

FEDERAL TRADE COMMISSION

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FEDERAL TRADE COMMISSION

In the Public Hearing on:)
COMPETITION AND INTELLECTUAL)
PROPERTY LAW AND POLICY IN)
THE KNOWLEDGE-BASED ECONOMY.)
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FEBRUARY 8, 2002

Room 332
Federal Trade Commission
6th Street and Pennsylvania Ave., NW

The above-entitled matter came on for hearing,
pursuant to notice, at 9:15 a.m.

- PANEL:
WILLIAM E. KOVACIC, FTC
WILLARD K. TOM, Esquire
FRANCES MARSHALL, DOJ
ROBERT POTTER, DOJ
HILLARY GREENE, FTC

P R O C E E D I N G S

1
2 MS. GREENE: Good morning. On behalf of the Federal Trade
3 Commission and the Department of Justice, welcome. My name is
4 Hillary Greene, and I'm in the general counsel's office here at the
5 FTC, and with me at the far table we have Robert Potter and Franc
6 Marshall who are from the Office of Legal Policy at the
7 Department of Justice.

8 We are truly delighted to present this session on
9 antitrust laws for patent lawyers and our distinguished
10 speakers, Bill Kovacic and Will Tom.

11 When the Chairman first announced these hearings, he
12 emphasized that properly understood, IP law and antitrust law
13 both seek to promote innovation and enhance consumer
14 welfare. Today's speakers are true pioneers in promoting and
15 understanding of how antitrust law serves those goals, and
16 not surprisingly, they've used that same understanding to
17 challenge and help the competition community to increase its
18 sensitivity and their ability to promote those shared goals.

19 To say that the respective accomplishments of our
20 speakers are far too immense to mention is an
21 understatement. Nonetheless, I'll mention a couple things.
22 I'll begin with Bill Kovacic, the Commission's general
23 counsel.

24 Bill returns to the FTC from a professorship at the

1 Most recently, he served as Deputy Director of the
2 Bureau of Competition here at the FTC from '97 to 2000, and
3 before that he was the Assistant Director for Policy and
4 Evaluation, also at the FTC, and before he joined us at the
5 FTC, he was a counselor to the Assistant Attorney General in
6 charge of the Antitrust Division at the Justice Department.

7 I guess the main thing that I want to say about Will
8 is that he's the reason that we're all here. It's his fault
9 that we're here today, and while that's not entirely true, it
10 is true to note that Will was one of the framers of the
11 antitrust guidelines for the licensing of intellectual
12 property, which the Federal Trade Commission and Department
13 of Justice issued back in 1995, and he has continued to be a
14 pioneer in this area and has written many subsequent
15 articles, which have revisited the guidelines and looked
16 critically at how they are functioning.

17 In addition, he's worked most recently as the guest
18 editor for the Antitrust Law Journal, which will be having a
symposiumment

1 working with us on these hearings, as well as the wonderful
2 collection of the professionals at the Commission that are
3 responsible for this work.

4 We do have one handout for you for my part of the
5 presentation today, just to give you a glimpse of what our
6 agenda is today. I'm going to give you a short overview of
7 the U.S. antitrust system, both examining certain key
8 features in doctrine and the evolution of doctrine over time,
9 but also to focus in a little bit on the key institutions
10 that are responsible for developing and implementing
11 competition policy in the United States.

12 We will then be talking about a host of issues
13 involving agreements, principally involving licensing
14 arrangements. We'll take a break about midway through, and
15 then I'll come back and speak a little about monopolization
16 and attempted monopolization and the set of controls that the
17 antitrust system imposes on the behavior of individual large
18 firms, and then we'll finish up with a discussion about
19 mergers.

20 I want to mention Will and I both, as we go through
21 the material today, we want to welcome you to ask questions,
22 so to pose them not only to ourselves, but for really hard
23 questions as an academic, I've learned as an academic I've
24 learned you always hand them to someone else, and that's why
25 Frances and Bob have been trapped in here with us.

1 If it's a really tough, imponderable question, I
2 developed academic skills at handing those off or, as I
3 mentioned to Bob and Will earlier, using devices such as saying,
4 "We'll get to that later," or "What do you think," the two "in ca
5 of emergency" academic tools for dealing with problems.

6 Also, Will and I have each papers for you to take a look at.
7 With Carl Shapiro, I did a paper that's about 17 pages long,
8 basically a tour through 110 years of U.S. antitrust history. That's
9 about a page and a half per decade, but what we've got there is a
10 summary of a number of the concepts that I'll be speaking about
11 today.

12 On one occasion in traveling in Russia, they had an
13 earlier version of this translated and sent to the Russian
14 audience, and my counterpart in Russia who we were working
15 with said, "Could you give us some instructions about what you
16 want to do with this," and I said, "We'll do what we do in a
17 typical law school classroom, that is, I'll grill them in a
18 very good natured way about what we're talking about."

19 I went to the seminar, and I've never seen people so
20 compulsively and ferociously well prepared; that is, they had
21 read everything. They had good questions, but I said, "I've
22 never seen such a grim bunch of folks in my life," and the
23 translator said, "Well, it's this damn letter that you sent
24 them." I said, "Well, what does it say in Russian?"

25 It says, "Professor Kovacic insists that you read this

1 to the future with a bit of historical concept, and then as a
2 way of framing the balance of our morning's discussion, to
3 focus on what many observers agree to be today the core
4 concepts of antitrust policy.

5 Again, as I go through this, if you have a question
6 or comment, something I can clarify, or to address, please
7 let me know.

8 What was the state of the competition policy art in
9 the United States before 1890? That is, as a way of thinking
10 about what the Sherman Act did to change the framework of
11 competition policy rules, what background was the U.S.
12 Congress in 1890 writing against?

13 The common law framework, as you might imagine,
14 induced judges to address what we would call competition
15 policy issues in a number of cases, usually in the course of
16 examining contract and property disputes, and out of that
17 common law environment came a couple of key concepts. That
18 is, judges were attuned to the notion that certain types of
19 contractual restrictions might be overreaching, and they
20 developed a key concept that applies to the whole stand of
21 antitrust policy for dealing with that called the Rule of
22 Reason.

23 Here's the formative case. It involves an apprentice
24 working for a baker in post-industrial England. The
25 apprentice has agreed with the baker for a certain period of

1 time, "I will agree not to compete against you;" that is, in
2 return for learning the skills that you're offering me as an
3 apprentice, I agree as a condition of my employment that I
4 will not show up across the street except after a certain
5 period of time and compete against you.

6 And the question in this formative early case called
7 Mitchell versus Reynolds was, Was the duration of the
8 restriction on the apprentice's subsequent employment
9 excessively long? Was the geographic scope of the
10 restriction too broad because the baker had reached very
11 far?

12 As to duration, he said, You can never compete
13 against me in the future. And in what area? Over an area so
14 large, so far-reaching that it encompassed a good part of
15 England, and the apprentice breached the agreement. The
16 baker said, I want it enforced, goes into the English courts
17 to seek enforcement of the contract.

18 Issue before the court, Is the contract enforceable,
19 and the court said, Some measure of restraint would be
20 appropriate, else you would not have those skilled in certain
21 trades being willing to impart their know-how to apprentices
22 who come to work for them.

23 But on the other hand, to tell the apprentice that he
24 can never practice the trade in effect within the better part
25 of the country at any time in your life would deny not only

1 the individual the benefits of employment, but society the
2 benefits of the rivalry that would come from having a new
3 mind with new skills in the market offering consumers an
4 alternative.

5 So the court said, Some restriction would be
6 appropriate, but it must be a reasonable restriction, defined
7 in terms of both its geographic scope and the duration of the
8 restriction and the reasonable relationship of the
9 restriction to a legitimate business purpose.

10 So English common law courts dealt with many of these
11 formative concepts, and you also had those concepts imported
12 into the Colonies in the period running up to the Declaration
13 of Independence, the Constitution, and that provided the
14 template for common law contract adjudication in the 19th
15 Century.

16 What was the sanction if you had an overreaching
17 contract in this pre-Sherman Act period? The typical
18 sanction was non-enforcement of the agreement. Damages,
19 penalties? No, non-enforcement. Who had standing to sue?
20 The person restricted, not a customer, not a supplier, not a
21 competitor, the person who was a party to the contract, so
22 limited sanction for violating this basic restriction.

23 There was one national law in place before the
24 Sherman Act's adopted in the United States. Canada adopted
the first national (The peradfore the) Tj efore the

1 were predecessor state constitutions and statutes, both
2 through the guise of antitrust laws and corporation laws that
3 had competition policies principles. That's the framework
4 against which Congress is drafting when it comes to the
5 Sherman Act, again in 1890.

6 What are the key U.S. antitrust statutes? Basically
7 three enactments with a number of amendments each, but the
8 three foundational enactments are the Sherman Act, adopted in
9 1890. This is far and away the most important of the U.S.
10 competition policy statutes.

11 Section 1 of the Sherman Act basically imposes
12 restrictions upon collective action, agreements in restraint
13 of trade, both involving direct competitors, which are called
14 horizontal agreements, and those involving firms that are
15 aligned in the relationship of a supplier or a customer.
16 Those are what we usually call in our jargon vertical
17 agreements.

18 Section 2 of the Sherman Act provides antitrust's basic
19 mechanism of control for dominant firm behavior. This is the
20 location for the prohibition on the monopolization and
21 attempted monopolization. As we'll see today, antitrust
22 draws a fundamental distinction between concerted action, two
23 or more participants, and a unilateral conduct, with
24 concerted action being treated with much greater scrutiny.

25 The second most important of the statutes is the

1 Clayton Act adopted in 1914 and amended significantly in 1936
2 and 1950, amended with respect to substance in those years.
3 Section 2 of the Clayton Act prohibits certain forms of price
4 discrimination under the guise of the '36 statute called the
5 Robinson-Patman Act.

6 Section 3 involves a variety of distribution
7 practices and vertical restraints such as tying and exclusive
8 dealing, and Section 7 is the mechanism by which the U.S.
9 antitrust laws control mergers.

10 The Federal Trade Commission Act is adopted in 1914.
11 It is the foundation for the institution that is your host
12 today physically. The 1914 statute's key operative provision
13 is Section 5 of the Federal Trade Commission Act, which
14 prohibits unfair methods of competition.

15 For the most part, with some crucial amendments, the
16 basic architecture of the U.S. antitrust system is put in
17 place 25 years after the adoption of the Sherman Act by 1914.

18 Some key characteristics of these statutes, what I'll
19 call the open texture of the statutes, decentralized
20 enforcement and criminal and civil sanctions. Let's look at
21 each one.

22 What do I mean by open texture? The key operative
23 provisions of the U.S. antitrust laws are breathtakingly
24 open-ended. The Sherman Act, Section 1 and Section 2, for
25 many observers, especially foreign observers accustomed to

1 civil codes that specify misconduct in exactly detail, is a
2 shocking revelation.

3 Section 1 of the Sherman Act has fewer than 50
4 words. Section 2 is a bit longer, but less than a hundred.
5 What are the key operative terms? Terms such as restraints
6 of trade, monopolize. Section 7 of the Clayton Act and its
7 anti-merger provision, "may be substantially to lessen
8 competition." Section 5 of the FTC Act prohibits "unfair
9 methods of competition."

10 The statute does not define these terms, and as you
11 can see by themselves they are not self-defining. Yes,
12 Congress had in mind that judges would pay attention to
13 common law models that provided some description of what
14 these concepts might mean, but it made a formative change in
15 designing the law this way.

