

Track 2: How to Draft Licensing Agreements that Avoid Antitrust Problems

*Alex Fowkes
Pfizer Inc
New London, CT*

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I. Introduction

- A. An unlawful condition in a license agreement cannot be rendered lawful by creative drafting. The analysis of potential anti-trust violations is not concerned with the manner in which an unlawful condition is expressed. Rather, anti-trust analysis is concerned with the likely impact of the restraint on competition in the market place. This does not mean that if you are drafting a license agreement you don't have a role in avoiding anti-trust problems. To the contrary you have at least three key roles:
1. You are in the best position to identify those terms or combination of terms that may be problematic. Often, you are the last line of defense!
 2. A term may be drafted in a number of ways to achieve your client's objectives. You should be able to identify the best approach to minimize the risk that the term will be held unlawful.
 3. You need to exercise care to avoid inadvertently creating a problem by poor drafting.

II. Anti -Trust and Licensing

A. Treatment of Intellectual Property

The Department of Justice's (DOJ) and the Federal Trade Commission's (FTC) approach to intellectual property is set out in the "*Anti-Trust Guidelines for the Licensing of Intellectual Property*" issued in April 1995. In short the guidelines provide that the DOJ and FTC:

1. will treat intellectual property like any other form of property;
2. will not presume that intellectual property confers market power; and
3. recognize that intellectual property licenses are generally pro-competitive.

Unlike the agencies the courts still hold that a patent creates a rebuttable presumption of market power.¹ Nonetheless, the trend in anti-trust analysis of intellectual property licenses is away from a *per se* treatment towards a rule of reason analysis. This includes an inquiry into the facts peculiar to the business and market in question, the nature and history of the restraint, the reason for adopting it and the likely or actual effect of the restraint on competition.²

B. Anti-Trust and Misuse

The anti-trust statute most directly relevant to licensing is section 1 of the Sherman Act³ as it addresses bilateral conduct prohibiting “every contract, combination in the form of a trust, or conspiracy in restraint of trade or commerce”.

Section 2 of the Sherman Act addresses the conduct of an individual prohibiting a person who “shall monopolize, or attempt to monopolize...any part of trade or commerce”. In the intellectual property context section 2 tends to be more relevant to consideration of refusals to deal and accumulation, procurement and enforcement of patents. These matters will not be discussed in this paper.

The Sherman Act provides for both criminal and civil enforcement. The civil remedies include damages and a wide range of injunctive relief to redress the effects of the infringing acts.

Patent misuse is an affirmative defense to patent infringement and arises when a patentee “has impermissibly broadened the ‘physical or temporal scope’ of the patent grant with anti-competitive effect”.⁴ Misuse renders a patent unenforceable until the misuse is purged.⁵ A rule of reason approach is generally used to determine misuse. But, there remain practices that will be assessed under a *per se* standard.

The relationship between the anti-trust and patent misuse remains unclear. While a licensing practice that violates anti-trust laws will also constitute misuse this is not always the case in reverse. Generally, the analysis of practices is similar. But, differences remain.

In this paper only patent misuse will be considered. But, similar principles apply to other forms of intellectual property.

III. Licensing Restraints

A. Pricing Restraints

1. Principles.

Pricing restraints between competitors (horizontal restraints) are *per se* patent misuse and anti-trust violations. Likewise, most vertical pricing restraints are also *per se* illegal. But, the setting of a maximum price will be assessed under the rule of reason. Further, a limited exception exists for setting of minimum prices in a

1. Independent Ink, Inc., v Illinois Tool Works, Inc. and Trident, Inc., Fed. Cir., No. 04-1196, 1/25/05.

2. Board of Trade v United States, 246 U.S. 231, 238 (1918)

3. 15 U.S.C § 1

4. Windsurfing International Inc. V. AMF, Inc., 782 F.2d 995, 1001 (Fed. Cir.)

5. Senza-Gel Corp. v. Seiffhart, 803 F.2d 661, 668 (Fed. Cir. 1986).

patent license: A licensor may control the price at which a licensee sells the licensed product if:

- i. the product is covered by the licensed patent; and
- ii. the licensor also manufactures the product.⁶

The DOJ has repeatedly attacked this exception and still maintains the view that all price restraints are *per se* violations.

