competition vary in industries that exhibit different characteristics.

⁶⁸ See Applications for FDA Approval to Market a New Drug; Patent Listing Requirements and Application of 30-Month Stays on Approval of Abbreviated New Drug Applications Certifying That a Patent Claiming a Drug is Invalid or Will Not be Infringed, 68 Fed. Reg. 36,675 (2003) (to be codified at 21 C.F.R. § 314).

III. THE BIOTECHNOLOGY INDUSTRY

A. Introduction

The biotechnology industry also relies primarily on patents to provide incentives to invest in innovation. Biotechnology companies seek patent protection to appropriate the value of their inventions, to attract investment from capital markets, which funds their costly research, and to facilitate inter-firm relationships necessary for commercial development of their inventions. Patent disclosures can assist biotechnology firms in focusing their R&D efforts on areas not covered by patents. Competition also encourages innovation, for example, as firms race to develop new technologies.

Although panelists generally agreed on the benefits of patents in the biotechnology industry, many panelists also stated that the issuance of questionable patents is harming innovation in the industry, and that the mechanisms for challenging such patents, including litigation, are inadequate. Some also expressed concern that the need for multiple, patented research tools has the potential to create difficulties for follow-on innovation. Others discussed how licensing practices, such as reach-through license agreements and patent pools, can be used to surmount some of these difficulties by facilitating access to research tools that promote further innovation.

The panelists who represented biotechnology firms or organizations at the Hearings were David W. Beier, Counsel to the Biotechnology Industry Organization;

Lee Bendekgey, representing Incyte Genomics; Robert Blackburn, representing Chiron Corp.; Monte R. Browder, representing Ivax Corporation; Barbara Caulfield, representing Affymetrix, Inc.; David Coffin-Beach, representing Torpharm, Inc.; David J. Earp, representing Geron Corp.; Michael K. Kirschner, representing Immunex Corp.; and Ross Oehler representing Aventis Corp. Rochelle K. Seide, from Baker Botts, LLP, also participated in a business perspective panel on the biotechnology industry.

B. Industry Description

The biotechnology industry uses cellular and molecular (*i.e.*, biological) processes to address problems or make products. R&D in the biotechnology industry focuses on cells and large biological molecules (such as DNA and proteins) rather than the chemical compounds that the pharmaceutical industry uses to make small molecule drug products.⁶⁹

Cells are the basic building blocks of all living things. Plants, animals, and humans are incredibly diverse, yet there are remarkable similarities among the species that are invisible to the naked eye. All living things use essentially the same cellular processes and speak the same genetic language.⁷⁰ This unity at the cell level of different species provides the foundation for biotechnology research.

Participants asserted that R&D

⁶⁹ See Beier 2/26 at 248.

⁷⁰ See Biotechnology Industry Organization, *Biotechnology: A Collection of Technologies*, at http://www.bio.org/er/technology_collection.asp.

spending in the biotechnology industry “is more than double the average of the pharmaceutical industry (both on a per employee basis and as a percentage of sales), and the pharmaceutical industry is several times more R&D intensive than any other industry.”⁷¹ R&D is particularly lengthy for biotechnology firms, because biotechnology innovation is more uncertain than innovation in other industries.⁷² Panelists also noted that the commercialization of biotechnology research is particularly difficult, due to three factors. First, as discussed above in relation to the pharmaceutical industry, the drug development process is time-consuming, uncertain, and expensive. One panelist noted that his company took 10 years to bring its first product to market, and another 6 years before it brought its second product to market.⁷³ Second, much biotechnology research is basic, at least a step removed from the more applied research that is directly susceptible to commercialization.⁷⁴ Biotechnology thus highlights the issues that lie at the core of the prospect theory regarding incentives for, and efficiencies in, bridging the gap between basic research and ultimate commercial sales.⁷⁵ Third, most

⁷¹ Biotechnology Industry Organization, *Testimony (2/26/02) 2*, at <http://www.ftc.gov/opp/intellect/020226davidwbeier.pdf> (hereinafter BIO (stmt)); Kirschner 2/26 at 240.

⁷² See Beier 2/26 at 248-49; Kirschner 2/26 at 240.

⁷³ See Kirschner 2/26 at 239.

⁷⁴ See Earp 2/26 at 252; Seide 3/19 at 167.

⁷⁵ See Rai 4/10 at 21 (citing bio-pharmaceuticals as a context in which “patents serve not only the traditional incentive function but also serve the function of incentivizing further commercialization and development”); see generally *supra* Ch. 2(III)(A)(1) (discussing Professor Kitch’s prospect theory).

biotechnology industry participants are small, particularly relative to the pharmaceutical industry, and lack internal financial resources sufficient for undertaking extensive drug development.⁷⁶

Although innovation in the biotech industry has many facets, it generally results in two classes of inventions.⁷⁷ One class relates to newly discovered and isolated genes or proteins or to pharmaceutical inventions based on those genes or proteins. Although one cannot patent a naturally-occurring gene or protein as it exists in a plant, animal, or human, one can patent a gene or protein that has been isolated from the body and is useful in that form as a pharmaceutical drug or other application.⁷⁸ The other class of biotechnology inventions relates to methods of treating patients with a given disease through the use of a particular gene or protein. Even if someone has a patent on a gene or protein, a researcher who discovers a new method of use for that gene or protein can patent the new method of use.⁷⁹

The biotechnology industry is closely related to the pharmaceutical industry. One panelist observed that both industries try to

⁷⁶ See Earp 2/26 at 252.

⁷⁷ See generally Biotechnology Industry Organization, *Primer: Genome and Genetic Research, Patent Protection and 21st Century Medicine*, at <http://www.bio.org/genomics/primer.html> (hereinafter BIO, *Primer*).

⁷⁸ See United States Patent and Trademark Office, *Manual of Patent Examining Procedure* § 2105 (8th ed. 2001), available at <http://www.uspto.gov/web/offices/pac/mpep/mpep.htm> (hereinafter MPEP); Seide 3/19 at 167-68.

⁷⁹ See BIO, *Primer* at 6.

discover end-use products.⁸⁰ Indeed, small molecule-type research, the aim of which is to produce a traditional pharmaceutical drug product, has become much more efficient through the use of biotechnology tools such as proteins and genomic sequences.⁸¹ Also, many biotechnology companies conduct basic research to identify promising products, and then partner with a pharmaceutical company to test and commercialize the product.⁸² Patents facilitate this process; there is a tremendous amount of licensing, as well as acquisition activity, between the two industries searching for synergies to bring products to market.⁸³

C. The Role of Competition in Spurring Biotechnology Innovation

Several panelists discussed the role of competition in spurring biotechnology innovation.⁸⁴ One panelist commented that “one thing that competition does is, it sure makes you hurry up.”⁸⁵ Drawing on his experience in the biotech industry, he observed that companies typically found

⁸⁰ See Blackburn 2/26 at 250-51.

⁸¹ See Seide 3/19 at 188-89, 244-45 (discussing “rational drug design”); Blackburn 2/26 at 250, 261-62.

⁸² See, e.g., Blackburn 2/26 at 251; Earp 2/26 at 252.

⁸³ See Bendekgey 2/26 at 257-59; Oehler 2/26 at 254.

⁸⁴ See, e.g., Caulfield 3/19 at 242-43.

⁸⁵ See Bendekgey 2/26 at 286. Patent races may lead to excessive R&D in a particular area, although distinguishing beneficial from wasteful overlapping efforts may prove difficult. See *supra* Ch. 2(III).

their initial success by introducing a product with no comparable or rival product.⁸⁶ After this success, much bigger and better funded competitors entered the market, thus adding competitive pressure to keep innovating.⁸⁷ In general, however, although panelists found competitive forces important, they placed emphasis on the role of patents as drivers of innovation in the biotech industry.

D. The Implications of Patent Protection for Innovation

1. The Role of Patents in Spurring Innovation in the Biotechnology Industry

a. Patentability Encourages Investment in R&D

In 1980, the Supreme Court in *Diamond v. Chakrabarty*⁸⁸ decided that living organisms produced by human intervention are patentable. Participants stated that the biotechnology industry would not have emerged “but for the existence of predictable patents,”⁸⁹ and that *Chakrabarty* spurred significant growth in the biotechnology industry.⁹⁰ Their discussion describes the role of patents in an industry with a very costly, high-risk R&D process and a structure consisting significantly of

⁸⁶ See Bendekgey 2/26 at 285-86.

⁸⁷ See *id.*

⁸⁸ *Diamond v. Chakrabarty*, 447 US 303 (1980).

⁸⁹ See Kirschner 2/26 at 240-41, 328.

⁹⁰ BIO (stmt) 4.

small, not-yet-profitable firms.⁹¹

A biotechnology trade association highlighted one particular role of patents in this setting: patentability of biotech inventions enables the biotechnology industry “to attract venture capital.”⁹² Biotechnology companies overwhelmingly underscored the importance of patents for attracting venture capital.⁹³ As one of these panelists stated, “patents are indeed the key asset for us. They enable us to have access to the capital markets and to continue our innovation and development.”⁹⁴ The venture capital accessed through patents thus enables not-yet-profitable companies to “sustain . . . innovation through massive investments in research and development.”⁹⁵

b. *The Role of Patent Disclosures in Fostering Biotechnology Innovation*

The panelists differed on the extent to which required patent disclosures encourage the dissemination of information and, therefore, foster follow-on innovation in biotech.⁹⁶ One panelist stated that the patent literature “has not been a significant source of ideas” for the company’s

research.⁹⁷ By contrast, a panelist from a pharmaceutical firm with a biotechnology affiliate noted that “there is value to be found in patents as literature.”⁹⁸ Another panelist noted that “the information transfer happens in the scientific literature [rather than] the patent literature,” but added that “quite a bit of the scientific literature is enabled by the fact that there’s been a patent filed on it.”⁹⁹ This panelist observed that patent literature is a more important source of information in the pharmaceutical industry than the biotechnology industry.¹⁰⁰

c. *Patenting of Biotechnology Research Tools*

A research tool is a technology that is used by pharmaceutical and biotechnology companies to find, refine, or otherwise design and identify a potential product or properties of a potential drug product.¹⁰¹ As such, it serves as a springboard for follow-on innovation. Examples of these types of enabling tools include high-throughput screening technologies, micro-array-type technologies, genomic databases, and

⁹¹ See *id.* at 2, 4; Beier 2/26 at 265-66; Blackburn 2/26 at 275-76.

⁹² BIO (stmt) 4.

⁹³ See Earp 2/26 at 237; Bendekgey 2/26 at 256; Blackburn 2/26 at 263.

⁹⁴ See Earp 2/26 at 326.

⁹⁵ BIO (stmt) 4.

⁹⁶ See Kirschner 2/26 at 318; Blackburn 2/26 at 319; Oehler 2/26 at 319.

⁹⁷ Kirschner 2/26 at 318.

⁹⁸ Oehler 2/26 at 319.

⁹⁹ See Blackburn 2/26 at 319.

¹⁰⁰ See *id.* at 320.

¹⁰¹ See Blackburn 2/26 at 250, 260 (noting that there are likely to be slightly varying definitions of research tools); Bendekgey 2/26 at 267-68, Cohen 10/30 at 150, McGarey 11/6 at 160.

Box 3-4. Effects of Research Tool Patents and Licensing on Biomedical Innovation

John P. Walsh, Ashish Arora & Wesley M. Cohen in PATENTS IN THE KNOWLEDGE-BASED ECONOMY 285 (Wesley M. Cohen & Stephen A. Merrill eds. 2003), available at <http://books.nap.edu/books/0309086361/html/285.html#pagetop>.

John P. Walsh, Ashish Arora, and Wesley M. Cohen conducted an empirical study of the implications for innovation of patenting and licensing practices in the pharmaceutical and biotech industries. The authors conducted “70 interviews with IP attorneys, business managers and scientists from 10 pharmaceutical firms and 15 biotech firms, as well as university researchers and technology transfer officers from 6 universities, patent lawyers and government and trade association personnel.”

The authors found that patents on research tools have increased, but have not significantly hindered drug discovery. The increased complexity of the patent landscape, they concluded, has not resulted in a tragedy of the anticommons. (See Box 3-5 for further explanation of this theory.) They noted that some university research has been delayed by restrictions on the use of patented genetic diagnostics, and that there have been some delays or access restrictions to research tools or other foundational discoveries. In some instances, research was re-directed to areas where there were fewer patents. Overall, however, the researchers found that no valuable research projects were halted as a result of limited access to a research tool. The authors cautioned, however, that the potential exists and ongoing scrutiny is warranted. See *infra* Ch. 3(III)(D)(4).

The authors also concluded that firms and universities use a range of strategies to avoid breakdown and restricted access to research tools, including taking licenses, inventing around patents, infringement (often informally invoking a research exemption), developing and using public tools and challenging patents in court. New PTO guidelines, active intervention by the NIH, and overall shifts in the courts’ attitudes towards research tool patents also have lessened these potential threats, they found. A new Federal Circuit case that stated a narrow scope of the research exemption available to universities led the authors to question the extent to which some of these findings will remain applicable. The relevant Federal Circuit case, *Madey v. Duke University*, 307 F.3d 1351, 1362 (Fed. Cir. 2002), *cert denied*, 123 S. Ct. 2639 (2003), is discussed *infra* Ch. 4(II)(D).

modeling programs. Research tools are generally patentable. Researchers require a license to use patented research tools to identify and develop inventions, but typically do not require a license from the research tool patent holder to practice the ensuing inventions.¹⁰²

Several commentators discussed the benefits to innovation derived from using and patenting research tools.¹⁰³ For

¹⁰² See Blackbum 2/26 at 260.

¹⁰³ See *id.* at 262; Bendekgey 2/26 at 258-59 and 267-68; Seide 3/19 at 167. For discussion of issues raised by research tool patents, see John P. Walsh et al., *Effects of Research Tool Patents and Licensing on Biomedical Innovation*, in PATENTS IN THE KNOWLEDGE-BASED ECONOMY 285 (Wesley M. Cohen & Stephen A. Merrill eds. 2003), available at

example, one panelist explained that with gene chip array technology “what used to take a post-doc[toral student] in the laboratory approximately six months with proper front-end research can now be done in 20 minutes.”¹⁰⁴ Another panelist suggested that research tools have led to a considerable reduction in the cost and time required for the targeting of therapeutic antibodies during the initial stages of new drug research. He mentioned “a very small pre-IPO firm that has moved into a phase two product in three years based on research tool technology” and went on to state that this would have been “inconceivable to have

<http://books.nap.edu/books/0309086361/html/285.html#pagetop> (hereinafter *Research Tool*) and Box 3-4.

¹⁰⁴ See Caulfield 3/19 at 135.

happened 20 years ago, before the invention of research tools.”¹⁰⁵

Two panelists stressed the importance of patenting research tools.¹⁰⁶ One of them asserted, for example, that “if there’s anything you want to protect and incent with patents, it’s the research tool technology.”¹⁰⁷ He argued that patent protection will be critical in encouraging investment in the next generation of research tools, which might reduce the costs and time required for the clinical trial phases, which are the most “expensive part” of the drug development process.¹⁰⁸

2. The Quality of Biotechnology Patents

Panelists discussed concerns with the quality of biotechnology patents. Many of the panelists observed that poor quality patents can hinder innovation and competition.¹⁰⁹ A number of panelists stated that poor quality patents can harm innovation and competition by deterring a rival firm from entering or continuing with a

¹⁰⁵ Blackburn 2/26 at 261, 262 (discussing the screening of small molecules); Oehler 2/26 at 277-78 (noting that research tools offer “great promise,” but as yet have only reduced the time required for the early phases of research).

¹⁰⁶ See Blackburn 2/26 at 262; Bendekgy 2/26 at 258-59, 267-68.

¹⁰⁷ See Blackburn 2/26 at 262.

¹⁰⁸ See *id.* at 262-63. See *supra* Ch. 3(II)(B) (discussing the phases of pharmaceutical drug development).

¹⁰⁹ See Bendekgy 2/26 at 230; Earp 2/26 at 238; Kirschner 2/26 at 241; Oehler 2/26 at 292; Blackburn 2/26 at 294.

particular area of research.¹¹⁰ Two panelists observed that questionable patents create a “significant drag” on competition, and another panelist stated that questionable patents have a “chilling effect on both public and private sector research.”¹¹¹

One panelist stated his personal view that “the PTO’s ability to provide a meaningful examination of biotechnology patents right now is in a cris[is].”¹¹² Acknowledging the dedication and quality of the PTO’s examiners, this panelist noted that the examiners are under such time constraints that they may be unable to conduct a meaningful patent examination.¹¹³ According to this panelist, the PTO should

¹¹⁰ See Earp 2/26 at 238, 290-91; Caulfield 3/19 at 159; Blackburn 2/26 at 296.

¹¹¹ Caulfield 3/19 at 159; Barbara A. Caulfield, *Business Perspectives on Patents: Biotech and Pharmaceuticals*, Federal Trade Commission/Department of Justice Hearings (3/19/02) (slides) at 6, at <http://www.ftc.gov/opp/intellect/020319barbaracaulfield.pdf> (hereinafter Caulfield Presentation); Blackburn 2/26 at 296, Kirschner 2/26 at 328.

¹¹² See Kirschner 2/26 at 242. Mr. Kirschner voiced concerns with patents issued to wrong parties or to multiple parties on the same invention; patents that “contain overly-broad claims in view of the prior art or the scope of what was enabled or the scope of what was described” *id.* at 242; and patents for which “the best prior art was not cited to the patent office, was not discovered by the patent office, or was cited to the patent office and clearly the examiner did not appreciate it.” *Id.* at 241-42, 289.

¹¹³ See Kirschner 2/26 at 241-44, 288-90. Similarly, a panelist commented that “examiners have an incentive to move cases along and dispose of them.” See Bendekgy 2/26 at 231 (“I’ve certainly had comments repeated to me to the effect that . . . examiners have an incentive to move cases along and dispose of them, and sometimes they think there’s something novel here, they’re not sure what, and so they’re just going to allow it and let things get sorted out in litigation. And I can tell you, when you’re at the receiving end of litigation like that it has a decidedly chilling effect on competition.”).

“focus on improving quality, at least within [the biotechnology patent examination group],” because patent quality is more important than pendency in the biotechnology industry.¹¹⁴ Another panelist observed, “of the issues that people raise . . . in many cases [it] just come[s] down to the quality of the examination.”¹¹⁵

Although panelists agreed that poor patent quality can adversely affect innovation, disagreement existed whether patent quality in the biotechnology area was any different from that in other industries. One panelist reported that patent quality is not a field-specific problem.¹¹⁶ In fact, he observed that biotechnology patents may be of a higher quality than those in other industries, because of “the concentration of the Patent Office on guidelines and resources in the biotech field” in the last 10 years.¹¹⁷ The representative of a biotechnology trade association similarly noted that the PTO has responded affirmatively to public controversies in relation to biotechnology patents as they have arisen and thus has headed off any lasting adverse impacts of questionable biotechnology patents.¹¹⁸

¹¹⁴ See Kirschner 2/26 at 243, 329. *But cf.* Armitage 3/19 at 134 (raising concerns with pendency periods for biotechnology patent applications).

¹¹⁵ See Bendekgey 2/26 at 230.

¹¹⁶ See Oehler 2/26 at 292.

¹¹⁷ See *id.*

¹¹⁸ See Bcier 2/26 at 296 (noting that “the patent system has been remarkably self-correcting.”); see also Kirschner 2/26 at 329 (noting the PTO’s responsiveness to concerns raised by the industry).

3. The Mechanisms Available for Challenging Questionable Patents

Firms in the biotechnology industry reported that they avoid infringing even questionable patents and therefore refrain from entering or continuing with a particular field of research.¹¹⁹ Most panelists observed that the two existing mechanisms for challenging a questionable patent are generally inadequate.¹²⁰

a. Challenging Questionable Patents Through Litigation

Panelists considered litigation to be an inadequate means of challenging a patent for three main reasons. First, the pace of innovation in the biotechnology industry is so rapid that by the time a court determines the question of patent validity, the research or product opportunity has passed. As one panelist observed, “six months can be a tremendous amount of time” in biotechnology research, while a biotechnology patent case “takes two to three years” to litigate.¹²¹ Moreover, other

¹¹⁹ See, e.g., Earp 2/26 at 290-91, 238; Blackburn 2/26 at 296; Caulfield 3/19 at 161; see also Alik Widge, *Comments Regarding Competition and Intellectual Property* (Public Comment), at <http://www.ftc.gov/os/comments/intelpropertycomments/widgealik.htm>.

¹²⁰ See Bendekgey 2/26 at 231; Earp 2/26 at 238, 291, 327; Kirschner 2/26 at 244, 328; Blackburn 2/26 at 294; Caulfield 3/19 at 160. One panelist noted that a third option exists that permits the public to submit comments to the PTO about patent applications published because they have been pending before the PTO for longer than 18 months. He also acknowledged this approach was not as “perfect and as targeted as an opposition proceeding, as in Europe.” Oehler 2/26 at 294.

¹²¹ Caulfield 3/19 at 160; see also Barton 2/26 at 220-21.

panelists suggested that just because a patent is not challenged through litigation does not mean that the patent is not problematic.¹²²

Second, the cost of litigation is prohibitively expensive for many firms in the biotechnology industry. One panelist reported that a biotechnology patent case costs between five and seven million dollars to litigate.¹²³ Such expenditure, this panelist observed, on an area that may not end up producing revenue is beyond the means of most firms in the biotechnology industry.¹²⁴ According to panelists, most firms tend to be small and generally have to obtain funding from the capital markets or venture capitalists because of the difficulties in commercializing products.¹²⁵

Finally, current standing requirements prevent a potentially infringing party from determining in advance the merits of a questionable patent.¹²⁶ A potentially infringing party can seek a declaratory judgment to invalidate a patent only after that party has been threatened with litigation by the patent owner. Patent owners in the biotechnology industry are careful to avoid such a situation.¹²⁷ This means the potentially infringing party has to choose whether to forge ahead with the research, and risk being sued after

¹²² See Blackburn 2/26 at 309; Kirschner 2/26 at 308.

¹²³ See Caulfield 3/19 at 160.

¹²⁴ See *id.*

¹²⁵ See Kirschner 2/26 at 239; Earp 2/26 at 252; Armitage 3/19 at 166; Seide 3/19 at 167.

¹²⁶ See Blackburn 2/26 at 294.

¹²⁷ See *id.*

significant costs have been sunk, or avoid the area of research.¹²⁸ Panelists stated their companies usually will choose to avoid the area of research altogether rather than risk possible infringement later in the R&D process.¹²⁹ One panelist observed that the inability of a company to challenge the validity of a patent unless that company itself has been threatened with litigation by the patent owner results in harm to competition, because “bad patents [are able to] . . . sit out there . . . [where] you can’t touch them.”¹³⁰

b. Challenging Questionable Patents Through Reexamination Procedures

Any person at any time may file a request for reexamination, and if the request raises a substantial new question of patentability affecting any claim of the patent, reexamination is commenced. Reexamination is available on an *ex parte* and *inter partes* basis.¹³¹ The panelists unanimously considered the reexamination procedures as they existed at the time of the hearing inadequate for a third party to challenge the validity of another party’s patent.¹³² Participants articulated three

¹²⁸ See *id.* at 295.

¹²⁹ See Earp 2/26 at 238, 290-291; Caulfield 3/19 at 159; Caulfield Presentation at 6; Blackburn 2/26 at 296.

¹³⁰ Blackburn 2/26 at 294-6.

¹³¹ For further discussion of reexamination, opposition, and review, see *infra* Ch. 5(III).

¹³² See, e.g., Earp 2/26 at 301, Bendekgey 2/26 at 303, Beier 2/26 at 301, Blackburn 2/26 at 294-96. One panelist wryly observed that as of the time of the hearing the *inter partes* reexamination procedures had been invoked in only four out of 160,000 cases. See Beier 2/26

problems with the reexamination system, two of which Congress has addressed by legislation since the Hearings.¹³³ The remaining problem panelists cited was that participation in an *inter partes* reexamination proceeding estops a third party participant from raising a broad spectrum of issues in subsequent court litigation.¹³⁴

c. Challenging Questionable Patents Through a New Opposition System

Three of the panelists suggested that the United States should implement an opposition system for challenging questionable patents.¹³⁵ These panelists recommended that such an opposition system draw on the best features of other patent opposition proceedings, particularly

at 301.

¹³³ These two problems were: a third-party who invoked the reexamination procedure was precluded from appealing the PTO's decision to the federal courts (*see* BIO (stmt) 24; Beier 2/26 at 301; Earp 2/26 at 301; Bendekgey 2/26 at 303); and prior art of record during the patent application process could not be the basis for a reexamination (*see* Earp 2/26 at 302). Amendments to the patent statute enacted in November 2002 conferred appeal rights on third party requesters in *inter partes* patent reexamination proceedings, overruled the decision in *In re Portola Packaging Inc.*, 110 F.3d 786 (Fed. Cir. 1997) (holding that reexamination could not be used if the basis is the same prior art references that the examiner considered, since such references do not raise a substantial new question of patentability), and clarified that patent reexamination on the basis of previously cited prior art "is not precluded." Patent and Trademark Office Authorization Act of 2002 § 5-6, 35 U.S.C. § 303(a), 312 (a) 134, and 141-44.

¹³⁴ *See, e.g.*, Beier 2/26 at 301.

¹³⁵ *See* Bendekgey 2/26 at 231; Earp 2/26 at 238, 291, 327; Kirschner 2/26 at 244, 329.

the European system.¹³⁶ One panelist suggested that the best features of the existing United States reexamination system should also be incorporated into any opposition system.¹³⁷

Another panelist stated that an opposition system should be implemented regardless of whether the problems discussed above in relation to reexamination proceedings were addressed by statute.¹³⁸ In fact, he noted that even if the reexamination proceedings were improved, it "probably wouldn't convince a whole lot more people to go forward with it."¹³⁹ This view was not challenged among the panelists.

4. The Potential for Patents to Impede Innovation in the Biotechnology Industry

Unlike the pharmaceuticals industry, in which major aspects of the innovation process are relatively discrete, biotechnology innovations typically form the basis of, or provide the tools for, independent follow-on R&D. Commentators discuss two ways in which patents have the potential to harm follow-on innovation in biotechnology: (1) through the development of an anticommons;¹⁴⁰ and (2) through the withholding of access to technologies

¹³⁶ *See* Earp 2/26 at 238, 291, 327; Bendekgey 2/26 at 231.

¹³⁷ *See* Kirschner 2/26 at 244.

¹³⁸ *See* Earp 2/26 at 327.

¹³⁹ *See id.*

¹⁴⁰ For further explanation of this theory, *see* Box 3-5.

needed for follow-on innovation.¹⁴¹

a. *The Development of an Anticommons*

Scholars have argued that innovation can be harmed by the development of an anticommons, which can arise when multiple property right owners have claims to separate inputs needed for some product or line of research.¹⁴² Some panelists believe that an anticommons threatens innovation in the biotechnology industry.¹⁴³

¹⁴¹ One potential limit on such harm may spring from an experimental use defense. Although there is some debate about its scope, the industry panelists generally accepted that an experimental use defense exists at common law offering some shelter from infringement litigation to non-commercial research. See Armitage 3/19 at 186-87; Polk 3/19 at 190; cf. Thomas 2/8 (Patent Session) at 30; Sung 2/8 (Patent Session) at 136-38; Caulfield 3/19 at 163. For further discussion of the research exemption, see *infra* Ch. 4(II)(D). In their study of the biotechnology industry, Walsh, Arora, and Cohen noted that informal reliance on this defense by members of the research community has helped to prevent an anticommons or lack of access to existing patents from stifling follow-on innovation. See Walsh et al., *Research Tool* at 333-34.

The Federal Circuit has stated a narrow scope of this exemption in an opinion in October 2002: *Madey v. Duke University*, 307 F.3d 1351, 1362 (Fed. Cir. 2002), *cert denied*, 123 S. Ct. 2639 (2003). Some believe that this decision will chill university research, because researchers will no longer be able to rely on the exemption to overcome anticommons or access issues. See Cohen 10/30 at 149-52, 161-62.

¹⁴² See Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, SCIENCE MAG., May 1, 1998, available at <http://www.sciencemag.org/cgi/content/full/280/5364/698> and Box 3-5. For further discussion of anticommons and related issues deriving from the presence of multiple patents, see *supra* Ch. 2(III)(C).

¹⁴³ See Kirschner 2/26 at 241, 310-11; Caulfield 3/19 at 163-64; McCarey 11/6 at 153-54. See also Tom Horton, *Patenting Our Lives and Our Genes: Where Does Congress Stand in the Coming Clash?* 7-8 (noting the development of practical problems from the proliferation of biotechnology patents but finding the effect on research

One panelist stated, for example, that the need “to have access to a wide range of technologies to discover, create, manufacture and market a human therapeutic product” means the biotechnology industry is “highly vulnerable to . . . the tragedy of the anticommons”;¹⁴⁴ he found “the risk of” an anticommons problem.¹⁴⁵ He cited the example of Enbrel, which at one time was subject to royalties paid to seven companies.¹⁴⁶ The panelist later noted that the royalty stacking that took place in relation to Enbrel was prior to the advent of research tool patents and reach-through royalties, which, he indicated, have increased the likelihood of anticommons problems.¹⁴⁷

In their business survey of the biotechnology industry, Professors Walsh, Arora, and Cohen examined whether the existence of multiple research tool patents associated with a new product or process poses anticommons concerns.¹⁴⁸ They concluded that such concerns have “not been especially problematic,” because mechanisms are being used, such as relying on a research exemption, obtaining a license, or inventing around patents, to prevent harm

“uncertain”), at <http://www.ftc.gov/os/comments/intelpropertycomments/horntonthomasjarticle.pdf>.

¹⁴⁴ See Kirschner 2/26 at 241.

¹⁴⁵ See *id.* at 310-11.

¹⁴⁶ See *id.* at 241. He went on to note that one of those companies no longer receives royalties because its patent expired.

¹⁴⁷ See *id.* at 310. Reach-through royalties are discussed below.

¹⁴⁸ See Walsh et al., *Research Tool* at 286-89.

Box 3-5. Can Patents Deter Innovation? The Anticommons in Biomedical Research
Michael A. Heller and Rebecca S. Eisenberg, *Science* 1998 May 1; 280: 698-701.

The tragedy of the anticommons refers to a problem that might arise when multiple owners each have a right to exclude others from a scarce resource, and no one has an effective privilege of use. There are two mechanisms by which a government might inadvertently create an anticommons:

- (1) by creating too many concurrent fragments of intellectual property rights in potential future products;
- (2) by permitting too many existing patent owners to stack licenses on top of the future discoveries of users.

The authors theorize that patenting of gene fragments and of receptors useful for screening potential pharmaceutical products are two situations in which too many concurrent fragments may result in an anticommons. If a tragedy of the anticommons were to emerge, it might endure because of the transaction costs of rearranging entitlements, heterogeneous interests of owners, and cognitive biases among researchers, the authors suggest.

The authors suggest that policy-makers should seek to ensure coherent boundaries of existing patents and to minimize restrictive licensing practices that interfere with product development. Otherwise, they conclude that more patent rights may lead paradoxically to fewer useful products for improving human health.

to innovation from occurring.¹⁴⁹ Another factor that mitigated anticommons concerns, the authors noted, is the very high number of technological opportunities in the biotechnology industry, which enables firms to redirect their research efforts to areas less encumbered by patent claims to avoid possible infringement issues.¹⁵⁰

Some panelists expressed views similar to these findings.¹⁵¹ One panelist commented, for example, that licensors tend to be “fairly sensitive” to the implications of royalty-stacking for product commercialization.¹⁵² “If the licensor . . . is about to propose a royalty that’s going to kill the product, [the licensor] is not going to make any money. And most of the players

in this field are sophisticated enough to understand that,” he argued.¹⁵³

b. Access to Existing Technologies Needed for Follow-On Innovation

There is a debate among scholars as to the optimal balance of incentives to innovate between parties engaged in initial research and parties engaged in follow-on research. Some contend that broad patents maximize innovation by enabling the initial inventor to coordinate future follow-on R&D.¹⁵⁴ Others contend that restricted access to patents - especially broad patents - on discoveries such as research tools can

¹⁴⁹ See *id.* at 331, 333-34 (Although these mechanisms may prevent projects from being stopped, these scholars cautioned that they impose social costs, such as time delays and distraction from research.).

¹⁵⁰ *Id.* at 304, 331-32.

¹⁵¹ See Blackburn 2/26 at 314-15; Beier 2/26 at 312-13; Scide 3/19 at 189; Dreyfuss 7/10 at 62

¹⁵² See Blackburn 2/26 at 315.

¹⁵³ *Id.* But cf. Janice M. Mueller, *No “Dilettante Affair:” Rethinking the Experimental Use Exception to Patent Infringement for Biomedical Research Tools*, 76 WASH. L. REV. 1, 7, 57 (2001) (arguing that “[t]he royalty stacking problem in biotechnology . . . has escalated in severity”).

¹⁵⁴ See, e.g., Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J. L. & ECON. 265 (1977).

harm follow-on innovation.¹⁵⁵

In their business survey of the biotechnology industry, Professors Walsh, Arora, and Cohen evaluated whether the later possibility has arisen. They concluded that there is no evidence that biotechnology research has been significantly impeded. Nevertheless, “the prospect exists and ongoing scrutiny is warranted.”¹⁵⁶ They noted that access restrictions that harm innovation are most likely to occur when a research tool will be used primarily to develop innovations that will compete with one another in the marketplace, and the research tool is potentially key to progress in one or more therapeutic areas.¹⁵⁷ In such circumstances, the patent holder may seek either to develop the technology itself or exclusively license it to another.¹⁵⁸ Given that multiple technologies may require the use of such a research tool to foster further innovation, the authors saw such a development as likely to retard innovation.¹⁵⁹ These scholars also observed that mechanisms to mitigate such harm to innovation exist, such as “invoking a ‘research exemption’ that is broader than the

¹⁵⁵ See, e.g., Merges & Nelson, 90 COLUM. L. REV. 839; Frederick M. Scherer, *The Economics of Human Gene Patents*, 77 ACADEMIC MEDICINE 1348 (2002). For further discussion of these issues, see *supra* Ch. 2(III).

¹⁵⁶ Walsh et al., *Research Tool* at 331.

¹⁵⁷ *Id.* at 333. The authors cite stem cell technology as an example of a technology to which a patent holder might prefer to restrict access. *Id.* See also Cohen 10/30 at 94-95 (discussing Geron’s incentives to limit access to embryonic stem cell technology).

¹⁵⁸ Walsh et al., *Research Tool* at 333.

¹⁵⁹ *Id.* at 290-91, 333 (arguing that “no one firm can even conceive of all the different ways that the discovery might be exploited. . .”).

existing legal exemption,” inventing around patents, using the technology offshore, or seeking to invalidate the patent, but cautioned that many of these mechanisms can impose social costs.¹⁶⁰

E. Licensing Practices for Biotechnology Research Tools

The panelists discussed two licensing arrangements that have been used in the biotechnology industry to provide firms with access to research tools: reach-through license agreements and patent pools. They also offered some observations on the merits of exclusive licensing of research tools.

1. Reach-Through License Agreements

Reach-through license agreements (RTLAs) are a form of licensing agreement used by patent owners that hold rights on a biotechnology research tool, or other upstream areas of research, to share in the value of the discoveries by licensees. Typically, RTLAs establish royalty obligations measured as a percentage of sales of the licensee’s product. Usually, however, the licensee of the research tool does not need access to the research tool to make or sell its product. Rather, the licensee uses the research tool only to identify and develop the product.¹⁶¹ By letting eventual market results determine the amount of royalties paid, RTLAs potentially are a means to overcome some of the uncertainties and valuation disputes that may

¹⁶⁰ *Id.* at 324, 334-35.

¹⁶¹ See *supra* Ch. 3(III)(D)(1)(c).

impede efficient licensing, as discussed *supra* in Chapter 2.¹⁶²

One panelist identified two ways in which reach-through license agreements for research tools can promote competition and innovation. First, they can facilitate access to a wide range of research tools by reducing the up-front licensing costs.¹⁶³ This access is particularly important in the context of the biotechnology industry, which includes many small and yet-to-be-profitable firms.¹⁶⁴ Second, RTLAs may facilitate risk-sharing between the tool owner and the licensee.¹⁶⁵ One panelist suggested that RTLAs might place too much risk on the licensor, because the research tool may prove useful in the initial stages of R&D, but the potential product ultimately might fail in the clinical trial phase, thereby denying the tool owner licensing fees.¹⁶⁶ Such risk-allocation issues, however, might be resolved through adjustments to the pricing levels in RTLAs.¹⁶⁷

Other panelists identified potential ways in which RTLAs might harm competition and innovation, and noted uncertainty surrounding the antitrust analysis of these agreements. One panelist contended that RTLAs present a “severe

risk” of creating an anticommons by fostering royalty stacking.¹⁶⁸ Another panelist expressed concern that, by “demanding royalties on the sale of a product that is not covered by their patent,” a licensing company could be violating the patent misuse and antitrust laws.¹⁶⁹ This panelist stated that it is unclear how antitrust would weigh the competitive effects of these types of arrangements and suggested that additional guidance by the Agencies may be necessary to provide certainty surrounding the use of RTLAs.¹⁷⁰

2. Patent Pools

Patent pools involve “patents [from multiple patentees being] licensed in a package, either by one of the patent holders or by a new entity established for this purpose, usually to anyone willing to pay the associated royalties.”¹⁷¹ A biotechnology trade association stated that voluntary patent pools are “one of the important potential solutions to concerns regarding overlapping patents.”¹⁷² Indeed, this participant noted approvingly the paper released by the PTO entitled “Patent Pools: A Solution to the Problem of Access in Biotechnology Patents?,” which discusses the use of patent pools as a means of fostering access to

¹⁶² According to one panelist, RTLAs tend to be used “in more unique tool technology” rather than “fungible research tools.” See Blackburn 2/26 at 315.

¹⁶³ See *id.* at 275.

¹⁶⁴ See Beier 2/26 at 265; Blackburn 2/26 at 275-76; BIO (stmt) 2.

¹⁶⁵ See Blackburn 2/26 at 275.

¹⁶⁶ See Oehler 2/26 at 278.

¹⁶⁷ See Blackburn 2/26 at 279.

¹⁶⁸ See Kirschner 2/26 at 311.

¹⁶⁹ Earp 2/26 at 270.

¹⁷⁰ See *id.* at 272-73, 327-28. For further discussion of RTLAs under the antitrust laws, see Second Report (forthcoming).

¹⁷¹ Shapiro, *Navigating the Patent Thicket* at 127. For antitrust treatment of patent pools, see Second Report (forthcoming).

¹⁷² BIO (stmt) 12.

patented research tools.¹⁷³

The OECD, however, has questioned whether industry participants can solve the transaction cost problems that arise in markets for genetic inventions by forming patent pools.¹⁷⁴ It noted that these technologies are fundamentally different from the electronics sector, in which patent pools are used more frequently because of the importance of standards and interoperability.

3. Non-Exclusive Licensing of Patented Research Tools

Two of the panelists observed that owners of patented research tools generally have the incentive to grant non-exclusive,

¹⁷³ United States Patent and Trademark Office, *Patent Pools: A Solution to the Problem of Access in Biotechnology Patents?* 3 (2000), at <http://www.uspto.gov/web/offices/pac/dapp/opla/patentpool.pdf>.

¹⁷⁴ Organisation for Economic Co-operation and Development, *Genetic Inventions, Intellectual Property Rights and Licensing Practices: Evidence and Policies* 67 (2002) (“It is true that there is a growing interdependence among patents, that the claims of many patents are narrower, and that patents are held by multiple owners. Licensing transaction costs are burdensome and freedom of operation is restricted, thus increasing the potential for conflict among researchers. However, the pharmaceutical biotechnology industry may be fundamentally different from the electronics sector. It is not an industry in which defining standards is important, and assuring interoperability of technologies is not very important, especially not in the development of therapeutics. A company’s worth is tightly tied to its intellectual property and fosters a ‘bunker mentality.’ There are likely to be disagreements among partners over the value of the different patents in a pool, and dominant players may not have a strong incentive to join the pool. If a limited field of application and essential patents can be defined, the patent pool model is worthy of consideration in biotechnology (Marks et al., 2001). The suitability of the patent pool for biotechnology patents certainly requires further study, as does the role of government in promoting them.”), at <http://www.oecd.org/dataoecd/42/21/2491084.pdf>.

rather than exclusive, licenses. One panelist explained that firms prefer to grant non-exclusive licenses on their research tools, because it is impossible to know in advance whether any particular licensee will succeed in bringing a product to market.¹⁷⁵ He suggested that when the patentee can profit from the exploitation of a research tool, the incentives exist to drive the broad dissemination of the particular tool.¹⁷⁶ He did, however, note that there “are probably examples of tools that maybe are appropriately exclusively licensed” and suggested that the market for potential genomic cancer targets might be such a market.¹⁷⁷

Another panelist cited an example to demonstrate the potentially adverse implications for a business of exclusive licensing: in a market with two competitors over the provision of genomic database information, one of the companies gave an exclusive license to its database to a large pharmaceutical company. The direct consequence of this exclusive license was to force the other large pharmaceutical companies to seek nonexclusive access to the rival firm’s database.¹⁷⁸ This panelist noted that the economics of licensing databases or research tools dictate that companies license on a nonexclusive basis, because it is not possible to build a business

¹⁷⁵ See Blackburn 2/26 at 264.

¹⁷⁶ See *id.* at 265.

¹⁷⁷ See *id.* at 264 (noting that his company has identified so many potential genomic cancer targets that supply exceeds demand, and licensees can insist on exclusive licenses).

¹⁷⁸ See Bendckgey 2/26 at 268-69.

around a single customer.¹⁷⁹

F. Conclusion

Biotechnology innovation is heavily dependent on the patent rights that have been available for biotechnology inventions since 1980. Patents help firms to recover high, fixed R&D costs and are particularly useful in enabling biotechnology companies, which are generally small in size, to attract capital investment and to contract with other firms for commercial development of their inventions. This capital is critical for ongoing R&D, because product commercialization in the biotechnology industry is particularly time-consuming and expensive. Patent disclosures assist the innovation process by encouraging information dissemination and enabling the publication of discoveries in the scientific literature. Competition also encourages innovation, although panelists typically gave greater stress to the role of patents.

Poor quality biotechnology patents also have the potential to harm innovation by causing companies to avoid the field of inquiry covered by such patents, rather than to seek to invalidate them. Panelists stated that litigation is too expensive and time-consuming for small biotechnology companies. Views varied on whether patent quality in the biotechnology field differed from that in other industries.

Biotechnology, with its heavy investment in basic research and research tools, poses more issues of cumulative innovation than pharmaceutical drugs, for which much of the innovation process was

discrete. Biotechnology patents might harm follow-on innovation through the creation of an anticommons and by restricting access to inventions. A few panelists suggested that these problems can be mitigated by mechanisms such as reach-through royalty agreements, cross-licensing, and patent pools. It is also possible that recent uncertainty about the scope of the research exemption may hinder non-commercial research.

¹⁷⁹ See *id.* at 269.

IV. THE COMPUTER HARDWARE INDUSTRIES, INCLUDING SEMICONDUCTORS

A. Introduction

In the computer hardware industries, panelists reported that firms' attitudes toward the role of competition and patent protection in furthering innovation depends on the nature of the firm. Panelists stressed the importance of competition and trade secrecy as drivers of innovation for integrated design and manufacturing firms and foundries; for specialized design firms, panelists gave greater emphasis to patents. Discussion frequently highlighted the special issues that arise in industries characterized by incremental, cumulative innovation and by products requiring a great many, separately held patents. Commentators, for example, extensively discussed the problems that patent thickets pose for innovation and the licensing arrangements that firms use to maneuver through such thickets to achieve product commercialization. Commentators also expressed concern that patents may deter innovation in the computer hardware industries as a result of hold-up strategies by firms unconstrained by litigation concerns.

The panelists who represented computer hardware firms at the Hearings were Robert Barr representing Cisco Systems, Inc; George B. Brunt representing Alcatel USA; Peter N. Detkin representing Intel Corporation; Stephen P. Fox representing Hewlett-Packard Company; Les Hart representing Harris Corporation; Julie Mar-Spinola representing Atmel Corporation; Daniel McCurdy representing ThinkFire; Joel Poppen representing Micron

Technology, Inc; Desi Rhoden representing Advanced Memory International, Inc.; Frederick J. Telecky, Jr. representing Texas Instruments; Richard L. Thurston representing Taiwan Semiconductor Manufacturing Company, Ltd.; Harry Wolin representing Advanced Micro Devices, Inc.; and Gary Zanfagna representing Honeywell International. Two scholars, Bronwyn H. Hall, from the University of California, Berkeley, and Rosemarie Ham Ziedonis, from the University of Pennsylvania, also participated in business perspective panels on the computer hardware industry.

B. Industry Description

In general terms, the computer hardware industries produce the physical components for computers, telecommunications, and other information technology devices, such as the computer itself, monitors, servers, routers, and scanners.¹⁸⁰ The semiconductor industry produces one particular type of hardware: the integrated circuits and discrete devices that process binary data through the control of electrical signals. Integrated circuits are more commonly referred to as 'chips' or 'processors.'

The panelists discussed various types of firms that drive innovation in these industries: specialized design firms, integrated firms, and semiconductor foundries.¹⁸¹ Both specialized design firms and integrated firms engage in R&D, but

¹⁸⁰ "Hardware" is a general term that distinguishes the physical aspects of computers and related devices from "software," which is the intangible aspect that controls hardware through programs.

¹⁸¹ See Ziedonis 3/20 at 11, 16.

they differ in terms of the ownership of manufacturing facilities. Specialized design firms, which emerged in the 1980s,¹⁸² contract with semiconductor foundries¹⁸³ to have their products manufactured; integrated firms own their manufacturing facilities.¹⁸⁴ One panelist observed that the emergence of independent semiconductor foundries (or “contract manufacturers”) “enabled the creation and proliferation of a new generation of semiconductor companies - the fabless semiconductor company.”¹⁸⁵ Panelists reported that manufacturing facilities cost at least two billion dollars to construct, and the construction of the most advanced facilities can cost in excess of four billion dollars. They also stated that more

¹⁸² See Jeffrey T. Macher et al., *Semiconductors, in U.S. INDUSTRY IN 2000: STUDIES IN COMPETITIVE PERFORMANCE* 247 (1999), at <http://www.nap.edu/books/0309061792/html/245.html>. Hall and Ziedonis, in their business survey of the effects of strengthening patent rights on firms in the semiconductor industry, attribute the emergence of specialized design firms to the strengthening of patent rights in the 1980s. Bronwyn H. Hall & Rosemarie Ham Ziedonis, *The Patent Paradox Revisited: An Empirical Study of Patenting in the U.S. Semiconductor Industry, 1979-1995*, 32 RAND J. ECON. 101,104 (2001) and Box 3-6. A similar version of this study is available in draft under the name *The Effects of Strengthening Patent Rights on Firms Engaged in Cumulative Innovation: Insights from the Semiconductor Industry*, June 2001, at <http://emlab.berkeley.edu/users/bhall/papers/HallZiedonis01%20libecap.pdf>.

¹⁸³ Foundries are referred to as wafer fabrication facilities, or “fabs” for short, in the semiconductor industry.

¹⁸⁴ See Ziedonis 3/20 at 17.

¹⁸⁵ Richard L. Thurston, *Opening Statement of Dr. Richard L. Thurston, Vice President and General Counsel, Taiwan Semiconductor Manufacturing Company* (3/20/02) 3, at <http://www.ftc.gov/opp/intellect/020320richardthurstonstatement.pdf> (hereinafter Thurston (stmt)); see also Thurston 3/20 at 10 (noting that Taiwan Semiconductor Manufacturing Company has contracted with over 175 fabless companies).

advanced manufacturing facilities can become obsolete in less than five years, and that less advanced facilities become obsolete even more quickly.¹⁸⁶

C. The Role of Competition in Spurring Computer Hardware Innovation

Panelists representing integrated firms, foundries, and hardware companies observed that competition drives innovation.¹⁸⁷ Similarly, the business survey of Cohen, Nelson, and Walsh shows that obtaining lead-time over rivals, which is a function of the competitive process, is one of the two key mechanisms for ensuring appropriability of returns on R&D investments in the semiconductor industry. The other mechanism is trade secret protection.¹⁸⁸

¹⁸⁶ See Poppen 2/28 at 683; Thurston 3/20 at 29; Ziedonis 3/20 at 16, 83; Hall & Ziedonis, 32 RAND J. ECON. at 110.

¹⁸⁷ See Detkin 2/28 at 751 (stating that “the clear driving force behind innovation is competition”); Poppen 2/28 at 750; Fox 2/28 at 757; Barr 2/28 at 674-77; Brunt 3/20 at 91; Thurston (stmt) 9. For discussion of the changing nature of competition in the semiconductor industry, see Peter C. Grindley & David J. Teece, *Managing Intellectual Capital: Licensing and Cross-Licensing in Semiconductors and Electronics*, 39 CAL. MGMT. REV. 8, 27-29 (1997).

¹⁸⁸ See W. M. COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS: APPROPRIABILITY CONDITIONS AND WHY U.S. MANUFACTURING FIRMS PATENT (OR NOT) (National Bureau of Econ. Research Working Paper No. 7552, 2000), at <http://papersdev.nber.org/papers/w7552> (hereinafter COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS); Rosemarie Ziedonis, *The Role of Patents in Semiconductors: Insights from Two Recent Studies* (3/20/02) (slides) at 2, at <http://www.ftc.gov/opp/intellect/020320rosemarieziedonis.pdf>. Trade secrecy is discussed below. Patents were considered relatively unimportant for securing returns to innovation in the hardware industry.

The representative of one hardware company stated that between 1984 and 1993, the first 10 years of the company's existence, it filed only one patent, which issued in 1992.¹⁸⁹ Yet by 1994, "the company had grown to over a billion dollars in annual revenue. This growth was obviously not fueled by patents, it was fueled by competition and by open, nonproprietary interfaces."¹⁹⁰ Another panelist stated that "competition is what drives . . . innovation; patents have almost nothing to do with innovation."¹⁹¹ Similarly, a third panelist noted that "innovation is driven by competition in all of our markets."¹⁹²

D. Alternative Means of Fostering Innovation

The panelists representing integrated firms and foundries identified trade secrecy as an important mechanism for protecting a company's investment in innovation.¹⁹³ Some panelists expressed the view that trade secret protection is a supplement to patent protection in the sense that the two are used in different factual contexts, rather than as substitutes to be used in the same contexts.¹⁹⁴ One panelist suggested, for

example, that trade secrecy is useful in the early stages of innovation.¹⁹⁵

Other panelists discussed how they choose between the use of trade secret protection and patents as means to protect their inventions. They stated that firms consider whether they could detect patent infringement.¹⁹⁶ Disclosure of an invention due to patent requirements may simply enable rival firms to copy the invention without the patentee being able to detect and sue for patent infringement.¹⁹⁷ Because manufacturing processes cannot easily be observed by rivals, trade secrecy is particularly important for foundries and the manufacturing facilities of integrated firms.¹⁹⁸ Panelists observed that holders of trade secrets risk losing access to their technologies, however. Should a rival company obtain a patent on an invention for which a company had used trade secret protection, the patentee could successfully sue the company that used trade secret protection for patent infringement, despite its having discovered the invention earlier.¹⁹⁹

One panelist noted that reliance on trade secrecy could harm competition and innovation by stifling the flow of

¹⁸⁹ This panelist represented Cisco Systems.

¹⁹⁰ Barr 2/28 at 673-74.

¹⁹¹ Rhoden 2/28 at 754.

¹⁹² Zanfagna 3/20 at 90.

¹⁹³ See Thurston 3/20 at 29-30, 47-8; Wolin 3/20 at 51; Ziedonis 3/20 at 52; McCurdy 3/20 at 53; Brunt 3/20 at 26, 46-47; Detkin 2/28 at 666; Barr 2/28 at 756 and 10/30 at 79-80.

¹⁹⁴ See Ziedonis 3/20 at 52; McCurdy 3/20 at 53; Brunt 3/20 at 47.

¹⁹⁵ See Brunt 3/20 at 47.

¹⁹⁶ See, e.g., McCurdy 3/20 at 49-50, 53; Thurston 3/20 at 30, 47-48; Detkin 2/28 at 665.

¹⁹⁷ See McCurdy 3/20 at 49-50.

¹⁹⁸ See Thurston 3/20 at 30, 47-48.

¹⁹⁹ See *id.* at 47; McCurdy 3/20 at 49; MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 463 (explaining that trade secrets do not serve as prior art).

information to the public domain.²⁰⁰ Another panelist, however, questioned whether patents yield significantly better results, asserting that the disclosure of information through patents is seldom sufficient for a rival to replicate the innovation.²⁰¹ That panelist viewed the frequent inclusion of trade secret information in modern patent licenses to facilitate the licensee's harnessing of the technology as evidence of the uninformative nature of patent disclosures.²⁰²

E. The Implications of Patent Protection for Innovation

The panelists differed on how patents affect innovation; differences depended on whether patents fulfilled offensive or defensive purposes.²⁰³ Although the terms do not have a precise definition, "offensive patenting" generally means obtaining patents to appropriate returns in R&D; it can require the patent to be enforced through litigation.²⁰⁴ In this sense, the term is synonymous with the traditional economic justification for the patent system. "Defensive patenting" is primarily motivated by a desire to ensure freedom to operate and

includes the use of patents as bargaining chips in cross-licensing negotiations.²⁰⁵ It thereby reflects the strategy identified by economic analysts of using the prospect of mutually assured destruction to achieve detente, as discussed *supra* in Chapter 2.

1. The Role of Patents in Spurring Innovation

A number of representatives of integrated firms, foundries, and hardware companies testified that patents are necessary for innovation, and thus they obtain patents for offensive reasons.²⁰⁶ One panelist stated, for example, that the prevention of free riding is their primary motivation for obtaining patents; three other reasons are to negotiate cross-licenses, to obtain freedom to operate, and to generate revenue through licensing.²⁰⁷ Another panelist contended that, although patents are necessary to prevent free riding, the number of patents in the semiconductor industry far exceeds any requirement for that purpose.²⁰⁸ He pointed to the pharmaceutical industry as an example of one in which only a few patents cover each product, yet he considered free riding to be successfully

²⁰⁰ See Brunt 3/20 at 46.

²⁰¹ See McCurdy 3/20 at 53; *see also* Barr 2/28 at 755-56 ("it's been my experience in my practice, not just with Cisco, that I've actually never met an engineer that learned anything from a patent"). *But see* Telecky 2/28 at 754 (finding patent disclosures "a source of ideas").

²⁰² See McCurdy 3/20 at 38, 53.

²⁰³ See *e.g.* Detkin 2/28 at 751.

²⁰⁴ See Teece 2/27 at 507; David J. Teece, *IP, Competition Policy, and Enforcement Issues* (2/27/02) (slides) at 8, at <http://www.ftc.gov/opp/intellect/020227davidjteece.pdf>.

²⁰⁵ Cross-licensing is discussed below in the context of patent thickets. Obtaining freedom to operate and patent mining are discussed below in the context of hold-up.

²⁰⁶ See Thurston (stmt) 5; Fox 2/28 at 753; Barr 2/28 at 678, 755; Brunt 3/20 at 23-24.

²⁰⁷ See Fox 2/28 at 753.