16 It deliberately made the law open-ended to permit the
17 conscious process of evolution over time. It delegated to
18 federal judges, for the most part, and implicitly to the
19 federal enforcement agencies the role of elaborating the
20 substance of the doctrines over time.

21 So with some fixed points of reference from earlier
22 common law cases, for the most part what Congress said is, We
23 want to give the statute a consciously, deliberately
24 evolutionary scheme so that it can be adapted through
25 judicial interpretation over time to account for new

1 State governments also have standing under the
2 statute to bring cases as private parties, and, yes, there is
3 a private right of action that enables injured customers,
4 suppliers and competitors, to bring suit, and what induces
5 them to do it? An attorney's fees provision that compensates
6 the prevailing plaintiff, not the prevailing defendant, the
7 prevailing plaintiff for reasonable attorney's fees and costs
8 and the measure of damages for the prevailing private
9 plaintiff is three times actual harm.

10 No system of law in the United States delegates
11 prosecutorial authority so broadly and to so many parties,
12 and this has an important consequence. It means that no
13 single prosecutorial gate-keeper in the U.S. antitrust system
14 has the ability to control the evolution and flow of doctrine
15 and decide what matters get to the courts.

16 So that if you read these standard American antitrust
17 case books, you will notice that as many formative cases
18 feature titles involving private parties and private
19 litigation as do cases involving the government of the United
20 States or the Federal Trade Commission.

21 We can complicate this a bit by adding the presence
22 of so-called sectorial regulators, the Federal Communications
23 Commission, Federal Energy Regulatory Commission which also
24 had a competition mandate for mergers.

25 I put upward ratchet on the slide simply to raise

1 this point; that is, when you have so many prosecutorial
2 agents, there is the possibility that the most aggressive
3 preferences or the most aggressive agent are those that
4 determine which cases be brought. That can import an upward
5 ratchet into the prosecutorial process. What is the
6 rationalizing influence? The courts.

7 This mechanism depends crucially on judicial
8 elaboration to decide what the appropriate equilibrium of
9 doctrine ought to be. Of course, time can intervene. It has
10 in a number of times, but it's mainly the courts that decide
11 which norms, which standards ought to be applied.

12 The last key item I want to mention is the
13 coexistence of criminal and civil sanctions. Why is this
14 important? The U.S. system, through the Sherman Act, permits
15 the government of the United States to prosecute both
16 individuals and corporate entities as criminals. The statute
17 defines all offenses of the Sherman Act as crimes. Of
18 course, they can be pursued civilly as well, but had the
19 Justice Department chosen to do so, as a matter of technical
20 analysis, if it had wanted to convene a grand jury to indict
21 Bill Gates in the Microsoft Corporation, it could have.

22 That would have been a jarring departure from modern
23 prosecutorial practice, but it is, nonetheless, striking to
24 contemplate that the Sherman Act defines all of its offenses
25 as crimes.

1 What in fact has the government done over time? How
2 has it used its discretion? It has ruthlessly focused the
3 prosecution of criminal matters upon the most egregious
4 offenses, what we call hard-core horizontal restraints,
5 agreements between competitors to set prices, to allocate
6 markets or customers.

7 In order to make that exercise of authority appear
8 legitimate, courts over time have tried to carefully delimit
9 what sorts of offenses deserve that kind of combination.
10 Those tend to be called per se offenses in the language of
11 antitrust offense? What's a per se offense? A per se
12 offense is one for which the proof of liability depends only
13 upon demonstrating that the agreement or the behavior in
14 question took place, utterly without regard to actual effects
15 in the marketplace. As you'll be seeing a bit later today,
16 certain types of price related agreements are condemned per
17 se.

18 So what about goals, that is, what do the antitrust
19 laws try to accomplish? With that broad, open-ended
20 language, an enforcement agency or a court might ask, It's
21 hard to make sense of the law without having an idea of what
22 you want to do with the law.

23 If you were really concerned about preserving an
24 atomistic structure of suppliers, you might define monopoly
25 as any condition in which a firm acquires more than a trivial

1 share of the market. If your goal was absolute political and
2 economic social decentralization, you can do that. You might
3 sacrifice some economic efficiency, but that could be your
4 choice of enforcement strategies.

5 The choice on the list that matters a lot is economic
6 efficiency. Is it to promote practices that increase
7 society's total wealth by encouraging the efficient use of
8 resources? Is it to prevent transfers of wealth from
9 consumers to producers, transfers that take place often in
10 the face of price-fixing agreements that impose supra-
11 competitive prices?

12 Is it to promote economic decentralization as an end
13 in itself? Is it to achieve perceived political benefits of
14 maintaining a relatively decentralized structure of business
15 firms on the idea that large firms tend to be politically
16 dangerous because they can manipulate the political process,
17 whereas smaller firms might be seen as benign?

18 Is it to promote local autonomy by keeping business
19 units small enough that business units are not able to
20 distort cultural/social/political values at a local level or
21 are there others?

22 If you had asked Congress in 1890 which of these
23 count, they would have said all of them, every one, we wanted
24 to do all of that. You might ask yourself, Well, how do you
25 do them all? Aren't they internally contradictory at some

1 point? That is, you can't have some of the benefits from
2 economic scale if you want small cottage industry
3 configurations in which no firm has more than a dozen or so
4 employees.

5 Can you do that? Congress would have said or
6 answered this way, We don't think you have to be huge in
7 order to gain economic efficiency benefits. Congress would have
8 said, It is a disruption in the natural economic order to have huge
9 corporate enterprises. They only get that way and stay that way by
10 using improper means. There's no trade-off between the item on the
11 top line and those on the lower part of the chart.

12 One of the things we've learned as a part of this
13 evolutionary process and the strong role that economic
14 analysis plays in changing views about what normative rules
15 ought to be in this area is that there are trade-offs all
16 over the place.

17 Just to anticipate something that we'll see today,
18 what's the goal today? Top line, that's virtually the single
19 minded focus of decision making in the federal courts, and I
20 would say the single final decision making in the federal
21 antitrust systems.

22 It's the promotion of economic efficiency. I'll say
23 a little bit in a minute about how we got there. Do other of
24 these values come into play? Are they accomplished by

1 pursuing economic efficiency? Sure. That is, to the extent
2 that you promote economic growth and the fruits of that
3 growth are spread throughout a society, that has powerful
4 political consequences.

5 To the extent that you prevent artificial
6 restrictions on access to the marketplace, that has powerful
7 social and economic consequences, but those are not the
8 direct aims or directives of policy making. Efficiency in
9 the form of lower prices, greater innovation, those tend to
10 be the aims of modern competition policy today.

11 I'm going to give you a quick view of how policy changed and
12 evolved in the United States, and again for the mind-numbing
13 treatment of this, the Shapiro paper out on the table gives
14 you lots of the wonderful details of this trip. But I want
15 to emphasize for you how, in fact, policy changes over time
16 and will continue to change and let me give you a sense of
17 what's motivated the change.

18 To take the first 25 years, what comes out of the
19 first 25 years? What does the Supreme Court do? In the
20 Standard Oil case, one which I think you're all familiar
21 with, this is the case that split John D. Rockefeller's
22 empire into 34 separate pieces in 1911.

23 In the Standard Oil case, the Supreme Court said that
24 model of analysis I referred to before, the rule of reason,

1 that's the basic template for analysis in the antitrust area
2 too, and implicit in that is a trade-off, a balancing of
3 competitive benefits against competitive harms, with a
4 general view that restraints on competition should be no
5 greater than reasonably necessary to accomplish legitimate
6 wealth-increasing social ends.

7 The Standard Oil case also acknowledges that some
8 forms of behavior may be so vicious in their competitive
9 consequence, they can be condemned with a minimal court.
10 That's the so-called per se rule, that it also coexists
11 within the umbrella of the rule of reason.

12 Supreme Court mandated the break up of Standard Oil.
13 It was a dramatic demonstration that antitrust remedies
14 extended up to and including the restructuring of the firms
15 that had gained their preeminence or maintained it
16 improperly.

17 By 1914 the courts had recognized that criminal
18 enforcement of the antitrust laws was appropriate,
19 notwithstanding the seemingly open-ended language of the
20 statute itself, that antitrust offenses could be attacked as
21 crimes.

22 And institutionally you see Congress in 1914 deciding
23 that it would experiment basically with two forms of
24 administrative enforcement and elaboration, a principally
25 administrative mechanism through the FTC with an independent

1 regulatory commission, and now with the demise of the ICC,
2 the FTC is the oldest of the lot still in existence, and with
3 executive enforcement through the Department of Justice.

4 From 1915 to 1936, this is a period in which the
5 notion of reasonableness standards gains powerful currency in
6 the U.S. system. A distrust for using the possibility of
7 carving out certain rules and condemning certain behavior as
8 being intrinsically illegal by a per se standard, the attack
9 upon dominant firms that brought about the challenge to
10 Standard Oil largely falters from 1920 through the mid '30s.
11 The government simply doesn't bring large cases to
12 restructure major firms or attack dominant firm behavior.

13 Institutionally, especially in the midst of the Great
14 Depression, we have a number of national experiments with
15 coordination and economic planning, and I mention this simply
16 to point out that even though the U.S. economic system relies
17 heavily on a competitive process, with the adoption of the
18 Sherman Act, there are many economic actors who come to
19 realize that since private agreements and restraint of trade
20 become hazardous, the old-fashioned, best way to do it is to
21 get a public authority to do it for you, to run the cartel,

1 power. Many of the experiments in the 1930s endorsed this
2 approach and planted the seeds of a number of theories that
3 provide major exemptions from the operation of the antitrust
4 laws today.

5 It's really not until the second New Deal of Franklin
6 Roosevelt's presidency that there becomes a durable, sustained
7 commitment to the use of competition as the means for
8 organizing U.S. economic system.

9 From '37 to '72, we see a swing in the direction I
10 suggest for the use and reliance upon per se rules of
11 illegality. The Supreme Court endorses the concept that
12 certain types of behavior are intrinsically illegal.
13 Horizontal restraints such as price-fixing agreements, the
14 sort of behavior condemned in the Archer Daniels Midland Food
15 additives price-fixing conspiracy, allocations of customers
16 and agreement between one firm and another to decide which
17 customers they'll serve; resale price maintenance by which a
18 manufacturer imposes either a floor or a ceiling around the
19 price at which its retailers can sell a product; tying
20 arrangements in which the sale of one product is conditioned
21 on the sale upon another.

22 And it's in many of these tying cases in this period,
23 especially in the late '30s and early '40s, that the Supreme
24 Court plants the idea in a number of cases that the existence
25 of an intellectual property right is itself a source of

1 monopoly power, and Supreme Court decisions in this era in
2 antitrust cases glibly tend to equate patents with
3 monopolies, patents with monopolies, copyrights with
4 monopolies, trademarks sometimes with monopolies.

5 That's a point of view that the antitrust system no
6 longer holds. Fortunately, the evolution that I'm referring
7 to has taken us past that point, but if you're looking for
8 the roots of that concept, it's embedded in a number of the
9 cases that come out of this period.

10 There's another key assumption about structuralism,
11 and I'll simply describe it this way, is a sense that high
12 level of concentrations inevitably permit firms or encourage
13 firms to glue with each other, and even if they're not
14 actually sitting down in a hotel room deciding what to
15 charge, it's easy for them to coordinate their behavior at
16 arms length. Lots of antitrust laws accept that premise.

