

Patent Pools and Cross-Licensing
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Introduction

The Department of Justice and Federal Trade Commission are to be commended for their efforts over the past decade to provide guidance on the antitrust treatment of patent pools and cross-licensing practices. The agencies' 1995 Antitrust Guidelines for the Licensing of Intellectual Property and DOJ's 1997-1999 Business Review Letters on MPEG LA and DVD pool plans did much to clarify basic principles and outline how to structure these arrangements in ways that should minimize antitrust risk.

That said, however, guidance in these areas and particularly on patent pools should be seen as unfinished business in need of refinements and fresh thinking. The guidance to date does not address some critical issues presented by what can in some cases become sharply disparate effects of these arrangements on different classes of parties confronted by them. And these differences can importantly implicate the public's interest in competitive market conditions across many parts of the high-technology sector.

I. Patent Pools

Patent pools are efficient mechanisms for enabling widespread use of new technologies that require access to a multitude of patents dispersed among a multitude of parties. Combining the patents into single package licenses openly available to all interested parties can provide several competitive benefits that the agencies have recognized -- integrating complementary

technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation. We have come a long way from past generations when patent pools were often seen as “cartels” generating considerable antitrust hostility.

The MPEG LA and DVD letters delineate basic rules that can minimize antitrust risk and that are now widely employed. They can be summarized as follows: limiting aggregations to patents determined through objective means to be “essential” to employing the technology in question; assuring access to the assembled package to all interested parties on reasonable nondiscriminatory license terms; preserving opportunities for each licensor to negotiate licenses to its patents outside of the pool; protecting against dissemination of competitively sensitive proprietary information among the participants; and avoiding license conditions that impair future innovation incentives such as unduly broad grantback requirements and constraints on assertions of patent rights against licensors.

Those rules, however, often are not sufficient to provide the level playing field for all affected parties necessary to ensure unimpeded competition and to allow innovation to flourish around what may be an “infrastructure” standard that will transform a market and that the pool controls. There are inherent conflicts of interest between insiders -- the pool’s founding members owning the patents being assembled -- and outsiders -- often a diverse group of applicants for pool licenses including both many existing competitors of the insiders and later new entrants into the market that the insiders dominate as well as universities and other parties that do not directly compete in that market. My intention here is to delineate some of these conflicts, involving some aspects of pool licenses that have impeded outsiders’ opportunities. I will then comment more generally on insiders’ duties to outsiders and pool governance features that could more fully protect all interests, including those of the public that are at stake.

A. **Insufficient Responsiveness to Changing Market Conditions**

Patent pools generally accept the principle specified in DOJ's letters that their package licenses should be offered to all interested parties on "reasonable and nondiscriminatory" terms and conditions. Naturally enough, perspectives on what terms -- especially royalty rates -- are reasonable as well as nondiscriminatory in practice may differ markedly between and among different classes of affected parties. Pool insiders holding all of the patents and the pool administrator answerable to them may have an interest in maximizing use of the licensed rights across whole industries but they also have interests in the revenues that licenses generate. Outsiders on whom the royalties are imposed are pure payors with no share in revenue distribution. They must pay whatever rate the pool imposes with no opportunity for input into its determination.

Most importantly, changing market conditions may render license terms that are reasonable at the outset of pool operations unreasonable years later as applied to new entrants or parties that seek to use the licensed rights in products quite different from those giving rise to the pool at its inception. A royalty prescribed at the outset of the pool may represent an inconsequential part of the total cost of the products requiring the license at that time; the same royalty several years later may represent a competitively significant part of the cost of new generations of those products or of wholly new categories of products that employ the licensed rights. In short, an originally reasonable royalty may over time become an anticompetitive entry barrier; or, while nondiscriminatory on the surface, it may be anticompetitively discriminatory in its impact as between insiders sharing in the revenue stream and outsiders with no patents in the mix.