²⁰⁸ See Barr 2/28 at 678 (stating that, in an ideal world, to prevent copying in the semiconductor industry "we'd need probably one or two or three for each product on the key features, and that's what I think you'll find in [the pharmaceutical and medical devices] industries.").

prevented.²⁰⁹

Specialized design firms typically obtain patents for offensive purposes. According to Professor Ziedonis, patents are critical business assets for design firms, and are used in a manner consistent with how the patent system was intended to operate.²¹⁰ Such firms seek “very strong, solid patent protection” for two reasons: to raise venture capital and to stake out proprietary positions primarily against other niche market rivals, but also against integrated firms.²¹¹

Professor Ziedonis noted two differences about the patenting behavior of specialized design firms when compared to that of integrated firms, foundries, and hardware companies. First, the rate at which specialized design firms are enforcing their patent rights is high. Four out of every hundred patents issued to specialized design firms are enforced through a court action, which is a “very, very high number relative to other industries and within the semiconductor industry.”²¹² Second, as the revenue of specialized design firms increases and the companies mature, attitudes toward patenting shift, so that such firms begin to patent more defensively and to increase their patent portfolio size, she noted.²¹³

²⁰⁹ See Barr 2/28 at 678.

²¹⁰ See Ziedonis 3/20 at 19.

²¹¹ *Id.* at 17-18.

²¹² *Id.* at 18 (observing, however, that specialized biotechnology firms exhibit a similar high rate of patent enforcement).

²¹³ See *id.*

2. The Potential for Patents to Impede Innovation

a. Patent Thickets in the Computer Hardware Industries

None of the panelists disputed the existence of densely overlapping patent rights (*i.e.*, a patent thicket) in the computer hardware industries. One panelist stated that more than “90,000 patents generally related to microprocessors are held by more than 10,000 parties.”²¹⁴ Likewise, he reported, there are approximately 420,000 semiconductor and systems patents held by more than 40,000 parties.²¹⁵ This panelist observed that the number of patents on semiconductor-related inventions has increased to the point where there is an “unavoidable overlap” of intellectual property.²¹⁶

Panelists discussed three reasons for the emergence of patent thickets in the computer hardware industries: (1) incremental innovation due to the nature of

²¹⁴ Detkin 2/28 at 667-68 and Peter N. Detkin, *A Semiconductor Patent Survey (2/28/02)* (slides) at 5, at <http://www.ftc.gov/opp/intellect/020228peterndetkin.pdf> (hereinafter Detkin Presentation).

²¹⁵ Detkin 2/28 at 667-68 and Detkin Presentation at 5.

²¹⁶ Detkin 2/28 at 668 (“there’s an unavoidable overlap of IP. . . people are tripping over each other’s patents right and left”); see also Barr 2/28 at 677; Macher et al., *Semiconductors* at 281. Commentators have described the computer hardware industries as prime examples of “complex product industries,” in which relatively numerous patents protect individual commercializable products. See, e.g., Cohen 2/20 at 30.

Box 3-6. *The Patent Paradox Revisited: An Empirical Study of Patenting in the US Semiconductor Industry, 1979-1995*

Bronwyn H. Hall and Rosemarie Ham Ziedonis, *RAND Journal of Economics*, Vol. 32, No. 1, Spring 2001, pp 101-128.

Bronwyn H. Hall and Rosemarie Ham Ziedonis conducted an empirical study of patenting practices in the semiconductor industry in order to explain a paradox in the economic literature: the patenting rate per R&D dollar doubled in the semiconductor industry since the mid-1980s, while other economic studies indicated that industry participants did not regard patents as an important means for recouping investments in innovation.

The study was based on a combination of qualitative and quantitative research methods. The qualitative analysis involved the authors conducting interviews with intellectual property managers and executives from several U.S. semiconductor firms. The quantitative analysis involved the authors compiling a database of the patent portfolios of 100 publicly traded U.S. semiconductor firms whose R&D expenditures were primarily focused on semiconductor-related areas from 1975 to 1998. They matched these data with financial and other variables to formulate estimates of the patent propensities of individual firms during the period of the study.

The authors concluded that the significant increase in patenting per R&D dollar was attributable to the strengthening of patent rights in the United States, which spurred "patent portfolio races" among capital-intensive firms. Firms were engaged in these races to reduce concerns about "being held up by external patent owners and at negotiating access to external technologies on more favorable terms."

the underlying technology; (2) the rise of defensive patenting; and (3) the ease of obtaining patents at the PTO.

(i). Incremental Innovation and the Nature of Hardware and Semiconductor Technology

Four industry representatives testified that the technology developed by the hardware and semiconductor industries is susceptible to the creation of patent thickets, because hardware and semiconductors contain an incredibly large number of incremental innovations.²¹⁷ The complex nature of computer hardware technology is one factor that contributes to the existence of a technology thicket over

²¹⁷ See Detkin 2/28 at 669-70, 710-11; Poppen 2/28 at 684, 712; Barr 2/28 at 713-14; Fox 2/28 at 714. Their testimony offered confirmation of similar observations by academic panelists. See, e.g., R. Levin (stmt); Lemley 2/25 at 37 (noting the cumulative nature of semiconductor innovation).

which a patent thicket has developed.²¹⁸

(ii). The Rise of Defensive Patenting

As discussed above, firms in the computer hardware industries have been obtaining patents at rapidly increasing rates largely for defensive purposes. The likelihood of firms holding overlapping intellectual property increases as more patents issue over semiconductor and hardware innovations. In this way, the problem is self-perpetuating. As one panelist acknowledged, "the only practical response to this problem of unintentional and sometimes unavoidable patent infringement is to file hundreds of patents each year ourselves."²¹⁹

In their research, Professors Hall and

²¹⁸ See Teece 2/27 at 500.

²¹⁹ Barr 2/28 at 677; see also Hart 4/9 at 42-42.

Ziedonis identified a “pro-patent” shift in the US legal environment in the 1980s as the stimulus for the rise of defensive patenting.²²⁰ The authors believe that this shift resulted from a series of congressional reforms in the early 1980s, including the creation of the Court of Appeals for the Federal Circuit, which “put in place a number of procedural and substantive rules that collectively strengthened the rights of US patent owners.”²²¹

Professors Hall and Ziedonis also identified two events that arose out of the “pro-patent” shift and signaled the importance of the new patent regime to firms in the semiconductor industry. First, Polaroid’s successful patent infringement suits against Kodak resulted in Polaroid being “awarded almost \$1 billion in damages and Kodak . . . [being] barred from competing in the instant-film camera business.”²²² This case created a fear among firms that owned manufacturing facilities that the “courts were willing to take an aggressive stance against infringement by halting – either temporarily or permanently – production utilizing infringed technologies.”²²³ Second, the revenue obtained by Texas Instruments from mining its patents – that is, seeking patent royalties from firms that operate outside the range of

²²⁰ Hall & Ziedonis, 32 RAND J. ECON. at 105.

²²¹ Hall & Ziedonis, *The Effects of Strengthening Patent Rights on Firms Engaged in Cumulative Innovation: Insights from the Semiconductor Industry* at 12.

²²² Hall & Ziedonis, 32 RAND J. ECON. at 109.

²²³ *Id.* A number of panelists discussed the threat of an injunction. See, e.g., Poppen 2/28 at 686, 691, 725; Detkin 2/28 at 722-23; Barr 2/28 at 723.

Texas Instruments’ business – prompted other firms also to commence patent mining programs.²²⁴

(iii). Ease of Obtaining Patents

Professor Ziedonis contended that the ease of obtaining patents at the PTO, although not the sole cause of the thicket, is a contributing factor.²²⁵ She cited interviews conducted with participants in the semiconductor industry in which the participants stated that the standard for obviousness should be increased so as to prevent “very trivial inventions” being patented by the PTO.²²⁶

b. *The Potential for Patent Thickets to Harm Innovation*

The panelists discussed several ways in which patent thickets can harm innovation.²²⁷ First, the need of integrated firms and hardware companies to develop extensive patent portfolios for defensive purposes diverts funding from R&D into the obtaining of patents. As one panelist

²²⁴ Hall & Ziedonis, 32 RAND J. ECON. at 109. Panelists reported that some companies have sought to license their patents to companies that operate outside the market of the patent holder, because a higher royalty can be extracted due to an imbalance in bargaining positions. See Brunt 3/20 at 25; Poppen 2/28 at 684; Thurston 3/20 at 34. In this situation, one panelist contended, the management of a company treats patents as an asset that must generate a return, instead of as a means to exclude parties from a particular invention. See Wolin 3/20 at 81. See also *infra* Ch. 3(IV)(E)(2)(c)(i).

²²⁵ See Ziedonis 3/20 at 15-16.

²²⁶ *Id.*

²²⁷ Another potential harm, resulting from the strategic use of patents in licensing negotiations, is addressed in the next section.

observed, “the time and money we spend on patent filings, prosecution, maintenance, litigation and licensing could . . . be much better spent on product development and research leading to more innovation.”²²⁸

Patent thickets can reduce follow-on innovation by requiring an innovator to seek licenses from multiple patentees.²²⁹ In these industries, one panelist reported, “hundreds, thousands of patents cover a single product.”²³⁰ As discussed *supra* in Chapter 2, the transaction costs and potential for royalty stacking involved in obtaining multiple licenses from numerous patent holders may pose obstacles to the development of follow-on technologies.²³¹

Patent thickets also can harm innovation by creating uncertainty, which affects investment decisions. One panelist stated that the proliferation of patents and patent-related litigation has created “pervasive uncertainty about legal rights . . . [that] heightens risks surrounding innovation investment decisions . . . [and] is without doubt a serious drag on the technological and scientific progress that the patent system was designed to promote.”²³²

²²⁸ Barr 2/28 at 677-78. Similarly, another panelist contended that “patents are assets that suck money out of the system.” Brunt 3/20 at 25.

²²⁹ See Shapiro, *Navigating the Patent Thicket* at 120-121.

²³⁰ Poppen 2/28 at 684.

²³¹ See Detkin 2/28 at 764 (noting the presence of “half a million patents owned by 40,000 parties . . . and we have to worry about how we’re going to negotiate with them”); Poppen 2/28 at 690 (raising royalty stacking concerns).

²³² Fox 2/28 at 696; see also Barr 2/28 at 675-76.

c. *The Strategic Use of Patents in Licensing Negotiations*

Panelists discussed the strategic use of patents in licensing negotiations, and in particular one type of strategic use, generally known as “hold-up.”²³³ They discussed hold-up as enabled by sunk costs that a firm already has invested in product development or manufacturing, before learning of the patent, which in turn enable the patentee to demand royalties higher than it could have sought before the firm sunk its costs; with so very many patents at issue, panelists suggested, infringing *someone’s* patent may be inevitable, but there may be no economically feasible way, prior to making sunk investments, to identify and obtain rights to all the relevant patented technologies.²³⁴ Some commentators argue that hold-up in this sense harms competition and innovation.²³⁵ Others suggest that such behavior constitutes a legitimate exercise of a patentee’s right to exclude.²³⁶

²³³ For discussion of hold-up for antitrust enforcement purposes, see Timothy J. Muris, *The FTC and the Law of Monopolization*, 67 ANTITRUST L.J. 693, 704 (2000); Benjamin Klein, *Market Power in Franchise Cases in the Wake of Kodak: Applying Post-Contract Hold-Up Analysis to Vertical Relationships*, 67 ANTITRUST L.J. 283 (1999).

²³⁴ See, e.g., Barr 2/28 at 677; Detkin 2/28 at 764.

²³⁵ See Shapiro, *Navigating the Patent Thicket* at 124-26; see also *supra* Ch. 2(III)(C)(2) and *infra* Ch. 3(IV)(E)(2)(e)(iii).

²³⁶ See generally Frederick J. Telecky, *Statement of Frederick J. Telecky, Jr., Senior Vice President and General Patent Counsel, Texas Instruments: FTC/DOJ Hearings on “Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy”* (2/28/02) 5 (“refusal to license is at the heart of the patent system”), at <http://www.ftc.gov/opp/intellect/020228telecky.pdf> (hereinafter Telecky (stmt)).

In their business survey, Professors Hall and Ziedonis concluded that semiconductor firms with large sunk costs in complex manufacturing facilities started to patent defensively in the 1980s to reduce, among other things, “concerns about being held up by external patent owners.”²³⁷ These concerns stemmed in part from Polaroid’s successful patent infringement suit against Kodak.²³⁸ One industry participant interviewed by Professors Ziedonis and Hall stated, “a preliminary injunction would be detrimental to a firm if it means shutting down a high-volume manufacturing facility; loss of one week’s production alone can cost millions of dollars.”²³⁹ Firms in the computer hardware industries responded to the possibility of having their production enjoined by accumulating large patent portfolios. If a rival company sought to employ a hold-up strategy against them, they would draw on their portfolio to assert patent infringement counterclaims against that rival, resulting in what panelists described as “mutually assured destruction” or “MAD.”²⁴⁰

²³⁷ Hall & Ziedonis, 32 RAND J. ECON. at 104; see also Box 3-6; Rosmarie Ziedonis, *When the Giants’ Shoulders are Crowded: Fragmented Rights and Patent Strategies in Semiconductors 4* (July 2002) in draft at <http://www.isnie.org/ISNIE02/Papers02/ziedonis.pdf>.

²³⁸ See Hall & Ziedonis, 32 RAND J. ECON. at 109.

²³⁹ *Id.*; see generally John R. Boyce & Aidan Hollis, *Innovation, Imitation & Preliminary Injunctions in Patents* (Public Comment), at <http://www.ftc.gov/os/comments/intelpropertycomments/0205xxhollis.pdf>.

²⁴⁰ See Hall 2/28 at 662; Detkin 2/28 at 669; Poppen 2/28 at 684-85; Barr 2/28 at 713; see also Hall & Ziedonis, 32 RAND J. ECON. at 109.

(i). The Rise of Non-Practicing Entities

The potential for hold-up to result in mutually assured destruction means firms actively participating in the industry – patent practicing entities (PPEs) – are unlikely to employ this strategy against each other.²⁴¹ Panelists, however, identified firms referred to as non-practicing entities (NPEs) that can successfully employ a hold-up strategy without fear of retaliation.²⁴² NPEs obtain and enforce patents against other firms, but either have no product or do not create or sell a product that is vulnerable to infringement countersuit by the company against which the patent is being enforced. As discussed *supra* in Chapter 2, MAD strategies to mitigate hold-up will not work against NPEs, who are not susceptible to the threat of a countersuit shutting down their production.²⁴³ In contrast, NPEs can threaten PPEs with patent infringement and an injunction, which, if granted, could inflict substantial losses.²⁴⁴

Panelists identified three types of NPEs in the computer hardware industry: (1) non-practicing design firms, which patent their inventions but do not make or sell patented products to consumers; (2)

²⁴¹ See Poppen 2/28 at 684-86.

²⁴² See Rhoden 2/28 at 723-24; Carl Shapiro, *Technology Cross-Licensing Practices: FTC v. Intel (1999)*, in 4 THE ANTITRUST REVOLUTION: ECONOMICS, COMPETITION AND POLICY 350, 356 (John E Kwoka, Jr. & Lawrence J. White eds. 2004).

²⁴³ See Poppen 2/28 at 685-89; Detkin 2/28 at 671-72.

²⁴⁴ See Poppen 2/28 at 685-89; Detkin 2/28 at 671-72; Hall & Ziedonis, 32 RAND J. ECON. at 109. For additional discussion of issues raised by NPE conduct, see *supra* Ch. 2(III)(C)(2) and Second Report (forthcoming).

“professional” patent assertion companies that buy patents from other companies, particularly those that are bankrupt, and then assert them against practicing entities; and (3) “patent miners,” which are companies that assert their patent portfolios against firms outside of their business.²⁴⁵

Professor Ziedonis noted that the number of cases filed by NPEs has increased since the mid-1980s, and that the sale of patents by failing companies has increased since the 1990s.²⁴⁶ One third of the patent

²⁴⁵ See Poppen 2/28 at 685-88; Detkin 2/28 at 672.

The panelists discussed two reasons for the emergence of “patent mining” by companies. First, the need to patent defensively has forced many firms to develop extensive patent portfolios, at considerable cost. One business representative stated that it costs about \$200,000 to maintain a patent worldwide over a period of 20 years. See Brunt 3/20 at 25. Panelists reported that some companies have sought to offset these costs by seeking to license their patents to other companies, particularly companies that operate outside the market of the patent holder, because a higher royalty can be extracted due to an imbalance in bargaining positions. See *id.*; Poppen 2/28 at 684; Thurston 3/20 at 34.

Second, panelists contended that business attitudes towards patents have changed since the 1980s. The management of some companies, some asserted, have begun to treat patents as an asset that must generate a return, instead of as a means to exclude parties from a particular invention. See Wolin 3/20 at 81. Panelists cited two examples to support this change in attitude. First, a number of panelists mentioned Texas Instruments, which successfully instigated a patent mining program in the late 1980s to save the company from bankruptcy, and thereby became an example to other companies of how to mine their patents. See Thurston 3/20 at 28-29; Wolin 3/20 at 81; Ziedonis 3/20 at 83; Telocky 2/28 at 653; Macher et al., *Semiconductors* at 281; Grindley & Teece, 39 CAL. MGMT. REV. at 20. Second, a widely read book in business circles entitled *Rembrandts in the Attic* encourages managers to generate revenue from their patents by mining them. See Hughes 2/28 at 614; KEVIN G. RIVETTE & DAVID KLINE, *REMBRANDTS IN THE ATTIC: UNLOCKING THE HIDDEN VALUE OF PATENTS* (Harvard Business School Press 1999).

²⁴⁶ See Ziedonis 3/20 at 71, 73-74.

lawsuits filed by a group of 136 companies, for example, involved patents not invented by the company.²⁴⁷ Two panelists confirmed that an increasing number of companies are seeking to buy and sell the patent portfolios of failing companies to assert against other firms.²⁴⁸ In their business analysis of licensing practices in the semiconductor and electronics industry, Professors Grindley and Teece observe that “occasionally, firms can purchase a portfolio of patents with which to establish cross-licensing relationships; but quality patents often are not available in this fashion.”²⁴⁹

(ii). Hold-Up and Patent Thickets

In industries such as the computer hardware industries, where innovation is cumulative, panelists noted that hold-up is more likely to occur, because the presence of a patent thicket makes patent infringement very difficult to avoid.²⁵⁰ As Professor Shapiro observed, participants in the semiconductor industry receive “thousands of patents . . . each year and manufacturers can potentially infringe on hundreds of patents with a single product.”²⁵¹ Another panelist stated that “the large number of

²⁴⁷ See Ziedonis 3/20 at 73-74.

²⁴⁸ See Thurston 3/20 at 75; Wolin 3/20 at 76.

²⁴⁹ Grindley and Teece, 39 CAL. MGMT. REV. at 31; see also Shapiro 11/6 at 176 (observing that “I’ve even seen a situation where a portfolio was split up and some patents split off to a third party who had no other commercial interests, so they could assert it most aggressively against other industry players.”).

²⁵⁰ See Barr 2/28 at 676; Hall & Ziedonis, 32 RAND J. ECON. at 110.

²⁵¹ See Shapiro, *Navigating the Patent Thicket* at 125.

issued patents in our field makes it virtually impossible to search all potentially relevant patents, review the claims, and evaluate the possibility of an infringement claim or the need for a license.²⁵² This problem of unavoidable patent infringement is heightened, commentators stated, by the risk of patent applications still pending and unpublished by the PTO after a company has sunk significant costs in a new product.²⁵³

Commentators have also observed that companies seeking to hold up rivals can set the licensing fees below the cost of litigation, including the managerial distraction, so as to make the taking of a license the only economically sensible alternative, regardless of the strength of the patent.²⁵⁴ Professor Shapiro contends that the lack of effective mechanisms to challenge questionable patents, the presumption of validity, and “a patent office that is generous to patent applicants” also facilitate the use of hold-up strategies by NPEs.²⁵⁵ Several panelists asserted that companies can use a continuation on their own patent application deliberately to delay

patent issuance by the PTO.²⁵⁶ This enables such companies, one panelist asserted, to tailor their patent claims to cover a rival’s product using insights gained from reverse-engineering that product.²⁵⁷

(iii). The Potential for Hold-Up to Harm Consumers

Commentators identified four ways that hold-up can harm competition and innovation. First, obtaining a license after costs have been sunk will result in a higher royalty to the NPE than if a license were negotiated prior to the sinking of costs.²⁵⁸ One reason for this higher royalty is that PPEs obtaining a license under threat of hold-up typically do not have the option of designing around the patent the NPE asserted, because redesigning a product after significant costs have been sunk is usually not economically viable.²⁵⁹ According to Professor Shapiro, the higher royalty paid by companies subject to a hold-up strategy may result in higher prices to consumers, inefficiently low use of the affected

²⁵² Robert Barr, *Statement (2/28/02) 1*, at <http://www.ftc.gov/opp/intellect/barrrobert.doc> (hereinafter Barr (stmt)).

²⁵³ See Barr 2/28 at 676; Shapiro, *Navigating the Patent Thicket* at 125-26. See *supra* Ch. 2(III)(C) and *infra* Chs. 4(II)(C)(1) and 5(II)(C)(4).

²⁵⁴ See Ziedonis 3/20 at 71-72; Barr 2/28 at 680 and (stmt) 2; Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 NW. L.REV. 1495, 1517 (2001) (noting that “patent owners might try to game the system by seeking to license even clearly bad patents for royalty payments small enough that licensees decide that it is not worth going to court”).

²⁵⁵ Shapiro, *Technology Cross-Licensing Practices: FTC v. Intel (1999)* at 355.

²⁵⁶ See Poppen 2/28 at 687-88; McCurdy 3/20 at 37; Mar-Spinola 2/28 at 715-16; Barr 10/30 at 146-47; see also *infra* Ch. 4(II)(C)(1).

²⁵⁷ See Poppen 2/28 at 688.

²⁵⁸ See Shapiro, *Navigating the Patent Thicket* at 125.

²⁵⁹ See Shapiro, *Navigating the Patent Thicket* at 125; Barr (stmt) 2-3; Rosemarie Ziedonis, *When the Giants’ Shoulders are Crowded: Fragmented Rights and Patent Strategies in Semiconductors* at 8. Just as an NPE may wish to set the royalty fee it seeks at just below what it would cost the “held up” firm to litigate the validity or infringement of the NPE’s patent, so an NPE may wish to set its requested royalty fee at just below what it would cost the firm to redesign around the patent.

products, and deadweight loss.²⁶⁰ The cumulative effect of many such licenses may exacerbate these effects.²⁶¹ Second, innovation may suffer because some companies will “refrain from introducing certain products for fear of hold-up.”²⁶²

Third, by seeking royalties below the cost of challenging a patent’s validity, NPEs can obtain royalties on improperly granted patents. Royalties on improperly granted patents cause an inefficient allocation of society’s resources and a transfer that “encourages patenting and discourages competition to a greater extent than is socially optimal.”²⁶³ One panelist observed that NPEs can use this same strategy to induce PPEs to obtain licenses for patents that are likely not infringed by the PPE’s product.²⁶⁴ Finally, a number of panelists representing manufacturing firms contended that hold-up causes a wealth transfer from firms engaged in innovation that results in benefits to firms that are simply exploiting the patent system without benefitting consumers.²⁶⁵ One panelist, however,

²⁶⁰ See Shapiro, *Navigating the Patent Thicket* at 125; Poppen 2/28 at 690.

²⁶¹ See Shapiro, *Navigating the Patent Thicket* at 126.

²⁶² *Id.*; see also Grindley & Teece, 39 CAL. MGMT. REV. at 20.

²⁶³ Lemley, 95 NW. L. REV. at 1517.

²⁶⁴ Barr (stmt) 2-3.

²⁶⁵ See Poppen 2/28 at 689-90; Barr 2/28 at 679 and (stmt) 1-3 (the exploitation of the patent system as a revenue-generating tool in its own right has hindered true innovation and outweighed the benefits); Detkin 2/28 at 673 and 728-30. Another concern expressed was that hold-up may force innovative firms to move their manufacturing and sales operations offshore to minimize their exposure to such strategies.

responded that “we’re not sure that in every instance where there’s a patentee with no product, that they haven’t legitimately contributed something to the fund of human knowledge.”²⁶⁶

F. Tools to Navigate the Patent Thicket

The panelists discussed three licensing strategies that firms can use to navigate patent thickets: (1) cross-licensing; (2) patent pooling; and (3) standard setting. The panelists generally agreed that each strategy, despite involving certain transaction costs, has been effective in clearing the patent thicket.²⁶⁷

1. Cross-Licensing

Cross-licensing is one of the mechanisms used by integrated firms and hardware companies in particular to obtain design freedom when a patent thicket exists.²⁶⁸ The main variables are: (1) the number of patents at issue; and (2) the use of balancing payments (*i.e.*, monetary payments to even out the value of the portfolios being cross-licensed).²⁶⁹ The

²⁶⁶ Telecky 2/28 at 703.

²⁶⁷ See Grindley & Teece, 39 CAL. MGMT. REV. at 16; Detkin 2/28 at 711 (stating that hold-up is the problem, not thickets).

²⁶⁸ See McCurdy 3/20 at 67 (noting the greater prevalence of cross-licensing in semiconductors and information technology industries than in pharmaceuticals). For a discussion of the antitrust treatment of cross-licensing, see Second Report (forthcoming). For an historical overview of licensing practices at Texas Instruments, see E. Thompson 11/6 at 9-11.

²⁶⁹ See McCurdy 3/20 at 67-69.

number of patents that are cross-licensed can vary from two to a complete patent portfolio, which might include thousands of patents. Balancing payments are often negotiated by the parties and are used to address a relative imbalance in patent portfolio size or quality.²⁷⁰

One panelist outlined three factors his company considers when deciding whether to license: (1) potential patent infringement claims the prospective licensee might have against his company; (2) potential patent infringement claims his company has against the prospective licensee; and (3) the relative interest of the parties in reaching a cross-licensing arrangement.²⁷¹ According to another panelist, integrated firms and hardware companies usually settle cross-licensing negotiations without filing lawsuits.²⁷²

2. Patent Pools

The centralized management that patent pools entail may help in avoiding the royalty stacking/complements problems that economists have suggested may develop when multiple patents are needed for follow-on activities, and each patentee independently determines its own royalty

²⁷⁰ See *id.* at 69, 72.

²⁷¹ See Detkin 2/28 at 669-70 (stating that Intel considers three things when deciding whether to license: “What have they got on us, what do we have on them, and who cares?”).

²⁷² See McCurdy 3/20 at 69. For a discussion of some of the antitrust issues raised by cross-licensing, see Second Report (forthcoming).

rates.²⁷³ One panelist stated that “patent pools have become critically important mechanisms for enabling widespread use of new technologies that require access to a multitude of patents dispersed among a multitude of parties.”²⁷⁴

That panelist expressed two concerns, however, about the use of patent pools. First, he stated that some patent holders with critical patents avoid *ex ante* negotiations by asserting that the antitrust laws prevent them from negotiating royalties prior to selection of the specific patents in the pool.²⁷⁵ He argued that the negotiation of the royalty in advance of the selection of specific patents in the pool was preferable.²⁷⁶ Second, he contended that applicants should be able to choose which patents they license from a patent pool, rather than be forced to take a license for the totality of patents, which is the most commonly used approach.²⁷⁷

²⁷³ See Barr 2/28 at 733 (finding patent pools useful for consolidating administration and limiting royalty stacking problems). See generally *supra* Ch. 2(III)(C)(3) (discussing royalty stacking and Cournot’s complements problem).

²⁷⁴ Fox 2/28 at 700.

²⁷⁵ See *id.* at 732; see also Second Report (forthcoming).

²⁷⁶ See Fox 2/28 at 737, 732 (suggesting that lower royalties or better terms might be negotiated in return for accepting the patent into the pool). For analysis of analogous issues raised by *ex ante* negotiations involving standard-setting bodies, see Second Report (forthcoming).

²⁷⁷ See Fox 2/28 at 699. For analysis of the relevant antitrust considerations, see Second Report (forthcoming).

3. Standard-Setting

By establishing rules governing access to the intellectual property embodied in their standards, standard-setting organizations (SSOs) can clear patent thickets that otherwise might stand in the way of follow-on innovation. Professor Lemley, who recently conducted a study of SSOs, found them most active “in industries in which it looks like patent hold-up is the biggest problem [such as] in computers, in semiconductors . . . [but not in] pharmaceuticals, in biotechnology, and so forth.”²⁷⁸ Without a way to “clear[]” intellectual property rights held by “dozens or hundreds of different parties,” he warned, “nobody’s going to be able to make a product that works with a particular technical standard.”²⁷⁹ Professor Lemley found that 17 of the 21 SSOs studied in fact required “some form of licensing . . . [m]ost commonly . . . on ‘reasonable and non-discriminatory terms.’”²⁸⁰

G. Conclusion

Panelists in the hardware and semiconductor industries emphasized competition as a driver of innovation. Trade secret protection also contributes to innovation in these industries. Testimony regarding the role of patents was mixed. The record generally corresponded with the results obtained by Professors Cohen,

²⁷⁸ Lemley 4/18 at 35-37. Of course, other factors, such as considerations of achieving compatibility and network effects, also might explain this result.

²⁷⁹ *Id.* at 20.

²⁸⁰ *Id.* at 23. Certain of the antitrust issues raised by SSO activities are discussed in Second Report (forthcoming).

Nelson, and Walsh in their business survey of appropriability mechanisms for firms in the United States: the semiconductor industry was among the least reliant on patents to appropriate returns on investment in R&D.²⁸¹ Panelists, however, also identified an exception to these results: patents are a driver of innovation for design firms.

The hearing record highlighted many of the issues that economists suggested might arise in contexts that involve cumulative innovation and a multiplicity of patents. Specifically, the participants from these industries confirmed a trend toward defensive patenting and stated that patents can deter innovation: (1) by contributing to patent thickets, and (2) through their use by NPEs to hold up PPEs. Panelists also observed that various patent licensing arrangements – cross-licensing, patent pools, and the licensing requirements of standard setting organizations – have helped to mitigate the potential harm to innovation caused by patent thickets.

²⁸¹ See COHEN ET AL., PROTECTING THEIR INTELLECTUAL ASSETS.

V. THE SOFTWARE AND INTERNET INDUSTRIES

A. Introduction

In the software and Internet industries, innovation generally occurs on an incremental basis, with participation possible at the design level by individual programmers and small firms. Panelists consistently emphasized that competition is an important driver of innovation in these industries. Although some panelists stated that software and business method patents foster innovation, many disagreed, asserting that such patents are often questionable and are actually stifling innovation by increasing entry barriers and creating pervasive uncertainty. Some panelists questioned whether it was necessary to have patent protection on software, given the availability of copyrights. Others reported that defensive patenting has accelerated the development of a patent thicket, which, in turn, has increased the likelihood of patentees holding up their rivals. Panelists generally agreed that too many questionable patents are issued; they attributed this to the difficulty patent examiners can have in considering all the relevant prior art in the field and staying informed about the rapid advance of computer science.

The software and Internet industry panelists who participated in the Hearings were: Dean Alderucci, representing Walker Digital; Edward J. Black, representing the Computer & Communications Industry Association; Yar R. Chaikovsky, General Counsel, Zaplet, Inc.; Bradford L. Friedman, Director of Intellectual Property, Cadence Design Systems, Inc.; R. Jordan Greenhall, representing Divx Networks; Joshua Kaplan,

representing Intouch Group, Inc.; Robert H. Kohn, Vice Chairman, Borland Software Corp.; Paul Misener, representing Amazon.com; Mary U. Musacchia, representing SAS Institute; Scott Sander, representing SightSound Technologies; Richard Stallman, representing Free Software Foundation; Mark Webbink, representing Red Hat, Inc.; and Robert Young, Chairman, Center for Public Domain and Chairman, Red Hat, Inc. Two scholars, Dan L. Burk, from the University of Minnesota Law School, and David C. Mowery, from the University of California, Berkeley, participated in business perspective panels on the software and Internet industries. Also, three attorneys, Timothy D. Casey, from Fried, Frank, Harris, Shriver & Jacobson, R. Lewis Gable, from Cowan, Liebowitz & Latman, P.C., and James Pooley, from Milbank, Tweed, Hadley & McCloy, participated in business perspective panels on the software and Internet industries, and Dan Crouse, Deputy General Counsel of Microsoft Corporation, submitted a statement.

B. Industry Description

The software and Internet industries create programs, sometimes consisting of millions of lines of code, that direct the functions of a computer, or a group of several computers, and provide a range of services through electronic commerce. Commentators identified five factors that characterize the software and Internet industries. First, innovation occurs cumulatively.²⁸² As one panelist noted in a

²⁸² Microsoft, *Statement of Dan Crouse, Deputy General Counsel, Microsoft Corporation* (Public Comment) 2, at <http://www.ftc.gov/os/comments/intelpropertycomments/m>

paper he co-authored, “[i]nnovation in software is a cumulative activity, and individual software products frequently build on components from other products.”²⁸³ Another participant similarly noted, “The path of innovation is often incremental, with new ideas added, and products developed and commercialized, using earlier work as the foundation and building blocks.”²⁸⁴

Second, innovation in the software and Internet industries generally requires considerably less capital than innovation in other high-tech industries.²⁸⁵ Companies or individuals can develop and distribute software without the high up-front research costs, clinical trials, or factories required in the pharmaceutical, biotechnology, hardware, and semiconductor industries.

sc.pdf (hereinafter Microsoft (stmt)); see also Pamela Samuelson et al., *A Manifesto Concerning the Legal Protection of Computer Programs*, 94 COLUM. L. REV. 2308, 2346 (1994).

²⁸³ Stuart J. H. Graham & David C. Mowery, *Intellectual Property Protection in the U.S. Software Industry*, in PATENTS IN THE KNOWLEDGE-BASED ECONOMY 225 (Wesley M. Cohen & Stephen A. Merrill eds. 2003), available at <http://faculty.haas.berkeley.edu/graham/unix/swconf.pdf>.

²⁸⁴ Microsoft (stmt) 2.

²⁸⁵ See Young 4/11 at 31 (“we started [Red Hat] on our credit card balances”); Mowery 2/27 at 427 (“the cost of entry [in the software industry] . . . is relatively low”); Mark Webbink et al., *Red Hat’s Comments to the Joint FTC/DOJ Hearing on Competition and Intellectual Property Law* (Public Comment) 3, at <http://www.ftc.gov/opp/intellect/020320webbink.pdf> (hereinafter Webbink (stmt)); see also League for Programming Freedom, *Against Software Patents* (Public Comment) 3-4, at <http://www.ftc.gov/os/comments/intelpropertycomments/lpf.pdf> (hereinafter League for Programming Freedom (stmt)). But cf. Microsoft (stmt) 2 (discussing large investments made by Microsoft in connection with some products).

The growth of the Internet has further enhanced the market significance of programs developed with limited financial backing by creating “new channels for low-cost distribution and marketing.”²⁸⁶

Third, the rate of technological change in the software and Internet industries is rapid.²⁸⁷ Imitation may occur quickly,²⁸⁸ and entire product life cycles sometimes pass before patents can be issued.²⁸⁹ Fourth, alternative means of fostering innovation exist: software can be protected by copyright protection and can be developed using open source software strategies. Finally, the software and Internet industries have experienced a regime change in terms of the availability of patent protection.²⁹⁰ The formal recognition of the

²⁸⁶ Graham & Mowery, *Intellectual Property Protection in the U.S. Software Industry* at 223.

²⁸⁷ See Webbink (stmt) 3; Rusty Lee, *Comments regarding Competition & Intellectual Property* (Public Comment) 1, at <http://www.ftc.gov/os/comments/intelpropertycomments/leerusty.htm> (hereinafter Lee (stmt)); Microsoft (stmt) 4; Samuelson et al., 94 COLUM. L. REV. at 2345, n. 134; Julie E. Cohen & Mark A. Lemley, *Patent Scope and Innovation in the Software Industry*, 89 CAL. L. REV. 1, 46 (2001).

²⁸⁸ See Brunt 3/20 at 26 (innovations “walk out the door far before the patent is available to help us”); Jeremiah T. Moree, *IP Law* (Public Comment), at <http://www.ftc.gov/os/comments/intelpropertycomments/morejeremiaht.htm>.

²⁸⁹ See, e.g., Burk 3/20 at 140-41; Young 4/11 at 64 (“by the time we get a patent, we aren’t using that piece of technology anymore”).

²⁹⁰ See Mowery 2/27 at 427. *Diamond v. Diehr*, 450 U.S. 175 (1981), held that a process claim that included use of a computer program was patentable subject matter. The Federal Circuit’s ruling in *State Street Bank & Trust v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998), cert. denied, 525 U.S. 1093 (1999), made it clear that business methods can be patented. For a discussion of the history of software patents, see Cohen &

patentability of software and Internet-related business methods has spurred increased patenting and has presented challenges in locating the relevant prior art, much of which exists outside of traditional prior art sources.²⁹¹

C. The Role of Competition in Spurring Software and Internet Innovation

Several panelists asserted that competition to commercialize the most recent technological advance drives innovation in the software and Internet industries, and that the patent system does not encourage innovation.²⁹² One panelist stated, for example, that “innovation generally is promoted by competition.”²⁹³ Another panelist similarly commented that “a competitive marketplace between similar or only slightly different businesses is all that is truly necessary to spur improvements.”²⁹⁴

Lemley, 89 CAL. L. REY. at 7; Graham & Mowery, *Intellectual Property Protection in the U.S. Software Industry* at 226-31. See also *infra* Ch. 4(II)(E).

²⁹¹ See Mowery 2/27 at 427.

²⁹² See Chaikovsky 2/27 at 385; Kohn 2/27 at 350; Friedman 2/27 at 354, 357; Musacchia 4/9 at 44-45.

²⁹³ Kohn 2/27 at 350.

²⁹⁴ Mary U. Musacchia, *Prepared Remarks* (4/9/02) 2, at <http://www.ftc.gov/os/comments/intelpropertycomments/musacchiamaryu.pdf> (hereinafter Musacchia (stmt)); see also Musacchia 4/9 at 57-58. A panelist with expertise as a programmer stated that “it’s clear to me that software patents are just an obstacle to the development of software. . . . Even patents covering ideas I would say are brilliant have caused tremendous obstruction in [the] progress of software.” Stallman 4/9 at 17-18.

D. Alternative Means of Fostering Innovation

Participants discussed the role of two additional means for spurring innovation in the software industry: copyright, which is an alternative form of intellectual property, and open source software, which is developed without reliance on intellectual property protection.

1. Copyright

A number of participants noted that copyright exists as an alternative means for fostering software innovation.²⁹⁵ “Copyright protects only the *expression* contained within a work,” not “the underlying ideas expressed in that work.”²⁹⁶ Some commentators questioned whether it was necessary to have patent protection on software given the availability of copyright.²⁹⁷ As one participant noted, for example, “[i]ndividual software programs are also protected by copyright, so that even without any patent protection, software would be a lucrative enterprise.”²⁹⁸ Two scholars offered similar conclusions in an economic study of innovation in the software industry in which they stated that

²⁹⁵ See Kohn 2/27 at 350; Webbink (stmt) 3; Robert M. Hunt, *Nonobviousness and the Incentive to Innovate: An Economic Analysis of Intellectual Property Reform* (Public Comment) 7, at <http://www.ftc.gov/os/comments/intelpropertycomments/nonobviousness.pdf>; Lee (stmt) 1.

²⁹⁶ ROGER E. SCHECHTER & JOHN R. THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARKS* § 3.3 at 31-32 (2003) (emphasis in original).

²⁹⁷ See Webbink (stmt) 3; Kohn 2/27 at 350.

²⁹⁸ Lee (stmt) 1.

“copyright protection for software programs . . . may have achieved a better balance [for promoting innovation] than patent protection.”²⁹⁹

By contrast, one panelist observed that patents can be preferable to copyright for software, because patent protection also covers processes.³⁰⁰ This perspective finds support in an analytical study that concluded that certain aspects of computer programs not protected by copyright law “are vulnerable to rapid imitation that, left unchecked, would undermine incentives to invest in software development.”³⁰¹ The authors also noted that the extended period of protection available under copyright law has the potential to harm innovation and consumer welfare “by banning for seventy-five years functionally indistinguishable products, having independently created texts.”³⁰² The scholars, however, expressed some concern that applying two intellectual property rights regimes to software may not always work smoothly: “No one knows just where the boundary line between these domains does or should lie.”³⁰³ The use of overlapping regimes has left “considerable uncertainty about the scope of protection

²⁹⁹ James Bessen & Eric Maskin, *Sequential Innovation, Patents, and Imitation* (Public Comment) 20 (arguing that “software patents have been too broad and too obvious,” and that copyright protections focus better on barring imitations while permitting development of “potentially valuable complementary contributions.”), at <http://www.researchoninnovation.org/patent.pdf> (hereinafter Bessen & Maskin (stmt)).

³⁰⁰ See Gable 3/20 at 136-37.

³⁰¹ Samuelson et al., 94 COLUM. L. REV. at 2310.

³⁰² *Id.* at 2430.

³⁰³ *Id.* at 2347.

available from each.”³⁰⁴

2. Open Source Software

Commentators discussed the open source software movement and its role as an alternative means of fostering innovation. At the most basic level, open source software is software that is distributed with its source code so that the user may alter the program if she or he so chooses.³⁰⁵ By contrast, most commercial software is distributed in compiled form that cannot be altered by the user.

The development of open source software occurs through the use of three key organizational principles.³⁰⁶ These include: (1) the absence of most legal constraints on copying and use common to proprietary materials; (2) the accepting (and frequent public dissemination) of contributions from many developers; and (3) the confining of the right to modify the official version of the program to a smaller subset of individuals or a leader closely involved with the project.³⁰⁷

³⁰⁴ *Id.* at 2346-47.

³⁰⁵ See Zoe Konovalov, *The Economics of Open Source Software* (Public Comment) 5, at <http://www.ftc.gov/os/comments/intelpropertycomments/konovalovzoe.pdf> (hereinafter Konovalov (stmt)).

³⁰⁶ See JOSH LERNER & JEAN TIROLE, *THE SIMPLE ECONOMICS OF OPEN SOURCE 6* (National Bureau of Econ. Research Working Paper No. 7600, 2000), at <http://papers.nber.org/papers/w7600.pdf>.

³⁰⁷ See Webbink 3/20 at 98, 101; Konovalov (stmt) 15-16; Mark Ellis, *Comments regarding Competition and Intellectual Property* (Public Comment) 9-11, at <http://www.ftc.gov/os/comments/intelpropertycomments/ellismark.pdf>; LERNER & TIROLE, *THE SIMPLE ECONOMICS OF OPEN SOURCE* at 6; Yochai Benkler, *Coase's Penguin, or, Linux and the Nature of the Firm*, 112 YALE L. J. 369, 374-75 (2002).

Open source software has received considerable attention in recent years due to: (1) its rapid adoption, particularly by expert users and corporations; (2) significant capital investments in open source projects by corporations such as Hewlett Packard, IBM, and Sun Microsystems; and (3) the hailing of its collaborative nature of development by business and trade press as an important organizational innovation.³⁰⁸ Scholars have identified both disadvantages and advantages to open source methods. On one hand, “[c]ommercial projects have an edge on the current-compensation dimension because the proprietary nature of the code generates income.”³⁰⁹ On the other hand, open source may have certain cost advantages,³¹⁰ and may permit programmers to benefit from a range of delayed rewards.³¹¹

³⁰⁸ See LERNER & TIROLE, *THE SIMPLE ECONOMICS OF OPEN SOURCE* at 6; Konovalov (stmt) 37-39. The emergence of open source software as an alternative means of fostering innovation has led one scholar to identify it as “an emerging third mode of production . . . in the digitally networked environment,” which he titled “commons-based peer production,” and distinguished from “the property- and contract-based modes of firms and markets.” Benkler, 112 *YALE L. J.* at 374-75.

³⁰⁹ LERNER & TIROLE, *THE SIMPLE ECONOMICS OF OPEN SOURCE* at 16.

³¹⁰ See *id.* (citing programmers’ familiarity with open source software from university experience); Benkler, 112 *YALE L. J.* at 374-75, 377 (citing efficiencies in “large-scale collaborations in many information production fields” and increasing returns to “large- and medium-scale collaboration among individuals that are organized without markets . . . in the informational and cultural production system”).

³¹¹ See LERNER & TIROLE, *THE SIMPLE ECONOMICS OF OPEN SOURCE* at 17-18 (noting that open source methods permit outsiders to view an individual programmer’s contribution to a project); Konovalov (stmt) 19-20.

E. The Implications of Patent Protection for Innovation

1. The Role of Patents in Spurring Innovation in the Software and Internet Industries

Participants discussed various ways in which software and Internet patents can spur innovation: (1) by preventing free riding and encouraging investment in innovation; (2) by encouraging disclosure of inventions; and (3) by fostering design-around innovation. Commentators were generally skeptical about the benefits of the patent system in these industries.

a. The Role of Patents in Preventing Free Riding and Encouraging Investment in Innovation

Panelists expressed differing views about whether patents play significant roles in preventing free riding and encouraging investment in innovation in the software and Internet industries. Some panelists stated that patents provide incentives to invest in R&D by deterring free riding.³¹² One participant stated that “dynamic growth and robust innovation in the software industry in the United States [has been] coincident with the provision of patent protection to software-related inventions.”³¹³ Other panelists took a different view, contending that the availability of patents on software and Internet-based business methods does not significantly encourage investment in

³¹² See Kaplan 2/27 at 399; Alderucci 4/9 at 39-41; Sander 3/20 at 106.

³¹³ Microsoft (stmt) 5.

innovation.³¹⁴ Many of the panelists who expressed this view emphasized that competition provides incentives to innovate in the software and Internet industries. “Compared to the effect of competition in this industry, the current patent system has relatively little effect on the motivation to innovate,” according to one panelist.³¹⁵

Three panelists, two of whom were entirely opposed to the issuance of business method patents, commented that the patent term for business methods should be reduced to between three and five years.³¹⁶ One of these panelists commented, “three years is more in line with the development time and cost that . . . business methods face.”³¹⁷

b. *The Role of Patents in Fostering Innovation Through Disclosure*

Panelists also expressed differing views about whether software and business method patents foster innovation by forcing patent applicants to disclose their inventions. Some panelists expressed the view that the patent system spurs innovation by allowing “anyone to review the public disclosures in issued patents or published patent applications.”³¹⁸ A number of other

panelists disagreed, however, noting that the Court of Appeals for the Federal Circuit does not interpret current patent law to require patent applicants to disclose underlying technology, such as source code.³¹⁹ One of these panelists argued that without disclosure of the underlying technology, business method patent disclosures “fail to augment public knowledge,” because “in many instances, the business process, by its nature, is public.”³²⁰ Another panelist stated that “we have to require that the person applying for the software patent files the source code behind that patent, because the source code is the invention.”³²¹

Some of the panelists expressed concern that the possibility of exposing oneself to allegations of willful infringement by reading another firm’s patents reduces the value of patent disclosures. One panelist stated that “the [patent] system discourages you from looking very hard [at patent disclosures] because . . . simply by virtue of poking around to find out what patents exist you expose yourself to willfulness claims which can triple the amount of damages and exposure to attorney’s fees.”³²² A second panelist confirmed that the potential for being accused of willful infringement had

³¹⁴ See Chaikovsky 3/27 at 343 (stating that Yahoo reached \$120 billion market capitalization with only three issued patents); Friedman 2/27 at 357; Musacchia 4/9 at 44-45, (stmt) 2; Black 3/20 at 138; Webbink (stmt) 2.

³¹⁵ Friedman 2/27 at 354.

³¹⁶ See Misener 2/27 at 395-96; see also Musacchia (stmt) 4; Webbink (stmt) 4.

³¹⁷ Webbink (stmt) 4.

³¹⁸ Alderucci 4/9 at 40; see also Gable 3/20 at 118; Myrick 10/30 at 60.

³¹⁹ See Webbink 3/20 at 145; Burk 3/20 at 108; Musacchia (stmt) 2; Casey 4/9 at 32; Young 4/11 at 99-100; see, e.g., *Northern Telecom, Inc. v. Datapoint Corp.*, 908 F.2d 931, 941-43 (Fed. Cir. 1990); *Fonar Corp. v. General Electric Company*, 107 F.3d 1543, 1549 (Fed. Cir.), *cert denied*, 522 U.S. 908 (1997).

³²⁰ Musacchia (stmt) 2.

³²¹ Young 4/11 at 99.

³²² Pooley 2/27 at 380.

deterred him from reading patents.³²³

Another panelist reported that uncertainty in the patent system hinders the use of patent disclosures in a competitive manner.³²⁴ The panelist summed up the problem with the statement “there’s too much information and it is no longer meaningful.”³²⁵

c. *The Role of Patents in Fostering Design-Around Innovation*

A number of panelists raised questions concerning the extent to which the patent system fosters useful design-around innovation in the software industry. Some complained that design-around efforts may prove costly, duplicative, wasteful, and sometimes technologically impossible.³²⁶ One panelist stressed that entrenchment of a patented technology as a *de facto* standard might prevent design-around innovation from being adopted, even when it is technologically superior.³²⁷ Others observed that programmers can only design around those patents that are published, and the absence of a publication requirement for *all*

³²³ See Greenhall 2/27 at 420-21.

³²⁴ See Friedman 2/27 at 411-12. Factors this panelist identified as causing uncertainty include the issuance of questionable patents and the process of judicial review of patents.

³²⁵ *Id.*

³²⁶ See, e.g., Stallman 4/9 at 18-20, 38, and Richard Stallman, *The Danger of Software Patents*, Speech by Richard Stallman at Cambridge University, March, 25 2002 (Public Comment) 4, at <http://www.ftc.gov/os/comments/intelpropertycomments/stallmanrichard.pdf>; Musacchia 4/9 at 91; see also Cohen & Lemley, 89 CAL. L. REV. at 56 (noting that the courts may “apply the doctrine of equivalents too broadly in software infringement disputes, and thus may stifle efforts by second-comers to design-around existing patents”).

³²⁷ See Stallman 4/9 at 88-90.

patent applications means “it may be years beyond the time that a particular piece of technology has hit the marketplace before it is evident that it, in fact, is covered by a form of patent protection.”³²⁸ The skepticism, however, was not universal. One panelist argued that forcing design-around efforts may be “the most significant way in which patents promote innovation,” although he did not expressly tie his remark to the software industry.³²⁹

2. *The Potential for Patents to Impede Innovation in the Software and Internet Industries*

Panelists and participants discussed several ways in which patents might deter innovation: (1) by denying follow-on innovators access to necessary technologies; (2) by increasing entry barriers; (3) through business uncertainty and the expense required to avoid patent infringement; and (4) through the issuance of questionable patents.

a. *Patents May Impede Independent Follow-On Innovation*

Some participants cautioned that patents are likely to thwart beneficial follow-on R&D when innovation depends on incremental efforts, such as software and the Internet.³³⁰ As one participant has

³²⁸ Webbink 3/20 at 99-100; see *infra* Ch. 5(II)(C)(4) for a discussion of patent publication requirements.

³²⁹ Casey 4/9 at 85.

³³⁰ See, e.g., Stallman 4/9 at 17-18; Kohn 2/27 at 348-49 (stressing effects on development of complementary products); Bessen & Maskin (stmt) 2-3; League for Programming Freedom (stmt).

explained, “[A]n early patent holder has a potential claim against subsequent innovators. Anticipating the expected cost of such claims, a second innovator may choose to perform a sub-optimal level of R&D or, perhaps, not to invest in the innovation at all.”³³¹ This argument, of course, has limits; failure to reward initial innovators for the benefits that they confer upon follow-on activity could leave inadequate incentives for the initial innovators.³³² Another panelist contended that “the speed of innovation in [the software industry] is so fast that the long periods of protection granted by patents is stifling subsequent innovation.”³³³

b. Patents May Increase the Costs of Entry

In the software and Internet industries, innovation by firms and individuals with limited working capital may often be viable. Some participants, however, warned that patents can raise the cost of market entry or ongoing market participation and thereby deter such innovation.³³⁴ Some claimed that software

³³¹ James Bessen, *Hold-Up and Patent Licensing of Cumulative Innovations with Private Information* 1 (2002), at <http://www.researchoninnovation.org/holdup.pdf>; see also Samuelson et al., 94 COLUM. L. REV. at 2346.

³³² See *supra* Ch. 2(I) and (III)(A).

³³³ Webbink (stmt) 4.

³³⁴ See *id.*; Gregory Casamento, *Comments, FTC Hearings on Competition and Intellectual Property* (Public Comment) 1, at <http://www.ftc.gov/os/comments/intelpropertycomments/johcasamentogregory.htm>; Lee (stmt) 1-2; Eric Buddington, *Comments Regarding Competition and Intellectual Property* (Public Comment) 1, at <http://www.ftc.gov/os/comments/intelpropertycomments/bu>

patentability has introduced new costs, such as the cost of obtaining a patent, determining whether a patent is infringed, defending a patent infringement lawsuit, or obtaining a patent license,³³⁵ which may disproportionately affect small firms and individual programmers³³⁶ and the open source community.³³⁷ According to one commentator, “[T]he problem in the United States [software industry] . . . [is] that rights might be too *strong* to permit a healthy, competitive rate of entry.”³³⁸

c. Avoiding Patent Infringement Is Costly and Uncertain

Avoiding infringement raises its own

[ddingtoneric.pdf](#) (hereinafter Buddington (stmt)); League for Programming Freedom (stmt) 3-5; Stallman 4/9 at 96.

³³⁵ See Gable 3/20 at 136 (stating that the preparation, filing and prosecution of a routine patent in the software area costs between \$30,000 and \$40,000); Lee (stmt) 2.

³³⁶ Lee (stmt) 2 (observing that “although a few thousand dollars may not be a major expense for a large company, it is far too expensive for many small businesses and independent software developers who cannot even afford an office.”); see generally Place 2/27 at 477-478; Nickolaus E. Leggett, *Comments Regarding Competition & Intellectual Property* (Public Comment) 1, at <http://www.ftc.gov/os/comments/intelpropertycomments/leggettnick.htm>.

³³⁷ See Stallman 4/9 at 96 (arguing that the open source movement, which often relies on volunteer programmers, is particularly vulnerable to cost increases resulting from the patenting of software). See also Robert M. Riches, *Comments regarding Competition and Intellectual Property* (Public Comment) 3, at <http://www.ftc.gov/os/comments/intelpropertycomments/ipriches.pdf>.

³³⁸ Robert P. Merges, *A Comparative Look at Property Rights and the Software Industry*, printed in THE INTERNATIONAL COMPUTER SOFTWARE INDUSTRY: A COMPARATIVE STUDY OF INDUSTRY EVOLUTION AND STRUCTURE 285 (David Mowery ed., 1996).

set of concerns. In a setting with cumulative innovation and multiple surrounding patent rights, patent thickets may make avoiding infringement very difficult and give rise to defensive patenting and hold-up concerns.³³⁹ Avoiding infringement can also be fraught with uncertainty, because the metes and bounds of software patent claims are often ambiguous.³⁴⁰

(i). Patent Thickets, Defensive Patenting and Hold-Up

A number of panelists confirmed the existence of a patent thicket in the software industry, which makes avoiding patent infringement very difficult.³⁴¹ A panelist who had studied patenting trends in the software industry stated that the industry poses unusual challenges, because there can be “potentially dozens or hundreds of patents covering individual components of a product.”³⁴² Another panelist provided an anecdote to support the existence of a software patent thicket; he undertook a search to determine the patent landscape surrounding a particular patent relevant to his business and in the process identified 120 patents that appeared to overlap each other, as well as to be infringed by his own

³³⁹ See *supra* Ch. 2(III)(C).

³⁴⁰ See, e.g., Greenhall 2/27 at 376; League for Programming Freedom (stmt) 5.

³⁴¹ See Shapiro, *Navigating the Patent Thicket* at 120-121 (observing that a patent thicket has formed in the software and Internet industries); Mowery 2/27 at 427; Stallman 4/9 at 20; Burk 3/20 at 149; Greenhall 2/27 at 375-76.