17 Institutional changes: in 1950 Congress adopts the
18 current variant of the U.S. anti-merger policy, merger
19 statute, and in the late 1950s and early '60s we have a
20 tremendous renaissance of private actions. The three largest
21 manufacturers of heavy electrical equipment used to build
22 power plants basically decided that they would allocate sales
23 opportunities for different public utilities.

24 This resulted in the largest horizontal price-fixing
25 conspiracy prosecution in the history of the statute to that

1 point and greatly inspired a great growth in the use of
2 private suits.

3 '73 to '91 is what I call the ascent of the Chicago
4 School. What's the Chicago School? Chicago School is a
5 shorthand term for a line of economic reasoning, theory, that
6 has two principal tenants. One is that antitrust policy
7 ought to focus on prosecuting plain vanilla violations of
8 two types: Agreements among competitors to set prices or to
9 allocate customers, so-called hard-core horizontal
10 restraints; and to prevent mergers to monopoly.

11 Beyond that antitrust ought to stay out, and the
12 second related concept that the Chicago School has, Why have
13 such a plain vanilla antitrust policy? Because courts and
14 enforcement agencies aren't particularly good at doing
15 anything else. You need relatively simple, clear rules
16 focused on a handful of practices because that matches the
17 institutional capability of the bodies responsible for
18 putting a system into operation, and if you let courts and
19 enforcement agencies do something else, the rate of errors
20 can go way up.

21 Major institutional changes that reflect some of the
22 new economic thinking may be the most important, single set
23 of administrative guidelines issued by either federal agency
24 in their history. One of the truly remarkable influential
25 accomplishments of modern era, the 1982 merger guidelines

1 issued by the Department of Justice, a remarkable
2 accomplishment in the field of competition policy, a great
3 increase in criminal enforcement of hard-core horizontal
4 restraints, the emergence in the 1980s of state governments
5 as major enforcers of the federal antitrust laws and what I
6 called HSR in 1976, a major change, the Hart-Scott-Rodino
7 Antitrust Improvements Act, which imposes a requirement that
8 mandates that parties to mergers give the federal agency a
9 limited period to decide whether to challenge transactions
10 before they're actually completed.

11 '92 to the present: major intellectual developments
12 is in the school of economic thinking that's been called the
13 Post-Chicago School. The Post Chicago School of the great
14 dialectic process is the counterweight to the Chicago School,
15 it's the antithesis in some ways of the Chicago School, and
16 that simply did pose many tensions.

17 How does the Post Chicago School differ? Two key
18 respects. One is that it sees an appropriate role for
19 antitrust enforcement beyond what I call the plain vanilla
20 agenda of the Chicago School. As a matter of concept, there
21 are forms of business behavior, especially involving
22 misconduct by dominant firms, that ought to be the subject of
23 scrutiny, and second, with respect to institutions, there's
24 much greater confidence on the part of Post Chicago School
25 enthusiasts about the capacity of enforcement agencies and

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1 pricing case against American Airlines, the FTC's consent
2 decree involving Intel.

3 MR. POTTER: Call it a predatory conduct case.

4 MR. KOVACIC: Predatory conduct case, yes, exactly in
5 fact more than just pricing, a host of activities to deter
6 entry by entrants into the airline sector.

7 Institutional changes, major changes in the federal
8 merger guidelines, and as Will will be talking about a bit,
9 the introduction of intellectual property guidelines, which
10 are far more receptive than the earlier structuralist's
11 perspective. The per se perspective that I referred to
12 before was towards a variety of licensing and other practices
13 involving the use of intellectual property and the emergence
14 of what I would call a public enforcement triad; that is, the
15 establishment of state governments as being if not absolutely
16 equal in their dedication of resources and activity to
17 competition policy, certainly well entrenched as elements of
18 the U.S. competition enforcement scheme.

19 Core concepts today, let me just mention a few areas
20 that we'll be thinking about. One is the importance of identifying
21 and measuring market power accurately. It was a general view that in
22 many instances antitrust policy is most properly focused when it
23 focuses on the improper accumulation of use of market power.

24 So knowing how to define that in a meaningful way is

1 important, and one thing I'll emphasize to you, that contrary
2 to earlier cases or decisions that sometimes equated certain
3 species of intellectual property as per se indices of market
4 power, that point of view is no longer adopted today. It
5 depends on the number of alternative substitutes for the item
6 that is subject to an intellectual property right.

7 Second is the focus of identifying and finding
8 hypothesi of antitrust, what I call collusive effects on
9 competitors to achieve and exercise market power through
10 agreements among themselves, what I call exclusionary
11 effects involving the efforts of firms to achieve or increase
12 market power by denying access to the market to rival firms,
13 and last the focus on what we might call efficiency and
14 efficiency concerns, what's a good justification for
15 practices.

16 I'm going to turn to Will who will focus on

1 the term monopoly -- the question is, What is the meaning or
2 what is the difference between a patent monopoly and an
3 antitrust monopoly?

4 I think the term monopoly is a very unfortunate label
5 to apply to either of those circumstances. I think the
6 vocabulary we might find better used when we're talking about
7 patents, we're really talking about the right to exclude, and
8 the right to exclude may have some commercial value. It may
9 have none at all.

10 If I have an idiotic idea that happens to be
11 patented, I have the right to exclude you from using it
12 except with my permission, but I may have no market power at
13 all. I may start with my idiotic idea that happens to
14 patentable, commercially useful, a submarine tank that
15 flies. It's patentable. It's a great idea. Or a fur-lined
16 bathtub or some other extraordinary innovation that I've come
17 up with that has no commercial value, no market power.

18 When we talk about market power in the antitrust
19 context, the monopoly in the antitrust trust context, we're
20 talking about products for which there really aren't good

1 substitutes for the product in question, and when we talk
2 about monopoly in this institution and two blocks over at the
3 Department of Justice, we're talking about the capacity of an
4 individual producer to raise price significantly above a
5 competitive level without losing a substantial amount of
6 sales.

7 And that depends entirely upon the availability -- in
8 many instances on the availability of substitutes, so I think
9 when we speak about monopolies, it's probably better to talk
10 about the patent monopoly, when we really need to be talking
11 about the right to exclude one from the use of that property
12 right where the property right itself might have no value in
13 some sense.

14 Yes, sir?

15 MR. WILLIAM MOORE: You said the main goal of the
16 1890 statute was economic efficiency and that the other goals
17 had kind of fallen by the wayside, but there is nothing in
18 the current rubric that concerns diversification in the
19 economy, which would equate to economic decentralization I
20 think in the original goals.

21 MR. KOVACIC: I would say that there is a concern
22 about diversification in this respect. That is, antitrust
23 people tend to be very suspicious about private arrangements
24 that artificially restrict access to the market or suppress
25 the emergence of, for example, new technologies or the

1 emergence of new competitors, and we are also suspicious of
2 public restrictions that do the same thing.

3 So we have a keen -- we have a great deal of faith
4 about the vitality that entering into the market tends to
5 bring to the process of innovation, decisions about pricing,
6 and you'll see that I think -- both of us have a great
7 concern about private or public restrictions that have the
10y go effective Bill K abcic, who is227

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1 of restraints, and with some reference to the infamous Nine
2 No-Nos.

3 Let me start with the horizontal versus vertical
4 distinction, and to do that, inspired by the history lesson
5 that we had already this morning, I'm going to go back to
6 1906 I believe, and this little schematic diagram represents
7 the case of Bement & Sons versus National Harrow Company,
8 and this was a patent pool, and it dealt with a subject that
9 was undoubtedly at the technological forefront of the day,
10 namely, float springs and tooth harrows.

11 Does anyone know what a tooth harrow is? Can I have
12 a show of hands here? Well, a harrow is basically something
13 that you drag behind a farm animal or a tractor or something
14 to break up the ground. And somewhere along the

1 way people figured out that as you put springs in the teeth,
2 it gives it certain advantages in dealing with rocky soil and
3 the like.

4 And so a float spring tooth harrow was invented, and
5 actually there were a number of purveyors of float spring
6 tooth harrows, and ultimately about 22 of them emerged, and
7 around about the turn of the century, they realized that
8 competing with so many competitors was not a very comfortable
9 thing, and they ought to form a pool.

10 And they all had patents on their individual
11 products, and the nature of the pool was that they would all
12 contribute the patents to the pool and then license them back
13 on terms that essentially fixed the price at which they could
14 resell their products, a fairly common practice in the
15 intellectual property world.

16 But this pool had some unique features, and I
17 diagrammed that by using different geometric figures,
18 squares, triangles and circles, because the unique feature of
19 this pool was that each manufacturer was allowed to license
20 back only the technology it had contributed to the pool.

21 So manufacturer A got the license back from the pool
22 the right to use, the right to practice manufacturer A's
23 patents, and manufacturer B got to license back and practice
24 manufacturer B's technology and so on. Kind of an odd pool,

1 you would think.

2 I'm going to ask for a volunteer, preferably someone
3 who knows nothing about either this case or antitrust, and
4 ask you how you think that case should have come out. Can I
5 have a volunteer? Sir? Go ahead.

6 MR. POLK: I think from an antitrust standpoint,
7 it seems like customers didn't really get anything. The
8 patentees are just selling what they could have done without
9 the pool.

10 MR. TOM: Exactly. The answer my victim just gave
11 is that it doesn't seem like customers were getting anything
12 out of this deal, that each manufacturer was able, after the
13 pool, only to do what it could have done to start with, so
14 where was the benefit to consumers?

15 And indeed I think that's how an antitrust lawyer or
16 economist or professor would look at it today. This pool
17 contributes nothing to economic efficiency. It doesn't bring
18 together complementary products. All it does is fix the
19 price of the product, and therefore this pool should be
20 condemned as unlawful.

21 What did the Supreme Court do? Well, as I think Bill
22 alluded to, there's been an evolution in the law, and given

1 the degrees of inconsistency between some of the old cases
2 and some of the current cases, they can't both be right, and
3 let me suggest that the Supreme Court nodded on this one. It
4 was 1902, excuse me.

5 The Supreme Court in this case said: "The general
6 rule is absolute freedom in the use or sale of rights under
7 the patent laws of the United States. The very object of
8 these laws is monopoly." And therefore the Supreme Court
9 upheld this pool, said it was lawful.

10 By the way, I guess I differ with Bill in one
11 respect, the notion of patents as monopolies does not just
12 arise from that unfortunate period in which the Supreme Court
13 attacked patent rights wherever they could find them but also
14 goes all the way back to 1902 in which the Supreme Court
15 said, Patent equals monopoly, and therefore, the
16 anti-monopoly laws have to yield.

17 Now, we'll see later in our history, as Bill was
18 talking about, a period in which the Supreme Court did the
19 same thing, patent equals monopoly and therefore the patent
20 laws have to yield. I would suggest they got it wrong both
21 times, and let's fast forward a bit to that period.

22 This was I believe around 1945. The case of United
States versus Line Material Company, and Line Material

1 does not give the patentee any exemption from the provisions
2 of the Sherman Act beyond the limits of the patent
3 monopoly."

4 Well, what does this mean? What is beyond the limits
5 of the patent monopoly? In another setting I analogize the
6 whole focus of the inquiry during this period being like
7 siblings trying to share a bedroom, and they got a sheet
8 between them, and there are constant, daily arguments about
9 whether the sheet is one inch on my side or one inch on your
10 side, and all of the arguments are about whether you are
11 within or outside the limits of the patent monopoly.

