The AIPLA Antitrust News

A Publication of the AIPLA Committee on Antitrust Law **May 2011**

Chairs' Corner

Welcome all, and I hope you will be joining us at the Spring Meeting in San Francisco. Our Committee, together with the Corporate Counsel and Licensing Committees, is presenting a fantastic program touching on some of the most interesting issues involving IP and antitrust law. Indeed, this issue of the AIPLA Antitrust News includes articles on the same subjects - the FTC's most recent commentary on patent issues and the current state of play on reverse payments. Thanks, as always, to the authors: Geoff Oliver and David Maiorana; Michael O'Brien; and Robert Pluta and Brandon Helms.

In considering these issues, it appears that we may be witnessing some interesting developments beyond those specific to individual matters or even the FTC's report itself. As pointed out by Geoff and David in their fine overview of the FTC's recent report, "An Evolving IP Marketplace," the FTC's focus is not on antitrust law, but on pure patent law, and what the FTC believes may be competitive issues arising from the application of the patent laws.

But is this a proper direction for the FTC? Does the FTC's focus take the interest of patent owners properly into account, and does the FTC, an antitrust agency, give proper deference to the patent laws? Indeed, when we consider the FTC's report and its current efforts in the reverse payment area, are we witnessing efforts by the agency that are aimed directly at weakening the established rules and standards for enforcement of patents and the rights and benefits that a strong patent system provides?

What are the implications? The FTC has clearly set forth its position that its efforts are directed to enhancing competition and innovation. But is it, and is it direction consistent with other Administration efforts on these issues? In this regard, I commend to you the report issued this past February by the National Economic Council, Council of Economic Advisors and the Office of Science and Technology Policy, entitled "A Strategy for American Innovation." This report makes plain that for the United States to remain globally competitive and for innovation to flourish, patent holders interests must be reinforced. This report also provides interesting perspectives suggesting that even the FTC's concept of innovation may be limited, and not sufficiently broad or balanced as is necessary to support true economic growth and competitiveness.

At a minimum, these are interesting questions, but they do go beyond the academic. We look forward to your participation in the dialogue.

As always, much thanks to David Swenson, our tireless and committed editor, publisher and guiding light for this Newsletter, for yet another great edition.

AIPLA Antitrust Committee

Richard S. Taffet, Chair
Bingham McCutchen, LLP
richard.taffet@bingham.com

George Gordon, Vice-Chair
Dechert LLP
george.gordon@dechert.com

Federal Trade Commission Issues Report on the Evolving Intellectual Property Marketplace

David M. Maiorana
Geoffrey D. Oliver
Jones Day
Cleveland, OH
dmaiorana@jonesday.com
gdoliver@jonesday.com

In March of this year, the Federal Trade Commission ("FTC") issued a long-anticipated report recommending changes in patent law and practice relating to notice and remedies. The FTC's report, entitled "The Evolving IP Marketplace: Aligning Patent Notice and Remedies With Competition" (the "Report"),[1] focuses on issues of public notice of the scope of patent claims coverage and remedies for patent infringement. It contains multiple specific recommendations for changes in patent law and practice, summarized in the Executive Summary in the form of 35 recommendations directed to Congress, the Patent and Trademark Office and the courts. Many of the FTC's recommendations go to fundamental issues of patent law and, if adopted and implemented, would have a significant impact on both patent prosecution and litigation.

Background

The FTC has addressed intellectual property issues before. Together with the Antitrust Division of the U.S. Department of Justice ("DOJ"), the FTC issued guidelines on the licensing of intellectual property rights in 1995.[2] In 2007, the FTC and DOJ together issued a report focusing on antitrust enforcement and intellectual property rights.[3] Each agency has addressed issues of intellectual property law in the context of its enforcement actions, amicus briefs, speeches and other statements of policy. These sources reflect the agencies' positions with respect to the question of how the antitrust laws should be applied to conduct involving intellectual property that affects competition.