³⁴² Mowery 2/27 at 427; see also Kohn 2/27 at 349 (complex software can contain “potentially hundreds of thousands” of patentable inventions).

product.³⁴³ Commentators noted that patent thickets are likely to arise in industries where innovation occurs on an incremental basis, such as the software industry.³⁴⁴

Defensive patenting has accelerated the development of a patent thicket in the software industry. Panelists explained that firms pursue defensive patenting: (1) to maintain detente with rivals; (2) to obtain portfolio cross-licenses from rivals; and (3) to raise a patent infringement counter-claim should a rival sue a firm for patent infringement.³⁴⁵ One panelist commented that the process of obtaining defensive patents to obtain portfolio cross-licenses from rivals, and thereby maintain freedom to operate, is essentially an attempt “to solve the problem you’re creating” by issuing patents on software in the first place.³⁴⁶

Another panelist observed that defensive patents have implications for innovation. Companies may have to divert resources from R&D to fund their defensive patent programs. The panelist issued a directive to his company requiring that they “reallocate roughly 20 to 35 percent of [their] developer’s resources and sign on two separate law firms to increase [their] patent portfolio” for purely defensive reasons.³⁴⁷ The engineers’ time dedicated to assisting in the filing of defensive patents, which “have no . . . innovative value in and of

³⁴³ See Greenhall 2/27 at 375-76.

³⁴⁴ See Telecky (stmt) 3; Teece 2/27 at 500.

³⁴⁵ See Kohn 2/27 at 350-51; Friedman 2/27 at 356; Greenhall 2/27 at 375-76.

³⁴⁶ Stallman 4/9 at 88.

³⁴⁷ Greenhall 2/27 at 376.

themselves,” could have been spent on developing new technologies, this panelist asserted.³⁴⁸

The existence of a software patent thicket significantly increases the likelihood of companies being held-up due to the difficulty of avoiding patent infringement. Commentators reported that a software program with hundreds of thousands of patentable ideas can be held-up by a patent that claims a single routine in the program.³⁴⁹ Building up a patent portfolio by engaging in defensive patenting cannot always protect against hold-up; when small companies or NPEs engage in hold-up, they generally are not susceptible to pressure from patent infringement counter-claims.³⁵⁰

(ii). **The Metes and Bounds of Patent Claims Are Ambiguous**

Some panelists expressed concern that the subjective and ambiguous process of construing patent claims makes avoiding patent infringement uncertain and deters innovation.³⁵¹ Others asserted that a lack of an effective disclosure requirement exacerbated the difficulty of construing patent claims in the context of software

³⁴⁸ *Id.* at 377 and 420; *see also* Kohn 2/27 at 350-51.

³⁴⁹ *See* Kohn 2/27 at 351-52; Pooley 2/27 at 382.

³⁵⁰ *See* Chaikovsky 2/27 at 390-91; League for Programming Freedom (stmt) 6. For further discussion of hold-up issues in the context of patent thickets, *see supra* Ch. 3(IV)(E)(2)(c) and Ch. 2(III)(C)(2).

³⁵¹ *See* Greenhall 2/27 at 375-76; Lee (stmt) 2; League for Programming Freedom (stmt) 5; *see generally* Black 3/20 at 161-62 (discussing uncertainty from a business perspective).

patents.³⁵²

Two commentators described the impact of this uncertainty on their businesses:

“[O]ne of the biggest risks I face is uncertainty in the marketplace. I can minimize my risk by understanding my competitor’s products . . . , my products . . . , [and] what the consumers and customers want. But I’ve found . . . that I really can’t understand the patent landscape and that I’m sitting with a nuclear bomb on top of my products that could go off at any point and cause me to simply not have a business anymore.”³⁵³

“For some software projects that I have worked on, I have personally spent over 30% of my time trying to ensure that I was not accidentally infringing on a patent . . . This results in an incredibly large amount of wasted labor, harms our nation’s economy and results in less time spent on actual software innovation.”³⁵⁴

d. Questionable Patents Create Uncertainty and Hinder Innovation

Many participants stated that the PTO issues too many questionable software

³⁵² *See* Webbink 3/20 at 145; Burk 3/20 at 149-150.

³⁵³ Greenhall 2/27 at 375.

³⁵⁴ Lee (stmt) 1.

and business method patents.³⁵⁵ They identified two main reasons. First, some argued that the PTO fails to examine all the relevant prior art and consequently issues patents that are either overly broad or obvious.³⁵⁶ Panelists identified factors to which this lack of adequate consideration of prior art is attributable, including: (1) the informal nature of software development, especially among the open source community; (2) the rapidly changing and complex nature of the software and Internet industries; (3) the absence of a legal requirement for patent applicants to disclose source code; (4) the use of trade secrecy for almost 20 years of commercial software development; and (5) the relatively recent recognition of the validity of business method patents by the courts.³⁵⁷

Questionable patents may have a disproportionately adverse impact on entry by small firms and individuals who lack the resources to challenge such patents. As one software programmer commented, “the ease with which the US Patent Office has been granting patents in the last few years has already dampened my plans to write software as a primary business.”³⁵⁸ In contrast, a panelist from a larger firm suggested that incentives to innovate are not

undermined by questionable patents.³⁵⁹ The panelist observed that it is “a fairly straightforward exercise for our research department to investigate the relevant prior art [for an overly broad patent] and therefore obviate any further discussion on the matter.”³⁶⁰

The lack of effective mechanisms for third-party challenges to patents compounds the harm to innovation caused by questionable patents, according to some. Panelists contended that the court system is too uncertain, time-consuming, and costly to examine questionable patents effectively.³⁶¹ They argued that the reexamination process also has significant defects: the challenging party is at a significant disadvantage procedurally and is then stopped from raising key issues in the courts.³⁶² Panelists advocated that reforms be made to the reexamination procedures so as to increase their effectiveness for challenging questionable patents and that the possibilities for pre-grant comment also be more fully utilized.³⁶³

A number of commentators maintained that the PTO’s issuance of

³⁵⁵ For further discussion of business method patents see *infra* Ch. 4(II)(E).

³⁵⁶ See, e.g., Webbink (stmt) 2-3; Friedman 2/27 at 355; Gable 3/20 at 114-5.

³⁵⁷ See Kohn 2/27 at 428; Gable 3/20 at 116-17; Lee (stmt) 3; Webbink (stmt) 2-3; see also Cohen & Lemley, 89 CAL. L. REV. at 42-46. For further discussion of challenges posed by business method patents, see *infra* Ch. 4(II)(E).

³⁵⁸ Buddington (stmt) 1.

³⁵⁹ See Alderucci 4/9 at 58.

³⁶⁰ *Id.*

³⁶¹ See, e.g., Pooley 2/27 at 379; Friedman 2/27 at 411-12; Gable 3/20 at 155; Sander 3/20 at 156.

³⁶² See Gable 3/20 at 163; Pooley 2/27 at 405; Edward J. Black, *Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy*, *Testimony of Edward J. Black, President & CEO (3/20/02)* 7, at <http://www.ftc.gov/opp/intellect/020320black.pdf>.

³⁶³ See Gable 3/20 at 163; Pooley 2/27 at 405; Misener 2/27 at 396; Black 3/20 at 126. For a discussion of recent reforms to reexamination procedures, see *infra* Ch. 5(III)(A).

questionable patents results in part from a lack of funding that is attributable to the diversion of PTO user fees to non-patent related matters.³⁶⁴ Several panelists argued that if the PTO had more examiners, made a greater effort to keep experienced examiners, and gave patent examiners more time to spend on their initial examination, the PTO would issue fewer questionable patents.³⁶⁵ “Improving patent quality will increase confidence in the validity of patents, thus making it easier for patent owners to commercialize their inventions and decreasing the possibility that potential defendants will have to address infringement allegations that ultimately prove to be without merit,” one commentator stressed.³⁶⁶

F. Licensing Strategies to Navigate the Patent Thicket

As in the panels devoted to the computer hardware industries, software and Internet panelists discussed three licensing strategies that firms can use to navigate patent thickets: (1) cross-licensing; (2) patent pooling; and (3) standard setting.³⁶⁷ Two panelists suggested that the process by which royalties are determined for patent licensing – one patentee at a time, with potential for royalty stacking and hold-up by patents on small pieces of much larger

³⁶⁴ See Alderucci 4/9 at 12-16; Musacchia (stmt) 4; Webbink 3/20 at 171; Gable 3/20 at 121-22; Microsoft (stmt) 5-6.

³⁶⁵ See Gable 3/20 at 121-22; Alderucci 4/9 at 12-16; Microsoft (stmt) 5-6.

³⁶⁶ Microsoft (stmt) 6.

³⁶⁷ See, e.g., Friedman 2/27 at 355; Greenhall 2/27 at 377, 417; Stallman 4/9 at 38. For further discussion of each strategy, see *supra* Ch. 3(IV)(F).

programs – exacerbates the problem of hold-up and lessens the effectiveness of the licensing strategy.³⁶⁸ One panelist argued that there should be a reasonableness element to determining royalties, which should be based on the value of the contribution of the particular patented feature to the total product.³⁶⁹ Such determinations need to be made at an early stage, he urged, so that royalty negotiations are not conducted under the threat of litigation, preliminary injunctions, and damages.³⁷⁰ Another panelist suggested a mechanism for permitting a legal action by which a company could implead all relevant intellectual property owners to settle all outstanding royalty claims in a single forum.³⁷¹ Such a mechanism might be a means for addressing royalty stacking problems that may arise when royalties are negotiated sequentially.³⁷²

G. Conclusion

The software and Internet industries generally are characterized by five factors: (1) innovation occurs on a cumulative basis; (2) capital costs are low, particularly relative to the pharmaceutical, biotechnology and hardware industries; (3) the rate of technological change is rapid, and product life cycles are short; (4) alternative means of fostering innovation exist, including copyright protection and open source

³⁶⁸ See Kohn 2/27 at 351-52, 415, 429; Pooley 2/27 at 381-83.

³⁶⁹ See Kohn 2/27 at 351-52, 415, 429.

³⁷⁰ See *id.* at 415, 429-30.

³⁷¹ See Pooley 2/27 at 415-16.

³⁷² See *supra* Ch. 2(III)(C)(3).

software; and (5) the industries have experienced a regime change in terms of the availability of patent protection.

Panelists consistently stated that competition drives innovation in these industries. Innovation is also fostered by some industry participants' use of copyright protection or open source software. Several panelists discounted the value of patent disclosures, because the disclosure of a software product's underlying source code is not required.

Many panelists and participants expressed the view that software and Internet patents are impeding innovation. They stated that such patents are impairing follow-on incentives, increasing entry barriers, creating uncertainty that harms incentives to invest in innovation, and producing patent thickets. Panelists discussed how defensive patenting increases the complexity of patent thickets and forces companies to divert resources from R&D into obtaining patents. Commentators noted that patent thickets make it more difficult to commercialize new products and raise uncertainty and investment risks. Some panelists also noted that hold-up has become a problem that can result in higher prices being passed along to consumers.

**CHAPTER 4 COMPETITION PERSPECTIVES ON SUBSTANTIVE
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CHAPTER 4

COMPETITION PERSPECTIVES ON SUBSTANTIVE STANDARDS OF PATENTABILITY

Patent quality influences much of how the patent system and competition interact. The substantive standards and procedural criteria that govern patent rights have potentially significant and diverse competitive effects. In different settings, these patent rules may promote entry or give rise to market power. They may foster initial innovation, yet impede follow-on efforts. They may confer economic benefits or cause net economic harm.

Consequently, more patents in more industries and with greater breadth are not always the best answers for maximizing consumer welfare. A questionable patent can raise costs and prevent competition and innovation that otherwise would benefit consumers.¹ As Chapter 3 details, many panelists in knowledge-based industries such as biotech, computer hardware, and software asserted that, because of questionable patents, they must steer their innovative efforts away from potentially productive areas, accede to possibly unjustified licensing terms, or enter into cross-licensing agreements that effectively “contract out” of the patent system.

To understand patent quality, we look first to the substantive standards of patentability. They govern when to grant and uphold a patent as valid and how to determine the proper scope of a patent’s claims. The substantive standards of patentability manage the patent system’s “careful balance between the need to promote innovation and the recognition that

imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy. . . .”²

We bring a competition perspective to bear on these issues. A competition perspective assumes consumer welfare over time as the goal of both competition and patent policy and reflects the application of economic analysis to patent issues.³ From a competition perspective, the standards for patentability should achieve four major policy objectives: (1) provide efficient incentives for innovation; (2) safeguard the patent system’s disclosure functions; (3) avoid unnecessary restraints on competition;⁴ and (4) minimize the sum of error and process costs and the detrimental effects of uncertainty.⁵

I. STATUTORY STANDARDS OF PATENTABILITY

A brief review of the statutory standards of patentability suggests that they are generally well-suited to achieve these

² *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989).

³ See *supra* Ch. 1.

⁴ For example, to avoid unnecessary restraints on competition, substantive patent standards should tend to support patentability only for those inventions that, “but for” the prospect of a patent, would not have been forthcoming as soon (or for which disclosure or commercial development would not have occurred as soon). See *supra* Ch. 1(I)(C)(1)(a).

⁵ See *supra* Ch. 1(IV)(B)(5).

¹ See generally Chs. 1-3.

four policy objectives.⁶ An invention must be novel⁷ – that is, “[t]o obtain a patent, you must do something *new*.”⁸ This requirement tends to exclude from patentability inventions that already exist and may be subject to competition. The requirement thus sets proper incentives for innovation – rewarding that which is new, not imitative – and avoids unnecessary restraints on competition.⁹ On the other end of the spectrum, the requirement that a claim must be “useful” tends to exclude areas of basic

⁶ See also Box 4-1 for a summary of the statutory standards for patentability.

⁷ Section 102 of the Patent Act sets forth a variety of tests for novelty, such as whether “the invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent,” 35 U.S.C. § 102(a). One eminent nineteenth-century treatise writer described “novelty” as the consideration that an inventor provides to society to obtain a patent:

An inventor does not become entitled to a patent merely by exercising his creative faculties in the production of an art [*i.e.*, process] or instrument. *The consideration for the grant of his exclusive privilege is the benefit which he confers upon the public by placing in their hands a means through the use of which their wants may be supplied.* If the same means has already been made available to them by the inventive genius of a prior inventor, . . . , no benefit results to them from his inventive act and there is no consideration for his patent. (Emphasis added).

¹ WILLIAM ROBINSON, *THE LAW OF PATENTS FOR USEFUL INVENTIONS* § 22 at 305 (1890), cited in ROBERT P. MERGES & JOHN F. DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* 361 (3d ed. 2002).

⁸ MERGES & DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* at 361.

⁹ Novelty was not a major point of discussion during the Hearings and is not further addressed in this chapter. Thus, we do not discuss the complexities that can arise in the evaluation of whether a claimed invention is “novel.” See generally *id.* at 361-539.

research from patentability, thus leaving such matters available for the development of competing inventions.¹⁰

A claimed invention also must be nonobvious. Some describe the nonobviousness doctrine as “the heart of the patent law.”¹¹ It establishes a patentability step – a level of development beyond the prior art – that must be accomplished before a patent can issue.¹² As codified by Congress:

A patent may not be obtained . . . if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. . . .

35 U.S.C. § 103. A leading text explains, “Nonobviousness asks whether a development is a significant enough technical advance to merit the award of a patent”; it “can accurately be described as a

¹⁰ 35 U.S.C. § 101. See generally MERGES & DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* at 254-58; ROGER E. SCHECHTER & JOHN R. THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARK* §§ 15.1-15.3 at 315-21 (2003). See also *infra* Ch. 4(I)(D).

¹¹ *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy, Herbert C. Wamsley Testimony July 10, 2002*, at page 20 (hereinafter, citations to transcripts of these Hearings state the speaker’s last name, the date of testimony, and relevant page(s)).

¹² See *Stoner* 3/36 at 117; *Scotchmer* 4/10 at 60-61, 69; Ted O’Donoghue, *A Patentability Requirement for Sequential Innovation*, 29 *RAND J. ECON.* 654, 657 (1998).

‘nontriviality’ requirement in patent law.”¹³
The requirement that an invention be nonobvious preserves the public domain by creating a patent-free zone around the existing state of the art.¹⁴

Properly applied, the “nonobviousness” requirement can ensure that the patent system avoids patents that “hav[e no] social benefit[,] because . . . others would have developed the idea even without the incentive of a patent.”¹⁵ The “nonobviousness” requirement also can

patents and avoiding royalties on obvious inventions,¹⁶ and can avoid the costs of granting obvious patents, which “may create a proliferation of economically insignificant patents that are expensive to search and to license.”¹⁷

A patent application also must meet certain disclosure requirements. A patentee must disclose the invention clearly enough so that one skilled in the art can understand it well enough to make and use it without having to undertake undue

Box 4-1. The Statutory Standards for Patentability

Patent law establishes the standards of patentability against which the PTO measures a patent application. These standards ask whether the claimed invention is:

- **patentable subject matter** under 35 U.S.C. § 101 (basically processes, machines, manufactures, and compositions of matter);
- **novel** under 35 U.S.C. § 102, which requires that the invention not be wholly anticipated by prior art or public domain materials;
- **nonobvious** under 35 U.S.C. § 103, which requires the invention to be beyond the ordinary abilities of a skilled artisan knowledgeable in the appropriate field;
- **useful** under 35 U.S.C. § 101, which means the invention must be minimally operable towards some practical purpose; and
- whether the application meets the **disclosure requirements** under 35 U.S.C. § 112 by: (i) so completely describing the invention that skilled artisans are enabled to practice it without undue experimentation; (ii) providing a description sufficient to ensure that the inventor actually has invented what the patent application claims; and (iii) containing distinct, definite claims that set out the proprietary interest asserted by the inventor. *See generally* ROGER E. SCHECHTER & JOHN R. THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS* § 13.1 at 282 (2003).

provide undiluted incentives for inventors to create nonobvious inventions, by prohibiting

¹³ See MERGES & DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* at 644.

¹⁴ See Thomas 2/8 (Patent Session) at 57; SCHECHTER & THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARK* § 17.1 at 370-71.

¹⁵ MERGES & DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* at 646 (citations omitted).

experimentation.¹⁸ This “enablement” requirement tends to safeguard the patent system’s disclosure function by ensuring relatively swift dissemination of technical information from which others in the art can

¹⁶ See *id.* at 646-47.

¹⁷ *Id.* at 647. See generally *supra* Ch. 3(IV) and (V).

¹⁸ See 35 U.S.C. § 112.

learn.¹⁹ The disclosure also must include a “written description” sufficient to show that the applicant was in possession of the claimed invention as of the applicant’s filing date.²⁰

Apart from some misgivings about the written description requirement,²¹ no one at the Hearings disputed the usefulness or analytical aptness of these statutory criteria for patentability. Rather, the Hearings record tends to support a conclusion that the statutory standards for patentability account for competitive issues and do not require changes.²² Panelists did not perceive the statutory standards of patentability themselves as sources of problems with patent quality or adverse competitive effects.

¹⁹ See generally MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 259-60. See *supra* Ch. 1(I)(A)(2) and (IV)(B)(2) and *infra* Ch. 4(II)(B).

²⁰ 35 U.S.C. § 112.

²¹ See, e.g., Janis 4/10 at 119-20 (stating that the written description requirement has been very difficult for the Federal Circuit to characterize in any meaningful way and that efforts to elucidate this requirement detract attention from enablement, which could be used more effectively); Thomas 4/10 at 128-30 (questioning the administrability of the written description requirement).

²² See *infra* Ch. 4(II); American Intellectual Property Law Association (AIPPLA), *AIPPLA Testimony* (Public Comment) 16, at <http://www.ftc.gov/os/comments/intelpropertycomments/aippla.pdf>; Intellectual Property Owners Association, *Comments on the Joint Hearings of the Federal Trade Commission and the Department of Justice Regarding Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (Public Comment) 16, at <http://www.ftc.gov/os/comments/intelpropertycomments/ipo.pdf> (hereinafter IPO (stmt)).

II. THE INTERPRETATION AND APPLICATION OF THE STANDARDS OF PATENTABILITY

Hearings participants did raise questions and concerns about the interpretation and application of certain statutory standards, however. This Section considers these topics in turn, discussing the competitive implications of each doctrine and summarizing and examining testimony to identify both areas of harmony and points of concern. When the system is functioning well, from a competition perspective, the discussion highlights the reasons for harmony. When problems are evident, it offers recommendations for taking better account of competition considerations within the patent system. When difficulties may be emerging, it identifies relevant issues and suggests appropriate precautions.

A. The Interpretation and Application of the Nonobviousness Requirement

1. Significance for Innovation and Competition

The nonobviousness doctrine establishes a patentability step – a level of development beyond the prior art – that must be accomplished before a patent can issue. The interpretation and application of this doctrine can have a variety of effects on innovation and competition. To begin, the size of the required patentability step affects the innovation incentives of both initial and follow-on innovators. For the initial innovator, the size of the required patentability step affects the extent to which

it must share revenues with independent improvers; if the required step is too small, for example, an initial inventor must split royalties with improvers that otherwise could not patent in the “obvious” area around the initial patent.²³ For follow-on innovators, the size of the step required for patentability affects the choice between seeking ambitious or niche improvements.²⁴

Second, a lax nonobviousness standard can generate proliferation or clutter problems — the thickets, minefields, royalty stacking, anti-commons, and flooding problems identified by various panelists.²⁵ A profusion of minor patents can significantly limit freedom of operation and require costly licensing negotiations.²⁶ In some settings, such as in semiconductors, these hurdles may be inevitable to some degree,²⁷ but in other

²³ See generally Duffy 7/10 at 113 (lax nonobviousness doctrine “not pro-inventor . . . because it can decrease the royalties to . . . people who really did invent”) and Duffy 10/30 at 110 (stating same principle).

²⁴ See Scotchmer 4/10 at 70. Follow-on innovators may be less likely to develop inventions that clearly fall short of that patentability step; without their own patent rights, such trivial improvers could face appropriation of their inventions by the initial innovator. See Scotchmer 4/10 at 69-70. Of course, to the extent that other appropriability mechanisms, such as first-mover advantages, are effective, the improver retains some incentive to develop follow-on inventions.

²⁵ See, e.g., Duffy 10/30 at 63; Stoner 10/30 at 58; *supra* Chs. 2 and 3.

²⁶ See, e.g., Duffy 7/10 at 110 (swarm of paltry patents may constitute a minefield). For discussion of issues that may be raised by a profusion of patents within a given industry, see *supra* Chs. 2(III)(C) and 3(IV) and (V).

²⁷ Several panelists indicated that technological limitations, the high ratio of patents to products, and the incremental nature of the innovation process all would contribute to the development of thickets in semiconductors irrespective of particular patent policies. See, e.g., Detkin 2/28 at 668-70 (technological advance has led to

contexts the choice of obviousness standard may affect whether proliferation evolves.²⁸

Box 4-2. Nonobviousness and Potential Competitive Concerns

The nonobviousness standard defines the *level of development beyond the prior art* required for a patent to issue — that is, *the size of the required patentability step*. The size of the required patentability step can affect:

- innovation incentives of initial and follow-on inventors (who gets what rewards in what proportions?);
- the extent of patent proliferation problems (e.g., if only a small step is required for patentability, a profusion of minor, “obvious” patents may require costly licensing negotiations and limit future firms’ freedom of design); and
- the extent of any patent-related market power (a patent on a technically trivial development sometimes can create significant market power, but withholding patent protection from entrants through an overly rigorous nonobviousness standard may delay their contribution to competition).

Third, either an overly lax or overly restrictive nonobviousness standard may result in unwarranted market power. A patent on a technically trivial development can sometimes create significant market power.²⁹ When market power already is

consolidation of multiple functions on single chips and “[t]here’s only a certain number of ways that you can connect transistors together,” resulting in “unavoidable overlap”); Poppen 2/28 at 712 (semiconductor thickets largely a result of the technology); Lemley 2/25 at 39 (noting high ratio of patents to product); Fox 2/28 at 714-15 (stressing incremental inventions).

²⁸ See, e.g., Barton 2/26 at 223. Indeed, the ability to surround a competitor’s initial patent with technically trivial variants is a key element in flooding strategies. See *supra* Ch. 2(III)(C)(6).

²⁹ See, e.g., R. Levin 2/6 at 102 (warning that market power can be a potentially serious consequence of a low threshold for patenting); Duffy 7/10 at 110-13

present, rather trivial patents may help to maintain or extend it. Thus, some panelists explained, portfolios of patents might be used to add breadth to an existing patent, creating a fence around its zone of exclusion.³⁰ Others suggested that existing market power may be extended beyond the life of the initial patent through an accumulation of minor improvement patents,³¹ although such an extension would require some reason why competitors offering the now-unpatented core product could not adequately constrain pricing of the slightly improved version still protected by patents.³² An overly rigorous nonobviousness standard may have its own market power effects; to the extent that withholding patent protection delays competition from entrants, an initial innovator's dominance may be extended.³³

("technical triviality does not at all equal economic triviality," citing the example of the Selden patent on the automobile).

³⁰ See, e.g., Cohen 2/20 at 31 and Wesley M. Cohen, *Patents: Their Effectiveness and Role* (2/20/02) (slides) at 14 (patents used to block substitutes by creating fences around core innovations), at <http://www.ftc.gov/opp/intellect/cohen.pdf>; Merges 2/26 at 162-65 (portfolios can add breadth); *supra* Ch. 2(III)(C)(5) (discussing patent fences).

³¹ See, e.g., Coffin-Beach 3/19 at 204-05; Scherer 7/10 at 180.

³² See *supra* Ch. 2(III)(C)(5) (discussing patent extensions).

³³ See Merges 2/28 at 581-82; Robert M. Hunt, *Nonobviousness and the Incentive to Innovate: An Economic Analysis of Intellectual Property Reform* (Public Comment) 2 (under a strong nonobviousness requirement "[c]ompeting proprietary technologies take longer to accumulate so the patent holder's profits are larger and last longer"), at <http://www.ftc.gov/os/comments/intelpropertycomments/nobviousness.pdf> (hereinafter Hunt (Nonobviousness stmt)); O'Donoghue, 29 RAND J. ECON. at 656.

2. Analytic Tools to Balance Patent and Competition Concerns

In the context of nonobviousness, "but for" thinking may be useful to better align patent law with competition policy. The concept is simple: to ask whether an invention likely would emerge in roughly the same time frame – that is, without significant delay – "but for" the prospect of a patent. Analogously, one can ask whether disclosure and commercial development of the invention would have occurred as soon "but for" the prospect of a patent. As a theoretical matter, if, even without the prospect of a patent, the invention would emerge (and would be disclosed and commercially developed) without significant delay, then the invention does not warrant a patent.³⁴

This test has roots in patent law: when a patent elicits little social benefit – such as when the invention could be expected anyway – patent law recognizes that withholding the patent and avoiding any costs to innovation and competition will maximize consumer welfare over time.³⁵ The test also accords with long-established

³⁴ See *supra* Ch. 1(I)(C)(1)(a). See Glynn S. Lunney, *E-Obviousness*, 7 MICH. TELECOMM. & TECH. L. REV. 363, 386 (2001); F. M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 443 (2d ed. 1980).

³⁵ See *Graham v. John Deere Co.*, 383 U.S. 1, 11 (1966) ("The inherent problem was to develop some means of weeding out those inventions which would not be disclosed or devised but for the inducement of a patent."); Edmund W. Kitch, *Graham v. John Deere Co.*: *New Standards for Patents*, 1966 SUP. CT. REV. 293, 301 (stating – prior to developing his prospect theory – "the basic principle on which the non-obviousness test is based: a patent should not be granted for an innovation unless the innovation would have been unlikely to have been developed absent the prospect of a patent"); 1 ROBINSON, THE LAW OF PATENTS FOR USEFUL INVENTIONS § 22 at 305, cited in MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 361; see generally *infra* Ch. 6.

modes of antitrust analysis: antitrust law is accustomed to comparing the world with and without a suspect transaction.³⁶ To the extent that patent law confers its right to exclude only if necessary to create, disclose, or develop an invention, congruence between patent and competition policy is more likely.³⁷

As noted earlier, application of the “but for” principle generally will not work in individual cases.³⁸ Some advances may be

³⁶ In evaluating mergers, the Antitrust Enforcement Agencies consider only merger-specific efficiencies, *i.e.*, only the efficiencies that are unlikely to be accomplished without either the merger or some other means having comparable anticompetitive effects. Federal Trade Commission and U.S. Department of Justice, Horizontal Merger Guidelines § 4 (1992), available at <http://www.ftc.gov/bc/docs/horizmer.htm>. In evaluating competitor collaborations under the rule of reason, “the central question is whether the relevant agreement likely harms competition by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the agreement.” Federal Trade Commission and U.S. Department of Justice, Antitrust Guidelines for Collaborations Among Competitors § 3.1 (April 2000), available at <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf>.

³⁷ Some tensions could still persist. The “but for” test states at most a necessary, not a sufficient, condition for patentability. An invention worth developing solely because of competitive advantages conferred by its patent rights could raise exclusionary concerns, yet would pass through a “but for” screen.

³⁸ The panelists widely recognized the standard’s unsuitability for practical application. *See, e.g.*, Banner 10/30 at 71-72 (giving the concept a “D” as a practical test in light of the difficulties that it would pose for judge or jury); Myrick 10/30 at 60 (“unworkable”); John Love 2/28 at 635 (concern with imposing another level of uncertainty and complexity on examiners); Stoner 10/30 at 58 (need a “more practical sieve”); Kitch 10/30 at 51 (“but for” thinking not a test for application “on a retail basis” to individual innovations); *see also* Robert P. Merges, *Uncertainty and the Standard of Patentability*, 7 HIGH TECH. L. J. 1, 19 (1992) (describing the “but for” test as “the conventional ideal standard of patentability” but concluding, “It would be impossible in most cases to apply

ripe due to underlying technological or regulatory change and would flow without patent protection.³⁹ Other inventions may require substantial fixed costs and would not be forthcoming without the shelter from imitation that patent protection affords.⁴⁰ Distinguishing these situations through case-by-case inquiry would be costly, time-consuming, and prone to error. Indeed, sorting out the need for any given patent might prove impossible when multiple inventions flow from a single research program. Moreover, if the cost of invention is much less than the subsequent cost of developing a commercial product, a “but for” test would have to consider whether the innovation would be commercially developed absent the patent.⁴¹ “But for”

this standard”); *supra* Ch. 1(1)(C)(1)(a).

³⁹ *See* Duffy 7/10 at 113-15 (suggesting that some methods may have become obvious once the Internet developed and that a combination of ibuprofen and a common cold remedy could be expected once ibuprofen became an over-the-counter drug); Fox 2/28 at 715 (constantly seeing multiple inventors independently coming up with the same invention once the “logical bases for that invention come into place”).

⁴⁰ *See, e.g.*, Merges 2/28 at 580-81 (noting that “though something is extremely straightforward technically, it may be very very expensive to achieve” and urging that the nonobviousness standard take that into account); Merges, 7 HIGH TECH. L. J. at 48-50 (urging a relaxation of nonobviousness standards when R&D is very costly, in order to compensate for effects of risk aversion that might otherwise make innovation less likely). Any cost analysis would have to consider risks of failure, as well as cost in an individual case, lest only the cost of the one success in a field be counted. *See* Scherer 7/10 at 127-28; Duffy 7/10 at 132. The analysis also should not penalize the efficient inventor, whose cost will be less than the norm. *See* Kitch 10/30 at 51-52.

⁴¹ *See, e.g.*, Sobel 7/10 at 124-26; Scherer 7/10 at 126-27; Burk 7/10 at 129; Lunney 7/10 at 130-31; Dreyfuss 7/10 at 141-42 (adjust test to focus directly on risk of development). *But cf.* Duffy 10/30 at 133 (questioning whether patent system is really intended to encourage investment following the granting of the patent and

thinking also can account for the patent system's disclosure objectives, but further adjustments would be necessary.⁴²

Yet the Hearing record as a whole showed very substantial support for "but for" thinking as an idealized, foundational principle⁴³ that can be a useful tool for shaping general policy analysis.⁴⁴ We will return to it after a review of current interpretations and applications of the nonobviousness doctrine.

3. Nonobviousness: Interpretation and Application in the Courts

Participants generally perceived a

suggesting that post-invention investments can be protected by subsequent patents).

⁴² In fact, the patent system's disclosure function is reflected in the Supreme Court's language in *Graham* describing "the inherent problem" in formulating standards of patentability as "develop[ing] some means of weeding out those inventions which would not be disclosed or devised but for the inducement of a patent." *Graham*, 383 U.S. at 11 (emphasis added). See Lunney, 7 MICH. TELECOMM. & TECH. L. REV. at 385-86 (phrasing a "but for" standard in terms of whether the invention "would have been developed, commercialized and disclosed even without a patent") (emphasis added). If the patent system is viewed as a mechanism for increasing the efficiency of post-invention development, neither the "but for" test nor the obviousness standard may have a logical role. See Kitch 2/20 at 84-85; Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J. LAW & ECON. 265, 284 (1977) (urging "substantial novelty" as the standard for patentability under the prospect theory).

⁴³ Herbert Wamsley summarized, "I suspect that everybody on this panel agrees that we should have a . . . test, one that finds nonobvious only inventions that wouldn't have been made otherwise or for which there's some incentive needed." Wamsley 7/10 at 139.

⁴⁴ As James Pooley concluded, "The 'but for' standard strikes me as a useful analytic tool to sort of check our direction in a policy sense, but not a particularly useful standard for measuring specific inventions." Pooley 10/30 at 55.

trend since the advent of the Federal Circuit toward reducing the size of the step required for patentability – that is, reducing the rigor of the nonobviousness standard.⁴⁵ Several participants voiced concern about too great an issuance of obvious patents.⁴⁶ Panelists

⁴⁵ See, e.g., R. Levin 2/6 at 102-03 (nonobviousness standard "diluted"); Kitch 2/20 at 68 (Federal Circuit has "seemed to soften the non-obviousness test"); Lunney 7/10 at 97-99 and Glynn S. Lunney, Jr., *Patents, the Federal Circuit, and the Simply Property Perspective* (7/10/02) (slides) at 13, at <http://www.ftc.gov/opp/intellect/020710glynnslunneyjr.pdf>; Duffy 7/10 at 185; Dreyfuss 7/10 at 196-97; Hunt (Nonobviousness stmt) 2, 8; Cecil D. Quillen, Jr., *The U.S. Patent System: Is It Broke? And Who Can Fix It If It Is* (Public Comment) 3-5, at <http://www.ftc.gov/os/comments/intelpropertycomments/quillenattachments/isitbrokewhocanfixit.pdf> (hereinafter Quillen (U.S. Patent System stmt)); see also Lunney, 7 MICH. TELECOMM. & TECH. L. REV. at 366-80; Gerald Sobel, *The Court of Appeals for the Federal Circuit: A Fifth Anniversary Look at its Impact on Patent Law and Litigation*, 37 AM. U. L. REV. 1087, 1089 ("a climate more favorable to upholding the validity, and particularly the non-obviousness of patents has emerged"); Charles Weller, *Patent Reform by Daubert Litigation*, 2 EXPERT EVIDENCE REPORT 232, 234-35 (2002) (Public Comment), at <http://www.ftc.gov/os/comments/intelpropertycomments/weller2.pdf>. But see Polk 2/20 at 71-72 (nonobviousness standard has become "more uniform" but has not been lessened). Some of the panelists found the trend toward a less rigorous nonobviousness standard particularly pronounced in biotechnology contexts. See Kunin 7/10 at 27-28 (in biotechnology Federal Circuit has made it "fairly easy to pass muster" under nonobviousness requirement); Burk 7/10 at 29; Arti Rai, *Intellectual Property Rights in Biotechnology: Addressing New Technology*, 34 WAKE FOREST L. REV. 827, 833 (1999) ("In considering DNA-based inventions, the CAFC has employed nonobviousness in a manner that dramatically lowers the bar for patentability and, therefore, significantly impoverishes the public domain."); cf. Dreyfuss 7/10 at 141-42 ("a lot of the watering down on nonobviousness has come in the chemical field").

⁴⁶ See, e.g., Ziedonis 3/20 at 16 (consistent view expressed in semiconductor industry interviews was that "if we had to change one thing, let's just make it a little harder to get all of these very trivial inventions coming out from the patent office"); Scherer 7/10 at 53 ("the inventive content of the average U.S. patent is quite low"); Kohn 2/27 at 413; T.S. Ellis 7/11 at 109; John H. Barton, *Reforming the Patent System* (Public Comment) 1-2, at

spoke of serious clutter problems and issues involving market power maintenance and extension.⁴⁷

Participants viewed the Federal Circuit's application of its "suggestion test" and its treatment of secondary factors such as "commercial success" as applications of nonobviousness doctrine that can result in "obvious" patents. As interpreted by the Supreme Court in *Graham*, nonobviousness requires a three-part inquiry:

the scope and content of the prior art are to be determined; differences between the prior art and the claims at issue are to be ascertained; and the level of ordinary skill in the pertinent art resolved.⁴⁸

Although the Court lists the key elements, it does not tell how to apply them.⁴⁹ The Federal Circuit has filled the gap in part through its "suggestion" test, which focuses on the extent to which "the prior art would have *suggested* to one of ordinary skill in the art that this process should be carried out and would have a reasonable likelihood of

<http://www.ftc.gov/os/comments/intelpropertycomments/bar-tonjohnh.htm>; Cecil D. Quillen, Jr., *Testimony of Cecil D. Quillen, Jr. Presented at the Public Hearing on the Standard of Nonobviousness* (Public Comment), at <http://www.ftc.gov/os/comments/intelpropertycomments/quillenattachments/nonobviousness.pdf>; Eric Buddington, *Comments Regarding Competition and Intellectual Property* (Public Comment) 1, at <http://www.ftc.gov/os/comments/intelpropertycomments/buddingtoneric.pdf>.

⁴⁷ See *supra* Ch. 4(II)(A)(1).

⁴⁸ *Graham*, 383 U.S. at 17.

⁴⁹ See Duffy 7/10 at 116 ("[T]hese primary factors . . . sort of leave you off at the very point you think the analysis should start.").

success"⁵⁰

The Supreme Court's *Graham* opinion also identified a number of "secondary considerations," including "commercial success, long felt but unsolved needs, [and] failure of others," that "may have relevancy" as "indicia of obviousness."⁵¹ The Federal Circuit has required consideration of any evidence of these secondary characteristics and, at times, has given them considerable weight as means for overcoming what might otherwise be a *prima facie* case of obviousness under the primary *Graham* factors.⁵²

a. Nonobviousness and the "Suggestion Test"

Section 103 requires two basic inquiries to determine "nonobviousness." First, what is the prior art for the claimed invention?⁵³ Prior art typically consists of documents – often patents and publications, although affidavits and testimony also may

⁵⁰ *Brown and Williamson Tobacco Corp. v. Philip Morris, Inc.*, 229 F.3d 1120, 1124 (Fed. Cir. 2000) (emphasis added).

⁵¹ *Graham*, 383 U.S. at 17-18 (emphasis added).

⁵² See, e.g., *Hybritech, Inc. v. Monoclonal Antibodies, Inc.*, 802 F.2d 1367, 1380 (Fed. Cir. 1986) ("Objective evidence [i.e., evidence of secondary considerations] . . . must be considered *before* a conclusion on obviousness is reached and is not merely 'icing on the cake'") (emphasis in original); *cert. denied*, 480 U.S. 947 (1987); *Stratoflex, Inc. v. Aeroquip Corp.*, 713 F.2d 1530, 1538 ("evidence rising out of the so-called 'secondary considerations' must always when present be considered").

⁵³ See 35 U.S.C. § 103 (inquiry focuses on "differences between the subject matter sought to be patented and the prior art"); see, e.g., Kesan 4/10 at 88 ("That's the first thing, knowing what the prior art is.").

present prior art⁵⁴ – that reflect one or more of the features or elements of the claimed invention. Comparing the claimed invention to the prior art requires identifying the major features of the claimed invention and determining the extent to which those features already exist in the prior art.⁵⁵ Second, what “would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains[?]”⁵⁶ Patent practitioners sometimes shorten the term “person having ordinary skill in the art” to “PHOSITA.”⁵⁷

Sometimes all of the elements of a claimed invention exist not in any one document, but in a combination of different prior art references.⁵⁸ For example, in one case, the PTO rejected as obvious a patent application for a plastic orange garbage bag decorated with a face and lines that would look like a jack-o-lantern when filled with

⁵⁴ See, e.g., *Sakraida v. Ag Pro Inc.*, 425 U.S. 273, 280 (1976) (“The scope of the prior art was shown by prior patents, prior art publications, affidavits of people having knowledge of flush systems analogous to respondent’s, and the testimony of a dairy operator with 22 years of experience who described flush systems he had seen on visits to dairy farms throughout the country.”).

⁵⁵ See, e.g., MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 44-48 (in drafting a patent around the prior art, “[i]t is often useful to construct a table listing the major features or elements of the invention and showing which of those features are shared by items in the prior art”).

⁵⁶ See 35 U.S.C. § 103; Kesan 4/10 at 88 (“secondly, what is a person in that field, what do they think of that prior art.”).

⁵⁷ See Kieff 4/10 at 77.

⁵⁸ If all of the elements already exist in a single prior art reference, “that’s anticipation and we’re done.” See Kieff 4/10 at 80.

trash or leaves. There were four prior art references – two about conventional trash or lawn bags, and two about children’s art projects to make jack-o-lanterns. When combined, these four prior art references held all of the major elements of the claimed invention. That fact alone was insufficient to meet the Federal Circuit’s suggestion test, however, and thus did not establish obviousness.⁵⁹

In discussing the decision of the Board of Patent Appeals and Interferences, which upheld the examiner’s rejection of the patent application as obvious, the Federal Circuit stated:

Nowhere does the Board particularly identify any suggestion, teaching, or motivation to combine the children’s art references . . . with the conventional trash or lawn bag references, nor does the Board make specific – or even inferential – findings concerning the identification of the relevant art, the level of ordinary skill in the art, the nature of the problem to be solved, or any other factual findings that might serve to support a proper obviousness

⁵⁹ *In re Dembiczak*, 175 F.3d 994 (1999). *Accord, Arkie Lures, Inc. v. Gene Larew Tackle, Inc.*, 119 F.3d 953, 957 (Fed. Cir. 1997) (“It is insufficient to establish obviousness that the separate elements of the invention existed in the prior art, *absent some teaching or suggestion, in the prior art, to combine the elements.*”) (emphasis added). See, e.g., Thomas 2/8 (Patent Session) at 56-57; Duffy 7/10 at 117. Similarly, the PTO must identify a suggestion, teaching, or motivation for modifications to a piece of prior art before declaring such modifications obvious. See John F. Duffy, *Nonobviousness: The Economics and Legal Process of the Doctrine* (7/10/02) (slides) at 14, at <http://www.ftc.gov/opp/intellect/020710johnfduffy.pdf> (hereinafter Duffy Presentation).

analysis.⁶⁰

This is one in a line of recent cases in which the Federal Circuit has rigorously imposed the suggestion test in overturning PTO findings of obviousness.⁶¹

(i). Hearings Record

Panelists identified the Federal Circuit's application of the "suggestion test" as a core issue in assessing nonobviousness and a focal point of current debate.⁶² As PTO Deputy Commissioner for Patent Examination Policy Stephen Kunin phrased it, the Federal Circuit is insisting that the PTO find "the glue expressly leading you all the way" and that it "connect the dots . . . very, very clearly"⁶³

⁶⁰ *In re Dembiczak*, 175 F.3d at 1000.

⁶¹ See *In re Sang-Su Lee*, 277 F.3d 1338 (Fed. Cir. 2002) (rejecting the PTO's finding that a method of automatically displaying the functions of a video display device and demonstrating how to select and adjust those functions was obvious in light of separate prior art references describing (i) a television set with a display for adjusting audio and video functions and (ii) a video game display with a "demonstration mode" showing how to play the game); *In re Zurko*, 258 F.3d 1379 (Fed. Cir. 2001); *In re Kotzab*, 217 F.3d 1365 (Fed. Cir. 2000); Wamsley 7/10 at 19-25; Kunin 4/10 at 47. Stephen Kunin cited the pre-Federal Circuit opinion *In re Keller*, 642 F.2d 413, 425 (C.C.P.A. 1981), which stated that "the test is what the combined teachings of the references would have suggested to those of ordinary skill in the art," and concluded that "with [recent] cases like *Dembiczak* and *Kotzab*" it's like the approach based on the collective suggestion of the references "never existed in the law." Kunin 4/10 at 47; 7/10 at 137. See *infra* at Ch. 4(II)(A)(3)(a)(i).

⁶² See, e.g., Chambers 2/8 (Patent Session) at 98-99 ("from the standpoint of obviousness that's usually what the argument is about"); Duffy 7/10 at 117-18 ("suggestion test . . . has become extremely important"); Wamsley 7/10 at 19-25.

⁶³ Kunin 7/10 at 137.

Hearings participants generally agreed that the Federal Circuit's suggestion test asks a helpful question – *i.e.*, to what extent would the prior art "have suggested to one of ordinary skill in the art that this process should be carried out and would have a reasonable likelihood of success"⁶⁴ Nonetheless, they disagreed with the Federal Circuit's recent applications of the test, which seem to require "specific and definitive [prior] art references with clear motivation of how to combine those references."⁶⁵ To illustrate problems with the "suggestion test," Professor Duffy pointed to the Selden patent on the automobile. Assuming that Selden was the first to mount the newly developed gasoline engine on a carriage, no specific prior art would have suggested the mounting, yet it is something that likely was obvious:

Everybody seemed to know that if you got a new engine of any kind, you would put it on a carriage. That's the first thing that people did with just about any kind of engine, put it on a carriage with some gears and see how it works.⁶⁶

Participants noted that Federal Circuit articulations of the suggestion test are not uniformly rigid. The court sometimes has stated that the suggestion need not be express, but can be "implicit from the prior art as a whole," or may come from "the knowledge of one of ordinary skill in the art" or from "the nature of the problem to be

⁶⁴ *Philip Morris*, 229 F.3d at 1124 (emphasis added).

⁶⁵ *Dickinson* 2/6 at 66.

⁶⁶ See Duffy 7/10 at 132-33.

solved.”⁶⁷ Nonetheless, commentators such as Professor Duffy noted that references to implicit suggestions and suggestions from the nature of the problem to be solved may be “a point in the case law,” but “not perhaps the feel of the case law.”⁶⁸ Criticisms of recent opinions focus on the rigorous manner in which the Federal Circuit has applied the suggestion test, rather than the totality of the court’s language.

Stephen Kunin contrasted some of the recent applications of the suggestion test with earlier interpretations that “would permit one . . . to look at the information from the perspective of one of ordinary skill in the art” and “glean the information . . . with some level of technical knowledge and skill.”⁶⁹ As another panelist, Kenneth Burchfiel, has written, “the court’s frequent emphasis on ‘motivation’ from the teachings of the prior art bypasses the knowledge of those of ordinary skill in the art, and restricts the obviousness inquiry to a literal reading of the disclosure of the prior art.”⁷⁰ Summing

up these developments, former PTO Director Q. Todd Dickinson stated:

[T]he courts have required the Office to apply only specific and definitive art references with clear motivation of how to combine those references, and only that will suffice for this obviousness determination. . . . [T]he examiner could not even rely on the general knowledge that the examiner had in the field or even common sense for an obviousness determination.⁷¹

Several panelists recommended that the test be moderated.⁷²

(ii). Analysis

Policy Issues. The Federal Circuit has repeatedly sought to protect inventors from findings of obviousness based purely on hindsight. “Good ideas may well appear ‘obvious’ after they have been disclosed, despite having been previously unrecognized.”⁷³ As Judge Newman of the

⁶⁷ *Kotzab*, 217 F.3d at 1370; see *In re Huston*, 308 F.3d 1267, 1280-81 (Fed. Cir. 2002) (quoting some of the same language from *Kotzab* reproduced in the text but finding adequate motivation in the prior art references themselves); *In re Thrift*, 298 F.3d 1357, 1363 (Fed. Cir. 2002) (same). See generally *In re Berg*, 320 F.3d 1310, 1315 (Fed. Cir. 2003) (explaining that absent legal error or contrary factual evidence, the PTO’s determination of the meaning of prior art references and the motivation to make the claimed invention that those references provide can establish a *prima facie* case of obviousness).

⁶⁸ See Duffy 7/10 at 119.

⁶⁹ Kunin 7/10 at 137.

⁷⁰ KENNETH J. BURCHFIEL, BIOTECHNOLOGY AND THE FEDERAL CIRCUIT 84 (1995) (footnote omitted). See generally Barr 10/30 at 53-54 (arguing that current obviousness standards fail to reflect the skill of his firm’s engineers, who “every day” independently invent things that have been deemed nonobvious); Quillen (U.S. Patent

System stmt) 4 (criticizing the Federal Circuit’s treatment of the person of ordinary skill in the art as “a literalist, without imagination or creativity . . . who is incapable of considering collectively the combined teaching of relevant prior art references unless ‘motivated’ to do so by explicit directions in the references themselves”).

⁷¹ Dickinson 2/6 at 66.

⁷² See, e.g., Duffy 7/10 at 120-21 and Duffy Presentation at 17; Wamsley 7/10 at 154-55; Banner 10/30 at 73-74; cf. Gambrell 10/25 at 19 (insistence on express references leads to patents that should not be issued); Merges 2/28 at 631 (implicit in the Supreme Court’s *Graham v. John Deere* analysis is a “rejection of some of the more extreme Federal Circuit cases on the so-called suggestion test”).

⁷³ *Arkie Lures, Inc.*, 119 F.3d at 956.

Federal Circuit noted at the Hearings, many patents are attacked on grounds of obviousness. “It’s fuzzy ground. It’s hard to decide, difficult to administer, even harder to set.”⁷⁴ Thus, Federal Circuit “case law makes clear that the best defense against the subtle but powerful attraction of a hindsight-based obviousness analysis is rigorous application of the requirement for a showing of the teaching or motivation to combine prior art references.”⁷⁵ Otherwise, the Federal Circuit has said, “[c]ombining prior art references without evidence of such a suggestion, teaching, or motivation simply takes the inventor’s disclosure as a blueprint for piecing together the prior art to defeat patentability – the essence of hindsight.”⁷⁶ In addition, the Federal Circuit’s application of the suggestion test arguably has the virtue of certainty and predictability,⁷⁷ and it helps to ensure fulfillment of the PTO’s “obligation to develop an evidentiary basis for its findings.”⁷⁸ One can readily see the validity

⁷⁴ Newman 2/6 at 45.

⁷⁵ *In re Dembiczak*, 175 F.3d at 999 (citing cases).

⁷⁶ *Id.*; see also *In re Rouffet*, 149 F.3d 1350, 1358 (Fed. Cir. 1998).

⁷⁷ One panelist praised the Federal Circuit’s interpretations as “relatively crisp and objective and relatively easy to apply.” Kieff 4/10 at 81. Another panelist, however, expressed doubt that application of the test would really be so clear-cut in practice. See Katsh 4/10 at 90-93.

⁷⁸ See *In re Sang-Su Lee*, 277 F.3d at 1344. Following the Supreme Court’s determination that review of PTO findings of fact ought to proceed under the “substantial evidence test” rather than the less deferential “clearly erroneous” test, see *Dickinson v. Zurko*, 527 U.S. 150 (1999), the Federal Circuit has stressed the need for the PTO to ensure that each administrative record is amenable to review. See *In re Sang-Su Lee*, 277 F.3d at 1342, 1344-45; *In re Zurko*, 258 F.3d at 1385-86 (requiring “concrete evidence in the record” rather than “general conclusions

of the Federal Circuit’s concerns.

Yet, there are competing, and competitive, concerns to weigh on the other side of the ledger. A demand for specific and definitive motivating prior art references effectively raises the bar for finding obviousness⁷⁹ – thus permitting more patents to issue – and does so in a way that raises competitive concerns to the extent that it violates “but for” principles. As noted earlier, “obvious” patents can convey market power or provide means for its extension and can contribute to a proliferation of patents that increase search and licensing costs unnecessarily, so a standard that fails to weed out patents on obvious inventions can cause competitive harm.⁸⁰ Whether the goal is protecting against judgments based on hindsight or ensuring reviewable administrative records, a standard that requires suggestions or motivations exceeding what inventors actually need, or that rigidly insists upon concrete documentation of facts that by their very nature are not concretely demonstrable, could impair competition.

Interpretation of Section 103. Some of the patents recently upheld as nonobvious under the suggestion test may be obvious under the statutory standards. As noted in Professor Duffy’s example of the Selden automobile patent, an invention may be obvious even if the combination of elements

about what is ‘basic knowledge’ or ‘common sense’” for interpreting the consequences of particular items of prior art).

⁷⁹ See Kunin 4/10 at 47 (“cases like *In re Kotzab*, *In re Sang Lee* . . . make[] it extremely difficult to satisfy a 103 [obviousness] standard”).

⁸⁰ See *supra* Ch. 4(II)(A)(1).

that it reflects was not specifically suggested or motivated in any prior art. The combination may nonetheless be “obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains.”⁸¹ Some applications of the suggestion test, however, appear almost to have read the PHOSITA out of the statute.⁸² Inventive processes typically involve judgment, experience, and common sense capable of connecting some dots. The suggestion test, rigidly applied, assumes away a PHOSITA’s typical levels of creativity and insight and supports findings of nonobviousness even when only a modicum of additional insight is needed.

Indeed, too rigorous an application of the “suggestion” test can operate as a one-way ratchet: it can help confirm obviousness, but it does not necessarily identify nonobviousness. The presence of “specific and definitive art references with clear motivation of how to combine those

references”⁸³ may confirm the obviousness of an invention. In contrast, the absence of such prior art references does not provide any evidence about whether a PHOSITA could have combined prior art references to achieve the invention, given the typical level of insight in that field. In sum, the suggestion test, as it has been applied in some cases, seemingly understates levels of ordinary skill, awards patents for inventions that inevitably would be forthcoming, and potentially confers market power when competition need not be sacrificed.

In one very recent case, the Federal Circuit appears to have moved away from rigid application of the suggestion test, stating:

As persons of scientific competence in the fields in which they work, examiners and administrative patent judges on the Board [of Patent Appeals] are responsible for making findings, informed by their scientific knowledge, as to the meaning of prior art references to persons of ordinary skill in the art and the motivation those references would provide to such persons. Absent legal error or contrary factual evidence, those findings can establish a prima facie case of obviousness.⁸⁴

This more flexible articulation might signal an approach that would better enable

⁸¹ 35 U.S.C. § 103.

⁸² See, e.g., *In re Sang-Su Lee*, 277 F.3d at 1340-45 (in rejecting patent application as obvious, PTO did not provide a “specific hint or suggestion in a particular reference,” but instead relied on “the common knowledge and common sense of a person of ordinary skill in the art” and the fact that the claimed invention came from same field of endeavor as one prior art reference; the Federal Circuit vacated the conclusion of obviousness, stating that “[c]ommon knowledge and common sense, even if assumed to derive from the agency’s expertise, do not substitute for authority when the law requires authority.”). The Federal Circuit has recognized that a suggestion may be express or implicit, see *Medical Instrumentation & Diagnostics Corp. v. Elekta AB*, 344 F.3d 1205 (Fed. Cir. 2003); *WMS Gaming, Inc. v. International Game Tech.*, 184 F.3d 1339, 1355 (Fed. Cir. 1999), and has at times found implicit suggestions sufficient to demonstrate obviousness. See, e.g., *SIBLA Neurosciences, Inc. v. Cadus Pharm. Corp.*, 225 F.3d 1349, 1357 (Fed. Cir. 2000). But, as noted by Professor Duffy, that is not the “fed” of the case law. See Duffy 7/10 at 119.

⁸³ *Dickinson* 2/6 at 66.

⁸⁴ *In re Berg*, 320 F.3d at 1315 (affirming determination of obviousness in absence of legal error or contrary factual evidence sufficient to question findings made by the PTO as to teachings of prior art and motivation that prior art references would give a skilled artisan to make the claimed invention).

application of the suggestion test in ways sensitive to competitive concerns.