Serious problems rarely arise at the outset of pool operations when sponsors are incented to attract outsiders and get a new technology widely accepted. Serious problems, however, often arise in later years as affected product markets evolve and pool insiders with established market positions come to have little interest in facilitating further entry or competition from innovative new products developed by outsiders. Pool administrators tend to resist outsiders' efforts to negotiate over new license terms, preferring on behalf of the insiders to maintain the status quo. Pools tend not to have procedures in their governing documents for reconsideration of their license terms at the request of either existing licensees or new applicants. Pools, in short, often do not readily adjust to new circumstances in a competition-facilitating or innovation-facilitating manner. This is a point on which further DOJ guidance would be desirable, encouraging sensitivity to changing market conditions and their bearing on appropriate license terms.

B. Resistance to Partial Licenses

The common approach to pool licensing today is a "one-size-fits-all" package license for the totality of patents within the pool. This is generally deemed consistent with DOJ's letters as long as the pool as a whole includes only patents found to be essential to employment of the particular technology in question. But while all of the patents within the pool may be essential to the pool founders at the outset of the pool, some or many of them may be neither essential nor useful to outsiders seeking to employ the technology. An outsider may need only a fraction of all of the patents since it may already have access to a substantial number of them through existing licenses or cross-licenses with pool participants. Or a new entrant's innovative product may require use of only part of the package. Even insiders may reasonably want only a part of the package for some of their new products as they introduce such new products in response to changing competitive pressures.

Competitors and new entrants in those situations should be able to license the set of patents they need without being forced to take and pay for the whole package. In other words, pools should be amenable to issuing partial licenses to such applicants. Forcing upon them what in their case is a combination of needed and completely unneeded licenses raises costs, impedes new entry, discourages innovation and thereby in all of these ways results in less than optimal competition generally.

I am aware of two explanations for pools' resistance to partial licenses but I do not believe they withstand scrutiny. First, pool sponsors suggest partial licenses would create undue administrative burdens. It is difficult to believe that tiered fee schedules and associated allocations among patent holders cannot be fashioned with due allowance for associated costs of implementation. Second, pool sponsors suggest the availability of individual negotiations with patent holders is a sufficient alternative for parties needing less than the whole set. But this ignores numerous impediments to that approach: major transaction costs and time required for multiple negotiations; holders' disincentives to entertain negotiations; likelihood that the sum of individually negotiated royalties would significantly exceed the prescribed package license royalty; and the likely necessity of exchanging competitively sensitive information with one's competitors in the administration of individual licenses.

In the current environment, it is too easy for pool sponsors to dismiss the idea of partial licenses on the ground that the outstanding DOJ letters on patent pools bless pool arrangements without this feature. Some insiders even feel that any departure from the DOJ letters such as by providing partial licenses raises too much antitrust risk. But there can be no conceivable antitrust objection to pool experimentation with partial license approaches. Competitive impediments presented by pools that do not allow partial licenses may not rise to the level of creating

cognizable antitrust liability, but that is not the end of the story. DOJ could appropriately encourage partial license features by recognizing their potential for enhancing procompetitive effects, thereby offsetting anticompetitive risks under the applicable antitrust rule of reason.

C. **Other Concerns**

Slowness in adjusting to changing market conditions as they bear on the reasonableness of royalty rates and resistance to partial license approaches are not the only sources of conflict or potential conflict between insiders and outsiders. Another concern with some relationship to both of those points is outsiders' inability to participate in or challenge determinations of patent essentiality. DOJ's letters caution pools to remain alert to the possibility that some patents initially determined to be essential should be reconsidered in light of subsequent information that they are invalid or that they cease to be essential to the package for any other reason as well. Mechanisms facilitating outsiders' input in this regard would be desirable since they may possess relevant information -- particularly in light of developments years after a pool is organized -- not readily available to insiders. Pools should, in addition, be open to outsiders' proposals for subdividing the pool's portfolio into two or more separate packages for separate licensing where doing so could lower costs of new entry or facilitate product innovation efforts.

Concerns also arise over the scope of grantback requirements and other license provisions impeding a licensee's assertions of its own patents against a licensor within the pool. Again, DOJ's letters include cautions about unduly broad provisions of these kinds insofar as they may reduce future innovation incentives and innovation rivalry. Also again, however, outsiders should have meaningful opportunities for input on these parts of the license, and one-size-fits-all may not be appropriate for all licensees. A broad grantback or inhibition on asserting patent rights against a licensor may have no significant impact on some licensees while amounting to a

major forfeit of value in IP investments for other licensees. There should be room for negotiation over these issues and acceptance of differences in these provisions as written into licenses issued to different licensees.

