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DEPARTMENT OF JUSTICE ANTITRUST DIVISION
and FEDERAL TRADE COMMISSION

Hearings on:

COMPETITION AND INTELLECTUAL PROPERTY LAW
AND POLICY IN THE KNOWLEDGE BASED ECONOMY

Cross-Licensing and Patent Pools

Wednesday, April 17, 2002

Great Hall of the U.S. Department of Justice
333 Pennsylvania Avenue, N.W.
Washington, D.C.

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5 Hewlett-Packard Company

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6 Baryn Futa, Chief Executive Officer, MPEG LA

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MORNING SESSION

(9:00 a.m.)

BOB POTTER: Good morning. It is a pleasure today to welcome you to the Great Hall of the Department of Justice. It is one of those truly great venues in government. We have some big shoes for our panelists to fill today.

I hope this morning you heard the weather forecast. Today for the weather we have August in April. And I think our air conditioning is working well, and hopefully it will make us comfortable during the session.

We are here to kick off what is really the second stage of the joint Department of Justice/Federal Trade Commission hearings on intellectual property and antitrust. Thus far the FTC has hosted a number of hearings on the basic premises of intellectual property.

And I think the hearings thus far have shown that intellectual property law provides some important incentives for innovation by establishing enforceable property rights.

1 Today and for tomorrow and the next
2 coming weeks the Department of Justice will host
3 a number of hearings that will focus more
4 specifically and directly on the intersection
5 of antitrust and intellectual property.

6 I fully expect the hearings will
7 focus on some of the questions that the agencies
8 increasingly are dealing with as we examine
9 antitrust issues that are affected by
10 intellectual property rights.

11 At the outset I want to thank our
12 colleagues from the Federal Trade Commission for
13 their truly admirable efforts thus far. I also
14 want to thank the Patent and Trademark Office.
15 The PTO's participation in these hearings has
16 been extremely helpful as we go through this
17 process.

18 Frankly I suspect that PTO is
19 relieved that the hearings are now focusing more
20 D (afIlcipat4sP ylrow feath has) Tj T* (feath has)fo

1 House Subcommittee on Courts, the Internet, and
2 Intellectual Property of the House Committee on
3 the Judiciary held a hearing to consider whether
4 the antitrust laws should be modified to
5 explicitly state that the existence of an
6 intellectual property right does not
7 presumptively establish market power.

8 Of course the agencies, as you can see
9 from reading our IP guidelines, do not adopt this
10 presumption. Indeed virtually no knowledgeable
11 observer does.

12 Frankly I very much hope that the
13 questions we delve into go well beyond those
14 questions to get to the really harder questions
15 that we are facing as agencies in dealing with
16 antitrust and intellectual property.

17 Before I make a very brief overview of
18 the upcoming sessions, I would just like to make
19 a couple of very general observations that will
20 be short about antitrust and intellectual
21 property law.

22 It is now accepted lore that antitrust

1 and intellectual property share a common
2 objective or end, and that is promoting
3 innovation and thereby enhancing consumer
4 welfare. And of course some assert they get to
5 that objective by taking opposite means to reach
6 that end.

7 Intellectual property rights allow the
8 owners of such rights to in a sense restrict
9 competition. Antitrust focuses on removing
10 unreasonable restrictions on competition. Does
11 that mean that these two bodies of law are
12 irreconcilable? No. Of course I don't think it
13 means that.

14 But it does cause some potential
15 conflicts in particular factual situations.
16 And I think our panelists will delve into some
17 of these as we go forward.

18 As I examine what I consider to be
19 "typical" approaches of intellectual property
20 experts and antitrust law experts and how they
21 look at these issues, I have been struck by what
22 I refer as the sort of ex ante versus ex post

1 approach. And frankly I'm concerned about it.

2 Typically I think intellectual
3 property experts are focused solely on an ex ante
4 approach and are not concerned with potential
5 competition problems down the road. Antitrust
6 experts however by their very nature typically
7 examine these issues ex post.

8 And that is the intellectual
9 property right already exists and now there is an
10 allegation of competitive harm. I think part of
11 the very nature of antitrust is that experts
12 want to solve that competitive harm.

13 However -- and I think this is
14 important -- the enforcers must not lose sight of
15 the fact that ex post decisions while they may be
16 perfectly well in a vacuum to solve a competitive
17 problem can change ex ante incentives in ways
18 that may ultimately harm instead of help
19 competition and innovation.

20 Finally, in my general observations I
21 would note that I think it is important as we go
22 forward that panelists and others understand what

1 we mean by using certain terms of art.

2 I think in reviewing this area of
3 the law I have sometimes been left with the
4 impression that different people are using the
5 same term with different meanings. Just to give
6 one example, I have heard it said that a patent
7 grants its owner a monopoly.

8 While that is correct if one defines
9 monopoly as the right to exclude others from
10 making, using, or selling the patent invention
11 for a period of time, it is incorrect if one
12 defines monopoly in a classic antitrust sense of
13 the power in a relevant market to maintain prices
14 above a competitive level.

15 And the reason of course is that even
16 patented inventions may have close substitutes
17 that can preclude the exertion of market power.
18 Now turning to the hearings, today's session is
19 going to focus on the antitrust issues that arise
20 in cross-licensing and patent pool contexts.

21 With the increasing number of
22 patents we are seeing increasing numbers of

1 cross-licensing agreements and patent pools. We
2 have a very distinguished group of panelists who
3 are raring to go that will be introduced shortly.

4 They will be discussing the legal and
5 economic analysis behind the cross-licensing and
6 patent pooling. I would say this is certainly a
7 timely panel.

8 In fact just opening up the paper
9 yesterday I saw a press report of a settlement
10 between Intel and Intergraph in their IP
11 litigation that included among other terms a
12 cross-license.

13 There was a New York Times article
14 a couple of months ago on the expansion of
15 IP rights. In that article they quoted an
16 intellectual property counsel of a semiconductor
17 maker on what the article termed the "frenzy of
18 cross-licensing."

19 He was quoted as saying, "Pretty soon,
20 if it continues, you'll find that everyone's
21 going to have rights to everyone else's
22 technology, so there's not going to be any

1 competition."

2 While I'm not sure that that view is
3 necessarily shared by others, today's panel is
4 going to examine situations in which those
5 agreements are procompetitive and those
6 situations in which they may be anticompetitive.

7 They are going to ask questions like?
8 What are the issues that the antitrust agency
9 should develop in reviewing the panel is

1 economic benefits for consumers. What are the
2 antitrust issues associated with standard setting
3 in this context?

4 Is disclosure, or more precisely the
5 lack of disclosure, of IP rights an antitrust
6 issue? Should we be concerned as antitrust
7 enforcement agencies if market power is based on
8 the adoption of industry standards that are based
9 on intellectual property rights?

10 Following that on May 1st we will
11 tackle the strategic use of licensing including
12 whether an unconditional, unilateral refusal to
13 license intellectual property should ever violate
14 antitrust laws.

15 For those of you familiar with the
16 case law, it is referred to as the Kodak and CSU
17 decisions. Obviously imposing requirements to
18 license intellectual property seems to conflict
19 with the rights granted by the license.

20 Whatever one's view of Kodak and CSU,
21 I think we will hear from our panel that some
22 lower Courts have gone beyond CSU and concluded

1 that the right to refuse to license means that a
2 predicate condition to a license agreement can
3 never state an antitrust violation.

4 Frankly, I expect many antitrust
5 experts will seriously question the extension of
6 CSU in that manner. Shortly thereafter we will
7 have a session on tying, bundling, and grant
8 backs. Are per se rules appropriate or not?
9 Should there be different rules for different
10 sectors of the economy?

11 Different industries and different
12 economic times have not yet required an antitrust
13 code that is as complicated as the tax code.
14 Personally I hope they never do. And therefore I
15 think there is a little bit of a burden to show
16 that the antitrust laws need to be modified for
17 specific industries.

18 That panel will also look at what we

1 equivalent of full-blown patent litigation?

2 How should we analyze a merger between
3 two companies currently competing when the output
4 of one of them is predicated on what is alleged
5 to be an illegal infringement of intellectual
6 property rights?

7 Later in May we will have two days of
8 comparative law hearings in which will focus on
9 other jurisdictions' approaches to intellectual
10 property and antitrust. Again I want to welcome
11 you to these sessions and look forward to a truly
12 enlightening discussion of these important issues
13 by our panelists.

14 Now I would like to introduce the
15 co-moderator of today's session and a person who
16 deserves tremendous credit for working so hard on
17 behalf of the DOJ as the person responsible for
18 these hearings, Frances Marshall.

19 FRANCES MARSHALL: Thank you, Bob.
20 Good morning, and welcome everyone. We are very
21 glad that you all have joined us for today's
22 session and have gone through our security

1 gauntlet.

2 Today, as Bob noted, we are discussing
3 the benefits and competitive concerns of business
4 arrangements used when firms seek to produce
5 products that are likely to infringe multiple
6 patents owned by multiple parties. And those
7 two things are patent pools and cross-licensing
8 agreements.

9 This morning we're going to start by
10 examining some of the fundamental reasons why
11 pools and cross-licenses are formed and examine
12 some of the anticompetitive concerns raised by
13 these arrangements as well as the benefits of
14 them.

15 Then this afternoon we'll take a
16 closer look at the case law that governs these
17 arrangements, examine the FTC's VISX case and
18 the guidelines that have emerged from the
19 Department's business reviews of the patent
20 pools that were issued in the late '90s.

21 Before we introduce our panelists, I'd
22 like to go over just a few housekeeping details.

1 As you can see, we are located in the Great Hall
2 of the main Justice building which creates
3 certain security concerns.

4 The basic rule of thumb if you are not
5 a DOJ employee is that you need to be escorted
6 around the building. Our escorts, otherwise
7 known as Antitrust Division paralegals, are
8 wearing name tags highlighted in green.

9 And they should be available at the
10 back of the room to escort you back out of the
11 building if you need to leave the session. The
12 restrooms are down the hall. We also have phones
13 available upstairs. We have been told that cell

1 I am today fortunate to have some
2 very talented co-moderators for this session.
3 Mary Sullivan is acting assistant chief of
4 the Division's economic regulatory section.

5 And Bill Cohen is an assistant
6 secretary general counsel for policy studies at
7 the FTC. And we are joined by Ray Chen who is an
8 assistant solicitor at the U.S. Patent and
9 Trademark Office.

10 Now I'd like to introduce our
11 panelists. I'm going to just say a few brief
12 words about them so we can get going. You have
13 in your handouts the full bio of everyone who's
14 on the panel. In alphabetical order, please
15 raise your hand as I introduce you.

16 I'm going to start with Garrard
17 Beeney, a partner at the law firm of Sullivan &
18 Cromwell. And he has represented patent holders
19 in the formation of licensing pools including
20 those related to MPEG-2, DVD, DVB-T, and the
21 IEEE 1394 technologies. We are very glad to have
22 you here.

1 Jeffery Fromm over on this side is
2 the Senior Managing Counsel at Hewlett-Packard
3 Company. He has practiced as an intellectual
4 property attorney since 1982 with a focus on
5 computer, printer, and imaging technologies.
6 Thank you for being here today.

7 Baryn Futa down here is manager, CEO,
8 and founder of MPEG LA. In 1997 MPEG LA began
9 licensing a worldwide portfolio of patents that
10 are essential for MPEG-2.

11 Peter Grindley is a senior managing
12 economist at LECG in London. We are so happy
13 he has come all this way to be with us.
14 Dr. Grindley has broad experience in economic
15 consulting in the areas of valuation,
16 intellectual property, licensing, competition
17 policy, and business strategy, especially in
18 high-tech industries.

19 Christopher Kelly, sitting down at the
20 end of our table here, is special counsel to Kaye
21 Scholer on intellectual property, e-commerce, and
22 technology and competition. This is a long name,

1 Chris.

2 CHRISTOPHER KELLY: No, no. Just
3 special counsel.

4 FRANCES MARSHALL: Special counsel,
5 all right, at Kaye Scholer in Washington, D.C.
6 It's really a pleasure to welcome Chris back to
7 the Department.

8 At the end of his illustrious career
9 at the Division he was special counsel for
10 intellectual property and worked extensively on
11 patent pooling and a few letters we will be
12 discussing later today.

13 Howard Morse over at this side is an
14 antitrust partner in the Washington office of
15 Drinker, Biddle & Reath, and he's co-chair of the
16 firm's antitrust group.

17 And before he joined Drinker in 1998,
18 he was assistant director of the Federal Trade
19 Commission Bureau of Competition where he
20 oversaw antitrust investigations and litigation
21 in a variety of industries.

22 Sitting I believe near this end is

1 today. And he teaches and writes in the areas of
2 securities regulation, contracts, corporations,
3 professional responsibility, and on the
4 intersection of antitrust law and intellectual
5 property.

6 Josh Newberg is down here. He is
7 assistant professor at the Robert H. Smith School
8 of Business at the University of Maryland at
9 College Park. And prior to entering academia he
10 served in the FTC's Bureau of Competition and was
11 an attorney-advisor to Commissioner Starek there.

12 Jonathan Putnam also down at this end
13 of the table is an assistant professor of law,
14 economics, and intellectual property at the
15 University of Toronto. And he has a wide variety
16 of research interests which include the
17 measurement of value of intellectual property
18 rights, the optimal design of IP incentive
19 mechanisms, and the role of information
20 disclosure in IP incentives.

21 And Lawrence Sung is also right
22 here and is assistant professor of law at the

1 University of Maryland School of Law in Baltimore
2 where he heads the intellectual property law
3 program and teaches courses including patent law,
4 biotechnology law, and licensing and technology
5 transfer.

6 Did I miss anyone? Okay. Great.
7 Our session today will be a combination of
8 presentations and discussions. We are going to
9 try to limit our panelists to 15 minutes in their
10 presentation so we can get through everybody
11 today.

12 And during the discussion periods we
13 are going to try -- and we have yet to see if
14 the panelists would put up their name tents to be
15 recognized. With this format I'm not sure how we
16 will see people. We may have to raise our hands.

17 For those of you in the audience we
18 are going to try an experiment with a method of
19 getting your questions to the panelists. There
20 should be some blank index cards in the back of
21 the room.

22 If you want to jot down any questions

1 you have on them and give them to an escort at
2 the lunch break or in the afternoon, and if we
3 have time we will pose those questions to the
4 panelists at the end of our session today. With
5 that, let's get started.

6 MARY SULLIVAN: I would like to give
7 an introduction to Josh Lerner. He's going to
8 be presenting basically some of the policy
9 implications from his current research study
10 on patent pools.

11 And I'd also like to say that Josh has
12 made intellectual property one of the major areas
13 of his academic research. So he's really an
14 expert in the area.

15 Since I've been working with him to
16 put this together, I've learned that while patent
17 pools have been around for a long time, research
18 on patent pools has not been around for a long
19 time.

20 So right now what we're learning from
21 academic studies on patent pools is sort of --
22 we're learning a lot that has to do with our

1 entertain the alumni in San Diego tonight. So we
2 said by all means. Even though we certainly want
3 to help Mr. Ashcroft and the administration we
4 also have to keep the dean somewhat happy with
5 us as well.

6 So I'm also going to sort of begin
7 with a little bit of a commercial as well for
8 those who are interested. When I got invited to
9 come speak here, we were aiming for completing
10 this project by the end of May. When I'm here to
11 present a seminar at the Antitrust Division on
12 May 28th we'll actually have the completed paper.

13 But Mary made a very compelling
14 argument that given that I spent the last year
15 and a half doing very little else except for
16 reading through patent pooling agreements from
17 the nineteenth and early twentieth centuries, I
18 really ought to speak here as well.

19 So in some sense this is perhaps a
20 little less far along than we would like. But
21 what I'd like to do with sort of the relatively
22 limited time we have is give at least a flavor

1 for some of the work that we are doing looking
 2 into patent pools and draw some preliminary
 3 conclusions from this work.

4 For anybody who's interested if you
 5 want to give me your card or send me an E-mail,
 6 I'd be delighted to share with you the paper
 7 which will hopefully be ready in three or four
 8 weeks.

9 I also should mention that this is
 10 joint work with Jean Tirole who is an economic
 11 theorist based at the University of Toulouse and
 12 MIT. And essentially what we have done is try to
 13 look systematically from an economist's

8 legal community and people like Rob Merges and
 9 and others who have tried to do this
 210 series, but we have sort of lost at and sort of
 211 explained in terms of the issues, s

1 writing and thinking and really digging into
2 this stuff.

3 What we tried to do is both sort of
4 align the more traditional, theoretical modeling
5 with the sort of much more dirty process of
6 actually looking at the pools themselves.

7 I think we basically managed to
8 collect somewhere on the order of 65 pools which
9 go back to 1895 or so and up to the current day
10 and which we have sort of dug out of various

1 I guess I should also acknowledge that
2 we have been spending a fair amount of time out
3 in the field talking to various organizations.
4 And for instance, Baryn's colleagues have been
5 tremendously helpful in terms of understanding
6 some of the dynamics of the MPEG as well as many
7 of the firms that participated in the exercise.

8 In terms of the goals of this project
9 we -- first of all, just to understand from a --
10 not so much from a legal perspective, but from
11 an economic perspective, what are some of the
12 trade-offs and considerations that firms think
13 about as they go through a process of going and
14 considering forming patent pools.

15 But secondly we wanted to really very
16 much try to create -- try to visit some of the
17 issues that policy makers have to deal with as
18 these things are increasingly coming in the door.

19 Are the kinds of criteria, kinds of
20 approaches which are being taken that are being
21 used in the reviews, in particular this sort of
22 idea that only essential patents are to be

1 included in the pools, that pool members have a
2 right to do separate licensing, that essentially
3 even though you are part of a pool one of the
4 criteria that's used in reviews is sort of
5 highlighting that the individual pool members
6 still can go out and do individual agreements,
7 and that there be, you know, some
8 non-discriminatory licensing of the pools, are
9 these kinds of criteria that are the right ones
10 to be using or are they in some sense too
11 stringent or perhaps not profitable?

12 I ought to just mention one thing
13 because this is certainly one of the sort of
14 pieces of ambivalence out in the literature where
15 there isn't really sort of a clear and systematic
16 definition of what constitutes a patent pool.

17 Essentially we can think about many
18 different things. I'll come back to this point
19 at the end when I talk about some of the policy
20 considerations. But certainly I think of
21 basically two flavors of pools.

22 In particular we highlight examples,

1 first of all, where open pools -- where there is
2 licensing to third parties where there's at least
3 two or more firms that come together to form one
4 of these organizations.

5 And then there's also what we term
6 closed pools where it's basically organizations
7 coming and contributing intellectual property,
8 not licensing it to third parties but basically
9 simply using it for their own use.

10 And certainly both the analyses that
11 we did theoretically and empirically, we said in
12 these cases we have to have at least three or
13 more firms participating to sort of get away from
14 the many routine cross-licensing agreements where
15 you just simply have two firms sharing their
16 intellectual property with each other.

17 Now, one of the sort of dreadful
18 things about economics is that there's always
19 models. There are lots of assumptions and
20 equations and so forth.

21 And I resisted the temptation to go
22 into too much depth in terms of trying to talk

1 through how we did this because simply I knew it
2 would be deadly boring especially with lots of
3 lawyers who invited us.

4 But we are just sort of reinforcing
5 the worst stereotypes about ourselves as a
6 profession. So we'll sort of give just a little
7 bit of a sense of some of the assumptions using
8 in this process.

9 Basically we start off with a very
10 sort of simple setting whether it's basically --
11 you know, given a number of patents each one of
12 which is owned by a separate firm, and
13 essentially it's all fixed.

14 So we are avoiding all the problems
15 that real life patent pools have to deal with
16 where you sort of have shades of gray where maybe
17 some patents are included in it, but Lucent or
18 somebody else is holding out and not taking part
19 in the pool and so forth.

20 And furthermore we sort of avoid the
21 complications that certainly were very -- sort of
22 make Baryn's life on the MPEG board difficult of

1 having not only people be intellectual property
2 owners, but also users.

3 So you have perhaps an organization
4 like Sony which was using the intellectual
5 property behind MPEG having perhaps a somewhat
6 different set of incentives than Columbia
7 University who wasn't obviously, you know,
8 manufacturing.

9 So we're assuming a very simple and
10 stylized kind of setting here and seeing then
11 what sort of comes out of it. We also assume
12 that essentially there are a lot of users out
13 there. We all benefit from using the pools, the
14 patents.

15 And essentially we're assuming they
16 can benefit from the use of some of them. The
17 more they have, the more they benefit from them
18 although it is perhaps not a sort of smooth -- a
19 sort of straight line. And we also assume there
20 might be some diversity in terms of the users
21 where some may benefit more than others.

22 Now, again just to sort of give the

1 intuition behind what we are looking at to sort
2 of make the results a little less -- sort of
3 pulling them out of a black box, what we
4 essentially do is sort of look at the challenge
5 that a patent holder faces in a setting where
6 there is a patent pool or where there isn't a
7 patent pool, and try to look at some of the sort
8 of trade-offs that are at work.

9 We first consider a sort of situation
10 where essentially if you are a user you have to
11 go -- and there's no pool, you have to go out and
12 license individually, essentially go and approach
13 each of the firms and negotiate a license with
14 them.

15 We look at the sort of decision of a
16 corporation which owns one of these patents, the
17 patent holder in terms of how they think through
18 this process.

19 And what we highlight is there are
20 two choices, two issues that are going into their
21 mind as they are setting the licensing rate as
22 they're trying to decide how high a rate do we

1 license our individual patent at.

2 First there is sort of the worry that
3 is called the competition margin, the competition
4 problem which is essentially that because these
5 patents are all sort of somewhat related it may
6 be that if we charge just a really exorbitant
7 rate then basically firms won't license our own.

8 They will basically sort of license

9 eight other patents out there and just skip ours(0 -lebf0.2kip
9-asrs(25 lpfecgupp-le atss ats related it m uil Tj Tj r -21 Tn't li0.2s

1 means and how we might think about looking for it
2 and testing for it -- you can be quite confident
3 that a patent pool would end up increasing or
4 enhancing the welfare of everyone in the pool.

5 The other situation is less clear, and
6 it may be that pools either help the welfare or
7 harm the welfare. It is a little less easy to
8 make any kind of implications.

9 But there are sort of three lessons
10 that we end up drawing from the modeling
11 exercise. The first is that the patents in
12 the pools don't necessarily need to be strict
13 complements.

14 In other words where they are not
15 really -- you know, where there's no real element
16 of substituting for each other to enhance
17 welfare.

18 In fact in many -- when we sort of
19 really look at patents and ask the questions as
20 the opening marks alluded, we don't often see
21 cases where patents are either pure complements
22 of each other or pure substitutes in terms of

1 doing these active things.

2 Instead mostly we have sort of shades
3 of gray where there are some elements of
4 complements and some elements of substitutes.
5 And we show that certainly in many cases when you
6 are in that middle ground patent pools can indeed
7 enhance social welfare.

8 Of course, if the patents are direct
9 substitutes for each other, they are basically
10 just alternative ways of doing the same thing,
11 it's almost going to be certain that they're
12 going to harm welfare in that case.

13 Secondly as I sort of alluded to

1 So if we're thinking about a situation
2 where individual firms are basically licensing
3 their patents as separate entities -- and I'm
4 essentially then -- I raise my price by

1 example which is the criterion around independent
2 licenses, that basically firms need to be able to
3 have the right to go out and license the patents
4 separately instead of being forced to license as
5 part of the patent pool.