Recommendation. The Commission urges that in assessing obviousness, the analysis should ascribe to the person having ordinary skill in the art an ability to combine or modify prior art references that is consistent with the creativity and problem-solving skills that in fact are characteristic of those having ordinary skill in the art. Requiring concrete suggestions or motivations beyond those actually needed by a person of ordinary skill in the art, and failing to give weight to suggestions implicit from the prior art as a whole, suggestions from the nature of the problem to be solved, and the ability and knowledge of one of ordinary skill in the art, errs on the side of issuing patents on obvious inventions and is likely to be unnecessarily detrimental to competition.

b. Nonobviousness and the “Commercial Success Test”

In *Graham v. John Deere*, the Supreme Court noted that:

Such secondary considerations as *commercial success*, long felt but unsolved needs, failure of others, etc., *might* be utilized to give light to the circumstances surrounding the origin of the subject matter sought to be patented. As indicia of obviousness or nonobviousness, these inquiries *may* have relevancy.⁸⁵

The Federal Circuit has elevated the

⁸⁵ *Graham*, 383 U.S. at 17-18 (1966) (emphases added).

importance of these so-called “objective factors” as considerations that potentially override conclusions of obviousness based on consideration of prior art:

Objective evidence such as *commercial success*, failure of others, long-felt need, and unexpected results *must* be considered *before* a conclusion on obviousness is reached, and is not merely ‘icing on the cake,’ as the district court stated at trial.⁸⁶

Hearings participants generally did not question the Federal Circuit’s use of “secondary” or “objective” factors such as long-felt need,⁸⁷ but did question whether and, if so, under what circumstances, an invention’s commercial success evidences its nonobviousness, and whether, as applied by the courts in practice, the commercial success standard merits the weight given to it as an “objective” factor.

⁸⁶ *Hybritech*, 802 F.2d at 1380 (emphases added, but not for third emphasis). See MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 736 (stating that the objective factors have “grown in stature” since *Graham*). Although the Federal Circuit has stressed that “secondary [*i.e.*, objective] considerations are not secondary in importance to primary considerations,” it also has explained that secondary/objective considerations will not always “carry sufficient weight to override a determination of obviousness based on primary considerations.” See *Ryko Mfg. Co. v. Nu-Star, Inc.*, 950 F.2d 714, 719 (Fed. Cir. 1991).

⁸⁷ See *Katsh* 4/10 at 97-98; cf. Robert P. Merges, *Commercial Success and Patent Standards: Economic Perspectives on Innovation*, 76 CAL. L. REV. 805, 830 (1988) (finding a direct connection between failure of others and nonobviousness but arguing that long-felt need depends on an inference that others were contemporaneously trying to produce a similar invention).

(i). Hearings Record

Participants expressed concern that courts might unduly rely on “secondary” or “objective” factors, such as commercial success, to rebut a *prima facie* case of obviousness based on the prior art. Yale University President Richard Levin and U.S. District Judge T.S. Ellis III, for example, voiced concern that the commercial success test has “diluted”⁸⁸ or “trivialized”⁸⁹ the obviousness inquiry.⁹⁰

Legal scholars long have debated whether courts should consider an invention’s commercial success as evidence of nonobviousness. Some conclude that any relevance of commercial success to nonobviousness rests on a chain of inferences, with weaknesses evident at each link.⁹¹ In contrast, others see a measure of an

⁸⁸ R. Levin 2/6 at 103.

⁸⁹ T.S. Ellis 7/11 at 109.

⁹⁰ President Levin noted that “[a] recent study documents how decisions by the Court of Appeals for the Federal Circuit have tended to substitute “secondary” for “primary” tests of obviousness, resulting in a standard that comes perilously close to ‘if someone invested money in developing this invention, it must not be obvious.’” Richard C. Levin, *Testimony of Richard C. Levin, President, Yale University* (2/6/02) 2, at <http://www.ftc.gov/os/comments/intelpropertycomments/levinrichardc.htm> (hereinafter R. Levin (stmt)), citing Glynn S. Lunney, *E-Obviousness*, 7 MICH. TELECOMM. & TECH. L. REV. 363 (2001).

⁹¹ As Professor Kitch has explained:

The argument involves four inferences. First, that the commercial success is due to the innovation. Second, that if an improvement has in fact become commercially successful, it is likely that this potential commercial success was perceived before its development. Third, the potential commercial success having been perceived, it is likely that

invention’s contribution to the field in the willingness of customers to buy it.⁹² From a practical perspective, supporters stressed that secondary factors such as commercial success have value as objective guideposts for the obviousness inquiry.⁹³ Critics, in contrast, saw a vice in that virtue: several panelists expressed concern that juries find it too easy to avoid difficult questions about prior art and instead to focus on readily perceived facts about a product’s success.⁹⁴

Several panelists criticized how the Federal Circuit has *interpreted* the commercial success standard. Although the court requires a nexus between the invention

efforts were made to develop the improvement. Fourth, the efforts having been made by men of skill in the art, they failed because the patentee was the first to reduce his development to practice. Since men of skill in the art tried but failed, the improvement is clearly non-obvious.

Kitch, 1966 SUP. CT. REV. at 332 (concluding that “[e]ach inference is weak”); *see also* *Merges*, 76 CAL. L. REV. at 838 (terming commercial success “a poor indicator of patentability” because “it depends on a long chain of inferences, and the links in the chain are often subject to doubt”).

⁹² *See* Rochelle C. Dreyfuss, *The Federal Circuit: A Case Study in Specialized Courts*, 64 N.Y.U. L. REV. 1, 9 (1989). *See generally* ROBERT L. HARMON, PATENTS AND THE FEDERAL CIRCUIT § 4.6(b) at 170 (5th ed. 2001) (asserting, without explanation, that commercial success is persuasive evidence of nonobviousness).

⁹³ *See* Frankel 4/10 at 98-99; Dreyfuss 7/10 at 142-43; *see also* Dreyfuss, 64 N.Y.U. L. REV. at 8-10.

⁹⁴ *See* Pooley 10/30 at 56-57; Banner 10/30 at 72; Katsh 4/10 at 97-98 (referring to secondary factors in general); *cf.* Mosinghoff 10/30 at 70 (acknowledging attractiveness to juries). Nor are judges necessarily immune. Professor Kitch suggests, “Perhaps commercial success is a familiar distraction for judges confused by the facts.” Kitch, 1966 SUP. CT. REV. at 332.

and the success,⁹⁵ it typically demands only that the invention *be* a success.⁹⁶ It does not require the patentee to demonstrate that the invention *caused* that success. Thus, if the patentee shows that the claimed features of the patent are coextensive with those of a successful product, such as when a patented paving stone has succeeded in the marketplace,⁹⁷ then the burden shifts to the challenger to present evidence to rebut the inference that the invention – rather than factors such as marketing, advertising, an incumbent’s advantages, etc. – caused the commercial success.⁹⁸

Some argued in favor of changing the test to require patentees to show that the

invention *caused* the commercial success.⁹⁹ According to a panelist, such a standard prevailed in the pre-Federal Circuit era,¹⁰⁰ and the PTO continues to require that commercial success be “directly derived from the invention claimed” and not the result of “business events extraneous to the merits of the claimed invention.”¹⁰¹ One panelist objected, cautioning against requiring patentees to prove a negative – *i.e.*, that no other factor caused the invention’s success.¹⁰² Another panelist countered, however, that a patentee might reliably show causation from proof of positives: that “the problem existed for a long time and . . . the materials to solve that problem were in existence, but for the intellectual component.”¹⁰³

A number of panelists voiced concern

⁹⁵ See, e.g., Parkhurst 4/10 at 96-97; Duffy 7/10 at 120.

⁹⁶ See *Ryko Manufacturing Co. v. Nu-Star, Inc.*, 950 F.2d 714, 719 (Fed. Cir. 1991) (“prima facie evidence of nexus is established if there was commercial success and if the invention disclosed in the patent was that which was commercially successful”); *Demaco Corp. v. F. Von Langsdorff Licensing Ltd.*, 851 F.2d 1387, 1394 (Fed. Cir.) (“It is sufficient to show that the commercial success was of the patented invention itself”), *cert. denied*, 488 U.S. 956 (1988).

⁹⁷ See *Demaco*, 851 F.2d at 1391-94.

⁹⁸ See HARMON, PATENTS AND THE FEDERAL CIRCUIT § 4.6(a) at 169-70. One recent opinion explains:

A nexus between commercial success and the claimed features is required. However, if the marketed product embodies the claimed features and is coextensive with them, then a nexus is presumed and the burden shifts to the party asserting obviousness to rebut the presumed nexus. The presumed nexus cannot be rebutted with mere argument; evidence must be put forth.

Brown & Williamson Tobacco Corp. v. Philip Morris Inc., 229 F.3d 1120 (Fed. Cir. 2000) (concluding that sufficient evidence had been put forward to rebut the presumed nexus).

⁹⁹ See, e.g., Kesan 4/10 at 200-01 (urging that the test be restructured to require that “but for” the inventive activity the commercial success would not have occurred); Duffy 7/10 at 121 and Duffy Presentation at 17 (“[I]mit to situations where patentee can prove that no exogenous changes account for success”).

¹⁰⁰ See Lunney 7/10 at 148; see also Merges, 76 CAL. L. REV. at 824-25 (collecting case authority comparing some pre-Federal Circuit opinions that had required that commercial success be the “direct result” of the claimed invention with Federal Circuit interpretations, viewed as merely requiring “some connection” between the invention and the success).

¹⁰¹ United States Patent and Trademark Office, *Manual of Patent Examining Procedure* § 716.03(b) (8th ed. 2001), available at <http://www.uspto.gov/web/offices/pac/mpep/mpep.htm> (hereinafter MPEP). See also *In re Huang*, 100 F.3d 135, 139-46 (Fed. Cir. 1996); *Ex parte Remark*, 15 U.S.P.Q. 2d 1998 (Bd. Pat. App. & Interf. 1990).

¹⁰² See Dreyfuss 7/10 at 143-44; see also HARMON, PATENTS AND THE FEDERAL CIRCUIT § 4.6(a) at 170.

¹⁰³ Duffy 7/10 at 144-46.

that courts and juries do not always apply the current nexus requirement properly.¹⁰⁴ For example, panelists indicated that judges and juries have sometimes erroneously given weight to the success of a product as a whole, rather than focusing on the invention embedded in the product.¹⁰⁵ Others voiced concern that the Federal Circuit has sometimes given insufficient weight to challengers' identification of reasons other than the invention itself that explain an invention's commercial success.¹⁰⁶

(ii). Analysis

As noted by some during the Hearings, application of the "secondary" or "objective" factors can give greater certainty in answering whether an invention is nonobvious. That certainty is problematic, however, when a factor – such as commercial success – is arguably an unreliable indicator of nonobviousness. Legal tests should achieve a proper balance

¹⁰⁴ See, e.g., Kesan 4/10 at 201; Banner 10/30 at 72-73. *But cf.* Parkhurst 4/10 at 97 (effectiveness of nexus requirement can only be assessed on case-by-case basis).

¹⁰⁵ See Pooley 2/27 at 382-83 (juries fail to isolate the relevant success of an invention buried within a successful product); Banner 10/30 at 72. See generally Merges, 76 CAL. L. REV. at 826 (citing *Alco Standard Corp. v. Tennessee Valley Authority*, 808 F.2d 1490 (Fed. Cir. 1985), as upholding a patent primarily on commercial success evidence even though the patented invention "played only a small part" in an overall generator testing service). In other instances, the court has been more careful to insist on a nexus between the commercial success and the specific invention claimed. See, e.g., *In re Paulsen*, 30 F.3d 1475, 1482 (Fed. Cir. 1994).

¹⁰⁶ See Lunney 7/10 at 148-49 (Federal Circuit not giving much weight to showings of extraneous factors such as heavy advertising and distribution advantages); Merges, 76 CAL. L. REV. at 826-27 (Federal Circuit has given reduced weight to advertising and marketing advantages, citing, *inter alia*, *Hybritech*, 802 F.2d at 1382).

between the costs they entail (including those of uncertainty) and their accuracy in result.¹⁰⁷ The commercial success test does not appear to achieve that balance.

To begin with, the commercial success test has no direct connection to the "technical advance" at issue in the nonobviousness inquiry.¹⁰⁸ Even if commercial success reflects a claimed invention's economic significance, economic significance does not necessarily reflect technical significance – as illustrated by the Selden patent on the automobile¹⁰⁹ – so a commercial success standard will not necessarily yield accurate nonobviousness results. The single source relied upon by the Supreme Court's *Graham* opinion justifies the commercial success test only through the inference that others had tried and failed,¹¹⁰ and the separate objective factor that focuses directly on failure by others seems to take account of the same consideration with

¹⁰⁷ See generally Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEXAS L. REV. 1, 16 (1984); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Richard A. Posner, *An Economic Approach to Legal Procedure & Judicial Administration*, 2 J. LEGAL STUD. 399, 401 (1973).

¹⁰⁸ See *supra* Ch. 4(1).

¹⁰⁹ See Duffy 7/10 at 110-13.

¹¹⁰ See *Subtests of "Nonobviousness": A Nontechnical Approach to Patent Validity*, 112 U. PA. L. REV. 1169 (1964) (citing *S. H. Kress Co. v. Aghnides*, 246 F.2d 718 (4th Cir. 1957), *cert. denied*, 355 U.S. 889 (1958), for the explanation that a substantial latent demand would likely already have induced others to produce the invention if it had been obvious). Indeed, some of the Supreme Court's pre-*Graham* cases that gave weight to considerations of commercial success clearly arose in contexts of long-felt need and failure of others. See *Expanded Metal Co. v. Bradford*, 214 U.S. 366, 379-81 (1909); *Carnegie Steel Co. v. Cambria Iron Co.*, 185 U.S. 403, 445-46 (1902).

greater accuracy.¹¹¹

Moreover, experience with competition analysis teaches that a product's commercial success may result from many factors other than the nonobviousness of a particular invention. Incumbents may have advantages over entrants. Vertical integration sometimes yields other advantages. Economies of scope may be present from simultaneously producing, distributing, or marketing other products. Inventions compatible to *de facto* or *de jure* standards in contexts that exhibit strong network effects may have commercial advantages over incompatible, but less obvious inventions.¹¹² Of course, these advantages will not always accrue, but the fact that they may arise suggests that a mere correlation between invention and success is not enough. Case-by-case inquiry into the *cause* of the product's success is necessary in court litigation, just as it is in PTO examination. In addition, the number of different reasons that may explain a product's commercial success and the fact that the patentee is likely to have the greatest access to relevant information counsel against a default rule that establishes a presumption that the invention caused the commercial success.

All of this is cause for concern, because the commercial success test raises significant issues from a competition perspective. For any given level of

¹¹¹ See Merges, 76 CAL. L. REV. at 874 (suggesting that courts link consideration of commercial success with that of failure by others).

¹¹² See Kesan 4/10 at 201; see generally Guerin-Calvert 2/20 at 214-221 (discussing network effects and competition).

appropriability, commercially successful inventions are more likely than others to emerge even without the prospect of patent protection.¹¹³ In addition, commercially successful patents are the ones most likely to confer market power.¹¹⁴ Thus, the commercial success test could tend to allow grants of unnecessary patents that confer market power and could thereby work at cross purposes to the "but for" principles discussed *supra* in Ch. 4(II)(A)(2). Moreover, a nexus test that requires only that an invention be successful could cause competitive harm by systematically tilting the patent rules toward those whose preexisting prominence may make commercial success more likely.¹¹⁵

Recommendations. First, the Commission recommends that courts evaluate on a case-by-case basis whether commercial success is a valid indicator of the nonobviousness of the claimed invention. Second, the Commission recommends that patentees bear the ultimate burden of demonstrating that the claimed invention caused the commercial success. In the absence of these inquiries, application of the commercial success test errs on the side of issuing patents on obvious inventions and is likely to be unnecessarily detrimental to competition.

¹¹³ See Scherer 7/10 at 54 ("When it has commercial value, that's a stimulus to inventors, and sooner or later they're going to invent with or without the patent.").

¹¹⁴ See Kitch, 1966 SUP. CT. REV. at 333-34.

¹¹⁵ See *supra* note 112 and accompanying text.

B. Enablement, Written Description, and Best Mode

Section 112 of the Patent Act states a second set of doctrines crucial to patentability:

The specification shall contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains, or with which it is most nearly connected, to make and use the same, and shall set forth the best mode contemplated by the inventor of carrying out his invention.¹¹⁶

Section 112 gives rise to three distinct disclosure doctrines: written description, enablement, and best mode.¹¹⁷ See Box 4-3 for further details.

1. Relationship to Patent Breadth

The disclosure doctrines play major roles in defining patent breadth – that is, how broad the claims are that an inventor may make. Patent breadth determines the extent of protection from competition that a patented invention receives. Products or processes within the patent's breadth infringe; those outside that breadth do not.

Frequently, much will be learned and developed after an initial invention is made:

¹¹⁶ 35 U.S.C. § 112.

¹¹⁷ See SCHECHTER & THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS, AND TRADEMARK § 18.1 at 394-404.

follow-on innovations will occur, and new uses will be found. The question then becomes, how many of these subsequent developments ought to be ascribed to the initial inventor and made subject to his or her patent? For example, in determining that an inventor who had obtained rat insulin cDNA could not validly assert a claim covering human insulin cDNA, the Federal Circuit applied an analysis based on one of the disclosure doctrines.¹¹⁸

The *enablement* inquiry asks how many of the future embodiments of a claimed invention the initial patent has made viable. A patent's claims may extend until they reach the boundary of what the patent enables – that is, the point at which a follow-on innovator must engage in undue experimentation to move beyond the original invention.¹¹⁹ If a patent applicant claims more than he or she has enabled, the patent claim must be narrowed or rejected.¹²⁰ Nonetheless, because the examination determines enablement as of the time of the patent application, a patent claim can cover then-unknown, subsequent developments

¹¹⁸ See *Regents of the Univ. of Cal. v. Eli Lilly & Co.*, 119 F.3d 1559 (Fed. Cir. 1997).

¹¹⁹ See *Merges* 2/28 at 639-41 and 2/26 at 154-55. *In re Wands*, 858 F.2d 731, 737 (Fed. Cir. 1988) (“Factors to be considered in determining whether a disclosure would require undue experimentation . . . include (1) the quantity of experimentation necessary, (2) the amount of direction or guidance presented, (3) the presence or absence of working examples, (4) the nature of the invention, (5) the state of the prior art, (6) the relative skill of those in the art, (7) the predictability or unpredictability of the art, and (8) the breadth of the claims.”).

¹²⁰ See *Chambers* 2/8 (Patent Session) at 64-65; HARMON, PATENTS AND THE FEDERAL CIRCUIT § 5.2(b) at 200-01.

and uses.¹²¹

The courts and the PTO traditionally have used the *written description* requirement to police amendments to claims.¹²² An applicant must show that the original written description of the claimed invention supports the matter introduced in any claim amendments. If the applicant does not thereby demonstrate possession of that matter when he or she first filed the application, the claim amendment cannot rely on the original filing date.¹²³ Recently, the Federal Circuit has extended its use of the written description requirement to invalidate some *initially* filed claims, particularly in biotech contexts, finding that without having undertaken the additional work necessary for a more detailed description, the applicant had not shown that he or she was truly in possession of the claimed invention.¹²⁴

2. Significance for Competition: General Application of Disclosure Doctrines

a. Hearings Record

From a competition perspective, patent breadth raises a variety of potential

¹²¹ See Duffy 10/30 at 107-09; Rai 4/10 at 127-28; Kunin 4/10 at 123-24; MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 299-301; *In re Hogan*, 559 F.2d 595, 606-07 (C.C.P.A. 1977).

¹²² See, e.g., Chambers 2/8 (Patent Session) at 72-73; Rai 4/10 at 135-36; Merges 2/26 at 156-58; *Gentry Gallery, Inc. v. Berkline Corp.*, 134 F.3d 1473, 1478-80 (Fed. Cir. 1998).

¹²³ See 35 U.S.C. § 120.

¹²⁴ See, e.g., Chambers 2/8 (Patent Session) at 73-74; Rai 4/10 at 136; *Eli Lilly*, 119 F.3d at 1566-69.

concerns. If breadth is defined too broadly – that is, more broadly than is truly enabled – products that should be free to compete instead will infringe, and unwarranted market power may result.¹²⁵ Numerous business panelists voiced concerns about patents with undue breadth.¹²⁶

In contrast, defining breadth too narrowly may unnecessarily subdivide patent rights, potentially adding to the number of patents and contributing to the growth of patent thickets. Breadth in some instances can affect the number of patents needed to produce a product (or a commercially viable line of products). It can affect whether an industry evolves along a discrete product model (with relatively few patents necessary per commercializable product) or along the complex product model (with many patents necessary per product) that is characteristic

¹²⁵ See Scotchmer 2/26 at 171 (“the thing that determines who gets to compete in the market is the distance between them that’s required not to infringe”). See Scotchmer 4/10 at 71 (overly broad patents may enable excessive market power consolidation). Similarly, an unduly broad patent can obscure the competition that should exist and prevent antitrust enforcement to protect that competition. Cf. Scotchmer 2/26 at 130-31, 136 (IP Guidelines analysis depends on whether, absent a license, one firm would have infringed the other’s patent); U.S. Department of Justice and Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property § 3.3 (Apr. 6, 1995), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,132 (horizontal relationship between licensor and licensee depends on whether they would have been actual or potential competitors in a relevant market absent a license), *available at* <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm>.

¹²⁶ See, e.g., Kirschner 2/26 at 242; Friedman 2/27 at 411-12; Kohn 2/27 at 413; Fox 2/28 at 696; Thurston 3/20 at 34; Richard Stallman, *The Danger of Software Patents*, Speech by Richard Stallman at Cambridge University, March, 25 2002 (Public Comment) 4, *at* <http://www.ftc.gov/os/comments/intelpropertycomments/stallmanrichard.pdf>.

of thickets.¹²⁷

Finally, patent breadth can have major consequences for follow-on innovation. Here the testimony split into diverging strands. One strand emphasized that broad initial patents may raise significant problems for follow-on innovation.¹²⁸ From this perspective, vesting the initial innovator with broad patent rights reduces the incentives of follow-on innovators and potentially impedes their access to upstream innovation inputs. Follow-on innovators, some argued, would receive high royalty demands or endure unwarranted design-around expense.¹²⁹ The opposing viewpoint stressed that broad initial patents may be beneficial, providing adequate rewards for initial innovators and furthering prospect theory goals of efficient future development.¹³⁰ They stressed that the holder of a broad initial patent generally will

¹²⁷ See Cohen 2/20 at 37-38 (numerous patents per commercializable product implies “mutual dependence across firms’ patent holdings”) and 10/30 at 92-93 (explaining that in Japan, where patents tend to be narrow “everything is a complex product industry”).

¹²⁸ See, e.g., Scherer 7/10 at 54-55 (“early basic patents can retard or bar innovation by a downstream inventor or developer, slowing down the pace of technological advance”); Cohen 2/20 at 22 (broad patents problematic when innovation cumulative), 71 and 10/30 at 93-95 (citing research indicating “significant potential for problems” with access to upstream biomedical inventions); Langenfeld 2/20 at 10, 12, and James Langenfeld, *Innovation, Competition, and Intellectual Property: Providing an Economic Framework* (2/20/02) (slides) at 4, at <http://www.ftc.gov/opp/intellect/langenfeld.pdf>; Lemley 2/25 at 37-38; Rai 4/10 at 21-22 and 51-52.

¹²⁹ See, e.g., Rai 4/10 at 19; Kesan 10/25 at 25-26.

¹³⁰ See, e.g., Scotchmer 2/26 at 130-34, 171-72 and 4/10 at 68-69 (emphasizing the importance of “leading breadth” – an economic stake in things beyond what the initial innovator has actually invented); Kitch 2/20 at 81-84.

Box 4-3. Enablement, Written Description, and Best Mode

Written description ensures that the inventor actually has invented what the patent application claims; the inventor must describe the invention sufficiently to show that he or she is in possession of the invention. See, e.g., Chambers 2/8 (Patent Session) at 64; Kushan 4/11 at 102.

Enablement ensures that the *public* is put in possession of the invention, *i.e.*, enablement implements the patent system’s disclosure requirement. An inventor must disclose the claimed invention sufficiently that a person skilled in the art can make and use it without undue experimentation. See, e.g., Chambers 2/8 (Patent Session) at 63-68; Kushan 4/11 at 102; Kunin 4/10 at 122.

The **best mode** requirement adds a subjective test: if the inventor has developed techniques that he or she recognizes at the time of filing as the best way of carrying out the invention, those techniques must be disclosed. See Chambers 2/8 (Patent Session) at 64, 78-79.

have incentives to find ways to foster follow-on activities.¹³¹

Economic analysis substantially informed the follow-on innovation discussion. As discussed *supra* in Chapter 2(II)(B)(2), Professor Scotchmer focused attention on the division of profit between successive generations of innovation.¹³² When the first generation lays the foundation for the second, the first innovator should receive some portion of the second

¹³¹ See, e.g., Kieff 4/10 at 163; Blackburn 2/26 at 264-65.

¹³² See Scotchmer 2/26 at 128-30, 135-36 and 4/10 at 71. “The challenge is to reward early innovators fully for the technological foundation they provide to later innovators, but to reward later innovators adequately for their improvements and new products as well.” Scotchmer, 5 J. ECON. PERSP. at 30.

generation profits.¹³³ According to Professor Scotchmer, an unduly narrow initial patent may allow competition from follow-on products to undermine the incentive for the initial innovation on which both generations rest;¹³⁴ at the same time, an unduly broad initial patent may stifle follow-ons.¹³⁵

Different assessments of the likelihood of licensing distinguish the opposing views. Broad initial patents are most likely to support efficient follow-on activity if *ex ante* licensing occurs – that is licensing before the follow-on innovator makes investments. Once the follow-on innovator makes sunk investments, however, the follow-on innovator faces heightened exposure to opportunistic royalty demands.¹³⁶

Several panelists questioned whether *ex ante* licensing would likely occur. They noted that it would likely be difficult to protect a follow-on innovator’s not-yet-patented ideas during *ex ante* licensing negotiations; that negotiations focused on uncertain research results and inchoate patent rights typically have high transactions costs; that, especially given the early stage of the follow-on research, the initial and follow-on

inventors may place significantly different relative values on their contributions; and that some initial innovators may refuse to license, wishing to maintain market power by developing follow-on products in-house rather than licensing to potential future competitors.¹³⁷ Others responded that transaction costs and the effects of uncertainty usually can be overcome.¹³⁸ Anecdotal information and case studies point both ways.¹³⁹

b. Analysis

A synthesis of the follow-on innovation discussion suggests that if initial innovation is costly and follow-on innovation is relatively predictable, quick, and inexpensive, then in theory initial innovators should receive patents of greater breadth. In contrast, if initial innovation is inexpensive and follow-on innovation is relatively risky, time-consuming, and costly, then in theory initial innovators should receive narrower patents, leaving follow-on innovators greater opportunity for reward. Such an arrangement, in general terms, would serve efficiency goals by allocating

¹³³ Scotchmer, 5 J. ECON. PERSP. at 31.

¹³⁴ Scotchmer 2/26 at 130.

¹³⁵ *Id.* at 135; Scotchmer, 5 J. ECON. PERSP. at 31 (“enough profit must be left for the second innovators so that they will invest if investing is efficient”); *see also* Stoner 2/26 at 118-19.

¹³⁶ *See, e.g.*, Scotchmer 2/26 at 135; Rai 4/10 at 19; *see also supra* Ch. 2(III)(B)(3). In contrast, some panelists argued that when improvements are significant and adequate information is available, awarding a blocking position to the follow-on innovator may sufficiently protect that innovator even if licensing negotiations are conducted *ex post*. *See* Parkhurst 4/10 at 93-94; Kieff 4/10 at 163-64.

¹³⁷ For more detailed discussion of possible licensing impediments, *see supra* Ch. 2(III)(B)(3); Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 TEX. L. REV. 989, 1048-61 (1997); Rebecca S. Eisenberg, *Patents and the Progress of Science: Exclusive Rights and Experimental Use*, 56 U. CHI. L. REV. 1017, 1073-74 (1989). Professor Scherer highlights the potential for bargaining stalemates when the initial innovation involves basic research with little commercial value itself and the follow-on innovations require substantial investment. Frederick M. Scherer, *The Economics of Human Gene Patents*, 77 ACADEMIC MEDICINE 1348, 1362 (2002).

¹³⁸ *See, e.g.*, Teece 2/26 at 210-11; Arora 2/25 at 88; Kieff 4/10 at 159-60, 199-200.

¹³⁹ *See supra* Ch. 2(III)(B)(3).

patent protection to the stage “where appropriability can make the greatest contribution to innovation.”¹⁴⁰

Current disclosure doctrines accord reasonably well with these goals. For example, enablement of a given embodiment depends in part on the amount of experimentation required and on the predictability of the art. When considerable experimentation is necessary, follow-on innovation is likely to be costly; the more stringent enablement requirements that follow from greater need to experiment reduce the breadth of the initial innovator’s patent,¹⁴¹ and expand the rewards potentially available to follow-on innovators. Similarly, less predictability makes follow-on innovation more costly; again the more stringent enablement requirements that follow reduce the breadth of the initial patent and provide opportunities for expanded follow-on rewards. These results are in line with the economic reasoning for settings in which initial innovation is inexpensive and follow-on innovation is costly¹⁴² and accord with advice of antitrust innovation

¹⁴⁰ See Stoner 10/30 at 99-100.

¹⁴¹ When more experimentation is needed, a given level of disclosure enables fewer future embodiments.

¹⁴² See *Merges 2/28* at 641-43 (suggesting that “where it is more costly to build on old inventions” enablement principles appropriately restrict the initial patent right). The correspondence, however, may not always be perfect. For example, if the initial innovator had to overcome the same unpredictable art or engage in the same type of experimentation as the follow-on innovator, the initial innovation may not have been inexpensive, as assumed, and there would be no basis for preferring one generation over the other.

theorists.¹⁴³

3. Significance for Competition: Disclosure Doctrines in Practice

a. *Hearings Record*

Variations in the predictability of the art and differences in the nature of the person having ordinary skill in the art (the “PHOSITA”) necessarily require different levels of disclosure in different fields of endeavor. The distinctions do not arise because of special industry treatment under the statute; a single standard applies across industries and technologies. Rather, as already noted, an industry or technology where the art is more unpredictable requires greater disclosure.¹⁴⁴ Similarly, an industry or technology in which the PHOSITA is relatively unskilled requires greater disclosure than when the PHOSITA possesses greater ability.¹⁴⁵

Panelists found differences in the disclosure requirements in different industries or technologies. Most typically, they contrasted software disclosures with those required for biotechnology.¹⁴⁶ Many

¹⁴³ See *Rubinfeld 2/25* at 19, 23 (when the strategy of innovation is unpredictable or random, a reasonably large number of innovation efforts is desirable – more innovation is likely with more diversity).

¹⁴⁴ See, e.g., *Kunin 4/10* at 122; *Mossinghoff 10/30* at 113-14; *MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS* at 290.

¹⁴⁵ See, e.g., *Burk 3/20* at 132-34 and 7/10 at 155-56.

¹⁴⁶ See, e.g., *Burk 3/20* at 107-10 and 7/10 at 155-56 (finding a much less rigorous disclosure requirement for software than for biotechnology inventions); *Kesan 4/10* at 55, 121 (same); *Rai 4/10* at 105-06 (same); *Kunin 7/10* at 28, 191-92.

viewed the software disclosure requirements as relatively lax. Several cases have concluded that patent applicants need not reveal source code;¹⁴⁷ some panelists indicated that mere recitation of a program's function will be adequate.¹⁴⁸ Several panelists urged the requirement of greater software disclosures.¹⁴⁹ In comparison, panelists indicated that biotech disclosures have been rigidly policed, with genetic sequence codes often required to satisfy

¹⁴⁷ See, e.g., *Robotic Vision Systems, Inc.*, 112 F.3d 1163, 1166-67 (Fed. Cir. 1997); *Fonar Corp. v. General Electric Co.*, 107 F.3d 1543, 1548-49 (Fed. Cir.), cert. denied, 522 U.S. 909 (1997); *Hayes Microcomputer Products, Inc. v. Ven-Tel, Inc.*, 982 F.2d 1527, 1534 (Fed. Cir. 1992); *Northern Telecom, Inc. v. Datapoint Corp.*, 908 F.2d 931, 941-43 (Fed. Cir.) (stating that "[t]he possible design of superior software . . . is not relevant in determining whether the inventor has complied with the enablement requirement"), cert. denied, 498 U.S. 920 (1990).

¹⁴⁸ See, e.g., Burk 3/20 at 108 ("essentially . . . no disclosure requirement for software;" neither code nor flowcharts are necessary) and 7/10 at 155 ("you don't need to give us the code . . . [y]ou don't need to give us a flow chart . . . just give us a functional disclosure, tell us what it does"); Kesan 4/10 at 56 (no policing of enablement in software; "functional descriptions" suffice, and system is "essentially giving patents to ideas"); Rai 4/10 at 106 ("incredibly broad claims without any disclosure whatsoever"); Kunin 7/10 at 191-92 ("mere functional description" adequate).

¹⁴⁹ See, e.g., Janis 4/10 at 118-19 (enablement standard for software could be made "much more rigorous with good effect"); Kesan 4/10 at 55-57, 120-21 (disclosure fails to show "how the algorithm is being tailored for use in this application"), 130 ("disclosures are so scant that you're really talking about basically taking another invention to actually enable what is disclosed"); Kieff 4/10 at 113 (suggesting that inventors submit source code); Burk 3/20 at 110-11. See generally Dan L. Burk & Mark A. Lemley, *Is Patent Law Technology Specific*, 17 BERKELEY TECH. L. J. 1155, 1196 (2002) (suggesting that narrower patents resulting from more stringent disclosure requirements might better promote innovation in a software industry characterized by incremental improvements).

written description requirements.¹⁵⁰ Indeed, some found the disclosure requirements in biotech excessive, forcing inventors to take time tying down details that readily could be elucidated by others, and thereby delaying the raising of venture capital.¹⁵¹

¹⁵⁰ See, e.g., Burk 3/20 at 110, 134 ("You must have actually found the sequence even if one of ordinary skill would know how to find the sequence.") and 7/10 at 156, 160-61; Rai 4/10 at 105; Kunin 7/10 at 28; Boulware 10/30 at 158 ("the Federal Circuit is looking at written description and enablement very closely in the biotech area"). For the PTO's interpretation and implementation of written description requirements, see United States Patent and Trademark Office, *Guidelines for Examination of Patent Applications under the 35 U.S.C. 112, ¶ 1, "Written Description" Requirement*, 66 Fed. Reg. 1099 (2001).

¹⁵¹ See, e.g., Burk 3/20 at 110-11, 134-35; Burk & Lemley, 17 BERKELEY TECH. L. J. at 1195-96 (suggesting that the narrow patents that follow from rigorous disclosure requirements may increase the potential for anticommmons problems in biotechnology); cf. Merges 2/28 at 642 (discussing, as a general matter, the potential waste inherent in an unduly rigorous enablement standard); Rai 4/10 at 106 (arguing that although the written description demands for biotech are excessive, they will yield an economically desirable result if confined to upstream research).

Similar, though not identical, patterns emerged from testimony regarding the usefulness of patent disclosures in different industry contexts. The strongest criticism involved software, for which the predominance of industry panelists found patent disclosures of little value. See, e.g., Webbink 3/20 at 145; Casey 4/9 at 32; Young 4/11 at 99-100 ("Software is not software without source code."); Barr 10/30 at 142; cf. Kahin 3/19 at 56 (software patents not read). But see Myrick 10/30 at 59-60 ("Software patents disclose an enormous amount"); Alderucci 4/9 at 40 (disclosures useful). In contrast, as noted *supra* in Chapter 3(II)(C), testimony from the pharmaceuticals industry almost uniformly indicated value in the patent disclosures. See, e.g., Blackburn 2/26 at 319; Glover 3/19 at 174, 224-25; Coffin-Beach 3/19 at 212. Biotech industry testimony on this point was mixed. Compare Boulware 10/30 at 159 (patent literature looked at regularly) with Kirschner 2/26 at 318 (patents not a significant source of ideas) and Blackburn 2/26 at 319-20 (suggesting that patent literature may be more significant in pharmaceuticals than in biotech, but adding that patents enable information transfer through scientific literature). Semiconductor and high-tech hardware industry participants expressed diverse views. See, e.g., Telecky 2/28 at 754 (disclosures useful); McCurdy 3/20 at 53 (patents seldom

b. Analysis

Critics of current disclosure requirements in particular industries typically argued that the Federal Circuit has an erroneous view of the predictability of the art or the skill of the PHOSITA.¹⁵² They observed that these variables change over time as industries develop and mature, and they suggested that the patent system has not always kept current in its assessments.¹⁵³ They directed their criticisms toward the *application* of the disclosure requirements, not toward any fundamental problem inherent in the basic standards.

The role of disclosure requirements in shaping patent breadth and the consequences of that breadth for potential market power and cumulative innovation make the nature and effective application of the disclosure requirements a matter of significant competitive concern. Accurate, up-to-date assessments of the predictability of the art and of the abilities of the PHOSITA in evolving industries are

disclose enough to allow practice of the invention without some work); Barr 2/28 at 756 (“I’ve actually never met an engineer that learned anything from a patent.”).

¹⁵² See, e.g., Burk 3/30 at 133 (seeing an underestimate of the difficulty of writing software) and 7/10 at 155 (same); Rai 4/10 at 106 (Federal Circuit thinks everything in biotech is “incredibly unpredictable”).

¹⁵³ See, e.g., Burk 3/20 at 111-12 (“courts developing standards that might have applied 5, 10, 15 or even 20 years ago”) and 7/10 at 198-99 (courts have not kept up with growing predictability of some biotech techniques); Kesan 4/10 at 120 (software has become more complex since the early cases governing enablement); see also Kunin 7/10 at 192-93 (increasing complexity of software inventions may have reduced the predictability); Burk & Lemley, 17 BERKELEY TECH. L. J. at 1199-1201 (explaining how reliance on precedent rather than the particulars of each case may lead to outdated conceptions of the PHOSITA’s level of skill).

important elements for achieving efficiency goals and harmonizing the patent and antitrust regimes.

C. Other Doctrines that Affect Patent Breadth

Other doctrines, beyond the disclosure requirements, also set and interpret the scope of a patent’s claims and thus affect patent breadth. This section highlights two of these doctrines. The first is the use of “continuing applications” – that is, “continuations” – to redefine the scope of a patent’s claims. The second is the application of the doctrine of equivalents in interpreting claims. Both can significantly affect competition.

1. Continuations and the Formulation of Claims

a. Hearings Record

The patent system has long struggled with problems that flow from delay and secrecy in handling patent applications. Until recently, patent applications were not public information. Years might pass between the filing of an application and the issuance of a patent. An applicant’s competitors may have invested substantially in the interim in designing and developing a product and bringing it to market, only to learn, after the patent finally issues, that they are infringing someone else’s claims. At that point, redesign might be prohibitively expensive, and the newly announced patentee might be in position to extract large

royalties.¹⁵⁴ Such a scenario raises the potential for what some panelists have termed “a hold-up.”¹⁵⁵

A statutory change that now requires all patent applications (other than those filed only in the United States) to be published 18 months after filing¹⁵⁶ may have considerably eased this problem with unanticipated “submarine” patents.¹⁵⁷ A PTO panelist indicated that 90% of current applications are so published.¹⁵⁸ Several panelists anticipated that the new publication rule would help substantially with submarine concerns,¹⁵⁹ although some indicated dissatisfaction with the remaining 18-month delay¹⁶⁰ and with excepting from publication patents filed only domestically.¹⁶¹

Another potential hold-up problem remains, however. Through the use of claim amendments during the prosecution process, a patent that states broader claims than those

published at 18 months can still emerge.¹⁶² To maintain the filing date of the original application, the original specification must contain support for the new claims.¹⁶³ If that is the case, the applicant may enlarge or otherwise modify the scope of its claims during the examination process.¹⁶⁴ The potential for anticompetitive hold-up increases the longer it takes for the broader claims to emerge. By filing one or more continuing applications¹⁶⁵ the applicant may extend the prosecution period – and the potential for working mischief by broadening claims – for years.

Panelists explained that continuations can serve legitimate functions when the applicant, or the applicant’s attorney, has in

¹⁵⁴ See, e.g., Stallman 4/9 at 18-19 (describing unknowing infringement of patents kept secret during the application period as “stepping on . . . a land mine”); Barr 2/28 at 675-76.

¹⁵⁵ See, e.g., Shapiro 11/6 at 15-16, 176.

¹⁵⁶ 35 U.S.C. § 122(b)(1). Applications that are filed only domestically, however, need not be made public. 35 U.S.C. § 122(b)(2)(B).

¹⁵⁷ See also *supra* Ch. 1(III)(A)(2)(a).

¹⁵⁸ John Love 2/28 at 647.

¹⁵⁹ See, e.g., *id.*; Kohn 2/27 at 429; Gable 3/20 at 118-19; Casey 4/9 at 32.

¹⁶⁰ See Oehler 2/26 at 254 (“18 months can seem like an eternity when you’re caught in the middle of it trying to answer ‘am I free to operate?’”).

¹⁶¹ See *infra* at Ch. 5(II)(C)(4).

¹⁶² See, e.g., Katsh 4/10 at 193; Barr 2/28 at 676.

¹⁶³ 35 U.S.C. § 120. Similarly, novelty requirements prevent issuance of a patent on inventions “known or used by others in this country . . . before the invention thereof by the applicant for a patent,” and the prohibition on derivation in theory bars issuance of a patent to one who “did not himself invent the subject matter sought to be patented” 35 U.S.C. §§ 102(a) and (f). See MERGES & DUFFY, PATENT LAW & POLICY: CASES AND MATERIALS at 398-403, 437-39.

¹⁶⁴ See, e.g., Merges 2/26 at 156-58; Chen 2/28 at 718; Rai 4/10 at 135-36.

¹⁶⁵ The filing may take various forms. It may involve a new application, which might take the form of a “continuation application,” retaining the original written disclosures and the original filing date; a “continuation-in-part,” which adds some new matter to the disclosures and loses the original filing date insofar as its claims rely on the new matter; or a “divisional,” which carves out what had been a separate invention within the original application while retaining the original filing date. See 35 U.S.C. §§ 120-21; 37 C.F.R. § 1.53(b); Chambers 2/8 (Patent Session) at 101-02. Alternatively, the filing may involve a request for continued examination, which works to extend the examination of the original application. 37 C.F.R. § 1.114. For ease of exposition, this discussion will refer to all of these variants, including those portions of continuations-in-part that maintain the original filing date, as “continuing applications” or “continuations.”

essence missed its own product in the initial application¹⁶⁶ or when the applicant and examiner need to maintain an extended dialogue.¹⁶⁷ Several panelists expressed concern, however, regarding the use of continuation practice in ways harmful to competitors. They explained that some applicants keep continuations pending for extended periods, monitor development of the market, and modify their claims to ensnare competitors' products after sunk costs have been incurred.¹⁶⁸ One panelist voiced the further worry that continuations could be used to undercut standard setting organizations' disclosure rules.¹⁶⁹ None of the testimony offered justification for the use of continuation practice to broaden claims to cover competitors' subsequent products and to exploit the consequences of their subsequent sunk investments. As American Intellectual Property Law Association

¹⁶⁶ See Barr 10/30 at 146; Chambers 2/8 (Patent Session) at 103; Telecky 2/28 at 720-21 (finding nothing wrong with "chang[ing] your mind as you see the art, and as you think about it, as to what your invention is," as long as the claims are supported by the disclosure). *But see* Poppen 2/28 at 692 ("an inventor ought to know what his invention is and shouldn't have to wait to see what everybody else is doing").

¹⁶⁷ See Armbrrecht 3/19 at 68-69; *cf.* Myrick 10/30 at 179-80 (explaining possible use of continuations to correct the prosecution history).

¹⁶⁸ See, e.g., Poppen 2/28 at 687-88; Mar-Spinola 2/28 at 715-16; Quillen 3/19 at 70-71; McCurdy 3/20 at 37; Rai 4/10 at 136; Barr 10/30 at 79, 146; Myrick 10/30 at 178 (warning that divisionals may be similarly used to "game the system"), 180; Cecil D. Quillen Jr. & Ogden H. Webster, *Continuing Patent Applications and Performance of the U.S. Patent and Trademark Office*, 11 FED. CIR. BAR J. 1, 6 (2001). See generally Banner 10/30 at 181-82 (continuations a problem).

¹⁶⁹ See Stoner 10/30 at 145-46 (noting that continuations might be used "to spring a new patent claim on firms that are producing pursuant to a standard" absent a controlling disclosure requirement).

President Ronald Myrick summarized, "[T]he continuation practice we have today is not good. It's out of control."¹⁷⁰

b. Analysis

Implications for Competition and Innovation Continuation practice can allow opportunistic behavior, such as post-filing modification of patent claims to capture competitors' products or processes that would not have infringed the original claims. Such opportunistic behavior can disrupt competitive activity. It wastes inventive resources that a competitor could have redirected, had it fully known the scope of an applicant/patentee's claims. It imposes redesign costs that might have been avoided if the competitor had had greater lead time. It fosters high royalties, inflated by a competitor's exposure to operational disruption from injunctive relief after sunk investments have been made. It magnifies potential competitors' risks and reduces their incentive to develop substitutes for the patentee's invention. Moreover, competitors' uncertain ability to predict from the written description at 18 months what the patentee ultimately will claim limits any opportunity to anticipate and avoid this exposure. Such behavior wastes resources, raises costs and risks, and potentially deprives consumers of the benefits of

¹⁷⁰ Myrick 10/30 at 177; see also Myrick 10/30 at 180 (use of continuation practice as marketplace develops to capture what was never in the applicant's mind "an exceedingly troublesome thing"). Such conduct, however, may not give rise to an offense under patent law. See, e.g., *Kingsdown Medical Consultants, Ltd. v. Hollister Inc.*, 863 F.2d 867, 874 (Fed. Cir. 1988) (holding that amending a claim to cover a competitor's product learned about in the course of the prosecution process was not in itself evidence of deceitful intent relevant to charges of inequitable conduct and stating, in *dictum*, that it was not "in any manner improper"), *cert. denied*, 490 U.S. 1067 (1989).

innovation and competition.¹⁷¹

Suggestions for Reform of Continuation Practice Patent reform efforts have long focused on how to remedy the opportunistic broadening of patent claims to capture competitors' products. The 1967 President's Commission on the Patent System determined that "it is desirable that claims never be broadened after publication," but concluded that it might be impossible to enforce an all-inclusive prohibition.¹⁷² The Hearings suggest that the same types of concerns persist and will likely remain a problem in the future unless changes are implemented.¹⁷³ Suggestions for dealing with the problems identified in continuation

¹⁷¹ For a general discussion of hold-up problems raised by unanticipated patents see Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting*, in 1 INNOVATION POLICY AND THE ECONOMY 119 (Adam Jaffe et al. eds., 2001). Indeed, the Commission's complaint in a pending administrative proceeding cites continuations as an element contributing to broader, alleged anticompetitive conduct involving claim modifications during a patent applicant's participation in standard-setting activities. *Rambus Inc.*, No. 9302 at ¶¶ 37-38, 47-69 (Complaint June 18 2002), available at <http://www.ftc.gov/os/adjpro/d9302/020618admincomp.pdf>.

¹⁷² REPORT OF THE PRESIDENT'S COMMISSION ON THE PATENT SYSTEM, reprinted in TO PROMOTE THE PROGRESS OF THE USEFUL ARTS, SUBCOMM. ON PATENTS, TRADEMARKS AND COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY, 90TH CONG., 1ST SESS. 39 (1967). The President's Commission recommended imposing time limits on continuing applications. *Id.* at 26.

¹⁷³ Although some panelists suggested that a 1995 change in patent term – from 17 years after issuance to 20 years after filing – limits the ability to prolong examinations, see, e.g., Telecky 2/28 at 721 and Detkin 2/28 at 729, other testimony indicated that 20 years was more than enough time to abuse continuation practices. See Poppen 2/28 at 693. Moreover, some predicted that the use of continuations to broaden or otherwise add to literal claims will increase, given current trends toward narrowing the doctrine of equivalents (discussed *infra* in Ch. 4(II)(C)(2)). See, e.g., Mossinghoff 10/30 at 144-45; Myrick 3/19 at 48; Thomas 10/30 at 105-06.

practice include extending and making greater use of the doctrine of prosecution laches,¹⁷⁴ imposing time limits on broadening claims,¹⁷⁵ and creating intervening rights to protect competitors who become exposed to infringement claims by virtue of continuations.¹⁷⁶

Analysis Any of the remedies listed above could address competitive concerns. A remedy, however, should protect legitimate uses of continuing applications, as well as deter anticompetitive uses of continuations. Creating intervening or prior user rights¹⁷⁷ would most directly cure

¹⁷⁴ The Federal Circuit has approved a PTO rejection of patent claims on grounds that the applicant had forfeited his right to a patent under the doctrine of prosecution laches by filing twelve continuations over a period of eight years without advancing the prosecution of his application. See *In re Bogese II*, 303 F.3d 1362 (2002); see also Chen 2/28 at 718-19 (PTO exploring possibilities for rejecting applications based on prosecution laches). The doctrine of prosecution laches also potentially provides a defense to an infringement action when the patentee has engaged in unreasonable and prejudicial delay in securing the patent's issuance. See *Symbol Technologies, Inc. v. Lemelson Med., Educ., & Research Found.*, 277 F.3d 1361 (Fed. Cir.), cert. denied, 123 S. Ct. 113 (2002).

¹⁷⁵ See Poppen 2/28 at 692-94 (suggesting barring broadening of claims 18 months after filing); Chen 2/28 at 718 (18-month limit on broadening claims "an interesting idea . . . one way to promote some level of certainty"); cf. Katsh 4/10 at 139 (suggesting a time limit on continuations).

¹⁷⁶ See Myrick 10/30 at 180-81 (suggesting "intervening rights or some such thing that would protect the later entrant in the marketplace against these patents that show up so tardily").

¹⁷⁷ Analysts have not always distinguished these terms with consistency. For present purposes, we use "prior user rights" to refer to absolute defenses against infringement actions and "intervening rights" to refer to protections that, in whole or in part, depend on a court's weighing of the equities, as exemplified, respectively, by provisions in 35 U.S.C. § 273(b) and 35 U.S.C. § 252, discussed below.

potential competitive problems without interfering with legitimate needs for continuations, reducing business uncertainty without increasing costs of error. Such rights should shelter inventors and users that infringe a patent only because of claim amendments following a continuation, provided that the sheltered products or processes are developed or used (or the subject of substantial preparation for use) before the amended claims are published.¹⁷⁸ This would protect third parties from hold-ups derived from any extended period of secrecy made possible by continuations, while allowing the patent to be enforced against those who would have infringed a properly described pre-continuation claim¹⁷⁹ or who had timely opportunity to gain knowledge of the amendments.

Protections sheltering the legitimate expectations and investments of third parties affected by late-date claim amendments have substantial precedent. Limited intervening rights already are available under 35 U.S.C. § 252 to third parties who infringe a patent because of a broadening of claims through post-grant reissue, a procedure that, in cases of “error without any deceptive intention,” allows certain claim amendments *after* a

¹⁷⁸ Whether amended claims are published upon the filing of continuations depends upon the specific continuation format used and the way that amendments are presented, and often is “[a]t applicant’s option.” See 37 C.F.R. § 1.215; American Inventor’s Protection Act of 1999 Questions and Answers § C (Eighteen-Month Publication), available at <http://www.uspto.gov/web/offices/dcom/olia/aipa/infoexch.htm>.

¹⁷⁹ The phrase “properly described claim” refers to claims that satisfy the written description requirement of 35 U.S.C. § 112. The intervening or prior user right would not be defeated by a pre-continuation claim that exceeds the applicant’s written description.

patent has issued.¹⁸⁰ The intervening rights proposed herein would provide protection to third parties similarly confronted with late-date claim amendments *during* the course of the prosecution process. The courts, however, have applied existing intervening rights narrowly¹⁸¹ and likely would need to broaden them to confer meaningful protection in light of investments made or business commenced by the third party and the likely costs and full economic consequences of any redesign to avoid infringement. Regarding prior user rights, Congress in 1999 enacted such protections to shelter some third parties from infringement claims based on business method patents.¹⁸² More broadly, the 1992 Advisory Commission on Patent Law Reform, in conjunction with a separate recommendation to determine patent priority on a first-to-file basis, proposed conferring prior user rights on those who “in good faith” use, or make

¹⁸⁰ See 35 U.S.C. § 251.

¹⁸¹ See, e.g., *Shockley v. Arcan, Inc.*, 248 F.3d 1349, 1361 (Fed. Cir. 2001) (refusing to consider intervening rights in view of defendant’s unclean hands from willful infringement); *Seattle Box Co. v. Industrial Crating and Packing, Inc.*, 756 F.2d 1574 (Fed. Cir. 1985) (leaving unanswered whether intervening rights would have been available for anything more than bundles made from pre-reissue inventory); J. Christopher Carraway, *The Uncertain Future of Enforcing Patents that Have Been Broadened through Reissue*, 8 FED. CIRCUIT B.J. 63, 68, 74 (1998) (“The grant of equitable intervening rights is extremely rare, however, most likely out of discomfort with allowing a party to continue to infringe a patent. . . . Although one who has designed around the original claims may be protected from paying damages on any pre-reissue activity, . . . equitable intervening rights to continue production of the originally noninfringing product are almost universally denied, thereby destroying investments made in creating and building the market for the product.”).

¹⁸² See 35 U.S.C. § 273(b) (sheltering those who reduced a business method to practice at least a year before the patent application and used the method before the effective filing date).

substantial preparation for using, an invention before the filing date of a subsequently issued patent.¹⁸³

Recommendation. Accordingly, the Commission recommends the enactment of legislation to protect from infringement claims a third party who reduces to practice, uses, or makes substantial preparation for using a process, machine, manufacture, or composition of matter (“product or process”) prior to first publication of a claim covering that product or process in a continuing application, provided that no parent application¹⁸⁴ contained a properly described claim covering the product or process prior to the third party’s reduction to practice, use, or substantial preparation for use.¹⁸⁵

¹⁸³ ADVISORY COMMISSION ON PATENT LAW REFORM, A REPORT TO THE SECRETARY OF COMMERCE 11, 21 (1992) (Recommendation I-A), available at <http://world.std.com/obi/USG/Patents/overview>.

¹⁸⁴ “Parent application” is used broadly here to encompass all predecessors in a string of continuing applications.

¹⁸⁵ The Hearing record does not permit assessment of the extent to which reissue proceedings have been used to broaden patents to cover competitors’ products after the competitors have made their sunk investments, nor does it explore the justifications for broadening reissue. It nonetheless appears that reissue in some instances may be used like continuations “to encompass activity by a competitor.” See United States Patent and Trademark Office 21st Century Strategic Plan, *Permit Assignees to File Broadening Reissue 1* (April 2, 2003), at <http://www.uspto.gov/web/offices/com/strat21/action/lr1fp55.htm>. To the extent that reissue poses, or develops in a way that poses, comparable competitive problems to those raised by continuations, corresponding protections, including a possible broadening of existing intervening rights, ought to be considered.

2. Doctrine of Equivalents

a. Hearings Record

Several panelists addressed claim interpretation issues under the doctrine of equivalents.¹⁸⁶ The doctrine of equivalents “protects [a patent holder] against efforts of copyists to evade liability for infringement by making only insubstantial changes to a patented invention.”¹⁸⁷ It does so by allowing a claim to be construed to cover more than its literal language, thereby extending patent breadth.¹⁸⁸ The answer to the question of when changes are “only insubstantial” thus can become an important determinant of patent breadth.

