

CPI's North America Column Presents:

Comments on the U.S. Antitrust Agencies' Proposed Updated IP Guidelines

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September, 2016

Last week, the Global Antitrust Institute (GAI) at George Mason Law School submitted the comment below to the U.S. Antitrust Agencies on their Draft Updated Antitrust-IP Guidelines. The GAI's main comments are as follows:

General Comments

We commend the Antitrust Agencies for remaining faithful to the principle that intellectual property rights (IPRs) and real property rights will be analyzed symmetrically. In the Proposed Guidelines, the Agencies preserve the principle that the antitrust framework is sufficient to address potential competition issues involving all IPRs—including both standard-essential patents (SEPs) and non-SEPs. In doing so, the Agencies correctly reject the invitation to adopt a special brand of antitrust analysis for SEPs in which effects-based analysis is replaced with unique presumptions and burdens of proof. As Federal Trade Commission (FTC) Chairwoman Edith Ramirez has explained prior to the Updated Guidelines, “the same key enforcement principles [found in the 1995 IP Guidelines] also guide our analysis when standard essential patents are involved.”² SEP holders, like other IP holders, do not necessarily possess market power in the antitrust sense, and conduct by SEP holders, including breach of a voluntary assurance to license its SEP on fair, reasonable, and nondiscriminatory (FRAND) terms, does not necessarily result in harm to the competitive process or to consumers. Again, as Chairwoman Ramirez has stated, “it is important to recognize that a contractual dispute over royalty terms, whether the rate or the base used, does not in itself raise antitrust concerns.”³

As the Antitrust Agencies recognized in their 2007 IP Report, it is important to distinguish between two sources of potential market power: “the market power that comes from the technology on its own and the market power that comes just from the standard, the act of setting a standard that elevates a technology above the competitors.”⁴ Empirical research suggests there are limited circumstances in which incorporation in a standard makes a patent a “winner” in the market; instead, more important technologies are natural candidates for inclusion in standards and therefore standard-development organizations (SDOs) tend to “crown winners,” not to create them.⁵ For example, a recent study analyzing a database of patents declared essential to a range of standards including telecommunications technology (e.g., W-CDMA) and imaging standards (e.g., MPEG2 and MPEG4) found that inclusion in a standard has no or negligible impact on the value or importance of a patent, measured by forward citations, which suggests the inclusion in a standard in itself does not necessarily or even ordinarily create market power.⁶

Thus, whether a particular SEP holder has market power requires a case-by-case fact-specific inquiry into whether a single SEP constitutes a well-defined relevant market, whether there are potential substitutes, and the degree to which market power is mitigated by complementarities. SEPs are self-declared to SDOs yet no SDO evaluates essentiality, which may change as the standard continues through development. Therefore, until an independent legal and technical review establishes that a particular patent declared “essential” is in fact essential for want of substitutes or of off-setting complementarities, there should be no presumption that an SEP confers market power. Even restricting the analysis to truly essential patents, we cannot conclude that an individual SEP or a portfolio of SEPs constitutes a well-

defined relevant market or that the owner possesses market power. SEPs are perfect complements, which creates a connection among patents and patent holders such that SEPs cannot be licensed in isolation (i.e., FRAND royalty rates are tied to the value the patented technologies contribute to the standard, which inherently accounts for all valuable contributions to the standard). Thus, in contrast to a monopolist, which can set prices without considering the reaction of other firms, an SEP holder must take into account the value of other SEPs when setting its royalty rates. In addition, because licensees know they must license other SEPs to be compliant with a given standard, they push back in negotiations if they think an SEP holder is attempting to ask for more than its share. This, too, lessens any market power that might be conferred by a patent having been deemed essential.⁷

Whether particular conduct involving SEPs, including breach of a FRAND assurance, has net anticompetitive effects also requires a case-by-case, fact-specific analysis. For example, whether a refusal to license at the component level (which may or may not violate a FRAND assurance depending upon the specific SDO IPR policy at issue) results in harm to competition or consumers depends upon factors such as: (1) whether competition has been substantially foreclosed, which seems unlikely where the industry practice is not only not to license but also not to assert SEPs at the component level and instead to license at the end-user device level; and (2) whether there are any procompetitive or legitimate business justifications for such conduct, such as avoiding the patent exhaustion doctrine, reducing administrative costs to allow for easy monitoring or verification of units sold, and following industry practice.