6 What we show is that if we are in that
7 sort of good state of the world where that demand
8 margin is holding, then we basically get a
9 situation where that requirement, that
10 restriction is something that firms won't
11 object to.

12 So essentially if that is a
13 requirement that is made of firms and we are
14 in this sort of state where patent pools are
15 unquestionably beneficial, then that's going to
16 be something that the pool members won't find to
17 be a requirement that's costly or troublesome.

18 And if you are in the other state
19 of the world it might be much more in terms of
20 kickback or objection on the part of the firms to
21 these requirements.

22 And we similarly show in a number of

1 other sets of criteria that in many senses it
2 seems there is a quite a sound footing for a
3 number of tests that the DOJ has used in terms of
4 looking at these pools even though of course they
5 clearly didn't have the benefit of the model at
6 the time they were doing it.

7 Now, I guess I should acknowledge of
8 course that we are certainly -- and we make no
9 pretense about this -- still at an early stage in
10 terms of this process. And there's certainly a
11 lot of things that we don't examine here that we
12 clearly need to which are incredibly important in
13 the real world.

14 One of these of course is the impact
15 of having substitutes, other patents which are
16 outside the pool which are members. And we can
17 think about sort of MPEG again and Lucent's
18 decision not to be part of the pool. Certainly
19 we might think that that ended up affecting some
20 of the impact in terms of some of the process.

21 Simply we might think about sort of
22 some of the dynamic issues, what happens if you

1 have sort of subsequent inventions happening by
2 third parties who aren't part of the pool, what
3 might be some of those issues.

4 And there's also a variety of other
5 areas. We're getting into situations now where
6 firms are able to slip in patents that aren't
7 truly essential and in fact don't have a lot to
8 do with the nature of the pool.

9 What might be some of the implications
10 there? And similarly what are the implications
11 of the various provisions that have been used
12 over the years such as grant backs and other
13 types of things?

14 Before I come to the conclusion I just
15 wanted to sort of highlight one caution which is
16 that in some sense we have been sort of very much
17 modeling and we've been studying patent pools as
18 sort of clean organizations where you basically
19 have a number of organizations coming together
20 and sharing their intellectual property.

21 But certainly in terms of the field
22 based research in a series of interviews we have

1 had with opni/F0 11boeelndard setting bodirltoin

1 Even though that is kind of hard to
2 do, similarly it may be that it's important to be
3 cautious that many of the same things that can be
4 accomplished through pools can be accomplished by
5 other means including things which perhaps look
6 much more benign, like standard setting
7 organizations and so forth.

8 And so just to wrap up within my
9 allotted time, certainly patent pools are a
10 phenomenon for which economists -- there has
11 been relatively little study, even though it is
12 clear that there is considerable policy
13 importance particularly given the growth of these
14 arrangements over time.

15 This effort is to really try to dig
16 into and try to understand these dynamics both
17 from the theoretical side which I have
18 highlighted as well as the empirical side.

19 And what we have tried to do and what
20 we have ended up doing is at least suggesting
21 some of the rationales for some of the approaches
22 that DOJ has taken.

1 And what we hope will also come out of
2 it is some suggestions regarding further avenues
3 or further questions that also Npd DOJ may want to be
4 asking and looking at for future pools. So with
5 that I'll conclude. Thank you.

6 (Applause.)

7 FRANCES MARSHALL: Thanks, Josh.
8 Since you did end a couple of minutes early,
9 I think I'll take Npd opportunity to ask some
10 follow-up questions if that's okay once you get
11 back to your seat.

12 I'm intrigued by one of Npd statements
13 you made in one of Npd results of your study
14 which concerns our requirement that also Npd firms of
15 the pool have Npd option of licensing Npd
16 patents independently from the pool.

17 And your statement was that also if the
18 demand margins are binding Npd that is requirement
19 should not be burdensome to firms. Are you
20 referring to firms in the pool?

21 JOSH LERNER: Exactly. So what also I was
22 suggesting Npd there was essentially one can sort of

1 look and see where that kind of requirement to
2 sort of do -- the sort of stipulation that you
3 have to be able to make independent licensing
4 might end up leading to a situation which lowers
5 the confidence for the firms which are
6ohpl

1 But certainly as a first pass as one screening
2 criterion is it is a very reasonable approach.

3 FRANCES MARSHALL: Thank you. I have
4 another question. Sorry. Chris?

5 CHRISTOPHER KELLY: Can you hear me?
6 Do I need to be on mike? Josh, I just wanted
7 to make sure I understood a couple of the
8 fundamental points you were making. And the
9 first one is just a distinction between the
10 competition margin and the demand margin.

11 Is another way of characterizing
12 it saying that the competition margin is the
13 patentee's concern about its own -- the viability
14 of its own patent whereas the demand margin is
15 focusing more on profitability of the asset and
16 the use of the standard?

17 JOSH LERNER: I think that's sort of a
18 neat kind of formulation.

19 CHRISTOPHER KELLY: So the demand
20 margin would be especially important. When you
21 are using the assumptions I think you have to
22 bring the downstream manufacturers into the pool.

1 JOSH LERNER: Exactly. And I think
2 that while clearly it's a little hard to just
3 kind of speculate -- it's not quite as far down
4 and so forth. In the sort of preliminary stuff
5 where you have to relax some of the assumptions
6 it seems things are very much less --

7 CHRISTOPHER KELLY: Have you seen many
8 pools where they are made up of only patentees
9 who don't have something sitting in the
10 manufacturing world at stake?

11 JOSH LERNER: The answer is you can
12 certainly think of examples like that. This is
13 sort of -- now I feel like it's if you have a
14 Trivial Pursuit game with a patent pool option.

15 We looked at a traffic cab pool from
16 1946 where they did have a series of firms
17 essentially which had no interest in
18 manufacturing traffic cabs who nonetheless
19 ended up collaborating with each other.

20 But certainly when you look at the
21 oddity of patent pools it's largely been driven
22 by firms which have, you know, have a variety of

1 goals. But certainly one of them is using them
2 for their own purposes.

3 And clearly there are other
4 motivations as well which aren't captured here.
5 Certainly in terms of our field research, being
6 at Harvard Business we always have a compulsion
7 to want to go out and discover what's really
8 going on in the world.

9 It gets distressing when it doesn't
10 match up with your theory. But that's the way
11 the real world is.

12 Certainly when we have gone out and
13 talked to companies like various MPEG members,
14 what one sees is there is a very complex array of
15 motivations, for instance getting -- sort of
16 speeding the adoption of MPEG as the standard.

17 Sort of facilitating the standard
18 setting process seems to be an important
19 motivation certainly at many of firms mentioning
20 this topic. There is a lot more stuff going on
21 in this problem. Even in our best world we will
22 only be able to capture a fraction of the real

1 world. I guess one more.

2 CHRISTOPHER KELLY: You mentioned that
3 a pool is likely to -- if I got it right, in a
4 situation where if you raise the price of one
5 patent the demand for the other patents may drop,
6 wouldn't that suggest that the patents were
7 complements?

8 JOSH LERNER: I think the answer
9 is certainly in a case where there are strict
10 complements -- certainly there is sort of a big
11 middle ground.

12 I think one of the things that
13 motivates us is inasmuch as there has been any
14 writing by economists on the subject there is a
15 tendency to start thinking about either a very
16 strict world of strict substitutes or strict
17 complements.

18 I think that everything we seem to
19 know about the real world is the stuff is really
20 in between. It doesn't really fall to the one or
21 the other extreme.

22 WILLIAM COHEN: I think there is a

1 point I was trying to look for -- if you can, try
2 to encapsulate for us an intuitive understanding
3 of why the demand binding constraint is thought
4 to be a determiner of welfare.

5 JOSH LERNER: I admit that I like
6 the earlier formulation. Essentially the
7 individual members are concerned more about the
8 welfare of the pool than they are about their
9 individual patents.

10 But I think that you are also right in
11 saying that we have more work to do to sort of
12 get it down to the proper sound bite. And also I
13 can say is by May 28th I hope to back it up.

14 WILLIAM COHEN: Thank you.

15 FRANCES MARSHALL: Good answer. Okay.
16 Let's turn to Peter Grindley's presentation now.
17 Peter is going to be making some comparisons
18 between cross-licensing and patent pools.

19 And Peter has a lot of practical
20 experience in working with areas, intellectual
21 property matters. And a lot of his comments
22 today are going to be drawn from some studies he

1 did of cross-licensing agreements in the
2 semiconductor industry.

3 (Due to technical difficulty with the
4 audio, a portion of this morning's hearing was
5 unavailable for transcription. The transcript
6 resumes with the latter portion of Lawrence
7 Sung's presentation.)

8 LAWRENCE SUNG: -- whereby they don't
9 have a lawyer. And most scientists now will say,
10 talk to my technology transfer department.

11 Or in fact most scientists may say,
12 talk to my attorney; I have a private attorney
13 that handles all of my material transfer
14 agreements, talks about confidentiality, about
15 how we go forward with this because I've been
16 told that intellectual property protection is
17 important.

18 And indeed for the sector itself it
19 is important because you're talking about a very
20 long product development cycle. And they need
21 to be able to sell or capitalize on their
22 intellectual property protection as though it's

1 living an itinerant existence because I have a
2 semester off and I've been going various places
3 to do some research.

4 So what I've given you in the hard
5 copy form is a fairly sparse outline. And I
6 decided to succumb to herd behavior and do
7 PowerPoints, which I only got done on the plane
8 here yesterday.

9 So I apologize to my fellow panelists
10 that you don't have the PowerPoints. They follow
11 the substantive points of the outline fairly
12 closely.

13 I am very much aware that you have
14 been sitting there a long time and I am the last
15 speaker before lunch. And that imposes certain
16 obligations on me even though we have a
17 discussion period in between. And so I will
18 try my best to be brief and hopefully somewhat
19 entertaining to keep things going.

20 There's a saying among legal academics
21 that the way to succeed in law school as
22 professor is to be kind to your colleagues and

1 unkind to the Supreme Court, which goes along
2 with the adage that says no one ever got tenure
3 saying why the law was right.

4 This is an exception to those adages
5 or this topic is an exception because my basic
6 view is that with respect to pools the DOJ's been
7 doing a good job. The criteria that are being
8 used are sensible. They're being employed in a
9 reasonable manner. There are always things that
10 people can talk about.

11 But there's enough carping about
12 what's wrong with intellectual property policy
13 and what's wrong with antitrust law that I think
14 we should take a moment to recognize -- and this
15 may be just a bit of Chris Kelly -- that this is
16 an area where things have gone pretty well.

17 I noticed that Justice Holmes is out
18 there on the fresco, and I'm always worried when
19 I give an antitrust talk when I think of Holmes
20 because he thought the whole enterprise of
21 antitrust was worthless. Issues to consider, I
22 want to talk about three things.

1 The first is basically pools is an
2 aspect of managing the intersection between
3 antitrust and intellectual property. I won't
4 spend a lot of time on that.

5 But I want to talk just a little bit
6 about where the goals for enforcement relative to
7 pools fit into the overall perspective of the
8 antitrust/intellectual property intersection.
9 The second is something that I try and persuade
10 my students of and I never succeed. But you all
11 are professionals.

12 You've been working for a while. And
13 I hope this is not a hard sell. Comparative
14 advantage is the only kind. That is my basic
15 rule for both enforcement decisions and decisions
16 about cases. I want to talk a little bit about
17 pools compared to competition for the market and
18 standard setting organizations.

19 This is a point that Josh Lerner
20 touched on earlier, which is that pooling is
21 one way of doing something. There are other
22 ways of doing something. And if you enforce as

1 aggressively as against pools, what I want to
2 talk about is the problems that you will create
3 for yourself in other fields.

4 What we have is a type of problem.
5 And different solutions and different enforcement
6 procedures will affect that problem in different
7 ways. There is no solution. It's not as though
8 you take an aspirin and the headache goes away.

9 It's a problem to be managed, not
10 solved. And finally I'll talk a little bit about
11 the criteria for assessing pools. So first off,
12 managing the intersection.

13 Bob Potter said at the outset
14 that there is to some degree a tendency of
15 intellectual property lawyers and the IP statutes
16 and the IP orientation, way of thinking, to think
17 very much ex ante and think about returns,
18 incentives to invest, and not think about the
19 effects on the market as a whole of the IP rights
20 that are granted.

21 There is a corresponding tendency
22 among antitrust enforcers and among antitrust

1 lawyers to think about ex post effects. Those
2 are essentially functions of the tools that
3 you're given to work with.

4 When I think about intellectual
5 property -- and I'm not an economist so let
6 me put in all my caveats now -- I think about
7 finance, financial economics. It's a rate of
8 return analysis. When I think about antitrust,
9 I think about price theory and industrial
10 organizations. I think about game theory.

11 These are different tools. You can
12 say that they're complementary, and that's fine.
13 They are in a sense. We have the same end. But
14 I don't think that we should deny the fact that
15 there are different analytical ways of thinking
16 about these problems.

17 There is a risk, yes, that antitrust
18 can enforce itself so strongly that it undercuts
19 incentives to invest and disrupts the rate of
20 return calculation embodied in the IP laws.

21 There is a corresponding risk that the
22 IP folks and the people who grant intellectual

1 property rights can send out such a slew of
2 rights that there are overall welfare effects
3 that are undesirable.

4 We're not going to get out of this.
5 This is a difference in approaches. It is a
6 difference in emphases. It is a difference in
7 tools.

8 And that's why I see it as a problem
9 that has to be managed. Pools are one way -- and
10 I think this is fairly obvious. I'm not going to
11 cover the beginning of my outline which I think
12 is fairly obvious ground.

13 If one takes the hypothesis that we
14 have a lot of patents, probably patents that
15 people are surprised -- I heard on Saturday on

1 There are a variety of ways of dealing with the
2 problems.

3 But I do want to say at the outset
4 that what we're doing when we talk about
5 enforcement as against pools is operating at that
6 intersection. And we have to be very careful
7 that the problem is not viewed wholly from one
8 perspective or the other.

9 We can't totally have antitrust
10 deferring to the rate of return methodology
11 and say it increases incentives, ergo legal --
12 providing your first born child a security
13 performance on an agreement lowers the risk of
14 the agreement either. It does not follow that
15 that is a valid security.

16 Nor can we go all the other way. So
17 let me talk about in context -- get down to a
18 little bit more practical aspects, pooling as
19 compared to other approaches.

20 I'm going to take the example which
21 is what most of the -- what we've been talking
22 about, and particularly the DVD related pools --

1 of a pool where you're pooling technology to
2 develop a standard. You've got a product where
3 standardization is desirable.

4 DVD players are the combination of
5 content, encryption technology, and hardware.
6 The encryption technology we know exists so that
7 a fifteen-year-old somewhere in Norway can
8 decrypt it and post it on the internet and then
9 we bring the DMCA in.

10 Pooling may employ -- in this type of
11 situation pooling may employ a choice to compete
12 within an agreed upon standard. If you don't do
13 that, what happens? We're going to pool our
14 intellectual property. We're going to arrange a
15 series of IP rights so that we can create a
16 product that implements a standard.

17 If you don't do that, what do you do?
18 You might have proprietary competition for the
19 market. Let's call this Microsoft. We will
20 compete with firms enforcing their rights,
21 asserting their rights, each firm as against the
22 other. We'll have a lot of low price

1 competition.

2 We'll have a lot of very aggressive
3 first stage competition and a winner-take-all
4 type of scenario. All right. That's one thing
5 we could do. We could go through a standard
6 setting organization. Instead of pooling we
7 should say we're going to bureaucratize this in
8 some sort of a formal way.

9 We're going to go to ISO, IEC, all of
10 those organizations. You can have a hybrid.
11 MPEG-2 has a hybrid aspect to it as I recall.
12 There is an ISO standard involved.

13 If you push on one of these methods,
14 if you make antitrust riskier on one than the
15 other, you will see a tendency -- this is a
16 polycentric problem -- to pick different types of
17 problems based on the method you choose.

18 So, for example, if you make
19 enforcement of pools a priority and you enforce
20 pools very aggressively and you take the position
21 we're only going to -- we will bring an
22 enforcement action against any pool we think is

1 at all suboptimal, all right, now you have
2 competition for the market.

3 And you get your single firm antitrust
4 issues: Intel/Intergraph, Image Technical,
5 In Re: ISO Refusal to License, and related
6 issues. What do you get when you get competition
7 for the market in a market that has strong
8 network effects associated with it? You get

1 setting organizations. There's the possible
2 market effect from adoption as a standard.
3 You've got that whole set of cases. You can
4 go down that route also.

5 The point that I want to emphasize
6 here is that when you have the particular
7 structure I'm talking about, you've got a market
8 with strong network effects, standardization is
9 desirable, utility of the good increases with
10 consumption, you have a set of antitrust
11 problems. Costs get sunk up front.

12 Marginal cost is low. There are going
13 to be issues. There are going to be worries.
14 They may take different forms. But they're
15 there. And it's not as though by going after
16 pools -- you say I've gone after pools and I'm
17 aggressively enforcing pools and that's going to
18 solve the problem.

19 It will create different problems.
20 That's part of the management of the entire
21 intersection. So I've been asked today to
22 talk about and look at this problem from an

1 enforcement point of view, putting my enforcer's
2 hat on. And really this should be Chris doing
3 this because I'm not an enforcer.

4 I was a lawyer in practice. And I'm
5 now an academic. But this is what I think about.
6 What are my goals ideally? What am I thinking
7 about when I think about pools?

8 I'm thinking about a cooperative space
9 that's large enough for intellectual property
10 rights to be arranged to facilitate production
11 at the lowest combined cost of transaction and
12 administrative costs.

13 And there's going to be some interplay
14 between the demands you place on a pool and how
15 much you try and push it and the cost of the
16 pool. Cost and demand are inversely related,
17 meaning the costlier you make a pool to run, the
18 more you load it up, the less desirable it may
19 appear.

20 So there's going to be an equilibrium
21 there, which facilitates one path of competition
22 without foreclosing others either by licensors or

1 licensees, and which does not skew competition
2 through discrimination. That's my ideal world.

3 My ideal world is this imaginary space
4 where intellectual property rights are floating
5 around, and sometimes they conflict with each

1 get what's perfect? I've got my image.

2 I've got my goal. I know what I want
3 to see. If there's a deviation, I don't want to
4 have licensors be able to license outside the
5 pool. Let's say that proposal comes to you.
6 Why not? I would ask why, and I would demand
7 parsimonious explanations.

8 And this is simply my personal belief
9 from my days in practice, that the plausibility
10 of my clients' stories were inversely related
11 with their length. What we're dealing with here
12 are fairly straightforward concepts. A short,
13 straightforward explanation should be sufficient.

14 This is related to something that Josh
15 mentioned and also something that Chris mentioned
16 in terms of Josh's competition and demand
17 margins. Josh's basic point was if you say -- if
18 you as an enforcer say you must be able as a
19 licensor to license outside of the pool and you
20 get some push back on that, why?

21 Why is that undesirable? Is it
22 because people are afraid that if licensors can

1 license outside of the pool only one licensor
2 will have any customers? Is competition margin
3 binding?

4 Or are they really not worried about
5 that because -- and I read this point the same
6 way that Chris did -- what's in the pool really
7 are strong complements and I really don't have
8 that much of a worry about it?

9 What you're really trying to
10 do because you're at an informational
11 disadvantage -- these people are in the industry.
12 Their lawyers spent a lot of time learning the
13 industry. They know the parameters better than
14 you. You're trying to use your model to test and
15 get explanations as to what you see.

16 Why does it exist? If it deviates
17 from what I want, why does it deviate from
18 what I want? However, although that level of

1 be.

2 In the final analysis I think what you
3 have to ask when you're analyzing this from a
4 legal point of view is am I better off with this
5 arrangement than I would be without this
6 arrangement including any chance that I might be
7 able to bring some sort of an enforcement action
8 and maybe get it modified.

9 In that sense this is a game of
10 chicken, right? All law rests on a theory of
11 human behavior. What is my theory of human
12 behavior for people exploiting IP rights? They
13 maximize income. What are they going to do?
14 They're going to try and make money. They may
15 make money in ways that I like.

16 They may make money in ways that I
17 don't like. That's what I expect out of them.
18 I need to try and reach the best equilibrium
19 possible. That I think has got to be the target.

20 This is an area in which pursuit of
21 the best can be the enemy of the good. All
22 right. Assessing pools, practical problems.

1 I would not recommend -- and I've not seen this.
2 And this is I think a tribute, as I said, I
3 think things -- to the way that things have
4 been proceeding in this area.

5 If you see a pool that reflects a
6 choice to compete within a standard rather than
7 for a standard -- we're going to collaborate on
8 a standard, and then we'll compete on price,
9 quality, whatever else within the implementation
10 of the standard -- that is a valid choice.

11 That is a mode of competition. I
12 would be wary of trying to force competition
13 towards a certain model. We don't like
14 competition within a standard; we want
15 competition for the standard. We don't like
16 competition within the market; we want
17 competition for the market.

18 You trade off for a different set of
19 problems like that. And what you're seeing if
20 you see somebody bringing a pooling arrangement
21 to you is at least some evidence so long as
22 you've got -- you don't have facts that are

1 screaming out to you that this is some sort of
2 collusive and unproductive conduct.

3 You've got some evidence that there
4 are efficiencies to be had through that mode of
5 competition. So I would scrutinize efficiency
6 justifications on their own terms rather than
7 comparing them to a model that you might prefer
8 in the abstract. There is however no model of
9 avoiding competition.

10 There are different models of
11 competition. I just want to distinguish that to
12 say -- to make clear that what I'm saying is not
13 that you take at face value everything that is
14 said, but that you recognize that there are
15 alternatives that may be being pursued, and your
16 enforcement decisions may influence the path
17 those alternatives take.

18 All right. Practical aspects in this
19 is basically -- what I want to do is mention a
20 couple of things that I think are important, and
21 they are aspects in which I think the business
22 review letter process has done well, and I'll

1 tell you why. Obviously -- and this is something
2 that the guidelines and the letters talk
3 about.

4 The desirability of these arrangements
5 depends on the validity of the IP. I want to
6 know a lot about what's in the pool. want to
7 make sure that what's in the pool is actually a
8 legitimate patent. I want to make sure that it
9 is -- well, I'll talk about necessity in a
10 moment.

11 I want to make sure that they were not
12 loading up or protecting technology that really
13 shouldn't have been given a patent in the first
14 place. There has been employed in the letters
15 the expert procedure. This is more on necessity.
16 But there was a hint in one of them that it might
17 be on validity as well.

18 How do you figure this out? One way
19 is to build in incentives for pool members to
20 challenge the IP of other pool members. The
21 royalty structure can do that if the royalties
22 keep to the amount of IP in the pool.

1 Do they have a reputation that could
2 suffer if they are perceived to be as -- in my
3 former litigation days we would think there are
4 some expert witnesses that you have when you --
5 that you buy -- buy. Hire. Boy, there's a
6 Freudian slip. I would hate to see -- let me put
7 this more bluntly.

8 I would hate to see this procedure
9 go the way that expert witnesses have gone in
10 litigation where the one thing that you're sure
11 of is that you're probably not getting the
12 disinterested analysis that you would get if
13 you sat down and had a cup of coffee.