While price restraints are generally problematic, it is permissible for a licensor in a vertical arrangement to recommend pricing or provide a basis for price discussions.

2. Drafting.

When drafting you should approach with caution any provisions that may control the licensee's freedom to set prices.

Prudence dictates that the *General Electric* exception should only be relied when there is no alternative and only after an anti-trust expert has analyzed the specific facts to determine the advisability of including the restraint. If your client is concerned that the value of the royalty stream will be undermined by the licensee's pricing practices an alternate to a price restraint may be the inclusion of minimum fixed sum royalty.

If asked to provide for recommended pricing or pricing discussions in a license, you should take care to make it clear that the licensee is under no obligation to follow the recommendation.

B. Field of Use Restraints

1. Principles.

Generally, field of use restrictions are permissible. A licensor may limit a licensee's use of patented product to specified fields.⁷ But, problems could arise if the fields are not separate and identifiable.⁸ The field should not represent a division of customers within a market.

A licensor may not restrain a licensee's use of an un-patented product made by a patented process.⁹

2. Drafting.

Ensure the limitation only applies to use of the patented article or process.

Check that the field as drafted clearly describes either a separate use or separate market. If in doubt, explore the business rationale for the restraint and conduct a preliminary rule of reason analysis.

6. *United States v. General Electric Co.*, 272 U.S. 476, 47 S. Ct. 192, 71 L. Ed. 362 (1926).

7. *Mallinckrodt Inc. v. Medipart Inc.* 976 F.2d 700 (Fed. Cir. 1992)

8. *United States v. Crown Zellerbach Corporation* 141 F.Supp. 118

9. *United States v. Glaxo Group Limited* 410 U.S. 52, 93 S. Ct. 861

C. Non-Compete

1. Principles.

A rule of reason approach will be applied to the assessment of a non-compete provision in a license. As with non-compete provisions in other vertical arrangements, the restraint's reasonableness will be assessed by its scope and duration. If unreasonable, the non-compete provision may be held improper as an anti-trust violation or patent misuse.¹⁰

2. Drafting.

Each non-compete will need to be drafted on its merits. It is important to clearly articulate both the temporal and physical scope of the restraint to avoid it be later construed as wider than intended.

D. Post Expiration Royalties

1. Principles.

A requirement to pay royalties after a patent has expired is per se patent misuse¹¹ even if the licensee voluntarily agrees to pay post expiration royalties.¹² But, if the license fee is a lump sum to be paid in installments that extend beyond the life of the patents this is not patent misuse. In other words, it is permissible to require payments after expiry of the patent if the payment is for pre-expiration use.

Know-how royalties may extend beyond the term of the patent in a hybrid license. But, if there is a combined royalty covering the patent and the know-how this royalty may not continue after expiry of the patent.¹³ Instead, it must be reduced to reflect the loss of value attributable to the loss of the patent.¹⁴

2. Drafting.

There should be little problem in avoiding post-expiration royalties in a naked license of a single patent. The license should clearly state that the obligation to pay royalties ends on expiry of the patent. But, greater care may be needed when drafting the license for a package of patents or a hybrid license.

In the first case, the ruling in *Scheiber* suggests that it will be misuse if a license requires payment of a royalty on a package of patents until the last to expire of the patents, even though it is for the convenience of the parties.¹⁵ As a result, a conservative approach dictates the provision of separate royalty rates for

10. *Compton v. Metal Products inc.*, 453 F.2d 38, 172 U.S.P.Q. 263 (4th Cir. 1971)

11. *Brulotte v Thys Co.* 379 U.S. 29 (1964)

12. *Scheiber v Dolby Laboratories Inc.* 293 F.3d 1014, 63 USPQ2d 1404 (7th Cir. 2002)

13. *Pitney-Bowes Inc v. Mestre*, 701 F.2d 1365

14. *Aronson v Quick Point Pencil Co.*, 440 U.S. 257, 99 S.Ct. 1879.

15. See also *American Securit Company v. Shatterproof Glass Corporation* 268 F.2d 769

each patent or a mechanism for reducing the royalty as patents expire. But, the approaches described in G(2) below may also be applicable here.