Some panelists favored the doctrine of equivalents as a means to protect patentees from imitators who might otherwise escape infringement by tinkering in trivial ways with patented products or

¹⁸⁶ Other discussion dealt with literal claim interpretation, in particular the effects of the ruling in *Markman v. Westview Instruments, Inc.*, 517 U.S. 370 (1996), that claim interpretation is a matter of law, not fact. Although panelists noted that the ruling had been expected to increase certainty by vesting interpretation issues in judges rather than juries, see e.g., T.S. Ellis 7/11 at 113 (finding that certainty has increased) and Barr 10/30 at 185, some observed that achieving certainty has now been delayed until appeal of the trial judge’s conclusions. See, e.g., Weinstein 2/27 at 451; Katsh 4/10 at 103-04; Kunin 7/10 at 37; Banner 10/30 at 182-83; see also Kimberly A. Moore, *Are District Court Judges Equipped to Resolve Patent Cases?*, 12 FED. CIRCUIT B.J. 1, 32 (2002) (advocating statutory reform that would permit “[e]xpeditious appeals of a limited number of claim construction issues”). Neither the Hearing record nor the academic literature permits a sorting of competitive consequences.

¹⁸⁷ See *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co., Ltd.*, 535 U.S. 722, 727 (2002).

¹⁸⁸ See, e.g., Sung 2/8 (Patent Session) at 128; Wamsley 7/10 at 14; *Festo*, 535 U.S. at 731-32; HARMON, PATENTS AND THE FEDERAL CIRCUIT § 6.3(a)(ii) at 343.

processes.¹⁸⁹ It may be unrealistic, some thought, to expect patentees to foresee and provide against all such tinkering; the inherent limits of language may ensure that whatever words are chosen will prove insufficient to cover every eventuality.¹⁹⁰ Others, however, stressed that leaving claim boundaries obscure increases uncertainty and makes negotiation and business planning more difficult.¹⁹¹ One panelist noted a further effect of the doctrine: it forces competitors to steer away from designs that would come close to literal infringement and instead direct their efforts toward beneficial, leapfrog innovation.¹⁹² The same effect, however, could also be viewed as permitting uncertainty to enhance the patentee's right to exclude,¹⁹³ suggesting that an unduly broad doctrine of equivalents can have a competitive downside.

b. Analysis

Recent trends show a narrowing of the doctrine of equivalents.¹⁹⁴ The Supreme Court's earlier decision in *Warner-Jenkinson Co. v. Hilton Davis Chemical Co.*¹⁹⁵ and its more recent decision in *Festo*¹⁹⁶ narrow the

¹⁸⁹ See Sobel 7/10 at 173-178.

¹⁹⁰ See Dreyfuss 7/10 at 83; Sobel 7/10 at 172.

¹⁹¹ See, e.g., Kieff 4/10 at 38-39; Kesan 4/10 at 196-97.

¹⁹² See Sobel 7/10 at 175.

¹⁹³ See *id.* at 80.

¹⁹⁴ See Wamsley 7/10 at 13-15.

¹⁹⁵ *Warner-Jenkinson Co. v. Hilton Davis Chemical Co.*, 520 U.S. 17 (1997).

¹⁹⁶ *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co., Ltd.*, 535 U.S. 722 (2002).

doctrine through application of prosecution history estoppel.¹⁹⁷ Other recent cases have kept tight rein by insisting on element-by-element comparisons with literal claims¹⁹⁸ and by deeming matter disclosed in the specification but not included in the literal claims to be excluded from the doctrine's operation.¹⁹⁹

In deciding how to interpret and apply the doctrine of equivalents, both the Supreme Court and the Federal Circuit have explicitly noted and discussed the tradeoffs involved.²⁰⁰ The Supreme Court stated:

It is true that the doctrine of equivalents renders the scope of patents less certain. . . . If competitors

¹⁹⁷ As explained by *Festo*, "When . . . the patentee originally claimed the subject matter alleged to infringe but then narrowed the claim in response to a rejection, he may not argue that the surrendered territory comprised unforeseen subject matter that should be deemed equivalent to the literal claims of the issued patent." *Festo*, 535 U.S. at 733-34. The Court in *Festo* resolved questions regarding the nature of amendments that give rise to this estoppel and the circumstances under which some equivalents may still infringe. *Id.* at 735-41. The Federal Circuit has recently remanded the case for trial court determination whether one of those circumstances – the possibility that the equivalent was unforeseeable at the time of the claim amendment – was present. *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 344 F.3d 1359 (Fed. Cir. 2003).

¹⁹⁸ See, e.g., *Cooper Cameron Corp. v. Kvaerner Oilfield Products, Inc.*, 291 F.3d 1317 (Fed. Cir. 2002); see also Sung 2/8 (Patent Session) at 128-29 ("Ninety-nine of the elements or limitations may be identical in nature but the court is still going to only focus on that one particular element to decide is that change in that element substantial or insubstantial.").

¹⁹⁹ See *Johnson and Johnston Assoc. v. R.E. Service Co.*, 285 F.3d 1046 (Fed. Cir. 2002) (*en banc*).

²⁰⁰ See *supra* Ch. 1(III)(A)(2)(b) and *infra* Ch. 6(I)(B)(1)(C).

cannot be certain about a patent's extent, they may be deterred from engaging in legitimate manufactures outside its limits, or they may invest by mistake in competing products that the patent secures. . . . Each time the Court has considered the doctrine, it has acknowledged this uncertainty as the price of ensuring the appropriate incentives for innovation, and it has affirmed the doctrine over dissents that urged a more certain rule.²⁰¹

The Supreme Court concluded that, if the doctrine of equivalents were to be discarded, Congress should do so and not the Court.²⁰² These cases reflect decisions made with an awareness of the importance of public notice as well as a concern for the patentee's ability to secure the benefits of its patent.

D. Utility and Research Issues

One question is how to determine when an invention has evolved to the point that it should receive a patent. If patents covered very basic research, for example, then patent law could deter much follow-on innovation by independent inventors. If, in contrast, an inventor could not receive a patent on an invention ready for commercialization, that would substantially undermine the incentives of the patent system. Two means exist to address these issues. First, the statutory standard of utility requires that an invention be "useful" to receive a patent.²⁰³ Second, a common-law

²⁰¹ *Festo*, 535 U.S. at 732.

²⁰² *Id.* at 739.

²⁰³ 35 U.S.C. §§ 101 and 112.

"experimental use" exemption has developed, upon which researchers sometimes rely to exempt their activities from infringement claims.

1. The Utility Standard

Inventions must be "useful" to support issuance of a patent. As it has evolved, the utility standard is relatively lenient and typically is not a significant barrier to patentability.²⁰⁴ It has had some application, however, in biotechnology and chemistry, in which inventions may be forthcoming before their precise use is known.²⁰⁵

The utility doctrine may be important in protecting basic research from premature patenting. Analysts have characterized the utility requirement as "a timing device, helping to identify when an invention is ripe for patent protection."²⁰⁶ Its use relates to concerns that patents on basic research, very far upstream, may impede follow-on innovation by virtue of effects on incentives

²⁰⁴ See, e.g., Thomas 2/8 (Patent Session) at 39-40 ("generally that's a very lenient standard"); Caulfield 3/19 at 183 (utility test "a very big screen through which a lot of material goes"); Rai 4/10 at 106 (utility standard "low"); Kunin 4/10 at 123-24 (a single utility provides protection against all uses); Kieff 4/10 at 126 (questioning need for separate utility requirement); *but cf.* Kushan 4/11 at 85-86 (outlining how applicant's utility characterizations might be used to greater effect in applying other criteria of patentability).

²⁰⁵ See, e.g., *Brenner v. Manson*, 383 U.S. 519 (1966); *In re Brana*, 51 F.3d 1560 (Fed. Cir. 1995); Thomas 2/8 (Patent Session) at 40-42.

²⁰⁶ See Rebecca S. Eisenberg, *Analyze This: A Law and Economics Agenda for the Patent System*, 53 VAND. L. REV. 2081, 2087 (2000).

and on access to upstream technology.²⁰⁷ Commentary from the last few years has focused in particular on how inventors may have to combine a high number of basic patents to yield a downstream product. Some worry that too early patenting will create an “anticommons,” a setting in which follow-on technology is inadequately developed because too many upstream owners each hold separate patent rights.²⁰⁸ Analysts concerned with patenting “too close to the laboratory bench”²⁰⁹ have urged application of a somewhat more rigorous utility standard as a means to avoid such consequences.²¹⁰

The PTO has responded to concerns such as these by issuing (and revising) a set of Utility Examination Guidelines.²¹¹ These Guidelines require that before a patent can issue, there must be a utility well-established in the art (a utility that would be immediately appreciated by a person of ordinary skill in the art), or the applicant must have asserted a

specific, credible, and substantial utility.²¹² The Guidelines, as revised in 2001, have largely been well received,²¹³ and the Hearing record does not highlight substantial competitive issues regarding utility examination.

2. Experimental Use and Research Tools

The experimental use defense for research activities has been described as “a very nascent, ill-developed principle from a few early cases in the 19th century.”²¹⁴ Case law traditionally has exempted research activities that are noncommercial and “for amusement, to satisfy idle curiosity, or for

²¹² See *Id.* at 1098-99; Thomas 2/8 (Patent Session) at 45; Chambers 2/8 (Patent Session) at 46-47.

²¹³ See, e.g., Beier 2/26 at 297 (“the stakeholders are largely pleased”); Rai 4/10 at 23-24 (“applaud[ing]” the PTO for taking an “appropriately cautious approach”); Biotechnology Industry Organization, *Testimony* (2/26/02) 6, 8, at <http://www.ftc.gov/opp/intellect/020226davidwbeier.pdf>; see also John P. Walsh et al., *Effects of Research Tool Patents and Licensing on Biomedical Innovation, in PATENTS IN THE KNOWLEDGE-BASED ECONOMY 299* (Wesley M. Cohen & Stephen A. Merrill eds. 2003) available at <http://books.nap.edu/books/0309086361/html/285.html#pagetop> (hereinafter *Research Tool*). But cf. Bendekgy 2/26 at 304 (Utility Guidelines not a “huge improvement”).

²¹⁴ Thomas 2/8 (Patent Session) at 30. The doctrine often is traced to an 1813 opinion by Supreme Court Justice Story on circuit. See *Whittemore v. Cutter*, 29 F. Cas. 1120, 1121 (C.C.D. Mass. 1813) (“It could never have been the intention of the legislature to punish a man who constructed such a machine merely for philosophical experiments, or for the purpose of ascertaining the sufficiency of the machine to produce its described effects”). There is no general statutory exemption covering experimental use of patented inventions. 35 U.S.C. § 271(e)(1) provides a limited exemption from infringement for uses reasonably related to the development and submission of information in order to secure Food and Drug Administration approval of pharmaceutical drugs.

²⁰⁷ See, e.g., Caulfield 3/19 at 158-62; Rai 4/10 at 23-24, 51-52. See generally *supra* Ch. 4(II)(B)(2).

²⁰⁸ See, e.g., Thomas 2/8 (Patent Session) at 43-44; Scherer 7/10 at 56-57; Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 *SCIENCE* 698 (1998).

²⁰⁹ Thomas 2/8 (Patent Session) at 42.

²¹⁰ See, e.g., Barton 2/26 at 222; Rai 4/10 at 23-24 (suggesting cautious use of the utility standard to limit patenting in “certain narrow [upstream] areas,” but warning that the utility standard ought not to be set too high as a general matter).

²¹¹ United States Patent and Trademark Office, *Utility Examination Guidelines*, 66 Fed. Reg. 1092 (2001) (current guidelines).

strictly philosophical inquiry.”²¹⁵ The strength and contours of the defense have not been fully tested; as several panelists testified, corporations typically have not sued universities.²¹⁶ Some, however, have questioned whether the truce will endure,²¹⁷ and, if it does not, whether the existing experimental use doctrine will afford much protection.²¹⁸

The situation grew more complicated in October 2002 with issuance of a Federal Circuit opinion rejecting application of the experimental use defense.²¹⁹ The court ruled the defense inapplicable “regardless of whether a particular institution or entity is engaged in an endeavor for commercial gain, so long as the act is in furtherance of the alleged infringer’s legitimate business and is not solely for amusement, to satisfy idle curiosity, or for strictly philosophical inquiry”²²⁰ Moreover, the court determined that research projects with no

²¹⁵ See *Roche Products, Inc. v. Bolar Pharmaceuticals Co.*, 733 F.2d 858, 863 (Fed. Cir.), cert. denied, 469 U.S. 856 (1984).

²¹⁶ See, e.g., *Blackburn* 2/26 at 325; *Dickinson* 10/25 at 187; *Mossinghoff* 10/30 at 168.

²¹⁷ See *Merrill* 10/30 at 169; cf. *Caulfield* 3/19 at 183 (patentees increasingly demanding royalties from universities).

²¹⁸ See, e.g., *Sung* 2/8 (Patent Session) at 136-38 (seeing no experimental use exception, “broadly” speaking and describing it as “potentially anachronistic” and “extremely difficult” to establish); *Cohen* 10/30 at 152 (seeing an “extraordinarily narrow” exemption); *Janice M. Mueller, No “Dilettante Affair”: Rethinking the Experimental Use Exception to Patent Infringement for Biomedical Research Tools*, 76 WASH. L. REV. 1, 17-24 (2001).

²¹⁹ See *Madey v. Duke University*, 307 F.3d 1351 (Fed. Cir. 2002), cert. denied, 123 S. Ct. 2639 (2003).

²²⁰ *Id.*, 307 F.3d at 1362.

commercial applications “unmistakably further” a research university’s “legitimate business objectives, including educating and enlightening students and faculty participating in these projects.”²²¹ Although the panelists differed regarding how much precedential power to attach to the opinion’s holding,²²² the discussion indicated that the opinion could unsettle expectations regarding the availability of an experimental use defense and could have a chilling effect on university research.²²³

Panel discussion of the research exemption highlighted three distinct

²²¹ *Id.*

²²² Compare *Cohen* 10/30 at 161 (arguing that the case essentially deprives universities of the experimental use defense because research is the business of a university) with *Kitch* 10/30 at 165-66 (arguing that Duke asserted a very broad position – that anything used by a university in research cannot infringe – and suggesting that a more targeted research defense might be better received) and *Mossinghoff* 10/30 at 168 (case presents a unique set of facts and consequently is not of much guidance). The case involved Duke’s use of laser equipment that incorporated components covered by a former employee’s patents.

²²³ See *Cohen* 10/30 at 149-52, 162-63 (noting potentially significant chilling effect on those who previously assumed that they were protected by experimental use defense). The precise meaning of the Federal Circuit’s opinion remains in debate. In seeking *certiorari*, Duke University argued that, by its rulings regarding the legitimate business of universities, the opinion necessarily bars application of the experimental use defense to private universities. Petition for a Writ of *Certiorari*, at 14, *Duke University v. Madey* (No. 02-1007) (2002). In contrast, the United States opposed *certiorari* on grounds that by remanding for consideration of both “the legitimate business that Duke is involved in and whether or not the use was solely for amusement, to satisfy idle curiosity, or for strictly philosophical inquiry,” 307 F.3d 1351, 1363 (emphasis added), the court preserved the traditional, narrow experimental use defense. See Brief of Amicus Curiae for the United States, *Duke University v. Madey* (No. 02-1007), available at <http://www.usdoj.gov/osg/briefs/2002/2pet/6invit/2002-1007.pet.ami.inv.html>.

scenarios.²²⁴ One involves research on a patented invention to see how or if it works. Panelists generally supported a research exemption for this purpose.²²⁵ A second scenario involves research to improve a patented invention, either creating a blocking situation (in which both the initial and the follow-on innovator need licenses to use the other's invention) or designing around the initial patent. This case was cast as a middle ground, invoking potentially conflicting goals of fostering competition for improvements and protecting incentives of, or coordination by, the initial innovator.²²⁶ Panelists expressed a range of views – from support through uncertainty and doubt – whether this research should be exempted.²²⁷ Third, there is the possibility of using a patented item as a research tool to create an unrelated product. Panelists generally voiced objections to exempting patented items produced for use by researchers.²²⁸

²²⁴ See Duffy 10/30 at 170-74; see also Eisenberg, 56 U. CHI. L. REV. at 1074-76.

²²⁵ See, e.g., Kitch 10/30 at 167; Duffy 10/30 at 171.

²²⁶ See Duffy 10/30 at 160, 172-74.

²²⁷ See, e.g., Barton 2/26 at 172 (supporting compulsory licensing, with or without royalty, for research in this context); Duffy 10/30 at 172 (noting Professor Kitch's nodded assent to statement of reservations), 173-74 ("a hard question"); Kitch 10/30 at 167.

²²⁸ See, e.g., Barton 2/26 at 221; Bendekgey 2/26 at 258-59, 267-68; Kitch 10/30 at 163-64, 166 (emphasizing adverse effect on incentive to produce equipment for researchers). Some panelists identified a separate variant of the third research category. They focused on a subset of patented research tools that are not sold as products in the marketplace, but rather are used only to develop products that are sold. An example might be a patent on a target or receptor used in biotechnology. See McGarey 11/6 at 159; Blackburn 2/26 at 260-61. The Hearing record, however, did not resolve whether this subset warranted separate analysis for purposes of an

a. *Analysis*

Both scholarly analysis and Hearing participants favor an experimental use defense in the first setting.²²⁹ Research to determine if or how a patented invention works essentially makes effective the required enablement disclosure. Indeed, some of the panelists suggested that such activity is already covered by the experimental use defense.²³⁰ The primary issue, then, appears to be whether a more explicit affirmation would be useful.

Extending an experimental use defense to infringement arising through use of tools to develop unrelated products appears problematic. Inventors of tools used by researchers need an income stream from those who use their inventions. The Hearing record provides no basis for exempting such tools from patent protection, and leading scholarly commentary agrees.²³¹

experimental use defense. Compare McGarey 11/6 at 159 (distinguishing, in a context of discussing reach-through royalties, "broad enabling tools that are not destined to be products themselves one day" from tools that are "produce[d] as a product") and Caulfield 3/19 at 158-59, 161-63 (recommending a research exemption to encourage genomic research) with Blackburn 2/26 at 262-63 (viewing patent protection as essential for maintaining proper incentives and raising venture capital for future research tool development).

²²⁹ See Eisenberg, 56 U. CHI. L. REV. at 1074-75.

²³⁰ See Armitage 3/19 at 186. In fact, this first scenario was expressly referenced by Justice Story in *Whittemore v. Cutter*, 29 F. Cas. at 1121. See *supra* note 214. A defense of this nature is typically available abroad. See Duffy 10/30 at 171.

²³¹ See Eisenberg, 56 U. CHI. L. REV. at 1074. Citing concerns over increasing royalty stacking problems in biotechnology, one author advocates compulsory licensing, under reasonable, reach-through royalty arrangements, of research tools used in developing other products. See Mueller, 76 WASH. L. REV. at 58. A recent

Use of a patented invention in research directed toward its own improvement poses the most difficult problem, because it affects the division of profits between initial and competing follow-on innovators, both of which need adequate incentives if their independent contributions are to be sustained.²³² Arguably, such use could be justified as essentially an extension of disclosure requirements.²³³ Some have argued that a research exemption for improvers might be “consistent with the overall thrust of our patent system”²³⁴ and is

survey, however, indicates that, at least thus far, the negotiation breakdowns and royalty stacking problems suggested by anticommons theories have not significantly blocked biomedical research. See Cohen 10/30 at 149; Walsh, et al., *Research Tool* at 297-300. Moreover, a panelist explained that many significant research tools are now covered by National Institutes of Health requirements ensuring nonexclusive licensing, see Boulware 10/30 at 155-57, and this may mitigate some of the concerns regarding research tools in biotechnology.

²³² Of course follow-on innovation may also come from other routes: an initial innovator with a broad patent covering future development might pursue, or license others to pursue, the follow-on innovations. See, e.g., Kitch 2/20 at 83-84; Scotchmer 2/26 at 129-30.

²³³ See *Integra Lifesciences I, Ltd. v. Merck KgaA*, 331 F.3d 860, 875, 878 (Fed. Cir. 2003) (Newman, dissenting) (arguing that the prohibition of improvement research cannot be squared with the framework of patent law and distinguishing between research into the technology used in patents and the use in research of patented products or methods). In some settings, such as with some methods and processes, follow-on innovators may develop improvements simply from knowledge of the nature of the patented invention; in other settings, such as in software contexts in which the program must be run in order to support any improvement efforts, the patented invention must be used. Plainly, the need to secure a license in order to develop an improvement is more a matter of the nature of the invention than of any general patent law principle.

²³⁴ See Duffy 10/30 at 173-74; see also MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 1008 (“Traditionally, patent law has operated on the assumption that other inventors remain free to seek improvement patents within the claims of an earlier

widely accepted abroad.²³⁵ Others note that so long as follow-on research yields a product or process that infringes the initial patent, the initial patentee will share in any follow-on benefits even if the research is deemed non-infringing. Nonetheless, they concede, the patentee would be harmed if the research designs around the patent.²³⁶ With such offsetting incentive effects, the ideal balance is unclear.

The Federal Circuit’s ruling in *Madey v. Duke University* has a potential to upset the equilibrium regarding research uses of patented inventions and may heighten any problems raised by uncertainty over the reach of the experimental use defense. This warrants continued attention as the implications of these recent developments in the law become better understood.

E. Business Method Patents: An Illustration of Transition Issues

Section 101 of the Patent Act states, “Whoever invents or discovers *any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof*, may obtain a patent”²³⁷ Despite this broad mandate, courts have long interpreted certain types of inventions as unpatentable. Traditional common law

patent.”).

²³⁵ See Duffy 10/30 at 172-74 (“de facto, there is a research exemption like that in U.S. law. It’s called Europe.”); MERGES & DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS at 1015-16; Mueller, 76 WASH. L. REV. at 37-39.

²³⁶ See Eisenberg, 56 U. CHI. L. REV. at 1076.

²³⁷ 35 U.S.C. § 101 (emphasis added).

exceptions include phenomena of nature, abstract intellectual concepts, mental steps, mathematical algorithms with no substantial practical application, printed matter and, for many years, business methods.²³⁸ Over time, however, these common law exceptions to patentability have eroded.²³⁹

The applicability of § 101, and its common law exceptions, to business methods received particular attention during the Hearings.²⁴⁰ According to the PTO, business methods follow software controlled microprocessors as the next step in the “unbroken evolutionary path” in business data processing.²⁴¹ As one panelist stated, “99 percent of . . . business method inventions are automated techniques for doing something that people used to do in a nonautomated way.”²⁴²

Some Hearing participants observed

²³⁸ See, e.g., Thomas 2/8 (Patent Session) at 25-27, 32, and John Thomas, *Patent Law & Policy: An Introduction* (2/8/02) (slides) at 17, at <http://www.ftc.gov/opp/intellect/jayth1.pdf> and 4/11 at 73; Sung 2/8 (Patent Session) at 139.

²³⁹ See, e.g., Nydegger 4/11 at 106-07; Thomas 4/11 at 70. In two landmark decisions, *Diamond v. Chakrabarty*, 447 U.S. 303, 310 (1980), and *Diamond v. Diehr*, 450 U.S. 175, 185 (1981), the Supreme Court held, respectively, that man-made, living organisms and computer software constitute patentable subject matter under Section 101.

²⁴⁰ Though business method patents were discussed intermittently throughout the Hearings, the following sessions provided sustained treatment: 2/27 (pm); 3/19 (am); 3/20 (pm); and 4/11 (am).

²⁴¹ See generally AUTOMATED FINANCIAL OR MANAGEMENT DATA PROCESSING METHODS (BUSINESS METHODS), USPTO WHITE PAPER (March 2000) (emphasis added), at <http://www.uspto.gov/web/menu/busmethp/> (hereinafter PTO BUSINESS METHOD WHITE PAPER).

²⁴² Kushan 4/11 at 113-14.

that whenever common law exceptions to patentability erode, a transition period ensues during which the patent system struggles to adapt its standards and procedures to apply to the new technology.²⁴³ Presumably, patent quality may suffer during this period.²⁴⁴ Society’s experience with patents on “automated financial or management data processing methods (*Business Methods*)” exemplifies both such a transition period and the initiatives that may be required to minimize the problems posed during the transition.²⁴⁵ At the Hearing, discussion suggested that the challenge these transition periods pose lies not only in resolution of whatever specific problems arise when examining these newer subject matters, but – perhaps of greater importance – in the anticipation of and proactive treatment of those problems before they fully

²⁴³ See, e.g., Robert P. Merges, *As Many as Six Impossible Patents Before Breakfast: Property Rights for Business Concepts and Patent System Reform*, 14 BERKELEY TECH. L.J. 577, 589 (1999).

²⁴⁴ John Love 2/27 at 467 (The PTO undertook the Business Method Initiative “partially in response to a public concern about the quality of patents that were being issued in the business method area . . .”). See also Merges, 14 BERKELEY TECH. L.J. at 589 (noting that the scope of the transition problem may be worse for business methods than in the early years of software and biotech patents owing to the “simple matter of overall volume” – the rapid increase in the number of business method applications filed).

²⁴⁵ See PTO BUSINESS METHOD WHITE PAPER at iv (The PTO Business Method Initiative culminated in a white paper that “discusses the patent history of business data processing, the transition this technology is beginning, and the initiatives the USPTO is engaged in to keep pace with this transition and to improve quality in the examination of this technology.”). In 1999, Congress took steps to ease the transition to an era of business method patenting by creating a defense to infringement allegations in the form of prior user rights covering third parties who (i) reduce a business method to practice at least a year before the filing of a patent application and (ii) use that business method before the application’s effective filing date. 35 U.S.C. § 273(b). See *supra* Ch. 4(II)(C)(1).

materialize.²⁴⁶

More fundamentally, the continuing debate regarding business method patents raises the issue of the proper boundaries of patentable subject matter and provides an opportunity to consider some of the ongoing controversies (including the relationship between innovation and patents) underlying the patent system more generally. As these issues arise in fresh contexts, policy makers should use the opportunities to ensure that the patent law reflects an integration of competition values.

1. Legal Status of Business Method Patents

In *State Street Bank & Trust v. Signature Financial Group*, the Federal Circuit ruled that business methods can be patented.²⁴⁷ The court held, “[s]ince the 1952 Patent Act, business methods have been, and should have been, subject to the same legal requirements for patentability as applied to any other process or method.”²⁴⁸ Whatever the status of business method patents prior to 1998,²⁴⁹ *State Street* clearly sanctioned their use prospectively. The

²⁴⁶ Aharonian 2/27 at 551.

²⁴⁷ *State Street Bank & Trust v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998), cert. denied, 525 U.S. 1093 (1999).

²⁴⁸ *State Street*, 149 F.3d at 1375.

²⁴⁹ Panelists expressed a wide range of opinions about whether *State Street* accurately captured the prior treatment of business methods under patent law. Compare Thomas 4/11 at 71 (“[P]atent law has been concerned about business methods from the very beginning. The earliest common law antecedent . . . said business methods are out.”) with Dickinson 2/6 at 67 (stating that business method patents have been issuing “since the mid-1860’s on”).

Federal Circuit’s ruling launched a surge in the number of business method patent filings, though, in absolute terms their numbers remain relatively small.²⁵⁰ In its 2000 White Paper on business methods, the PTO noted that *State Street* “triggered an awareness of the ‘business method claim’ as a viable form of patent protection. We are at the beginning of a change in the approach to how inventors choose to describe their inventions.”²⁵¹

2. Application of Patentability Criteria to Business Methods

Panelists had decidedly mixed assessments regarding both the quality of business method patents issued to date and the prospects for improving quality in the future. In general terms, some worried that the level of abstraction and the multi-disciplinary nature of many business methods prevent efficient application of traditional patent standards.²⁵² Others, however, found little cause for concern; like other areas of patent growth, they reasoned, business method patenting will undergo a maturation process that will eliminate initial

²⁵⁰ Dickinson 2/6 at 68. The PTO assigns most computer-implemented business method patent applications to Class 705, which encompasses automated business data processing technologies. PTO BUSINESS METHOD WHITE PAPER at 6. In FY 1999, the 2658 Class 705 applications represented approximately 1% of all applications filed with the PTO. *Id.* at 7. In FY 2000, 7800 Class 705 applications were filed, out of which the PTO issued 899 patents. In FY 2001, the PTO anticipated 10,000 Class 705 applications would be filed, with over 400 patents issued from among them. Joy Y. Xiang, *How Wide Should the Gate of “Technology” Be? Patentability of Business Methods in China*, 11 PAC. RIM L. & POL’Y J. 795, 828 n.103 (2002).

²⁵¹ PTO BUSINESS METHOD WHITE PAPER at iv.

²⁵² See, e.g., Kahin 4/11 at 18-20.

difficulties.²⁵³ Panelists tended to focus upon the application of several traditional patentability criteria – nonobviousness, written description, and enablement – when assessing PTO grants of business method patents.²⁵⁴

a. Nonobviousness

As discussed previously, nonobviousness is at the core of patent law, and prior art is at the core of nonobviousness.²⁵⁵ The PTO recognized that inventors' increased patenting of business methods required changes in the examination process, including a shift in the examiner knowledge base.²⁵⁶ Locating prior art is particularly difficult for business methods. In part this stems from the infrequency with which such patents previously were sought.²⁵⁷ Other factors – the absence of a drive to publish within business method fields (unlike, for example, the sciences), and the fact that commercial practices in question often only exist in the “heads of business persons” – are systemic problems that may

be more unique to business methods.²⁵⁸

Given the centrality of prior art to nonobviousness determinations, the effective identification of non-patent prior art is critical to ensuring that the PTO issues quality business method patents. Accordingly, former PTO Director Dickinson undertook the Business Method Initiative, which had two primary goals: 1) the identification of sources of non-patent literature, and 2) the creation of mandatory fields of search for examiners.²⁵⁹ Identifying sources of non-patent prior art more generally is likely to be an ongoing task for the PTO, as technological advances multiply and the number of patent applications continues to rise.²⁶⁰

Assessing prior art poses an additional challenge for the PTO. Is the automation of an existing business method inherently obvious? The PTO responded to this challenge by implementing another level

²⁵³ See, e.g., Myrick 10/30 at 186-87; Stoll 4/11 at 170. For a recent empirical study concluding that Internet business method patents “were no worse than patents in general in the late 1990s . . . and may have been better than average,” see John R. Allison & Emerson H. Tiller, *The Business Method Patent Myth*, 18 BERK. TECH. L. J.— (forthcoming 2003), in draft at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID421980_code030727560.pdf?abstractid=421980.

²⁵⁴ See, e.g., Kushan 4/11 at 104, 113; Janis 4/11 at 65-66.

²⁵⁵ See *supra* Ch. 4(II)(A).

²⁵⁶ See generally PTO BUSINESS METHOD WHITE PAPER at 8-10.

²⁵⁷ See, e.g., Gable 3/20 at 116-18.

²⁵⁸ Thomas 4/11 at 111. Recent research, however, cautions against overemphasizing distinctions between business method patents and other patents based on the accessibility of prior art. See John R. Allison & Emerson H. Tiller, *Internet Business Method Patents, in PATENTS IN THE KNOWLEDGE-BASED ECONOMY* at 259, 260 (Wesley M. Cohen & Stephen A. Merrill eds. 2003) (“We conclude that criticisms of Internet-related patents that focus on prior art in particular should be taken with some caution, as we find the statistical differences between these patents and more general patents to be small and, if anything, to suggest that Internet-related patents are well supported by prior art references.”), available at <http://books.nap.edu/books/0309086361/html/260.htm#page01>.

²⁵⁹ Love 2/27 at 467-68.

²⁶⁰ For example, when the Commission on Patent Law Reform sat over ten years ago, see *supra* Ch. 1, Box 1-5, the Commission recommended that the PTO create its own database, because “the technology develops so rapidly that you really are not going to find in the patent database the real prior art” Taylor 2/27 at 473.

of review of business method patents by a more senior examiner or examination panel, known as a “second pair of eyes.” The PTO recognized that applying patentability criteria to emerging technologies may be difficult or, at minimum, might differ from their application to more established subject matter, and that more senior examiners could assist with the tough judgment calls that ensue. PTO Group Director for Cryptography and Security Technology Center (TC 2100) John Love noted that the allowance rate for Class 705 (covering most computer-implemented business methods) has consistently decreased since the program was introduced and interpreted this as an indication that patent quality has increased.²⁶¹ Presumably, a second review of this nature might heighten the quality of patentability determinations in other areas of emerging technology as well, as recently suggested by the PTO’s 21st Century Strategic Plan.²⁶²

b. Written Description

Panelists expressed concern that business method patents will contain claims that encompass every manner of

²⁶¹ John Love 2/27 at 475. Love stated the allowance rate for Class 705 was 55 percent in 2000 (the reforms were in place for the second half of 2000) and 45 percent in 2001. *Id.* at 470-71. Love further stated that the reduction in Class 705 patents issued indicates improved searching on the part of the PTO for prior art and, he hoped, the narrowing of claims so that they more closely capture a patentee’s innovative contribution. *Id.* at 475.

²⁶² United States Patent and Trademark Office 21st Century Strategic Plan, *Patent Quality Improvement: Expansion of the Second-Pair-of-Eyes Review* (April 2, 2003), at <http://www.uspto.gov/web/offices/com/strat21/action/q3p17a.htm>. See *infra* Ch. 6(III)(A)(2).

implementing a particular business model.²⁶³ In theory, rigorous application of the written description requirement, which ensures that the inventor has invented what the patent application claims, might avoid such results.²⁶⁴ Some of the panelists suggested difficulties with describing business methods, however.²⁶⁵ As one panelist noted, the general concern is the difficulty of providing a consistent vocabulary to describe abstract subject matter such as high-level software patents and business method patents.²⁶⁶ Another panelist framed the issue in terms of the inherent difficulty of “defin[ing] an idea.”²⁶⁷

c. Enablement

Several panelists argued that business method patents, which frequently encompass software-automated or online processes, are not enabling. As discussed previously, enablement ensures the public is in possession of the invention, *i.e.*, it implements the patent system’s disclosure

²⁶³ Kushan 4/11 at 114. Mr. Kushan, the author of the PTO’s guidelines for computer-implemented inventions, stated that patents containing claims that encompass every manner of implementing a particular business model should not issue and that stringent written description requirements could play a preventative role. Kushan 4/11 at 114.

²⁶⁴ Kushan 4/11 at 114. See generally *supra* Ch. 4(II)(B) (discussing written description requirements). The enablement and utility doctrines might also prevent the improvident granting of such patents. Kushan 4/11 at 114-15.

²⁶⁵ See, e.g., Kahin 4/11 at 112; Young 4/11 at 112.

²⁶⁶ Kahin 4/11 at 112.

²⁶⁷ Young 4/11 at 112.

requirement.²⁶⁸ Without the publication of the underlying source code, however, some panelists questioned whether that requirement was met.²⁶⁹ For example, Mr. Kushan observed that the higher-level discussion of software currently required may not be sufficient to prove the patent works in the manner claimed or to reveal any dependence on a particular implementation.²⁷⁰ Toward that end, Mr. Kushan believes that requiring patentees to post their source code, somewhat analogous to the micro-organism deposits in the biotech area, would help achieve “the goal of satisfying public need and access to an operable invention.”²⁷¹

3. Patentable Subject Matter

Although all panelists agreed that improvement in the application of traditional patentability criteria to business methods was necessary, they disagreed as to whether such improvement would be sufficient. On one side, Mr. Kushan argued that improvement of business method patents must come through keeping the PTO’s examination “focused on the measurement criteria of inventiveness as opposed to the definitional

criteria of eligibility. . . .”²⁷² By contrast, Professor Kahin argued, “we ought to be willing to draw lines around patentable subject matter. And I say this recognizing that this is a chronic policy problem in an age of porous boundaries, that it is hard to maintain lines. But the alternative is to swallow the world, and I don’t think that’s what the patent system should be doing.”²⁷³ A number of panelists discussed the viability or value of a “technicity” requirement for drawing the line regarding patentable subject matter.²⁷⁴

The record offers substantial guidance concerning patentable subject matter more generally.²⁷⁵ On one hand,

²⁷² Kushan 4/11 at 24.

²⁷³ Kahin 4/11 at 20.

²⁷⁴ See, e.g., Thomas 4/11 at 55 (“point of patentable distinction involves . . . manipulation of natural laws . . . concerning physical elements”); Musacchia 4/9 at 26 (urging United States to move toward European and Japanese approaches requiring industrial application and technical features); cf. Hughes 2/28 at 622 (European discussions on software and business methods “could be very revealing to us”). According to the European Patent Office, “in order to be patentable, an invention must be of a technical character to the extent that it must relate to a technical field, must be concerned with a technical problem and must have technical features in terms of which the matter for which protection is sought can be defined in the patent claim.” Available at http://www.european-patent-office.org/news/pressrel/2000_08_18_e.htm. Panelists disagreed as to what this meant as a practical matter. See, e.g., Stoll 4/11 at 162 (noting that “anecdotally many, many attorneys have told me they are patenting both software and business methods in Europe”); Thomas 4/11 at 174 (noting that the UK and French patent offices “have spoken out against business methods, but the German Patent Office seems in favor of them”).

²⁷⁵ The precise boundaries of the patent system’s domain are still unresolved. Although the Supreme Court’s *Chakrabarty* opinion observes that “Committee Reports . . . inform us that Congress intended statutory subject matter to ‘include anything under the sun that is made by man,’” 447 U.S. at 309, the Court immediately adds, “This is not to

²⁶⁸ See *supra* Ch. 4(II)(B).

²⁶⁹ See also *supra* Ch. 4(II)(B)(3).

²⁷⁰ Kushan 4/11 at 102.

²⁷¹ Kushan 4/11 at 102. For a contrary view, see National Academy of Sciences Board on Science, Technology, and Economic Policy, Conference on the Operation of the Patent System: Insights from New Research 222 (Transcript of Proceedings Oct. 22, 2001) (“the Patent Office doesn’t want the source code, because they have nowhere to store it, and they have nowhere to get access to it in a useful way”), at http://www7.nationalacademies.org/step/transcript1022_PD_F.pdf (Testimony of Robert Sterne).

defenders of business method patents stressed that universality of patentable subject matter has been a significant factor in U.S. technological development.²⁷⁶ They argued that in the absence of clear empirical evidence, the default position should be that an invention is patentable. Stated alternatively, they suggested that the promotion of innovation should be presumed unless empirical evidence to the contrary exists.²⁷⁷ On the other hand, critics argued that business method patents do not foster incentives to innovate, because business methods traditionally evolve in response to competition and internal business needs, without regard to legal rights to exclusivity.²⁷⁸ In other words, it is unclear whether business method patents satisfy “but for” principles.²⁷⁹ Moreover, Yale University President Richard Levin noted possibilities for the exercise of market power and the impairment of follow-on innovation.²⁸⁰

suggest that § 101 has no limits or embraces every discovery. The laws of nature, physical phenomena, and abstract ideas have been held not patentable.” *Id.*

²⁷⁶ See Jeffrey R. Kuester & Lawrence E. Thompson, *Risks Associated with Restricting Business Method and E-Commerce Patents*, 17 GA. ST. U. L. REV. 657, 685 (2001); Kuester 4/11 at 44-45; IPO (stmt) 16 (describing patents as a bedrock of the economic incentive to innovate in all technologies).

²⁷⁷ Kuester & Thompson, 17 GA. ST. U. L. REV. at 680-81; Kuester 4/11 at 37-38, 44, 115-16; Nydegger 4/11 at 184.

²⁷⁸ See, e.g., Musacchia 4/9 at 24-26; Young 4/11 at 61, 63-64; Thomas 4/11 at 57-59.

²⁷⁹ See *supra* Ch. 4(II)(A)(2).

²⁸⁰ See R. Levin (stmt) 2 (“There are potentially serious consequences of a low threshold for patenting in emerging technology areas. A patent, after all, grants an exclusive right, and in some cases it can confer power in product and innovation markets. We should be very wary

Recommendation. Given the complexity of the issues and the diversity of views reflected in the Hearing record, the Commission makes no recommendation for judicial or legislative action to reconsider or restrict the patentability of business methods. Nonetheless, in light of the uncertainty surrounding the benefits and the possible competitive downside from extending patent coverage to new fields, future extensions, and any future reconsideration, by courts or by Congress, of patentable subject matter extensions, require – at a minimum – a conscious policy choice, in addition to a searching and rigorous application of the other patentability criteria. In assessing such future issues, decision makers should ask whether the extension of patentability will “promote the Progress of Science and useful Arts” or instead will hinder competition that can function effectively to spur innovation. Such consideration is consistent with the historical interpretation of Section 101, which typically recognizes that granting patent protection to certain things, such as phenomena of nature and abstract intellectual concepts, would not advance the patent system’s Constitutional goals.

of creating unwarranted market power by granting unwarranted patents.”); *see also*, Langenfeld 2/20 at 18; Thomas 4/11 at 60; Kushan 4/11 at 114; Robert M. Hunt, *You Can Patent That? Are Patents on Computer Programs and Business Methods Good for the Economy?*, Q1 BUSINESS REVIEW 5, 14 (2001) (finding reason to question whether business method patents will provide significant incentives to innovate). Hunt also stresses the need for “more careful empirical research on the effects of increasing the availability of patents in high technology industries” to give policymakers “more and better information about the costs and benefits of the ongoing changes in our patent system.” *Id.*

III. CONCLUSION

The Hearings highlighted both the potential benefits and potential harms of patents. Clearly, they help foster innovation. At the same time, the testimony identified a number of potential adverse effects, including greater market power, higher costs and risks for competitors, and higher costs and reduced incentives for independent follow-on innovation. The presence of both potential benefits and potential harms implies a need for making tradeoffs and judicious policy choices. In deciding issues at the interstices of the patent statutes, in amending those statutes, and in making determinations about patentable subject matter, policymakers should strive to take conscious account of the likely effects on innovation and on competition, with the goal of adopting policies that contribute most to consumer welfare over time.

In some cases, “but for” thinking can provide useful guidance for overall policy directions. For example, to the extent that the suggestion test for nonobviousness lacks convincing correlation to the likelihood that invention would occur or that it would be disclosed and developed without the patent, the test raises the potential for conferring exclusionary rights without offsetting social benefit. The Commission, therefore, urges that in assessing obviousness, the analysis should ascribe to the person having ordinary skill in the art an ability to combine or modify prior art references consistent with the creativity and problem-solving skills that in fact are characteristic of those having ordinary skill in the art. Failure to give weight to suggestions implicit from the prior art as a whole, suggestions from the nature of the problem to be solved, and the ability and knowledge of one of ordinary skill in the art

may be unnecessarily detrimental to competition.

Competitive considerations help inform other substantive aspects of the patent system. They raise questions about the commercial success test for nonobviousness and confirm the importance that courts evaluate, case by case, whether commercial success is a valid indicator of the nonobviousness of the claimed invention and that patentees bear the ultimate burden of demonstrating that the claimed invention caused the commercial success. They suggest that current disclosure doctrines accord reasonably well with economic goals at a systemic level but that accurate, up-to-date assessments of the predictability of the art and of the abilities of the PHOSITA in evolving industries are important elements for harmonizing the patent and antitrust regimes. They suggest the need to monitor carefully the consequences of *Madey v. Duke University* for the vitality of follow-on innovation and the functioning of the experimental use defense.

Finally, competition concerns suggest the need for a legislative change. The Hearing record indicates that current continuation practice disrupts business certainty and harms competition by permitting applicants to broaden their claims after competitors have developed their products and incurred sunk costs. The Commission recommends that legislation be enacted providing intervening or prior user rights that would protect third parties from hold-ups made possible by continuations.

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CHAPTER 5

COMPETITION PERSPECTIVES ON HOW PROCEDURES AND PRESUMPTIONS AFFECT PATENT QUALITY

This Chapter shifts the analysis toward procedures and presumptions and their effects on patent system quality. Assuming the substantive standards of patentability as given, this Chapter assesses the competitive impact of the principal procedures and presumptions that the patent system uses to examine, reexamine, and litigate patent validity.

In theory, to ensure patent quality, the patent system needs procedures and presumptions that work efficiently as screens, first, to protect against improvidently granted patents or patents of improper breadth, and next, to weed out any patents that are granted improvidently or with improper breadth despite the first screen. As a practical matter, however, significant questions can arise about which procedures work most efficiently to achieve high quality for commercially significant patents. For example, a recent article by Professor Lemley asserts that “the PTO doesn’t do a very detailed job of examining patents, but we probably don’t want it to.”¹ Professor Lemley notes that most patent applications involve claims of little economic significance,² and argues that

¹ See Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 Nw. L. Rev. 1495, 1497 (2001).

² See also *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy*, Lawrence J. Udell Testimony Feb. 28, 2002, at page 568 (small percentage of patents actually reaches the market) (hereinafter, citations to transcripts of these Hearings state the speaker’s last name, the date of testimony, and relevant page(s)); Linck 4/9 at 30 (only a fraction of one percent of patents are actually litigated); Taylor 10/25 at 51-52; F. Scott Kieff, *Summary of Proposed Testimony* (Public Comment) 3-4, at <http://www.ftc.gov/os/comments/intelpropertycomments/ha>

therefore “it is much cheaper for society to make detailed validity determinations in those few cases [in which patents are challenged] than to invest additional resources examining patents that will never be heard from again.”³ Thus, improvement of patent quality requires consideration of how best to invest limited resources.

Patent quality also raises process and transactions cost issues, such as how long it takes, and how much it costs, for the PTO to issue a patent and for the court system to issue a final determination of patent validity. Other questions concern how patent procedures and presumptions can affect business uncertainty.

This Chapter offers no overall assessment of patent system quality, but notes certain danger signals and focuses on identifying ways to improve procedures and presumptions that affect patent quality. The discussion shows first that patent quality may have significant effects on competition. It then looks inside the patent system to assess issues surrounding patent examination, reexamination/opposition, and litigation, highlighting in each instance ways in which a competition perspective may inform the evaluation and recommending steps that might be taken to better address competition concerns.

rvardlaw.pdf (hereinafter Kieff (stmt)).

³ Lemley, 95 Nw. L. Rev. at 1497.

I. IMPACT ON COMPETITION

Professor Jonathan Levin identified three economic consequences that, depending on potential infringers' chosen response, may flow from issuing patents of questionable validity.⁴ First, such patents may slow follow-on innovation by discouraging firms from conducting research and development in an area out of fear that they may be infringing. Of course, to the extent that fear of infringement discourages firms from entering a market, there may be distortions in prices and in resource allocation as a result of any ensuing market power. Second, even if the research does go forward, such patents may induce unnecessary licensing. Payment of royalties on an invalid patent distorts the incentive system that the patent system was designed to provide. Third, if instead the patent is challenged in litigation, the ensuing costs are a drain on the system. The impact of uncertainty complicates all of these potential economic effects. This section discusses the testimony on each of these issues.

Discouraging Entry and Innovation: Several panelists expressed concern over the potential effects on entry and competition. Judge T.S. Ellis, III, for example, noted that high litigation costs are a disincentive to market or use a process or product "close to the border to the patent scope," consequently, "improperly expanding" patent boundaries.⁵ Other panelists stressed the impact on research and development,

⁴ J. Levin 10/25 at 20-21.

⁵ See T.S. Ellis 7/11 at 110. Others voiced similar concerns. See, e.g., Thomas 2/8 (Patent Session) at 60; Pooley 2/27 at 379; Webbink 3/20 at 100.

suggesting that improperly awarded patents may distort firms' research choices and influence them to shun whole areas of R&D activity.⁶ Moreover, litigation threats can scare away venture capital.⁷

Inducing Unnecessary Licenses and Royalty Payments: For firms that choose to continue their R&D or production activities, taking a license and paying royalties on the questionable patent is another alternative. If the royalties are less than the expected value of potential litigation costs, firms may prefer to pay for the license.⁸ A number of panelists indicated that small firms, unable to bear the costs of litigation, are particularly likely to be forced to license,⁹ although some noted that large firms, with greater exposure,

⁶ See, e.g., Kirschner 2/26 at 244-45, 308-09; Earp 2/26 at 291; Friedman 2/27 at 411-12; Josh Lerner, *Into the Patent Thicket* (2/20/02) (slides) at 7, at <http://www.ftc.gov/opp/intellect/lerner.pdf> (hereinafter Lerner 2/20 Presentation); Caulfield 3/19 at 161; see also Josh Lerner, *Patenting in the Shadow of Competitors*, 38 J. L. & ECON. 463 (1995) (finding that a firm's willingness to patent in biotechnology subclasses in which others already hold patents varies inversely with the firm's projected litigation costs).

⁷ Lerner 2/20 at 188-89. Of course, doubtful claims will not always have serious consequences. Some panelists explained that demand letters asserting dubious claims often, after reasonable inquiry, may be simply ignored or may be easily countered by citing back readily found prior art. See, e.g., Garner 10/25 at 15-16; Hart 4/9 at 36-37.

⁸ See, e.g., Casey 4/9 at 68-69; Kesan 4/10 at 152-54.

⁹ See, e.g., Lerner 2/20 at 159; Kahin 3/19 at 89-90; cf. Webbink 3/20 at 100 (small firms particularly exposed when invalid claims asserted); Gambrell 10/25 at 18 (same). See generally, E. Bruce Barnes, *Comments Regarding Competition & Intellectual Property* (Public Comment) 1 (independent inventors are harmed when others assert questionable patents), at <http://www.ftc.gov/os/comments/intelpropertycomments/barnesebruce.pdf>.

are also subject to *in terrorem* effects.¹⁰ In either case, entering an unnecessary license reduces the licensees' rewards and distorts their incentives to innovate or compete.

Imposing Litigation Costs: A third possibility is litigation. The record is replete with discussion of the cost of litigation and its potential to operate as a drag on the system.¹¹ Although some panelists questioned whether patentees would frequently expose questionable patents to a litigated judgment,¹² others noted that cases are litigated and lost all the time,¹³ and that patentees limit their exposure to a loss by accumulating a range of claims from broad to narrow, so that a more limited, fall-back position will remain.¹⁴

Impact of Uncertainty: Contributing to each of these effects is the massive uncertainty that numerous panelists

described as characteristic of the patent system.¹⁵ The validity of patents emerging from the PTO often is subject to question and not resolved until the end of litigation. The scope of the patents, both in terms of their literal claims and the operation of the doctrine of equivalents, often is unclear. When unpublished applications and lengthy continuations are added to the mix, uncertainty is further magnified.

Panelists identified numerous impacts of uncertainty:

(i) Uncertain patent rights pose severe difficulties for business planning: they undermine competitors' decisions about where to channel R&D and what products to market.¹⁶ Several panelists voiced frustration at their firms' inability to know if they are infringing.¹⁷

¹⁰ See Kushan 10/25 at 22-23.

¹¹ See, e.g., Aharonian 2/27 at 460-61; Kahin 3/19 at 89-90; Musachia 4/9 at 93; Kesan 10/25 at 26; Barr 10/30 at 78; see also AMERICAN INTELLECTUAL PROPERTY LAW ASS'N, REPORT OF THE ECONOMIC SURVEY 22 (2003) (presenting survey results reporting (i) the median cost of participating in patent infringement litigation with less than \$1 million at risk as \$290,000 through discovery and approximately \$500,000 through trial and appeal; (ii) the median cost of participating in patent infringement litigation with between \$1 million and \$25 million at risk as approximately \$1 million through discovery and \$2 million through trial and appeal; and (iii) the median cost of participating in patent infringement litigation with more than \$25 million at risk as approximately \$2.5 million through discovery and \$4 million through trial and appeal).

¹² See Kieff 4/10 at 169-70; Myrick 10/30 at 95-96.

¹³ See Katsh 4/10 at 181.

¹⁴ See Pooley 10/30 at 102; Thomas 10/30 at 103-04.

¹⁵ As Professor Teece explained, "[T]here are a lot of fuzzy boundaries around intellectual property, unlike real property . . . it's only when subsequently tested in court that you know that in fact these claims are valid." Teece 2/26 at 202-03.

¹⁶ See, e.g., Sung 2/8 (Patent Session) at 109-10; Blackburn 2/26 at 295 (if "you go to your head of R&D" and ask "Can I do this," he says, "Well, invest the 800 million and I'll tell you in 10 years whether you can do it or not." And that's unacceptable."); Intellectual Property Owners Association, *Comments on the Joint Hearings of the Federal Trade Commission and the Department of Justice Regarding Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (Public Comment) 3, at http://www.ftc.gov/os/comments/intelpropertycomments/ip_o.pdf. See generally Wamsley 7/10 at 140-41 (patentee's competitors need to know what the patent rights in their industry are).

¹⁷ See, e.g., Greenhall 2/27 at 375-76 ("I really can't understand the patent landscape . . . I'm sitting with a nuclear bomb on top of my products"); Barr 10/30 at 28, 99; Banner 10/30 at 182-83.

(ii) Uncertainty heightens investment risks and equates to costs.¹⁸

(iii) Uncertainty hinders the raising of capital.¹⁹

(iv) Uncertainty disrupts the working out of licenses.²⁰

(v) Uncertainty induces litigation that imposes costs and interferes with competition and innovation.²¹

II. PATENT EXAMINATION

A. Data on Overall Performance

The Hearing record documented a surge in patent applications, described by PTO Director James Rogan as an “unprecedented explosion.”²² Applications have doubled in the last twelve years, and are increasing about 10% per year.²³ With

¹⁸ See, e.g., Fox 2/28 at 696 (finding “pervasive uncertainty” in the patent system); Black 3/20 at 161.

¹⁹ See, e.g., Teece 2/26 at 204-05 (markets are always implicitly discounting the value of patents untested in court) and David J. Teece, *Intellectual Property, Valuation, and Licensing* (2/26/02) (slides) at 4 and 5, at <http://www.ftc.gov/opp/intellect/020226davidjtece.pdf>; Ziedonis 3/20 at 18.

²⁰ See, e.g., Teece 2/26 at 203-04, 220.

²¹ See Teece 2/26 at 203-04; Wamsley 7/10 at 195.

²² Rogan 2/6 at 26.

²³ See Lerner 2/20 at 157; Chambers 2/8 (Patent Session) at 86; James Langenfeld, *Innovation, Competition, and Intellectual Property: Providing an Economic Framework* (2/20/02) (slides) at 6, at <http://www.ftc.gov/opp/intellect/langenfeld.pdf> (hereinafter Langenfeld Presentation). The record suggests numerous possible explanations for this surge in patenting activity,

yearly application totals approximating 300,000, they arrive at the rate of about 1,000 each working day.²⁴ In 2001, the PTO issued approximately 190,000 patents.²⁵

A corps of some 3,000 examiners must deal with the flood of filings.²⁶ Many

without establishing their relative significance. Some panelists attributed the increase in patent applications to an increase in the value of patents as motivators of innovation. See, e.g., Rogan 2/6 at 26 (“the value of patents as business portfolio assets has increased, their validity has become more predictable”); Dickinson 2/6 at 68-69 (“investors feel more secure in the patent system”). Some viewed the increased applications, at least in part, as a reflection of greater research and development activity. See, e.g., Mossinghoff 2/6 at 82-83; Dickinson 2/6 at 68; see also Paul F. Morgan, *Personal Comments for the Joint FTC and DOJ Public Hearings on Intellectual Property Law Beginning February 6, 2002* Entitled: “Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy” (Public Comment) 6, at <http://www.ftc.gov/os/comments/intelpropertycomments/morganpaulattachment.pdf>; Daniel Wilson, *Are We Running out of New Ideas? A Look at Patents and R&D*, FRBSF Economic Letter No. 2003-26, at 1 (Sept. 12, 2003) (observing that over the period between 1953 and 2000, R&D performed by private firms outpaced the growth in patents issued to U.S. residents). PTO Director Rogan pointed out that “the area[s] in which patents could be obtained expanded,” Rogan 2/6 at 26, and former PTO Director Dickinson made note of increased filing by foreign applicants. Dickinson 2/6 at 68. Others offered less benign explanations. For example, Cecil Quillen viewed the increased filings as “a direct consequence of the Federal Circuit’s lowered standards of patentability.” Cecil D. Quillen, Jr., *The U.S. Patent System: Is It Broke? And Who Can Fix It If It Is* (Public Comment) 12, at <http://www.ftc.gov/os/comments/intelpropertycomments/quillenattachments/isitbrokewhocanfixit.pdf>. See generally Ziedonis 3/20 at 15-16. Several panelists stressed the role of defensive patenting as contributing to the surge in patent applications. See *supra* Ch. 3(IV)(E)(2) and (V)(E)(2)(C). Adding a further level of complexity, some testimony emphasized that explanations for patenting may vary from industry to industry. See, e.g., Cohen 2/20 at 29-33.