14 There's going to be a trade-off
15 between the procedures that you try and impose
16 on the pool for assessing validity. Are you
17 going to let licensees -- are you going to let
18 outsiders come in and challenge the pool --
19 challenge the validity of IPRs, and the cost
20 of administering the pool?

21 The more bureaucratic complexity that
22 you build into it, the more costly it becomes.

1 And the more costly something is, all else being
2 equal, the less desirable it is. That tension is
3 something that I think is a valid point for
4 people to bring up, and I think it's something
5 you would have to think about.

6 Necessity -- and I'll go through these
7 very quickly because I think the letters explain
8 them pretty quickly, and we're going to talk
9 about them this afternoon as well.

10 I think that because what we're
11 talking about is the practical combination of
12 intellectual property rights relative to the
13 production of a technology or a product, we have
14 to have a practical approach. I would not favor
15 abstract, technological approaches.

16 I would favor can this actually work;
17 is it necessary to get something done. How to
18 determine necessity, this is something I talked
19 about just a minute ago. You as an enforcer can
20 undertake investigations. You can solicit input.
21 You can see if there are ways for necessity to be
22 challenged at various stages.

1 And I should highlight here one of the
2 things that I think is important going forward in
3 this process is seeing how these issues change
4 over time. We've got some good experience with
5 the initial formation.

6 The dynamic nature of innovation and
7 the duration of the pool is something that is I
8 think going to be an issue I'll talk about with
9 innovation in just a second. I wouldn't mandate
10 a particular method.

11 But the confidence you have that the
12 pool is procompetitive is going to rest in large
13 part on the confidence that they give you and the
14 effectiveness of the method it identifies.
15 Exclusivity, I should say non-exclusivity. I
16 think the ability to license outside the pool is
17 very important.

18 I would be extremely -- and it's not
19 something you've seen challenged in the pools.
20 I would be extremely curious as to what the
21 justification for an exclusive arrangement
22 would be.

1 I'd really want a very short,
2 good explanation for that. Improvements in
3 innovation, dynamic technologies, the one thing
4 we've learned, this goes back to my fundamental
5 goal.

6 I think that it's important that
7 licensors and licensees be free to combine
8 technology either to improve or compete with the
9 pooled technology, meaning my vision is that we
10 have here a space in which IPRs are arranged
11 relative to a standard or a product.

12 My most desirable situation is one in
13 which that space of cooperation does not prevent
14 other spaces from forming, other paths of
15 cooperation from forming. It facilitates it.
16 It's permissive. But it does not prevent others
17 from happening. Grant backs are the bottom.

18 We talked about a little bit earlier
19 the guidelines mentioned under section 5.6. I
20 would consider evolution of a standard, if we're
21 going to talk about a pool forming a standard,
22 evolution within the pool and innovation outside

1 the pool.

2 It would make sense for -- if they
3 chose to do so, it would make sense for pool
4 members to take steps to ensure that the standard
5 they were creating so that people could implement
6 it could evolve over time. I can see situations
7 in which grant backs from licensees would be
8 desirable.

9 The guidelines talk about
10 non-exclusivity being more desirable than
11 exclusivity. And part of the reason the
12 guidelines talk about that is the ability of
13 improvers to get revenues on their own, which
14 means that the royalties come into play. There
15 is also -- and Chris mentioned this earlier.

16 There should be a relationship between
17 the field of the license and the field of the
18 grant back. Royalties, and I've only got a
19 couple of more. Reasonable and
20 non-discriminatory, like system to licensees,
21 we have seen that. That is also standard in
22 standard setting organizations.

1 This is an area of overlap. You've
2 got most favored nations provisions in a couple
3 of the letters. How does the royalty vary with
4 the value of the intellectual property right?

5 You've got in the Toshiba letter -- I
6 do the DVD letters by Toshiba and Philips -- a
7 fairly textured pricing policy, newer patents
8 worth more than older patents. You can go into
9 the -- you can have pools where you go into a
10 pricing mechanism that really gets into -- how do
11 I say -- that gets to a very detailed per IPR
12 analysis of pricing.

13 You can go down to a level where the
14 pool is really fairly a minimal rearrangement of

1 Does the royalty decrease over time as
2 production costs lower, as you get this sort of
3 standard; we've established the innovation;
4 we're at the end of its more mature product
5 stream. And how significant the royalty is
6 relative to the product, this is a point that's
7 been mentioned in a couple of the letters.

8 Can the royalty be used to facilitate
9 collusion? Does it suggest to you that something
10 is going on in the first place -- downstream
11 collusion especially -- something that's going on
12 in the first place that makes you suspect the
13 pool as a whole? And the last thing that I want
14 to mention is the treatment of information.

15 This is something we've also seen in
16 the letters. There's going to be a need for the
17 members to have some information about what is
18 being done with their IPRs. There's going to be
19 a need for some information.

20 There should be procedures in place so
21 that the information that is granted relates to
22 the exploitation by the pool of the IPRs rather

1 than becoming a conduit for the types of
2 information sharing that you would not want to
3 see. Hopefully I've stayed reasonably within
4 my time. And thank you very much.

5 (Applause.)

6 MARY SULLIVAN: We have about twenty
7 minutes for some questions here as we end this
8 morning's session. And I'd like to start out,
9 David, by going back to your issue about parties
10 being free to license outside the agreement. And
11 that certainly has been -- was a factor in the
12 DOJ pooling review letters.

13 But I'm curious as to whether the
14 parties are free to license outside of the
15 agreement whether they in fact have the incentive
16 to do so and whether that changes as the size
17 of the pool, the amount of IP contained within
18 the pool, gets bigger.

19 DAVID MCGOWAN: Well, let me take it
20 in sort of mid-reverse order. I don't know the
21 answer to the question of how frequently it
22 occurs. There are people here that are better

1 suited to -- or have better information on that
2 than I do. So I would sort of defer to them.

3 My instinct is it's going to depend
4 on the intellectual property right. The thing
5 that I have in mind, if the pool is properly

1 That sort of flexibility is what to me
2 is important in the sense that it leaves open
3 alternative paths of innovation that might lower
4 the cost of alternative paths if you can draw on
5 some existing technology. Will a pool member
6 have an incentive to license as part of that new
7 venture?

8 The short answer is it's going to
9 depend on what they think will maximize their
10 profits. I don't think that anyone should have
11 any Pollyanna views about that. And that's going
12 to be in part a projection of, the present value,
13 the expected value of the innovation on an
14 alternative standard.

15 What I'm really concerned about is the
16 ability to make that decision being untrammelled
17 by the pool, the pool representing an area of
18 collaboration, and area of cooperation, but not
19 foreclosing others. So that's the basic idea.
20 The frequency with which it occurs, I'd be
21 interested actually in hearing.

22 MARY SULLIVAN: Any experience here on

1 the pool? Josh?

2 JOSH LERNER: I can give you some
3 personal experience. To the extent that pools
4 are small and the number of participants,
5 licensors in the pool is small, then the
6 propensity to license outside the pool is high.

7 To the extent that the number of
8 licensors in the pool is very large, large being
9 a number, say, greater than four -- you don't
10 probably think of that as large.

11 But in trying to do -- essentially
12 licensing from, say, five or six or ten different
13 licensors, the probability of someone being able
14 to invest the effort and the time -- and time is
15 very critical in most of the industries we're
16 talking about -- goes down.

17 The opportunity in a large pool to
18 actually do this licensing outside the pool is
19 in fact for most -- for many firms not a real
20 opportunity. Even firms that have significant
21 economic incentive to do so, they simply don't
22 have the number of hours in the day before a

1 product has to be introduced.

2 MARY SULLIVAN: Chris?

3 CHRISTOPHER KELLY: It sounds then
4 like we could probably expect that within the
5 standard for which the pool is directed we can
6 expect the likelihood of independent licensing to
7 be a function of the need for the pool in the
8 first place.

9 If you do have a lot of IP owners, a
10 lot of disparately held IP that's implicated by
11 the standard, then it wouldn't make a lot of
12 sense to expect independent licensing because
13 whoever went on that path would then have to
14 continue on that path with a vast number of other
15 IP owners and take on all those transaction
16 costs.

17 But I guess that wouldn't necessarily
18 apply to individual licensors' willingness to
19 support rival standards and even form pools for
20 those purposes if it seemed like a viable
21 proposition.

22 But that would be more a function of

1 the type of standard setting questions that I
2 suppose you'll be talking about tomorrow.

3 FRANCES MARSHALL: Garrard?

4 GARRARD BEENEY: It's an interesting
5 question, Frances, about the incentives for
6 individual licensing and the comment about the
7 propensities of big pools and small pools. And
8 obviously I'm only working within the experience
9 that I've had.

10 But in representing pools and
11 representing individual licensors in pools, and
12 representing the individual licensors when they
13 are approached for bilateral negotiations and
14 licenses, in my experience I guess partly because
15 of the advice that I offer to individual
16 licensors, the individual licensors are prepared
17 to enter into individual licenses generally
18 within the margins of their expected revenue
19 stream from the pool.

20 But at the end of the day the
21 prospective licensee just simply isn't interested
22 and they just walk away and they end up with a

1 pool license.

2 And I guess what I'd like to suggest
3 is that doesn't mean that there aren't
4 alternatives. It just means that one is so
5 competitively compelling that there isn't
6 actually much of it done.

7 I kind of think of it in a way that,
8 you know, I don't want to have to fly from New
9 York to Los Angeles -- I could fly a commercial
10 plane or I could charter a jet. But the
11 economics are so compelling that I have never
12 flown anything other than commercially.

13 So I mean I think it's the same thing,
14 that the licensors that I've represented are
15 always more than willing to enter into these
16 bilateral negotiations or willing to enter into a
17 bilateral license at about the royalty level that
18 they would get from the pool.

19 But at the end of the day it just
20 doesn't make sense from the licensee point of
21 view. And I don't think you can fault the patent
22 pool for becoming increasingly more attractive as

1 it becomes bigger, as if that were some fault.
2 That's an increase in its efficiency and an
3 increase in its attractiveness.

4 And the fact that the licensee chooses
5 not to avail itself of the alternative doesn't
6 mean that it's not there.

7 FRANCES MARSHALL: Baryn?

8 BARYN FUTA: Actually I think this is
9 more perhaps Peter's point than mine. But I
10 think that my experience comports with Peter's
11 experience, which most bilateral relationships I
12 see in the marketplace are field of use or larger
13 in scope.

14 And programs like the MPEG-2 program
15 are dealing with a very thin sliver or one
16 intersection point, if you will, between two
17 bilateral partners, that being essential patents,
18 however defined, for a standard like MPEG-2.

19 So I don't think the largeness or
20 smallness of a patent joint licensing program
21 impacts the marketplace utilization of unilateral
22 licensing.

1 FRANCES MARSHALL: Let me go down here
2 for a couple of questions or comments and then,
3 Josh, I do want to get back to your comments.
4 Peter?

5 PETER GRINDLEY: I basically wanted to
6 support the two points we just made that with the
7 standard, the package of IP seems to be worth
8 more than some of the individual patents because
9 the coordination of the access to these IPs has
10 already taken place.

11 It's -- the potential for holdout by
12 the last -- if you went around individually
13 trying to get these licenses, the potential for
14 the last one charging you everything that
15 you've -- all your remaining wealth has been
16 resolved because the coordination has taken place
17 in advance.

18 So I'm not quite sure how that works
19 out comparing the individual patent licensing
20 versus the package. But I'm just saying that the
21 package is inherently -- just as a pure matter of
22 network externalities and coordination problems

1 really not the reality.

2 Having attempted to do it in the real
3 world, you find out that there -- if you've got
4 a whole series of licensors, some are more
5 motivated to license than others. Some are very
6 unmotivated.

7 Some may not even have licensing
8 organizations in a real sense. And some of them
9 are completely de-motivated to do the licensing
10 even though the DOJ letters require it.

11 So I'm just saying that there are
12 lots of different licensees that may wish to go
13 different ways. But the practical realities tend
14 to push them towards the pool in a very strong
15 way because of time and cost.

16 FRANCES MARSHALL: Okay. James?

17 JAMES KULBASKI: One of the -- a
18 question to Jeff is he said that for large pools
19 there is a tendency to license through the pool
20 but for smaller pools such as four- or
21 five-entity organizations there is a higher
22 likelihood of going outside of the pool.

1 Everyone knows about the larger pools
2 which have been approved by the DOJ and are very
3 popular and profitable. But I'm not too familiar
4 with smaller four- and five-company type pools.

5 How many of those do you think exist
6 and in what areas of technology are they
7 successful? If people are going outside of them
8 is there really a purpose of forming a four- or
9 five-member pool?

10 JEFFERY FROMM: I think most of the
11 pools start out as relatively small groups, or
12 many of them do. And so to the extent that they
13 start out that way and stay that way -- and the
14 ones that start small, perhaps they look a lot
15 more like cross-license arrangements than pools
16 like the DOJ has focused on.

17 But there are quite a few of them that
18 just never get -- they just don't have large
19 patent pools. They don't have large economic
20 impacts. And people do coordinate their
21 licensing.

22 It doesn't seem to be difficult for

1 people to figure out how to do it. They have
2 read the DOJ guidelines. And so as long as they
3 stay within them they figure they are okay.

4 FRANCES MARSHALL: This afternoon we
5 are going to get more deeply into this issue of a
6 full pool license versus a partial license being
7 available.

8 I think one of the things that I would
9 like to point out to Jeff is that I don't believe
10 that the DOJ letters require the individual
11 licensors to license their patents, but just that
12 they be permitted to do so, and it's up to them
13 to choose whether or not to do so.

14 Peter, did you have something else?

15 PETER GRINDLEY: No.

16 FRANCES MARSHALL: Josh, I'd like to
17 finally get back to you.

18 JOSH LERNER: I'd just like to follow
19 up on Frances' question and just ask David
20 something I've never understood.

21 This idea of being able to license
22 outside the pool as -- being permitted to license

1 outside the pool as though that's an unabashedly
2 good thing, I don't understand why it isn't the
3 case that licensing outside the pool under
4 certain circumstances is just another way of
5 discriminating under a particular set of facts
6 against some prospective licensee.

7 And so the pool can in effect
8 facilitate discrimination instead of putting an
9 end to it because in fact you're charging
10 different prices for the same piece of

1 permitting independent licensing. Under a
2 different set of facts they can beat you up for
3 discriminating, and they don't have to justify --
4 and discriminating sounds bad, but in fact
5 economists frequently think that discriminating
6 is good.

7 So what I detect here is either I'm
8 really confused or there's not a coherent
9 intellectual framework. And I just don't want to
10 let this pass. I want to say -- I want to ask
11 whether it's true that independent licensing is
12 always a good thing.

13 DAVID MCGOWAN: My short answer
14 is that I don't think I said that price
15 discrimination is bad. If I did I didn't mean
16 to. The ability to license -- as I say, I am
17 talking about this from an enforcement point
18 of view.

19 I think the ability to license outside
20 is good because it allows flexibility in the
21 deployment of the rights. Now, it may be -- as
22 Garrard says, it may be that the economic

1 proposition of the pool is so compelling that
2 you see none of it.

3 So what I'm saying is that as an
4 enforcement matter I'm wondering whypropositiit hat

1 are on equal footing, that's fine.

2 There's an issue about what
3 discrimination actually means, whether it should
4 be relative to the yield that a licensee is going
5 to obtain from the use of your intellectual
6 property rights.

7 And, you know, quite frankly there's a
8 compelling story to tell on price discrimination.
9 I don't disagree with you about that. I'm more
10 worried about particular uses of intellectual
11 property rights to block certain forms of
12 competition.

13 And this is sort of an analogy from
14 the Allied Tube, the standard setting cases that
15 I mentioned earlier where what you have is in
16 effect a cartel of uninventive people trying to
17 block the adoption of a superior technology.

18 I worry that if you don't have the
19 ability for somebody to come to a licensor with
20 an economic proposition that makes sense but
21 requires the use of a particular technology, I
22 worry that the obligations of a licensor to other

1 I'm not implying what I think you think I'm
2 implying.

3 FRANCES MARSHALL: Chris?

4 CHRISTOPHER KELLY: Just a word on
5 behalf of incoherence. I think Frances made a
6 very important point about the fact that the
7 pools -- the letters did not -- although the
8 extent of exclusivity was a factor in the
9 analysis, it was not an on/off switch saying if
10 you were exclusive we would say no to you.

11 I think it's probably right to say
12 that had the pool -- any of those pools been
13 exclusive and prohibited the members of the pool,
14 the licensors from licensing outside the pool,
15 that certainly you would have ratcheted up the
16 pressure of the analysis of the pool because at
17 that point it's the only game in town.

18 And so we would care much more about
19 each other aspect of the thing. But I could
20 easily imagine circumstances in which a pool
21 could come to DOJ and say, we are a consortium
22 which has defined a new product which we are

1 innovating within it and says, well, you know
2 what, we're going to take a little more from you;
3 if any of us like what you have come up with
4 we're going to get a license on it.

5 And we said, terrific, because what
6 that probably means is that the people who are
7 simply just using the technology without
8 enhancing it and see less value in it are as a
9 result going to see a lower aggregate royalty
10 then they would if the licensor were to try and
11 find a single royalty that captured the value
12 from everybody uniformly.

13 PANELIST: Can I make one quick point?
14 I just wanted to say I think a point that Chris
15 made I would suggest from an enforcement
16 perspective is generalizable, which is to say
17 that -- it seems to me a risky thing to say that
18 any of these factors is an on/off switch as Chris
19 put it.

20 Practically speaking you are going to
21 have to hit an equilibrium and decide whether
22 that equilibrium is something that you live with

1 rather than the alternatives.

2 And that seems to me just a realistic
3 aspect of any sort of judgment about whether to
4 bring a suit as a private party, or an
5 enforcement decision.

6 And, you know, the process of weeding
7 through the justifications and seeing how they
8 make sense in particular markets and different
9 things will make sense in particular markets.

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AFTERNOON SESSION

(1:00 p.m.)

FRANCES MARSHALL: Let's all take our seats and get started again. With this morning's session apparently we had a lot of trouble with the sound system and people not being able to hear very well.

We've requested that the blowers be turned off, and I think they have been. And the consequence of that is that it may get warm in here. So if it gets too warm let us know and we can do the trade-off again, turn them back on.

I think what we need to do for the panel -- not all the speakers are -- the mikes are on. They turn them on as we -- they recognize that we're going to be talking.

So if you just give a couple seconds for the mike to come on when you pick it up, that would be good. If people could speak slowly and articulately that will probably help people understand as well.

So to begin this afternoon's session

1 Josh Newberg is going to give us an overview of
2 the case law of patent pools and cross-licenses

1 uncertainty more broadly speaking with regard to
2 the economic relationships among patents in a
3 pooling arrangement.

4 I want to begin with a talk about
5 the case law. I'll talk about Standard Oil, Line
6 Material, and a little bit about BMI versus CBS.

7 Then I'll give an overview and
8 analysis of the Summit/VISX case and use that
9 case as a vehicle for showing how the uncertainty
10 issues played out, and then talk a little bit
11 about implications, recommendations for
12 competition policy regarding patent pools.

13 I want to try to be a little bit
14 provocative and maybe convince you of three basic
15 propositions. One is that the Supreme Court's
16 antitrust analysis of patent pooling is highly
17 problematic and fails to offer rules of decision
18 that maximize welfare.

19 Second, I want to suggest that as much
20 as we long to categorize intellectual property
21 neatly in the conceptually distinct categories of
22 competing, complementary, blocking, patents like

1 facts are stubborn things that frequently defy
2 such convenient classifications. They may
3 straddle one or more classifications. And their
4 scope and/or validity may be just fundamentally
5 uncertain.

6 Third, since this indeterminacy often
7 informs the actual business decisions, the actual
8 business relationships that are structured around
9 sharing patent rights, antitrust analysis should
10 be adapted to account for such uncertainty to try
11 to factor it in rather than pretending that it
12 doesn't exist.

13 Now, perhaps the most frequently cited
14 Supreme Court case on patent pooling is Standard
15 Oil of Indiana versus United States. It's a case
16 from 1931. And it's typically cited for two
17 propositions.

18 One proposition is that the rule of
19 reason is to be applied to the analysis of patent
20 pooling arrangements. It's also cited for the
21 proposition that it is permissible for firms to
22 combine blocking patents. That is to say that

1 combining patents in order to resolve blocking
2 relationships is not likely to raise antitrust
3 problems.

4 With regard to the first proposition,
5 I think it's fairly sound to cite Standard Oil.
6 But with regard to the second proposition, I
7 think it's problematic.

8 The case involved a pooling
9 arrangement among four firms. It was established
10 in the 1920s. And these four firms had
11 alternative technologies for cracking gasoline.
12 This was a revolutionary method for refining
13 petroleum into gasoline.

14 And it represented a huge advance
15 over so-called straight run methods of cracking
16 gasoline -- of refining gasoline. And it could
17 increase the yield from a barrel of petroleum
18 from anywhere from two-and-a-half to seven
19 times what you would get under the previous
20 technologies.

21 So this was revolutionary. And one
22 process was patented. Then more processes were

1 patented. And soon the industry was faced with
 2 an enormous amount of costly litigation. And so
 3 four firms entered into the pooling arrangement
 4 that was ultimately challenged by the Justice
 5 Department.

6 And in this pooling arrangement four
 7 firms agreed that they would cross-license each
 8 other's cracking technologies. And each member
 9 of the pool would be able to license the package
 10 or any combination of the pool patents to third
 11 parties.

12 And it was quite successful for a
 13 while in ways that I'll talk about in a little
 14 bit. But it was problematic and I'll talk about in a little bit.

6 Ton Supra and Cement's creation is a
 7 result of this pooling arrangement. For a
 8 decision, the parties agreed to license the
 9 technology to each other. Why? The parties
 10 wanted to avoid the possibility of litigation.
 11

21 12 perhaps might have been avoided by the parties.

1 And what they concluded was that as a percentage
2 of all gasoline the four cracking patents firms
3 accounted for only about 26 percent of all the
4 gasoline market.

5 So not only were there no downstream
6 price or output restraints, the Court decided
7 that 26 percent didn't constitute dominance.
8 So you have a very competitive, perfectly
9 competitive, or acceptably competitive
10 market.

11 And also there was not a lot of
12 evidence of any kind of exclusion of firms that
13 wanted to license the patents. Well, what's
14 wrong with the Court's analysis then? First of
15 all they looked at the wrong market.

16 It probably would have been
17 appropriate to look at the technology market,
18 to use a technology market analysis and to make
19 a distinction between the upstream licensing
20 market in which these four firms operated and
21 distinguish that from the downstream market for
22 gasoline.

1 The patent pool was not in the
2 business of selling gasoline. The patent pool
3 was in the business of licensing the technology
4 to refine gasoline.

5 If you look at it from that
6 perspective, these four firms accounted for
7 something like 80 or 90 percent of all cracking

1 a revolutionary technology without which there
2 would be no automobile revolution here in the
3 United States. So in any case Standard Oil is a
4 sort of ambivalent legacy.

5 It's a case that is about competing
6 patents, competing technologies that is, as I
7 said, cited for the proposition that combinations
8 of blocking, i.e. complementary technologies, are
9 lawful.

10 The actual discussion of blocking
11 is in one footnote, footnote 5 of the opinion.
12 And it's good. It says that blocking can be --
13 pooling arrangements to resolve blocking can be a
14 good thing. But it's not part of the holding of
15 the case.

16 The next case that's relevant to the
17 analysis of pools is United States versus Line
18 Material which specifically dealt with the issue
19 of blocking patents.