Primary Specific Recommendations

Sections 2.1 and 3 – Refusals to License

We are concerned that the statements regarding refusals to license in Sections 2.1 and 3 of the Proposed Guidelines seem to depart from the general enforcement approach set forth in the Antitrust Agencies' 2007 IP Report, which recognizes that: (1) "the unilateral right to refuse to grant a patent license is a core part of the patent grant," and "liability [for refusal to license] would restrict the patent holder's ability to exercise [this] core part of the patent"; (2) "[a]ntitrust liability for mere unilateral, unconditional refusals to license patents will not play a meaningful part in the interface between patent rights and antitrust protections"; and (3) "[a]ntitrust liability for refusals to license competitors would compel firms to reach out and affirmatively assist their rivals, a result that is 'in some tension with the underlying purpose of antitrust law.'"⁸ To bring the Proposed Guidelines in line with the Agencies' 2007 IP report, as well as Supreme Court and federal appellate court rulings, we strongly urge the Agencies to revise the statement in Section 2.1 as follows:

Except in specific limited circumstances, the antitrust laws generally do not impose liability upon a firm for a unilateral refusal to assist its competitors, in part because doing so is likely to may undermine incentives for investment and innovation, infringes upon an intellectual property owner's core right to exclude, and creates administrative problems, such as forcing an antitrust agency to dictate the terms of a compulsory license. As such, antitrust liability for mere unilateral, unconditional refusals to license will not play a meaningful part of the Antitrust Agencies' enforcement program.

For the same reasons, we strongly urge the Antitrust Agencies not to qualify with "ordinarily"

the statement in Section 3.1 that “[t]he Agencies will not require the owner of intellectual property to create competition in its own technology.” Given that forced sharing alone does not necessarily make a market more competitive, it would require the agencies to act as central planners setting prices and other terms. Alternatively, in the very least, we respectfully request that the Antitrust Agencies clarify that there is no obligation to create competition as a remedy for a unilateral refusal to license but, as noted in the proposed footnote 25, an IP license may be an appropriate remedy in merger cases “to prevent the substantial lessening of competition,” particularly when the parties voluntarily agree to license as an alternative to a more restrictive remedy such as divestiture.

Section 2.2 – “Unreasonable Conduct”

Section 2.2 states, in relevant part, that “even if [an IPR owner] lawfully acquired or maintained [market] power, the owner could still harm competition through unreasonable conduct in connection with such property.” We strongly urge the Antitrust Agencies to delete the phrase “unreasonable conduct” and replace it with a clear statement that conduct will not be found unlawful absent a finding of anticompetitive effects that outweigh procompetitive benefits, i.e., an effects-based approach. In particular, we are concerned that the phrase “unreasonable conduct” lacks any clear definition or boundaries and may be interpreted broadly, particularly by foreign competition agencies that rely upon ambiguous catch-all phrases such as “unreasonable conduct” in lieu of undertaking an effects-based analysis.

Section 3.2.3 – Research & Development Markets

For the following reasons, we respectfully urge the Antitrust Agencies to reconsider the inclusion (or at the very least substantially limit the use) of research and development (R&D) markets: (1) the process of innovation is often highly speculative and decentralized, making it impossible to identify all market participants; (2) the optimal relationship between R&D and innovation is unknown; (3) the market structure most conducive to innovation is unknown; (4) the capacity to innovate is hard to monopolize given that the components of modern R&D—research scientists, engineers, software developers, laboratories, computer centers, etc.—are continuously available on the market; and (5) anticompetitive conduct can be challenged under the actual potential competition theory or at a later time.⁹

