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Before the

ANTITRUST MODERNIZATION COMMISSION

HEARING on PATENT LAW REFORM

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Thank you for inviting me to join this afternoon's discussion of patent law reform, a topic on which the Federal Trade Commission (FTC) has produced an extensive report.¹ In these brief remarks, I will discuss the FTC's activities in this area, including follow up to the Commission's report. Rather than delve into the particular details of the FTC's recommendations for patent reform, however, I would like to share some of what we heard from business people about how the patent system operates to promote or deter competition and innovation in their particular industries. This broader context may best illustrate how patent law relates to the work of the Antitrust Modernization Commission. The views I express are my own and do not necessarily represent those of the FTC or of any Commissioner, although the Commission has authorized me to appear and provide this statement.

A. The Relationship between Competition and Patent Law

Competition and patent law stand out among the federal policies that influence innovation. Both competition and patents can foster innovation. Competition through free enterprise and open markets is the organizing principle for most of the U.S. economy.

¹ *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy*, A Report by the Federal Trade Commission, Oct. 2003.

Competition among firms can spur the invention of new or better products or more efficient processes. For example, firms may race to be the first to market an innovative technology. Patent policy also can stimulate innovation. A patent can enable firms to increase their expected profits from investments in research and development, and thus foster innovation that would not occur but for the prospect of a patent. Because the patent system requires public disclosure, it can promote a dissemination of scientific and technical information that would not occur but for the prospect of a patent.

Despite the use of different methods to encourage innovation, competition and patents are not inherently in conflict. Patent law plays an important role in the property rights regime essential to a well-functioning competitive economy. Patents do not necessarily confer monopoly power on their holders, and most business conduct with respect to patents does not unreasonably restrain or serve to monopolize markets. Analogously, the Supreme Court has recognized the importance of competition to the patent system. As stated in the Court's decision in *Bonito Boats*,² "free competition" is "the baseline" on which "the patent system's incentive to creative effort depends."

Thus, both competition and patent policy can foster innovation, but each requires a proper balance with the other to do so. Errors or systematic biases in how one policy's rules are interpreted and applied can harm the other policy's effectiveness. As antitrust practitioners have learned, overzealous antitrust enforcement – such as that during the 1970's – can undermine the innovation that patents can promote. Conversely, an invalid patent can harm competition. For example, if patent law were to allow patents on "obvious" inventions, it could thwart the

² *Bonito Boats, Inc. v. Thunder Craft Boats*, 489 U.S. 141, 146 (1989).

competition that might have developed based on the obvious technology. Poor patent quality and legal standards and procedures that inadvertently may have anticompetitive effects can cause unwarranted market power and can unjustifiably increase costs. Such efforts can hamper competition that otherwise would stimulate innovation.

To examine the current balance of competition and patent law and policy, the FTC, together with the Antitrust Division of the Department of Justice, undertook Joint Hearings in 2002. The FTC's report, issued in 2003, discusses and makes recommendations for the patent system to maintain a proper balance with competition law and policy. A second joint report, by the FTC and the DOJ, will discuss and make recommendations for antitrust to maintain a proper balance with the patent system. We are working with renewed vigor on completing that report.

B. The Joint Hearings

The Hearings took place over 24 days between February and November 2002. They included testimony from more than 100 written submissions and 300 panelists, including business representatives from large and small firms and independent inventors; leading patent and antitrust organizations; leading antitrust and patent practitioners; and leading scholars in economics and patent and antitrust law. Business representatives were mostly from high-tech industries: pharmaceuticals, biotechnology, computer hardware and software, and the Internet.

Hearings participants found much to praise in the current patent system. Pharmaceutical and biotechnology representatives, for example, testified that strong patent protection is essential to innovation in their industries. Business representatives characterized innovation in these industries as costly and unpredictable, requiring significant amounts of pioneering research to discover and test new drug products. By preventing rival firms from free riding on discoveries,

patents allow pharmaceutical firms to recoup the substantial capital investments made to discover, test, and obtain regulatory approval of new drug products. Biotech representatives emphasized that patent protection is critical to obtain the capital necessary to fund this high-risk investment. Indeed, firms believed that the biotech industry would not exist but for patents.