In the second case it is recommended that you provide separate know-how and patent royalties. The patent royalty should end on expiry of the patent. The other approach is to provide a single royalty rate that is reduced on expiry of the patent.

E. Reach Through Royalties

1. Principles.

The parties to a license can agree as a matter of convenience for royalties to be paid on sales of products not covered by the patent.¹⁶ But, it is patent misuse for the Licensor to *condition* the license of a patent on payment of royalties not covered by the patent.¹⁷

2. Drafting.

As a reach through royalty is only a problem if it is coerced, before drafting the relevant provision you should investigate the negotiation record. If the record reflects the Licensee's voluntary agreement to the payment of reach through royalties then you can proceed. But, if the record shows that the Licensee resisted the royalty structure and the Licensor refused to consider 'non-reach through' alternatives, you have a problem that drafting will not fix. You should resist the temptation to 'rewrite the record' in the agreement. Instead, a more detailed analysis of the rationale for the royalty structure should be undertaken with your client.

F. Tying to Goods or Services

1. Principles.

If a licensor has market power, it may be unlawful for the licensor to condition a patent license on (1) the purchase, from the licensor, of goods or service not covered by the patent;¹⁸ or (2) a promise not to purchase a third party's goods or services.¹⁹ A rule of reason analysis will be applied.²⁰

A tying condition will not be unlawful, if the tied good can only be used in a process or in an article covered by the licensed patent.²¹ Such goods are referred to as a 'non-staple goods'.

16. *Automatic Radio Mfg. Co. v Hazeltine Research Inc.*, 339 U.S. 827 (1950)

17. *Zenith Radio Corp. v Hazeltine Research Inc.*, 395 U.S. 100 (1969)

18. *International Salt Co. v United States*, 332 U.S. 392, 68 S. Ct. 12

19. *In Recombinant DNA Patent & Contract Litigation*, 850 F. Supp. 769

20. *Windsurfing International Inc. v AMF Inc.* 782 F2d 995

21. 35 U.S.C. § 271(d)(1),(2) and *Dawson Chemical Company v Rohm and Hass Company* and *Calhoun v State Chemical Manufacturing Company* 448 U.S. 176, 100 S.Ct. 2601

In the case of patent misuse, market power must be demonstrated.²² But, under anti-trust laws a patent still carries with it a rebuttable presumption of market power.

2. Drafting.

When drafting tying provisions you should determine if the tied goods could be used in a non-infringing manner. If they could, you should assess whether the licensor has market power and also undertake a preliminary rule of reason analysis. This will include an investigation of the business rationale for the tie (e.g. quality or safety concerns).

It is important to keep in mind that the mechanism used to ‘force’ the tied goods is not important. If the effect is to tie in or tie out goods then the problem may arise. For example: a right to terminate if competing goods are purchased has the effect of a tie out.²³

A Licensor may want to sell staple goods with a license to use them in a patented process or device and include the license fee in the price of the staple goods. Often, this is done by way of a label license. To avoid a claim of unlawful tying the label should clearly state the following:

- i. The standard license fee is included in the price
- ii. Licensor will license anyone requesting a license at the standard license fee.
- iii. The staple goods will be sold ex-license fee to anyone who wishes to use them for other purposes.

G. Tying to Other Intellectual Property

1. Principles.

If a licensor has market power, it may be unlawful for the Licensor to condition a patent license on the Licensee taking a license to other intellectual property.²⁴ A rule of reason analysis will be applied.²⁵

2. Drafting.

As a tie to other intellectual property is only a problem if it is coerced, before drafting the relevant provision you should investigate the negotiation record. If the record reflects the Licensee’s voluntary agreement to the tie as a matter of convenience then you can proceed. But, if the record shows that the Licensee resisted the tie and the Licensor refused to consider alternatives, you have a problem that drafting may not fix. You should resist the temptation to ‘rewrite the record’ in the agreement. Instead, you should undertake a rule of reason of analysis including discussing with your client the business rationale for the tie.