12 No attention to the fact that -- as Bill said, the
13 whole idea of a patent monopoly is just an unfortunate term
14 in the first place, because when you talk about monopoly in
15 an antitrust sense, you're talking about the presence or
16 absence of substitutes. You're not talking about property
17 rights, and what the Supreme Court here is calling a patent
18 monopoly is really no more than a right to exclude but just
19 as if I owned a factory, I have a right to exclude people
20 from coming in and producing goods in my factory, but that
21 doesn't make me a monopolist if someone else has a factory
22 down the street producing the same kinds of goods, goods that
23 are that substitutes for mine.

24 Okay. Where are we today? I think we can take a
25 number of examples, but I'll take the Department of Justice

1 in the business review letters that we did for the MPEG 2
2 patent pool and DVD patent pool. Basically these were
3 situations in which a great number of firms had patents that
4 were essential to practice the standard for an emerging
5 technology.

6 They were, in other words, all blocking patents, and
7 the formers of the patent pools realized that given the mess
8 the Supreme Court and the courts generally have left us in
9 the pooling area, that there was some antitrust risk and
10 uncertainty, and given the diversity of sources, and of
11 course when you can't rely entirely on the enlightenment of
12 principles that I think the enforcement agencies have
13 migrated to, they decided to seek a business review letter
14 from the Justice Department.

15 And what the Department did in this case was
16 essentially focus on this question of whether these patents
17 competed with each other or were indeed complements or
18 blocking patents, and the mechanism that was set up to ensure
19 that only blocking patents were contributing to the pool is
20 that the members of the pool agreed to appoint an independent
21 patent examiner to examine all the patents that were
22 contributing to the pool and to make a determination that
23 they were indeed necessary in order to implement the standard
24 in this area.

25 Now, there were a number of safeguards as well, but

1 this was the essential and most critical safeguard to ensure
2 this was really a Line Material kind of pool and not a peril
3 kind of pool.

4 So what is the test here? I think Rich Gilbert
5 mentioned it on Wednesday. The key test in the Intellectual
6 Property Guidelines for distinguishing a horizontally
7 relationship from a vertical relationship is "would there
8 have been competition absent the license?"

1 horizontal and vertical, but that's really what we're getting
2 at.

3 We're getting at, Would there have been competition.
4 Did these two things compete, and if there would not have
5 been competition absent the license, you really can't call
6 these horizontal competitors. Even if you have got two
7 manufacturers that seem to be producing the same thing, if
8 one of them is in business only by virtue of a license from
9 the other, you do not have a horizontal relationship.

10 Let me now pass on to the subject per se versus rule
11 of reason and just to enumerate the basic categories that are
12 treated as per se unlawful. The core per se offense is
13 horizontal restraints that fix prices, divide markets or
14 restrict output.

15 This is obviously an area in which it is very
16 important to determine whether you're dealing with a
17 horizontal or a vertical relationship because what is --
18 probably one of the most common licensing restraints in the
19 intellectual property area, it is territorial restrictive
20 licenses, I license you in North America to practice this
21 technology, but my patents in South America I license to
22 somebody else. There is nothing wrong with that, as long as
23 you're dealing with a vertical restraint.

24 Now, if you're dealing with a Bement versus Harrow
25 kind of situation where each of those manufacturers were

1 perfectly capable on their own of competing effectively with
2 each other and you create this pool or a cross license with
3 restrictive territorial terms and I'll take east of the
4 Mississippi and you take west of the Mississippi, then you do
5 have a horizontal restraint, and you're talking about per se
6 unlawful violations.

7 There are also some per se restraints that are more
8 or less hangovers from an earlier day in antitrust, and one
9 of the virtues of common law tradition in antitrust is that
10 it is largely self-correcting. If you have a stupid idea
11 that is embodied in a bunch of court precedents but not
12 embodied in a statute, it is fairly easy for courts to
13 distinguish them, ignore them or otherwise deal with them.

14 In fact, in the symposium that Hillary mentioned, one
15 of the authors has contributed an article praising the
16 Federal Circuit for really accomplishing its mission of
17 reforming patent law, making patent law more rational, and I
18 think it's fair to characterize his argument as saying, When
19 the Federal Circuit was being formed, there was all this
20 testimony about forum shopping and about the problems that
21 were created by different circuits imposing different rules
22 for the same conduct and indeed in some cases the same
23 patents.

24 Well, that was all largely window dressing. If you
25 looked at Judge Markey's testimony before the Congress and

1 when he talked about irrational decisions that were based on
2 slogans instead of analysis, all of the examples that he
3 pointed to came right from the Supreme Court, and the thrust
4 of this author's argument is that the Federal Circuit has
5 essentially accomplished its mission by ignoring silly
6 positions from the Supreme Court.

7 And you can accept the argument or not accept the
8 argument, but basically the judge-made law tends to be self-
9 correctable. It's not 100 percent true, and there are things
10 that end up being relics, but by and large the courts and the
11 agencies are trying to make sure that those relics do as little
12 damage as possible.

13 It is probably the case that the per se rule against
14 vertical minimum price restraints is one of those. Since I
15 no longer work for the Federal Trade Commission, I can say
16 that. I'm sure that there were some former bosses of mine
17 who would be very unhappy and will be very unhappy when they
18 see that I've said this, but I advanced the disclaimer that I
19 speak for no one here but myself, certainly not for former
20 agencies that I worked for nor for any of my partners or
21 clients of Morgan Lewis, but there it is.

22 There are also per se rules against certain tying
23 arrangements and concerted refusals to deal. Those per se
24 rules still do exist, but they've been moderated over the
25 years by including as an element of the per se offense the

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1 very substantial investment, whether it's R&D investments or
2 building a tangible facility of some kind, to put in place
3 reasonable restraints to ensure the ability to reap the
4 rewards of that investment.

5 And to give an example, a very mundane example, non-
6 intellectual property example to illustrate that point, I'm
7 going to diagram the Beltone case that the Federal Trade
8 Commission dealt with probably a couple of decades
9 ago by now, and this involved hearing aids. Beltone was a
10 manufacturer of hearing aids.

11 The way it marketed its product was to put
12 advertisements in publications like Modern Maturity or
13 publications that had the right demographic for their target
14 audience, and those advertisements would have little clip out
15 coupons that you could send in to the manufacturer and
16 saying, yes, I want more information, or telephone numbers
17 that you could call.

18 And what Beltone would do with all of these sales
19 leads is find out whatever geographic area the customer was
20 in and send those leads to the distributor in those areas
21 that would go and make the sales calls on the sales lead.

22 Within their agreements with their sales
23 representatives, their distributors, was an exclusive dealing
24 provision that prevented the distributors from dealing with
25 any hearing aid manufacturers other than Beltone, and this

1 was challenged as an exclusive dealing arrangement because it
2 restrained competition at the distributor level, so the
3 allegation went.

4 And the Federal Trade Commission looked at that and
5 did a very complete and exhaustive analysis, but one of the
6 bases on which the exclusive dealing arrangement was upheld
7 was that this was simply a way of preventing free riding.

8 If Beltone goes through all of the expense of placing
9 these advertisements and creating a database and sending the
10 sales leads out to the distributors, and included in the
11 wholesale price of the sales to the distributors is the cost
12 of all of that advertising and so on, and then the
13 distributor takes those sales leads and buys the el cheapo
14 hearing aid from the other firms that are not undertaking
15 those investments and goes to the sales leads and sells the
16 other manufacturer's sales leads, this whole distribution
17 system would collapse. So this exclusive dealing
18 was a way of protecting the investments and preventing free
19 riding.

20 Well, you see this all the time in the intellectual
21 property area. Where there are restraints, as you'll see
22 when we go through individual restraints, many restraints are
23 there in order to prevent free-riding on the patent holder's
24 investment in developing the patent in the first place.

1 That's essentially why we have a patent system to promote the
2 progress of science and useful arts.

3 Just a quick introduction and review of the general
4 principle of the 1995 guidelines, and I think you heard these
5 on Wednesday. For antitrust purposes, intellectual property
6 is comparable to other kinds of property.

7 Well, what does that mean? Well, it's for antitrust
8 purposes. We're not saying that intellectual property is not
9 different in any respect from other kinds of property, but
10 antitrust can take those into account, and we'll go over some
11 of those differences in a moment.

12 Second, this whole idea of a patent monopoly has
13 nothing to do with antitrust. The fact that you have a
14 patent doesn't mean you have a monopoly. You might have a
15 monopoly if there are no adequate substitutes to your
16 product, but the mere possession of a patent doesn't give you
17 monopoly.

18 And finally intellectual property licensing is
19 generally pro-competitive because it allows firms to combine
20 complementary products.

21 What does it mean, intellectual property is
22 for antitrust purposes like other forms of property? Well,
23 it doesn't mean there are no differences. Certainly
24 intellectual property is easier to misappropriate. If
25 you build a factory, you can put locks on the doors. You can

1 build a fence around your factory. You can hire security
2 guards. You're not totally reliant on the law against
3 trespass. In the case of intangible product, in particular
4 the intellectual property, you really are reliant on the

1 case called Townshend v. Rockwell in the Northern District of
2 California, less than two years ago. The principle
3 enunciated in Townshend v. Rockwell is "because the patent
4 owner has the legal right to refuse to license his or her
5 patent on any terms, the existence of a predicate condition
6 to a license agreement cannot state an antitrust violation."

7 So I can refuse to license altogether, and
8 therefore I can impose any condition as a condition to that
9 license, and that condition must necessarily itself be
10 lawful. This is a kind of antitrust immunity for a patent
11 license, and let me suggest to you that that statement, as
12 superficially plausible as it might seem, is simply wrong.

13 And I think probably the best answer to that
14 proposition was given by the late Bill Baxter, who was really
15 a giant in the antitrust field. He was President Reagan's
16 first chief antitrust enforcer. He was a professor at
17 Stanford, authored a number of seminal articles, and was a
18 leading proponent of the Chicago School that rationalized
19 antitrust and pared back some of the earlier excesses that
20 we talked about.

21 And in 1966, the original article, then Professor
22 Baxter had this immortal sentence: "A promise by the
23 licensee to murder the patentee's mother-in-law is as much
24 'within the patent monopoly' as is the sum of \$50, and it is
25 not the patent laws which tell us that the former agreement

1 is unenforceable and subjects the parties to criminal
2 sanctions."

3 The mere notion that the patentee can withhold a
4 license all together doesn't absolve you from looking at the
5 nature of agreements that the patent holders enter in to with
6 other parties.

7 Let me turn now to specific types of restraints, and
8 we'll start with this one, the Nine No-Nos. Normally I would
9 put on the top Nine No-Nos, because I'm a firm believer in
10 the principle that the fewer words on Power Point slides the
11 are better.

12 However, these slides will probably get posted on the
13 web. I'm certainly willing to Email them to anyone who wants
14 a copy and sends me their Email address, and these things
15 take on a life of their own, and I thought it important to
16 retitle this slide a little bit, lest there be any
17 confusion.

18 What are the Nine No-Nos? Let me list them quickly,
19 and we'll examine them quickly, and then we'll examine them
20 in detail through modern times.

21 Tying of unpatented supplies; mandatory grantbacks;
22 post-sale restrictions on resale by purchasers of patented
23 products; tie outs; licensee veto power over the licensor's
24 grant of further licenses; mandatory package licensing;
25 royalties not reasonably related to sales; restrictions on

1 sales of unpatented products made by a patented process; and
 2 resale price agreements. Don't write these down. They'll
 3 only confuse you.