20 In that case one firm, the Line, and
21 the other, the Southern Corporation, one firm had
22 a patent for a circuit breaker technology, but

1 the product that they made with the patent wasn't
2 all that efficient.

3 Another firm had invented a better,
4 more efficient circuit breaker, but they couldn't
5 market that. They couldn't produce it unless
6 they had a license from the first company. So
7 they entered into a pooling arrangement to share
8 the rights of the combined technology.

9 They appointed one of the two firms
10 to be the licensor of the technology. They also
11 fixed the downstream prices of the circuit
12 breakers that actually were made with the
13 technology.

14 Now, in this case the Court not only
15 said that this was a bad thing, it was per se
16 unlawful. The Court said that this arrangement
17 was per se unlawful. What if anything is wrong
18 with that analysis? Well, there was no -- there
19 was no rule of reason inquiry.

20 There was no inquiry into relevant
21 market. There was no inquiry into competitive
22 effects. And also it's difficult to tease out

1 from the opinion how significant the setting of
2 the downstream prices was to the decision.

3 Based on my reading of it, it looks as
4 if the Supreme Court still would have condemned
5 it even if there wasn't a downstream product
6 price fixing because they had a problem with the
7 two licensing firms, the two patent holders
8 getting together to fix a royalty rate.

9 So anyway, on the one hand you have
10 the Standard Oil case which is usually cited for
11 the proposition that you can -- that pools to
12 resolve blocking arrangements are okay. But it
13 doesn't deal with blocking patents.

14 And then you have the Line Material
15 case which says that a combination to resolve a
16 blocking relationship is per se unlawful. So
17 this is to say the least kind of a difficult and
18 ambivalent legacy from the case law.

19 Well, let's fast forward to
20 Summit/VISX, to a modern patent pool. The
21 technology in Summit/VISX, as you probably know,
22 was for PRK, the sort of revolutionary technology

1 to reshape the cornea to correct for various
2 refractive errors through applying a laser.

3 In 1992 the two leading firms in the
4 development of this technology several years
5 before it was approved by the FDA entered into
6 a pooling arrangement, the Pillar Point
7 Partnership. They pooled the PRK apparatus and
8 method patents. They established a \$250 per
9 procedure fee.

10 Whenever somebody actually did the
11 procedure with either a Summit machine or a VISX
12 machine, a \$250 fee would be paid to the pool.
13 The firms however remained free to compete on
14 the sale of the machines.

15 What are the principal antitrust
16 issues? One was what's the economic relationship
17 among the patents in the pool and the
18 relationship between those patents and the two
19 firms' technologies. And a second was what were
20 the competitive effects.

21 Well, in 1998 the FTC brought a
22 three-count complaint. And they argued first

1 that the pool was an unlawful restraint of trade
2 based on a reading of the relationship among the
3 patents as being competitive. So the argument --
4 the FTC decided that this was a pooling not
5 primarily or solely of complements but of
6 competing approaches.

7 The FTC also charged conspiracy to
8 monopolize the PRK and equipment and technology
9 markets, and a third fraudulent procurement of
10 the VISX patent, key VISX PRK patent was the
11 third count. This was resolved by settlement.
12 The pool was dissolved.

13 And in the settlement VISX granted a
14 license to Summit for the pooled VISX patents.
15 So Summit could use the patents although Summit
16 could not sublicense. Summit could not license
17 third firms.

18 Now, the decision that the Commission
19 made in analyzing the patents is certainly
20 defensible. I was a part of it. I worked on the
21 litigation team. But there were and there are
22 alternative approaches that could have been

1 taken.

2 Based on the evidence that we had
3 before us, based on outside observers, you could
4 look at the same pool and say these are not
5 competing technologies. What you have is a
6 blocking relationship being resolved by this
7 pooling arrangement. That's what the parties
8 argued. And this was not a frivolous argument.

9 It could have been interpreted that
10 way. Alternatively it could have been argued
11 that effectively VISX was a lawful monopolist.
12 VISX had such a broad patent that they
13 effectively covered the market.

14 And what they were doing was entering
15 into essentially a vertical relationship with
16 Summit where Summit needed to license the VISX
17 patent to be able to operate at all.

18 Another approach, another way which I
19 think is probably the way I'm inclined to look at
20 it is that this pool and the relationship among
21 the patents in this pool was defined by its
22 uncertainty. The patent scope of important

1 patents was uncertain. And the validity of
2 the most important patent was uncertain.

3 Now, depending on which of those
4 perspectives that you take, each of which I would
5 submit was defensible, could be supported by the
6 same evidence in the case, it has of course
7 substantially different implications for the
8 antitrust analysis.

9 The competitive effects then depends

1 If you take the position that the
2 relationship of the major patents was in fact

1 difficulties facing me. One of them is that my
 2 general interest here is in talking about patent
 3 pools, but I recognize that the specific way I've
 4 been billed is you're talking about VISX and
 5 that's an important topic. So I'm going to try
 6 to just move through the general topics and get
 7 to VISX.

8 Second, I have to admit that I have
 9 to pick my jaw up off the floor hearing smsT10rlf hf

13 ok opposit thides.t I have

14 8 I should6 secicognize tfalllki smsT10rlf h fr

1 priv ab litig aion. Second, woize met m goyout I have

1 decide whether or not a given pooling arrangement
2 is going to be termed pro- or anticompetitive.
3 There's an inadequate analytical framework in
4 those guidelines.

5 And I'm going to try to show you why
6 that is in general and also in the context of
7 the specific pleadings in the case of VISX. The
8 second point that I want to make is that when you
9 actually get down to implementing the tests in
10 the guidelines you discover that there's no
11 "there" there.

12 And it's very difficult to say without
13 a theoretical framework how you would look to
14 data and decide whether or not any given
15 arrangement conveyed market power onto members
16 of a pool. It's that inability to decide those
17 empirical questions that makes the litigation of
18 these cases especially problematic.

19 So in particular what I mean by
20 that is I mean that the notion of a competitive
21 level in the context of intellectual property
22 litigation generally and the patent pooling in

1 particular is not defined within the guidelines.

2 If you define market power -- the
3 merger guidelines do as the ability to price
4 above the competitive level for a significant
5 period of time, but you don't have a definition
6 of the competitive level, you don't have a
7 definition of market power.

8 Similarly if you don't define price
9 you also don't have a definition of market power.
10 And you would think, well, price is easy to
11 observe. But price is not easy to observe in the
12 context of innovation because the whole point of
13 innovation is that you change the quality of the
14 good that's being offered.

15 And so when you observe a nominal
16 price, that price is not just the amount of money
17 that one party pays for the good. It's also the
18 willingness to pay for a good that has been
19 augmented by the innovation to begin with.

20 So if innovation is happening the way
21 it's supposed to be happening, real prices should
22 be dropping. Quality adjusted prices should be

1 dropping even if nominal prices are rising. If
2 you don't define price to mean quality adjusted
3 price, they'll never pick that up.

4 The other point that I want to make is
5 that this is a two-stage analysis. And so if you
6 misregulate with respect to one party or another,
7 the problem is that you alter the incentives for
8 all future inventors. And the harm that you
9 cause from misregulation dwarfs the damage that
10 you do in any particular market because you've
11 changed the incentives.

12 So the theme here which I'm just
13 going to breeze over is that you really need a
14 two-stage analysis. And unless that analysis
15 encompasses time, you are going to get it
16 fundamentally wrong. So in the typology that was
17 given earlier today, I'm an ex ante guy.

18 I would contend as an economist that
19 the only way -- right way to think about this is
20 ex ante because that's the only way that you
21 think about both stages of the problem. And the
22 way you take into account time is you look at the

1 incentives the parties have, not just simply what
2 they did.

3 You look at their expectations in
4 advance, not just what actually happened. You
5 look at the optimal path that you are trying to
6 create for parties and not just whether at any
7 given instance the outcome deviated from a
8 benchmark that you would prefer.

9 And then the question is over time how
10 do you actually measure this given the data that
11 that you are going to be given in discovery. The
12 guidelines have three principles. Very briefly
13 they are these: Intellectual property is like
14 real property; there is no presumption of market
15 power; and licensing is procompetitive.

16 Let me just explain briefly why I
17 think those principles are problematic. They
18 sound like they're completely vanilla. They are
19 not. Let's just focus on the key language here.
20 The characteristics of intellectual property can
21 be taken into account by standard antitrust
22 analysis.

1 Now, is that true? The answer is no.
2 Unlike all -- most other forms of property,
3 intellectual property does not contain the right
4 to use. That's very important.

5 When I walk onto my land, I have the
6 right to walk onto my land. When I have a piece
7 of intellectual property, I don't necessarily
8 have the right to use it; I only have the right
9 to exclude somebody else from using it. The lack
10 of a right to use in a property irig bmave the right

1 to become significant in a moment.

2 The second principle is intellectual
3 property is not presumed to have market power.
4 Why is that? Because there will often be
5 sufficient actual or potential close substitutes,
6 standard analysis. So this is important.

7 The presumption that intellectual
8 property doesn't have market power is predicated
9 on the presumption that there may be close
10 substitutes for it.

11 Now, what is market power? It is the
12 ability to maintain prices above a certain level.
13 What's that level? We don't know. Let me give
14 you an example. I'm going through this quickly.
15 You will be able to see it in the handout.
16 Suppose there are two companies that are both
17 competing to get a patent.

18 One of them succeeds. The other one
19 fails. In this example they both spend \$100 on
20 R & D. One of them wins and makes 250. What is
21 the rate of return you will observe for the
22 successful patent owner? You're going to observe

1 a rate of return of 150 percent. They spent
2 \$100. They made 250. That's a lot of money.

3 What's the ex ante return that they
4 expected to make? They expected to make a
5 25 percent return because there was only a
6 50 percent chance they were going to win the
7 patent race. If their cost of capital was
8 25 percent, that means they exactly broke even.

9 So what that tells you is the biased
10 sample of successful inventions is going to
11 contain firms that are making a whale of a lot of
12 money but it's not going to take into account all
13 the firms that failed.

14 The policy implication of this is that
15 any remedy that reduced the incentive -- that
16 reduced the return that the company made for its
17 successful invention would have -- in this
18 example would have been sufficient to render that
19 investment unprofitable ex ante. Your capital
20 costs you 25 percent.

21 You would be expecting less than a
22 25 percent return. You never would have invested

1 even though it looks like you are making a whale
2 of a lot of money. That's a problem. You don't
3 know whether your remedy in an antitrust case
4 is time consistent or not.

5 Would the firm have made the
6 investment if it had known that you were going to
7 do what you intend to do in the second stage? As
8 I've already said, there is no definition of
9 competitive price or even price, and so therefore
10 you can't decide what market power is.

11 The third principle is that licensing
12 is generally procompetitive. Why is that?
13 Because it may promote the coordinated
14 development of technologies that are in a
15 blocking relationship. What does that mean?
16 It means the presumption of procompetitive
17 licensing rests on the presumption that they
18 are complements.

19 Principle two said we don't presume
20 there's market power because there may very well
21 be substitutes. Principle three says we think
22 that licensing may be procompetitive because they

1 may very well be complements.

2 Well, whether they're perfect
3 complements or perfect substitutes, they're
4 either one or the other in some fashion. They
5 are not both simultaneously at least with respect
6 to a particular other party.

7 And so you have three principles,
8 one which presumes no market power based on
9 substitutability and one which assumes
10 procompetitiveness based on complementarity.
11 That's not consistent. I'm just going to skip
12 this example of the cross-licensed patents and
13 move straight to VISX and Summit.

14 Josh has already given you the
15 background, and so I'm not going to review that.
16 The complaint said, as Josh pointed out, that the
17 pool in question restrained trade, stabilized and
18 maintained prices, raised the cost of entry, and
19 deprived consumers of the benefits of
20 competition.

21 And so I ask two questions. One is:
22 Relative to what? What were you expecting? This

1 is what patents are due. And so if your null
2 hypothesis is the world should have looked

1 technology are substitutes. This is an illegal
2 combination or conspiracy. VISX of course had
3 its defenses.

4 It said that patents were not
5 substitutes, they were complements, and that
6 therefore it was efficient to combine them
7 and that as Josh pointed out because of the
8 uncertainty surrounding whose patents were going
9 to be found valid in the litigation that also
10 existed between Summit and VISX at this time.

11 No one knew what exactly what the
12 final configuration of the market was or even who
13 was going to enter because this was three years
14 before the machines were allowed to enter the
15 market.

16 Under the consent decree the patent
17 pool was dissolved. Each party got its own
18 patents back. The royalties were set
19 independently. And there was a royalty
20 free cross-license.

21 So the FTC obtained the result
22 that has been generally affirmed to be better

1 in patent pooling arrangements: independent
2 licensing; low, in this case zero,
3 cross-licensing rates; and the ability
4 to control your own patent rights.

5 What's the result of the FTC's
6 intervention with respect to third parties?
7 Nidek, who is the third entrant in the market,
8 gets sued now by VISX and they get sued by
9 Summit. Why?

10 Because now the complementary patents
11 that VISX and Summit had are being asserted
12 independently against new entrants, and the
13 combined price that the two parties seek to
14 enforce against a third entrant is higher than
15 the price that the entrant would have paid under
16 the pool, which just illustrates the fact that
17 complementary patents are efficient.

18 I want to come to count three now
19 which is not about patent pooling but about fraud
20 on the Patent Office. VISX's broadest patent was
21 alleged to be fraudulently obtained. That is not
22 an issue for a patent pooling case except for one

1 thing which will illustrate the difficulty I had
2 with the guidelines.

3 The FTC -- there were three -- the
4 argument was that there were three potential
5 markets. Certainly one of them was itself the
6 technology market, the patent in question. And
7 the FTC said all firms need a license of this
8 patent, and VISX is monopolizing this market
9 using this fraudulently obtained patent.

10 The complaint counsel could not --
11 did not have a definition of what the competitive
12 level was. So they said that market power is the
13 ability to exclude from a relevant market.

14 If you are asserting a fraudulent
15 patent in a relevant market which is the market
16 for that patent, and you have the ability to
17 exclude and you ought not to, that's the
18 antitrust violation.

19 VISX's response is obvious. There is
20 no theory of the competitive level. You don't
21 know what prices ought to be. If you actually
22 look at VISX's rate of return on investment, it

1 was within -- it was certainly normal. The
2 royalty rate as a percentage of the final price
3 of the good was normal.

4 And you're not taking into account
5 the fact that people are better off because they
6 prefer to have their eyes zapped with a laser
7 than to wear glasses the rest of their lives.
8 Here is the critical point.

9 The problem is that if all other
10 firms under count three needed a license to this
11 allegedly fraudulently obtained patent then the
12 patent is in fact a complement.

13 But under counts one and two the FTC
14 had already said that VISX's patents did not
15 block Summit's patents and that the two firms
16 ought to have competed in the goods market.
17 In other words, they were substitutes. So
18 the question is which are they.

19 In the end the patent was found not
20 to be fraudulently obtained. So that's the end
21 result of that. There are three principles. Do
22 I think the antitrust agency should not regulate

1 intellectual property? No.

2 I think that you should take the
3 following philosophy. Intellectual property
4 is the private means to a public end. The
5 authorization phrase of the Constitution says
6 that intellectual property exists to promote
7 progress.

8 If you take that seriously, then your
9 overarching charge is to decide whether the

1 take into account. And there may be insufficient
2 private incentives to police behavior.

3 And a third principle -- and this is
4 I think what I want to leave you with -- is that
5 free entry into research and development plays
6 the role that entry does in competition with the
7 product markets.

8 You have to believe that the system is
9 self-correcting in the same way that it is that
10 if you allow entry in markets with high prices
11 those prices will fall eventually as competition
12 increases.

13 Now, what we are doing in the case of
14 intellectual property is moving that preference
15 for entry to solve the problems in the market
16 one stage back to the research phase. And we're
17 saying is there's free entry in the R & D market.

18 Eventually the high prices that
19 you observe that are being earned by this
20 intellectual property will be corrected as
21 other people come along and enter, develop new
22 technologies, and render the current technologies

1 obsolete. That's our preferred method for
2 regulation, is entry.

3 What's my normative proposal for
4 this? The question that the agencies should
5 seek to address is: Was the restraining question
6 anticipated to be reasonably necessary to induce
7 the investment at the time the investment was
8 made?

9 If it was and we have a preference
10 for this investment because it resulted in this
11 new valuable technology, then there should be a
12 presumption that it's not anticompetitive. If
13 it's just something that they developed after the
14 fact in order to further exploit their monopoly
15 rights, then I think it's much more suspect.

16 But if you take a two-stage approach,
17 you have to ask the question ex ante: Did the
18 companies foresee that they would have to price
19 and license in this fashion in order to justify
20 their initial investment? Certainly the parties
21 in Summit and VISX did, and that's why they chose
22 the arrangement that they did.

1 By that standard the patent pooling
2 arrangement would not have been nearly as
3 suspicious or would have contained a presumption
4 of procompetitiveness. I think that's -- I think
5 we're running late, and I would like to allow
6 time for questions. So thank you very much for
7 your time.

8 (Applause.)

9 FRANCES MARSHALL: Are there any
10 questions from the panel?

11 DAVID MCGOWAN: Just speaking from a
12 sort of lawyer's point of view, an enforcement
13 point of view, one of the problems that I've
14 always thought of -- and this goes back to an
15 article that Lewis Cappler wrote a long time
16 ago -- is that if you take the financial
17 economics point of view it's very difficult to
18 estimate the revenue stream at any given point

1 proposal is to solve that problem by positing
2 that the subjective expectations of somebody
3 who's sinking costs into an investment as to what
4 conduct will be necessary to clear whatever their
5 hurdle rate is on that investment should control
6 the antitrust analysis such that if they thought
7 that this was a means of exploitation necessary
8 to cover their costs that it would follow from
9 that belief on the part of the rights holder that
10 it was legal.

11 JONATHAN PUTNAM: I'd have to say that
12 probably as a lawyer you are much more deeply
13 cynical about human behavior than I am, and your
14 point is well taken although I think at some sort
15 of fundamental level it's almost an evidentiary
16 question rather than an economics question.

17 I think that there are -- the agencies
18 routinely use their discretion to decide whether
19 pricing documents are a sham or whether they
20 actually reflect true intentions of the parties.

21 And so it seems to me what I'm really
22 asking for is not that the agencies develop a

1 whole new analysis, but that they take it one
2 step backwards in time and say what did the
3 parties think that they needed to do in order to
4 invest, not what did the parties having invested
5 and succeeded do in order to price their product,
6 because by the time you get to the product market
7 you are answering the wrong question.

8 We already have the technology. We
9 need to go back initially and say would we have
10 had the technology under this regime or not. And
11 if the answer is no, then the licensing regime
12 presumably promoted progress, and so therefore
13 it's presumptively efficient. That's obviously
14 a rebuttable of presumption.

15 But I think right now there is no need
16 for either agency to take it into account at all.
17 The investment decision is wholly irrelevant to
18 whether or not there is an illegal restraint in
19 the product market or in the licensing of the
20 intellectual property, and I just think that's
21 wrong.

22 DAVID MCGOWAN: The other thing that I

1 think about, if you made this a multiplayer thing
2 so that you had multiple potential inventors,
3 would you be able to draw any strong predictions
4 as to the desirability of a given antitrust rule
5 relative to a multiplayer game?

6 So, for example, a broad -- a grant or
7 an antitrust rule that would favor an individual
8 rights holder, would allow that rights holder to
9 cover their costs, might also deter other rights
10 holders from entering, or it might not.

11 I'm just wondering. If you add other
12 inventors in as you would do, for example, in
13 the model in which the probability of innovation
14 varies inversely with the number of people
15 competing because you are going to lose your cost
16 if it is a winner take all market, how do you fit
17 that sort of multiple dynamic into this approach?

18 As an enforcer I'd be wondering, all
19 right, if I mandate dealing that might draw in
20 new people, but then it might have an adverse
21 effect as you are talking about.

22 JONATHAN PUTNAM: It's an excellent

1 question, and I'm going to say I don't know.
2 And what I would need to know is at what point --
3 timing like this is important because the
4 question becomes, you know, are the other parties
5 competing sort of in the initial stage, or are
6 they competing once the pool is formed and they
7 are competing to generate improvements.

8 I think your answers tend to vary
9 because obviously you don't just have discrete
10 two-stage games. You have sort of end stage
11 games that are overlapping.

12 Competition in the product market
13 occurs simultaneously with innovation for the
14 next stage. And so I'd hesitate to offer a
15 general rule. It's a good question. I just
16 don't know the answer.

17 FRANCES MARSHALL: Chris, did you have
18 a question? Not obliged.

19 CHRISTOPHER KELLY: Oh, okay, if
20 I have to. John, I think the answer to your
21 rhetorical question of isn't this what patents
22 do is no.

1 If the second principle of the
2 guidelines is right, the idea that a patent does
3 not necessarily confer monopoly power or even
4 market power, then no, a patent guarantees you
5 the right to make supercompetitive rents on your
6 invention.

7 If you do happen to be the only game

1 I'm saying you need to take into
 2 account the dynamics, in particular the ex ante
 3 expectations, in deciding whether or not there
 4 has been -- there is market power and there is
 5 supercompetitive pricing. Unless you take into
 6 account expenditures on R & D, you are going to
 7 get the second stage pricing wrong.

8 CHRISTOPHER KELLY: I may be mistaken.
 9 And probably Ruth Rubiczek if she's here knows
 10 this way better than I do. But I was thinking
 11 that the guidelines themselves do contain a
 12 mandate or two to think about the impact on a

1 enforcemenclveule skewdelinan I dn R & s he,ntain a
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6 8 JONATHAN PUTNAMR KYeah. Iitwo to-- wron a
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1 I want to just hit the ball back on
2 the question of do patents raise prices because I
3 think as an economist the only responsible answer
4 to that question is yes. The only reason why you
5 invested to begin with is because you thought you
6 would make money on that investment.

7 And you obtained that patent right
8 because you thought it was going to provide you
9 with some kind of return. And the form that
10 return takes ultimately is the ability to
11 restrain somebody else from doing something that
12 would cause you to make less money than you would
13 have made otherwise.

14 So what this question really is about
15 is what's the appropriate -- the question is
16 really about what's the competitive level.
17 Obviously the competitive level cannot be what
18 you would have earned if you didn't have the
19 patent right.

20 The competitive level has to be
21 something like an appropriate return on your
22 investment versus an inappropriate return. Now,

1 I'm not -- that's a complicated question.

2 But it has to be the case that patents
3 raise prices and restrain trade by definition.
4 The question is relative to what or is it too
5 much or just enough.

6 CHRISTOPHER KELLY: Brother McGowan,
7 you look like you have the answer too.

8 DAVID MCGOWAN: No. I don't have an
9 answer. I would say one thing. From a legal
10 point of view it is true that patents have this
11 potential. They carry it out through a very
12 complex web of legal rules.

13 For example, to realize the revenue
14 that patents allow you to realize, you would hope
15 to have a contract law system. And I think
16 Professor Baxter many years ago said we don't
17 need to know a whole lot to know that a patent
18 doesn't give you the right to put a gun to
19 somebody's head to conclude a license.

20 That is a function of the surrounding
21 legal context into which the patent is inserted.
22 Antitrust is a part of that. And I think one of

1 the reasons it's difficult from a legal point of
2 view is that there is this sort of dialogue and
3 ongoing reconciliation of the goals of a wide
4 variety of legal regimes.