²⁴ See Chambers 2/8 (Patent Session) at 86; Langenfeld 2/20 at 17 and Langenfeld Presentation at 6.

²⁵ Dickinson 2/6 at 65.

²⁶ See Chambers 2/8 (Patent Session) at 84.

of the panelists saw need to provide examiners more time per examination.²⁷ Lacking official statistics, panelists varied in their estimates of the amount of time available to examine an application from start to finish, but all indicated that it was very short. Participants stated estimates of 24.9 hours at the outside, but often half that,²⁸ 21 hours,²⁹ 20 to 25 hours,³⁰ 18 hours,³¹ 8-18 hours,³² and more than 11-12, but “not a lot of hours”³³ to read and understand the application, search for prior art, evaluate patentability, communicate with the applicant, work out necessary revisions, and reach and write up conclusions.³⁴

²⁷ See, e.g., Dickinson 2/6 at 64-65 (“Patent examiners need more time to examine.”); Kirschner 2/26 at 242-43 (time constraints “clearly inadequate” for a meaningful examination of a biotech patent application); Gable 3/20 at 121; Kesan 4/10 at 100 (time constraints do not allow adequate search for software prior art).

²⁸ Chambers 2/8 (Patent Session) at 88.

²⁹ Seide 3/19 at 219.

³⁰ Kirschner 2/26 at 243.

³¹ Burk 3/20 at 167; see also Lemley, 95 Nw. U. L. REV. at 1500 (examiners spend an average of 18 hours during course of a patent prosecution); John R. Thomas, *Collusion and Collective Action in the Patent System: A Proposal for Patent Bounties*, 2001 U. ILL. L. REV. 305, 314 (2001) (estimating, based on an interview with the President of the Patent Office Professional Association, that the average time allocated for examiners to address an application is 16-17 hours).

³² Kesan 4/10 at 100.

³³ Chen 2/20 at 194.

³⁴ Scholars have identified other factors that could interlink with limited examination time in ways that detract from patent quality. According to one researcher, the examiner compensation system functions through a combination of base salary and bonuses, with bonus points “accumulated only for ‘dispositions,’ i.e., final allowances or rejections of patents.” Robert P. Merges, *As Many as Six Impossible Patents Before Breakfast: Property Rights*

Even with rapid handling, backlogs have been building, and pendency has been lengthening. Several panelists from a cross-section of industries indicated that current pendency periods are a significant problem.³⁵

Solid data on patent quality were limited. Some panelists took comfort in the PTO’s patent quality review data,³⁶ and some viewed an increase in the number of prior art references cited in patents as an indication that the system is functioning

for *Business Concepts and Patent System Reform*, 14 BERKELEY TECH. L. J. 577, 607 (1999). Some have suggested that given opportunities to continue prosecutions even after rejections, “the only way to earn bonus points with confidence is to allow a patent application,” *id.*, resulting in “a strong incentive to issue patents to persistent applicants, rather than to continue rejecting the applications.” Lemley, 95 Nw. U. L. REV. at 1496 n.3. Others seem to share concerns over the potential impact of examiner time-management rules on patent quality. See, e.g., David Hricik, *Aerial Boundaries: The Duty of Candor as a Limitation on the Duty of Patent Practitioners to Advocate for Maximum Patent Coverage*, 44 S. TEX. L. REV. 205, 228-229 (2002); Thomas, 2001 U. ILL. L. REV. at 324-325; see also, Dickinson 10/25 at 78 (suggesting that examiners may be reluctant to question applicants directly unless they receive “time credit” for doing so); Kushan 10/25 at 78 (same).

³⁵ See, e.g., Misener 2/27 at 396; Barr 2/28 at 678; Armitage 3/19 at 134; Gable 3/20 at 117; Young 4/11 at 63-64.

³⁶ See Dickinson 2/6 at 66-67 (finding that the data show “a remarkable consistency in quality over the long-term”); John Love 2/27 at 466-67 and John J. Love, *Steps Taken to Improve Patent Quality (2/27/02)* (slides) at 4, at <http://www.ftc.gov/opp/intellect/020227johnlove.pdf> (hereinafter John Love Presentation) (showing error rates of 5.5%, 6.6%, and 5.4% in fiscal years 1999, 2000, and 2001, respectively); see also United States Patent and Trademark Office, *FY 2002 USPTO Performance and Accountability Report* 18 (2003) (showing an error rate of 4.2%), at <http://www.uspto.gov/web/offices/com/annual/2002/>.

adequately.³⁷ Others, though, sharply questioned the adequacy of patent quality. One panelist, Professor Lemley, found that 45-46% of all patents litigated to final results are held invalid.³⁸ Another, Cecil Quillen, maintained that, when corrected for the effects of continuation applications and continuations-in-part, the PTO's grant rate, defined in terms of applications allowed as a percentage of application disposals, reached 98% in 2000, considerably higher than in Europe (67%) and Japan (64%).³⁹ "The comparative lack of rigor by the USPTO is apparent," Mr. Quillen concluded.⁴⁰ The PTO's Deputy Commissioner for Patent Examination Policy, Stephen Kunin,

³⁷ See Merges 2/28 at 591, 634, referring to John R. Allison & Mark A. Lemley, *The Growing Complexity of the United States Patent System*, 82 B. U. L. REV. 77, 101-03 (2002) (treating citations to prior art as a proxy for the rigor of examination and finding that such citations nearly tripled between 1976-78 and 1996-98).

³⁸ See Lemley 2/25 at 41-42; John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q. J. 185, 205 (1998). The result should be interpreted with caution: self-selection in bringing and settling suits makes it unlikely that patents litigated to final results are fully representative of patents as a whole. Cf. Lunney 7/10 at 92-93 (discussing self-selection bias in cases appealed to the Federal Circuit).

³⁹ See Quillen 3/19 at 31-33; Cecil D. Quillen Jr., *FTC/DOJ Hearings on Competition and Intellectual Property Law in the Knowledge-Based Economy: Statement of Cecil D. Quillen, Jr.* (3/19/02) 7 (stating also that, after adjustment for continuing applications and assuming a two-year lag, 95% of applications filed were granted in 2000), at <http://www.ftc.gov/opp/intellect/020319cecilquillen.pdf> (hereinafter Quillen (3/19 stmt)). For a fuller treatment, providing more detail regarding the underlying assumptions, see Cecil D. Quillen Jr. et al., *Continuing Patent Applications and Performance of the U.S. Patent and Trademark Office – Extended*, 12 FED. CIR. BAR J. 35 (2002); see also Cecil D. Quillen Jr. & Ogden H. Webster, *Continuing Patent Applications and Performance of the U.S. Patent Office*, 11 FED. CIR. BAR J. 1 (2001).

⁴⁰ Quillen (3/19 stmt) 7.

disputed this⁴¹ and a recent article by a PTO senior legal advisor states that the challenged calculations double-count many patents awarded through continuing applications; calculates that 74-75% of original applications ultimately resulted in patents; and concludes that the grant rate in the United States is comparable to that in Europe and Japan.⁴²

B. *Ex Parte* Nature

Patent examinations are conducted on an *ex parte* basis, involving an examiner and an applicant, but no third parties. This has several consequences for patent system quality.

First: The public is unaware of the existence of the patent application and the nature of its claims until the application is published. Under the procedures enacted in 1999, most patent applications are now published 18 months after filing.⁴³ A subset of applications, however – those that are only filed domestically – need not be published; their applicants may “opt out” of the publication requirements and maintain the secrecy of their applications until the

⁴¹ See Kunin 7/11 at 184 (PTO “will publish papers to show that the asserted allowance rates are quite overstated”); see also Mossinghoff 10/30 at 143-44 (stating that the cited numbers are “not valid”).

⁴² See Robert A. Clarke, *U.S. Continuity Law and its Impact on the Comparative Patenting Rates of the US, Japan and the European Patent Office*, 85 J. PAT. & TRADEMARK OFF. SOC'Y 335 (2003). A recalculation of Mr. Clarke's results, *id.* at 340, 343, using his own methodologies to focus just on the three most recent years in the data sample indicates for the United States that 77-81% of original applications ultimately resulted in patents.

⁴³ See *supra* Ch. 4(II)(C)(1).

patent issues.⁴⁴

Second: Because the proceeding is *ex parte*, the examiner is largely on his or her own in conducting prior art searches, a focal point of the examination process. Panelists expressed considerable concern that the PTO often may lack adequate access to prior art. They indicated that difficulties are particularly acute when non-patent prior art is important⁴⁵ and in new areas of technology, *e.g.*, software and biotechnology, and new fields of patenting activity, *e.g.*, business methods.⁴⁶ Some argued, however, that over time patent prior art in these new areas inevitably builds up and searches improve,⁴⁷ and they stressed that when specific problem areas have been identified, the PTO has undertaken substantial initiatives to enhance access to non-patent literature.⁴⁸ Others, however,

⁴⁴ See 35 U.S.C. § 122(b)(2)(B).

⁴⁵ See, *e.g.*, Lerner 2/20 at 162-63; Taylor 2/27 at 473 (discussing software); Scherer 7/10 at 69; Banner 10/30 at 75; see also Allison & Lemley, 82 B. U. L. REV. at 102 (finding, from a study of citations in a random sample of issued patents, that the "absence of non-patent prior art is particularly striking," despite having increased considerably during the twenty-year period studied).

⁴⁶ See, *e.g.*, Kirschner 2/26 at 289; Bendekgy 2/26 at 304; Friedman 2/27 at 355-56; Mowery 2/27 at 426; Aharonian 2/27 at 455-57; Webbink 3/20 at 100; Gable 3/20 at 114-15; see also *supra* Ch. 4(II)(E).

⁴⁷ See, *e.g.*, Mowery 2/27 at 426-27; Merges 2/28 at 633; Gable 3/20 at 117-18.

⁴⁸ See, *e.g.*, Chen 2/20 at 198-99 (describing the Business Methods Patent Initiative implementing an outreach program for improving access to non-patent prior art) and 2/27 at 424-25 (same); John Love 2/27 at 467-69 (same) and John Love Presentation at 6-10; *cf.* Alstadt 3/19 at 42 (noting efforts to improve search capabilities and examiner training with regard to computer-related technology). *But cf.* Taylor 2/27 at 473 (noting that longstanding recommendations for developing internal

questioned whether prior art problems will necessarily be solved in fields characterized by limited or abstract patent disclosures or lacking a culture favoring non-patent publication.⁴⁹ Some panelists concluded that internal PTO upgrades can accomplish only so much because the most relevant information is in the hands of applicants and their competitors.⁵⁰

Information in the hands of applicants is the focus of the duty of candor.⁵¹ PTO regulations provide:

databases of non-patent prior art have not been implemented).

⁴⁹ See, *e.g.*, Kesan 4/10 at 57 (in software, "[T]here is no prior art being built up . . . because . . . the knowledge, the disclosure is not there"); Thomas 4/11 at 111 (finding no drive to publish business method prior art); Kahin 4/11 at 112 (the more abstract the subject matter, the more difficult to develop a consistent vocabulary).

⁵⁰ See, *e.g.*, Chen 2/26 at 300 (competitors have best access); Kesan 4/10 at 144-47 (those best informed are patentee and its competitors); Kushan 4/11 at 89 (inventors know more than the examiner about the technology and where to search for prior art); see also Jay P. Kesan, *Carrots and Sticks to Create a Better Patent System*, 17 BERKELEY TECH. L. J. 763, 766-67 (2002). A PTO proposal to shift search functions to commercial contractors would not affect access to information in the hands of applicants and their competitors. See United States Patent and Trademark Office 21st Century Strategic Plan, *Certification of Searching Authorities* (April 2, 2003), available at http://www.uspto.gov/web/offices/com/strat21/action/q8p07_01.htm.

⁵¹ Mechanisms for securing access to relevant information in the hands of competitors are addressed in the discussion of reexamination and opposition, *infra* at Ch. 5(III). Further mechanisms, authorizing third parties to file protests prior to publication of an application and to submit patents or publications (but no explanations thereof) within two months following publication of an application, have been little used. See 37 C.F.R. §§ 1.99 and 1.291; Dickinson 10/25 at 77-78; ROGER E. SCHECHTER & JOHN R. THOMAS, *INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS* § 19.7.2 at 452-53 (2003). See generally *infra* note 141 (discussing third

Each individual associated with the filing and prosecution of a patent application has a duty of candor and good faith in dealing with the Office, which includes a duty to disclose to the Office all information known to that individual to be material to patentability

37 C.F.R. § 1.56. This duty has several limitations. It imposes no requirement to search. The applicant must reveal material prior art that already is known but has no obligation to conduct a search that would bring additional prior art to his or her attention.⁵² Moreover, the duty of candor is confined to the inventor named in the application and the attorneys and other persons who are substantively involved in preparing the application.⁵³ Consequently, prior art known to others in the inventor's laboratory may not have to be revealed.⁵⁴ Finally, the PTO's Manual of Patent Examining Procedure states that the agency "does not investigate" duty of disclosure issues and "does not . . . reject" applications on that basis.⁵⁵

party reluctance to submit prior art citations).

⁵² See United States Patent and Trademark Office, *Manual of Patent Examining Procedure* § 2001.06 (8th ed. 2001) (describing the duty in terms of "information [the covered individuals] are aware of") (emphasis original), available at <http://www.uspto.gov/web/offices/pac/mpep/mpep.htm> (hereinafter MPEP); Taylor 2/27 at 485-86.

⁵³ 37 C.F.R. § 1.56(c).

⁵⁴ See Taylor 10/25 at 53-54.

⁵⁵ See MPEP § 2010 (explaining that such Office determinations "would significantly add to the expense and time involved in obtaining a patent with little or no benefit to the patent owner or any other parties with an interest"); Chambers 2/8 (Patent Session) at 90. See generally Taylor

Third: The *ex parte* nature of the proceeding leaves the examiner on his or her own to evaluate and challenge applicants' assertions. Because the courts have placed the burden on the PTO to demonstrate grounds for rejecting a patent, rather than on the applicant to demonstrate that it meets the statutory criteria, difficulties in assembling responsive evidence work in favor of patent applicants. As the Court of Customs and Patent Appeals explained:

We think the precise language of 35 U.S.C. § 102 that "a person shall be entitled to a patent unless," concerning novelty and unobviousness, clearly places a burden of proof on the Patent Office which requires it to produce the factual basis for its rejection of an application under sections 102 and 103⁵⁶

The Federal Circuit has continued to place the burden of demonstrating unpatentability on the PTO.⁵⁷ Thus, "the burden of proof is on the examiner . . . essentially the examiner has to establish a prima facie case of unpatentability on any of the patentability criteria."⁵⁸

2/27 at 485-86 (noting the difficulty of policing a search requirement).

⁵⁶ *In re Warner*, 379 F.2d 1011, 1016 (C.C.P.A. 1967). The language relied upon, that a "person shall be entitled to a patent unless" appears in § 102 of the Patent Act, dealing with novelty but not in § 103 (dealing with nonobviousness) or § 112 (dealing with enablement, written description, best mode, and utility).

⁵⁷ See, e.g., *In re Piasecki*, 745 F.2d 1468, 1472 (Fed. Cir. 1984).

⁵⁸ Kunin 4/10 at 85; see also Chambers 2/8 (Patent Session) at 88; John Love 2/28 at 627, 645.

Yet the PTO lacks testing facilities, and assertions that cannot be overcome by documentary evidence promptly identifiable by the examiner often must be accepted.⁵⁹ The PTO's Stephen Kunin made the agency's quandary plain:

[T]o a large degree when the going gets tough, certainly the applicant is in the position to have the experts to do the testing, to submit documentary evidence to show why the examiner should allow the case. And, of course, as I said, we don't have laboratories, and we don't have independent experts in that regard. So therefore, we are really compelled to accept some of that, particularly from the standpoint of the fact finding, that is presented to us.⁶⁰

The allocation of burden, coupled with examiners' limited ability to probe applicants' assertions, may explain the significant presumptions that favor applicants during patent examinations. Many of the key issues are rebuttably presumed in the applicant's favor.⁶¹ Thus,

"If the examiner does not produce a *prima facie* case [of obviousness], the applicant is under no obligation to submit evidence of

⁵⁹ See, e.g., Chambers 2/8 (Patent Session) at 70, 88-89; Thomas 4/10 at 141.

⁶⁰ Kunin 4/10 at 167.

⁶¹ One panelist summarized, "[P]atent applicants are in a really great position because by filing an application they're presumptively entitled to receive the grant." Thomas 4/10 at 141.

nonobviousness."⁶²

"A specification disclosure which contains a teaching of the manner and process of making and using an invention in terms which correspond in scope to those used in describing and defining the subject matter sought to be patented must be taken as being in compliance with the enablement requirement . . . unless there is a reason to doubt the objective truth of the statements contained therein . . ."⁶³

"The examiner should assume that the best mode is disclosed in the application, unless evidence is presented that is inconsistent with the assumption. It is extremely rare that a best mode rejection properly would be made in *ex parte* prosecution."⁶⁴

"There is a strong presumption that an adequate written description of the claimed invention is present when the application is filed."⁶⁵

⁶² MPEP § 2142.

⁶³ MPEP § 2164.04 (citation omitted); see also Chambers 2/8 (Patent Session) at 70 ("when the application comes in there's a presumption at the Patent and Trademark Office that it is enabled"); *In re Marzocchi*, 439 F.2d 220, 223-24 (C.C.P.A. 1971).

⁶⁴ MPEP § 2165.03.

⁶⁵ United States Patent and Trademark Office, *Guidelines for Examination of Patent Applications under the 35 U.S.C. 112 ¶ 1, "Written Description" Requirement*, 66 Fed. Reg. 1099, 1105 (2001) (noting, however, that applicants should show support in the original disclosure for new or amended claims); see Chambers 2/8 (Patent Session) at 97, 100.

“Office personnel . . . must treat as true a statement of fact made by an applicant in relation to an asserted utility, unless countervailing evidence can be provided that shows that one of ordinary skill in the art would have a legitimate basis to doubt the credibility of such a statement.”⁶⁶

Even when examiners develop a *prima facie* case against patentability, they often lack the ability to probe behind the expert affidavit filed by the applicant in response, and the PTO may be compelled to accept the affidavit’s opinions and assertions.⁶⁷

Fourth: Some testimony suggested that the PTO’s *ex parte* exposure only to applicants in the course of its examination processes might limit its perspectives in ways that favor issuing patents. Panelists cited recent PTO planning documents, subsequently revised, that had identified patent applicants, rather than the general public, as the agency’s customers, and that had viewed the agency’s mission as helping

⁶⁶ United States Patent and Trademark Office, *Utility Examination Guidelines*, 66 Fed. Reg. 1092, 1098-99 (2001) (hereinafter *Utility Examination Guidelines*). See Chambers 2/8 (Patent Session) at 96 (indicating that assertions of utility, if plausible, are accepted for utility determination purposes, but may be further scrutinized as part of the enablement inquiry).

⁶⁷ See Kunin 4/10 at 166-67; Chambers 2/8 (Patent Session) at 98; *Utility Examination Guidelines*, 66 Fed. Reg. at 1099 (examiners must accept opinion from qualified expert that is based on relevant facts whose accuracy is not questioned; “it is improper to disregard the opinion solely because of a disagreement over the significance or meaning of the facts offered”).

those “customers” get patents.⁶⁸ Some warned that these narrow perspectives could affect examiners’ perceptions of their roles⁶⁹ and might influence the agency to advocate unwarranted expansions of patent protection.⁷⁰

C. Analysis

The Hearing record suggests that enhancing examiners’ access to and ability to appreciate and deal with prior art and reducing uncertainty regarding pending patent claims could improve patent quality and remove impediments to competition. Turning first to the prior art issues, this section focuses on opportunities to learn more from applicants.⁷¹ It discusses, without recommendation, proposals for increasing applicants’ duty of candor by imposing certain duties of inquiry and then presents recommendations that (i) applicants submit relevance statements, upon request of the examiner, describing the prior art cited in connection with the patent application and (ii) the PTO enhance its use of examiner inquiries during the patent prosecution process. Then, directing discussion to business certainty regarding pending patent

⁶⁸ See, e.g., Kahin 3/19 at 84, 86 and Brian Kahin, *Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (3/19/02) (slides) at 3, at <http://www.ftc.gov/opp/intellect/020319briankahin.pdf>; see also *infra* Ch. 6(III)(A)(3).

⁶⁹ Chambers 10/25 at 31-32 (examiners now view their role as serving patent applicants rather than protecting the public from bad patents).

⁷⁰ See, e.g., Kahin 3/19 at 85 and 10/25 at 190-91.

⁷¹ For discussion of ways to improve access to third parties’ expertise and prior art, see *infra* at Ch. 5(III).

claims, it recommends building upon the current 18-month filing requirement by eliminating the opportunity of those who file only domestically to opt out of publication.

1. Duty of Candor

Hearing testimony generally indicated that, so far as it goes, the duty of candor induces substantial compliance.⁷² Indeed, rather than a withholding of prior art, the more typical strategy may involve flooding the examiner with more citations than can be adequately reviewed.⁷³ In general, the record suggests that existing duties serve a useful function in prompting significant disclosure.⁷⁴

Some of the panelists urged that the duty of candor be expanded to impose some obligation to search.⁷⁵ Indeed, the PTO's 21st Century Strategic Plan initially included

⁷² See, e.g., Gabel 3/20 at 168; Taylor 10/25 at 53. *But cf.* Burk 3/20 at 168 (characterizing current duties as "toothless" in the sense that noncompliance penalties are rare).

⁷³ See, e.g., Thomas 4/10 at 167-68; Kesan 4/10 at 171-72 ("You just simply . . . throw everything over the fence") and 10/25 at 61; *but cf.* Garner 10/25 at 70-71 (no flooding in the "garden variety" case). Once the patent issues, the panelists explained, any prior art cited to an examiner is virtually "bulletproof" in court, so applicants may benefit from flooding the examiner with citations. See, e.g., Kesan 4/10 at 171 and 10/25 at 61.

⁷⁴ See, e.g., Taylor 10/25 at 53; Chambers 10/25 at 65 (duty of candor serves a useful function in an *ex parte* system); Gambrell 10/25 at 69-70; Garner 10/25 at 70; Kushan 10/25 at 73 (current rule "overall . . . is providing the right kind of impetus to disclose"). *But cf.* Linck 10/25 at 55 (arguing that firms would provide more useful information if not for the fear of violating the duty of candor).

⁷⁵ See, e.g., Aharonian 2/27 at 457. See generally Gambrell 10/25 at 70 (duty of candor should be strengthened).

a proposal to supplement the duty of candor by imposing a requirement that the applicant search prior art already in his or her possession.⁷⁶ Another modification discussed during the Hearings would extend the disclosure duty to an inventor's co-employees. Some panelists opposed expanded search duties as adding to patent preparation costs, raising difficult enforcement problems, fueling frivolous inequitable conduct defenses, or not necessarily contributing additional useful disclosure.⁷⁷

The Hearing record does not permit full assessment of the proposed revisions to the duty of candor. The cost of added search responsibilities is unclear, as is the ability to enforce effectively new obligations. Given these uncertainties, and the skepticism expressed by panelists with diverse backgrounds and varying viewpoints regarding potential benefits of an expanded duty, the Commission makes no recommendation on this topic.

2. Relevance Statements

Citing applicants' proclivity to

⁷⁶ United States Patent and Trademark Office 21st Century Strategic Plan, *Mandatory Information Disclosure Statements (IDS)*, P-09 at 3 (June 3, 2002). On February 3, 2003, the PTO announced, based on "feedback" received in the interim, that the proposal has been dropped. See United States Patent and Trademark Office, The 21st Century Strategic Plan, *available at* <http://www.uspto.gov/web/offices/com/strat21/index.htm>.

⁷⁷ See, e.g., Taylor 2/27 at 485-86, 10/25 at 54; Thomas 4/10 at 167 (questioning need for strengthening duty of candor); *cf.* Parkhurst 4/10 at 168 (finding the current duty of candor at about the right level). One panelist testified that the PTO's proposal to require applicants to search documents in their own possession had aroused substantial opposition from members of the patent bar. See Dickinson 10/25 at 50-51.

overwhelm examiners with numerous prior art citations, resulting in lots of “information” but little “knowledge,”⁷⁸ some panelists suggested that this burden could be better managed, and examination quality enhanced, if applicants were required to state the relevance of the materials cited.⁷⁹ PTO testimony indicated that this could significantly lighten examiners’ burdens.⁸⁰ Indeed, the 2002 version of PTO’s 21st Century Strategic Plan proposed requiring applicants to provide statements of relevance when citing more than 20 prior art references,⁸¹ but that proposal has now been withdrawn.⁸²

At the Hearings, relevance statements drew criticism on two accounts.

⁷⁸ See Kesan 10/25 at 60-61.

⁷⁹ See Kesan 4/10 at 147-48, 171-73 and 10/25 at 62; Parkhurst 4/10 at 168; cf. Aharonian 2/27 at 458-59 (urging that a way be found for applicants to better identify how their invention improves on the prior art).

⁸⁰ See Kunin 4/10 at 164 (“because there’s no requirement in the existing rules to identify relevancy of, in particular, U.S. patents, then the burden obviously is substantially on the examiner to acquire all the information”).

⁸¹ 21st Century Strategic Plan, *Mandatory Information Disclosure Statements (IDS)*, P-09 at 3 (June 3, 2002).

⁸² See The 21st Century Strategic Plan, available at <http://www.uspto.gov/web/offices/com/strat21/index.htm>. The plan’s current version, nonetheless, continues to acknowledge the potential benefit of relevance statements: applicants seeking to take advantage of a proposed accelerated examination procedure would need to “identify . . . [references] deemed to be the most closely related to the claimed subject matter and include a relevancy discussion for each reference identified.” United States Patent and Trademark Office 21st Century Strategic Plan, *Accelerated Patent Examination 2* (April 2, 2003), at <http://www.uspto.gov/web/offices/com/strat21/action/aep10.htm>.

Some of the testimony expressed concern that even slight errors in description could fuel claims of mischaracterization and inequitable conduct.⁸³ Other testimony focused on the cost.⁸⁴ One panelist noted that the PTO at one time required a synopsis of references but abandoned the requirement because of the expense that it had imposed in requiring attorneys to understand and properly describe all references.⁸⁵ Suggesting an alternative, two panelists indicated that it might be useful merely to require that applicants identify the most relevant references.⁸⁶ Another urged that any problem with excessive references could be managed by allotting examiners additional time in relation to the amount of prior art cited and collecting corresponding greater fees.⁸⁷

Recommendation. The Commission recommends that the PTO amend its regulations to require that, upon request of the examiner, applicants submit statements of relevance regarding their prior art references. The Hearing record suggests that such statements could materially enhance examiners’ ability meaningfully to analyze applications during the finite time available, reducing the opportunity for error and enhancing the efficiency of the examination

⁸³ See Chambers 10/25 at 63-64; Garner 10/25 at 70. See generally Dickinson 10/25 at 50-51 (noting the patent bar’s concern that prior art descriptions could raise malpractice issues).

⁸⁴ See, e.g., Garner 10/25 at 71.

⁸⁵ See Chambers 10/25 at 63.

⁸⁶ See Gambrell 10/25 at 67-68; see also Kesan 4/10 at 173 (“some [references] are more important than others. And the Patent Office should know that.”).

⁸⁷ See Garner 10/25 at 165-66.

process.⁸⁸ Objections appear surmountable. Requiring the submissions only upon the examiner's request would appropriately confine costs; when prior art references are small in number or readily reviewed and understood, applicants may face no additional burden, and the examiner sometimes may narrow the issues before selecting particular references for explanation. Indeed, current practice requires applicants to provide a "concise explanation of the relevance, as it is presently understood" of foreign-language prior art,⁸⁹ so it is clearly possible to provide explanations when benefits are likely to be high.⁹⁰ Although concern that mandatory statements of relevance could give rise to dubious allegations of inequitable conduct is well taken, the record suggests that the law in recent years has developed in ways that reduce the potential for abuse.⁹¹ Given the need to draw more fully upon applicants' knowledge to improve patent quality within the limitations of the examination system, selective requirement of relevance

⁸⁸ Even a critic of the proposal implicitly acknowledged that relevance statements could provide benefits. See Garner 10/25 at 166 (suggesting fee discounts for applicants who state the relevance of references). *cf.* Kushan 10/25 at 74-75 (questioning the value of relevance statements, given that examiners can read and understand the material, yet acknowledging value in pointing examiners to the specific portion of a reference warranting greatest attention).

⁸⁹ 37 C.F.R. § 1.98(a)(3)(i) and § 1.56(a).

⁹⁰ See Parkhurst 4/10 at 168 (suggesting that relevance disclosure practices pertinent to foreign language prior art be extended to prior art in English).

⁹¹ See Kesan 4/10 at 147 ("The standards for inequitable conduct, especially the intent requirement, have been set very high."); Wamsley 7/10 at 18-19 (suggesting that with clarification of the law as to materiality and intent in fraud and inequitable conduct cases, "we don't see as many people raising complaints of that nature now").

statements would provide a useful, and potentially highly beneficial, new tool.

3. Examiner Inquiries

A number of panelists suggested that greater use could be made of PTO Rule 105, which permits examiners to request "such information as may be reasonably necessary to properly examine or treat the matter . . ."⁹² Under existing regulations, such requests might seek, for example, copies of patent or non-patent literature used in the invention process or related to the claimed invention; a description of any search that had been conducted; and identification of whatever products or processes the claimed invention improves.⁹³ Proponents argued that Rule 105 presents substantial opportunities to improve patent examinations⁹⁴ but noted that it has not been much used, perhaps because of examiners' time constraints.⁹⁵ Very recently, however, PTO proposed amending Rule 105 to make expanded use of examiner inquiries by placing greater emphasis on seeking information through interrogatories and clarifying the record through stipulations.⁹⁶ Particularly in view of these proposals, requests for relevance statements,

⁹² 37 C.F.R. § 1.105.

⁹³ 37 C.F.R. § 1.105(a)(1).

⁹⁴ See, e.g., Thomas 4/10 at 176-78; Parkhurst 4/10 at 168-69; Kushan 4/11 at 89-90 and 10/25 at 75-76; Dickinson 10/25 at 78.

⁹⁵ See Thomas 4/10 at 176-77; Kushan 4/11 at 90 and 10/25 at 78.

⁹⁶ See United States Patent and Trademark Office, *Changes to Support Implementation of the United States Patent and Trademark Office 21st Century Strategic Plan*, 68 Fed. Reg. 53816, 53832, 53852-53 (Sept. 12, 2003).

as discussed *supra* in Ch. 5(II)(C)(2), might appropriately be added to the examples of authorized examiner inquiries.⁹⁷

Recommendation. The Commission recommends a concentrated effort to use examiner inquiries more often and more extensively. As panelist Jeffrey Kushan emphasized, “to get better quality and shrink the amount of work,” there is need to call more on the knowledge in possession of applicants, who typically “know more about the technology than the examiner does, and where you might find something that might be relevant.”⁹⁸ Unfortunately, one aspect of the governing regulation appears counterproductive:

Any reply that states that the information required to be submitted is unknown and/or is not readily available to the party or parties from which it was requested will be accepted as a complete reply.⁹⁹

As discussion at the Hearings indicated, such ready acceptance of excuses might hinder the rule’s effectiveness,¹⁰⁰ and the Commission urges that the regulation be reformulated to permit reasonable follow-up and to encourage more complete disclosure.

⁹⁷ Cf. United States Patent and Trademark Office, 68 Fed. Reg. at 53832 (indicating that expanded application of Rule 105 would cover inquiries directed at an “applicant’s interpretation of which portions of each claim correspond to the admitted prior art in the specification”).

⁹⁸ See Kushan 4/11 at 89.

⁹⁹ 37 C.F.R. § 1.105(a)(3).

¹⁰⁰ See Thomas 4/10 at 177-78.

4. Publication of Applications

As explained *supra* at Ch. 5(II)(B), most patent applications are now published 18 months after filing. Although applicants who file only domestically may opt out of such publication, roughly 90% of all applications are published.¹⁰¹ Several panelists found the publications beneficial and emphasized their contribution to business certainty and rational planning.¹⁰²

¹⁰¹ See John Love 2/28 at 647 (“very few people opt out of publication”). Patent applicants are protected from pre-issuance copying of their inventions by statutory royalty rights, provided that the patent ultimately issues. 35 U.S.C. § 154(d).

¹⁰² See, e.g., Oehler 2/26 at 253; John Love 2/28 at 647; Gable 3/20 at 118-19; Casey 4/9 at 32. Other testimony, however, sounded a cautionary note. See Hayes-Rines 3/19 at 116-17 (cautioning against creating publication rules without studies to determine effects on independent inventors). As described by one commentator, the 18-month publication requirement enacted in 1999 was compromise legislation, an effort to reconcile the interests of those who wanted the benefits of early access to patent disclosures and those who sought to preserve that information as trade secrets until the time of patent issuance. See Reiko Watase, *The American Inventors Protection Act of 1999: An Analysis of the New Eighteen-Month Publication Provision*, 20 CARDOZO ARTS & ENT. L.J. 649, 667 (2002). Proponents of pre-grant publication cited, *inter alia*, the value of early disclosure of new technology and the benefits to business planning from reducing exposure to unanticipated “submarine” patents. See *id.* at 672-73, 676-78. Opponents argued that pre-grant publication would be “particularly damaging for small business entities and individual inventors because their trade secrets would be revealed to the public before patent rights are granted, allowing larger companies to exploit their trade secrets.” *Id.* at 667-68. The statutory royalty rights provided by 35 U.S.C. § 154(d) dealt with these concerns for cases in which a patent ultimately issues; the ability to opt out of publication by filing only domestically addressed concerns of those whose inventions prove unpatentable. See *id.* at 679, 682. For additional background concerning the debates leading up to the 18-month publication requirement, see *Symposium, Early Patent Publication: A Boon or a Bane? A Discussion on the Legal and Economic Effects of Publishing Patent Applications after Eighteen Months*, 16 CARDOZO ARTS & ENT. L.J. 601 (1998).

Some panelists suggested that further benefits could flow from publishing all applications after 18 months.¹⁰³ American Intellectual Property Law Association President Ronald Myrick expressly recommended eliminating the ability to opt out of publication,¹⁰⁴ and this proposal is part of the PTO's 21st Century Strategic Plan.¹⁰⁵ Similarly, both the 1992 Advisory Commission on Patent Law Reform¹⁰⁶ and the 1966 President's Commission on the Patent System¹⁰⁷ recommended early publication of all applications. As the 1966 Report explained, "Early publication could prevent needless duplication of the disclosed work, promote additional technological advances based on the information

disclosed, and apprise entrepreneurs of their potential liability."¹⁰⁸

Recommendation. In view of the benefits of publication to business certainty and the potential competitive harms and hold-up opportunities that flow from unanticipated "submarine" patents,¹⁰⁹ the Commission recommends legislation requiring publication of patent applications 18-months after filing, whether or not the applicant also has sought patent protection abroad.¹¹⁰ The PTO could use its planned public comment period to explore the costs and benefits of mechanisms for accordng any necessary protection to independent inventors.¹¹¹

III. REEXAMINATION, OPPOSITION, AND REVIEW

Considerable discussion at the Hearings focused on issues of reexamination and proposals for opposition and post-grant review. Current procedures have significant limitations, and several of the panelists suggested possible enhancements. Panel discussion made evident that, in this area, choices necessarily reflect the initial goals. As one panelist phrased it, much follows from determining whether the intention is to provide a mechanism for limited error

¹⁰³ See Myrick 3/19 at 21 and 10/30 at 127; Casey 4/9 at 32; cf. Oehler 2/26 at 254 (emphasizing that even 18 months can "seem like an eternity" to a firm trying to determine if it is free to operate).

¹⁰⁴ See Myrick 3/19 at 21 and 10/30 at 127.

¹⁰⁵ United States Patent and Trademark Office 21st Century Strategic Plan, *Eighteen Month Publication – Elimination of Non-Publication and Redaction Exceptions and Exclusions of Plant Applications* (April 2, 2003), at <http://www.uspto.gov/web/offices/com/strat21/action/lr11hp67.htm>. The PTO indicates that as a first step, it will publish, and receive comments on, the proposed legislative change. *Id.*

¹⁰⁶ THE ADVISORY COMMISSION ON PATENT LAW REFORM, REPORT TO THE SECRETARY OF COMMERCE 23 (Aug. 1992) (Recommendation III-A(i): "Publish patent applications within 24 months from the earliest priority date claimed . . ."), available at <http://world.std.com/obi/USG/Patents/overview>.

¹⁰⁷ REPORT OF THE PRESIDENT'S COMMISSION ON THE PATENT SYSTEM at 16 (Recommendation VII: "Publication of a pending application shall occur eighteen to twenty-four months after its earliest effective filing date . . ."), reprinted in TO PROMOTE THE PROGRESS OF THE USEFUL ARTS, SUBCOMM. ON PATENTS, TRADEMARKS AND COPYRIGHTS OF THE SENATE COMM. ON THE JUDICIARY, 90TH CONG., 1st SESS. (1967) (hereinafter 1966 REPORT OF THE PRESIDENT'S COMMISSION ON THE PATENT SYSTEM).

¹⁰⁸ *Id.* at 17.

¹⁰⁹ See *supra* Ch. 4(II)(C)(1).

¹¹⁰ To protect against pre-issuance imitation following publication of the applications, the provisional royalty rights already provided by 35 U.S.C. § 154(d) should extend to all applications published after 18 months. See *supra* note 101.

¹¹¹ See *supra* notes 102 and 105.

correction or to afford a serious alternative to litigation.¹¹²

A. Current Procedures

The PTO traditionally has employed an *ex parte* reexamination procedure. Any person at any time may file a request for reexamination, and if the request raises a substantial new question of patentability affecting any claim of the patent, reexamination is commenced.¹¹³ The same *ex parte* procedures that apply to initial examinations govern traditional reexamination.¹¹⁴ Patentees often invoke reexamination themselves, seeking to insulate their patents from late-surfacing prior art by cutting back the claims.¹¹⁵ Potential infringement defendants frequently forgo reexamination, preferring the safeguards available in court and fearing that reexamination might weaken their position in litigation.¹¹⁶

Since 1999 patent law has also provided an *inter partes* reexamination proceeding. Any person at any time may request such a proceeding, and if the request identifies a substantial new question of patentability, the PTO Director opens an

inter partes proceeding.¹¹⁷ The procedures parallel those of initial examinations, but require service of documents on the third-party requester and permit the requester to file written comments each time the patent owner files a response to an action on the merits.¹¹⁸ The requester thus has some ability to participate in writing, but no opportunity for discovery, cross-examination, or oral presentations. Third-party requesters are estopped from asserting in litigation the invalidity of any claim on any ground that the requester “raised or could have raised” during the *inter partes* proceeding.¹¹⁹ Prior to enactment of a statutory amendment in November 2002, requesters could not appeal adverse decisions to the federal courts.¹²⁰ *Inter partes* reexamination has been rarely used – only four times between its enactment in 1999 and the time of the Hearing record.¹²¹ Panelists cited concerns with the estoppel and (original) appeal provisions as well as fears that reexamination would unduly favor the patentee as reasons why *inter partes* reexamination has been virtually ignored.¹²²

Both types of reexamination limit the issues that may be considered. The proceedings are confined to issues of novelty

¹¹² See Janis 4/10 at 182-84.

¹¹³ 35 U.S.C. §§ 302-04. In addition, the PTO’s Director may order a reexamination on his or her own initiative. 35 U.S.C. § 303.

¹¹⁴ Nydegger 4/11 at 134.

¹¹⁵ See Hall 2/28 at 760-63 (citing data showing 50% of reexaminations are requested by the patentee); Mowery 2/27 at 408 (same); Telecky 2/28 at 759, 762.

¹¹⁶ See, e.g., Lerner 2/20 at 196; Seide 3/19 at 220; Casey 4/9 at 69-71; Janis 4/10 at 182-83; Nydegger 4/11 at 134-35.

¹¹⁷ 35 U.S.C. §§ 311-313.

¹¹⁸ *Id.* § 314.

¹¹⁹ *Id.* § 315(c).

¹²⁰ *Id.* § 315(b) (amended 2002).

¹²¹ See Kunin 7/10 at 70; Nydegger 4/11 at 141 (“[T]hat is virtually no effect. It is, for all practical purposes, unsuccessful.”).

¹²² See, e.g., Janis 4/11 at 125-26; Stoll 4/11 at 130; Burchfiel 4/11 at 131-32; Kesan 4/10 at 150-51 and 10/25 at 85; Kushan 10/25 at 105.

and nonobviousness based on prior art in the form of patents or printed publications.¹²³ Reexamination does not permit challenges to enablement, written description, best mode, or utility.

B. Proposals for Reform

The Hearings addressed several different proposals for reform. Most fit within one of three categories.

1. Enhanced *Inter Partes* Reexamination

Some panelists urged that reexamination procedures be improved.¹²⁴ They focused greatest attention on *inter partes* reexamination. Participants indicated that the recent enactment of legislation to permit third-party requesters to appeal adverse decisions to the Federal Circuit will prove a significant step toward making *inter partes* procedures viable.¹²⁵ Several argued that a necessary further step is some loosening of the estoppel provisions, perhaps by invoking estoppel only if the

¹²³ See Chambers 2/8 (Patent Session) at 91-92; Janis 4/11 at 126 (suggesting that the limited subject matter discourages use of reexamination procedures).

¹²⁴ See, e.g., Dickinson 2/6 at 65-66 (“the reexamination system is a very valuable one but it needs additional reform”); Gable 3/20 at 163; Linck 4/9 at 30, 68 and 10/25 at 17, 97-98; Kushan 10/25 at 106. (Panelists sometimes saw merit in multiple proposals, and identifying them as supporting one approach should not suggest their opposition to others.)

¹²⁵ See, e.g., Bendekgey 2/26 at 303; Linck 10/25 at 82; Biotechnology Industry Organization, *Testimony* (2/26/02) 6 n.30, at <http://www.ftc.gov/opp/intellect/020226davidwbeier.pdf>.

third party appeals to the Federal Circuit.¹²⁶ A number of panelists also focused on the scope of reexamination, urging that it be broadened to cover topics such as enablement and written description.¹²⁷

2. Post-Grant Opposition/Review

Other testimony supported a move toward post-grant oppositions or reviews.¹²⁸ Under these proposals, third parties would have more extensive participation rights than under *inter partes* reexamination. Thus, they might have opportunity to present oral testimony, cross-examine experts, and engage in limited discovery.¹²⁹ Such a proceeding normally would entail a fact-finding hearing before an adjudicator with greater legal training than most examiners possess. Subject matter might be broadened beyond novelty and nonobviousness to

¹²⁶ See, e.g., Beier 2/26 at 301; Linck 4/9 at 66-67 and 10/25 at 82; Casey 4/9 at 71; Janis 4/10 at 185; Kushan 10/25 at 105-06. *But cf.* Garner 10/25 at 166-67 (arguing that third parties should be willing to present their prior art in reexamination rather than saving it for future litigation); Parkhurst 4/10 at 186 (if reexamination were broadened to include all attacks on validity, some form of estoppel could be retained).

¹²⁷ See, e.g., Janis 4/10 at 184 (include enablement and other patentability issues); Parkhurst 4/10 at 186 (“open [reexamination] up to all attacks”); Kushan 10/25 at 100-01, 105-06 (include enablement and written description, with a time limitation); Dickinson 10/25 at 90-91 (urging expansion of Director-initiated reexaminations to include enablement and written description issues). Former Director Dickinson urged expanded use of Director-initiated reexaminations in general. *Id.* at 170.

¹²⁸ See, e.g., R. Levin 2/6 at 103-04; Kirschner 2/26 at 244-45; Earp 2/26 at 291-92; Janis 4/10 at 184 and 4/11 at 146-47; Kunin 7/10 at 70; see also Gerald J. Mossinghoff, *Post-Grant Review of Patents: Enhancing the Quality of the Fuel of Interest*, 85 J. PAT. & TRADEMARK OFF. SOC’Y 231 (2003).

¹²⁹ See Kushan 10/25 at 102-03.

include additional issues relevant to validity. Europe and Japan both have post-grant opposition procedures,¹³⁰ and the PTO has included a proposal for post-grant review in its 21st Century Strategic Plan.¹³¹

Skeptics feared that opposition procedures will be abused. They saw possibilities for expense and delay.¹³² For example, former PTO Director Q. Todd Dickinson, although supporting an enhanced reexamination/opposition system, drew attention to the fears that have been expressed by the independent inventor community that oppositions could be used to impede their ability to assert their patents.¹³³ Some panelists questioned whether oppositions can ever meaningfully substitute for litigation,¹³⁴ and others expressed doubt that competitors will risk “paint[ing] big targets on themselves” by actively opposing others’ patents.¹³⁵

¹³⁰ See, e.g., Earp 2/26 at 238, 291-92 (Europe); Nydegger 4/11 at 135-38, 144-45 (Europe); Thomas 4/11 at 142-45 (Europe); Maebius 4/11 at 149 (Europe), 150-52 (Japan).

¹³¹ United States Patent and Trademark Office 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* (April 2, 2003), available at <http://www.uspto.gov/web/offices/com/strat21/action/sr2.htm>; Kunin 7/10 at 70.

¹³² See, e.g., Beier 2/26 at 298 (citing delays experienced under the Japanese opposition system); cf. Linck 4/9 at 68 (oppositions are very time-consuming) and 10/25 at 81-82 (clarifying that she is “really not an opponent” of opposition systems).

¹³³ See Dickinson 10/25 at 88.

¹³⁴ See, e.g., Gambrell 10/25 at 107-09.

¹³⁵ See, e.g., Myrick 10/30 at 61 (noting the concern without rejecting the concept of opposition systems).

3. Pre-Grant Opposition

Other participants urged implementation of a pre-grant opposition system.¹³⁶ This would allow active participation by third parties prior to issuance of a patent. Some urged that pre-grant opposition would have the advantage of introducing third-party participation before the PTO is on record with a position, thereby avoiding any undue tendency to affirm prior acts.¹³⁷ Others, though, warned that the potential for delay and harassment may be particularly acute with regard to pre-grant opposition, which by its nature can slow issuance of a patent.¹³⁸

C. Analysis

As former Director Dickinson explained, reexamination and opposition are means for “competitors to interact” with the patent process “much more efficiently and effectively” to “improve . . . the quality of patents that issue.”¹³⁹ The various proposals for improving reexamination or creating a post-grant review process offer significant opportunities for enhancing patent quality and raising business certainty and focus directly on what are most likely to be economically significant patents. Such steps

¹³⁶ See Kesan 4/10 at 150-52, 187-90 (noting a decline in the vigor of opposition activity in Japan and Germany following a switch from pre-grant to post-grant oppositions); Scherer 7/10 at 55; John H. Barton, *Reforming the Patent System* (Public Comment) 3, at <http://www.ftc.gov/os/comments/intelpropertycomments/bartonjohnh.htm>.

¹³⁷ See Kesan 4/10 at 150-52, 189-90.

¹³⁸ See, e.g., Kunin 7/10 at 70-71 (citing foreign experience with pre-grant opposition).

¹³⁹ Dickinson 10/25 at 87-88.

help to promote competition and to foster continued innovation.¹⁴⁰ The Commission supports efforts to develop effective post-grant review procedures.

1. Efficient Quality Enhancement

Post-grant review offers substantial opportunities to improve patent quality by drawing upon the information and expertise of competitors. Under an *ex parte* system, access to competitors' knowledge is limited, at best.¹⁴¹ In contrast, a competitor engaged in an administrative challenge to a patent will be well-positioned to supply the best prior art, as well as the expertise necessary to probe beneath the surface of an applicant's affidavits and declarations. As one panelist phrased it, "[W]hen you have an opposition procedure, those people who have information that is not within the domain of the patent examiner will bring that information forward and get the job done properly."¹⁴²

¹⁴⁰ See *id.* at 87 ("if you improve the re-examine/opposition system, you'll improve competition"), 89; see also *supra* Ch. 5(1).

¹⁴¹ Pursuant to 35 U.S.C. § 301, "Any person at any time may cite to the Office in writing prior art consisting of patents or printed publications which that person believes to have a bearing on the patentability of any claim of a particular patent." To date, however, this provision has been little utilized. See, e.g., Casey 4/9 at 69 (expressing concern that submitting prior art in an *ex parte* context merely enables the applicant to strengthen the patent, while undermining the prior art on judicial review); Dickinson 10/25 at 170 (noting that litigators often advise against citing a competitor's best prior art to the PTO); Kahin 10/25 at 163, 167.

¹⁴² Scherer 7/10 at 69; see also Lerner 2/20 at 191; Kesan 4/10 at 146-47; Merges, 14 BERKELEY TECH. L. J. at 614-15 ("We need to design a system that better taps into patent validity information, much of which is in private hands. Until we get better information in the system, the quality of patents will not improve.").

Moreover, post-grant review offers a market-based means to focus the most intensive inquiry on the most significant patents. Trying to perfect all examinations might be exorbitantly costly and highly inefficient.¹⁴³ Too many applications are examined, and most involve claims of little economic significance.¹⁴⁴ Post-grant review lets the market decide which patents are worth the cost of intensive review and uses that market-based selection to reduce error costs while holding process costs down. Rather than spreading finite resources too thinly to do much good, it directs them toward important cases.¹⁴⁵

¹⁴³ See Dickinson 10/25 at 78 (estimating that increasing average examiner time per application costs \$13-15 million per hour); Taylor 10/25 at 51.

¹⁴⁴ See, e.g., Udell 2/28 at 568 (small percentage of patents actually reaches the market); Linck 4/9 at 30 (only a fraction of one percent of patents are actually litigated); Taylor 10/25 at 51-52; Kieff (strmt) 3-4.

¹⁴⁵ See, e.g., Linck 4/9 at 30-31; Parkhurst 4/10 at 186. Stuart J. H. Graham et al., *Patent Quality Control: A Comparison of U.S. Patent Re-examinations and European Patent Oppositions*, in PATENTS IN THE KNOWLEDGE-BASED ECONOMY 74, 114 (Wesley M. Cohen & Stephen A. Merrill eds. 2003) (finding that in European oppositions "more valuable or technologically important patents . . . are more likely to trigger challenges"), available at <http://books.nap.edu/books/0309086361/html/114.html> (hereinafter *Patent Quality Control*). This analysis builds on the insights expressed by Mark Lemley in his journal article, *Rational Ignorance at the Patent Office*, 95 NW. L. REV. 1495 (2001). Professor Lemley argues that "it is much cheaper for society to make detailed validity determinations in those few cases [in which patents are asserted against competitors] than to invest additional resources examining patents that will never be heard from again." "In short," he continues, "the PTO doesn't do a very detailed job of examining patents, but we probably don't want it to. It is 'rationally ignorant' of the objective validity of patents . . ." *Id.* at 1497. Although the thrust of Professor Lemley's approach is to leave careful patent validity determinations to the courts, he observes that "an opposition system might be consistent with the insight of this article, if one believes that applications that are opposed tend to be the ones that are later litigated (or at

2. Timely Resolution of Uncertainty

Post-grant review offers an opportunity for timely resolution of uncertainty regarding patent validity. Such uncertainty harms competition and innovation by distorting business planning, increasing costs and risks, and interfering with the raising of capital and the negotiation of licenses.¹⁴⁶ Hearing testimony expressed concern with waiting for final judicial resolution of validity challenges, because this can come long after the damage has been incurred.¹⁴⁷ As panelist Robert Blackburn explained, “There certainly are areas of research that Chiron would have done, or would have pursued a little bit longer than it had if there had been an effective, cheap, quick way of testing the validity of a third-party patent.”¹⁴⁸ Prompt administrative resolution of uncertainty through post-grant review would cut the delay and reduce the social harms.¹⁴⁹

Significantly, if uncertainty regarding

least licensed).” *Id.* at 1525 (discussing, specifically, pre-grant oppositions).

¹⁴⁶ See *supra* Ch. 5(I).

¹⁴⁷ See, e.g., Kirschner 2/26 at 244-45, 308-09 (noting the undesirable choice between “avoiding an area that otherwise you may have worked on and innovated within” and waiting until “you’ve spent your \$800 million and 10 years in product development” to find out if you were right or wrong); cf. Nydegger 4/11 at 139 (describing value of administrative proceeding “to remedy the possible issuance of overly broad patents in a timely fashion”); J. Levin 10/25 at 93 (one of main economic benefits of an opposition is “to resolve uncertainties sooner”).

¹⁴⁸ Blackburn 2/26 at 309.

¹⁴⁹ See, e.g., R. Levin 2/6 at 103-04; Rai 4/10 at 196; Kesan 4/10 at 187-88 (oppositions in Germany provide early, clear signals to the marketplace of a patent’s value), 196.

validity cannot be resolved through a relatively timely and less expensive administrative process, it may never be eliminated through litigation. Several panelists explained that incentives to challenge patents may be inadequate. Because the costs of a challenge are borne by the challenger, but the benefits of invalidation spill over to other potential licensees and to consumers, the private incentives to launch a challenge are less than would be warranted by the social return.¹⁵⁰ Procedures that reduce the private costs of challenging validity – such as administrative alternatives to full-blown litigation – are likely to better align private and social returns and thus to encourage efficient responses to patent quality issues.¹⁵¹

3. Offering Sufficient Value Without Duplicating Litigation

No post-grant procedure will be successful unless it is used. The virtually disregarded *inter partes* reexamination experience provides a case in point. Panelists noted the tension between keeping costs sufficiently low and outcomes sufficiently speedy, while simultaneously providing a scope and level of inquiry sufficiently high, to ensure broad use;

¹⁵⁰ See, e.g., Gilbert 2/6 at 94-95; Thomas 2/8 (Patent Session) at 23; Farrell 2/28 at 603 and 11/6 at 181-82; Merges 2/28 at 590 (“no individual may have an incentive to invalidate it, even though we would all be better off if they did”). When multiple patents are involved, coordination problems may also abound. See Gilbert 2/6 at 95.

¹⁵¹ See, e.g., Kesan 4/10 at 174. In addition to the cost-related effects noted in the text, an administrative alternative to litigation may facilitate patent validity challenges currently delayed or barred by the standing requirement for bringing declaratory judgment actions. See *infra* Ch. 5(III)(C)(4).

careful balancing may be required.¹⁵²

Panelists generally urged extending reviewable subject matter beyond the novelty and nonobviousness issues currently allowed.¹⁵³ Most favored extending the scope to include enablement and written description.¹⁵⁴ Some would include utility and patentable subject matter.¹⁵⁵ Indeed, the PTO's Strategic Plan recommends subjecting all issues of patent validity to its proposed post-grant review procedure.¹⁵⁶ In

¹⁵² Compare J. Levin 10/25 at 92-93 (noting need for careful "trade-off of keeping costs down versus providing a more thorough system") and Janis 4/10 at 184 (urging that a middle course involving post-grant oppositions be sought) with Thomas 4/11 at 143-44 (questioning whether oppositions less extensive than court litigation will work) and Gambrell 10/25 at 107 (questioning utility of reexamination/opposition efforts that may prove either too expensive or too cosmetic).

¹⁵³ See, e.g., R. Levin 2/6 at 103; Janis 4/10 at 184; Parkhurst 4/10 at 186 ("open it up to all attacks").