4 Okay. Tying of unpatented supplies, what's that all
 5 about? Well, remember this notion of the patent doesn't give
 6 the patentee rights that go beyond the scope of the patent
 7 monopoly? And anything that goes beyond the scope of the
 8 patent monopoly must be a violation of the antitrust laws in
 9 addition to being a patent excuse and therefore
 10 unenforceable.

11 I think that misguided notion is probably what gave
 12 rise to the notion that tying of unpatented supplies must be
 13 an antitrust violation because if I say to you, You may
 14 license my patent or you may buy my patented product but only
 from IBM, or Xerox, or whatever, that's not a violation of antitrust
 law. Well, clear as day that antitrust goes beyond the scope of the
 patent monopoly.

15 That's right. I warn you here: antitrust may

1 get into intellectual property, I'm presuming it to be zero,
2 right? So you look at where marginal revenue intersects with
3 marginal cost. You get the quantity you should sell.

4 There's your profit maximizing price, P, and what you earn at
5 that profit maximizing price is everything below the dashed
6 line, and that's your return on your intellectual property.

7 You're giving up quite a bit that's under the line.

8 How do you solve that problem? Well, if you

1 have not put out on the table up front today because I
2 don't have reprints of it and of course I certainly do not
3 want to infringe the copyright of the American Bar
4 Association, so again send me your contact information. When
5 I do get reprints I can -- I'll be happy to send you a copy.

6 Okay. The next No-No is grantbacks.

7 A grantback as you all know since this is an IP
8 audience is licensing on the condition that the licensee will
9 license assign back or otherwise convey rights to any
10 improvements if the licensee. What are the implications of
11 that?

12 Well, the fundamental question that we have to ask here is
13 what are the effects on the incentives to innovation? And they're
14 somewhat mixed. The licensee who, let's say, in the strongest
15 possible situations is subject to a requirement that it assign back
16 any proven patents with no rights on the part of the licensee
17 even to use the improvement will have a greatly diminished
18 incentive to continue to innovate and make additional
19 improvements to the original patent.

20 On the other hand, in the typical situation, the
21 the licensor will not grant the license in the first place if it
22 views itself as merely creating competition for itself down the road,
23 and maybe being blocked out of the market entirely by a new and
24 better product invented by the licensee.

25 So typically grantbacks are permissible in some form

1 at least in order to facilitate the licensing transaction in
2 the first place, but the courts have wrestled with this:
3 exclusive or non-exclusive; does the licensee retain rights to
4 practice the patent; what are the royalty terms and so on and
5 so forth.

6 And I think the guidelines contain the statement that
7 non-exclusive grantbacks are less likely to raise problems
8 than exclusive grantbacks, but exclusive grantbacks are not
9 necessarily unlawful either.

10 I do want to put on an example of a grantback
11 situation that could cause problems and would likely attract
12 antitrust enforcement attention. We're back to a policy
13 situation again. This is again a real case. It's the
14 Justice Department's case against the automobile
15 manufacturers back in the 1970s and a somewhat stylized
16 representation of the facts.

17 All the major automobile manufacturers got together
18 in a pool with respect to pollution control devices, and they
19 contributed all of their patents in the pollution control
20 area and set up as one of the conditions of the pool the
21 requirement that any future inventions by any individual

1 manufacturer also be contributed to the pool on a royalty-
2 free basis and effectively licensed royalty- free to all pool.

3 What's the problem with that? Well, the problem with
4 that is if you know in advance that you cannot earn any
5 return on your patent, what's the incentive to invent in the
6 first place? If you've got to share with the entire industry
7 any patents that you get, why patent? Why research?

8 It's fundamental to the idea in the patent system
9 that there be a reward for new and useful compositions,
10 machines, and so on, and therefore the effect of that
11 requirement in the pool was to bring to a grinding halt
12 further progress in pollution control devices in the
13 automobile sector because no company could get a competitive
14 advantage from any further breakthroughs in that area, so
15 that was challenged and a consent decree resulted.

16 Somewhat, in fact substantially, more controversial
17 application of a similar principle, and I am reminded
18 whenever I discuss the Intel case of a panel I was on with
19 Judge Rader not very long ago in which we had a little
20 conversation before the panel, and Judge Rader said, You
21 know, I am also an academic, I teach on an adjunct basis, and
22 one of my favorite things to do as a professor is to deal
23 with one of my own decisions as a judge, and by the end of
24 it, the students are generally convinced that whatever judge

1 issued that opinion has to be the craziest old fool that
2 there is.

3 So in the spirit of Judge Rader, I talk about the

1 counterclaims certainly. Nothing wrong with that. That's
2 the way the patent system is supposed to work.

3 But it also did something else. Digital happened
4 also to have about a \$2 billion personal computer business.
5 Personal computers don't use alpha chips. Even Digital's
6 personal computers didn't use alpha chips. Only servers and
7 work stations used alpha chips. They used Intel chips
8 because personal computers run Microsoft with those and that
9 sort of thing, and it was written in the microprocessor and
10 so on.

11 So this \$2 billion personal computer business was
12 entirely dependent on a supply of microprocessors from
13 Intel. Intel's response to being sued was, Well, we will
14 continue to order your purchase orders; by the way, as
15 everyone knows, we don't have any long-term contracts, we
16 sell on a purchase order, and we're not telling what will be
17 next, and also, by the way, you as a personal computer
18 manufacturer have all of these instruction manuals, if you will,
19 manuals that tell you what signals come out of what pins,
under what D (r 0 51 ll -5h ll -5h ll -5h ll aff) Tjednsals tha

1 You have one product, a thousand patents, ten thousand patents,
2 all right, and the cost of individual licensing transactions
3 with each of those patent holders could be enormous, and the
4 risk that you could get held up by any one of those patent
5 holders is also enormous.

6 And so there's Intel out there succeeding in the
7 marketplace with a great product and so on, and I didn't put
8 it in the previous diagram, but there were similar episodes
9 alleged, not just with respect to Digital but with respect to
10 a couple of other companies, Intergraph and Compaq, here's
11 Intergraph which had exited the microprocessor business,

1 used as an illustration of the importance of property rights.

2 Well, here the strategy of anti-commons is the danger
3 of the proliferation of patent rights, and in this case it is
4 not the antitrust enforcers singing that song, but it was
5 Respondent.

6 To sum up where we are on grantbacks, I think these
7 are pretty good rules of thumb. The grantbacks typically
8 pose problems when they significantly reduce the incentives
9 to innovate of those who could innovate absent the pool.

10 Grantbacks ought to pose no problems where the
11 licensee grantor could not innovate or sponsor innovation
12 absent a licensee from licensor grantee, so we're back to
13 that theme of what's horizontal and what's vertical.

14 Post-sale restrictions on resale, I'm going to go
15 through these fairly quickly in the interest to time.
16 Involved here is the first sale of doctrine. Lawyers are
17 more aware of that than antitrust lawyers.

18 By and large, this whole notion of the for sale
19 doctrine is pretty uninteresting to U.S. antitrust authorities,
20 so I won't speak for the technology transfer block exemption
21 in Europe or for other parts of the world, but the for sale

1 doctrine is more of that business about what's within the
2 scope of the patent monopoly and what's outside the scope of
3 the patent monopoly, and it doesn't really tell you.

4 What's a post-sale a piece on resale but a piece of
5 price discrimination, and therefore ought to be -- I'm not
6 saying it is, but it ought to be regarded fairly benignly by
7 modern antitrust.

8 So if you're counseling or if you end up in court in a
9 private suit, you have to worry about what the courts will do, but
10 generally speaking, the case law does allow the use of a patent to be
11 licensed separately from manufacture and sale of the patented
12 product, and therefore separate royalties to be charged, which is the
13 result the antitrust enforcers would reach through the price
14 discrimination route. The courts reach the same result in
this limited context a piece of

1 The allegation was that Microsoft licensed to
2 computer manufacturers companies, like Compaq and Dell and
3 Gateway and so on, on the condition that they pay royalties
4 for every box sold, regardless of whether Microsoft's operating
5 system was in that computer or not.

6 At the time there were competing operating systems,
7 like DR-DOS, which Novella, OS-2 which IBM owned, and the
8 fear of the Justice Department was the effect of the licensing
9 agreement was a kind of exclusive dealing. The manufacturers
10 had to have Microsoft's product because it was so widely
11 accepted, and there were network kinds of things there, so
12 some of their product had to have a Microsoft operating
13 system. The license terms in effect required these computer
14 manufacturers to use Microsoft for all of its computers
15 because they would have to pay Microsoft one way or another.

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1 practices the licensed patent. Now, there are cases where that
2 causes problems as in the Microsoft case, but in many other cases, it
3 would be nothing other than if one would meter.

4 The courts have had some trouble with this one
5 because again it seems to violate the principle of staying
6 within the scope of the patent monopoly, and you have the
7 Zenith versus Hazelton case and the Supreme Court saying that
8 royalties that are based on products that don't use the
9 teaching of the patent are problematic, except in those cases
10 where they are mutually agreed to for the convenience of the
11 parties, but if a patentee imposes this requirement on a
12 licensee, that's bad, again because it seems to extract a
13 royalty on something that's not patented.

14 And in the case of Brulotte, the Supreme Court also
15 condemned post-expiration royalties and royalties based on
16 sales of the product after the patent expires.

17 From my vantage point at least, it's hard to see why
18 this is particularly a problem, and whatever power the patent
19 confers at the time of the license is being entered into,
20 which is of course a time when patent is still valid, is
21 essentially a fixed amount, and whether you extract them
22 today or you postpone them until tomorrow shouldn't
23 particularly make a difference to antitrust authorities, but

1 this particular rule I think is going to be with us for some
2 time to come, whether I happen to think it's a good idea or
3 not, and so you've got to counsel your clients accordingly,
4 but there it is.

5 Okay. Microsoft I, we already talked about. There
6 is a case in which it did cause a problem.

1 So a patent exception to the antitrust rule against
2 resale price maintenance, and since -- if I've made anything
3 clear, it's probably that I think that patent exceptions to
4 the antitrust laws aren't necessary. You can guess that I'm
5 not terribly happy with this state of affairs, but because of
6 the per se rule against resale price maintenance, maybe this
7 one is necessary.

8 So that's a rule. I think the agencies are generally
9 sympathetic to General Electric. If you read the '95 IP
10 guidelines, the message of the agencies was essentially,
11 Look, this is a new body of law governed by some case law.
12 The Supreme Court has made it a fairly arcane and technical
13 body of case law, and we're just not going to touch it,
14 period.

15 So General Electric is fine, and the exceptions that
16 the courts have engrafted on to General Electric and that
17 almost entirely swallow up General Electric are also fine,
18 and here they are: Multiple licenses with parallel price
19 restrictions, okay?

20 If I, as the licensor, say, I'm going to have 12
21 manufacturers all practicing in this patent, not exclusively,
22 they're going to compete with each other, I think competition
23 is good for me as a licensor, and I'll collect licenses from
24 all of them, but I don't want them to sell below a certain
25 price.

1 The court says, Can't do that. Unpatented products
2 of patent processes, as I said before, can't do that one
3 either.

4 Resale prices, it's fine for the licensor to set the
5 price at which the licensee will sell. Once those products
6 have passed into the stream of commerce, those -- the prices
7 of those products can no longer be set by the licensor. The
8 resale prices are not something that General Electric
9 handles.