5 And the rate of return analysis, what
6 I call the sort of finance analysis of IP, is a
7 crucial part, and I agree very much with that.
8 And I agree with the proposition that in
9 enforcing the antitrust laws one needs to make
10 sure you don't kill the goose that laid the
11 golden egg; you don't kill innovation.

12 But it's also true that I think as a
13 social matter intellectual property rights almost
14 as a legislative and a practical presumption
15 operate within a broad legal context. And those
16 intersections are things that need attending to.
17 And I would agree with your point, your general
18 point that this should not be a binary analysis.

19 It's going to need to be context
20 specific. I think I'm a little bit more
21 optimistic about the guidelines' ability to be
22 flexible. I don't view them as necessitating a

1 sort of binary analysis.

2 But, you know, I think the trick
3 for us as lawyers and enforcers is to make all
4 of those laws work as well as possible in
5 conjunction with each other as they must. If I
6 abolish contract law tomorrow, patents are going
7 to have a radically different expected return
8 than they did today.

9

1 just the scope of what I'd be talking about which
2 was how in particular at DOJ since it just by
3 chance fell to us to look at the MPEG and two DVD
4 patent pools, how we approached that.

5 I say 1997 because that's when Joel
6 Klein gave a speech to -- a brave speech to the
7 American Intellectual Property Law Association
8 within spitting distance of The Alamo and really
9 kicked off the Division's new approach to patent
10 pools.

11 But I could just as easily say 1995
12 because that was when the IP guidelines were
13 issued. And I think you could make a decent
14 argument that once those came out everything else
15 was really just a matter of connecting the dots.
16 Let me give you a quick disclaimer. I now
17 represent Sony.

18 And as you can probably imagine, they
19 are a willing participant in two of the three
20 patent pools that the DOJ looked at. Please
21 don't blame them for anything that I say today.
22 It doesn't necessarily reflect what they think.

1 What I am going to talk about in
2 theory is differing approaches to patent pools,
3 the three pools that DOJ looked at, what those
4 pools stand for analytically, and probably most
5 importantly the issues that are still hanging out
6 here.

7 Those of you who were here this
8 morning probably have a pretty good sense at
9 least of what some of those issues are. The bad
10 old days, okay, patent pools as you heard in part
11 from Josh tended to be viewed fairly reflexively
12 by antitrust lawyers as a bad thing.

13 Line Material is one of the cases
14 that's cited for that proposition. On the other
15 hand, I think unlike Josh I tend to read Line
16 Material really as being a case about at bottom
17 resale price maintenance and in fact whether or
18 not the General Electric case from the, what,
19 1920s should be extended to this setting.

20 And in that regard I guess I view Line
21 Material as one in a series of cases in which the
22 Supreme Court has done everything it possibly

1 and I'll be glad to e-mail these to you. Here is
2 my little gripe about Line Material.

3 On the other hand, even though we tend
4 to talk about patent pools as being a long time
5 bogeyman in the antitrust lore, the fact is that
6 as long ago as 1918 the Justice Department gave
7 the thumbs up to a patent pool formed by a bunch
8 of aircraft manufacturers who viewed each other
9 as their competitors who go together under duress
10 appa5ulahgetn Secretary o thNavy Franklinss
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21 B t w th's remarkablelect is thsth leashat

1 the question of the incentives to innovate, the
2 analysis is very, very similar to what you see in
3 the more recent pool letters. And in fact you'll
4 see this pool cited in Joel Klein's speech from

1 market power are not the same patents which would
2 then be bundled into a procompetitive licensing
3 regime. I think you have two different groups
4 here.

5 And that's why those two statements
6 can stand next to ea25 ltitive licensing
9 HjreTj T*jre one,t Tj only4 here.

wi u

1 Also relevant of course is the
2 relationship of the members of the pool to each
3 other. If they are competing at some level, you
4 do want to know what the pool may do to that
5 relationship.

6 Degree of exclusivity as I suggested
7 before is important, can't really ignore it, and
8 in some cases I could imagine it being quite
9 important. But to the extent that a pool is
10 non-exclusive that sure takes a lot of heat off
11 of the analysis of other factors.

12 Maybe the most interesting question
13 posed by the pools is their effect on licensing
14 innovation. And that became most relevant in the
15 analysis of the MPEG-2 pool because of that what
16 I refer to as a constructive grant back.
17 Garrard, there's actually -- what's the name of
18 that clause?

19 GARRARD BEENEY: Yanking.

20 CHRISTOPHER KELLY: The yanking
21 clause. How could I forget? That really raised
22 some very interesting issues for us. But as

1 you know, we ultimately saw it the same way the
2 Attorney General saw things back in 1918.

3 So MPEG-2, there's the URL for it
4 if you want to click to it once you get these
5 slides. Technology for video compression,
6 originally it was just a humble little mom and
7 pop of 9 firms with 27 patents. Now it's grown
8 to 27 and 100. God bless them.

9 And it was I'd say of the three
10 patent pools the most elaborately laid out, in
11 particular what MPEG -- the MPEG-2 pool has that
12 the other pools we looked at lacks is a
13 joint licensing agent with a separate corporate
14 identity from the other members of the pool.

15 And that agent, MPEG LA, whose Baryn
16 Futa is with us here today, is contractually
17 required by virtue of its agreement with the
18 other members of the pool to grant a license to
19 all comers for use with that standard, not a
20 license for other purposes.

21 But within that standard anybody who
22 wants one is entitled to one assuming I guess

1 that its credit is good. Licenses concern both
2 hardware and software, and as we heard before the
3 members get to split the royalties once they are
4 in on a per patent basis. It's fairly strict.
5 There is no subjective element to that.

6 It's not my patent is more path
7 breaking than yours. It's you have five patents
8 and I have three in Bolivia and that's what we
9 count for dividing up royalties as to sales in
10 Bolivia. Key features, the essential patents as
11 you heard are identified by a technical expert
12 that MPEG LA retains.

13 The expert has a continuing role any
14 time a question of essentiality arises either
15 because you come to the pool with a patent which
16 you'd like to have admitted to the pool and
17 licensed through the pool or because a member who
18 is, remember, collecting its royalties on a per
19 patent, pro rata basis all of a sudden gets the
20 idea that another patent in the pool which is
21 taking money out of its pocket isn't essential.

22 At that point the member or anyone,

1 you or I, could call up Baryn and start the
2 ball rolling with a good faith assertion that
3 a particular patent is no longer or never was
4 essential. And at that point there would be the
5 review by the expert which would then be binding
6 on the pool.

7 We have talked about the constructive
8 grant back; awfully interesting feature and
9 unique to MPEG-2. We don't see that in either of
10 the DVD pools. When the Department of Justice
11 took a look at this, by far the greatest part of
12 the analysis dealt with the relationship of the
13 patents.

14 And the conclusion was that the pool
15 was very likely to be integrating complements as
16 opposed to substitutes. By making the criterion
17 for inclusion in the pool essentiality to
18 compliance with the standard, that meant that by
19 definition the patents that were covered by the
20 pool were complements.

21 There was no way that they could be
22 anything but complements if you absolutely had to

1 get access to them in order to comply with the
2 standard. You get a license from, for instance,
3 Philips on the first five MPEG patents. Well,
4 that's wonderful.

5 But in terms of complying with the
6 MPEG standard, they are worthless until you
7 get the other patents that you need. So by
8 definition by limiting the pool to essential
9 patents the expert mechanism assuming that it
10 worked right would ensure that the pool was
11 bringing complements and only complements
12 together.

13 The letter concluded that there didn't
14 seem to be any other aspects of the pool which
15 would be likely to inhibit innovation in any
16 significant way. As we mentioned before, it was
17 non-exclusive. Members could license outside
18 the standard or even outside the pool for the
19 standard.

20 I think the point is that the
21 pool, other than its positive attributes,
22 did not do anything to make members less

1 able to license independently of the pool
2 than they had been before the pool came into
3 existence.

4 Licensees aren't inhibited in any
5 particular way as to what they do once they have
6 the license to make the products in conformity
7 with the standard.

8 And the letter determined that even
9 though this constructive grant back as we call it
10 or yanking clause as Garrard calls it is pretty
11 hard bargaining with the licensees, that it
12 didn't seem to be anticompetitive on balance.

13 In fact it in some ways was a
14 nifty way as we talked about this morning of
15 identifying innovators to whom the creation of
16 the pool and the support of the standard were
17 really valuable, and made the pool or put the
18 poll in a position to extract a little more from
19 those folks while still keeping the basic license
20 low or at some lower level to other -- a broader
21 range of licensees.

22 So on balance it looked to us like

1 there was a good chance that this in fact was
2 procompetitive price discrimination and was the
3 kind of thing that we shouldn't get in the way of
4 especially at this stage of things. DVD, as you
5 know, is digital versatile disc, not video.

6 These letters dealt with the standard
7 for DVD ROM and DVD video for which there are not
8 any kind of meaningful competition. You may know
9 that there are several standards out there or
10 potential standards, candidate standards with
11 regard to recordable DVD formats. And it will be
12 interesting to see what happens with that.

13 But here we have the DVD formats for
14 which there was an agreement that everybody could
15 sign on to. But there wasn't just a single pool.
16 There were two of them. If one pool is good, why
17 wouldn't two be better? We had Philips, Sony,
18 and Pioneer.

19 Actually now I say Sony, Philips,
20 Pioneer, but I forgot to change this around since
21 joining my new firm. As you can see, they had a
22 whole lot of patents, none of this MPEG stuff

1 with 27 or so. We have a lot. And then we had
2 Toshiba and Time Warner with quite a few of their
3 own.

4 And obviously from one standpoint if
5 you were designing the world, if you were the
6 philosopher queen you would want them to form
7 one pool.

8 But as we heard I think from David
9 earlier today and maybe from others as well, the
10 real question I think with the analysis of these
11 pools is do they make things better, not do they
12 make things as good as you would like them to be.
13 It's do they make them better or do they make
14 them worse.

15 Here even though two pools might not
16 be as good as one, it is certainly better than a
17 world in which each of these licensees was off by
18 itself and had to be dealt with individually
19 by -- excuse me. I said licensees. I meant
20 licensors. Licensors was off by itself and had
21 to be dealt with individually by each licensee.

22 That was I think a largely unspoken

1 premise in MPEG-2 where you didn't have the ugly
2 spectre of two separate patent pools. But at the
3 same time it was quite clear that the MPEG-2 pool
4 did not necessarily include all the patents that
5 you would need in order to comply with the MPEG
6 standard.

7 Nor does it even now I would guess.
8 Or have you got the waterfront covered now?
9 Still got to go elsewhere?

10 GARRARD Ball the pTT MPEG-2 pool

1 agreed with the licensing agent how things were
2 going to be.

3 Philips negotiated deals with Sony and
4 Pioneer to be -- to license on their behalf. If
5 I remember right, there's not an agreement that
6 would be between, say, Sony and Pioneer. It all
7 extends out from Philips.

8 Perhaps the other significant
9 difference between DVD and MPEG is that there's a
10 slightly greater degree of subjectivity in the
11 criterion as to essentiality. And as a practical
12 matter it may end up not being important. But
13 because it was there on paper, it had to be dealt
14 with.

15 And it's this criterion which says
16 necessary (as a practical matter) for compliance.
17 Well, what is as a practical matter? Very hard
18 to say. But I think where we came out was that
19 at the end of the day the way this standard was
20 going to be applied was quite likely going to be
21 virtually the same as that for MPEG-2.

22 There was also some question about the

1 robustness of the independent expert mechanism.
2 Here the expert was retained directly by Philips,
3 one of the IP owners, as opposed to MPEG LA in
4 the MPEG situation. And that's the degree to
5 which the expert was insulated from influence by
6 Philips and the other patentees was an issue.

7 Ultimately though the letter concluded
8 that the independent expert was sufficiently
9 robust a mechanism that we could be reasonably
10 certain that it would be all right. As you can
11 see, non-exclusivity, here the royalties though
12 were allocated not on a per patent basis but on a
13 negotiated basis.

14 Philips and Sony agreed what Sony's
15 cut would be. Philips and Pioneer agreed what
16 Pioneer's cut would be. And so there's not this
17 per patent mechanism which did in the MPEG
18 situation create an incentive for each member of
19 the pool to keep an eye out for other people with
20 non-essential patents in the pool.

21 Here Sony could complain about a
22 Philips patent being non-essential and could get

1 it ejected through the mechanism of the expert,
2 but it wouldn't have any impact necessarily on
3 its cut of the royalties. So you lose that --
4 you do lose that incentive. No constructive
5 grant back, as I mentioned. Okay.

6 Since we issued a positive letter you
7 can guess what it said, right? Pool combines
8 complements. A little bit of churlish griping
9 about the flawed expert mechanism. But at the
10 end of the day the letter concluded that it was
11 reasonably likely to limit eligibility to
12 essential patents.

13 And again no other indicia that would
14 suggest that the pool would limit competition
15 among the other folks. I told you Time Warner
16 was very much a similar situation, raised the
17 subjectivity issue to some extent. There was
18 some question about the expert mechanism again.

19 As you can tell, we were a little bit
20 more sensitive about that issue by this time than
21 we were in looking at the MPEG letter. Our
22 mantra became independent of what; independent of

1 what. Unfortunately it's very difficult to come
2 up with an expert mechanism that is utterly
3 independent.

4 Unless and until some very wealthy
5 person endows a foundation whose sole purpose
6 will be to determine essentiality of patents to
7 standards and then pools decide unilaterally to
8 rely on that stuff, you're going to have quite
9 likely an expert that's being compensated by
10 the pool organization to make these calls.

11 So it is a very difficult thing to
12 get around, but at any rate pretty much the same
13 analysis although the Toshiba-Time Warner pool
14 was sufficiently altruistic that, by God, its
15 members are obligated to offer patents
16 independently of the pool.

17 They are not merely free to offer
18 patents independently of the pool; they have to.
19 So it seems like an energetic way of dealing with
20 that issue. Let me skip real quickly. And you
21 all know about this one so -- oh, my God. We
22 will be here 15 just waiting for this one to end.

1 Let's see if page down will do
2 something about this. And it's not even that
3 good of a slide. What they stand for, yes. As
4 you can guess from the discussion this morning,
5 complementary is really, really where it's at in
6 these letters.

7 And so if it turns out that
8 complementarity is not necessarily what is key to
9 the benefits of patent pools, then these letters
10 have a little problem.

11 As I said, one unresolved issue is how
12 are you ever going to get yourself satisfied that
13 you have a truly bullet proof mechanism for
14 determining essentiality or as I would say
15 ultimately complementarity.

16 And how much can antitrust enforcers
17 or plaintiffs or Courts realistically ask of a
18 pool when they put something like that together?

19 Ordinarily when people enter into a
20 transaction of any kind we start -- we don't ask
21 everybody who enters into a joint venture or a
22 contract to hire an independent expert to make a

1 determination that they are in a complementary
2 relationship with each other.

3 We just start with the idea that
4 people tend to enter into contracts because they
5 have complementary resources they want to bring

1 Then the question is, is that so bad.

2 If what you have is an exclusive
3 cross-license, I still think you have -- that
4 just tells you what it is you are looking at and
5 to what you are applying the rule of reason.

6 And again if the touchstone for the
7 analysis is the world prior to the creation of
8 this entity whether it's a pool or cross-license,
9 the question is are we better or worse off
10 without it. And I would guess that in a lot of
11 cases the answer is going to be, well, we might
12 well be better off.

13 Finally as I said, you can tell
14 there's quite a bit of interest in the question
15 of how important complementarity is. One thing
16 to look at I guess on this point might be the
17 copyright societies. We've been talking all
18 about patent pools.

19 But a lot of what, say, an ASCAP or
20 a BMI does is somewhat similar to what we are
21 talking about with patent pools. One difference
22 is that I think with ASCAP or BMI there is a

1 greater sense that overall what they are doing
2 is combining complements.

3 That certainly seems to be what drives
4 things like the Supreme Court's BMI decision.
5 But on the other hand, the antitrust scrutiny
6 that has shadowed these societies over the
7 decades is I think premised in large part on
8 the sense that in some way they also combine
9 substitutes, that different love songs compete
10 against each other in certain circumstances.

11 As you know, in those -- in the case
12 of those societies non-exclusivity is quite
13 important. It's a deal breaker. And so that may
14 be what we would be thinking about if we got
15 towards a regime where we had -- where we could
16 contemplate patent pools that did not necessarily
17 convey complements.

18 On that point I just want to point you
19 to this one business review letter from the Japan
20 Fair Trade Commission which seems directly to
21 take on a joint patent licensing mechanism which
22 by definition appears to encompass technologies

1 which compete with each other. Might be well
2 worth a look if you are interested in the topic.
3 Let me leave it there. Thank you.

4 FRANCES MARSHALL: Thank you, Chris.
5 Garrard Beeney is now going to talk about pools
6 as a solution to these thickets of patents and
7 I think also how the agencies might refine the
8 rules that have emerged from our DOJ letters.

9 I'd just like to remind our panelists
10 that we have a limited amount of time, and we'd
11 like to get to some discussion time. So if you
12 can limit your presentations to your 15 minutes,
13 that will give us some time to talk. Thank you.
14 It wasn't just you, Chris.

15 MARY SULLIVAN: It was just that one
16 troublesome slide.

17 GARRARD BEENEY: Let me begin by doing
18 two things. First in the three or four answers
19 I gave to Chris during his presentation I think
20 only one of them was wrong. There are actually
21 21 licensors in the MPEG-2 pool, not 27. But
22 they do license 100 patent families.

1 Second I want to thank the Commission
2 and the Division for the opportunity to
3 contribute to these very worthwhile proceedings.

4 I think finding the right interplay
5 between antitrust and intellectual property law
6 will be critical to the ability of innovative
7 companies to invent and consumers to reap the
8 benefit of new technology and sophisticated
9 products.

10 As you may know, it was my privilege
11 to work with some very talented people, Frances,
12 Ruth, and even Chris here before he joined the
13 dark side, on two of the three principal business
14 review letters which address a significant
15 portion of today's topics, patents and
16 intellectual property pools.

17 Today I'd like to suggest to you that
18 those letters which contain I believe a careful
19 and thorough analysis of the competition issues
20 raised by intellectual property pools have
21 withstood the test of time.

22 While experiences with pools over the

1 last several years may require additional thought
2 and refinement of the three letters' analysis
3 at the margins, the basic message those letters
4 convey regarding the agency's enforcement
5 decisions should remain unchanged. This
6 afternoon I'd like to address a few of those
7 issues which may require refinement.

8 But before doing so I'd like to
9 briefly address the role of intellectual property
10 pools in today's economy. No one can seriously
11 dispute the increasing high cost of research and
12 development. Billions of dollars are spent each
13 year on research.

14 Indeed private research and
15 development has grown at a formidable 17 percent
16 rate from 1995 to 2000, exceeding \$200 billion by
17 the end of the decade.

18 The high cost of R & D and the
19 increasing need in a global competitive economy
20 to reduce development costs and reduce risks that
21 develop initiatives that lead to marketable
22 products has led to at least two significant

1 developments:

1 Indeed the 1995 guidelines that
2 we've discussed today talk about the fact
3 that intellectual property pools may provide
4 procompetitive benefits by integrating
5 complementary technologies, reducing transaction
6 costs, clearing blocking positions, and avoiding
7 costly infringement litigation.

8 Thus I think it is important to start
9 by emphasizing that in an appropriate forum pools
10 are good. As Professor Gilbert said again at an
11 earlier hearing, licensing is a good thing; we
12 would like to have more of it, not less of it.

13 Therefore I respectfully submit that
14 the question for today is not patent pools yes
15 or no, but how to balance the measures necessary
16 to licensors and licensees alike with rules
17 intended to minimize any harm to competition
18 or innovation.

19 In the paper that I submitted for
20 these hearings I suggested nine concepts,
21 characteristics of a pool, that absent unusual
22 circumstances will drastically increase

1 confidence that a particular pool is
2 procompetitive and further suggested that with
3 refinement these nine concepts could be developed
4 into a safe harbor for intellectual property
5 pools to guide the marketplace.

6 Many of these nine concepts I believe
7 come from the business regulators and the
8 intellectual property guidelines that are not
9 controversial: a defined field of use in the
10 license, certain characteristics of grant
11 backs, freedom of use and development on the
12 part of licensors and licensees alike,
13 non-discrimination, the safeguarding of
14 competitively sensitive information learned in
15 the licensing process, and the non-exclusive
16 nature of pools as a source for individually
17 owned intellectual property.

18 But today I'd like to concentrate on
19 two of the nine concepts which might create a bit
20 more controversy as they expand on the limits
21 suggested by the Division's business review
22 letters: first, permitting intellectual property

1 in a pool which may in fact be substitutes and,
2 second, permitting inclusion under limited
3 circumstances of non-essential intellectual
4 property in the pool license.

5 In evaluating the competitive
6 effects of a pool a question of unparalleled
7 significance, as Chris suggested, is what's being
8 licensed; what's swimming in the pool, if you
9 will.

10 I take no issue with the Commission's
11 complaint in VISX as it was pleaded to the
12 extent that it challenged placing in a pool an
13 amalgamation of patents that were in effect pure
14 substitutes for the only two approved methods for
15 PRK eye surgery.

16 Pooling there arguably alludes to
17 eliminating competition between two competitive
18 packages of intellectual property rights can be
19 an anticompetitive agreement restricting price
20 competition.

21 On the other hand, I do depart in
22 some minor respects from the Division's business

1 review letter analysis and suggest that not all
2 intellectual property rights licensed in a pool
3 must be pure complements for the pool to be
4 procompetitive.

5 Substitutes should be permitted in a
6 pool when, one, at least one of the substitutes
7 is necessary to produce the downstream product or
8 follow the standard specified in the license but,
9 two, the substitute IP is not sufficient to
10 produce the downstream product or follow the
11 standard but other intellectual property is
12 required and is offered by the license.

13 Now, why on balance is this
14 procompetitive? Basically because of the way
15 standards or processes are defined. In attempts
16 to create open standards or less restrictive
17 protocols for products there may be manufacturing
18 steps, calculations or processes which must be
19 accomplished but which may be accomplished in
20 more than one way.

21 The step to be performed may be
22 essential, like crossing water on a journey to

1 Europe, but there may be different ways of
2 getting there, plane or boat. I have heard this
3 referred to as mandatory options. The IEEE 1394
4 standard for high speed data transfer is an
5 example.

6 By way of illustration assume with me
7 the following. We're evaluating an intellectual
8 property pool in which the downstream product is
9 defined as a dedicated integrated circuit with
10 defined specifications. To function the circuit
11 must receive electrical signals within defined
12 parameters.

13 The acquired signal to the circuit can
14 be delivered in three different ways, each of
15 which is covered by a single patent which is not
16 infringed by the other two alternative methods.

17 Thus A owns a patent on method A which
18 does not infringe method B or C. B owns a patent

1 methods of delivering electrical signals within
 2 defined parameters. If that were the licensed
 3 field of use, under the Commission's I believe
 4 quite appropriate analysis in VISX such a pool
 5 should be challenged.

6 On the other hand, if the licensed
 7 field of use is the integrated circuit and a
 8 method of signal delivery is only part of
 9 that product, the fact that there are three
 10 alternatives for the signal delivery give rise
 11 to the three alternative rules for the integrated
 12 circuit pool.