The Report is different. It does not deal with application of the antitrust laws. Rather, it addresses issues of pure patent law. The FTC chose to comment on these issues because it believes the way the patent laws are implemented can affect competition. The FTC recommended changes to the patent laws and the way those laws are implemented that, in its opinion, serve to better preserve competition. The FTC views the Report as continuing the "policy engagement with the patent system"[4] that it launched in its controversial October 2003 report regarding the "proper balance" of competition policy and patent law.[5]

[1] Fed. Trade Comm'n, "The Evolving IP Marketplace: Aligning Patent Notice and Remedies With Competition (March 2011) (available at http://www.ftc.gov/os/2011/03/110307patentreport.pdf).

[2] U.S. Dep't of Justice and Fed. Trade Comm'n, "Antitrust Guidelines for the Licensing of Intellectual Property" (April 6, 1995) (available at http://www.ftc.gov/bc/0558.pdf).

[3] U.S. Dep't of Justice and Fed. Trade Comm'n, "Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition" (April 2007) (available at http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf).

[4] Fed. Trade Comm'n, Press Release, FTC Report Recommends Improvements in Patent System to Promote Innovation and Benefit Consumers (March 7, 2011) (available at http://www.ftc.gov/opa/2011/03/patentreport.shtm).

[5] Fed. Trade Comm'n, "To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy" (October 2003) (available at http://www.ftc.gov/os/2003/10/innovationrpt.pdf).

The FTC began its study in December, 2008, soliciting contributions from the public and receiving over 50 written submissions from companies, academics and practitioners. It conducted eight days of hearings in Washington D.C. and Berkeley, California, at which more than 140 witnesses presented their views. The FTC supplemented this record with its own independent research.

Twenty-seven months after it began its work, the FTC issued the Report. The Report consists of eight chapters: chapters 1 and 2 describe the FTC's view of the evolving IP marketplace; chapter 3 focuses on patent notice; and chapters 4-8 deal with remedies. Chapters 3 and 5-8 contain the FTC's specific recommendations for changes to patent law and practice.

The introduction explains the FTC's specific focus on notice and remedies. The FTC states that notice affects competition at every stage of the R&D process. The "ability to identify and assess the scope of relevant patents at an early stage" is important to firms' decisions regarding investments in potential new products.[6] Specific product design decisions are affected by incomplete knowledge of the costs and availability of different technologies. And resolution of patent claims after product launch by means of litigation may not only increase costs but also deprive consumers "of the full benefit of competition among technologies."[7]

<u>Ex Ante v. Ex Post Patent Licensing Transactions</u>

The first two chapters set forth the FTC's understanding of the evolving nature of the intellectual property "marketplace." In the first chapter, the FTC describes its view of "open innovation," in which a company does not rely solely on its own internal research and development for innovation, but rather seeks the inventions it needs from outside sources as well. The FTC refers to acquisitions of technology in this manner as "ex ante" transactions, in which the purchaser or licensee first obtains the technology by means of a technology transfer from the patent owner. The FTC emphasizes that open innovation benefits companies as well as consumers, and points out that many aspects of patent law and the patent system help to promote open innovation.

In the second chapter, the FTC draws a sharp distinction between "ex ante" transactions and what it refers to as "ex post" transactions. It defines "ex post" transactions as situations in which the licensee has already invested in creating, developing or commercializing the technology in question. The Report notes that the licensee needs a license from the patent holder to avoid liability for patent infringement, but the license is not accompanied by any transfer of technology. According to the FTC, ex post transactions have the potential for both beneficial and detrimental effects. The FTC attributes ex post transactions in part to problems with patent notice and quality and with remedies for patent infringement, concluding that concerns regarding ex post transactions have increased in recent years because of an increase in patent litigation and the evolution of patent assertion business models. The FTC identifies the primary driver of this development to be "patent assertion entities," ("PAEs") defined as non-practicing entities with a business strategy based on patent enforcement. The FTC describes the respective roles of patent enforcement and licensing companies, litigation finance firms, patent aggregators,

[6] Report at 3.
[7] Id.

defensive buying funds and intermediaries. The FTC intends its report to address "the conditions of patent law and policy that have created conditions where a patent market based on ex post transactions has flourished and . . . that lead to or create incentives for patentees to pursue ex post patent transactions rather than technology transfer."[8]

Issues Relating to Patent Notice

Chapter 3 deals with issues relating to patent notice to third parties as well as patent quality. The FTC sets forth various recommendations (separated into 16 separate specific recommendations in the Executive Summary) intended to promote greater clarity in the scope of patent claims coverage, improve predictability of evolving or future patent claims, and facilitate more effective patent searches. Four of the recommendations would require legislation. Of these, one relates to funding of the PTO; three recommendations would change substantive law. Two recommendations are addressed to the courts, and the remainder are intended for the Patent and Trademark Office.