10 Agreements with other licensees or patentees, so
11 there's other licensees agreeing with each other. The
12 licensor agreeing with other patentees, those are there, so a
13 fairly intact legal body, and of the statute but there we
14 are.

15 Probably the last of the Nine No-Nos to survive as a
16 real reason for rule is you just got to follow them kind of
17 through.

18 MS. NANCY LINCK: Will, it looks like you turn an
19 awful lot on what form your patent claim's in. Is that true?
20 I mean, what if I throw in a product made by the process,
21 whereas the process is really -- we don't talk about heart of
22 intervention anymore. We don't talk about heart of invention
23 anymore, so oftentimes you can take something that go
24 patents, a unit, and then you'll also patent something that
25 the unit is in, and then maybe something even bigger than the

1 unit is in.

2 How do the courts deal with that or don't deal with
3 that?

4 MR. TOM: In the resale price arena?

5 MS. NANCY LINCK: In determining whether you're
6 trying to get a royalty on an unpatented product?

7 MR. TOM: Well, this is probably why I find so much
8 of that old case law unsatisfactory. What the antitrust
9 enforcements would say today is whatever the claims are, each
10 of those claims is a piece of property, and there's a right to
11 exclude associated from that piece of property, and we take
12 the property rights as different.

13 What we condemn are situations where you're
14 restraining competition that would exist, notwithstanding
15 that right to exclude, so if somebody else has another
16 product that doesn't infringe any of those claims and you
17 reach an agreement that restrains competition between you,
18 that's bad, but the whole argument over what's within the
19 patent scope and what falls without the patent scope is
20 just -- it gets almost metaphysical.

21 It's not connected to any economic principles or
22 antitrust principles, and generally speaking I think the
23 antitrust enforcers will try to stay as far away from that as
24 possible and simply accept the claims as given, with maybe a
25 little bit of an exception that I'll talk about in the patent

1 settlement context, playing off of the issue of the
2 boundaries or validity of patents.

3 How did courts deal with it in the areas where they
4 still apply this notion of where there is this is a sale
5 and a resale and is it the product of patent processes or is
6 it a patent product and all of those kinds of things?

7 It's not entirely clear from the case law, but I
8 guess if I were a patent holder, I would take comfort from
9 the fact that most of those cases are now going to end up in
10 the Federal Circuit, which is becoming one of the nation's
11 leading antitrust courts for better or worse, and when in
12 doubt, the patent holder will get the benefit of the doubt.

13 So in antitrust issues, I think if you look at the
14 record of the Federal Circuit in patent issues, there's a lot
15 of stuff that's of value, but sometimes the patent bar isn't
16 terribly happy at what the court is doing, but in the
17 antitrust area, very, very broad berth is being given to the
18 patentees in some respects unfortunately so in terms of kind
19 of language and analysis they're using, we'll get to that

12 11b-24k? Patent a2Do of nbt.

1 MS. GREENE: Ten minutes.

2 (Whereupon, a brief recess was
3 taken.)

4 MR. TOM: We've only got a little more to go on agreements
5 and what the restraint of trade will do, a segment on monopolization,
6 the Sherman Act which Bill will do and a very brief, maybe ten
7 minute session, on mergers at the end.

8 We'll try to get you close to the scheduled finishing
9 time. I've been asked to ask people to hold questions until
10 the end so that -- I'm willing to stay as long as we need to
11 answer questions, but that way we'll get through the whole
12 thing for people who do have to leave.

13 All right. Patent settlements. The issues here are
14 really similar to pooling and cross-licensing. That is,
15 we're talking here about either explicitly actual horizontal
16 restraints or restraints that appear like horizontal
17 restraints and that the courts can easily mistake for
18 horizontal restraints.

19 And I'm just going to take the pharmaceutical patent
20 settlements as an example because there have been a bunch of
21 those cases, including a trial that may be going on in this
22 very building today, but I'm not trying to single out the
23 pharmaceutical industry here or anything. Settlements often take the
24 form of pooling and cross licensing and mergers so it's not
25 surprising that they share issues in common.

1 Here's the pharmaceutical situation. You start out with the
2 guy up there labeled patentee. This is a pioneer drug company which
3 invests hundreds of millions of dollars in order to produce new
4 products. They make new breakthroughs that help cure or ameliorate
5 human disease.

6 It may make those hundreds of millions of dollars of
7 investments and end up with, quoting another industry, call
8 it a dry hole. Maybe about one in ten products ever make it
9 to commercialization, and most of the R&D efforts are being
10 essentially down the drain.

11 But if you do hit it, if you come up with that
12 blockbuster drug that really makes an advance in ameliorating
13 suffering, you get pretty handsomely rewarded for it. The
14 margins on the successful blockbuster drugs are enormous.

15 You often hear somewhat loose talk, particularly in
16 political settings, about the cost of producing this drug as
17 only ten cents a tablet, and why is the manufacturer charging
18 \$25 a tablet for it, and the answer of course is this is all
19 the reward that incentivises the investment in R&D in the
20 first place.

21 So as a result for this very successful drug where I
22 have drawn a very fat arrow with a dollar sign in it

1 representing not necessarily patients, the payers are paying
2 to the patentee for that drug, and whether it's hospitals or
3 insurance companies, managed care organizations or whatever,
4 or individual patients. They're paying a lot of money to the
5 pioneer drug company while the patent is in force.

6 Now, eventually, this is part of the bargain in our
7 patent system, eventually that patent expires. And even in the
cdE3aceuticald

1 difference between the fat arrow and the skinny arrow?

2 Well, we're talking hundreds and millions of dollars
3 here that the pioneer company is losing when the generic
4 company comes on to the market. Forestalling that
5 eventuality by a year, a month, a week, even a day can be
6 significant, and notice something else, the size of the arrow
7 going to the generic company is also very skinny because the
8 generic company, while it may take tremendous volume from the
9 pioneer company, is charging a much lower price than that
10 generic company was charging. So if you summed the size of
11 those arrows up, it would be only a fraction of the big fat
12 arrow that the patentee was getting in the first slide.

13 Well, what does that suggest? Well, one thing it
14 might suggest to a sufficiently inventive couple of companies
15 is if you could increase the flow of money of the generic
16 company from the patentee itself. You can restore for the
17 patentee the pre-expiration situation and get back the rents
18 that you're otherwise getting, and this is particularly so
19 because for the first 180 days under the Hatch Waxman Act,
20 there's only one generic that can come out.

21 So this is the diabolical view of what can happen in
22 these cases, and I am sorry to say that in the two district
23 court cases that have been rendered so far in private suits,
24 that's pretty much where the analysis ends. What is this in
25 the view of the Eastern District of Maryland and the Southern

1 District of Florida, this is nothing but a per se unlawful
2 market division in which two companies are getting together
3 and agreeing that in exchange for a payment, one of them is
4 going to stay off the market.

5 So far I don't think the FTC has ever gotten that
6 far. If you've looked at some of their public statements,
7 speeches of Commissioners, the statement that was released in
8 connection with the Price Standards Consent Order, they
9 recognize some of the complications that are present in this
10 area.

11 Why are those complications? Well, I talked earlier
12 about the fact that intellectual property is different from
13 tangible property in some respects and that when the
14 guidelines say that for antitrust purposes, they will be
15 treated the same as tangible properties, that only means that
16 antitrust principles are sufficiently flexible to deal with
17 the differences.

18 And what's the key difference in this area? Well, it
19 is that the property rights are not as clear-cut, and they're
20 not as certain. They may have to go through a litigation
21 before you determine whether there's a property right there
22 or not.

23 And in a particular pharmaceutical patent situation,
24 these disputes arise out of the litigation in which the
25 patentee is saying, I still have valid patents in this area

1 that block out any generics when a generic company is saying,
2 No, I certified to the FDA that my product is not -- either
3 my product does not infringe any of the patents that the
4 pioneer company claims covers this area, or that those
5 patents are invalid, and you've got a litigation, and the
6 arrangement between the two companies comes about as a result
7 of the litigation.

8 So the question which is being litigated or continues
9 to litigated, we're going to see interesting variations on
10 the subject, are how do you deal with uncertainty. Does the
11 FTC have to conduct a patent trial in order to determine
12 whether there would have been competition absent the license,
13 or is there some other way to resolve it?

14 Is there some kind of truncated rule of reason? Can
15 we say that this agreement has anti-competitive effects
16 without offsetting appropriate benefits, without saying that
17 these are marketing issues.

18 But one thing that should be clear is that you ought
19 not stop the analysis of whether this is a horizontal market
20 division because as long as there's uncertainty on the
21 subject, the analysis is not all that simple.

22 And on Wednesday you saw Professor Gilbert put up a
23 formula that suggests dealing with this in terms of
24 probabilities and expected values and so on, and I think that
25 may be helpful where there are a large number of patents, the

1 that applied when the principal actor is what might be called
2 or might be accused of being the dominant firm, and here
3 we're going to look in relatively quick order at a set of
4 doctrines that govern what antitrust specialists call
5 monopolization or attempted monopolization.

6 And by way of taking this tour, I want to again
7 acquaint you with the statutory framework that governs claims
8 in this area, a couple of quick words about historical trends
9 and the application of the relevant antitrust statutes, and
10 then to look at three principal operative concepts that
11 determine the implementation of this scheme, the definition
12 of relevant markets and the measurement of market power, the
13 ingredient of improper conduct, and just a little bit of the
14 formulation of remedies.

15 The statutory framework basically is grounded in
16 Section 2 of the Sherman Act, and Section 2 of the Sherman
17 Act encompasses three offenses, but two of them that are
18 principally important for us today, the offenses of
on18

on

1 loss of sales. That's how antitrust economists and lawyers
2 today define monopoly power.

3 But a vital concern in the antitrust system is that
4 the antitrust laws do not attack the mere status of monopoly
5 power, that as you could imagine a competition policy system
6 that stopped the inquiry after point one and took specific
7 measures to dissolve existing aggregations of monopoly
8 power.

9 By its own terms, the U.S. antitrust system doesn't
10 do that, and you can imagine why, for the same reason that
11 the system of intellectual property laws encourages innovation
12 and in many ways hold out a significant prize for innovation,
13 a prize in the form of the possibility of gaining super-
14 competitive returns.

15 Why else do many inventors get up early in the
16 morning, except to achieve that possibility? So too does the
17 competition policy system realize that if you attacked the
18 status of monopoly power, however lawfully attained, you
19 would diminish incentives to innovate.

20 The second ingredient is what's called the conduct
21 requirement. The plaintiff must show that the monopoly power
22 in question was either obtained improperly or maintained
23 improperly, and as you might imagine, great disputes focus on
24 both of those requirements, does in fact the defendant have
25 monopoly power and what is the definition of improper

1 exclusion.

2 The second offense, the attempted monopolization
3 offense, basically attempts to create a zone of concern or
4 scrutiny before that accomplishment of actual monopoly power,
5 and here there are three requirements. There has to be a
6 specific intent to monopolize, improper conduct once again
7 and the improper intent can be inferred from demonstrably bad
8 conduct, and last there has to be a showing that the
9 defendant has achieved a dangerous probability of attaining
10 monopoly power, and it is these two offenses that really
11 provide the core of controls on dominant firm behavior in the
12 United States.

13 You can break the U.S. experience in dealing with
14 Section 2 claims, especially government enforcement of them,
15 into four periods. To go back to the first period, 1890 to
16 1914, that features the formative well-known cases that lead
17 to the break up of the Standard Oil Company, American Tobacco
18 and a number of other early leading figures in American
19 enterprise.

