A Competition Policy Perspective on Patent Law: The Federal Trade Commission's Report on the Evolving IP Marketplace

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It is well recognized that intellectual property and competition laws share the fundamental goals of promoting innovation and consumer welfare. Patents encourage innovation by preventing others from appropriating the value of the patent owner's investment. The antitrust laws preserve competition among new products and technologies, ensuring that consumers share in the gains from innovation. Both encourage firms to

[1] Economics has been especially influential in shaping the analysis of conduct involving the exercise of patent rights, leading, for example, to rule of reason treatment for most licensing arrangements.[2] Today, many economists advocate more nuanced approaches to antitrust that take into account the impact that imperfect information and complex business strategies can have on markets.[3] But while economic tools and thinking have evolved, the effort to use economics to shape rules that discourage anticompetitive behavior and preserve incentives to innovate has remained the driving force behind antitrust law and policy for nearly forty years.

The Federal Trade Commission has long been a leading voice for adopting a similar economically grounded approach to patent law. The Commission issued its first major report on the patent system in 2003, focusing on the impact of patent quality on innovation and competition.[4]

ROMOTE INNOVATION: THE PROPE

Examining how trivial and overbroad patents undermine competition with no offsetting benefit to consumers, the Commission proposed reforming the patent examination process and the obviousness standards applied by courts. Some progress has been made in this area, with the Supreme Court tightening standards for obviousness[5] and eliminating the presumption that had led to nearly automatic injunctive relief as an infringement remedy.[6]

In its latest study, *The Evolving IP Marketplace: Aligning Patent Notice and R*[illegible]

But in many instances patent licensing and sales take place "ex post," after there has been an accusation of infringement, and, critically, after the accused firm has made a large irreversible investment in creating, developing, or commercializing the technology. Because patent infringement is a strict liability offense, the accused firm needs to avoid liability even if it invented the technology independently of the patent owner. The result can be "patent hold-up," a situation in which the patentee can use the licensee's sunk costs as leverage to negotiate a higher royalty than it broadly often becomes blurred.[17] For these reasons, the Commission does not make any recommendations directed uniquely to PAEs and instead proposes flexible reforms aimed at reducing the incentives to engage in patent hold-up for all participants in the IP marketplace.

Patents, Innovation, and Competition

These market developments have important implications for patent policy. Patents encourage investment in new technologies by enabling the patentee to appropriate the economic value of its innovation by either licensing its technology or selling a patented product.[18] In some cases, a patent wilmi themselves from patent hold-up by designing around the patent or negotiating a license before committing to the patented technology.

Remedies also play a powerful role. To create efficient incentives to invest in innovation, patent law should seek to broadly align the reward from innovation with the incremental contribution a technology makes to economic value. Remedies that reflect the ex ante market value of a technology support these incentives while discouraging opportunistic efforts to exploit the hold-up value of a patent, including opportunistic behavior by PAEs.

It is worth noting that the Commission is not claiming that the ex ante market value will always reflect the full economic contribution of a pate e0rÄolr66N”q7;7N[o1.t[o1.t]]trsN[qrt6”7N”q tt”t-””-N[3;u1o-”-N3 potentially involve thousands of patents, a standardized vocabulary makes computerized searches relatively easy.[25]

The Commission focuses on challenges in the following three areas that interfere with patent clearance: identifying and reviewing published patents and applications; understanding the boundaries of existing claims; and predicting claims that may issue from pending applications. It proposes reforms to the patent examination process and judicial standards governing claim interpretation and validity.

The U.S. Patent and Trade Office (PTO), for example, could improve the ease and accuracy of patent searches if it classified patents by industry, in ad [illegible] each potentially covered by hundreds or even thousands of patents. IT firms operating in these patent thickets typically adopt strategies of “mutually assured destruction” to create a patent detente with other players in the industry.[32] However, these defensive strategies are typically ineffective against PAEs that are not vulnerable to countersuit. And even this partial solution of mutually assured destruction has costs since the need to generate large defensive patent portfolios contributes to the problem of poor quality patents that may find their way into the secondary market.

In light of the overwhelming notice issues facing the IT sector, some commentators argue in favor of modifying the strict liability standard for inadvertent infringement. Proposals take a variety of forms, but recent attention has focused on an “independent invention” defense that would apply where invention is nearly simultaneous [illegible] little room for market facts. Under the four-factor *Panduit* test,[37] for example, courts deny lost profits to patentees facing competition from noninfringing substitutes, even if they could establish lost sales to an infringing competitor. The *Panduit* test thus risks undercompensating patentees that lost sales to an infringing competitor. The Commission recommends reconsideration of this rule to enable a patentee facing competition from noninfringing substitutes to show that its product was the next-best alternative for some customers that purchased the infringing product and recover lost profits on those sales.[38] Conversely, where the patented technology is one element in a multi-feature product, the "entire market value rule" permits the patentee to recover lost profits based on the value of all infringing sales, even where noninfringing substitutes for the patented feature were available. This mechanistic approach likely overcompensates patentees facing meaningful competition from noninfringing alternatives. Instead, the Commission recommends that patentees claiming lost profits based on infringement of a patented technology should be required to provide evidence of customer demand for the patented feature over noninfringing alternatives.[39]

Patentees that cannot establish lost profits from infringement can recover reasonable royalties.[40] Royalties are the largest category of patent damages and the focal point in the current controversy surrounding the size of damage awards.[41] Reasonable royalties that are based on the ex ante market value of the technology can discourage ex post infringement claims by patentees merely attempting to capitalize on the investments of others but will not discourage valid claims to protect patented technologies that an infringer would have valued over ex ante alternatives. To achieve these goals, royalty awards must place the patentee in the position he would have been in absent infringement.[42] Courts direct litigants to reconstruct this but-for world by reference to a "hypothetical negotiation" between a willing licensee and a willing licensor at the time of the infringement under the seminal *Georgia-Pacific* framework.[43]

Although courts recognize this framework in principle, they depart in practice in a number of crucial respects. In several cases, the Federal Circuit has allowed patentees to recover a reasonable royalty exceeding what a willing licensee and licensor would have negotiated on the grounds that additional damages are necessary to provide adequate compensation to the pat-

37 Panduit Corp. v. Stahlin Bros. Fibre Works, Inc., 575 F.2d 1152, 1156 (6th Cir. 1978) (holding that to establish lost profits on a patented product, a patentee must show demand for the product, absence of noninfringing substitutes, the capabilit[illegible]

entee or to punish infringement.[44] But excessive royalty awards that are a backdoor attempt to compensate patent owners for unproven lost profits or willful infringement allow patentees to capitalize on the hold-up value of the patent. The Commission urges against the use of reasonable royalty awards as a proxy for unproven lost profits and recommends instead that courts a

Patent hold-up should also be considered when balancing the relative hardships between the parties and evaluating the impact of injunctive relief on the public interest. While injunctions should not be denied every time switching costs exceed the ex ante value of the patent, a denial is appropriate when the harm to innovation and consumers from patent hold-up swamps other concerns. This is likely to be the case if the infringer did not copy the technolo