The most far-reaching of the recommendations relating to notice is the proposal that Congress enact legislation "to protect from infringement actions third parties who (i) infringe properly described claims only because of claim amendments (or new claims) following a continuation and (ii) developed, used, or made substantial preparation for using, the relevant product or process before the amended (or newly added) claims were published."[9] This recommendation is based on the FTC's concern that the specification may not provide sufficient notice to enable third parties to determine the likely scope of claims that may emerge from the continuation process. The FTC's concern is based in part on the fact that the written description requirement is not focused on the question of notice to others, and in part on its perception that the PTO has been lax in enforcing the written description requirement. According to the FTC, if competitors are unable to predict the claims that might emerge from the continuation process, competitors' investment decisions may be distorted and the competitive efforts of rivals may be impaired.

Obviously, this recommendation, if adopted, would have a dramatic impact on current practice. Patent owners likely would face considerable limits in their ability to enforce claims arising out of continuation applications. Their ability to enforce amended claims may depend on the nature and extent of the amendments. The recommendation, if adopted, would inject a complicated new factual issue into such patent litigation: when did the alleged infringer first start developing, using, or making "substantial preparation for using" the product or process in question? The recommendation could also affect the patent prosecution process, as applicants might be more likely to include more claims in initial applications and, depending on the circumstances, might resist amending patent claims more frequently.

The remaining recommendations for legislation, if adopted, would require publication of all patent applications 18 months after filing, regardless of whether the applicant has filed patent applications abroad, and require public recording of all assignments of patents and published patent applications. The FTC recommends that the courts should apply the standard of a person having ordinary skill in the art ("PHOSITA") in a manner that is fact-based

[8] Id. at 72.
[9] Id. at 16.

and appropriately tailored to the specific technology at issue, and that the PHOSITA's ability to foresee future evolution of the claims in a patent application should be more fully incorporated into application of the written description requirement. In particular, a patent applicant "should not be understood to have been in possession of the subject matter of a new or amended claim of scope broader than what the PHOSITA, on the filing date, could reasonably be expected to foresee from the specification."[10]

Issues Relating to Patent Remedies

Chapter 4 discusses remedies in general, with Chapters 5-8 analyzing lost profits damages, the hypothetical negotiation in reasonable royalty damages, calculating a reasonable royalty, and permanent injunctions, respectively.

The FTC begins by noting that, to be effective, encourage innovation and avoid distorting competition, patent remedies must give the patentee what it would have earned in the market absent infringement. To address perceived shortcomings, the FTC seeks to "derive an economically grounded approach" for analyzing patent remedies, then to evaluate the current system of damages and permanent injunctions against that approach.[11]

The FTC repeats an oft-stated criticism of the current system: remedies must be proportional to the value of the invention.[12] The patent remedies system must equate the overall value of an invention with the benefit conferred to the patentee. The FTC believes that aligning the value of the invention with the patentee's reward incentivizes innovators to pursue inventions that will be valued by consumers. This, in turn, promotes research and development of those areas most likely to have consumer value.

Chapter 5 focuses on lost profits damages and offers three recommendations: (1) courts should permit a patentee "flexibility" in creating the "but-for" world to avoid under-compensation; (2) courts should reject the "entire market value rule" altogether, and instead require proof of the degree of consumer preference for the patented invention over alternatives; and (3) courts should reject dual awards of lost profits and reasonable royalty damages when competition from alternatives would have prevented the patentee from making all of the infringer's sales.[13]

On the first point, the FTC urges courts to reject the "all-or-nothing" *Panduit* test for lost profits[14] in favor of a more flexible, but less defined, approach. This approach includes consideration of the extent of consumer preferences for the patented feature over alternatives, as opposed to determining whether alternatives fall on either side of a "bright line dividing the acceptable from the unacceptable."[15] Such an analysis would recognize a "degree of substitutability" between a patented product and noninfringing substitutes. The Report then discusses both ends of this spectrum, but not the likely more difficult cases in between. The FTC does, however, suggest that an economic analysis of the type used in antitrust merger review can help determine where alternatives fall on the spectrum.[16] (If applied, this would introduce a highly detailed, fact-driven and data-

[10] Id. at 15.
[11] Id. at 138.
[12] Id. at 139-40.