D. **Pools' Duties to Outsiders and the Public Generally**

There are two critical but insufficiently highlighted premises underlying all three of DOJ's letters in this area. First, pools can wield considerable power over access to and the ultimate shape of entire markets and technology spaces. Second, antitrust toleration of that power depends on acceptance of obligations to operate in the interests of all affected parties and, most importantly, to operate in a manner consistent with the public's interest in maximizing competition and innovation opportunities in all such affected markets and spaces. The concerns I have described as conflicts between pool insiders and outsiders point to the need for some more explicit and effective recognition of these premises in the manner in which pools are organized, administered and governed. Allow me to offer some suggestions in this regard.

A starting point would be commitments set forth in organizing documents to operate the pool at all times with due regard for the interests of all users of the technology to be licensed -- present and future licensees alike, members and nonmembers alike -- and with particular regard for the public interest in maximally open, competitive markets. Critical to the public's confidence that the pool's insiders adhere to these commitments is some reasonable degree of openness and publicity regarding significant aspects of pool operations. This could, for example, take the form of a publicly available website where minutes of meetings of the pool's governing board and reports on licensing activities are periodically posted.

Those steps, however, may not suffice to rein in the natural instincts of pool insiders to promote their own competitive interests. A further safeguard would be a mechanism under

which outsiders could challenge pool decisions about such matters as royalty rates, other license terms and patent essentiality. To be effective, the mechanism should provide for some form of neutral and objective dispute resolution. Another desirable safeguard would be inclusion on the pool's governing board of at least one person unaffiliated with any of the founding patent holders, perhaps a widely respected university guru or someone with expertise in the technology to be licensed but without a financial interest in pool revenues. He or she would be in the nature of an "outside director," expected to keep a vigilant eye on the public's interest in the pool's operations.

Guidance from the agencies encouraging pools to consider steps of those kinds should be welcomed in many quarters. Particularly with that kind of encouragement, these steps could help to minimize conflict between and among the different pool constituencies and help to ensure that pools operate in the public interest.

II. Cross-Licensing

Patent cross-licensing is pervasive throughout much of the high-technology sector, occurs in a wide variety of market contexts and takes a wide variety of forms. It is, for example, an inherent part of the kinds of patent pools that I have already discussed in some detail. More commonly, however, cross-licensing occurs between two parties as a way of either settling or avoiding the unhappy prospect of infringement litigation between them. In this context, cross-licensing enhances each party's design freedom and allows them to continue competing in their markets without the burden of always-expensive and often-unpredictable litigation over the validity and scope of each other's patents.

The common forms of cross-licensing should enjoy a strong presumption of legality under the antitrust laws. To the extent it frees competition from litigation clouds, or enables

continuation of competition that otherwise could end in the aftermath of a litigation outcome, it is distinctly procompetitive. Of course, that presumption can be overcome in circumstances where a cross-license is a sham for an agreement to avoid competition that could otherwise occur without infringing either party's patents, or where understandings collateral to the cross-license itself create incentives to refrain from any such future competition as a result of future innovation efforts. Those exceptional circumstances aside, cross-licensing generally facilitates competition and promotes longstanding public policy favoring settlement and avoidance of litigation.

The 1995 Antitrust Guidelines for the Licensing of Intellectual Property (Sec. 5.5) are consistent with my suggested presumption but not as expressly supportive of it as would be desirable. A 1997 address by then-Acting Assistant Attorney General Joel Klein¹ signaled a considerably broader enforcement agency concern and suspicion about cross-licensing than either agency had previously evinced. There was not then and is not today any apparent basis for heightened scrutiny of these practices generally. Thus, to the extent the agencies, in their final report on these current hearings, believe it appropriate to clarify policy in this area, it would be desirable to do so in the direction of the presumption that I have suggested.

¹ "Cross-Licensing and Antitrust Law," Address by Joel I. Klein, Acting Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Before American Intellectual Property Law Association, San Antonio, Texas (May 2, 1997).