At the very least, we strongly urge the Agencies to revise the guidelines to incorporate expressly the movement within the Agencies (as illustrated by the Agencies’ 2010 Horizontal Merger Guidelines) away from the focus on market definition and market power and towards a focus on competitive effects. As described in Section I, above, this is particularly important with respect to IPRs, for which it is often more difficult to determine market power because IP holders charge more than marginal costs and need to recoup their investment, and there are substantial risks involved in seeking to create and commercialize IP. Relatedly, in high-tech markets involving IPRs, the lines between markets may not be clearly delineated. The risk here is in inferring market power from shares (after delineating markets), an approach that is fraught with error, particularly in high-tech business models involving IP.

First, given that innovation is “intangible, uncertain, unmeasurable, and often even unobservable, except in retrospect,” it is exceedingly difficult to identify all of the firms that belong in an R&D market.¹⁰ Indeed, inventors often spring up out of nowhere—garages or,

more recently, college dormitories—to create entirely new products or processes, creating entirely new demand curves.

Second, “there is no functional relationship between the level of R&D expenditure and the level of innovation at the market level.”¹¹ More R&D does not necessarily result in more innovation. For example, a “merger that reduces R&D expenditure may be beneficial if it allows the R&D to be conducted more efficiently.”¹² Because competing R&D expenditures may be duplicative, “a merger that eliminates redundancy may lead to the same knowledge produced at lower costs, or even to greater knowledge at lower costs.”¹³ Attempting to define market power by R&D expenditures (or “specialized assets or characteristics of specific firms”) is likely to lead the Antitrust Agencies into error.

Third, numerous research projects have tested variations on the “Schumpeterian hypothesis” that monopoly is more conducive to innovation than competition. “These studies have sought to find statistical relationships between firm size or market concentration and various measures relating to R&D and innovation, including R&D expenditure, R&D productivity, patent counts, and counts of significant innovations.”¹⁴ As explained in Section I, above, the empirical record shows that the existing body of theoretical and empirical literature on the relationship between competition and innovation is inclusive and thus market structure provides at best a very crude signal of the likely impact a merger or conduct will have upon future competition.

Fourth, “if the main inputs to innovation are continually ‘in play,’ there is no opportunity to corner the market for innovation.”¹⁵ The Agencies’ IP Guidelines attempt to address this point by limiting R&D markets to situations where the Agencies can identify “specialized assets or characteristics,” but “most of the complaints in FTC innovation market cases do not identify the specialized assets [that] triggered the innovation market challenge.”¹⁶

Section 3.4 – Truncated Analysis

Section 3.4 of the Proposed Update cites the Supreme Court’s decision in *FTC v. Actavis* in the section that appears to describe when the Antitrust Agencies will apply a truncated rule of reason analysis. We respectfully recommend that the Agencies revise the guidelines expressly to state, as the Supreme Court explained in *California Dental* and in *Actavis* itself, that the “abandonment of the ‘rule of reason’ in favor of presumptive rules (or a ‘quick-look’ approach) is appropriate only where ‘an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets.’”¹⁷

The default method of evaluating antitrust-relevant conduct is the rule of reason, which involves costly, comprehensive weighing of any pro- and anticompetitive effects of the challenged conduct. Truncated analysis, by way of comparison, harnesses decision theory to develop shorthand analytical tools based upon judicial and market experience with the restraint at issue, as well as accumulated economic knowledge to identify conduct that is likely to harm competition.¹⁸ Truncated analysis is appropriate when it, rather than the full-blown or unstructured rule of reason, minimizes the sum of the error costs and the administrative costs of adjudicating antitrust claims. The benefit of truncation is that it economizes on existing judicial and economic knowledge to produce more efficient legal rules.

In short, truncated analysis is at its core intended to be an easily administrable, effects-based application of the rule of reason.¹⁹

Given the agencies' recognition, which is supported by substantial economic literature (described, above in the Section I), that licensing restraints are generally procompetitive, a truncated analysis has little to no place in analyzing licensing restraints.