13 First, inclusion of any of the
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1 product described in the licensed field of use,
2 allowing complements is procompetitive and
3 unlikely to attract an effort to fix prices.

4 Indeed a further step could be
5 taken to safeguard against such behavior. The
6 complement rule could also require that royalties
7 attributed to competitive intellectual property
8 be distributed to the patent holders in
9 proportion to the actual use by licensees of the
10 competitive intellectual property permitted in
11 the pool.

12 For example and again using our
13 hypothetical integrated circuit pool, we could
14 require that royalties are distributed to A, B,
15 or C based on the actual use of A, B, or C's
16 solution. This can be done by several methods.

17 First, we could require licensees to
18 report which type of chip they produced if doing
19 so didn't dramatically increase transaction
20 costs. Second, you could try to get market
21 statistics as to which types of chips are being
22 produced, A, B, or C.

1 Third, you could hire some independent
2 expert to try to make the calculation. Or there
3 are other ways in which you can come to a
4 reasonable division of royalties among A, B, or C
5 to ensure that they only receive royalties only
6 when their patents are actually used.

7 The second expansion of the business
8 review analysis I would like to suggest concerns
9 the issue of essentiality. Several issues are
10 obviously raised by a discussion of essentiality.
11 For example, how is it defined and once defined
12 who determines whether IP is essential.

13 This afternoon however I'd like to
14 focus on whether all IP in the pool need be
15 essential and suggest that again under carefully
16 defined circumstances a pool should be permitted
17 to license certain non-essential intellectual
18 property.

19 Licensor should be entitled to offer
20 licensees a non-assert agreement on non-essential
21 intellectual property. But the agreement not to
22 assert should also be limited to the use of that

1 non-essential intellectual property to the same
2 field of use as the license for the essential
3 intellectual property.

4 This condition would avoid any
5 spillover effect into other markets. There are
6 several reasons why permitting a non-assert does
7 not run afoul of the concerns expressed in the
8 guidelines or the business review letters.

9 First, I know of no situation in
10 which a licensee paying a royalty to a pool for
11 essential intellectual property has then been
12 targeted by a pool licensor to pay additional
13 royalties on the same product for infringing
14 non-essential patents.

15 Thus permitting the non-assertion in
16 the pool

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1 is doing is generally not a compelling rule
2 of reason defense, permitting the offer of
3 non-assertion agreements in pool licenses is
4 justified because doing so is procompetitive.

5 The typical analysis supporting a
6 rule which excludes non-essential intellectual
7 property from the pool is based on principles of
8 tying. If licensors are going to license all
9 the intellectual property in a pool only as a
10 package, then the licensee should need a license
11 under all the patents.

12 That is, all patents should be
13 essential to the field of use. That base of
14 the concern is that purchasers or licensees
15 not be burdened with the cost of products or
16 intellectual property they neither desire nor
17 need and that market power in one product not
18 be used to foreclose competition in another.

19 While this analysis is sound when
20 applied to widgets, I would like to suggest
21 that it may not have as much applicability when
22 applied to intellectual property basically

1 because while intellectual property is a form of
2 property it is different in several respects from
3 real property.

4 The distinction I would like to focus
5 on today is the fact that generally as a matter
6 of economics the incremental cost to a licensor
7 of adding additional intellectual property to a
8 pool is zero.

9 And even if you were to hypothesize
10 opportunity costs for licensing the intellectual
11 property in the pool context, even those
12 hypothetical costs are zero because licensors
13 typically do not offer additional licenses on
14 non-essential patents that are covered by the
15 pool field of use.

16 Thus there is no reason to presume in
17 the pool context that royalties would be higher
18 because of the inclusion of non-essential
19 property which generally costs the licensee
20 nothing.

21 Thus by allowing licensors to offer
22 non-assertion agreements the pool license becomes

1 more transparent, what generally is implicit in
2 the marketplace becomes explicit, licensees are
3 given greater certainty of their freedom to
4 manufacture and compete by offering different
5 implementations of the defined product without
6 fear of additional claimed royalties, and few if
7 any legitimate competitions are raised.

8 As I suggested earlier, the question
9 is not whether to permit or forbid the formation
10 of patent pools but rather to identify those
11 licensing practices that advance the undeniable
12 procompetitive aspects of pool licensing without
13 causing unjustifiable or countervailing
14 competitive concerns.

15 As Chairman Muris stated at the
16 February 6th hearing when these proceedings
17 began, intellectual property antitrust laws both
18 seek to promote innovation and enhance consumer
19 welfare.

20 These sentiments were shared by
21 Assistant Attorney General James who observed
22 that intellectual property and antitrust law

1 share the common purpose of promoting dynamic
2 competition and thereby enhancing consumer
3 welfare.

4 The goals of intellectual property and
5 antitrust law can be harmonized with respect to
6 patent pools. And I hope that you find some of
7 these concepts discussed today helpful in that
8 goal. Thank you very much.

9 (Applause.)

10 FRANCES MARSHALL: Thank you, Garrard.

1 Antitrust Division and the Federal Trade
2 Commission for inviting me to participate and
3 for their cooperation over the last few months
4 in connection with these hearings.

5 I don't have slides today, but you can
6 find what I'm saying sort of between the lines
7 in my paper. I would like to emphasize at the
8 outset that I'm here as an individual, not on
9 behalf of any client. The views expressed do not
10 necessarily reflect those of clients or of other
11 attorneys in my firm.

12 They are based on my years of
13 experience at the Federal Trade Commission and
14 more recently counseling clients in private
15 practice and focus on some of the practical
16 effects here from that perspective.

17 I do chair the ABA antitrust selection
18 intellectual property committee. As Bob Potter
19 noted, the ABA has been active in addressing the
20 subject of this whole set of hearings furthering
21 public policy debates through programs,
22 publications, on-line discussion.

1 But again the record should be clear
2 I'm testifying as an individual, and I'm not here
3 today on behalf of the ABA. Turning to the topic
4 before us, Frances suggests that my testimony
5 will provide a critique of the Department of
6 Justice business review letters.

7 To the contrary from my perspective I
8 believe the Department and the FTC have in recent
9 years provided much useful guidance to businesses
10 and their counselors with respect to antitrust
11 rules for patents.

12 We now all regularly look -- luckily
13 we're able to ignore much of that old Supreme
14 Court case law and focus in on the '95
15 IP guidelines, the DOJ business review letters,
16 and the agency enforcement actions such as the
17 Summit/VISX case which I think if we all ignore
18 the facts and just look at what the complaint
19 says actually has some logic to it.

20 My testimony summarizes current
21 governing legal principles. But since I'm up
22 here following both Chris and Garrard, I'll

1 focus only on the practical issues that I've seen
2 arising in applying those current principles.

3 My bottom line is I believe further
4 clarification of enforcement policy may be useful
5 in some of these areas and enforcement actions
6 may be warranted in others.

7 The business review letters like the
8 '95 guidelines start by and explicitly recognize
9 that patent pools may provide competitive
10 benefits by promoting the dissemination of
11 technology. The business review letters identify
12 potential competitive concerns in three different
13 areas.

14 I think Chris Kelly in his current
15 position is only focusing on areas one and three
16 and largely ignoring two. But the actual letters
17 I think focus on, one, limiting competition among
18 intellectual property rights within the pool;
19 two, among downstream products incorporating the
20 pooled patents; and three, in innovation among
21 parties to the pool.

22 To prevent such concerns the opinion

1 letters set forth a road map of practices that
2 minimize antitrust risks. I count six
3 limitations which require patent owners, one, to
4 limit patents to pools essential to implementing
5 the standard;

6 Two, ensure royalties are small
7 relative to the total cost of manufacturing
8 downstream products -- we haven't heard
9 much about that -- three, license on a
10 non-discriminatory basis to all interested
11 persons; allow each patent holder to license
12 its patents outside the pool;

13 Limit access to competitively
14 sensitive proprietary information; and avoid
15 grant back provisions that limit incentives to
16 innovate.

17 It's already been said that the pool
18 presents the greatest risk of harming competition
19 when it's comprised of patents defined to be
20 competing or substitutes rather than blocking or
21 complementary. The business review letters
22 address this concern by requiring pooled patents

1 be essential as opposed to merely advantageous.

2 Much of the analysis in the three
3 letters addressed the specific essentiality
4 standard applied which is technically essential
5 in one pool, necessary as a practical matter for
6 which existing alternatives are economically
7 unfeasible in the second, and no realistic
8 alternative in the third, interpreted to mean
9 economically feasible.

10 Several practical issues arise in
11 implementing the rule. The first one -- and I
12 think this follows some of what Josh Newberg was
13 saying. The business review letters state that
14 a fundamental premise in the analysis is that
15 patents to be licensed are valid since a
16 licensing scheme premised on invalid intellectual
17 property will not withstand antitrust scrutiny.

18 More generally the IP guidelines
19 require businessmen to make analyses based upon
20 conclusions whether patents are valid and would
21 be infringed in the absence of the licenseld
aying. Te

1 substitutes or unrelated.

2 Such conclusions actually ought to be
3 made, my IP friends tell me, based on specific
4 claims in patents rather than patents as a whole.
5 Moreover, definitive conclusions can often be
6 made with respect to those issues only after
7 years of litigation.

8 In practice business decisions must
9 be made in a world of uncertainty. It seems to
10 me that conduct ought to be lawful if business
11 decisions are made based on reasonable judgments
12 reached in good faith.

13 Companies shouldn't face treble
14 damages if a patent thought to be valid turns out
15 to be invalid or a conclusion that a patent is
16 blocking is ultimately proven wrong. That is,
17 you make decisions in a world of uncertainty. Of
18 course in the end that uncertainty might turn out
19 to go the wrong way.

20 On the other side of the equation
21 firms that take licenses to patent pools ought to
22 have a mechanism to bring relevant information

1 portfolio and which Will, Tom, and Josh Newberg
2 address in one of their articles.

3 A further issue is raised as to the
4 meaning of essentiality where some patents may be
5 technically essential to implement a standard but
6 are not essential as a practical matter for
7 certain potential licensees.

8 Current practice for at least
9 some pools appears to be to insist that all
10 prospective licensees take a license to the
11 pool's entire patent portfolio. The effect is to
12 condition a license to some patents to a license
13 to others.

14 Such mandatory package licensing

1 royalties when such firm only needs a portion
2 of the patents in a pool, there will be little
3 incentive to improve upon the standard.

4 Turning to the second concern, patent
5 pooling arrangements may affect competition not
6 only in technology markets but also in related
7 downstream markets that use the pooled
8 technologies as inputs.

9 I read the business review letters as
10 approving the MPEG and DVD pools with limitations
11 aimed at ensuring they would not foreclose
12 competition in downstream markets. First, DOJ
13 noted in each case the agreed royalty was a "tiny
14 fraction" of the downstream products or "small
15 relative to the total cost of manufacturing."

16 The parties made clear representations
17 that royalties would be reasonable. Second, DOJ
18 emphasized that each proposed pool would enhance
19 rather than limit access to essential patents by
20 requiring licensing on a non-discriminatory basis
21 to all interested parties prohibiting
22 disadvantageous terms on competitors.

1 Several issues -- practical issues are
2 raised by this analysis. First is the question
3 what is a reasonable royalty. While intuitively
4 a royalty of less than a few percentage points
5 may seem small, some standard is needed to guide
6 business officials. Closely related is what
7 happens over time.

8 The problem is that a royalty that
9 appears small originally may grow to be
10 significant over time as costs of producing
11 downstream products fall.

12 In order to be considered small
13 parties should perhaps be required to charge a
14 percentage royalty or at least have a percentage
15 cap that can't grow to be significant over time.
16 In addition, further clarification is essential
17 as to permissible discrimination.

18 The DVD pools appear to have narrowed
19 their representations limiting discrimination
20 without comment from the Department of Justice
21 in the DOJ business review letters at least as
22 compared to the MPEG pool. The MPEG letter said

1 that the pool would provide, quote, the same
2 terms and conditions to all licensees.

3 On the other hand, the DVD pools
4 promise only the benefit of any lower royalty
5 rate granted licensees under otherwise similar
6 and substantially the same conditions.

7 In practice the DVD pools are now
8 in fact offering different royalty rates to
9 different licensees depending upon when
10 prospective licensees sign their licenses. Even
11 when offering the same royalties, the DVD pools
12 are offering different terms to different
13 licensees.

14 Given the potential for significant
15 differences in effective price through non-price
16 terms, such discrimination has the potential to
17 swallow the prohibition. On the other hand, some
18 discrimination may be appropriate when firms use
19 pools of technology in different applications.

20 Indeed the DOJ business review letters
21 without comment allow the DVD pools to charge
22 different royalties, produce DVD hardware, and to

1 produce DVD disks.

2 It might be appropriate to allow
3 different royalty rates to be charged to firms
4 selling stand alone DVD players to be used
5 with televisions as compared to firms selling
6 computers with DVD drives at least so long as
7 the conclusion is reached that those downstream
8 products don't compete.

9 Firms producing competing products
10 should be treated similarly to prevent the pools
11 from being used to foreclose downstream
12 competition. Perhaps most significant, news
13 reports suggest that there are situations where
14 pool members have a license to pool technology at
15 zero royalty.

16 That is, discriminatory royalties are
17 being charged to similarly situated firms that
18 compete in downstream markets. The combined
19 impact of a substantial royalty and this
20 discrimination seems to undermine the theoretical
21 justification for patent pooling, the
22 dissemination of technology.

1 That is, such a pool is no longer an
2 efficient method of disseminating intellectual
3 property rights to would be users. It may
4 instead be a de facto exclusive agreement to
5 limit licensing and stop competition.

6 The preferred approach approved in the
7 MPEG business review letters is to require each
8 pool member to pay royalties to an independent
9 administrator and receive its share of royalties
10 in a lump sum distribution. Finally we've

1 non-discriminatory terms. In each case however
2 the scope of the grant back was commensurate with
3 that of the pool and considered so narrow that it
4 would not discourage innovation.

5 The letters also focus attention on
6 termination rights that allow withdrawal from a
7 particular licensee's portfolio license if the
8 licensees sue for infringement and refuse to
9 grant a license on fair and reasonable terms.

10 In recent years standards agreements
11 and patent pools with broad grant back provisions
12 and termination rights have proliferated.
13 Promoters of these provisions argue that they
14 lead to broad cross-licensing and are therefore
15 efficient.

16 I am aware of agreements that
17 automatically terminate a party's license if
18 a licensee initiates any infringement action
19 against any other licensee.

20 Notably such provisions cover entirely
21 unrelated technology, cover future as well as
22 present patents, cover non-essential as well as

1 essential patents, and provide for termination
2 regardless of the other firms' willingness to
3 grant a license on reasonable terms.

4 Lack of enforcement in such cases
5 sends a mixed message to the business community
6 as to what is allowable in this area.

7 My bottom line again, further guidance
8 on all of these practical issues through revised
9 guidelines, additional business review letters,
10 and enforcement actions would give a clearer road
11 map to intellectual property owners considering
12 forming pools and to businesses negotiating

1 complements, blocking, and substitutes, and what
2 we mean by these things.

3 I was wondering if there was
4 anyone who would like to take a crack at those
5 definitions. And I'm actually going to totally
6 reverse myself. I'm sorry.

7 I had set up that James Kulbaski was
8 going to be our lead-off commentator on these
9 presentations. Let's go to that, and then we can
10 get to some of these other issues. I'm sorry.

11 JAMES KULBASKI: Real quickly, I have
12 already prepared some written testimony that is
13 posted on the internet which reflects my views on
14 these topics. Those are my personal views and
15 not necessarily the views of any client or my
16 firm.

17 One point that a lot of the speakers
18 have touched upon but not really gotten into
19 is the business realities of some of these
20 situations and really the practical issues.

21 Sort of slightly changing the topic,
22 looking at consumer electronic companies most of

1 them are losing money on the particular products
2 covered by the patent pools at issue, MPEG-2,
3 DVD. There are really not a lot of high profit
4 items.

5 And the question is if they are losing
6 money selling these products or not making money
7 on products covered by the patents, then why
8 would a company continue to innovate and develop
9 products?

10 And I think that's really the key
11 here, that patent pools should not only provide
12 an efficient way for the licensees to receive the
13 technology, but the licensors should be able to
14 reasonably recover their investment in the
15 technology.

16 A specific example: a new company
17 came out selling DVD players last fall which
18 greatly undercut the market and basically was
19 selling DVD products at half of the price of the
20 major companies that developed the technology.

21 And without an efficient way to
22 collect royalties on those issues there is really

1 no way for the companies to continue to innovate.

2 And while the specific situation I'm
3 talking about there was not -- the company was
4 initially not paying royalties to any patent
5 pool, I think the patent pools as they apply to
6 DVDs will greatly help out that situation.

7 With regard to some of the other
8 issues, Chris Kelly talked about an independent
9 expert and some of the potential issues with that
10 and how independent really is the expert. And,
11 you know, he has to get paid by somebody, and
12 what is the standard for determining
13 essentiality.

14 I have developed a practice of working
15 with independent experts and trying to have
16 patents considered to be essential into these
17 patent pools. And my experience has been that
18 it's a very tough road to follow. The current
19 experts involved are very stringent in enforcing
20 the guidelines in trying to have a patent.

21 The ultimate decision as to whether
22 a patent is accepted to be essential is in

1 my experience being properly and strictly
2 implemented.

3 And despite the fact that the money
4 has to come from somewhere, I think that if the
5 evaluator was not being fair in just letting in

1 within the DOJ letters.

2 The practical implementation,
3 it is pretty much the same. And it is being
4 properly -- you know, the gatekeeper is existing
5 and that system's working.

6 FRANCES MARSHALL: Do you find that
7 when you are trying to get different patents
8 accepted into the different pools that your
9 arguments on essentiality differ based on the
10 standard?

11 JAMES KULBASKI: Not at all.
12 Basically the argument made to the evaluator
13 would be as if a standard patent infringement
14 test, as set forth in the Markman case first, the
15 claims have to be interpreted. And then you see
16 if the standard reads on the properly interpreted
17 claims.

18 And for the most part there is not a
19 lot of variation of essentiality. The question
20 is what -- you know, is what is recited in the
21 claims necessary to practice the standard.

22 And, you know, you could word

1 essentiality and define it in various ways. But
2 for most practical purposes is it necessary is
3 the same for most of the pools.

4 FRANCES MARSHALL: Garrard, this sort
5 of brings me back to your two points. You talked
6 both about loosening the standard somewhat so
7 that you might have some substitute patents in a
8 pool as well as complements. And I'd like to get
9 back to that topic.

10 But you also talked about it is not
11 necessary that all the patents be essential. I'm
12 wondering if you can explain to us how those two
13 things are related or unrelated.

14 It seems to me that if the patent
15 is essential to the standard to which it is
16 being compared then that is in and of itself a
17 definition of complementarity. Is that not true?

18 GARRARD BEENEY: I think that's true,
19 but I do think that there is some difference in
20 the concepts. I think that you can have patents
21 that are not essential to the standard but that
22 are nevertheless complements.

1 And I also think that you can have
2 patents that are essential -- that are not
3 essential that are substitutes obviously. So I
4 think the two concepts are somewhat different.

5 The way I look at essentiality is
6 very much the way it's been discussed I think,
7 which is that whether you take into account the
8 practicalities of the cost of production and the
9 cost of designing around particular claims in a
10 patent, basically the issue of essentiality is
11 can you produce the product or comply with the
12 standard that's defined by the licensed field of
13 use without infringing a claim of the patent.

14 And if you can, the patent's not
15 essential. If you can't, the patent is
16 essential. Complements I think of in terms
17 somewhat different, and that is that the
18 amalgamation of the rights increases the
19 value over and above the thing individually.

20 And I don't think that they
21 necessarily all have to be essential to the field
22 of use in the license in order to be thought of

1 CHRISTOPHER KELLY: No.

2 GARRARD BEENEY: I think in at least
3 one situation -- you know, in some standards as
4 I mentioned as I was trying to race through my
5 presentation, in some standards there are various
6 ways of doing something, but you've got to do it.

7 And in those situations each one of
8 those patents provides an access to an essential
9 element of the field of use, the standard. On
10 the other hand, they are not complements. They
11 may be pure substitutes.

12 FRANCES MARSHALL: Jeff?

13 JEFFERY FROMM: When the Department
14 was doing the original business review letters,
15 did they ever consider -- I'm a patent attorney.

16 So it kind of bothers me to talk about
17 essential patents as if patents are essential.
18 Of course they're not because it's only the
19 claims we're really concerned about, and that
20 most patents, perhaps the strong majority as
21 Howard alluded to, include claims that in fact
22 are not essential.

1 Did the Department ever consider the
2 issue of essential claims versus patents either
3 in the foregoing grants or in the grant back
4 provisions?

5 CHRISTOPHER KELLY: My sense was that
6 the analysis was geared to claims rather than
7 simply patents as such.

8 JEFFERY FROMM: But the review letter
9 of course only talks about patents.

10 CHRISTOPHER KELLY: If so, that's
11 the danger of having antitrust lawyers write
12 about patents. If that's right, then that's an
13 imprecision which is unfortunate, although I
14 would think that most people read it to refer --
15 to mean claims rather than patents, divorced from
16 the claims that they include.

17 JEFFERY FROMM: Well, I would never do
18 that. I mean certainly the license grants that
19 are granted underneath -- you know, in response
20 to the business review letters certainly talk
21 about patents. They don't talk about patent
22 claims. There is no mention of claims in them.

1 They talk about patents.

2 CHRISTOPHER KELLY: I think licenses
3 are granted in terms of patents, right, not in
4 terms of claim?

5 JEFFERY FROMM: No. I mean that's
6 how the Department considers it. I mean many
7 parties -- over there tomorrow you're going
8 to talk about standards. The standards
9 organizations have evolved.

10 They talk about claims. They don't
11 talk about patents anymore because patents may
12 of course include claims that have nothing to do
13 with the standard. And they certainly understood
14 that that's the real world.

15 GARRARD BEENEY: But it's really --
16 some pools that I'm familiar with license
17 patents. Other pools that I'm familiar with
18 license claims.

19 But if you are a licensee and from
20 a competitive analysis and you must be licensed
21 under a particular claim of a patent and a
22 license is restricted to a field of use, the fact

1 that you may be licensed on other claims that
2 have no bearing on the field of use is completely
3 immaterial because you can't use the license that
4 you have under those claims because your license
5 is restricted to a field of use.

6 So whether the Division uses patents
7 or claims makes no difference because, as I say,
8 if you have a license under claims restricted to
9 a field of use for which you cannot use that
10 license for those claims, it doesn't make any
11 difference.

12 JEFFERY FROMM: Read the contracts
13 under which the licenses are granted. I agree in
14 theory with what you just said, that if the field
15 were restricted and the grant back field were
16 similarly clearly restricted, there would be no
17 problem. But of course there is imprecision in
18 that process.

19 FRANCES MARSHALL: James?

20 JAMES KULBASKI: In practical reality
21 the evaluator looks at one independent claim and
22 usually picks the broadest claim, but it could be

1 a claim of your choosing. And if that claim is
2 found to be essential, then I believe the letter
3 issued by the evaluator says that this patent is
4 then essential to the standard, so.

5 FRANCES MARSHALL: Is that suggesting
6 that it may be a distinction without a real
7 difference? We may talk about patents' claims
8 are analyzed. I'm just wondering, Jeff, what
9 concern do you have that the letters talk about
10 patents as a whole and not about particular
11 claims?