Nonetheless, many participants in and observers of the patent system expressed significant concerns that, in some ways, the patent system is out of balance with competition policy. A global concern that representatives from each of the four industries described was that poor patent quality (for example, a patent for which there is invalidating prior art, or a patent broader than was enabled by the written description of the claimed invention) can blunt incentives to innovate. A poor quality or questionable patent is one that is likely invalid or contains claims that are likely overbroad. Hearings participants raised concerns about the number of questionable patents issued.

Questionable patents can deter or raise the costs of innovation. Professor Jonathan Levin identified three economic consequences that may flow from issuing patents of questionable validity. First, such patents may slow follow-on innovation by discouraging firms from conducting R&D in an area out of fear that they may be infringing. Indeed, firms in the biotech industry reported that they avoid infringing questionable patents and therefore will refrain from entering or continuing with a particular field of research that such patents appear to cover. Second, if a competitor chooses instead to negotiate a license to and pay royalties on the questionable patent, the costs of follow-on innovation and commercial development increase due to unjustified royalties. A number of panelists indicated that small firms, unable to bear the costs of litigation, are particularly likely to be forced to license if a questionable patent is asserted

against them, although some noted that large firms, with greater exposure, are also subject to *in terrorem* effects. For example, a questionable patent that claims a single routine in a software program may be asserted to hold up production of the entire software program. In either case, for small or large firms, entering an unnecessary license reduces the licensees' rewards and distorts their incentives to innovate or compete. Third, if instead the patent is challenged in litigation, the ensuing costs are a drain on the system. Let me note here that, in June 2004, the Executive Director of the American Intellectual Property Law Association (AIPLA), Michael Kirk, testified before Congress that the AIPLA's most recent survey of its members revealed that the average cost of patent litigation, including the costs of discovery, ranged between \$500,000 and \$3,995,000 per party, depending on the amount at risk.³ The frequency with which such very large costs are imposed could be reduced if fewer questionable patents were issued, and the size of these amounts could be reduced if challengers could use speedier procedures for the resolution of patent validity questions, such as the post-grant opposition procedures recommended by the FTC, the NAS, and the PTO, that are included in pending patent reform legislation in the House of Representatives.

These three economic consequences are not the only costs associated with questionable patents, however. In some industries, such as computer hardware and software, firms can require access to dozens, hundreds, or even thousands of patents to produce just one commercial product. Indeed, Peter Detkin, speaking at our hearings as a representative of Intel, explained that more than 90,000 patents generally related to microprocessors are held by more than 10,000

³ Michael K. Kirk, Executive Director of the AIPLA, Written Statement before the House Judiciary Committee, Subcommittee on Courts, the Internet, and Intellectual Property, on *Patent Quality Improvement: Post-Grant Opposition*, June 24, 2004.

parties. Much of this thicket of overlapping patent rights results from the nature of the technology; computer hardware and software contain an incredible number of incremental innovations.

Nonetheless, in industries with such incremental innovation, questionable patents can increase “defensive patenting.” One panelist undertook a search to determine the patent landscape surrounding a particular patent relevant to his business and in the process identified 120 patents that appeared to overlap each other, as well as to be infringed by his own product. As another panelist acknowledged, “the only practical response to this problem of unintentional and sometimes unavoidable patent infringement is to file hundreds of patents each year ourselves.”⁴ In this way, the problem is self-perpetuating. The need to develop extensive patent portfolios for defensive purposes diverts funding from R&D into the obtaining of patents; as one business representative explained, “the time and money we spend on patent filings, prosecution, maintenance, litigation and licensing could . . . be much better spent on product development and research leading to more innovation.”⁵

In the context of a patent thicket, questionable patents also can increase licensing difficulties, such as royalties stacked one on top of another. Moreover, questionable patents can increase uncertainty about the patent landscape. Panelists identified numerous impacts of uncertainty, reporting that uncertain patent rights: pose severe difficulties for business planning; heighten investment risk and hinder the raising of capital; disrupt the working out of licenses; and induce litigation that imposes costs and interferes with competition and innovation.