[13] Id. at 18-19.
[14] Panduit Corp. v. Stahlin Bros. Fibre Works, Inc., 575 F.2d 1152 (6th Cir. 1978).
[15] Report at 153.
[16] Id. at 154.

intensive analysis into patent damages calculations.)

The FTC urges courts to reject the "entire market value rule," which is used to determine whether to award lost profits based on the entire value of the patented product when the patented invention is only a small part of that product. Again, the FTC recommends rejection of a bright-line rule in favor of the potentially more nebulous "degree of substitutability" test.[17]

Finally, the FTC concludes that courts should reject dual awards of lost profits and reasonable royalties when competition from alternatives would have prevented the patentee from making all of the infringer's sales. In cases where courts have awarded lost profits damages based on a portion of the infringing sales, they have sometimes awarded reasonable royalties on the remaining infringing sales. The FTC views such awards as an example of over-compensation to patentees because it ignores competition from noninfringing alternatives.[18]

Chapter 6 reviews the hypothetical negotiation in reasonable royalty damages. The FTC recommends that courts considering reasonable royalty damages move back to the true purpose of such damages, compensating the patentee for the value of the invention, and away from attempts to punish or deter infringers.

The chapter begins by describing both sides of the contentious debate on patent damages reform, which the FTC views as expressing similar concerns: (1) patent damages have become divorced from the economic value of inventions, which has encouraged the development of PAEs who sue companies for alleged infringement by later-developed products, thus discouraging innovation, versus (2) reducing patent damages awards will encourage infringement, also discouraging investments in innovation.[19]

Within this framework, the Report rejects concerns with determination of the appropriate royalty based on a hypothetical negotiation between a willing licensor and a willing licensee. The first concern is the "counterfactual nature" of the hypothetical negotiation – in reality, the parties had the opportunity to negotiate a license but chose not to. The FTC dismisses these concerns as unfounded.[20]

A second concern with reasonable royalty damages is that merely requiring an infringer to pay what it would have paid anyway to license does not deter infringement. The FTC dismisses this concern by noting that because the hypothetical negotiation assumes that the patent is valid and infringed, royalties tend to be higher following trial than they would have been in the absence of litigation, thus reasonable royalty awards do have some deterrent effect. Finally, the FTC notes that there are other mechanisms in the law to deter infringement: enhanced damages and permanent injunctions. The FTC's recommendation is that courts should continue to utilize the hypothetical negotiation framework, free from any concerns about deterring infringement or punishing infringers.[21]

In Chapter 7, the FTC suggests several steps courts can take to increase the accuracy of reasonably royalty calculations. First, the FTC urges courts to recognize that

[17] Id. at 155-56.
[18] Id. at 157.
[19] Id. at 161-64.
[20] Id. at 170-72.
[21] Id. at 176.

the universally-applied *Georgia-Pacific* factors[22] are only a partial list of available evidence to be considered in calculating reasonable royalties. Next, the Report recommends that courts should include in a reasonable royalty analysis the incremental value of the patented invention over the "next-best" alternative, because this establishes the maximum amount a willing licensee would pay in a hypothetical negotiation.[23]

The FTC next recommends that courts make clear that the hypothetical negotiation occurs at an early stage of product development, before investments are made and become sunk costs. Including in the royalty calculation the cost of changing designs after sunk costs are incurred overcompensates patentees.[24]

The Report next recommends an increasing role of courts in the gatekeeping role of enforcing Rule 702 of the Federal Rules of Evidence. This has two prongs. First, courts must test the admissibility of expert testimony on damages by determining whether it will reliably assist the trier of fact in applying the hypothetical negotiation. Courts should also require a showing that the expert's methodology is reliable, that the expert reliably applies the methodology to the facts, and that the testimony is adequately supported by data.[25]