12 JEFFERY FROMM: First off I should
13 say that I'm not terribly concerned necessarily
14 that all -- there is this kind of essentiality
15 argument. There is this abstract essentiality.
16 But we are ignoring the very real fact that there
17 are lots of patents in this pool that include
18 claims.

19 The majority of patents that are
20 essential that meet this test include lots of
21 claims that are not essential. And that doesn't
22 seem to bother anybody on the foregoing side.

1 Certainly from the licensors' perspective they
2 seem to be unbothered by it.

3 And they participated in the creation
4 presumably of the license under which patents
5 are -- the grants are being made. So they are
6 apparently happy with it. But it is not a
7 distinction without a difference. There is a
8 very real difference.

9 And if you are a licensee, for
10 example, and you don't participate in the license
11 grant and yet you are required to give a grant
12 back that is a non-negotiable grant back as to
13 essential patents, that is a patent which has one
14 claim which is essential, then in fact you are
15 giving a license grant to non-essential claims on
16 a license agreement for which you have absolutely
17 no negotiating capability.

18 Now, you can argue that, well, that's
19 just part of the price of doing business. But --
20 and maybe it is.

21 But to argue that there is
22 no difference between essential patents and

1 essential claims is to overlook the way patents
2 are actually functioning, the way they are
3 actually written which is as to essential claims
4 only.

5 I mean that claims are what counts,
6 not the patents. And so there is a very real
7 difference in the economic impact just dependent
8 upon how the particular patent attorney ten years
9 earlier wrote the patent application.

10 FRANCES MARSHALL: Okay. Howard?

11 HOWARD MORSE: I think it also touches
12 on Garrard's other point which is that certain
13 other non-essential patents ought to be allowed
14 into the pool if you are already allowing certain
15 non-essential claims into the pool to some
16 extent. In fact he's already got his way.

17 But the concern I think that is
18 expressed in the Department's business review
19 letter is what I would characterize as the tying
20 in the foreclosure effect on someone else who has
21 competing technology to that non-essential patent
22 or non-essential claim who -- I think Garrard

1 would say but you are getting it at zero; you
2 are not paying more of a royalty for it.

3 I think the D.C. Circuit in the
4 Microsoft decision sort of undermines that

1 dealt with, each of them are circumscribed.

2 That is, the grant of the patent
3 holder to use the invention that's described
4 in the claims of the patent is limited to a
5 particular what's called field of use, meaning
6 that, for example, in the MPEG-2 patent portfolio
7 license you may not use the patents to produce
8 something akin to the space shuttle.

9 They have to be limited to practicing
10 the MPEG-2 standard. Similarly the grant back
11 provisions are limited to the field of use. You
12 must grant back any intellectual property you
13 have that's essential to the field of use, which
14 I guess is why I fail to understand why there is
15 any practical significance whatsoever to talking
16 about patents instead of claims.

17 Because, as I said, even if you were
18 to have a license under non-essential claims,
19 if that license is limited to practicing those
20 claims only within the field of use, then you
21 have no effective license under those
22 non-essential claims.

1 And if the grant back provision is
2 limited to the field of use, not to the patent
3 that's granted, it has no effect on the grant
4 back provision.

5 As to offering certain intellectual
6 property that is non-essential, again I think
7 limiting it to the field of use has very few
8 competitive effects because on the one hand it
9 can be an offer that the licensee doesn't have to
10 accept. It does not have any marginal cost to
11 the licensor.

12 And so I think it is incorrect to
13 presume that royalty rates would go higher.
14 And as to effect on competition, it does have
15 the effect of reducing competition for the
16 non-essential property that a particular
17 licensee may want to use.

18 But the countervailing procompetitive
19 effect is to open up competition in the
20 downfield, downstream market that's defined
21 in the license, because any licensee of the
22 essential intellectual property is free to

1 compete in all sorts of variations of
2 implementations of the field of use.

3 So I think in balancing the two I
4 think the suggestion to include non-essential
5 intellectual property limited to the field of
6 use is on balance procompetitive.

7 FRANCES MARSHALL: I believe Josh
8 Newberg had a comment.

9 JOSHUA NEWBERG: I wanted to try
10 to bring it back or perhaps relate it to the
11 discussion that we had in the morning of
12 cross-licensing and ask anyone who has an opinion
13 on it what the relationship is between the
14 concept of design freedom as that came up in the
15 cross-licensing context and essentiality as that
16 concept is used in the competition analysis of
17 patent pools, and whether patents that allow for
18 design freedom maybe -- you know, we don't know,
19 but we want those in there because we might
20 design something that infringes had in the morninsyo.nsyo.nn261

1 or not, and to what extent do design freedom and
2 essentiality conflict or overlap?

3 FRANCES MARSHALL: Jeff?

4 JEFFERY FROMM: I don't mind trying my
5 hand at the distinction you're trying to draw.
6 Of course in a cross-license you generally have
7 two parties. As several speakers have talked
8 about, there are really only two parties.

9 And so design freedom is almost
10 always an element or frequently an element of
11 cross-licensing.

12 Of course you can take the same
13 attitude you can about patent pools which is --
14 really the objective is basically to eliminate
15 all the patents. So there is absolutely no
16 reason that we just can't compete on whatever it
17 is we're going to compete on.

18 But patent pools aren't supposed to do
19 that. As between two parties if I'd like to do
20 that, if company A and company B want to say as
21 between us patents are going to become totally
22 irrelevant, that's their decision and they make

1 is going to be essential or not.

2 In a cross-licensing situation if you
3 are not sure you probably will still go ahead and
4 cross-license it. In a patent pool the standards
5 are a bit tougher. So you have to be fairly sure
6 that it's going to be essential or not.

7 And we have independent experts to try
8 to work that out. So I suppose the intention
9 with the pool is to keep it as narrow and tight
10 as possible, and with a cross-license is to cover
11 whatever you think is likely to be a problem in
12 the future. So slightly different criteria.

13 JOSHUA NEWBERG: Does that extension
14 make sense?

15 PETER GRINDLEY: Yes. I think it
16 does. It certainly makes sense from the
17 cross-licensing viewpoint.

18 From the pool I suppose that -- I
19 was arguing this morning that apart from the --
20 there's the antitrust concerns and just the
21 general administration of the pool becomes more
22 acute as it gets bigger. So you want to keep it

1 as focused as possible, so.

2 FRANCIS MARSHALL: I'd like to go back
3 to this just for a minute, to this concept of how
4 do we go about analyzing a pool that consists of
5 blocking patents.

6 And I think in our letters because
7 there was a standard against which to compare
8 them we used that as a proxy for determining
9 whether or not the patents were blocking or
10 complements.

11 But that also includes some substitute
12 patents. And let's say we take your example,
13 Garrard, and that is limited to the field of use.
14 How would you suggest that the antitrust
15 authorities go about determining whether that
16 pool is ultimately pro-competitive?

17 GARRARD BEENEY: I'm not sure,
18 Frances, if the analysis is different because you
19 have added the package of rights that licensors
20 may have that may or may not read on the
21 particular implementation of the standard. Is
22 that your question, how do you go about it if you

1 do that?

2 FRANCES MARSHALL: I think it ties
3 into the question of if you don't have a
4 standard. So far we have had -- we have analyzed
5 pools where there is a standard with which to
6 make a comparison.

7 But if you don't have a standard
8 I think that increases the difficulty of the
9 agencies looking at the patent pools to determine
10 whether the independent expert is going to
11 correctly put into the pool blocking patents.

12 So that's one question. And then the
13 other question -- and I think you get that same
14 issue when you define that the -- when you say
15 that the substitutes could come from a field of
16 use which doesn't have a standard associated
17 with it. So you're in that -- you're in that
18 same ballpark.

19 And I'm just wondering how you would
20 suggest that if the authorities, if we were
21 looking at a patent pool that was defined that
22 way, how we would go about making those judgments

1 when in the past we have used the standard and
2 the independent expert working together as a
3 proxy to make that determination, perhaps
4 imperfectly as everyone has said.

5 GARRARD BEENEY: I think that's a good
6 question. But I would not in any way suggest
7 that pools be permitted to offer a license under
8 anything other, whether it be essential or not
9 essential intellectual property, that the grant
10 of the license be -- exceed a field of use
11 because otherwise as you say there is no way of
12 determining the competitive effects unless the
13 scope of the license grant is limited to a
14 defined criteria, whether that be a defined
15 product or a defined standard.

16 But the scope of what's granted --
17 which is a question different from what it is
18 that you're granting.

19 But the scope of what you're granting,
20 that is what the licensee is entitled to do with
21 the rights in the license, has to be defined
22 and has to be limited. Otherwise, as you say,

1 there's just no way of analyzing the competitive
2 effects of a pool.

3 But once you do that I don't think
4 that the intellectual property that's in the pool
5 has to necessarily be limited to intellectual
6 property that is essential to practicing the
7 standard as opposed to something that may be
8 infringed by a particular voluntary
9 implementation of the standard.

10 And what I'm suggesting is that
11 licensees be given the freedom to compete
12 in the downstream markets by producing any
13 implementation of the standard that they want by
14 being given this non-assert from the licensors to
15 free up any concerns that they may have about
16 infringing non-essential intellectual property.

17 But the scope of the grant on the
18 essential and the non-essential intellectual
19 property has to be that standard of product. Was
20 that clear at all?

1 CHRISTOPHER KELLY: I'm just wondering
2 whether what you are driving at, Garrard,
3 suggests that whatever the field of use is it's
4 going to bear a very close relationship to
5 something that most people might view as a
6 standard of some kind.

7 That's going to be the context. So
8 whether it is essential or not you are still
9 going to be talking about something like an MPEG
10 or DVD as opposed to saying televisions or
11 tables. So it's not -- the field of use will be
12 fairly rigorously defined.

13 GARRARD BEENEY: Correct.

14 FRANCES MARSHALL: Pretty limited
15 as well. In a sense you are expanding your
16 definition of essentialities, and essential as
17 a practical matter then including things that
18 are -- different methods for implementing the
19 standard.

20 GARRARD BEENEY: Yes, but also that in
21 the course of implementing the standard you may
22 have to do something that's not even in the

1 standard.

2 And that's what I'm suggesting, but
3 that the grant of the patent right is only
4 limited to implementing the standard. But you
5 may be doing other things in creating what that
6 license allows you to create.

7 FRANCES MARSHALL: Any other comments?
8 Questions? Okay. Why don't we go ahead and take
9 a ten-minute break and come back at 3:35.

10 (Recess.)

11 FRANCES MARSHALL: Thank you all very
12 much. I've heard that we are stressing people's
13 legs and backs. But we are scheduled to end at
14 4:30 so hopefully this next session will be
15 easier. We are going to turn to Baryn Futa who
16 is the manager and CEO of the MPEG LA --
17 licensor?

18 BARYN FUTA: Licensing.

19 FRANCES MARSHALL: Licensing
20 administrator. And he's going to talk to us
21 about some lessons that he has learned from the
22 MPEG pool since its inception in 1997.

1 BARYN FUTA: Thank you, Frances.
2 Thanks for inviting me, first of all. And I
3 think the Division and the FTC have done a
4 terrific job putting these hearings and panels
5 together.

6 I have learned a lot from my fellow
7 panelists. I'd like to thank everybody. But
8 probably more importantly I'd like to thank you
9 in the audience today.

10 Given the availability these days of
11 location and time non-specific information, it
12 really is something when people actually show up
13 to these things and listen. So I appreciate you
14 for being there.

15 Also, Frances, I was going to say the
16 next time my 14-year-old or 11-year-old asks me
17 the type of stuff I get involved in during my
18 day I'll refer them to doj.gov and they can go
19 through all the testimony and that will let me
20 punt on the dinner conversation about work again
21 for another ten weeks.

22 I have some written statements which I

1 multilateral licensing involving non-assertions
2 that hasn't really been touched on today.

3 So, you know, really out there, there
4 are a lot of different efforts using a lot of
5 different approaches as Josh and Pete and others
6 have mentioned to give the marketplace access to
7 standard based technologies.

8 You know, as consumers we are in a
9 world of formats and standards. And as makers of
10 these products, makers of these products are in a
11 world of formats and standards.

12 And I also don't think any of you
13 have this impression, but I wouldn't want any
14 of you to get the impression that there is no
15 competition among these formats and standards
16 themselves. There are lots of different formats
17 trying to do lots of -- the same applications.

18 For example, in the DVD itself there
19 are going to be multiple formats for recordable
20 DVD. I believe the DVD forum also recently
21 approved a non-MPEG-2 coding that will be DVD
22 compliant.

1 In the broadcast area the United
2 States will using an entirely different digital
3 video terrestrial broadcast system than will
4 Europe.

5 So when we talk about MPEG-2 or we
6 talk about DVD as formats we all have to keep in
7 mind that there are lots of different formats
8 trying to address the same question and the same
9 opportunity.

10 But we are all dependent on
11 interoperability. As consumers and manufactures
12 we are all dependent on these same formats and
13 standards. And therefore they are all dependent
14 to some degree on each other's R & D.

15 I find that as Peter had mentioned
16 cross-licensing and MPEG-2-like programs are not
17 mutually exclusive. They co-exist very nicely in
18 the marketplace.

19 Bilateral licensing, cross-licensing
20 can deal with all the various intersection points
21 that may occur between two companies' IP needs,
22 whereas a program like the MPEG-2 is dealing with

1 only a narrow slice or one intersection point,
2 that being essential patents with regard to the
3 MPEG-2 technology.

4 There has been talk about design
5 freedom. And I think design freedom is a
6 very different thing than access to the
7 intellectual -- to the essential patents for a
8 given standard like MPEG-2.

9 Design freedom to me connotes a notion
10 of peace, and a notion of to be able to have your
11 product makers go out there and make products, to
12 invent, to innovate, and to diffuse. And that's
13 an entirely different kind of scope or a field of
14 use I guess to use the term than what I do every
15 day for a living.

16 So from my personal viewpoint I see
17 lots and lots of bilateral arrangements being
18 negotiated every day involving lots of different
19 technologies.

20 I don't have the experience in
21 licensing that problem like someone like Jeff or
22 people like Howard do, but in the context of the

1 MPEG-2 program I have worked with -- we have over
2 400 licensees.

3 And I would probably say that we have
4 probably dealt with many, many more companies
5 than that that are still potential licensees or
6 looking at the technology or technologies.

7 And I think I have a pretty good idea
8 of what they think is important, at least what
9 they tell us is important in regard to licensing
10 and MPEG-2-like programs. And for what it's
11 worth I'll go through my list.

12 Everybody is looking for better terms
13 than the next guy, and maybe they will settle
14 with same terms. And then that is in regard to
15 everything, royalty rate. Everybody's looking
16 for an MFN. They are looking for some upside
17 protection on their royalty rate upon renewal.

18 And I think in that regard a feature
19 that is in the MPEG-2 program that I think our
20 customers particularly like is that all of our
21 agreements are terminable on 30 days' notice by
22 the licensee.

1 So I think all the rate protection and
2 the rate related issues are in the hands of the
3 licensee in the case of MPEG-2. Because we're
4 all dependent on each other's R & D and therefore
5 each other's patents, licensees are looking
6 obviously for good coverage.

7 They are looking for some sense
8 that -- they realize they will not get
9 100 percent of essential patents from any
10 program, but they are looking for what they
11 consider to be good coverage of the essential
12 patents.

13 They are aware of the licensors of
14 those patents. And since many of these companies
15 are involved in the standard setting effort they
16 know which companies paid their dues, put in the
17 R & D, sent research teams, proposed things to
18 the standard setting body, and got their
19 inventions or techniques incorporated into the
20 standard.

21 Our licensees are very sophisticated
22 and they know how standards are developed and who

1 developed them. They want all their products
2 that use the spec covered.

3 I think probably one of the most
4 important terms is they want to see that the
5 licensors are also licensees and are also paying
6 the same royalty rates. As a business I consider
7 any program like MPEG-2 a non-starter unless
8 licensors that utilize the technology are also
9 licensees and pay the same royalty rates.

10 I don't know about competition or the
11 legal requirements. I just know as a business
12 person it is a non-starter unless the licensors
13 that make the products are also licensees and pay
14 the same royalties.

15 You know, I should mention also that
16 probably what will not be discussed tomorrow
17 but -- and I can't remember who mentioned it, it
18 might have been Chris -- is a copyright tool like
19 a clearinghouse approach.

20 I'm not necessarily aware of any
21 patent programs that are standard related that
22 use a clearinghouse approach. And I haven't

1 really thought much about it. But really, you
2 know, there may be a situation where it's
3 appropriate.

4 I would say that the 3-G licensing
5 concept is as close to a clearinghouse approach
6 as I've seen in a standard setting -- a standard
7 licensing situation, but not -- nothing like what
8 you suggest in terms of copyright. But, you
9 know, it might work in some situations.

10 You know, I couldn't help but -- being
11 at the end of the day, Frances, I couldn't help
12 but reflect on some of the things I have heard
13 already. And I just -- again anecdotally I'd
14 just make a couple comments.

15 In the case of the MPEG-2 program
16 licensees don't pay less for more or less
17 patents. So if a patent should be found to be
18 invalid and it's pulled off the list, that
19 licensor would not get proceeds for that patent.
20 But the license royalty rate would not go down.

21 I personally believe that invalidity
22 is an area where the courts of competent

1 jurisdiction should do their thing. I would
 2 be -- I haven't thought through all the
 3 ramifications of that being done in the context
 4 of the joint licensing program, but my gut tells
 5 me that that is not a good thing.

6 Again I think the notion of percentage
 7 royalties -- you know, really these programs
 8 operate in a marketplace. And what it boils down
 9 to is what the market will accept. Access to
 10 MPEG-2 is like any other subsystem cost that goes
 11 into a product that uses MPEG-2.

12 And in that sense it has to have a
 13 value equation such that the value is there. So
 14 I would not want to have -- I would not think

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think that I think that And in that sense it hasHavtellsai

1 because it would be high.

2 I think a sum certain also gives you
3 a sum certain, which is you know your cost.
4 Certainly as the costs of making these products
5 go down, then a percentage royalty looks good.
6 So again changing conditions may be changing
7 reaction.

8 I guess what I'm saying is that when
9 you are licensing, which is a product, and so I
10 consider myself a salesman selling a product,
11 what you will hear from the marketplace is the
12 argument that at the time renders a lower price
13 for that program.

14 Similarly I've heard arguments about
15 there ought to be a per patent rate or something.
16 Since we have gone from 25 to 100 patent families
17 and from something like 120 patents to 325
18 patents, I don't tend to hear that argument so
19 much anymore.

20 And last but not least I think that
21 all this discussion we had today operates in
22 an environment where we have never had more

1 entertainment video information platforms and
2 products that provide that to us than ever
3 before.

4 I think as consumers, American or
5 otherwise, we have available to us lots of
6 information and lots of products. And so to the
7 extent that progress is what we're looking for,
8 that's what patent law is all about.

9 And innovation is what the Division
10 cares about. I must submit that I really don't
11 see that much of a problem out there. Thanks.

12 (Applause.)

13 FRANCES MARSHALL: Thank you, Baryn.
14 I think we'll turn to Jeff Fromm, who as we said
15 before is senior management counsel at
16 Hewlett-Packard, for some of his views on the
17 practical aspects of licensing.

18 JEFFERY FROMM: And as the last
19 speaker of the day I'm going to make this as
20 short as I can. Obviously we've come a very long
21 way from the past generations where patent pools
22 were often seen as cartels.

1 The MPEG LA and DVD letters delineate
2 basic rules that can minimize risk and are now
3 widely employed and I think in fact have
4 increased competition.

5 Those rules, however, are often not

1 the different classes of affected parties.

2 Insiders holding patents and the pool
3 administrator answerable to them have an interest
4 in maximizing the use of license rights across
5 whole industries. But they also have an interest
6 in the revenues that the licenses generate.

7 Most importantly, changing market
8 conditions may render these license terms
9 reasonable at the outset of the pools,
10 unreasonable years later.

11 A royalty prescribed at the outset of
12 the pool may represent an inconsequential part of
13 total cost of the product. And that same royalty
14 several years later may represent a competitively
15 significant part of the cost.

16 As an aside not in my written remarks,
17 products that are first introduced as, you know,
18 selling for \$1,500, \$2,000, some years later it
19 is not unusual to see them sold for 89.95 at
20 Best Buy.

21 Obviously the same royalty on both if
22 it's a fixed dollar amount as we often prefer for

1 lots of reasons, may affect the competition in
2 the markets later on in a quite different way
3 than it does at the beginning, at the \$1,500
4 product.

5 In any case, serious problems rarely
6 arise at the outset of the pool's operation when
7 the sponsors are incented to attract outsiders
8 and get new technology widely accepted.

9 Pools unfortunately often do not
10 readily adjust to new circumstances and
11 competition facilitating or innovation
12 facilitating manners, which is a point in which
13 further DOJ guidance would be desirable,
14 encouraging sensitivity to changing market
15 conditions and their bearing on appropriate
16 license conditions going forward.

17 The common approach to pool licensing
18 today is one size fits all. Obviously we have a
19 different view whether you are the licensor or
20 the licensee.

21 This is generally deemed to be
22 consistent with the DOJ letters as long as the

1 pool as a whole includes only patents found to be
2 essential.

3 But while all the patents in the pool
4 may be essential to the pool founders at the
5 outset of the pool, some or many of them may
6 later turn out to be non-essential or non-useful
7 to outsiders seeking to employ the technology
8 later in unexpected ways.

9 Competitors or new entrants should be
10 able to license the set of patents they need
11 without being forced to take and pay for the
12 whole license. In other words, pools should be
13 amenable to issuing partial licenses to
14 applicants.

15 I'm aware of two explanations for
16 pools' resistance to the partial license concept.
17 First, pool sponsors suggest partial licenses
18 would create undue administrative burdens.

19 It's hard to believe that tiered fee
20 schedules and associated allocations among patent
21 holders cannot be fashioned with due allowance
22 for associated costs of implementation.

1 Second, pool sponsors suggest the
2 availability of individual negotiations with the
3 patent holders is a sufficient alternative for
4 parties needing less than the whole set. But as
5 I have talked about before today, this is more
6 illusory than real.

7 The DOJ should appropriately encourage
8 partial license features by recognizing their
9 potential for procompetitive effects, thereby
10 offseting anticompetitive risks under the
11 applicable antitrust rules of reason.

12 Another concern to outsiders'
13 inability to participate in or challenge
14 determinations of patent essentiality, the DOJ
15 letters caution pools to remain alert to the
16 possibility that some patents initially
17 determined to be essential should be reconsidered
18 in the light of subsequent information that they
19 are invalid or that they cease to be essential.

20 Mechanisms facilitating outsiders'
21 input in this regard would be desirable,
22 particularly since they often have the highest

1 financial incentive, especially if there's going
2 to be partial pool licensing.

3 Concerns also arise over the scope
4 of grant back requirements and other license
5 provisions impeding a licensee's assertions of
6 its own patents against a licensor within the
7 pool. Outsiders should be -- should have
8 meaningful opportunities for input on these
9 parts of the license.

10 And one size fits all may not be
11 appropriate for all licensees. A broad grant
12 back or an inhibition on asserting patent rights
13 against a licensor may have no significant impact
14 on the licensee -- on one licensee, while
15 amounting to a major forfeiture of value to
16 another licensee.