For GAI's full comment, visit

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2841207.

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² Edith Ramirez, Chairwoman, FED. TRADE COMM'N, *Standard-Essential Patents and Licensing: An Antitrust Enforcement Perspective* at 4 (Sept. 10, 2014), https://www.ftc.gov/system/files/documents/public_statements/582451/140915georgetownlaw.pdf

³ *Id.* at 11.

⁴ U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION at 39 (2007) [hereinafter 2007 IP REPORT] (quoting Lauren J. Stiroh, Vice President, Nat'l Econ. Research Assoc., Remarks at Hearing: Licensing Terms in Standards Activities 321–22 (Apt. 18, 2002)).

⁵ See, e.g., Anne Layne-Farrar & A. Jorge Padilla, *Assessing the Link Between Standards and Patents*, in INNOVATIONS IN ORGANIZATIONAL IT SPECIFICATION AND STANDARDS DEVELOPMENT at 19, 26-27 (Kai Jacobs ed., 2013).

⁶ *Id.* at 40-43.

⁷ *Id.*

⁸ 2007 IP REPORT, *supra* note 4, at 6 (quoting *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407-08 (2004)).

⁹ See, e.g., Phillip Areeda et al., ANTITRUST ANALYSIS: PROBLEMS, TEXT, AND CASES ¶ 545, at 782 (6th ed. 2004); Dennis Carlton & Robert Gertner, *Intellectual Property, Antitrust & Strategic Behavior*, in 3 INNOVATION POLICY AND THE ECONOMY 29 (Adam B. Jaffe et al. eds., 2003) [hereinafter Carlton & Gertner]; Ronald S. Katz & Janet Arnold Hart, *Extremism in Defense of Market Definition is a Vice*, in ANTITRUST/INTELLECTUAL PROPERTY CLAIMS IN HIGH TECHNOLOGY MARKETS 1 (ALI-ABA

Course of Study, Jan. 25, 1996), Westlaw CA26 ALI-ABA 1; Richard T. Rapp, *The Misapplication of the Innovation Market Approach to Merger Analysis*, 64 ANTITRUST L.J. 19 (1995) [hereinafter Rapp].

- ¹⁰ Rapp, *supra* note 9, at 27; *see also* Carlton & Gertner, *supra* note 9, at 42 (“[B]ecause the results of R&D are so difficult to predict, the analyst may be unable to determine all, or even most, of the relevant firms who might produce competitive products in the future.”).
- ¹¹ Rapp, *supra* note 9, at 33. For a summary of the relevant literature, see Jennifer F. Reinganum, *The Timing of Innovation: Research, Development and Diffusion*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 849 (1989) and F.M. SCHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 630-60 (3d ed. 1990).
- ¹² Carlton & Gertner, *supra* note 9, at 38.
- ¹³ *Id.*
- ¹⁴ Rapp, *supra* note 9, at 28.
- ¹⁵ *Id.* at 36.
- ¹⁶ *Id.* at 37.
- ¹⁷ *FTC v. Actavis*, 133 S. Ct. 2223, 2237 (2013) (quoting *Cal. Dental Ass’n v. FTC*, 526 U.S. 756, 770 (1999)).
- ¹⁸ Joshua D. Wright, Comm’r, FED. TRADE COMM’N, *Intellectual Property Rights, Truncation, and Actavis: Who’s Afraid of the Rule of Reason?* at 2-3 (Apr. 14, 2015), https://www.ftc.gov/system/files/documents/public_statements/636901/150414gcr-ip-antitrust.pdf.
- ¹⁹ ANDREW I. GAVIL ET AL., *ANTITRUST LAW IN PERSPECTIVE: CASES, CONCEPTS AND PROBLEMS IN COMPETITION POLICY* 185–87 (2d ed. 2008); Timothy J. Muris & Brady P.P. Cummins, *Tools of Reason: Truncation Through Judicial Experience and Economic Learning*, *ANTITRUST*, Summer 2014, at 46, 46-47, 50.