Applying this general recommendation, the FTC recommends that courts only admit testimony and evidence of comparable licenses upon a reliable showing of similarity between the licensed and infringed patents, and between the non-price terms of the comparable and hypothetical licenses. This is consistent with recent Federal Circuit precedent. The FTC applauds the Federal Circuit's rejection of "rule-of-thumb" evidence in the recent *Uniloc* case.[26]

The last aspect of reasonable royalties that the FTC addressed is the choice of the royalty base to which a royalty rate is applied to determine the amount of damages. Not surprisingly given the recommendation to eliminate the "entire market value rule" in the context of lost profits damages, the FTC recommends that courts should not use the entire market value rule when determining the appropriate royalty base in a reasonable royalty calculation. In addition, courts should select as the base the smallest priceable component that incorporates the inventive feature.[27]

Finally, in Chapter 8 the FTC analyzes permanent injunctions in patent cases, and makes several recommendations regarding the *eBay* equitable framework.[28] The overall theme is that permanent injunctions should be awarded in the majority of cases because (1) exclusivity is the foundation of the patent system's incentive to innovate, (2) injunctions deter infringement, and (3) a predictable injunction threat will promote licensing. But these goals must be balanced against the use of an injunction threat as "hold-up" to extract overcompensation.[29]

The Report provides some guidance regarding how to determine whether an injunction is appropriate or should be denied due to "hold-up." Such factors include: (1)

[22] Georgia-Pacific Corp. v. United States Plywood Corp., 318 F. Supp. 1116 (S.D.N.Y. 1970); Report at 179-80.
[23] Report at 189.
[24] Id. at 190-91.
[25] Id. at 199.
[26] Uniloc USA, Inc. v. Microsoft Corp., 2011 WL 9738 (Fed. Cir. Jan. 4, 2011).
[27] Id. at 212.
[28] eBay, Inc. v. MercExchange, LLC, 547 U.S. 388 (2006).
[29] Id. at 223-26.

whether the patented technology is a minor component of a complex product that would have been easy to design around ex ante, (2) whether the infringer uses the patented technology to compete with the infringer, and (3) the absence or presence of copying.[30] The FTC next analyzes the four *eBay* factors and provided recommendations for each.

Courts should not presume irreparable harm based on a finding of infringement, and should recognize that infringement can irreparably harm certain non-practicing entities that engage in technology transfer, such as universities and start-ups. Conversely, PAEs may not have the same concerns as other patentees about deterring future infringement and protecting their reputation as an innovator.

With respect to balance of the equities, courts should consider the hardship of an infringer facing "hold-up," and should reject the notion that an infringer cannot be heard to complain if an injunction would destroy its business.[31] Regarding the public interest, the FTC again focuses on situations where "hold-up" occurs, noting that this could adversely affect the public interest.[32]

The Report also notes that if courts deny a request for a permanent injunction, they should apply the hypothetical negotiation framework to determine an appropriate on-going royalty rate for post-judgment infringement.

In the last section, the FTC makes recommendations to the International Trade Commission ("ITC") to avoid "hold-up." The Federal Circuit has held that the ITC is not constrained by the *eBay* analysis when determining whether to issue an exclusion order, which is a permanent injunction against importation of an infringing product. The FTC recommends that the ITC use its domestic industry requirement to prevent access to the ITC by PAEs whose only activity is extracting ex post licenses from products already on the market.[33] Second, the FTC suggests that the ITC should utilize the public interest factor found in 19 U.S.C. § 1337(d)(1) to deny exclusion orders in cases involving hold-up, especially in cases involving standards.[34]

<u>Conclusion</u>

The FTC's report comes at a time when these and other issues are being debated in Congress, the courts and the Patent and Trademark Office. The Report does not carry any specific implications for the FTC's future antitrust enforcement. It remains to be seen, however, what, if any, impact the FTC's report may have on future patent prosecution and litigation. Certainly, as we have seen with recent efforts to reform U.S. patent law, different industries (and even companies within an industry), as well as non-practicing entities, may have divergent views on the wisdom of the FTC's specific recommendations. Much is likely to depend on the extent to which individual parties seek to use the Report to support their own individual arguments in these fora, and whether the report and recommendations are given any weight.

30 Id. at 227-28.
31 Id. at 232.
32 Id. at 234-35.
33 Id. at 241-42.
34 Id. at 242-43.