¹⁵⁴ See Janis 4/10 at 184; Nydegger 4/11 at 138-40; Linck 10/25 at 96; Kushan 10/25 at 99-101. Substantial objections, however, were lodged against including challenges based on the "best mode" requirement, in view of the subjective nature of the inquiry, what some saw as the PTO's relative lack of expertise in dealing with such issues, and the costs and complexity that including best mode issues might introduce. See, e.g., Linck 10/25 at 83, 96; Kushan 10/25 at 100. See generally Pooley 10/30 at 122 (best mode "interjects issues of state of mind"). On the other hand, the PTO already deals with best mode issues in the context of interference proceedings and consequently has some experience in resolving such issues. See 21st Century Plan, *Post-Grant Review of Patent Claims* at 6-7.

¹⁵⁵ See Nydegger 4/11 at 140; but cf. Kushan 10/25 at 101 (suggesting that "most of the utility issues that are going to be impacting on the claim scope are going to be properly raised under 112").

¹⁵⁶ 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 6-7 (allowing "any and all grounds that may be brought in a district court to challenge patent validity, but not to challenge patent enforceability" and explaining that this would allow the PTO "to use its

light of their potential competitive significance and their apparent susceptibility to administrative determination, the record as a whole suggests good basis for including at least nonobviousness, enablement, written description, and utility (in addition to novelty) as eligible subject matter in any post-grant review.

An administrative alternative to court litigation may well require a more thorough probing of the issues than is available through reexamination processes. The PTO's 21st Century Strategic Plan calls for documentary presentation of the case-in-chief followed by live cross-examination.¹⁵⁷ It also permits discovery "for good cause shown."¹⁵⁸ Cross-examination and an opportunity for appropriate discovery are likely to be needed if a review proceeding is to test an applicant's assertions and expert evidence on issues that extend beyond straightforward application of printed prior art,¹⁵⁹ particularly if the mandatory

expertise to check the quality of the patents and allow the district courts to use their expertise to determine issues such as fraud and inequitable conduct").

¹⁵⁷ 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 15.

¹⁵⁸ *Id.* at 12-14. The Strategic Plan also contemplates receipt of authority to impose sanctions "for failure to make disclosure or cooperate in discovery." *Id.* at 13-14.

¹⁵⁹ See, e.g., Burchfiel 4/11 at 146 ("any re-examination worth doing would have to give the opponent a chance to cross examine and submit the depositions"); Kushan 10/25 at 105-06 (finding cross-examination needed to probe certain testimony, but favoring *inter partes* reexamination rather than post-grant opposition); Taylor 10/25 at 116-17 (indicating, as an example, that applicants sometimes conduct post-filing experiments that might have "enormous relevance" to enablement, but describing the discovery necessary to unearth that information as beyond his vision of PTO activity); see also Jonathan Levin & Richard Levin, *Benefits and Costs of an Opposition*

disclosure requirements initially sought by the PTO are withdrawn.¹⁶⁰

Administrative review will also require a set of decision makers competent to handle the broader array of procedural and substantive issues that will flow from a fact-finding proceeding such as that outlined above.¹⁶¹ Panelists indicated that the PTO is institutionally capable of providing this type of review, as demonstrated by its handling of *inter partes* interference proceedings.¹⁶² Similar arrangements would be needed for post-grant review, and the PTO's 21st Century Strategic Plan would assign such review proceedings to administrative patent judges.¹⁶³ Reliance on independent judges would obviate many of the concerns expressed by some panelists with "post-decisional cognitive dissonance" arising from asking the PTO's corps of examiners to

Process, in PATENTS IN THE KNOWLEDGE-BASED ECONOMY at 120, 141 (Wesley M. Cohen & Stephen A. Merrill eds. 2003) (recommending opportunity for cross-examination, but cautioning against "extensive" pre-hearing discovery), available at <http://books.nap.edu/books/0309086361/html/141.html#page-top>; cf. Janis 4/11 at 147 ("we may end up with something that's administratively complex and not all that cheap, but we still may be better off than not having an effective system at all").

¹⁶⁰ See *supra* Ch. 5(II)(C).

¹⁶¹ See, e.g., Thomas 4/11 at 143; Janis 4/11 at 146, 154; Stoll 4/11 at 147; Linck 10/25 at 83; Kushan 10/25 at 101; Kesan 10/25 at 121-22.

¹⁶² See, e.g., Burchfiel 4/11 at 145; Stoll 4/11 at 147 ("we would be able to set up a system where we do cross examination, where we could do discovery"); Dickinson 10/25 at 90; cf. Linck 10/25 at 97 (noting that "the interference ALJs" believe that they can handle post-grant oppositions).

¹⁶³ 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 2.

review its own decisions of record.¹⁶⁴

4. Protecting Patentees from Harassment and Undue Delay

The record reveals substantial concerns that post-grant review proceedings could become very time consuming and might be used as vehicles for harassing patentees.¹⁶⁵ Although such concerns

¹⁶⁴ See, e.g., Kesan 10/25 at 86; Lerner 2/20 at 195-96; cf. Dickinson 10/25 at 167-68 (reexaminations no longer conducted by the initial examiner); Maebius 4/11 at 133 (same). Of course, *inter partes* reexamination would continue to play an important role of its own during the interim while a fully functioning post-grant review procedure is being put into place. Indeed, some panelists recommend retention of *inter partes* reexamination even after any post-grant review system is in operation. See Linck 10/25 at 96-97; Mossinghoff & Kuo, 85 J. PAT. & TRADEMARK OFF. SOC'Y at 253-54 (urging retention of current reexamination proceedings in addition to post-grant review). The PTO, in contrast, recommends eliminating *inter partes* reexamination upon implementation of post-grant review to make the most efficient use of its available examiners. See 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 2, 20 (April 2, 2003) (noting that eliminating *inter partes* reexamination would "free examiners to examine applications and reduce pendency thereof"). PTO's concerns regarding the resource costs of offering two separate review procedures with third-party participation warrant considerable weight.

¹⁶⁵ See, e.g., Linck 4/9 at 68 ("[o]ppositions go on for years and years and years") and 10/25 at 80-81; Dickinson 10/25 at 88 (reciting concerns of independent inventor community); J. Levin 10/25 at 92-93 (European oppositions cause 3-year delay); Merrill 10/25 at 94-95 (citing study showing that "length of time" is a "very significant problem" for European oppositions); Kushan 10/25 at 103-04 (absent a required threshold showing for initiating an opposition, "you can have people harassing you constantly"); Kesan 10/25 at 121 (warning against "a whole lot of discovery hearings and so on"); *but cf.* Maebius 4/11 at 150 (Japan has now increased the pace of opposition proceedings); Merrill 10/25 at 94 (study commissioned by the National Academy of Sciences shows that "the European opposition system has not been subject to the fears or concerns of the independent inventor community . . . small entities have fared as well as large entities in European oppositions"); Graham *et al.*, *Patent Quality Control* at 108-09 (presenting regression results "suggestive that patents held by independent inventors arc

warrant careful attention, several protections are available. Conducting review on a post-grant basis limits the effects of any harassment strategies.¹⁶⁶ Threshold showings may be required,¹⁶⁷ and time limits may be imposed on seeking post-grant review.¹⁶⁸ The former would ensure that reviews do not go forward on clearly spurious grounds, and the latter would contribute to administrative finality and protect against ongoing harassment of patentees. Once initiated, the post-grant review can be conducted under a defined

no more likely to be opposed [in a European opposition proceeding] than other patents, other things being equal.”)

¹⁶⁶ Cf. Kunin 7/10 at 133 (foreign experience revealed *pre-grant* opposition as “a form of applicant harassment”).

¹⁶⁷ For example, the current threshold for triggering an *inter partes* reexamination is “a substantial new question of patentability affecting a claim of a patent. . . .” 35 U.S.C. § 313. An alternative suggested by one panelist would be “something . . . like the *prima facie* standard for obviousness.” Kushan 10/25 at 104. The PTO’s 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 12, would allow the Director to issue a regulation specifying a time by which a petitioner must file its supporting information, after which the petition would be dismissed “if the showing is insufficient to justify proceeding.”

¹⁶⁸ 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 5-6 (requiring that a petition for review be filed either within 12 months of the issuance of any claim challenged or within four months after the review petitioner is placed in “substantial apprehension” of being sued for infringement). Portions of the Hearings testimony suggested that a rigid, one-year limit might be inadequate, see Linck 10/25 at 83 (“Ofentimes you aren’t even aware that a patent is a problem until much longer after the patent issues.”); Kesan 10/25 at 85 (a one or two year limit “can be problematic”); Kushan 10/25 at 99-100, 105 (favoring *inter partes* reexamination allowing open-ended treatment of prior art issues but imposing a 2-3 year limit for challenges based on enablement or written description), but that some form of limit might have benefits. See J. Levin 10/25 at 93 (noting that a time limit would motivate early resolution of uncertainty regarding a patent’s validity).

time schedule,¹⁶⁹ and the availability and extent of discovery can be controlled.¹⁷⁰ Although standing requirements for seeking review might add further protection, the Hearing record suggests that such requirements have impeded early resolution of uncertainty through declaratory judgment challenges to patent validity in federal court and may not fit well with the goals of post-grant review.¹⁷¹

5. Recommendation

The Commission supports the PTO’s efforts to establish a procedure for post-grant review of patent claims. Post-grant review offers greater value to challengers and a more thorough probing of the issues than *inter partes* reexamination, with less opportunity for delay and harassment than pre-grant opposition. The Commission recommends that (i) Congress enact legislation providing for post-grant review of patentability determinations including, at

¹⁶⁹ Thus, the PTO envisions a post-grant review procedure designed to be completed in one year, pursuant to a statutorily-specified goal and regulations designed to meet it. 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 2, 17-18. Similarly, the Federal Trade Commission conducts certain adjudicatory proceedings under a time schedule specified by regulation. See 16 C.F.R. § 3.11A.

¹⁷⁰ See 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 12-14 (proposing to allow discovery “for good cause shown,” thereby permitting the PTO “to determine whether the discovery is appropriate, and restrict its nature and volume”).

¹⁷¹ See Blackburn 2/26 at 294-96 (“you cannot begin a D.J. action and challenge the validity of a patent unless you’ve been threatened with litigation by the patent owner. And usually people are not dumb enough to do that . . . there are these bad patents that sit out there and you can’t touch them.”); Nydegger 4/11 at 149 (absence of a standing requirement is consistent with the goal of inducing the public to proactively challenge invalid patents before problems develop).

a minimum, issues regarding novelty, nonobviousness, written description, enablement, and utility; (ii) such a review proceeding be initiated or allowed to be maintained only upon a suitable threshold showing by the review petitioner; (iii) an administrative patent judge preside over the review proceeding; (iv) the review proceeding allow cross-examination of witnesses and appropriate, carefully circumscribed discovery; (v) the review proceeding be conducted within defined time limits and under sanctions authority necessary to control proceedings of this nature; (vi) limitations be established to protect against undue delay in requesting post-grant review and against harassment through repetitive petitions for review; (vii) settlement agreements (including collateral agreements referred to therein) resolving post-grant review proceedings be filed with the PTO and made available, on written request, to other government agencies under terms comparable to those currently applicable to settlements of interferences;¹⁷² and (viii) such a post-grant review proceeding be declared a delegation of authority permitting the ensuing PTO conclusions of law to carry the force of law.¹⁷³

¹⁷² See 21st Century Strategic Plan, *Post-Grant Review of Patent Claims* at 21-22 (recommending that post-grant review settlement agreements be filed with the PTO); 35 U.S.C. § 135(c) (governing filing of and access to interference settlement agreements); 37 C.F.R. § 1.666 (same).

¹⁷³ According to the Supreme Court's recent opinion in *United States v. Mead Corp.*, 533 U.S. 218 (2001),

administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the

IV. PATENT LITIGATION

A. General Trends

Testimony revealed that patent litigation, like the number of patents issued, has increased greatly in recent years, tripling between 1981 and 2000.¹⁷⁴ Some perceived more suits by large firms against smaller firms and entrants; more suits by niche rivals against each other; and more suits by

agency interpretation claiming deference was promulgated in the exercise of that authority.

533 U.S. at 226-27 (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984)). "It is fair to assume generally," the Court continued, "that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force." *Id.* at 230. Commentators have expressed uncertainty as to whether existing examination/reexamination procedures would constitute the "relatively formal administrative procedure[s]" that would trigger *Chevron* deference under *Mead*. See ROBERT MERGES & JOHN DUFFY, *PATENT LAW AND POLICY: CASES AND MATERIALS* 1167-68 (3d ed. 2002). Whatever the status of existing procedures, the Commission's recommendation is intended to confer such deference regarding conclusions of law reached in post-grant review proceedings. Both panelists and a prior patent reform commission have urged similar measures. See Rai 4/10 at 42 (urging greater judicial deference to PTO's application of substantive patentability criteria); see also Arti Rai, *Addressing the Patent Gold Rush: The Role of Deference to PTO Patent Denials*, 2 WASH. U. J. L. & POL'Y 199 (2000); cf. Kunin 4/10 at 45-49 (urging that the PTO be granted substantive rulemaking authority in order to qualify for *Chevron* deference); 1966 REPORT OF THE PRESIDENT'S COMMISSION ON THE PATENT SYSTEM at 26 (Recommendation XIII: "A Patent Office decision refusing a claim shall be given a presumption of correctness, and shall not be reversed unless clearly erroneous."); but cf. Duffy 7/10 at 123 (cautioning that judicial "tweak[ing]" of deference standard may not greatly affect Federal Circuit practices).

¹⁷⁴ See, e.g., Lerner 2/20 at 157-58 and Lerner 2/20 Presentation at 6.

organizations not active in the market.¹⁷⁵ Several panelists voiced concern that the high cost of litigation may work to the disadvantage of small firms, pressuring them to settle when accused and discouraging them from asserting their own patent rights.¹⁷⁶

A number of panelists cited data suggesting overall trends favorable to patentees since creation of the Federal Circuit in 1982.¹⁷⁷ Yet, the situation today is probably more complex. Considerable testimony indicated that with the advent of the Federal Circuit, patents typically have become easier to get, but more difficult to infringe, *i.e.*, we are seeing more, but narrower, patents.¹⁷⁸ Recent statistical data back both trends.¹⁷⁹ In particular, panelists

¹⁷⁵ See Lerner 2/20 at 158-61; Ziedonis 3/20 at 70-71.

¹⁷⁶ See, *e.g.*, Lerner 2/20 at 159-60; Arora 2/25 at 73; Barton 2/26 at 213; Kahin 3/19 at 89-90; Cohen 10/30 at 78.

¹⁷⁷ See, *e.g.*, Lerner 2/20 at 156-57 and Lerner 2/20 Presentation at 5 (percentage of appellate rulings upholding infringement rose markedly during the Federal Circuit's first eight years); Katsh 4/10 at 179 (percentage of patents invalidated fell dramatically following formation of the Federal Circuit); Scherer 7/10 at 33 (percentage of litigated patents determined to be either invalid or not infringed declined substantially following formation of the Federal Circuit).

¹⁷⁸ See, *e.g.*, Lunney 7/10 at 31, 91; Duffy 7/10 at 184-85; Dreyfuss 7/10 at 196-97 and 7/11 at 174; Quillen 7/11 at 156 (finding lower standards for patentability); Myrick 3/19 at 46 (citing trend against finding infringement). Software patents, however, were identified as a possible exception. See, *e.g.*, Burk 7/10 at 187.

¹⁷⁹ Thus, with regard to validity, data showed that 54% of final, published district court and appellate decisions during the 1989-96 period found patents valid, compared to only about 42% and 34%, at the district court and court of appeals levels, respectively, during the 1953-

cited trends toward easing the nonobviousness requirement but tightening breadth-determining factors such as the doctrine of equivalents and, at least in biotech cases, written description.¹⁸⁰ In view of this conflation of opposing trends, a number of panelists concluded that the

78 period prior to the formation of the Federal Circuit. See Allison & Lemley, 26 AIPLA Q. J. at 205 (studying 1989-96 period); GLORIA K. KOENIG, PATENT INVALIDITY: A STATISTICAL AND SUBSTANTIVE ANALYSIS 4-18 to 4-19, 4-21 to 4-23 (1980) (studying the 1953-78 period). The studies also revealed a second relationship that may better account for any self-selection bias in the nature of cases filed: in the 1989-96 period, district court determinations of patent invalidity were reversed 23% of the time, but district court determinations of validity were reversed only 10% of the time. Allison & Lemley, 26 AIPLA Q. J. at 241-42. "[I]n stark contrast," *id.* at 242, during the 1953-78 period, district court validity holdings were reversed substantially more often than district court invalidity rulings. See KOENIG, PATENT INVALIDITY: A STATISTICAL AND SUBSTANTIVE ANALYSIS at 4-34 to 4-41. The data suggest that the courts, particularly at the appellate level, may have grown more willing over the years to find patents valid. One further study, focused just on appellate rulings pre- and post-formation of the Federal Circuit, again showed a higher percentage of invalidity determinations during the earlier period (56% versus 49%), but the difference was not statistically significant. See Lunney 7/10 at 92-93.

In contrast, with regard to infringement, the data suggests that the Federal Circuit has not been supportive of patentees. See Myrick 3/19 at 46 (stating that in 2000 "[p]atent owners won only 12 decisions in the literal infringement area, while accused infringers won 47" and that under the doctrine of equivalents "patentees won five, while accused infringers won 44), citing Paul M. Janicke, *To Be or Not To Be: The Long Gestation of the U.S. Court of Appeals for the Federal Circuit (1887 - 1982)*, 69 ANTITRUST L. J. 645, 665 n.117 (2002).

¹⁸⁰ See, *e.g.*, R. Levin 2/6 at 102-03 (discussing obviousness); Duffy 7/10 at 184 (discussing written description and doctrine of equivalents); Taylor 7/11 at 137 (discussing written description); American Bar Association Section of Intellectual Property Law, *Statement of Robert P. Taylor on Behalf of Section of Intellectual Property Law American Bar Association on Competition and Intellectual Property Law and Policy In the Knowledge-Based Economy* (7/11/02) 8 (discussing written description), at <http://www.ftc.gov/opp/intellect/020711robertptaylor.pdf>.

overall picture cannot simply be portrayed as pro-patent.¹⁸¹

Nonetheless, the trends in validity rulings, coupled with the strong competitive concerns implicated by the quality of patents, direct attention to the nature of validity litigation. The evidentiary burdens that govern this process are the focus of the next section.

B. Presumption of Validity/Clear and Convincing Evidence

The Hearings focused attention on the significance attached in litigation to the issuance of a patent. The issue has two aspects. First, the Patent Act creates a presumption of validity applicable when a patent is challenged in federal court: “A patent shall be presumed valid.”¹⁸² Second, the Federal Circuit has interpreted this requirement to impose a clear and convincing evidence standard on those who challenge validity.¹⁸³ Both the presumption

and the clear and convincing evidence standard apply even when a patent is challenged on the basis of prior art that the PTO never saw, although, in such circumstances, the new evidence may “carry more weight and go further toward sustaining the attacker’s unchanging burden.”¹⁸⁴ The combination of the presumption and standard of proof drew considerable attention from the panelists.

Critics questioned whether that combination can be justified. Some noted the disparity between directing the PTO to issue patents based on an assessment of a mere preponderance of the evidence and subjecting third parties who challenge those patents to a higher standard of proof.¹⁸⁵ Others questioned whether there was a logical basis for extending the presumption or standard to challenges based on prior art that the PTO had never considered.¹⁸⁶ Several of the panelists took a pragmatic perspective, questioning whether the limited examination possible in terms of hours available and ability to probe behind applicants’ assertions justified the

¹⁸¹ See, e.g., Kitch 2/20 at 67-68; Myrick 3/19 at 46; Duffy 7/10 at 184; Wamsley 7/10 at 194; cf. ROBERT L. HARMON, PATENTS AND THE FEDERAL CIRCUIT 161 (5th ed. 2002 Supp.) (concluding that the “patent enforcement pendulum is swinging toward a more neutral position” than one in which the enforcement climate under the Federal Circuit had “strongly favor[ed] the patentee”).

¹⁸² 35 U.S.C. § 282.

¹⁸³ See, e.g., *American Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350 (Fed. Cir.), cert. denied, 469 U.S. 821 (1984); *SSIH Equipment S.A. v. United States Int’l Trade Comm.*, 718 F.2d 365 (Fed. Cir. 1983). Both cases relied upon the Supreme Court’s opinion in *Radio Corp. of America v. Radio Engineering Laboratories*, 293 U.S. 1 (1934), which, spoke in terms of “more than a dubious preponderance” of evidence, “clear and satisfactory evidence,” and evidence sufficient “to evoke a clear conviction,” *id.* at 8-10, but did not expressly

establish a clear and convincing evidence standard. Panelists generally attributed the clear and convincing evidence standard to the Federal Circuit. See, e.g., Weinstein 2/27 at 533-34; Kesan 4/10 at 148.

¹⁸⁴ See, e.g., *American Hoist & Derrick*, 725 F.2d at 1360; Duffy 7/10 at 118, 120.

¹⁸⁵ See, e.g., T.S. Ellis 7/11 at 118-19; Thomas 10/25 at 137-38; Gambrell 10/25 at 148.

¹⁸⁶ See, e.g., Duffy 7/10 at 121 and John F. Duffy, *Nonobviousness: The Economics and Legal Process of the Doctrine* (7/10/02) (slides) at 17, at <http://www.ftc.gov/opp/intellect/020710johnfduffy.pdf> (hereinafter Duffy Presentation); Kushan 10/25 at 142; Gambrell 10/25 at 148.

presumption or the high standard of proof.¹⁸⁷

Defenders of the presumption and standard urged that a finding of validity by a neutral government agency using a knowledgeable examiner justifies placing a heavy burden on challengers.¹⁸⁸ Some observed that the Federal Circuit has recognized that the challenger's burden is partially discharged when new, material prior art is presented, and argued that any remaining advantages flowing from the presumption and high standard of proof have little, or only a measured, practical effect.¹⁸⁹ Others, in contrast, asserted that the presumption and standard can have compelling effects on both judges and juries.¹⁹⁰ District Judge Ellis worried that the clear and convincing evidence burden may work to undermine the role contemplated by the patent system for court

challenges to weed out faulty patents.¹⁹¹

Panelists put forward an array of possible changes. Some called for eliminating the presumption of validity,¹⁹² at least in cases involving new, material prior art.¹⁹³ Other testimony focused instead on the standard of proof, urging that it be reduced from clear and convincing evidence to preponderance of the evidence.¹⁹⁴ Still other testimony suggested that the presumption of validity and/or the clear and convincing evidence standard might be applied only when a patent has undergone examination under a heightened disclosure requirement or has survived an *inter partes* reexamination or some form of opposition proceeding.¹⁹⁵

¹⁸⁷ See, e.g., T.S. Ellis 7/11 at 118-19; Kirschner 2/26 at 289-90; Weinstein 2/27 at 533; Kesan 10/25 at 146; cf. Langenfeld 2/20 at 17 (deference to issued patents presumes high accuracy in examination process); Linck 4/9 at 67-68 (time pressures limit what practically can be expected from examinations).

¹⁸⁸ See Garner 10/25 at 136, 163-64.

¹⁸⁹ See, e.g., Garner 10/25 at 136; Linck 10/25 at 151-53; Taylor 10/25 at 158-60.

¹⁹⁰ See, e.g., Seide 3/19 at 219 (because of the presumption of validity, the standard to invalidate a patent in court is "much higher" than the standard during examination); Gambrell 10/25 at 39-40 (the presumption of validity and clear and convincing evidence standard tell a jury that "unless we find something devastating[ly] effective against it, we're going to affirm it"), 150-51 (jurors "see the seal on the patent, they hear clear and convincing evidence, and their likelihood of going for the defendant is much slighter than it is for the patentee"), 153-54.

¹⁹¹ See T.S. Ellis 7/11 at 119-20; see also Sung 2/8 (Patent Session) at 141-42 (noting possible *in terrorem* effect of presumption of validity and clear and convincing evidence standard against challenging invalid patents).

¹⁹² See, e.g., Friedman 2/27 at 357; Kieff 4/10 at 162 (decrease or eliminate presumption of validity).

¹⁹³ See, e.g., Duffy 7/10 at 121 and Duffy Presentation at 17; Gambrell 10/25 at 148, 150-51. One panelist suggested that the presumption might be retained, but with a delayed effective date. Dickinson 10/25 at 91 (analogizing to incontestability of certain trademarks after five years).

¹⁹⁴ See Thomas 10/25 at 138; Gambrell 10/25 at 150-51; see also Lemley, 95 Nw. U. L. REV. at 1528-29; cf. Kunin 7/10 at 138 (preponderance of the evidence standard "perhaps being, let's say, a little bit more realistic from the standpoint of permitting the presumption to be rebutted").

¹⁹⁵ See Kesan 4/10 at 148-49, 10/25 at 62, 145-46; T.S. Ellis 7/11 at 126 (tying clear and convincing evidence standard to meeting enhanced disclosure requirements a good idea); see also Kesan, 17 BERKELEY TECH. L. J. at 773-75. *But see* Kushan 10/25 at 143 (unfair to withhold presumption of validity from a patent whose validity was never even questioned).

Analysis

As a simple matter of burden assignment, the presumption of validity is not objectionable. The patent has been examined and found valid by the PTO. If the patent subsequently is challenged, the burden of persuasion rests with the party seeking to overturn the PTO's ruling.¹⁹⁶

But there is no persuasive reason why the level of that burden should be clear and convincing evidence.¹⁹⁷ As panelists underscored, the PTO's determinations supporting issuance of patents are based only on a preponderance of the evidence. Perhaps even more telling, those determinations are reached under tight time constraints and on an *ex parte* basis allowing minimal opportunity to hear a third party's opposing views. All the failings of *ex parte* examination discussed *supra* in Ch. 5(II) – limited examiner time, the limited nature of applicants' disclosure obligations, limited access to potentially vital prior art and third-party expertise, the need for examiners to accept applicant's positions on point after point under presumption after presumption – have profound implications given that the burden rests on the PTO to demonstrate that patents should not issue. Rather than suggesting a basis for weighting judicial

¹⁹⁶ See Thomas 10/25 at 138 (“The burden is probably properly upon an accused infringer”); Linck 10/25 at 151-52 (“The presumption . . . is really a burden shifting device to put the burden on the challenger.”).

¹⁹⁷ It is not expressed in the Patent Act. As one commentator, analogizing to a tennis match, observes, “§ 282 [stating the presumption of validity] determines who will serve first, but does not regulate the height of the net.” Charles E. Phipps, *The Presumption of Administrative Correctness: The Proper Basis for the Clear and Convincing Evidence Standard*, 10 FED. CIR. BAR J. 143, 148 (2000).

review in the patentee's favor, these factors state a compelling case against imposing a heightened evidentiary standard on those challenging patent validity.¹⁹⁸

Recommendation. To the extent that the clear and convincing evidence standard distorts the litigation process, as some of the panelists indicate, it is a matter for particular concern. Litigation is a mechanism for focusing enhanced attention on those patents that are most likely to hold commercial significance and for weeding out from this group those patents that should not have been granted.¹⁹⁹ If these market-selected inquiries cannot be conducted on a level playing field, there is serious potential for judicially confirming unnecessary, potentially competition-threatening rights to exclude.²⁰⁰ Accordingly, the Commission recommends that legislation be enacted specifying that challenges to the validity of a patent be determined based on a preponderance of the evidence.

C. Willfulness/Treble Damages

A second aspect of litigation that drew substantial discussion was willful infringement. Pursuant to 35 U.S.C. § 284,

¹⁹⁸ Any benefit from enhanced certainty resulting from the heightened, “clear and convincing” evidentiary standard thus carries the potential harm of reduced accuracy and increased costs of error.

¹⁹⁹ See Kieff (stmt) 4. As noted *supra* in Ch. 5(III), post-grant review procedures would fill a similar role.

²⁰⁰ See Lemley, 95 Nw. U. L. REV. at 1529 (relying on in-depth litigation to eliminate examination errors in the cases that really matter will not work if validity litigation “defers to the cursory review already conducted. Based on what we know of patent examinations, deference is not appropriate.”).

a court may award up to three times the amount of damages found or assessed. This authority may be exercised when the defendant has willfully infringed a valid patent – that is, the defendant knew about the patent but nevertheless went ahead with the infringing conduct without a reasonable basis for so doing.²⁰¹

Panelists expressed considerable dissatisfaction with a state of affairs that in effect exposes firms to greater potential damages for trying to learn if they are infringing any patents than if they keep themselves blissfully ignorant.²⁰² A number of panelists stated that the exposure to willfulness charges in fact discourages firms from determining what patents they might be infringing, although some observed that the dangers of going forward with eyes closed sometimes are too great.²⁰³ Other panelists raised a separate problem: fear of

²⁰¹ *Ryco, Inc. v. Ag-Bag Corp.*, 857 F.2d 1418, 1428 (Fed. Cir. 1988) (“The test is whether, under all the circumstances, a reasonable person would prudently conduct himself with any confidence that a court might hold the patent invalid or not infringed.”); see also *Central Soya Co. v. Geo. A. Hormel & Co.*, 723 F.2d 1573, 1577 (Fed. Cir. 1983).

²⁰² See, e.g., Pooley 2/27 at 380 and 10/30 at 122 (willfulness doctrine generates “universal concern”).

²⁰³ Compare Greenhall 2/27 at 420-21 (stating that until recently, when he was required to sign warrants, “I simply didn’t look at any patents . . . and if anybody mentioned a patent I burned it as quickly as possible”); Lemley 4/18 at 46-47 (“a number of companies actually try very hard to avoid doing patent searches at all because they don’t want to learn anything that might alarm them”); Barr 2/28 at 677 and 10/30 at 81 (willfulness doctrine dissuades firms from performing clearance searches); and Pooley 10/30 at 87 (companies “specifically avoid looking at patents”) with Myrick 10/30 at 82-83 (“every product that gets sent out the door gets checked, and avoidance is a prerequisite”), 126 (emphasizing risk of infringing out of ignorance, while acknowledging that there is also risk under the willfulness doctrine).

willfulness charges discourages inventors from reading others’ patents, thereby undermining the disclosure function of the patent system.²⁰⁴ Other testimony indicated that when troublesome patents are identified, firms frequently seek to show due care and dissipate willfulness concerns by securing opinion letters regarding invalidity or non-infringement from outside counsel.²⁰⁵ Some testimony questioned the value of that practice and noted that attempts to inquire about or pierce the surface of opinion letters can raise thorny disputes over attorney-client privilege.²⁰⁶

The current state of the willfulness doctrine drew few defenders.²⁰⁷ One panelist noted that enhanced damages make sense when violations are likely to go undetected or unpunished, but believed that the number of instances when infringement

²⁰⁴ See, e.g., Thomas 10/25 at 139; Kahin 10/30 at 76; Myrick 10/30 at 125; see also Edwin H. Taylor & Glenn E. Von Tersch, *A Proposal to Shore Up the Foundations of Patent Law that the Underwater Line Eroded*, 20 HASTINGS COMM. & ENT. L. J. 721, 737 (1998) (many firms discourage employees from reading patents out of fear of willful infringement).

²⁰⁵ See Sung 2/8 (Patent Session) at 147 (a competent, independent legal opinion, even if incorrect, will usually help to rebut an allegation of willful infringement).

²⁰⁶ See, e.g., Thomas 10/25 at 155 (rather than getting “quality advice from counsel . . . we’re getting sort of pats on the back that, you might as well continue and here’s your shield from triple damages”), 177-78 (not suggesting that patent bar will “cynically dish out any kind of opinion”); Gambrell 10/25 at 169; Taylor 10/25 at 160.

²⁰⁷ A solicitation at one roundtable for any defenders of the willfulness requirement drew no takers. See Hearing Transcript 10/30 at 127.

will not be remedied is relatively small.²⁰⁸ Another worried that without a willfulness rule large companies may make conscious decisions to violate small firms' patents, but also shared the concerns expressed about current willfulness practices.²⁰⁹ Some expressed concern that legal expenses might eat up single-damage awards, but others noted that a separate statutory provision permits recovery of attorney fees.²¹⁰ Still others stressed that treble damages are rarely actually awarded,²¹¹ but panelists nonetheless testified to a disproportionately large *in terrorem* effect.²¹²

²⁰⁸ See Duffy 10/30 at 131-32. Another panelist added that the possibility of injunctive relief enhances deterrence. See Banner 10/30 at 130-31.

²⁰⁹ See Taylor 10/25 at 160-61.

²¹⁰ Compare *Ambrecht* 3/19 at 106 (noting potential inadequacy of single-damage remedy) with *Myrick* 3/19 at 106 (stressing potential to recover attorney fees) and 10/30 at 139 (same) and *Gambrell* 10/25 at 149 (awarding attorney fees is preferable to awarding treble damages, which are unrelated to actual costs). Pursuant to 35 U.S.C. § 285, attorney fees may be awarded to the prevailing party "in exceptional cases." One panelist suggested a possible lowering of the hurdle for recovering attorney fees if the willfulness doctrine is abandoned. See *Pooley* 10/30 at 131.

²¹¹ See, e.g., *Chambers* 10/25 at 146-47 (willfulness really only requires defendants to seek out a good opinion of counsel showing invalidity or noninfringement); *Gambrell* 10/25 at 148-49. Recent data, however, suggest that courts enhance damages in a significant percentage of decisions that find infringement. See *Kimberly A. Moore, Judges, Juries, and Patent Cases – An Empirical Peek Inside the Black Box*, 11 *FED. CIR. B.J.* 209 (2001). Professor Moore's data, culled from the records of all patent cases tried from 1983 through 1999, show a finding of willfulness in 39% of the 888 decisions that found infringement and enhanced damage awards in 70% of the 219 cases in which judges considered enhancement issues. *Id.* at 237, 241.

²¹² See *Banner* 10/30 at 127-28; *Pooley* 10/30 at 128 (willfulness promotes "a fear that animates decisions").

Analysis

Viewed from a competition perspective, two attributes of the willfulness doctrine stand out. First, fear of willfulness charges works to undermine the patent system's disclosure goals by discouraging third parties from reading patents. As one panelist put it, "[I]t is perverse to make it less desirable that people read what it is the public's paying for."²¹³ Second, panelists amply testified that willfulness considerations may significantly interfere with gaining the knowledge of others' patents necessary for planning a noninfringing business or research strategy.²¹⁴ This introduces unnecessary uncertainty, raises risks, and reduces efficiency. In light of the many concerns it raises, some of the panelists called for abolishing the willfulness doctrine.²¹⁵ Nonetheless, the record also reveals that the doctrine serves some use, such as when one

²¹³ *Myrick* 10/30 at 125 (finding the willfulness doctrine "a terrible deterrent to the use of the patent system to its full extent"); see also *Taylor & Von Tersch*, 20 *HASTINGS COMM. & ENT. L. J.* at 737 ("By placing potential infringers on notice for simply reading a patent, the Federal Circuit puts the patent owner's rights to exclude ahead of the public interest in disclosure . . . this defeats the basic purpose of the patent[] laws, dissemination of information."); *William C. Rooklidge & Robert O. Bolan, The Official Gazette and Willful Patent Infringement: Stryker Corp. v. Intermedics Orthopedics, Inc.*, 79 *J. PAT. & TRADEMARK OFF. SOC'Y* 605, 606-07 (1997) ("The specter of penalties for willful patent infringement could discourage corporations from using the Official Gazette and the patent information the Official Gazette identifies. This information is the very technical information that the patent system encourages inventors to disclose as part of the bargain between the inventor and the public.").

²¹⁴ See *supra* note 203.

²¹⁵ See, e.g., *Myrick* 10/30 at 127 ("Getting rid of willfulness is goodness because it helps to disseminate the information."); *Mossinghoff* 10/30 at 134 ("I fully support the abolition of willfulness").

firm knowingly and deliberately uses another's patented invention because the likelihood that the patentee can afford to bring suit, and the expected value of single damages, are low. Given difficulties in recovering attorney fees, some infringers can profit from this strategy.

Recommendation. A solution that raises the threshold for finding willfulness in a way that (i) permits firms to read patents for their disclosure value and to survey the patent landscape to learn about potential infringement pitfalls, yet (ii) retains a viable willfulness doctrine in other settings could protect both competition and wronged patentees. The Commission recommends that legislation be enacted requiring either actual, written notice of infringement from the patentee or deliberate copying of the patentee's invention, knowing it to be patented, as a predicate for willful infringement. Under such a system, so long as the defendant creates its own invention, it would not be harmed by knowledge gained through reading patents; the patent system's disclosure function would be protected, and firms could conduct searches to determine their potential exposure to infringement claims.²¹⁶ Yet an infringer could not just ignore a patentee's notice and dare a plaintiff to fund, bring, and win a single-damage court suit, without risking treble

²¹⁶ See Barr 10/30 at 135 (changing the willfulness standard to require notification "does help the problem of patent clearances, wanting to do patent clearances and patent searches"); Taylor & Von Tersch, 20 HASTINGS COMM. & ENT. L. J. at 741 (proposing to limit willful infringement to cases of literal infringement involving either (i) actual notice with a reasonable time to study the patent prior to litigation or (ii) clear and convincing evidence of copying of a marked product). *But cf.* Pooley 10/30 at 130-31 (arguing that most of the costs of the willfulness doctrine would remain even with a notice system).

damages. A plaintiff would continue to benefit from treble damage possibilities from the time of giving actual notice.²¹⁷ To avoid generating a spate of spurious demand letters, the requisite notice would need to take a form sufficient to endow the recipient with standing to challenge the patent's validity.²¹⁸ The price for creating an opportunity to seek treble damages, consequently, would be creating a corresponding opportunity to extinguish the patent if it can be shown to be invalid.

V. CONCLUSION

The procedures through which patents are examined, reexamined, and litigated are fundamental determinants of patent system quality. Issuance of patents of questionable validity may affect competition and innovation by discouraging entry and research efforts, inducing unnecessary licenses and royalty payments, and imposing litigation costs. Uncertainty and delay in resolving validity questions add to each problem. Other concerns are raised by procedures and doctrines that maintain secrecy of some pending applications and interfere with the patent system's disclosure function. Hearing testimony regarding

²¹⁷ Concerns that treble damages generally would be unavailable for periods in which a third party knowingly infringes in secret appear, on balance, less compelling than gains from securing the benefits of patent disclosures and avoiding the costs of determining willfulness under current practices.

²¹⁸ Standing to bring a declaratory judgment action challenging the validity of a patent requires "a reasonable apprehension that the defendant will initiate suit if the plaintiff continues the allegedly infringing activity." ROBERT L. HARMON, PATENTS AND THE FEDERAL CIRCUIT § 8.1(a)(iii) at 447 (5th ed. 2001). For discussion regarding the difficulty potential declaratory judgment plaintiffs sometimes experience in establishing such standing, *see* Blackburn 2/26 at 294-96; Nydegger 4/11 at 149.

examination, reexamination/post-grant review, and litigation suggested changes that could better address competition concerns.

The examination process could be strengthened by enabling examiners to take better advantage of the information and knowledge possessed by applicants. Specifically, the Commission recommends that the PTO require applicants, upon request of the examiner, to submit statements of relevance regarding their prior art references and that it remove impediments to greater use of examiner inquiries. Moreover, the Commission urges that, to reduce business uncertainty, public notice of patent applications be expanded by legislation eliminating the opportunity for some applicants to opt out of the 18-month publication requirement.

Establishment of a post-grant review procedure would offer important opportunities to draw upon the prior art and expertise of third parties most familiar with a patented invention's technology. It could enhance patent quality and resolve business uncertainty more rapidly than litigation. It could direct finite agency resources for improving patent quality toward those patents that the market finds both commercially significant and in need of further review. The Commission supports the PTO's efforts to establish a procedure for post-grant review of patent claims and suggests ways to ensure that the procedure offers sufficient value to be used, without imposing the costs and delays of litigation, and without exposing patentees to third-party harassment.

Finally, the Commission offers two recommendations for upgrading the patent

litigation process. Absent a viable *inter partes* reexamination/post-grant review procedure, litigation is essentially the public's one line of defense against improvidently granted patents and the potential harms to competition and innovation that they may cause. Yet, under current rules, the ability to challenge patents is hamstrung by a clear and convincing evidence standard incommensurate with the nature and realities of the *ex parte* examination process. The Commission recommends that legislation be enacted specifying that challenges to patent validity be determined based on a preponderance of the evidence. Moreover, under current application of the willfulness doctrine, a third party who reads a patent to learn from its technology disclosures or to make informed decisions regarding the infringement risks of a course of research or marketing is exposed to potential treble damage liability for infringement. The Commission recommends that legislation be enacted limiting treble damages for willful infringement to circumstances when the patentee gives written notice or the infringer deliberately and knowingly copies a patented invention. Such a change would preserve treble damage liability in appropriate cases, while boosting competition and innovation through unhindered use of patent disclosures.

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CHAPTER 6 COMPETITION AND PATENT POLICY CAN AND SHOULD WORK TOGETHER

Introduction. Competition and patent policy generally work together to promote consumer welfare over time. The substantive standards and procedural rules of each policy accordingly should account for values that underlie both policies. For example, competition policy, as implemented by antitrust enforcement, should take into account how antitrust can affect patents and the role of patents in promoting consumer welfare. Similarly, patent policy should take into account how it can affect competition and the role of competition in promoting consumer welfare. Mechanisms that allow each doctrine to take the other's values into account will help achieve the proper balance between them as means to promote consumer welfare over time.

This chapter examines a variety of perspectives on how competition and patent policy can work together. Section I considers some of the ways in which each legal doctrine can and should take account of its relationship with the other. Section II discusses the Federal Circuit, one of the points at which competition, antitrust, and patent policy most directly intersect, in terms of the scope of its role and the trends that some perceive in its case law. Section III concludes with recommendations for the PTO and the Antitrust Agencies on how to improve consideration of and coordination with each other's policies.

I. ANTITRUST AND PATENT LAW AND POLICY

A. Antitrust Law and Policy Can and Should Take Patent Policy into Account to Promote Consumer Welfare Over Time

Antitrust law focuses on promoting consumer welfare, not only in the short term, but in the long term as well. It recognizes and takes account of the importance of dynamic competition to generate new and improved goods and services through technological progress, as well as the importance of static competition, with its emphasis on price and output levels of goods and services provided by existing technology. This broad focus necessarily leads to the consideration of issues such as how antitrust enforcement should take into account the need to prevent free riding and to allow efficient combinations of assets, for example. That antitrust law develops largely through case law gives it the flexibility to incorporate the goals of patent law into the antitrust analysis of conduct with respect to patents.

The joint FTC/DOJ report (forthcoming) will discuss the antitrust analysis of business conduct with respect to patents. This section highlights a few of the basic concepts.

1. Incentives to Innovate

Patent laws provide "incentives for innovation . . . by establishing enforceable property rights for the creators of new and

useful products [and] more efficient processes. . . .”¹ The importance of incentives to innovate resonates in antitrust law, which, by protecting competition, also can spur innovation.² In the IP Guidelines, the Agencies recognized how patents can spur innovation by providing “incentives for innovation and its dissemination and commercialization” and by avoiding rapid imitation that could “erode incentives to invest, ultimately to the detriment of consumers.”³

Both antitrust and patent law must consider their effects on initial and follow-on innovation in cumulative technology industries. For example, when follow-on patents are obtained by independent follow-on innovators, grantbacks can “provide a means for the licensee and the licensor to share risks and reward the licensor for making possible further innovation based on or informed by the licensed technology.”⁴ Antitrust enforcement now recognizes this as a procompetitive benefit from grantbacks.⁵

¹ U.S. Department of Justice and Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property §1.0 (Apr. 6, 1995), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,132, available at <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm> (hereinafter IP Guidelines).

² “It is the possibility of success in the marketplace, attributable to superior performance, that provides the incentives on which the proper functioning of our competitive economy rests.” *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 281 (2nd Cir. 1979), cert. denied, 444 U.S. 1093 (1980).

³ IP Guidelines § 1.0.

⁴ *Id.* at § 5.6.

⁵ *Id.*

2. The Reduction of Free Riding

By conferring a right to exclude others from making, using, or selling an invention, patent law reduces the ability of rivals to free ride on a firm’s investments in innovation. Antitrust law is also concerned with the prevention of free riding. For example, in holding that antitrust law does not obligate firms to predispose technological innovations to competitors, the Second Circuit stated as follows: “[i]f a firm that has engaged in the risks and expenses of research and development were required in all circumstances to share with its rivals the benefits of those endeavors, this incentive would very likely be vitiated.”⁶ Similarly, the Supreme Court has upheld restrictions on competition that prevented competitors from “free riding” on a firm’s promotional efforts.⁷

3. The Generation of Efficiencies by Combining Complementary Factors of Production

The IP Guidelines also signaled the Agencies’ increased appreciation of the efficiencies generated through cross-licensing and other licensing practices. In particular, the Agencies recognized that “intellectual property licensing allows firms to combine complementary factors of production and is generally

⁶ See *Berkey*, 603 F.2d at 281.

⁷ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 54-55 (1977). See also IP Guidelines § 2.3 (the IP Guidelines note that “various forms of exclusivity” can give a licensee the incentive to invest in commercializing and distributing products that embody the intellectual property by “protecting the licensee against free-riding on the licensee’s investments by other licensees or by the licensor.”).

procompetitive.”⁸ Licensing can, for example, promote the coordinated development of technologies when the use of an independent follow-on innovator’s patent is blocked by a patent on first-generation technology.

4. The Reduction of Transaction Costs

Patent rights render innovation a tradeable commodity by reducing transaction costs and enabling licensing negotiations.⁹ In cumulative technology industries where downstream innovation can depend on access to upstream patents held by many different owners, the transaction costs of access can be substantial. By acknowledging the potential for patent pools and cross licenses to facilitate the commercialization of innovation in cumulative technology industries, antitrust analysis can be sensitive to the implications of transaction costs for innovation.¹⁰

B. Patent Law and Policy Can and Should Take Competition Policy into Account to Promote Consumer Welfare Over Time

1. Patent Law Takes Competition Policy into Account to Promote Consumer Welfare Over Time

⁸ IP Guidelines § 2.0.

⁹ See *supra* Ch. 2(I)(A)(2).

¹⁰ See Second Report (forthcoming).

Concern for public benefits also animates patent law, from its earliest predicates in the U.S. Constitution through its embodiment in the basic substantive standards of the Patent Act. The courts on occasion have fully discussed and considered the impact on public benefit in reaching conclusions about the proper interpretation of patent law.¹¹

The Constitution authorizes Congress to implement a patent system for a clearly specified purpose. Pursuant to Article 1, Section 8, “[t]he Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” The Supreme Court has characterized this clause as “both a grant of power and a limitation.”¹² The authority extends only to promoting the progress of science and useful arts, and it must be implemented accordingly:

The Congress in the exercise of the patent power may not overreach the restraints imposed by the stated constitutional purpose. Nor may it enlarge the patent monopoly without regard to the *innovation, advancement or social benefit* gained thereby.¹³

¹¹ See, e.g., *supra* Ch. 1(III)(A)(2)(b) (discussing the Federal Circuit’s attentiveness to notice function of patents), Ch. 4(II)(C)(2) (discussing Supreme Court’s attention, in *Festo*, to effects of doctrine of equivalents on competition).

¹² *Graham v. John Deere Co.*, 383 U.S. 1, 5 (1966).

¹³ *Id.* at 5-6 (emphasis added).

In economic terms, policies chosen with “regard to the innovation, advancement or social benefit gained thereby” are policies that contribute to consumer welfare over time. That is, patent policy is for the benefit of the public, not patent holders: The ultimate point of granting a patent is not to reward inventors, but rather to create incentives for actions – invention, disclosure, and commercial development – that will further the public interest and thus benefit consumers over time. Patent institutions, however, have not always brought this goal to the forefront in interpreting and applying the underlying policies. Sharper focus at both the administrative and judicial levels on the consequences of policy choices and the relationship of those choices to the patent system’s consumer welfare function could yield substantial public benefit.

In crafting the substantive standards of the Patent Act, Congress specified the mechanisms through which the PTO and the courts can pursue this fundamental goal. Each of the key substantive standards for granting or interpreting patents discussed in Chapter 4 – nonobviousness, enablement, written description, the doctrine of equivalents, and utility – rests on a foundation of principles chosen to advance innovation and provide public benefit.

a. Nonobviousness

The nonobviousness requirement arises out of the principle that the patent system does not promote innovation if it grants exclusive rights on inventions that are already, or could be soon, in the public

domain.¹⁴ As the Supreme Court’s *Graham* opinion states,

Congress may not authorize the issuance of patents whose effects are to remove existent knowledge from the public domain, or to restrict free access to materials already available.¹⁵

Similarly, as the Federal Circuit explains,

That is the real meaning of “prior art” in legal theory – it is knowledge that is available, including what would be obvious from it, at a given time, to a person of ordinary skill in an art. Society, speaking through Congress and the courts, has said, “thou shalt not take it away.”¹⁶

Granting a right to exclude based on “knowledge that is available, including what would be obvious from it,” upsets the balance between property protection and competition that the Supreme Court in *Bonito Boats* found so basic.¹⁷ It risks conferring market power without receiving something innovative in return and conflicts

¹⁴ Of course, the novelty standard raises similar considerations.

¹⁵ *Graham*, 383 U.S. at 6.

¹⁶ *Kimberley-Clark Corp. v. Johnson & Johnson*, 745 F.2d 1437, 1453-54 (Fed. Cir. 1984).

¹⁷ See *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989) (“From their inception, the federal patent laws have embodied a careful balance between the need to promote innovation and the recognition that imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy.”). For additional discussion of *Bonito Boats*, see *supra* Ch. 1.

with “the underlying policy of the patent system that [the public benefits] must outweigh the restrictive effect of the limited patent monopoly.”¹⁸ How the line demarcating nonobvious inventions is drawn, therefore, implicates the “careful balance” that sanctions patents only under the general circumstances that make them likely to benefit society.

b. Enablement and Written Description

The enablement standard secures the patent system’s disclosure goals. Disclosure is the *quid pro quo* for conferring patent rights,¹⁹ and enablement ensures that the patent applicant has upheld his or her end of the bargain. Moreover, the standard is a basic element in determining patent breadth. A patent’s coverage reaches no farther than what its disclosures enable, so the more follow-on developments that a patent’s disclosures enable without undue experimentation, the broader its claims may be.²⁰ Patent breadth, in turn, affects the

¹⁸ *Graham*, 383 U.S. at 10-11; see also *Bonito Boats*, 489 U.S. at 150 (“Taken together, the novelty and nonobviousness requirements express a congressional determination that the purposes behind the Patent Clause are best served by free competition and exploitation of either that which is already available to the public or that which may be readily discerned from publicly available material.”).

¹⁹ *FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy*, James Rogan Testimony Feb. 6, 2002, at page 21 (hereinafter, citations to transcripts of these Hearings state the speaker’s last name, the date of testimony, and relevant page(s)); see also *Bonito Boats*, 489 U.S. at 151 (“In consideration of its disclosure and the consequent benefit to the community, the patent is granted.”).

²⁰ See *Merges* 2/26 at 154-55; see also *supra* Ch. 4 (II)(B)(1).

division of rewards between initial and independent follow-on innovators.²¹ A patent broader than what actually has been enabled thus risks damaging follow-on innovation competition without providing the requisite public benefit. Again, drawing the line demarcating what has been enabled goes to the heart of *Bonito Boats*’ patent/competition bargain.

The written description requirement derives in part from similar considerations of patent breadth. By requiring patent applicants to provide a description sufficient to show that they are in possession of the invention, the requirement protects against overbroad claim amendments.²² Indeed, the Federal Circuit has described one “policy-based rationale” for the description requirement as follows:

Adequate description of the invention guards against the inventor’s overreaching by insisting that he recount his invention in such detail that his future claims can be determined to be encompassed within his original creation.²³

²¹ See *Scotchmer* 2/26 at 130-35; see also *supra* Ch. 4 (II)(B)(2).

²² As discussed *supra* in Ch. 4 (II)(B)(1), an applicant cannot broaden claims beyond the scope of the written description and still take advantage of the original filing date.

²³ *Vas-Cath Inc. v. Mahurkar*, 935 F.2d 1555, 1561 (Fed. Cir. 1991) (quoting *Rengo Co. v. Molins Mach. Co.*, 657 F.2d 535, 551 (3d Cir.), cert. denied, 454 U.S. 1055 (1981)). The court noted that another rationale, to give public notice of a patent’s scope, may have had greater bearing previously, before the patent statutes required that applications contain separately identified claims. *Id.* at 1560-61.

The written description requirement's roots thus trace, at least in part, from concern with potential competitive harms from after-the-fact "overreaching" beyond an applicant's actual invention, and the requirement plays its own role in shaping the competition/right-to-exclude interface.

c. Doctrine of Equivalents

The doctrine of equivalents brings the need for delicate balance to the fore. As the Supreme Court recognized in its *Festo* opinion, the doctrine raises issues of claim transparency that affect the public: "This clarity [of patent boundaries] is essential to promote progress, because it enables efficient investment in innovation. A patent holder should know what he owns, and the public should know what he does not."²⁴ The doctrine of equivalents, however, "renders the scope of patents less certain. . . . If competitors cannot be certain about a patent's extent, they may be deterred from engaging in legitimate manufactures outside its limits, or they may invest by mistake in competing products that the patent secures."²⁵ The Federal Circuit in *Festo* gave these considerations precedence, emphasizing the notice value of claims in finding a complete bar to application of the doctrine of equivalents to claim elements narrowed during the course of a prosecution.²⁶ The Supreme Court ultimately softened the appellate court's

²⁴ *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 535 U.S. 722, 730-31 (2002).

²⁵ *Id.* at 732.

²⁶ See *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 234 F.3d 558, 574-78 (Fed. Cir. 2000) (emphasizing the notice function of claims).

ruling, however, making the bar a matter of rebuttable presumption.²⁷ The key point, however, is not the outcome in the particular case, but rather that the parameters of debate again evolved in *Bonito Boats* terms, seeking the right balance between protection of the patentee and impact on outside competition.²⁸

d. Utility

The utility requirement reveals yet another element of the patent system's "careful balance" of rights to exclude with competitive concerns. The Supreme Court's *Brenner* opinion addressed this balance at some length:

[A] process patent in the chemical field, which has not been developed and pointed to the degree of specific utility, creates a monopoly of knowledge which should be granted only if clearly commanded by the statute. . . . Such a patent may confer power to block off whole areas of

²⁷ *Festo*, 535 U.S. at 737-41. The Court reasoned that a complete bar in these circumstances would exceed the inferences that courts reasonably can draw from a narrowing amendment and would "disrupt the settled expectations of the inventing community." *Id.* at 737-39. It sought to strike the appropriate balance by placing the burden of proof on the patentee to show why an amendment does not surrender the particular equivalent in question. *Id.* at 739-41.

²⁸ Indeed, similar considerations lie at the heart of another recent Federal Circuit ruling regarding a different aspect of the doctrine of equivalents. See *Johnson & Johnston Assoc. v. R.E. Service Co.*, 285 F.3d 1046, 1052-54 (Fed. Cir. 2002) (*en banc*) (prohibiting use of the doctrine of equivalents to cover subject matter disclosed in the specification but not included in the patent's claims, on grounds that this would conflict with the "primacy of the claims" in defining the scope of the patent rights and providing notice on which the public is entitled to rely).

scientific development without compensating benefit to the public. The basic quid pro quo contemplated by the Constitution and the Congress for granting a patent monopoly is the benefit derived by the public from an invention with substantial utility. Unless and until a process is refined and developed to this point – where specific benefit exists in currently available form – there is insufficient justification for permitting an applicant to engross what may prove to be a broad field.²⁹

Thus, concerns with patenting too close to the laboratory bench and with blocking off scientific development and follow-on research are part and parcel of the utility inquiry. Once again, the patentability standard is crafted, interpreted, and justified in terms of harmonizing with competition and providing public benefit.