22. 35 U.S.C. § 271(d)(5)

23. In *Recombinant DNA Patent & Contract Litigation*, 850 F. Supp. 769

24. *American Securit Company v. Shatterproof Glass Corporation* 268 F.2d 769

25. *Windsurfing International Inc. v AMF Inc.* 782 F2d 995

If the Licensee wants a license to a bundle of patents but only wants to pay royalties on actual patents used you should consider drafting a royalty provision that provides for different rates depending on the patents actually used. But, if the Licensor intends to provide package licenses to other licensees, you should take care to consider the impact of a ‘most favored licensee’ clause. For example what would be the impact of a ‘most favored licensee’ clause in a package license with a single royalty if a later licensee takes the package license with differential rates?

Another approach is for the royalty to be linked to a specified process or article covered by the patents. The same royalty remains payable until the relevant subject matter is no longer covered by a patent. This assumes that the Licensee is only interested in practicing an identifiable process or article covered by multiple patents.

H. Grant Backs

1. Principles.

It is not unlawful *per se* to require a Licensee to grant back improvements it makes to the licensed patents.²⁶ Generally, the courts have upheld grant back provisions unless they form part of a scheme to extend the licensor’s monopoly with anti-competitive effect. For example, if combined with other restraints such as price or territory restraints, tying, cross-licensing or patent pooling.

Grant back provisions requiring assignment, as opposed to a grant back of a non-exclusive license, are not looked upon favorably by the DOJ. Nonetheless, the Courts have upheld assignment grant backs.²⁷

The courts will apply a rule of reason analysis to considering grant backs. Factors considered in assessing the reasonableness of a grant back include the scope of improvements captured²⁸, the right of the licensee to practice the improvements²⁹ and the duration of the grant back obligation.

2. Drafting.

Before drafting a grant back provision you should consider whether the license contains other restraints. If it does, you should put the pen down and carefully consider both the intended and likely impact of these restraints operating together.

If you determine that the inclusion of a grant back provision is appropriate but that a conservative approach to drafting is prudent you should consider the following:

26. *Transparent Wrap Machine Corporation v Stokes & Smith Company* 329 U.S. 637 (1947)

27. *Transparent Wrap Machine Corporation v Stokes & Smith Company* 329 U.S. 637 (1947)

28. *Duplan Corp. v Deering Milliken, Inc.*, 444 F.Supp. 648

29. *Santa Fe-Pomeroy Inc. v P&Z Company, Inc.*, 569 F.2d 1084

- i. Confine the grant-back to a non-exclusive license. If you wish to provide for an assignment back you should ensure the licensee is able to practice the improvements without additional charge or obligation.
- ii. Confine the grant-back to improvements within the scope of the licensed patents.
- iii. Confine the duration of the grant back to the life of the license.

I. Exclusive License

1. Principles.

An exclusive license will be treated under section 7 of the Clayton Act³⁰ in the same manner as the transfer of any property. Accordingly, it will be considered a transfer of an asset under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“HSR”).

Notification may be required if the parties cross the size of person thresholds and more than \$15 million of assets will be transferred.

2. Drafting.

If it is possible that the license may require notification under HSR then it is prudent to provide for the completion of the notification process as a condition precedent to the license becoming effective.

IV. Other Drafting Considerations

If you have included a provision that, despite your best efforts, may still be held unlawful, you should consider whether the provision can and should be severed. It has been held that price restraints cannot be severed from the royalty provisions.³¹ Nonetheless, you should not include the ‘standard’ severance clause seen in most ‘boiler-plate’ without careful consideration of its potential consequences. There may be circumstances where your client does not want the remainder of the agreement to survive if a particular restraint was found to be unlawful. Alternatively, if the ability to sever is considered important you should carefully tailor the severance provision to give it the best chance of success.

Finally, it is very important to keep in mind that your efforts to draft a license agreement to avoid anti-trust problems will be for nothing if the Licensor or Licensee’s conduct does not reflect the conduct contemplated by the drafting. As stated at the beginning, drafting cannot render unlawful conduct lawful.

30. 15 U.S.C. § 18

31. *Patrizi v McAninch* 153 Tex. 389,269 S.W.2d 343 & *MacGregor v Westinghouse Electric & Mfg. Co.* 329 U.S. 402, 67 S. Ct. 421.

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