⁴ FTC IP Report, Ch. 3 at 35.

⁵ FTC IP Report, Ch. 3 at 37.

C. The FTC's Report and Follow-up Activities

In its report, the FTC made several recommendations for patent law. Some would require legislation; some would require changes in the case law; and some would require practitioners to adopt a broader policy perspective on patent law.

In terms of legislation, this past year has seen much activity. The FTC, together with the NAS and the AIPLA, held a series of town hall meetings focused on possible specific patent law reforms. These meetings provided a forum at which many stakeholders spoke; their remarks were transcribed, and an FTC staff summary of the discussions is available on the FTC's website. At the final town meeting in June, a draft patent law reform bill was discussed, and that bill contained 4 out of 6 legislative recommendations made by the FTC. The course of patent reform legislation never does run smooth, however, and various versions of the bill have provoked much discussion and debate. Nonetheless, the repeated concerns expressed about poor quality patents and other issues seem to have provided a basis for a significant effort to achieve improvements in the patent system.

In terms of the case law, I will simply note that a petition for certiorari has been filed in a patent case⁶ that raises one of the issues addressed in an FTC recommendation. The Supreme Court has requested the Solicitor General to provide the views of the United States government on whether to grant certiorari in this case.

Finally, I will speak to the last area of FTC recommendations – a broader policy perspective for patent law. It is this area that might be most fruitful for consideration by the

⁶ *Teleflex, Inc. v. KSR Intl. Co.*, 119 F. App. 282, 288 (Fed. Cir. 2005), *cert. petition pending*, No. 04-1350.

Antitrust Modernization Commission. All of you understand quite well how new economic learning, most generally associated with “Chicago school thinkers,” brought an updated economic framework to antitrust that, among other things, emphasized the importance of seeking to understand efficiencies, as well as possible anticompetitive effects, associated with particular business conduct. This new economic learning led to a more complex and pro-intellectual property understanding of how antitrust should view conduct with respect to patents.

The FTC recommended that patent practitioners similarly expand their consideration of economic learning and competition policy concerns in patent law decision making. The Supreme Court has made clear in several decisions that there is room for policy-oriented interpretation of the patent laws. Indeed, to find the proper balance between patent and competition law, the FTC stated, such policy-oriented interpretations are essential. Over the past twenty-five years, the incorporation of economic thinking into antitrust has provided significant insights that have substantially improved the development of antitrust law and competition policy. The Federal Circuit and the PTO may also benefit from much greater consideration and incorporation of economic insights in their decisionmaking.

The statute that created the AMC charges it with examining “whether the need exists to modernize the antitrust laws and to identify and study related issues,” among other things. Antitrust law protects competition and the competitive process “by preventing certain types of conduct that threaten a free market.”⁷ For the last twenty years, antitrust law has recognized enhancing consumer welfare as the single unifying goal of competition policy. Antitrust’s focus

⁷ FTC IP Report, Ch. 1 at 3, *citing* 1 HOVENKAMP ET AL., IP AND ANTITRUST § 1.2 at 1-5.

on consumer welfare reveals that governmental impediments to competition can be as harmful to consumers as private business restraints. As illustrated above by a wide variety of business testimony, the prevalence of poor quality patents is an impediment to competition, and it is an impediment that, by definition, is governmentally created and, like private business restraints, harms consumer welfare. The AMC may wish to consider the issue of patent law reform in this context.

Thank you for this opportunity to speak. I will be happy to respond to questions at the appropriate time.