2. Patent Institutions Should Expand their Consideration of Competition Policy Concerns in Decision Making

Despite these very substantial connections between the standards of patentability and consumer welfare goals, neither the PTO nor the Federal Circuit has consistently kept those goals at the forefront of its policymaking. To the contrary, several panelists observed that both the agency and the court generally were unreceptive to policy considerations and that both, to some extent, regarded policy issues as beyond the scope of their charters.

²⁹ *Brenner v. Manson*, 383 U.S. 519, 534-35 (1966).

Some suggested that the PTO merely carries out the dictates of the Patent Act, as enacted by Congress and interpreted by the courts, and consequently has little role in considering policy. For example, the PTO's John Love stated:

[T]he amount of discretion that the PTO has is very limited. . . . [W]e are constrained quite a bit, in the first place [by] a statute, 35 U.S.C., of course, that explains very specifically the conditions of patentability and, in addition to novelty and non-obviousness, patentable subject matter – 101 is a considerable restriction. We are also constrained by the way the CAFC interprets those provisions. . . . and we cannot go outside the constraints of the law, which state that, "A patent shall be granted unless . . .," I mean, there is your discretion.³⁰

In addition, Stephen Kunin, the PTO's Deputy Commissioner for Examination Policy, explained that the Federal Circuit has stated that the PTO rulemaking authority³¹ is interpretive in nature and does not entail the authority to issue substantive rules entitled to deference from the courts.³²

³⁰ John Love 2/28 at 626-27; *see also* Chen 2/28 at 629.

³¹ *See* 35 U.S.C. § 2(b)(2) (providing that the PTO "may establish regulations, not inconsistent with law, which (A) shall govern the conduct of proceedings in the Office . . .").

³² *See* Kunin 4/10 at 46 (citing *Merck & Co. v. Kessler*, 80 F.3d 1543 (Fed. Cir. 1996)). The Federal Circuit in *Merck* determined that Congress had not vested the PTO "with any general substantive rulemaking power," and consequently held that "the rule of controlling deference set forth in *Chevron* does not apply." *Merck*, 80

Some agreed with this narrow role for the agency,³³ but others saw value in a broader role for the PTO³⁴ or raised concerns with recent trends.³⁵ One of the panelists cited the PTO's 2001 revisions to its Utility Examination Guidelines³⁶ as an example of how "the PTO, absent the courts, . . . can exercise a fair bit of latitude with important consequences for innovation and economic welfare."³⁷ As noted *supra* in Chapter 4, those revisions generally have been well-received, but a review of the informal notice-and-comment process arguably

F.3d at 1550 (referring to *Chevron, USA, Inc. v. National Resources Defense Council*, 467 U.S. 837 (1984)). See also *United States v. Mead Corp.*, 533 U.S. 218, 229-30 (2001) (framing the deference inquiry in terms of whether Congress "provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement" with "the effect of law").

³³ See, e.g., Bendekgey 2/26 at 303-05 (PTO "shouldn't be raising and lowering standards" but does "have to apply the law to technology"); Mossinghoff 10/30 at 10; Pooley 10/30 at 13-14; Banner 10/30 at 15-16 (any "fixes to be made" should come from Congress, "most definitely not" from the PTO). *But cf.* Myrick 10/30 at 24 (PTO and the courts, "in their respective areas of relevance, should be making policy-like decisions, but the fundamental policy rests with the Congress").

³⁴ See, e.g., Rai 4/10 at 42 (acknowledging "the apparent lack of power of the PTO from an administrative law standard," but nonetheless arguing that the PTO is "the appropriate place to place the sort of power of determining how these particular substantive [patentability] criteria should be applied"); Katsh 4/10 at 58-59; Kunin 7/10 at 190-91 ("it's important for us [the PTO] to be able to have a very strong role in the norm setting process").

³⁵ See Merrill 10/25 at 186 (the environment of receptivity to policy arguments at the PTO has "deteriorated" and the PTO's in-house analytical capability has declined).

³⁶ United States Patent and Trademark Office, *Utility Examination Guidelines*, 66 Fed. Reg. 1092 (2001).

³⁷ Cohen 10/30 at 30.

suggests that in some instances the PTO may have taken a constrained view of its role in working – within the interstices of existing law – toward policies that maximize welfare.³⁸

At the same time, several panelists suggested that litigants do not perceive the Federal Circuit as receptive to economic arguments or attuned to the overall economic consequences of its decisions. Panelists testified that the Federal Circuit does not "think[] in economic ways"³⁹ and does not often receive briefs or write opinions citing to economic journals or law

³⁸ For example, the PTO noted that "[s]everal comments stated that DNA should be freely available for research," that "patents are not necessary to encourage additional discovery and sequencing of genes," and that "patenting of DNA inhibits biomedical research by allowing a single person or company to control use of the claimed DNA." *Utility Examination Guidelines*, 66 Fed. Reg. at 1095. Granting that such subject matter is patentable, such comments nevertheless raise significant issues relating to where the line should be drawn in finding basic genetic research sufficiently ripe to meet the statutory utility requirement. Yet the PTO dismissed these issues, with a five-sentence response that (i) noted that patentable subject matter and patentability standards are set by statute; (ii) quoted the statute; (iii) observed that "Congress creates the law and the Federal judiciary interprets the law;" (iv) pointed out that "[t]he USPTO must administer the laws as Congress has enacted them and as the Federal courts have interpreted them;" and (v) concluded that "when the statutory patentability requirements are met, there is no basis to deny patent applications claiming DNA compositions, or to limit a patent's scope in order to allow free access to the use of the invention during the patent term." *Id.* At least on its face, this approach avoids any policy consideration of *when* the statutory utility requirement is met, which the Utility Guidelines serve to explain. Such an approach arguably reflects a very limited view of agency responsibility for working with the statute's terms and the governing judicial interpretations to administer the Patent Act for the public benefit.

³⁹ See Rai 4/10 at 116; see also Merrill 10/25 at 186-87 (judicial receptivity to economic analysis has deteriorated).

review analyses.⁴⁰ One indicated that the courts do not see the implications of their decisions for progress and innovation as “their first order mission.”⁴¹ Moreover, as two panelists phrased it, the Federal Circuit has not seen patent law “as part of a whole panoply of tools that are used to promote innovation”⁴² and does not “give due credit to competition as a driver of innovation.”⁴³

Yet, as we saw in Chapter 4 and in Section I.B.1 above, the Supreme Court has made clear that there is room for policy-oriented interpretation of the patent laws. The statute, although more explicit than the antitrust laws, is still far from detailed. The basic nonobviousness standard requires two sentences,⁴⁴ and the enablement, written description, and best mode requirements all fit within the same, one-sentence text.⁴⁵ The entire utility requirement consists of the words “useful,” “use,” and “using.”⁴⁶ The doctrine of equivalents does not even appear

⁴⁰ See Dreyfuss 7/10 at 75-76 (“from time to time the Federal Circuit Judges have said that they don’t understand why people cite this material. . . . They’re not making policy. . . .”); Wamsley 7/10 at 76 (Federal Circuit makes few citations to economic journals or law review articles); Lunney 7/10 at 85 (Federal Circuit regards discussion of the economic literature as “the last refuge of the desperate”); Duffy 10/30 at 33; cf. Pooley 10/30 at 14 (noting that some judges would like more information in briefing, but asking how a broad enough array of economic input could be submitted to make it useful, rather than dangerous).

⁴¹ See Cohen 10/30 at 12.

⁴² Dreyfuss 7/10 at 47.

⁴³ Quillen 7/11 at 161.

⁴⁴ See 35 U.S.C. § 103(a).

⁴⁵ See *id.* at § 112, ¶ 1.

⁴⁶ See *id.* at §§ 101, 112.

in the statute. Under these circumstances, interstices are inevitable, and there is room for thought and choice in how they are filled.⁴⁷ As Professor Wesley Cohen explained, “there’s an enormous amount of latitude, and where you come down in that domain of flexibility can have enormous consequences for the pace of innovation and for economics, either considered narrowly or broadly.”⁴⁸

II. THE FEDERAL CIRCUIT: GOALS, JURISDICTION, CHOICE OF LAW, AND CASE LAW TRENDS

Nowhere is the intersection between institutional design and substantive outcomes more pronounced than within the context of the United States Court of Appeals for the Federal Circuit. Congress established the Federal Circuit in 1982 through merging two specialized courts of limited subject matter, but nationwide, jurisdiction – the U.S. Court of Claims and the U.S. Court of Customs and Patent Appeals. The Federal Circuit was an “experiment” designed to increase patent

⁴⁷ Professor John Duffy, for example, pointed out that even following the Supreme Court’s *Graham v. John Deere* opinion, the primary factors in nonobviousness analysis “leave you off at the very point you think the analysis should start . . . you’ve identified a gap between what’s in the prior art and this invention And *Graham* . . . doesn’t tell you how to judge whether the gap is sufficient for a patent.” Duffy 7/10 at 116-17. See also Rai 4/10 at 83-84 (patent law should be grounded in innovation policy and economic policy considerations); Stoner 10/30 at 37 (urging implementation of the patent system in ways that take account of economic goals).

⁴⁸ Cohen 10/30 at 30.

law uniformity.⁴⁹ Not surprisingly, the debates that occurred during its formation retain salience today. This section briefly discusses how aspects of the Federal Circuit relate to the balance between competition, antitrust, and patent policy.

A. The Federal Circuit and Its Intended Effect on the Law

1. Patent Law

Congress created the Federal Circuit “to bring about uniformity of decisions in certain critical areas of the law without the need for Supreme Court review to resolve conflicts between circuits. To this end, the Federal Circuit was given exclusive jurisdiction over appeals from all district courts in cases which arise under the patent laws. . . . A particular need was seen in the field of patents where instability in the law was having a detrimental effect on an important segment of our society, the industrial and business community.”⁵⁰ As Judge Newman observed, creation of the Federal Circuit was “a dramatic move for the purpose of adding stability to the patent law.”⁵¹ Prior to creation of the Federal Circuit, in the most extreme cases, “different courts dealing with the same patent reached

⁴⁹ THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT – A HISTORY (1982-1990), at xi (1991). This history was written by the Court of Appeals for the Federal Circuit and published by authorization of the U.S. Judicial Conference Committee on the Bicentennial of the Constitution of the United States.

⁵⁰ *Id.* at xii. See also Rogan 2/6 at 25 (observing that Congress created the Federal Circuit to promote a more stable patent system through the reduction of jurisdictional splits).

⁵¹ Newman 2/6 at 37.

different conclusions.”⁵² The Federal Circuit was to provide clearer and more consistent application of patent law, which in turn would increase the predictability of patents and, thus, their value as means to promote innovation.⁵³

2. Antitrust Law

Another important consideration was how the Federal Circuit would treat antitrust issues that may arise in conjunction with patent claims. As the then-Chairman of the ABA Antitrust Section observed at the Hearings, Congress specifically contemplated that the Federal Circuit would have a role in development of antitrust law, but Congress also expected the Federal

⁵² Taylor 7/11 at 22 (emphasis added). See generally S. REP. No. 97-275, at 5 (1981). At the time, not all agreed that circuit splits required creation of the Federal Circuit. See, e.g., Paul Janicke, *To Be or Not To Be: The Long Gestation of the U.S. Court of Appeals for the Federal Circuit (1887-1982)*, 69 ANTITRUST L.J. 645, 646, n.5 (2002) and accompanying text. Disagreement about this fundamental issue remains. Cf. American Bar Association Section of Intellectual Property Law, *Statement of Robert P. Taylor on Behalf of Section of Intellectual Property Law American Bar Association on Competition and Intellectual Property Law and Policy In the Knowledge-Based Economy* (7/11/02) 2-3 (noting that there had been a particular problem with the existence of several pockets of “anti-patent” judicial sentiment), at <http://www.ftc.gov/opp/intellect/020711robertptaylor.pdf> (hereinafter ABA IP Section (stmt)). Compare Taylor 7/11 at 22 (statistics demonstrate general disparity between circuits) with Quillen 7/11 at 52 (questioning the extent of the circuit splits prior to the Federal Circuit and whether any differences that did in fact exist between circuits had any statistical relevance) and Katsh 4/10 at 31 (“I don’t think the venue, the forum shopping argument, had any merit.”).

⁵³ See generally American Bar Association Section of Antitrust Law, *Report on the United States Court of Appeals for the Federal Circuit* (Public Comment) 8-14, at <http://www.ftc.gov/opp/intellect/0207salabarpt.pdf> (hereinafter ABA Antitrust Section, *Federal Circuit Report*).

Circuit to “zealously guard against the expansion of that role beyond areas implicating the development of patent law.”⁵⁴ Congress appears to have been “persuaded that the Federal Circuit would strictly construe its own jurisdiction and that its jurisdiction could not easily be manipulated.”⁵⁵ The manner in which the Federal Circuit has interpreted its jurisdiction will be addressed below.

B. Jurisdiction and Choice of Law Issues at the Federal Circuit

Two legal filters – jurisdiction and choice of law – affect the cases that the Federal Circuit decides and the law that the Federal Circuit applies in reaching its decisions. Jurisdiction is “the legal right by which judges exercise their authority. . . . It exists when [a] court has cognizance of class of cases involved, proper parties are present, and [the] point to be decided is within the powers of the court.”⁵⁶ Choice of law refers to the determination of what law should govern when a conflict in law arises.⁵⁷ When the Federal Circuit evaluates what cases it will hear and what law it will apply, the value of patent law uniformity is explicitly and implicitly at issue.

⁵⁴ Busey 7/11 at 17; *see also* ABA Antitrust Section, *Federal Circuit Report* at 16-22.

⁵⁵ Ronald S. Katz & Adam J. Safer, *Should One Patent Court be Making Antitrust Law for the Whole Country?*, 69 ANTITRUST L.J. 687, 691 (2002).

⁵⁶ BLACK’S LAW DICTIONARY 853 (6th ed. 1990).

⁵⁷ *Id.* at 241.

1. Jurisdictional Standards

“Determinations about federal jurisdiction require sensitive judgments about congressional intent, judicial power, and the federal system.”⁵⁸ The Federal Circuit’s interpretations of its subject matter jurisdiction similarly have required such sensitive judgments.

a. Arising Under Jurisdiction

Title 28, Section 1295 of the U.S. Code establishes Federal Circuit jurisdiction. The Federal Circuit has exclusive jurisdiction over appeals from final decisions of district courts, if the district court jurisdiction was “based, in whole or in part, on section 1338.”⁵⁹ Section 1338(a) provides that “[t]he district courts shall have original jurisdiction of any civil action arising under any Act of Congress relating to patents. . . .”⁶⁰ Historically, Federal Circuit jurisdiction has encompassed antitrust claims through their inclusion in a complaint, through joinder or consolidation of an antitrust claim with a pre-existing patent claim,⁶¹ or through the presence of a counterclaim.

⁵⁸ *Christianson v. Colt*, 486 U.S. 800, 809 n. 2 (1988) (discussing jurisdiction of Federal Circuit).

⁵⁹ 28 U.S.C. § 1295(a)(1).

⁶⁰ *Id.* at § 1338(a).

⁶¹ Nonetheless, Congress stated that “mere joinder of a patent claim in a case whose gravamen is antitrust should not be permitted to avail a plaintiff of the jurisdiction of the Federal Circuit in avoidance of the traditional jurisdiction and governing legal interpretation of a regional court of appeals. . . .” S. REP. NO. 97-275, at APP. 21-30 (1981). This statement suggests that Congress intended the Federal Circuit to prevent such efforts to use joinder to gerrymander Federal Circuit jurisdiction.

Most recently, the Supreme Court addressed what constitutes “arising under” jurisdiction when the plaintiff does not allege a patent law claim, but the defendant files a compulsory patent counterclaim.⁶² The Federal Circuit had ruled such compulsory counterclaims were sufficient to establish the Federal Circuit’s jurisdiction.⁶³ Nonetheless, in *Holmes v. Vornado*, the Supreme Court ruled they were not. The Court applied the “well-pleaded-complaint rule” as governing “arising under” jurisdiction for purposes of § 1338.⁶⁴ The Court held that, where a well-pleaded complaint does not assert any claim arising under federal patent law, the Federal Circuit cannot assert jurisdiction based solely upon

a patent counterclaim.⁶⁵

Panelists’ reaction to the Supreme Court ruling in *Holmes* was mixed. One practitioner opined that *Holmes* will narrow Federal Circuit jurisdiction, although to what extent is unclear.⁶⁶ Along similar lines, another panelist predicted “occasional races to the courthouse,” because antitrust plaintiffs who want to avoid the Federal Circuit will file their cases as an antitrust action, before defendants attempt to secure Federal Circuit jurisdiction.⁶⁷ This alone would not necessarily avoid Federal Circuit jurisdiction, however, since antitrust plaintiffs seeking regional circuit review also would have to plead in a manner to avoid *Christianson*, which we discuss next.⁶⁸

⁶² *Holmes Group, Inc. v. Vornado Air Circulation Sys., Inc.*, 535 U.S. 826 (2002).

⁶³ *Holmes Group, Inc. v. Vornado Air Circulation Sys.*, 13 Fed. Appx. 961 (2001); see also *Aerojet-General Corp. v. Machine Tool Works*, 895 F.2d 736, 741-42 (Fed. Cir. 1990).

⁶⁴ *Holmes*, 535 U.S. at 829 (citing *Christianson v. Colt*, 486 U.S. 800 (1988)). The “well-pleaded complaint rule” provides that a federal district court’s jurisdiction extends over “only those cases in which a well-pleaded complaint establishes either that federal law creates the cause of action or that the plaintiff’s right to relief necessarily depends on resolution of a substantial question of federal law. . . .” *Christianson*, 486 U.S. at 808. The Supreme Court further held that “linguistic consistency” requires that § 1338(a) jurisdiction likewise extends only to those cases in which “patent law is a necessary element of [a] . . . well-pleaded claim[.]” *Id.* at 808-9. The Supreme Court’s invocation of the well-pleaded-complaint rule in *Holmes* implicitly raises additional issues. For example, the “well-pleaded complaint” rule typically applies to complaints as filed. Could Federal Circuit jurisdiction change depending upon the disposal of patent issues after filing but prior to appeal, such as through voluntary withdrawal, dismissal with prejudice, or severance followed by partial final judgments? For a discussion of such issues, see generally Gordon 7/10 at 44, 65-66; ABA Antitrust Section, *Federal Circuit Report* at 36-43.

⁶⁵ *Holmes*, 535 U.S. at 833-34. See generally ABA Antitrust Section, *Federal Circuit Report* at 33-35; ABA IP Section (stmt) 4.

⁶⁶ Baker 7/11 at 39.

⁶⁷ Kobak 7/11 at 128; see also ABA Antitrust Section, *Federal Circuit Report* at 36.

⁶⁸ Kobak 7/11 at 130 (for example, such a party would not want to ask for a declaratory judgment of invalidity, which would provide a basis for Federal Circuit jurisdiction under *Christianson*, even though declaratory judgments frequently were sought before *Holmes*). Another question *Holmes* raises is whether “a patent claim [may] be filed as a separate action in federal court while a separate antitrust action is pending, or must the patent claim be dismissed for nonjoinder.” ABA IP Section (stmt) 5. The American Bar Association’s Section of Intellectual Property Law further noted that to the extent regional and Federal Circuit interpretations of patent law differ, incentives will exist for “plaintiffs to race to file in order to engage in . . . forum shopping.” *Id.*

b. Substantial Question of Patent Law

In *Christianson v. Colt*, the Supreme Court held that the Federal Circuit also has jurisdiction over those cases in which “the plaintiff’s right to relief necessarily depends on resolution of a substantial question of federal patent law.”⁶⁹ One panelist characterized the substantial question threshold in the following manner: “[d]o [the] claims require proof of [a] patent’s scope, validity, and/or infringement?”⁷⁰ The Federal Circuit itself has characterized *Christianson* as “set[ting] a lenient standard for jurisdiction under 28 U.S.C. § 1338(a).”⁷¹

c. The Breadth of Federal Circuit Jurisdiction

Panelists expressed varied assessments regarding the Federal Circuit’s jurisdictional interpretations. One panelist saw general agreement that the Federal Circuit has expanded its authority over the years.⁷² Another did not see the Federal Circuit expanding its jurisdiction through changing its precedent, but rather applying that precedent to new situations.⁷³ Still

⁶⁹ *Christianson*, 486 U.S. at 809; see also Gordon 7/11 at 43.

⁷⁰ George G. Gordon, *The Implications of Federal Circuit Jurisdiction for the Development of Antitrust Law* (7/11/02) (slides) at 7, at <http://www.ftc.gov/opp/intellect/020711georgegordon.pdf> (hereinafter Gordon Presentation).

⁷¹ *U.S. Valves, Inc. v. Dray*, 212 F.3d 1368, 1372 (Fed. Cir. 2000).

⁷² Dreyfuss 7/11 at 170.

⁷³ Gordon 7/11 at 100 (noting, however, a possible exception to this trend in breach of contract cases).

another saw Federal Circuit jurisdiction as fairly stable over the years.⁷⁴ No consensus emerged.

2. Choice of Law

To understand better the full effect of these jurisdictional matters, we look to choice of law issues. As the American Bar Association Intellectual Property Section noted, “jurisdiction and choice of law are inextricably intertwined as a practical matter, but should be examined independently for clarity.”⁷⁵

When Federal Circuit cases involve only patent issues, the Federal Circuit applies its own law, because it is the only court of appeals with jurisdiction over such cases. When cases involve both patent and other legal issues, however, choice of law issues necessarily arise. The Federal Circuit must decide whether to apply its own law with respect to the non-patent issues or to apply to those non-patent issues the law of the regional circuit in which the case would have been heard, absent the patent issues.⁷⁶

The intersection of antitrust and patents obviously raises choice of law issues for the Federal Circuit. From its inception, the Federal Circuit has generally interpreted choice of law in a manner to permit the infusion of its own ideas regarding the

⁷⁴ Taylor 7/11 at 101.

⁷⁵ ABA IP Section (stmt) 2; see also Weil 7/11 at 69; Dreyfuss 7/11 at 99.

⁷⁶ As one commentator has aptly noted, a “fundamental choice of law problem faced by the Federal Circuit arises from its limited subject matter jurisdiction.” ROBERT L. HARMON, *PATENTS AND THE FEDERAL CIRCUIT* § 18.3 at 1086 (5th ed. 2001).

relationship between patents and antitrust.⁷⁷ This implicit trend became concrete relatively recently in *Nobelpharma v. Implant Innovations*, when the Federal Circuit held that:

As a general proposition, when reviewing a district court's judgment involving federal antitrust law, we are guided by the law of the regional circuit in which that district court sits. . . . However, we apply our own law, not regional circuit law, to resolve issues that clearly involve our exclusive jurisdiction.⁷⁸

In *Nobelpharma*, a patent assignee brought an action for infringement, and the alleged infringer counterclaimed for antitrust violations. The Federal Circuit held that whether conduct in the prosecution or enforcement of a patent is sufficient to overcome any antitrust immunity arising under the principles of *Eastern R.R. President's Conference v. Noerr Motor Freight, Inc.*⁷⁹ and related cases, falls within its exclusive jurisdiction.⁸⁰ The court reasoned that most antitrust claims involving these issues will be filed as counterclaims by defendants in patent infringement suits and that, as a consequence, most cases involving

these issues will be appealed to the Federal Circuit. The Federal Circuit eschewed reliance on various regional precedents, because such reliance could endanger the court's efforts "to create a uniform body of federal law on this subject."⁸¹ Nonetheless, the Federal Circuit cited issues involving the "elements of antitrust law such as relevant market, market power, damages, etc." as areas where it will continue to apply regional circuit law.⁸²

During the Hearings, some supported the *Nobelpharma* reasoning as in accord with the purpose of the Federal Circuit to bring consistency to patent law.⁸³ One panelist argued that the same rationale supporting the need for a uniform appellate review of patent matters also supports a need for uniform appellate review of the patent/antitrust interface.⁸⁴ In contrast, another argued that the Federal Circuit should not be the only circuit deciding patent/antitrust interface issues, and determining "how patent law fits into the wider mosaic of rights and obligations in our

⁸¹ *Id.* at 1067-68.

⁸² *Id.* at 1068.

⁸³ See, e.g., American Intellectual Property Law Association (AIPLA), *AIPLA Testimony* (Public Comment) 15, at <http://www.ftc.gov/os/comments/intelpropertycomments/aipla.pdf> (hereinafter AIPLA (stmt)); Intellectual Property Owners Association, *Comments on the Joint Hearings of the Federal Trade Commission and the Department of Justice Regarding Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (Public Comment) 7-8, at <http://www.ftc.gov/os/comments/intelpropertycomments/ipo.pdf> (hereinafter IPO (stmt)). See generally ABA IP Section (stmt) 6-7 (indicating that recent experience with the interface of patents and antitrust law lies with the Federal Circuit).

⁸⁴ Baker 7/11 at 38.

⁷⁷ See generally ABA Antitrust Section, *Federal Circuit Report* at 52-71.

⁷⁸ 141 F.3d 1059, 1067 (Fed. Cir.), *cert. denied*, 525 U.S. 876 (1998). In so doing, the Federal Circuit overruled *Cygnus Therapeutics Sys. v. ALZA Corp.*, 92 F.3d 1153 (Fed. Cir. 1996), and two other cases, to the extent they held otherwise. *Nobelpharma*, 141 F.3d at 1068 (citing cases).

⁷⁹ 365 U.S. 127 (1961).

⁸⁰ *Nobelpharma*, 141 F.3d at 1067.

legal system.”⁸⁵ One patent practitioner maintained that the value of enhanced uniformity in patent/antitrust rulings does not alone justify unchecked expansion into “the development of antitrust law [where], as in other areas, competition can be a good thing.”⁸⁶ Similarly, an antitrust practitioner stated that antitrust jurisprudence benefits from the percolation and development of ideas that jurisdiction in several courts of appeal affords.⁸⁷

C. Trends in the Law of the Federal Circuit

1. Patent Law Trends

Congress’s primary goal for the Federal Circuit was to increase the uniformity of patent law.⁸⁸ Many panelists stated that the Federal Circuit’s patent jurisprudence has increased patent law certainty and consistency.⁸⁹ The Federal Circuit has brought stability and increased predictability to various elements of patent law, thus reducing legal uncertainty and

facilitating business planning. Nonetheless, some questioned the extent to which the Federal Circuit has succeeded in achieving this goal,⁹⁰ and others raised concerns that certain Federal Circuit opinions had conformed patent law, but in unhelpful ways.⁹¹ Chapter 4 discusses the issues that panelists raised most frequently as sources of concern.⁹²

Some have expressed concern that the Supreme Court’s decision in *Holmes v.*

⁹⁰ See, e.g., Quillen 7/11 at 156 (arguing that the Federal Circuit has introduced additional uncertainty into valuation of patents and determination of validity); Katsch 4/10 at 31 (“I think the Federal Circuit frankly has not been the success that it was intended.”); Weil 7/11 at 142-44 (Federal Circuit’s sometimes “rough treatment of precedent” has “created or exaggerated conflicts” among its decisions), at 144-45 (Federal Circuit’s tendency “to reach beyond” its appellate role and function as a “mini-trial” court undermines goal of certainty in decision making), at 145 (noting Federal Circuit’s reluctance to use *en banc* review to resolve intra-circuit conflicts), at 145-46 (observing that some of the problems identified have improved in recent years). But see Weil 7/11 at 151 (noting that the Federal Circuit has done “an incredibly good job” of bringing consistency to many areas of patent law).

⁹¹ Banner 10/30 at 182-83.

⁹² District courts also play an important role in impacting patent law uniformity. Professor Kimberly Moore has empirically studied patent enforcement in district courts and concluded “despite the creation of the Federal Circuit, choice of forum continues to play a critical role in the outcome of patent litigation.” Kimberly A. Moore, *Forum Shopping in Patent Cases: Does Geographic Choice Affect Innovation?*, 79 N.C. L. REV. 889, 892 (2001). According to Professor Moore, forum variation among district courts “increases the unpredictability of the law and its application” and, as a consequence, it “undermines the innovation incentive underlying patents.” *Id.* at 927. “Even with the Federal Circuit dispensing binding substantive legal pronouncements, district court outcomes vary procedurally and substantively in ways that the appellate court cannot regulate.” *Id.* at 932. Moore proposes two possibilities for limiting forum shopping: creation of a specialized trial court or statutory reform to tighten venue requirements. *Id.* at 934.

⁸⁵ Gordon 7/11 at 49.

⁸⁶ Matthew F. Weil, *Statement (7/11/02)* 15, at <http://www.ftc.gov/opp/intellect/020711weilmatthewf.pdf>.

⁸⁷ Busey 7/11 at 74.

⁸⁸ See *supra* Ch. 6(II)(A)(1).

⁸⁹ See, e.g., Mossinghoff 2/6 at 76-78; Myrick 3/19 at 17. Industrial Research Institute (IRI) members had been polled decades ago, prior to the advent of the Federal Circuit, and had supported centralizing patent appeals in a single court. See generally S. REP. NO. 97-275, at 5 (1981). Its current President, Ross Ambrecht, testified at the FTC/DOJ Hearings that his own informal poll of IRI members indicated that the Federal Circuit brought greater stability and predictability to patent process across all industries. Ambrecht 3/19 at 54-55.

Vornado will operate to undermine the consistency of patent law. Federal Circuit Chief Judge H. Robert Mayer has been quoted as saying that “*Holmes* is likely to limit the availability of Federal Circuit review and permit forum shopping, and both results may return the state of patent law to that existing before the Federal Circuit’s creation, a situation in which the diversity in the application of the patent laws reduced the value of patents.”⁹³ Others, such as a study group created by the Board of Governors of the Federal Circuit Bar Association, have voiced similar concerns.⁹⁴ Some panelists saw a virtue in allowing other courts of appeal to challenge Federal Circuit interpretations of Supreme Court patent law, citing the Federal Circuit’s treatment of obviousness under *Graham v. Deere* as one issue that could benefit from alternative interpretations.⁹⁵ Another panelist questioned the extent to which regional courts of appeal would disagree with Federal Circuit precedent, stating that “regardless of appellate forum, even after [*Holmes*],” it is clear that “Federal Circuit precedents [regarding patent law] are likely

to carry significant weight with many of the courts in which the agencies litigate.”⁹⁶

Others disagreed that *Holmes* might adversely affect patent law uniformity. For example, one panelist argued that Federal Circuit jurisdiction under *Christianson*, which recognizes Federal Circuit jurisdiction when a “substantial question” of patent law is involved, would prevent the Federal Circuit’s docket from being substantially reduced.⁹⁷

2. Antitrust Law Trends

The discussion of the Federal Circuit’s interpretations of antitrust law distinguished between the Federal Circuit’s holdings and how it articulates antitrust principles. There was general agreement that, in terms of its holdings, the Federal Circuit did not engage in any significant deviations from mainstream antitrust analysis.⁹⁸ Indeed, to the extent that Federal Circuit holdings differed from mainstream antitrust, it was to uphold verdicts in *Nobelpharma* and *Bard* on antitrust theories

⁹³ Anne M. Maher, *The “Holmes” Decision*, NAT’L L. J., July 8, 2002, at B11 (Col. 1).

⁹⁴ See *Report of the Ad Hoc Committee to Study Holmes Group, Inc. v. Vornado Air Circulation Systems, Inc.*, 12 Fed. Cir. B.J. 713 (2002) (arguing that the state of the law following *Holmes* “compromises the uniformity of patent law” and recommending legislative action that would effectively reverse *Holmes* by extending Federal Circuit jurisdiction to appeals of cases in which patent claims are raised only in responsive pleadings).

⁹⁵ Quillen 7/11 at 136, 159-60 (arguing this diversity would be a beneficial check on Federal Circuit patent law interpretations); see also Taylor 7/11 at 137 (agreeing that the opportunity to argue that the Federal Circuit misinterprets Supreme Court patent law precedents is more likely to exist under *Holmes*); *supra* Ch. 4(II)(A)(3).

⁹⁶ Gordon 7/11 at 50; Gordon Presentation at 15. “The level of unpredictability in patent law may largely depend on whether the regional circuits apply Federal Circuit precedent or choose to apply their own law to the cases before them.” Edward G. Poplawski, *Patent Litigation After Vornado*, 725 P.LI/PAT 407, 420 (2002).

⁹⁷ Baker 7/11 at 39-40. That same panelist also noted, however, that “*Holmes* may introduce conflicts in substantive law at the patent/antitrust interface that the public thought the Federal Circuit had settled.” Charles P. Baker, *Statement (7/11/02)* 14, at <http://www.ftc.gov/opp/intellect/020711charlesbaker.pdf>.

⁹⁸ See, e.g., Busey 7/11 at 18; Gordon 7/11 at 48; ABA Antitrust Section, *Federal Circuit Report* at 70, 77; ABA IP Section (stmt) 2, 5.

that typically failed in other circuits.⁹⁹

Nonetheless, observers commented that there are “some sweeping very unnuanced dicta” in certain cases.¹⁰⁰ Some panelists cited *CSU*¹⁰¹ and *Intergraph*¹⁰² as sources of overbroad dicta that, some analysts have suggested, lower courts have arguably misapplied, as in *Townshend v. Rockwell Int'l Corp.*¹⁰³ and *Minebea Co. v. Papst*.¹⁰⁴ One commentator expressed concern that the Federal Circuit could “skew or have adverse effect” on antitrust law development that is disproportionately large.¹⁰⁵

⁹⁹ Gordon 7/11 at 48 (referring to *C.R. Bard v. M3 Systems*, 157 F.3d 1340 (Fed. Cir. 1998), cert. denied, 526 U.S. 1130 (1999)).

¹⁰⁰ Kobak 7/11 at 132.

¹⁰¹ *CSU v. Xerox Corp.*, 203 F.3d 1322 (Fed. Cir. 2000), cert. denied, 531 U.S. 1143 (2001), See, e.g., Pitofsky 2/6 at 30-31 (criticizing *CSU* dictum); Whitener 5/1 at 232 (same); Kobak 7/11 at 132-33 (same). Under *Holmes*, the Federal Circuit would not have had jurisdiction over the *CSU* case.

¹⁰² *Intergraph Corp. v. Intel Corp.*, 195 F.3d 1346 (1999). See Kobak 7/11 at 132-33.

¹⁰³ *Townshend v. Rockwell Int'l Corp.*, 2000-1 Trade Cas. (CCH) 72,890 (N.D. Cal. 2000). See generally Gordon 7/11 at 48; ABA Antitrust Section, *Federal Circuit Report* at 84-85; R. Hewitt Pate, *Refusals to Deal and Intellectual Property Rights*, 10 GEO. MASON L. REV. 429, 435-36 (2002).

¹⁰⁴ *Minebea Co. v. Papst*, 229 F. Supp. 2d 1 (D.D.C. 2002). See generally Gordon 7/11 at 48; ABA Antitrust Section, *Federal Circuit Report* at 84-85.

¹⁰⁵ Gordon 7/11 at 48. But see ABA IP Section (stmt) 7, n.12 (concern that the Supreme Court cannot review most Federal Circuit cases because of absence of circuit splits is not accurate; the Supreme Court has been motivated by powerful Federal Circuit dissents to review cases).

Overall, the Hearings revealed ongoing challenges in balancing the value of accuracy obtained from diversity in development and the value of certainty derived from uniform application of the law. As stressed in Chapter 5, uncertainty interferes with efficient business activity, and the value of uniformity in the application of patent law is clear. At the same time, diversity of approach and the incremental development of case law have benefitted antitrust law greatly, increasing its accuracy by double-checking its doctrines. FTC General Counsel William Kovacic observed that “a uniquely remarkable feature of the U.S. antitrust system” is its heavy reliance, unprecedented in the field of economic regulation in the U.S., upon judicial elaboration of standards over time.¹⁰⁶ Panelist and antitrust practitioner George Gordon described “a concentration of decision-making authority in the Federal Circuit,” and argued that the current system “deprives regional circuits of the opportunity to develop views and express views” and “deprives the system of the benefit of getting a multiplicity of views.”¹⁰⁷ While recognizing the value of certainty to participants in the patent system, the Commission views *Holmes* as a potentially salutary development from an antitrust perspective, in light of the importance of “a

¹⁰⁶ Kovacic 2/8 (Antitrust Session) at 16. (Stating that in drafting the crucial antitrust statutes, Congress essentially said, “We want to give the statute[s] a consciously, deliberately evolutionary scheme so that [they] can be adapted through judicial interpretation over time to account for new developments in relevant social science disciplines such as economics and to adjust and adapt to new understandings of business behavior.” *Id.* at 15.).

¹⁰⁷ Gordon 7/11 at 69-70. Gordon further stated that these concerns have been expressed by many in industry. *Id.*

multiplicity of views” to the development of antitrust law.

III. INSTITUTIONAL CONSIDERATIONS FOR THE ANTITRUST ENFORCEMENT AGENCIES AND THE PTO

A. Recommendations Relating to the PTO

1. Provide Adequate Funding for the PTO

The Commission strongly recommends that Congress increase the PTO’s funding so that it can improve the quality of its determinations on patentability. The current Under Secretary of Commerce for Intellectual Property and Director of the United States Patent and Trademark Office, James E. Rogan, observed in the Hearings that “[f]or a number of years, the USPTO has been engaged in what sometimes seems to be an epic struggle to muster sufficient resources to provide the timely and quality service our customers need.”¹⁰⁸ Other heads of the PTO have agreed, noting that the quality of the PTO’s work depends on adequate funding.¹⁰⁹ Similarly, many

¹⁰⁸ Rogan 2/6 at 26. Funding issues arise notwithstanding the PTO’s considerable efforts to meet its challenges by increasing operational efficiency through modernization and reorganization of its systems. For PTO’s recent analysis of these issues, see United States Patent and Trademark Office, *The 21st Century Strategic Plan* (April 2, 2003), at <http://www.uspto.gov/web/offices/com/strat21/index.htm>.

¹⁰⁹ See, e.g., Mosinghoff 2/6 at 75 (arguing that fiscal restraints compromise the PTO’s ability to “do its job properly,” notably by slowing the implementation of e-

participants noted that the PTO lacks the funding necessary consistently to make high-quality determinations as to whether patent applications deserve to be granted.¹¹⁰ Some pointed out that inadequate funding makes it difficult for the PTO to hire enough staff to examine patent applications carefully and

government support); Dickinson 2/6 at 64-65 (“if the quality is to be further improved, resources have to be found”); *Commerce Secretary Wants to End Fee Diversion*, 65 PATENT, TRADEMARK & COPYRIGHT J. 430 (2003) (reporting that Secretary of Commerce Donald Evans testified on March 6, 2003 before the House Appropriations Committee that “[m]aking more fees available sooner will enable the agency to increase the quality of patents and trademarks issued”), available at <http://subscript.bna.com/SAMPLES/ptc.nsf/0/2bc4d8546b850c5d85256ce8008396d3?OpenDocument>, *Written Statement on the Commerce Department’s FY 2002 Budget: Hearing Before the House Appropriations Subcomm. on Commerce, Justice, State and the Judiciary*, 108th Cong. (2003) (statement of Commerce Secretary Donald L. Evans) (linking measures to improve funding to the PTO’s strategic plan to improve the quality of its output), available at <http://www.ogc.doc.gov/ogc/legreg/testimon/108f/evans0306.htm>. One PTO official attending the Hearings made a similar point. See Chen 2/26 at 299 (noting that statistical reviews have found that examination quality is improving and that correlation exists between resources and quality).

¹¹⁰ See, e.g., Bendekgey 2/26 at 230 (observing that allocating more resources to the PTO can improve the quality of its examinations); Levin 2/6 at 102 (recognizing steps taken by PTO to improve the quality of its review in emerging technology areas and its database, but maintaining that more resources may be necessary); Alderucci 4/9 at 12, 14-15 (stating that lack of funding hinders “timely and quality examinations of patent applications” and contributes to the issue of overly broad patents, but noting that “a mere increase in funding, without . . . substantial operational changes, rarely results in significant improvement of any organization”); Musacchia 4/9 at 28 (observing that full funding would improve quality of PTO’s work); IPO (stmt) 5 (“Many of the ‘competitive’ problems that have been cited in the course of these proceedings are symptoms of inadequate funding of the USPTO and an inability of the USPTO to keep pace with the quantity and complexity of the patent applications it receives.”).

efficiently.¹¹¹ Another panelist noted how hard it is to hire and retain talented staff in emerging technologies, where the private sector offers substantially higher salaries than the PTO.¹¹²

Patent review committees have long made this point. In 1979, the Advisory Committee on Industrial Innovation recommended that Congress give the PTO sufficient funding for the agency to hire more examiners, expand its database, and improve quality control.¹¹³ In 1992, the Advisory Committee on Patent Law Reform similarly recommended that PTO funding be maintained at a level sufficient to ensure timely and high-quality patent examination.¹¹⁴ As recently as 2002, the

¹¹¹ See, e.g., Katsh 4/10 at 29-30 (arguing that underfunding hurts the PTO's ability to employ enough expert examiners); Gable 3/20 at 122 (observing that the PTO's funding structure, especially as it relates to user fees, makes it difficult to hire the number of examiners necessary to do its job).

¹¹² See Lerner 2/20 at 161-62 (pointing to the importance of adequate funding to recruiting and retaining examiners in emerging fields where the private sector offers substantially higher pay). Several participants criticized Congress's diversion of PTO user fees to other government programs, arguing that it undermines the PTO's ability to conduct timely, high-quality patent examinations. See, e.g., Dickinson 2/6 at 64; Earp 2/26 at 326; Webbink 3/20 at 171; Delrahim 3/19 at 76-77; Mossinghoff 2/6 at 75; Miscner 2/27 at 396; Udell 2/28 at 566-67; Frankel 4/10 at 11-12; Myrick 3/19 at 74; Armitage 3/19 at 214; AIPLA (stmt) 18; IPO (stmt) 5-6.

¹¹³ See FINAL REPORT OF ADVISORY COMMITTEE ON INDUSTRIAL INNOVATION 153-54 (1979) (comparing PTO's funding unfavorably with that of the European Patent Office). The report also recommended that Congress return user fees to the PTO. See *id.* at 154.

¹¹⁴ See THE ADVISORY COMMISSION ON PATENT LAW REFORM, REPORT TO THE SECRETARY OF COMMERCE 191-92 (Aug. 1992) (proposing that PTO receive enough funding for it to review patent applications within 18 months without compromising examination quality).

Patent Public Advisory Committee stated that the PTO faces "a crisis in funding that will adversely and seriously impact . . . the quality of . . . issued patents."¹¹⁵ The Commission thus strongly believes that Congress should allocate sufficient funds to allow the PTO to ensure quality patent review.

2. Expand PTO's "Second-Pair-of-Eyes" Review to Selected Areas

The Commission endorses the PTO's recommendation that it expand its "second-pair-of-eyes" review to selected areas.¹¹⁶ The PTO began its second-pair-of-eyes review in March 2000, to allow a reviewer to examine each business method patent allowance and "to quickly flag issues that need further attention by the examiner or the examiner's supervisor."¹¹⁷

The Commission believes that expanding this program to cover such fields as semiconductors, software, and biotechnology would help boost the quality of patent review in areas where it will make

available at
<http://world.std.com/obi/USG/Patents/overview>.

¹¹⁵ PATENT PUBLIC ADVISORY COMMITTEE, ANNUAL REPORT 6 (Nov. 29, 2002), at <http://www.uspto.gov/web/offices/com/advisory/acrobat/ppacannual12-05-02.pdf>.

¹¹⁶ United States Patent and Trademark Office, The 21st Century Strategic Plan at Item 29 (April 2, 2003) ("Expansion of the Second-Pair-of-Eyes Review"), at <http://www.uspto.gov/web/offices/com/strat21/action/q3p17a.htm> (hereinafter 21st Century Strategic Plan at Item 29).

¹¹⁷ *Id.*

the most difference.¹¹⁸ The PTO's decision to target specific areas for enhanced review makes sense. Additional PTO review can be expensive, and such costs may well outweigh the benefits of universally expanding second-pair-of-eyes review.¹¹⁹

In industries such as semiconductors and software in which unwarranted upstream patents can hinder critical downstream innovation, however, additional review may well be worthwhile.¹²⁰ Second-pair-of-eyes review in such areas can protect downstream innovation by preventing issuance of unnecessary rights to exclude covering upstream intellectual property. Likewise, in emerging areas such as biotechnology, second-pair-of-eyes review can significantly help improve the quality of patent application review, since in emerging areas, examiners necessarily lack experience reviewing the new industry's patent applications, and the body of prior art is slim.¹²¹ As new technologies continue to emerge, the PTO ought to remain alert to possible additional needs for this program. The PTO also recommends evaluating whether second-pair-of-eyes review will prove effective earlier in the examination

¹¹⁸ *Cf. id.* (recommending expanding second-pair-of-eyes review to "such advanced fields as semiconductors, telecommunications, and biotechnology.").

¹¹⁹ *See, e.g.,* Dickinson 10/25 at 78 (noting that "get[ting] examiners additional time" costs "13 to 15 million dollars per hour").

¹²⁰ *See supra* at Ch. 3(IV) and (V); *see also* Levin 2/6 at 102.

¹²¹ *See supra* at Ch. 3(III); *cf. PATENT PUBLIC ADVISORY COMMITTEE, ANNUAL REPORT* at 8 (recommending additional review of patent applications to "identify errors that may crop up in examination, particularly in new technologies").

process, an option the Commission agrees merits exploration.¹²²

In short, the Commission recognizes the PTO's selective expansion of the second-pair-of-eyes process as part of its larger effort to "bolster confidence in the quality of U.S. patents,"¹²³ and the Commission endorses both that effort and its specific implementation here.

3. Continue to Implement the Recognition that the PTO Balances the Public's Interest in Intellectual Property and Individuals' Interests in Their Patents

The Commission also endorses the PTO's current recognition that its role is not solely to help applicants receive patents. Thus, while the PTO's 2002 Corporate Plan states that the "Under Secretary and Director champions intellectual property rights," it expressly recognizes that he also "forges a balance between the public's interest in intellectual property and each customer's interest in his/her patent and trademark."¹²⁴ This balance is crucial: in serving the

¹²² 21st Century Strategic Plan at Item 29 (April 2, 2003).

¹²³ *See Hearing Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary, 107th Cong. (2003)* (statement of James Rogan, Under Secretary of Commerce for Intellectual Property and Director of the United States Patent and Trademark Office), available at <http://www.uspto.gov/web/offices/com/speeches/stratplan2003apr03rogan.htm>. *Cf.* Chambers 10/25 at 207 (citing second-pair-of-eyes process as an example of PTO's efforts to take into account the economic effects of patent grants).

¹²⁴ *See* United States Patent and Trademark Office, *FY2002 Corporate Plan* 28 (2001), at <http://www.uspto.gov/web/offices/com/corplan/fy2002/index.html>.

objective of enhancing consumer welfare over time, the PTO functions as a steward of the public interest, not a servant of the patent applicants. Notwithstanding that the PTO should provide timely and high quality service to patent applicants, its core mission is to serve the public interest. Thus, the PTO must protect the public against the issuance of invalid patents that add unnecessary transaction costs and may confer market power, just as it should issue valid patents to encourage invention, disclosure, and commercial development.

Past PTO statements describing patent applicants as the PTO's customers, however, could suggest that the agency's mission is to promote the welfare of patentees or patent applicants, not the public. For example, the PTO's Corporate Plan for fiscal year 2001 stated bluntly, "[t]he Patent Business is one of the PTO's three core businesses. The primary mission of the Patent Business is to help customers get patents."¹²⁵ Such thinking may be more than surface deep; one prior PTO examiner/Associate Solicitor testified:

I don't know that the examiners view their role as protecting the public anymore. I think more often than not

they view their role as protecting the customer. And the customer, according to the patent office, is the individual filing for a patent.¹²⁶

As noted, the PTO has now rephrased some of the descriptions of its role, introducing a sense of "balance between the interests of patentees and the interests of the public,"¹²⁷ and this may be a reflection of a potentially very beneficial trend.

B. The FTC Will Pursue Steps to Increase Communication between Antitrust Agencies and Patent Institutions

1. The FTC Will Increase its Competition Advocacy Role through Filing Amicus Briefs in Appropriate Circumstances

The Commission will renew its commitment to the filing of amicus briefs in important patent cases that can affect competition, as well as in cases at the intersection of patent and antitrust law. When such cases have high stakes for the public, the Commission can serve the public interest by filing amicus briefs to present its perspectives regarding their implications for consumer welfare.¹²⁸ Some suggested that

¹²⁵ United States Patent and Trademark Office, *FY2001 Corporate Plan*, at <http://www.uspto.gov/web/offices/com/corpplan/>. Panelists criticized this type of view. See, e.g., Myrick 3/19 at 108-09 (noting that the Patent Public Advisory Committee had criticized a PTO mission statement as "inappropriate with regard to the public interest"), 10/30 at 40; Kahin 3/19 at 85-86 and Brian Kahin, *Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* (3/19/02) (slides) at 3 (criticizing the PTO for describing its mission in terms of helping customers get patents), at <http://www.ftc.gov/opp/intellect/020319briankahin.pdf>; James Love 3/19 at 114; Bhaskar 10/25 at 113, 183.

¹²⁶ Chambers 10/25 at 31.

¹²⁷ Myrick 3/19 at 109 (citing the Fiscal Year 2002 Corporate Plan); see also Kahin 3/19 at 85.

¹²⁸ Fox 2/28 at 696-697 (suggesting that the Agencies file amicus briefs to "present their perspectives on issues of patent law with significant competition implications"). Moreover, just as the Agencies helped courts develop coherent rules for market definition, they might, through the filing of amicus briefs, guide courts to

guidance is especially needed on issues such as licensee estoppel; patent misuse; prosecution laches and late claiming; the proper role of juries in patent cases; and intellectual property bundling.¹²⁹ Panelists suggested that amicus briefs would be helpful not just in the Supreme Court, but in the lower courts (including the Federal Circuit) as well.¹³⁰

2. In Appropriate Circumstances, the FTC Will Ask the PTO Director to Reexamine Questionable Patents that Raise Competitive Concerns

The Commission intends to play a more active, though still selective, role in asking the PTO Director to reexamine patents that raise competitive concerns when a substantial new question of patentability exists.¹³¹ As one panelist suggested, a “collective action problem” frustrates industry challenges to questionable patents: instead of challenging a patent’s validity, many firms may simply license it, since no single firm has the incentive to finance the expensive legal challenge.¹³² An enforcement agency, however, can take

the use of “sensible” rules governing the interaction of intellectual property and antitrust law. *See* Mackie-Mason 5/1 at 182-83.

¹²⁹ *See* Fox 2/28 at 697 (outlining the need for helpful intervention by the Agencies at “points of conflict” between intellectual property and antitrust law); Jacobson 5/14 at 34 (suggesting that the Agencies “actively seek out” cases involving intellectual property bundling in particular).

¹³⁰ *See, e.g.*, Fox 2/28 at 697; Jacobson 5/14 at 34.

¹³¹ *See* Myrick 3/19 at 50 (proposing this).

¹³² *See* Kesan 4/10 at 154.

account of the cost of the questionable patent to the entire industry, solving the coordination problem.¹³³ The FTC has done something similar at least once in the past,¹³⁴ and, in appropriate circumstances, it intends to be more active in this area in the future.

3. The FTC Will Encourage Increased Communication between Patent Institutions and the Antitrust Agencies

Increased coordination among the three federal agencies – the FTC, the DOJ and the PTO – that set the broad terms for competition and innovation involving inventions covered by patents is key to ensuring a better balance between intellectual property and competition policy. The three agencies have always communicated with each other, to be sure, but some panelists recommended that the communication become “continual and not occasional.”¹³⁵ As former PTO Director Dickinson noted, such communication “can head off problems . . . and is always, always beneficial.”¹³⁶

¹³³ *See id.* Some panelists debated whether the Agencies should sue to clarify the validity of questionable patents. *Compare* Gambrell 10/25 at 197 (suggesting that the Agencies “have to have a standing to sue and clarify the validity or invalidity for patents”) with Dickinson 10/25 at 213 (criticizing idea); Kahin 10/25 at 211 (same).

¹³⁴ In 1992, the FTC informed the PTO that FTC staff had reason to question the allowability of certain claims of a particular patent. *See* Letter from Janet Steiger, Chairman, Federal Trade Commission, to Douglas Comer, Commissioner of Patents and Trademarks, Patent and Trademark Office (Sept. 15, 1992).

¹³⁵ Kahin 3/19 at 90; *see also* Dickinson 10/25 at 188 (recommending that “effective dialogue” between the Agencies and the PTO become “more routine[.]”).

¹³⁶ Dickinson 10/25 at 188-89.

Moreover, as another panelist noted, interagency communication can allow the Agencies to bring to bear their “broad expertise . . . [to] help provide an economic understanding of innovation.”¹³⁷ Agency insights would help illuminate variations in innovation depending upon, among other factors, the technology, industry, and nature of the developmental process.¹³⁸ Such communication can also allow the Agencies to benefit from the PTO’s patent expertise.¹³⁹ An increasing number of the FTC’s competition matters require the application of antitrust law to conduct relating to intellectual property, and there is need for the best understanding possible of the nature and scope of patents. A closer working relationship with the PTO can only help in this regard. In short, antitrust enforcers and the PTO need to talk to each other regularly and often.

One means of improving interagency communication is the establishment of a Liaison Panel between the Antitrust Enforcement Agencies and the PTO. The Liaison Panel would be composed of individuals from the FTC, the DOJ’s Antitrust Division, and the PTO. It would meet regularly and make periodic public reports on current issues and activities involving intellectual property and competition policy. This Liaison Panel would function primarily as a practical,

¹³⁷ Kahin 3/19 at 90 (noting that this, in turn, “must be based on a deeper understanding of how patents work in practice, and how the costs of evaluating and negotiating patents play out.”).

¹³⁸ *See id.*

¹³⁹ The PTO’s statutory charter provides that it “shall advise Federal departments and agencies on matters of intellectual property policy” 35 U.S.C. § 2(b)(9).

policy-oriented group designed to permit the exchange of views on important new issues as they arise. An additional project for this panel could be the formulation of an empirical research agenda on the relationship between competition and intellectual property law, an agenda that economists, academics, and others can pursue.¹⁴⁰

Another means of fostering interagency dialogue would be through the founding of an Office of Competition Advocacy within the PTO.¹⁴¹ Such an office could, when appropriate, advise PTO policymakers about the competitive impact of its policy decisions, helping the PTO to serve the objectives of promoting consumer welfare over time. For example, the office could provide PTO policymakers with some economic analysis of the “downstream effects of their work.”¹⁴²

A final means of encouraging communication among the agencies is to request that Congress amend the membership categories of the Patent Public Advisory Committee (P-PAC). Congress created the P-PAC in 1999 to review the PTO’s patent “policies, goals, performance, budget and user fees” and to make annual reports on those

¹⁴⁰ One panelist suggested that the Agencies set forth such a “research agenda.” Kahin 3/19 at 91.

¹⁴¹ *See, e.g.,* James Love 3/19 at 114-15 (arguing for the establishment of “some kind of office of advocacy” at the PTO that would be attuned to the competitive consequences of patent grants).

¹⁴² Myrick 3/19 at 107.

issues.¹⁴³ Congress has provided that P-PAC's voting members "represent the interests of diverse users," represent "small and large entity applicants," and have "substantial background and achievement in finance, management, labor relations, science, technology, and office automation."¹⁴⁴ By expanding the P-PAC's membership to include competition experts and economists, Congress could allow the P-PAC to advise the PTO on competition issues generally.

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The Commission looks forward to working closely with the PTO and other patent organizations to increase communication and include all parties in discussion and implementation of the FTC's recommendations.

¹⁴³ 35 U.S.C. § 5(d). One panelist who served on the P-PAC noted that it advises the PTO on policy and budget matters, and that after it criticized the PTO's mission statement, the PTO provided more balanced descriptions of its role. *See* Myrick 3/19 at 108-09; *see also* Myrick 10/30 at 40.

¹⁴⁴ 35 U.S.C. § 5(b). Certain labor organization representatives are nonvoting members. *Id.*