1 that is revisited in 1982, and ultimately becomes the
2 foundation for the so-called modified final judgment by which

1 refiners in the United States. Case began in 1973 and was
2 ended in 1981. There were eight years of pretrial discovery, costing
3 tens of millions of dollars, both certainly to the private parties
4 and to the FTC. Case never went to trial.

5 This story isn't picked up again until the mid 90s
6 with the renewed interest in Section 2 government
7 enforcement, which includes the Intel case that Will
8 mentioned as well as U.S. versus Microsoft and a number of
9 other cases, perhaps commanding a bit less attention but also
10 renewing the government's interest in enforcement in this
11 field.

12 Talk a bit about the first requirement, the market
13 power requirement, and I'm using the terms market power and
14 monopoly power interchangeably here. The antitrust system
15 relies upon and entertains essentially two approaches to
16 proving market power. One might called direct evidence, the
17 other circumstantial.

18 The direct evidence methods of measurement would
19 include first and foremost directly measured demand
20 elasticities to directly measure the intensity of user
21 preferences and to use that direct measurement as a way of
22 identifying the extent to which consumers react or perhaps
23 more accurately do not react in the face of a relative
24 increase in prices.

1 to define a relative market for the products in question and
2 to measure the market shares of the defendant in that
3 relevant market.

4 Why is this circumstantial evidence? Well, it's a
5 proxy and the intuition behind the proxy is this: If a firm
6 acquires and maintains an inordinately high market share of
7 activity in a given market over a long enough period of time,
8 protected by barriers to entry into the market, you can infer
9 that they have power over price or power to exclude rivals.
10 If you show that, then you can infer that you've actually
11 observed the operation of a monopoly over time.

12 Other forms of circumstantial proof the courts have
13 looked at include profitability data or price cost ratios.
14 To take an example of these concepts in work in the U.S. v
15 the Microsoft case, the district court used and the court of
16 appeals entirely endorsed the use of both methodologies.
17 That is Judge Jackson's opinion from the district court with
18 the subsequent approval of the court of appeals, came at the
19 market power problems both directions, looked at direct
20 evidence.

21 And in particular the court of appeals fastened upon
22 Microsoft's suggestion at trial that Microsoft set its price
23 for software without regard to its competitors. In the D.C.
24 Circuit opinion, the Procarian (phonetic) opinion issued last
25 summer, said, Firms in competitive markets don't set prices

1 like that. They don't simply say, We don't care what
2 competitors are charging, here's our price, we don't think
3 about it. The court said, That's a form of direct evidence.

4 Circumstantial evidence, the court said, Let's look
5 at the market shares and concluded that looking at the market
6 characteristics as a whole, the market shares were a reliable
7 proxy for market power as well.

8 Court of appeals, in other words, came at this
9 problem, as did the district court, from both directions and
10 found that the results were the same in each instance.

11 To perform the market definition, market power
12 analysis, one has to define what we call a relevant market.
13 This is the arena of commercial activity in which competitive
14 effects are measured, and it has two dimensions. One is to
15 look at the product in question.

16 The principal basis for evaluating what the relevant
17 product market is is to focus on what consumers regard as
18 adequate substitutes for the product. To take the Microsoft
19 example again, from a demand side prospective, for personal
20 computer operating systems, the district court and the court
21 of appeals asked, Well, what else is there, and yes, it
22 considered each of Microsoft's arguments about alternatives,
23 and said, Well, maybe the PC is in the markets, it's a small,
24 decentralized, hand held devices, and said, Well, maybe it's
25 not just the Windows operating system, maybe it's Alcoa.

1 Maybe it's any number of other nascent competitive
2 possibilities in these areas.

3 But the court relied very heavily on the cross
4 examination of Microsoft's expert, a distinguished economist
5 in the field, who said, Microsoft faces constraints from all
6 of these directions, small hand-held devices, other operating
7 systems, and that large market share that Microsoft has,
8 that's an illusion because if it stops running for so much of
9 a second, the rest of the world simply is going to blow by it
10 so Microsoft, despite a high market share, has to run for its
11 life.

12 On cross examination, the government's expert, and I
13 focus on this just because it highlighted a point, was asked,
14 How soon are those other things going to overtake the
15 company? Well, not yet. When? A couple years, two, three,
16 four, five? Somewhere over the horizon. Thank you very
17 much.

18 And in this instance, the court concluded that while
19 there were other possibilities from a demand side
20 perspective, they weren't coming along quickly enough to
21 constrain Microsoft.

22 The other approach is to look at the possible
23 responses of suppliers; that is, how quickly can suppliers
24 reconfigure their production operations to produce the
25 product that the defendant, the hypothetical defendant,

1 produces? And if they can make adjustments relatively
2 quickly at relatively low cost, that's a powerful constraint
3 upon the operations of the defendant, and indeed it might be
4 that productive capability itself that tells you what the
5 real boundaries of the product market ought to be.

6 The geographic dimension simply asks where can
7 consumers look to purchase the product, how broad a
8 geographic round can they turn to, and increasingly in many
9 intellectual property or high technology markets, those
10 markets are global or at least based on large regions of the
11 world rather than simply local markets, especially of the
12 kind that we would characterize, say service markets for the
13 paving of roads.

14 City of Los Angeles isn't going to ask road pavers
15 located in Virginia to come on out usually and pave the
16 roads. If you're buying microprocessors, though, your scope of
17 activity might be truly global instead.

18 Let me quickly mention a couple places that are very
19 troublesome for the antitrust system. If this were a
20 sporting event and we were talking about match ups, I'm going
21 to describe the problem that matches up badly against the
22 antitrust system. And it's the problem of defining relevant
23 markets where you have a lot of technological dynamism, where
24 you have an old technology incumbent technology being
25 tendered by a new technology.

1 And I'll quickly mention two cases. One is a case
2 called Standard Oil of Indiana which did involve patents. It
3 involved a patent pool for the then new technology, miracle
4 technology for cracking gasoline as part of the refining
5 process. I'm going to offend all of you chemical engineers
6 here today, but what's a petroleum refinery? It's basically
7 a big tea kettle. The old technology is a big tea kettle.
8 You heat crude oil, and the light fractions that boil off are
9 the most valuable fractions, gasoline, kerosene in this
10 period.

11 The heavier stuff that's left can be burned in
12 industrial boilers, in ship boilers, used to make asphalt or
13 to produce much of the coffee that I drink regularly. That's
14 the last residual use of the last bit of the barrel that
15 can't otherwise be boiled off.

16 Obviously it's the higher valued fractions that are
17 the most useful, and the miracle of cracking was that by
18 reformulating the molecules themselves, you could extract a
19 larger percentage of gasoline and kerosene from a single
20 barrel of crude oil.

21 The problem in evaluating the pool, one problem for
22 the court was to define the relevant market because the
23 defendant's collective market share of activity swung widely
24 between the mid 20s and the low 50s, depending upon whether
25 you define the relevant market as being all refining

1 technology, that is distillation plus cracking or cracking
2 only.

3 And the Supreme Court said it's all fungible
4 capacity, so it's all refining technology, so the defendant's
5 market share for this pooling arrangement is in the low 20s,
6 not in the 50s. That wasn't the only variable for the court
7 but it had a lot to do with identifying what it thought to be
8 the competitive significance of the arrangement.

9 Basically what the court did was to discount the
10 extent to which the new technology was really going to simply
11 sail past the old technology and displace it, and indeed that
12 happens to a large extent over time.

13 But notice the dilemma for the court. How much
14 weight do you give? What formula do you use? Do you give
15 some weight to the old technology but have a heavily weighted
16 variable that gives more emphasis to the new technology? How
17 rapidly is the new technology going to gain acceptance and
18 how do you predict that?

19 The court basically said, Too hard for us to sort it
20 out, and instead arguably they underestimated the defendant's
21 market power by focusing on the full range of refining
22 technologies, which tended to bury or understate the
23 significance of the cracking technology.

24 DuPont Cellophane is another four minute example of a
25 court finding wrestling with a problem, arguably wrestling

1 badly with it. Dupont Cellophane was the Department of
2 Justice monopolization lawsuit against DuPont, one of
3 antitrust's famous customers over time, and in this instance
4 the government's claim was DuPont had illegally monopolized a
5 relevant market consisting of cellophane as a flexible wrapping
6 material.

7 DuPont said, Oh, no, relevant market isn't just
8 cellophane, it's all flexible wrapping materials, including
9 such wonderfully quaint names as Classene, Plyofilm as well
10 as other things known better as wax paper or aluminum foil.

11 DuPont said, In the all-flexible-wrapping-materials
12 market, we have a market share that's competitively
13 insignificant given traditional cases laying out market share
14 thresholds for monopolization.

15 The government said, But if you look at cellophane,
16 your market share is well over 70 percent, and in part it's
17 because you are the exclusive U.S. patent holder of the
18 relevant process, there are imports, but your market share is
19 70 percent plus.

20 So the court has to decide, Do you count all of the
21 other stuff in, or do you count only cellophane? In DuPont's
22 main argument, which the court accepted was, You can tell
23 that we don't have market power based simply on cellophane
24 because you know what happens if we try to raise the price
25 for cellophane. Users migrate to these other wrapping

1 wrestle with, dealing with the old and new.

2 The results you get in trying to measure market
3 shares are very sensitive to assumptions you make about what
4 you should count or not.

5 In Alcoa, U.S. v. Alcoa is a famous case that decided
6 in 1945 by the Second Circuit acting as the court of last
7 resort under a special congressional statute that accounted
8 for the fact that the Supreme Court did not have a quorum.

9 Alcoa involved a challenge to the company for
10 monopolizing a relevant market consisting of virgin aluminum
11 ingot. Alcoa for a long time had been the largest U.S.
12 producer of aluminum. The government said, That's the
13 relevant market, if you look at virgin aluminum ingot, you
14 have a market share of 90 percent plus monopoly power.

15 Alcoa said, No, you have to count in used aluminum as
16 well, recycled. We make aluminum, recyclers recycle it.
17 They sell ingot based on used aluminum scrap. That comes
18 back and competes against us all the time. If you put in the
19 recycled aluminum, you push their share immediately down into
20 the 60s, past the 90s.

21 The Second Circuit decision said, We're not going to
22 count it at all. Now, it's clear that some users insisted on
23 virgin aluminum. The aircraft industry did, for example, but
24 a number of others would use it and used a lot of it. Judge
25 Hand ruled it out completely.

1 Another category of activity involved internal
2 consumption. Alcoa not only made aluminum ingot, but it
3 fabricated aluminum parts and then sold the parts, so do you
4 count in their market share the stuff that they used
5 internally or do you exclude that?

6 Judge Hand said, That counts, we're going to include
7 that, probably a reasonable choice here. The last choice was
8 imports. How much do you count imports, and Judge Hand I
9 think correctly said it, It depends a lot on the trade
10 regime. If imports come easily in to the country, you count
11 them, but you only count them to the extent that trade
12 barriers or other hurdles in fact allow foreign suppliers to
ship into the country.

1 Who are the biggest dummies? They said government
2 purchasing agents. Those are the dummies, and they can't
3 figure this out, and the Kodaks of the world can exploit this
4 because the existing purchasers of their machines are locked
5 in. They're not going to sell their copiers and go some
6 place else, and because of information imbalances that it's
7 hard to calculate life cycle costs, those suckers and dummies
8 are vulnerable, so that the relevant focus of concern might
9 be the aftermarket for one's own product.