17 The concerns I've described as
18 conflicts between pools' insiders and outsiders
19 point to the need for some more explicit and
20 effective recognition of these premises and the
21 manner in which pools are organized,
22 administered, and governed.

1 The starting point would be
2 commitments set forth in the organizing documents
3 to operate the pool at all times with due regard
4 to the interests of all of the users of the
5 technology being licensed, present and future
6 licensees alike, members and non-members alike,
7 and with particular regard to the public interest
8 in a maximally open competitive market.

9 Critical to the public's confidence
10 that the pools' insiders adhere to these
11 commitments is some reasonable degree of openness
12 and publicity regarding significant pool
13 operations.

14 This could, for example, take the form
15 of a publicly available website where minutes of
16 the meetings of the pool's governing board are
17 posted periodically.

18 A further safeguard would be a
19 mechanism by which outsiders could challenge pool
20 decisions about such matters as royalty rates,
21 other license terms, and patent essentiality. To
22 be effective a mechanism should provide for some

1 form of neutral and objective dispute resolution.

2 Obviously we don't want to turn this
3 into another form of litigation. That's not the
4 purpose of pools. It is to avoid litigation.

5 To be effective a mechanism should
6 provide -- another desirable safeguard would be
7 the inclusion in the pool's governing board of at
8 least one person unaffiliated with any of the
9 founding patent holders, perhaps a widely
10 respected university guru or someone with
11 expertise in the technology to be licensed but
12 without any financial interest in the pool's
13 revenues.

14 He or she could be in the nature of
15 an outside director, something that's pretty
16 important in many venues today. Guidance from
17 the agencies encouraging pools to consider steps
18 of these kind should be welcomed in many
19 quarters.

20 Particularly with that kind of an
21 encouragement these steps could help to minimize
22 conflict between and among the different pool

1 constituencies and to help ensure the pools
2 operate in the public interest. Thank you.

3 (Applause.)

4 FRANCES MARSHALL: I think there are
5 a number of interesting issues here. Does the
6 panel want to respond to anything that was just
7 said? Baryn?

8 BARYN FUTA: I can talk about the
9 program I am familiar with, which was MPEG-2.
10 I'm sure comments addressing some other programs
11 like DVD or audio licensing or what have you --
12 I don't know if I quite have all the points he
13 made. But I'll go through the ones I remember.

14 First I think that our license --
15 licensees are our customers. So again I consider
16 MPEG LA a business and I consider myself a
17 salesman not unlike anybody else that's selling a
18 subsystem or hard drive or whatever that goes
19 into products.

20 So with all due respect I don't need
21 much reminder to tell me that I need to take care
22 of my customers and be responsive to their needs

1 anymore than probably HP needs to be told to take
2 care of their customers and respond to their
3 needs.

4 For example, effective January 1 we
5 reduced the MPEG-2 royalty rate from \$4.00 to
6 \$2.50 in light of market conditions. And I think
7 it's fair to say most of our licensees were
8 surprised and elated and delighted by that.

9 With regard to licensees being able
10 to challenge essentiality of patents, I find that
11 our customers like when the patent list
12 increases. They like the fact our coverage goes
13 back to the first product they ever paid and they
14 pay no more money for additional patents.

15 As you know, a patent could go on the
16 list tomorrow, but it could be licensable for a
17 substantial period prior to going on the list.
18 And our licensees have that coverage for the
19 products they manufactured and sold for those
20 prior periods for no additional royalty payment.

21 I can't speak to the other programs
22 about changed business circumstances, but anyone

1 I know that administers a patent licensing
2 program such as MPEG-2 is in a business and
3 operates as such.

4 With regard to -- I don't know if you
5 said this yet, but with regard to your written
6 testimony you said you were being forced to take
7 a combination of unneeded and needed licenses.
8 We talked about the notion of essentiality and if
9 you practiced the art of MPEG-2 in the case of
10 what I do that you are infringing those patents.

11 By not needed maybe you mean the
12 patents that you have access to under
13 cross-license. I will say all of our licensees,
14 including licensors, pay the same royalty rate.

15 However, if there is a cross-license,
16 the scope of which may include essential MPEG-2
17 patents between the two parties, then upon
18 request of those two parties and the waiving of
19 the confidentiality requirement that we have with
20 each of them as licensees and licensors, if they
21 waive it as to each other we will provide them
22 the figures so that they can quantify the value

1 of their cross-license with regard to essential
2 MPEG-2 patents that either of them may have and
3 are paying for a license for, and ultimately the
4 money going to each other or the licensor, and to
5 account for that within their existing or then
6 existing cross-license arrangement.

7 But that happens all external and
8 outside of MPEG LA. So I don't see anyone paying
9 for unneeded licenses. Our customers are very
10 sophisticated, including HP. I don't think they
11 would pay for unneeded licenses. We are in a
12 marketplace now where no one pays for what they
13 don't need.

14 FRANCES MARSHALL: Chris?

15 CHRISTOPHER KELLY: One point Jeffery
16 made that was interesting that maybe we don't
17 give enough thought to is one that is provided
18 for in both the IP guidelines and the competitor
19 collaboration guidelines, the idea that things
20 change over time and that a license today which
21 seems marvelous may have a very, very different
22 effect five years down the line when the licensor

1 has 90 percent of the market.

2 And that is something that needs to be
3 borne in mind. In a sense that links up with the
4 general approach of the business review letters,
5 which is if the facts turn out to be different
6 this goes out the window.

7 And so it's certainly always going to
8 be relevant for DOJ and FTC when they are looking
9 at pools that they have already passed on. They
10 need to think about whether things are different.

11 As to the royalty though I guess I
12 would think that even if the price of, say, the
13 players continued to drop there would -- it seems
14 unlikely to me that -- or I wouldn't -- obviously
15 DOJ can make up its own mind.

16 But I would not expect DOJ to react
17 ever on the question of whether the royalty
18 had become unreasonable or oppressive or
19 non-affordable for particular licensees. I
20 think that's pretty much out the purview of the
21 enforcement agencies, or at least it was when we
22 looked at the pools.

1 What we looked at was simply whether
2 the royalty was sufficiently large that it could
3 in some way form a basis for coordinating prices
4 on the downstream goods.

5 Whether it would be a royalty
6 acceptable to the market or beneficial to the
7 pool, as a business matter we figured we'd leave
8 it up to them and see what would happen.

9 Now, whether that would be true in
10 Europe or not I don't know. There gouging can be
11 an abuse of a dominant position, and I suppose
12 you might have an interesting issue there.

13 GARRARD BEENEY: There are some
14 interesting cases in Europe that address that
15 concept.

16 This is I guess off the point, but
17 there are a couple cases in Europe that address
18 the concept of whether as prices on the product
19 go down and the royalty rate becomes an
20 increasing percentage of that product does that
21 mean that changing conditions should allow for
22 the reformation of the license contract. And

1 those cases have said no. Sorry.

2 FRANCES MARSHALL: Baryn?

3 BARYN FUTA: Were you being
4 self-effacing or insulting Chris? I couldn't
5 figure that out. I forgot to address the part
6 about the partial license.

7 I think the MPEG-2 program is a
8 certain kind of product in the marketplace and
9 addresses a certain need. And if there is a need
10 for a partial product, there are cross-licenses
11 and bilateral licenses.

12 But having said that if there is a
13 marketplace need for subset licenses, if you
14 will, I actually to see them starting to occur.
15 For example, in the MPEG-4 situation AAC,
16 advanced audio coding, is a subset of the MPEG-4
17 normative audio specification.

18 But enough of the marketplace may have
19 an interest in just licensing AAC as a bundle
20 that I believe the licensors to AAC are forming a
21 joint licensing program that might be different
22 from the licensing program that includes all,

1 quote, unquote, of MPEG-4 audio or MPEG-4 audio
2 structured along the lines of the MPEG-2 video
3 and system program that MPEG LA administers.

4 I think that if the marketplace need
5 for certain subsets is such that there is a
6 demand, like any other product, people will be
7 there with a product to meet the demand.

8 If the subset is very specific to a
9 certain potential licensee, then we have defined
10 the terms, haven't we? By definition that
11 company needs to go out and deal with its own
12 unique subset with -- using the current
13 marketplace tools.

14 I think that -- so I don't want you to
15 get the impression that I don't think there's
16 room for what you are advocating. I think
17 there is.

18 But I don't see where we need to
19 customize or fractionalize the current MPEG-2
20 program because I'm not hearing from our
21 customers that there is a need for any subset
22 of -- with enough market core to address it.

1 Like HP, I mean there may be certain
2 customers that need a certain product. But until
3 you have enough customers with that same need,
4 marketing and product development are not going
5 to gear up to make a product for that market.

6 Those people have to avail themselves
7 of companies that specialize in customization or
8 custom implementation, like the INSEs of the
9 world with regard to Cisco equipment.

10 FRANCES MARSHALL: Jeff, do you want
11 to respond?

12 JEFFERY FROMM: I didn't mean to
13 suggest that MPEG LA is not responsive to its
14 customers. But I would posit that like most
15 organizations that are responsive to its
16 customers, it is a lagging indicator and that new
17 innovations get introduced and product plans get
18 plans for future products.

19 And by the time there's a groundswell
20 of demand for a revision in your product it's no
21 longer an innovation.

22 And since we're talking about

1 innovation markets and trying to encourage
2 competition in innovation markets, it's a
3 different dynamic than looking at the buying and
4 selling of products, which as a competitor I mean
5 if I decide that I'm going to be in a business
6 and be perfectly happy to sell a trailing product
7 and optimize my business model around selling a
8 non-leading edge product, that's perfectly fine.
9 But in fact the organizations such as
10 MPEG LA are in a very different kind of business

1 talking about. But if I'm looking for a
2 portfolio of patents we're talking about a year.

3 Now, the product life cycle where the
4 entire product is designed, introduced, and
5 becomes obsolete in only a year, that is a
6 problem.

7 That is the reason -- there is no
8 doubt that I think the dynamics of serving
9 customers is quite different when your customers
10 are really -- where you are trying to foster
11 innovation. And that's all I'm pointing out.

12 But never would I suggest that you
13 are ignorant or unresponsive totally to your
14 customers. I didn't mean to suggest that. And I
15 apologize if there was any misunderstanding.

16 PETER GRINDLEY: I'll try and make
17 some additional comments. I think the points
18 Jeffery has brought up are very pertinent and
19 very important.

20 Coming from a practitioner in the area
21 they are just very serious and need a lot of
22 consideration. And it's difficult to off the

1 cuff make remarks.

1 more efficient by licensing all the patents for
2 design freedom or just a specific patent.

3 I'm just wondering how that translates
4 to a patent pool story where we're not talking
5 about one patent. We might be talking about a
6 subset of patents.

7 So there may be parallels in the sense
8 that out of 27 patents you may want to just
9 license six, or -- you know, but I think once
10 you get very selective I think kind of the
11 administration of that partial license becomes
12 a problem. And so it's just an observation.
13 That's something that would need to be addressed.

14 If I can go on to another point, which
15 is the life cycle, how things change over time.
16 This is just another point to throw in here, is
17 that if the patent pool is oriented towards a
18 standard, then I guess not only is the technology
19 changing over time, but the need for the patent
20 pool, if you like, changes as the standard
21 becomes adopted.

22 In the early days of establishing

1 a standard it's very important what people's
2 expectations -- the credibility of that standard.
3 And the fact that they can be assured that their
4 basic package of IP will be available is likely
5 to be a very strong incentive to any user to
6 adopt that standard rather than another standard.

7 So it's very important in the early
8 stages. Once the standard is fully adopted and
9 it kind of defines the industry or the product
10 sector then I suppose the conditions change
11 somewhat and I don't know whether that means we
12 should use different criteria for analyzing.

13 It's very much I think we've talked
14 about ex post, ex ante, which seems to go through
15 a lot of these licensing issues, that ex post in
16 this case once the standard is adopted and
17 established, then it's a slightly different
18 situation than before.

19 So that's just another factor that we
20 need to think about. And, Jeffery, I'll be very
21 grateful if you have some comments to elucidate
22 these.

1 JEFFERY FROMM: I think we do concern
2 ourselves with those issues. I think the problem
3 with standards is as you say that in the
4 beginning there is lots of money to be made by
5 early adopters.

6 And over time I think it's the thing
7 we'll talk -- the standards discussion tomorrow
8 is that the economic value for the package of
9 patents in some markets goes down much faster
10 than the life of the patents.

11 Now, there are other markets of course
12 like the chemistry business where you have a
13 patent on this drug -- I mean the drug market.
14 You have a patent on this drug and in fact its
15 value goes up over time.

16 The patent on Viagra is going to
17 become more valuable ten years from now than it
18 is today. But in fact in these highly dynamic
19 innovation markets that most of these patent
20 pools operate in, the exact opposite is true,
21 that once the standard becomes pervasive it is
22 not a matter of whether you have a choice to have

1 or not have an MPEG player in your PC.

2 If you don't have it you are not in
3 the PC market. It's as simple as that because no
4 one is going to buy your PC if they can't play
5 their DVD or CDs on your product. So the
6 leverage against the product changes over time.
7 The dynamics of the industry changes over time.

8 And as they become the standard part
9 of the product, not of the DVD product but of
10 the greater product in which it's innovated,
11 once it's become a commodity the value to the
12 licensees goes down to zero and the leverage to
13 the licensors goes up. If there is no mechanism
14 to kind of adjust those things it causes
15 distortions.

16 That's not to say that as we talked
17 about before the business people who operate the
18 pools, especially in the case where you have a
19 businessman, a licensor who is also a licensee,
20 they have pushing and pulling in both directions
21 as well.

22 I think up front we need to recognize

1 that you can have a patent pool in which the
2 patents -- of course there are new patents to be
3 added to it that will be issuing later.

4 And especially since there are going
5 to still be patents pending in the U.S. Patent
6 Office -- I've prosecuted them where they didn't
7 issue for more than 20 years from the date of
8 filing.

9 That suggests there could be patents
10 out there right now that would be flowing into
11 the MPEG pool 20 years from now that we haven't
12 seen yet and then will have 17 more years of life
13 after that.

14 Potentially we could be looking for
15 the pool to have the ability to get a royalty on
16 the pool of patents some 34 or 35 years easily
17 after the initial pool was started or the
18 standard was adopted.

19 Now, obviously 30 years from now I
20 don't think any of us would expect that MPEG, for
21 example, or DVD or any of the technologies we
22 have today are going to be extracting anything

1 more than commodity prices from all consumers.

2 And I think we have the
3 antitrusters -- when the Department looks at
4 these pools they need to take those kinds of
5 effects -- situations into effect.

6 That's not to say that the system
7 might not self-adjust. I'm just saying that if
8 you think about the long-term impacts and the
9 fact that you almost have to have some from of
10 review on a regular basis.

11 If you're expecting the insiders or
12 the licensors to do it, that's fine. That's
13 essentially the way the program works today.

14 But it just may not be sufficiently
15 offsetting the end competitive effects that are
16 being ignored for a long period of time until
17 somebody gets pissed off enough to bring a
18 lawsuit. And we want to avoid those if we can.

19 FRANCES MARSHALL: Howard?

20 HOWARD MORSE: If you want to follow
21 up go ahead.

22 GARRARD BEENEY: I just wanted to make

1 an observation about partial licenses. One of
2 the truly procompetitive aspects of patent pools
3 is the reduction of transaction costs. It is one
4 of the principal reasons why licensors agree to
5 put their patents into a pool.

6 And it's one of the principal reasons
7 why licensees accept pool licenses. And I would
8 submit I guess that there is really no principled
9 way of formulating any antitrust concept that
10 would require a pool to offer partial licenses.

11 And I say it for this reason. The
12 partial license is really just a claim that I
13 want to be able to license fewer patents than
14 are offered in the pool.

15 But of course what's left unsaid is I
16 want to be able to do that for less royalty. If
17 the demand is that you license less patents but
18 are willing to pay the same royalty, then fine,
19 there are no transaction costs. We can strike
20 patents off the list of patents that are being
21 licensed.

22 But really obviously what's being

1 sought is a lower royalty rate than what other
2 pool licensees are paying. So, number one, it
3 is a request for a discriminatory royalty.

4 Second of all, if you take a pool
5 that has 100 patents, an MPEG pool has far
6 fewer -- excuse me, far more. One of the DVD
7 pools has more and another less.

8 So it's not an unrealistic number.
9 And you assume that those patents are issued
10 by 30 different countries in the world.

11 You then get into a situation where
12 allowing partial licenses and to let licensees
13 pick and choose among the patents in the
14 portfolio, that the licensing agent has to offer
15 thousands of permutations of licenses, perhaps
16 all with different royalty rates.

17 Excuse me. You may have someone
18 who wants just a license in France for two of
19 the patents. You may have someone who wants a
20 license in the U.S. for three out of the thirty
21 patents in the U.S., et cetera, et cetera,
22 et cetera.

1 And if you formulate some antitrust
2 concept of requiring partial licenses as opposed
3 to letting the market play its role, there is no
4 principled way to limit that -- the effect of
5 that to the huge transaction cost that would be
6 created by requiring the people that are
7 licensing to try to track thousands of different
8 royalty rates for thousands of different licenses
9 in any pool of any size.

10 Next I think that you would find that
11 licensors would be reluctant. There would be a
12 great disincentive to form a pool if there was
13 some rule that this was really just a menu where
14 licensees could go in and pick and choose what
15 they want. If that's the case then why have a
16 pool at all; let's just have individual
17 licensing.

18 I guess finally the point that I'd
19 like to make is that you have a pool as an
20 alternative. If the pool doesn't fit I guess
21 what I'm suggesting is then you have the
22 alternative that would be available to you if

1 there was no pool at all, that is, individual
2 licenses.

3 The only reason why anyone can claim
4 that individual licenses are not a realistic
5 alternative is because the pool exists in the
6 first place.

7 So if a pool doesn't fit and it
8 doesn't meet the needs of a licensor, then forget
9 the pool ever existed in the first place. And
10 you have to do what you would have to do but for
11 the existence of the pool.

12 So I think that creating an antitrust
13 rule that would require licensors who decide to
14 form a pool in part to reduce transaction costs,
15 lower royalty rates so those transaction costs
16 are not reflected in the price of the pool, and
17 then to fashion a rule that says you have to
18 substantially increase your transaction cost and
19 offer thousands of different permutations of
20 licenses really I would submit is not a
21 principled application of antitrust law.

22 FRANCES MARSHALL: Thank you. Howard,

1 do you want to move on?

2 HOWARD MORSE: I want to come back to
3 the point that Chris made where Chris I think
4 suggested that at least if he worked at the
5 Department of Justice he would not look at the
6 reasonableness of the rates being charged.

7 At least in the 6-C pool letter
8 requesting the Department of Justice approval --
9 and these guys don't make representations in
10 these pool requests that are well represented
11 unless they have a reason for making the
12 representation in the letter.

13 In the October 9, '98 letter to Joel
14 Klein on 6-C there are two representations. One
15 is the licensors agree that the pool will make
16 the essential DVD patents available on fair,
17 reasonable, and non-discriminatory terms.

18 And elsewhere -- that's at page 11.
19 At page 20 it says the royalty rates proposed by
20 the DVD rule are reasonable. And I do think, you
21 know, we can come back to this ex ante, ex post
22 notion.

1 These are representations that were
2 made to Justice that are made out to the business
3 community who endorses the DVD standard in part
4 because of this I think.

5 And then maybe ex post as the cost
6 of manufacturing goes down, if it no longer is
7 reasonable it does seem to me that this is an
8 area where it's appropriate, particularly in a
9 situation where the rates are combined with
10 discrimination.

11 We talked earlier about the fact that
12 I believe certain of these pools the members of
13 the pools aren't paying a royalty at all.

14 I think that puts you in the situation
15 which the IP guidelines describe where at least
16 if the pool participants collectively possess

1 So looking at -- the question is, is
2 it appropriate to look at the reasonableness of
3 the rates. And I sort of asserted that at least
4 in certain circumstances looking at that issue it
5 does become relevant particularly when combined
6 with discrimination.

7 MARY SULLIVAN: Okay, Chris. I see
8 you have a comment.

9 CHRISTOPHER KELLY: Whether or not it
10 should be relevant, all I can say is that letter
11 that you quote was to Joel Klein, not by Joel
12 Klein, and there are many things that letter says
13 about the pool.

14 And I would doubt that you would
15 expect that each of them would then have been
16 adopted and ratified by Mr. Klein's letter and
17 thus become a critical component of the antitrust
18 analysis of the pool.

19 For instance, just to point up
20 one example, that letter as I mentioned very
21 enthusiastically, energetically, altruistically,
22 pointed out that the members of the pool had

1 committed to license outside the pool.

2 Does that mean that the DOJ patent
3 pool letter therefore said that one must commit
4 to license outside the pool in order for the
5 things to be reasonable? I don't think so. I
6 guess I'll leave it at that.

7 MARY SULLIVAN: I'd like to pose a
8 question I guess to the panel in general, but
9 maybe in particular to our economists just on the
10 panel and ask the question: If all the patents
11 in the pool are essential, should the antitrust
12 authorities place any restrictions on the royalty
13 rates charged by the pool?

14 PETER GRINDLEY: You seem to be
15 looking at me. I am the only economist at this
16 end.

17 MARY SULLIVAN: Then I guess it's you,
18 Peter.

19 PETER GRINDLEY: It is a big question
20 and I would hate to answer it with a yes or no.
21 Are these the only essential guns, are these
22 all the patents that you need to operate, or are

1 they just only essential patents and you still
2 need to go outside.

3 It seems -- just off the cuff without
4 having -- obviously this is an issue I have
5 thought about, but I'm not quite sure I'm ready
6 to give a yes or no answer.

7 It seems that these are freely
8 negotiated in the marketplace and they should
9 reflect what the package of patents is worth.
10 And on its face I can't really see that there's
11 a regulatory interest in that.

12 You know, I think the questions go
13 beyond that into thinking in terms of the longer
14 term points, the grant backs, et cetera, what
15 happens over time, maybe that things will change,
16 et cetera, what's essential now may not be
17 essential in three years' time.

18 So I think it's difficult to give a
19 clear answer other than at a very specific point
20 in time for a specific set of patents. But my
21 answer seems to be that if it's a freely
22 negotiated package then it should reflect the

1 real value and for the reasons we've said it
2 should be economically efficient.

3 FRANCES MARSHALL: Garrard?

4 GARRARD BEENEY: Yes. I just wanted
5 to offer one observation on that issue, which is
6 I think if you tell patent holders that they have
7 a choice, that they can license individually
8 unrestrained by the government in terms of price
9 or pool their patents and have the government
10 dictate a price, I think both the Commission and
11 the Division won't have to worry about patent
12 pools anymore.

13 So I also think that we as lawyers --
14 or certainly this lawyer is ill equipped to
15 determine a market price. And thirdly, I don't
16 think that there is a problem there in the
17 marketplace as it exists now.

18 FRANCES MARSHALL: Well, our time
19 is drawing to a close here. Are there any
20 concluding remarks that any of our panelists
21 would like to make at this point? Not from
22 Howard?

1 All right. Well, I would just like to
2 thank you all for taking time out of what I know
3 are all busy schedules to spend a significant
4 amount of time with us, with writing your
5 presentations which will all be available on the
6 web, and that will really be helpful for us as we
7 look at these issues down the road.

8 I'd like to remind everyone to please
9 leave your plastic badges on the table downstairs
10 before you go out this evening. Thank you very
11 much.

12 (Applause.)

13 (Evening recess.)

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