10 Couple of concluding thoughts about conduct. As you
11 might imagine, it's not enough again just to have monopoly
12 power. It's not enough to be big. You have to be big and
13 bad. What does it mean to be bad in this area? What's
14 improper exclusion?

15 For a long time the antitrust laws answered this
16 question by saying, Every time you twitch, if you have a
17 particularly large market share, that could be bad, that you
18 don't have to actually take a swing at someone, just looking
19 at someone in an impolite way could be bad.

1 entry by companies that might have serviced the same demand.

2 Now, many observers have looked at that and said, In
3 effect what would you expect them to do otherwise? That is,
4 what was the avoidable behavior, ought Alcoa to have stood
5 back and said, People want more aluminum but we're not going
6 to produce it, we're not going to expand our facilities to
7 produce more.

8 Again if you look at the period in which Alcoa was
9 making these decisions, the 1930s, you can ask, Would it have
10 been a better thing for the country if they had made less
11 aluminum, added less capacity in the run up to the
12 mobilization for World War II?

13 There is a theory called strategic entry deterrents
14 where capacity additions, capacity announcements might be
15 improperly exclusionary, but Alcoa underscored a basic
16 normative concept about antitrust which is the rules ought to
17 be able to give businesspeople clear guidance about what
18 they can and can't do and ought to forbid clearly what it
19 lacks.

20 A narrower perspective that comes from the 1980s, a
21 case named Matsushita involving predatory pricing, is
22 representative of what I would call a modern trend which is a
23 trend that gives dominant incumbent firms much greater
24 freedom to chose product development, pricing and promotional
25 strategies of their own liking, not uninhibited, but the

1 general trend has been in looking at the conduct requirement
2 to give firms broader freedom to act as they wish but not
3 uninhibited freedom.

4 The modern formula for identifying what's bad is
5 suggested by the Microsoft decision where the court says
6 Let's go through a four step inquiry. First
7 requirement has to be monopoly power. Second, Has the
8 plaintiff offered a hypothesis that shows there will be
9 anti-competitive effects, and again, as Will said before,
10 does not simply mean harm to the plaintiff, harm to the
11 competitive process.

12 Anti-competitive effects that will provide in a
13 social society-wide basis, an economy-wide an increase in
14 prices or a reduction in innovation, reduction in output;
15 harms to competitors is not equated with harm to competition in
16 this formula, but the plaintiff has to step forward and
17 provide a hypothesis about those effects.

18 Then the defendant has an opportunity to justify the
19 ~~behavior by showing~~ behavior, as Will was suggesting before, for

1 And in Microsoft, again to look back at the court of
2 appeals decision, again this was given the difficulties and
3 demand of the case in my own view is this is a considerable
4 vindication for the Department of Justice and the position it
5 took in the case. The court focused on the use of exclusive
6 contracts which Will was referring to before and focused on
7 the use of bundling of certain forms.

8 It focused on the deliberate effort to suppress the
9 emergence of new technology on the part of one of its
10 customers, Intel, and in these and other key respects found
11 that the company's behavior was improperly exclusionary.

12 Conduct claims sometimes are put into a collection of
13 different compartments: Predatory pricing, refusals to deal,
14 product design and development, abuse of the administrative
15 process.

16 I want to go simply for the moment to the second and
17 fourth of these, and looking at refusals to deal, simple
18 question, is a firm compelled to license its technology,
19 required to license? Short general answer is no, no more
20 than one would ordinarily be required to share any other form
21 of property right with a competitor or with a firm upstream
22 or downstream.

23 There is a doctrine, however, that has raised
24 questions about that, and that's called the essential
25 facilities doctrine. The doctrine is principally emerged

1 where the asset in question involves some physical bottleneck
2 rather than say an intellectual bottleneck or a bottleneck
3 defined by an intellectual property right.

4 And I'll simply say that in a limited number of
5 circumstances, courts have said that where the asset in fact
6 does confer monopoly power on its owner and is not feasibly
7 replicated by a competitor, and there is no good business
8 justification for denying or restricting use, a court can
9 intervene to mandate on reasonable terms.

10 If you apply all four of those conditions ruthlessly,
11 you have a tiny set of arguable matters in which access
12 will be mandated, but I suppose a continuing question for
13 holders of intellectual property rights is whether or not the
14 right they hold in some sense might be characterized as
15 falling within that category.

16 The Federal Circuit's opinion in the Intergraph
17 case, which was the private counterpart to the FTC's Intel
18 case, answered that question with a decisive no. In looking
19 at some of the conduct, a variant of the conduct that Will
20 was describing, this time in a claim pursued by a
21 manufacturer work stations Intergraph in private litigation
22 with Intel.

23 The last I'll mention is the abuse of the
24 administrative process. What happens in a somewhat clumsy
25 way you need to enlist the government or use the process of

1 Part of the D.C. Circuit's answer is, Maybe it's the
2 government's job ultimately to bring cases that help define
3 what the legal rules are, what the liability rules are.
4 Maybe the allocation of labor in that instance is for private
5 claimants to step forward and obtain treble damages.

6 And arguably in the class action suits and perhaps in
7 the AOL versus Microsoft suit, one might describe those
8 developments as being part of the division of labor that the
9 D.C. Circuit had in mind here.

10 The last point I have about institutional capability:
11 there have been a number of observers who simply said,
12 special challenge in technologically dynamic sectors is where
13 the section moves quickly, do the enforcement and judicial
14 processes move quickly enough to adapt to, to absorb that
15 information and to account for the speed of change?

16 And I think the Microsoft case was a good example of
17 how you can hold a trial in a time well short of a lifetime,
18 and you can certainly overcome the notion that the litigation
19 of a major Section 2 case in the high tech area is going to
20 take a decade at a minimum.

21 I'll turn back to Will to do mergers.

22 MR. TOM: Thank you, Bill. I will try to do mergers
23 well short of a lifetime myself. I think we can probably do
24 this in about ten minutes.

25 A few minutes to bear in mind about mergers, just to

1 put this all in perspective. About 99 percent of mergers go
2 through unchallenged so we're talking about a very small
3 group of challenges here. Many of the others can be
4 restructured to solve the competitive problem, that is a
5 particular line of business spun off, a product licensed or
6 what have you, so generally speaking the efficiency enhancing
7 aspects of mergers can be captured.

8 And most of the problems that we talk about come
9 about when one firm acquires a direct horizontal competitor
10 in a concentrated market.

11 Let me start with the simplest case, an acquisition
12 of a direct horizontal competitor. The key question we're
13 looking at here is how much other competition is there, and
14 you heard talk earlier in these hearings about the kinds of
15 mergers that the agencies look at these days are typically
16 five to four, not even that, four to three, three to two, two
17 to one kinds of mergers.

18 If entry is easy, you're not going to have merger
19 challenges. Someone can have 100 percent of the market, but
20 if he tries to exploit that position by raising price, other
21 sellers will quickly leap out, and he's not going to be able
22 to exercise market power.

23 And finally more and more of the agencies are looking
24 at efficiencies, and they need to be efficiencies that can
25 only be achieved through the merger, but where there are

1 doesn't really work very well, and the proof of that is
2 particularly in the case of some of the pharmaceutical
3 mergers where you've got, for example, either -- you've got
4 one product in the market and that firm is acquiring another
5 firm that has a product very far along in the FDA pipeline,
6 no other close substitutes.

7 Do you have a competitive problem, even though the
8 second firm has not yet commercialized its product? I would
9 suggest you do because of the fact that if, particularly with
10 the FDA pipeline, you've got a pretty clear indication that
11 there is going to be any competition for the existing product
12 in the near term, it's only going to come from the product of
13 the company that's being acquired.

14 And it makes sense to require that product, that
15 pipeline product to be divested as a condition for the merger
16 going through, and there have been a number of cases that the
17 FTC has dealt with reaching exactly that result.

18 We also have seen some I would say probably somewhat
19 esoteric situations where the horizontal parity is not
20 entirely obvious on the face of the merger, and here I
21 generally use the gene therapy aspects of the Ciba Sandoz
22 merger as an example, and playing off some of the diagrams
23 you saw in the licensing presentation.

24 Here we had a situation where in order to produce a
25 commercial gene therapy product. You needed a lot of

1 complementary inputs. Some of the inputs that were needed
2 would be the patents on the genetic material itself, the
3 isolation of the gene responsible for a particular disease
4 entity, and those are represented by the circles up there at
5 the top of the diagram.

6 But simply identifying the gene responsible for a
7 form of brain cancer or hemophilia or something of that
8 nature doesn't give you a commercial product. In order to
9 have a commercial product you need lots of other things,
10 including the vectors that enable you to get the genetic
11 material into the cell, you need the manufacturing facilities
12 that have been certified by FDA as we do in manufacturing
13 processes and the like.

14 And the FTC's investigation to oversimplify a little
15 bit identified Ciba and Sandoz as the only possessors of the

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1 that they expected to partner with, joint venture where you
2 sell out to. When you do all your research and get your
3 patents, then you approach Ciba and Sandoz and you say, Let's
4 do a venture or if you want, if the price is right, just buy
5 my company all together.

6 If the two companies merge and you had only one such
7 entity to deal with, who would take most of the rents? Well,
8 the monopolist of the bottleneck would take enough of the
9 represents that a lot of these research ops were actually
10 giving serious consideration to shutting down abandoning
11 their research and so on, so the FTC stepped in and made a
12 solution for that problem a condition of the merger.

13 Innovation markets, I'm not going to talk about very
14 much at all because it's been taught to death. It really
15 doesn't matter in the vast majority of cases.

16 Rich Gilbert in an article that he and I coauthored
17 in the last year or so examined the Agency's merger
18 challenges in the period before the guidelines and after the
19 guidelines, and I think we concluded that there were only
20 three of those mergers in which innovation markets really
21 made a difference as to whether the merger would be
22 challenged or restructured or not.

23 And I even have some doubts about those three, but we
24 had to talk about something.

25 A limiting feature on use of innovation markets in

1 antitrust challenge that I think really pairs this down to a
2 very small set of circumstances is the specialized assets or
3 characteristics to do innovation in this area need to be
4 scarce, and so if you're not a business in which any inventor
5 in his garage might come from left field in disrupting kind
6 of market, this is probably not a good candidate for
7 innovation market analysis.

8 And the only other subject I want to touch on briefly
9 is intellectual property as a defense in mergers of tangible
10 assets, and this has come up in a number of cases mostly at
11 the Department of Justice.

12 There was one, the Boston Scientific case, at the FTC
13 many years ago, one in which it was raised as a defense but
14 disposed of by the FTC, and a challenge did take place, but
15 here the question is when are competitors that appear to be
16 horizontal competitors really non-horizontal competitors, and
17 the answer is where the patents, one of them are broad enough
18 in scope to really cover the activities of the other.

19 So that going back to what's your definition of
20 horizontal, if there is no legitimate competition absent a

1 issue was at stake in the acquisition of TV Guide by GemStar,
and that case did not result in ef0 5 V Gef0 case erefore.5

1 C E R T I F I C A T I O N O F R E P O R T E R

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3 CASE TITLE: HEARINGS ON COMPETITION AND INTELLECTUAL
4 PROPERTY LAW AND POLICY IN THE KNOWLEDGE-BASED ECONOMY

5 HEARING DATE: FEBRUARY 8, 2002

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7 I HEREBY CERTIFY that the transcript contained herein