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May 9, 1988

The Honorable Robert W. Kastenmeier
Subcommittee on Courts, Civil Liberties
And The Administration Of Justice
Committee On The Judiciary
United States House of Representatives
2137 Rayburn House Office Building
Washington, D.C. 20515

Re: H.R.4086 (100th Cong., 2d. Sess.)
The Patent Licensing Reform Act of 1988

Dear Congressman Kastenmeier:

On April 26, 1988, I received a copy of H.R.4086 and learned that you scheduled hearings on the bill for May 11, 1988. I ask that you include this letter in the record of those hearings.

I write you as a citizen concerned about the incentives for increasing the productivity of the American economy through technical change. One indicator of America's ability to achieve productivity gains is to compare its performance to the countries with whom we trade. If our trading partners achieve technical productivity gains at a more rapid rate than America, we will experience a decline in the share of worldwide sales of goods and services made by Americans and a decline in the share of the world's wealth owned by Americans. Congress has a vital duty to evaluate the effect of its laws on achieving productivity increases by technical innovation.

The bill relates to patent law. Patent law is the principal body of law on which the American economy relies

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to provide correct incentives for the production and use of technical information in the private sector. If patent law may be changed to produce a net economic benefit for the country, the law should be changed.

Summary

I write to convey five primary thoughts.

First, H.R.4086 is directed to rules that limit a patent owner's conduct (1) in obtaining the patent from the patent office and (2) in exploiting it by agreements with others. The Courts have made the laws under which patent owners engage in those activities, with only one legislative exception. I applaud the effort by Congress to evaluate whether the judicial law makes economic sense.

Second, those two sets of rules have a tremendous impact on the incentives created by the patent system and, therefore, on the productivity of the American economy. Congress could sensibly intervene to create more economically sensible law.

Third, certain features of H.R.4086 would improve economic performance. The bill has other features that would probably impair economic performance. The bill could be improved. On balance, I do not support H.R.4086 in its current form. However, H.R.4086 provides a valuable focus for determining sensible economic policy for these parts of the patent law of this country. There has been considerable analysis of the economic impact of the laws relating to exploitation of patent rights. Some of that analysis may be brought to bear on Section 2 of H.R.4086 by May 11, 1988, though without the rigor that a somewhat longer time would permit. There has been little analysis of the economic impact of the laws the Courts created to regulate the patent owner's conduct before the patent office. Hence, the economic impact of Section 3 of H.R.4086 will not be analyzed with the desirable rigor by May 11. However, before you enact Section 3, ask yourself whether you would be willing to be subject to its provisions in carrying out your responsibilities in even one area -- proposing or supporting new legislation. Imagine that Congress required Congressmen to make disclosures under an identical rule every time they introduced legislation or spoke in favor of enacting any legislation. Surely the quality of legislation in the United States is every bit as important as the quality of patents. Surely better

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information is as important to passing correct legislation as it is to issuing correct patents. Surely some Congressmen introducing or supporting bills have more information about the bill than other Congressmen and the public. Suppose that, if any Congressman proposed or supported any legislation without making the required disclosure, all such legislation could be declared unenforceable by the Courts. I do not think I need to explain to you the costly and debilitating effects such a rule would have on our system of government. Please think about that before permanently imposing these rules on the patent system. In this letter, I have outlined some of the things that Congress should consider before legislating on either of these matters. I will not attempt in this letter to describe comprehensively the state of the law, the history of the development of that law in the Courts, the theories that lead the Courts to make up those laws, or the economic analysis of the likely effects of each of the provisions of H.R.4086. I offer the following summary comments, because of the shortness of time.

Fourth, before it acts, Congress should determine whether our major trading partners have laws on these issues providing greater benefits to their economies at less cost than H.R.4086. If our major trading partners have more efficient patent laws for their economies and if American innovators rely more on the value of the American patent system than on foreign patent systems to earn returns from innovation, we are shooting our innovators and ourselves in the feet to enact rules that are less efficient than theirs. If you believe that is important, I hope you will ask some knowledgeable people to determine whether Japan, West Germany and our other international competitors have laws regulating patent owner conduct in obtaining and exploiting patent rights that provide greater net economic benefits than ours. If our international competitors have such laws, and if American innovators rely more on the United States market than foreign markets to earn returns to innovation, that should be a warning to us to consider very carefully whether to enact H.R.4086.

Fifth, I understand that H.R.4086 was introduced in part as the result of the inability of the conference to agree on all the intellectual property provisions of the Omnibus Trade bill, H.R.3. That bill contained a patent misuse provision (Title XXXIV of the Senate bill), and a "licensee challenges to validity" provision (Title XXXV of the Senate bill). H.R.4086 would be improved by addressing the "validity challenge" issue.

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The Patent Laws Of Japan And Europe On These Issues
May Be More Efficient Than Current U.S. Law And H.R.4086

If you investigate foreign law, my understanding is that what you will be told that our major trading partners have no patent misuse rule whatsoever. Of the two types of conduct H.R.4086 regulates, the rules regulating the ways patent owners exploit the rights are probably more important economically than the rules relating to conduct before the patent office. It is my understanding that Japan has no patent misuse rule. It is my understanding that the European Economic Community has no rule that results in a patent being found unenforceable because a patent owner exploited it in certain ways. My understanding is that, in each of those economies, patent agreements that are deemed to impose greater economic costs than economic benefits are declared unenforceable. A fine may also be imposed. The underlying patent rights are never rendered unenforceable. The United States is an anomalous exception. The United States Supreme Court created the exception in the late 1930s and early 1940s. Japanese and European lawmakers have known about the misuse rule for at least forty years and have decided not to adopt it. We should ask ourselves why they have not. I believe the reason is that our misuse rule makes no sense. If you are a U.S. automobile manufacturer and your agreements with car dealers violate the antitrust laws, the consequence is not that your dealers keep all the cars sold under the agreements without paying for them, and not that any member of the public is able to steal those cars off the lots. However, if you manufacture an invention and your property is the U.S. patent right, the misuse rule provides exactly that result. If the licenses by which you make those rights available to your dealers, called licensees, contain a clause that violates the antitrust laws, your patent is unenforceable against your licensees and anyone else. They may use the invention for free. The misuse doctrine does give you the right to re-establish enforceability as to future infringement by showing that your offending conduct has ceased and the effects fully dissipated, but in the meantime your rights vanish. Japan and the EEC have no such misuse doctrine. In addition, if you are a U.S. automobile manufacturer, you also need to comply with only one standard, the antitrust laws. If you are an invention manufacturer, you must comply with antitrust standards and a separate standard the Supreme Court made up based on its view of the public interest. Licenses in Japan and the EEC are subject to a single standard, the standard provided by their antitrust laws.

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H.R.4086 also provides that a patent may not be enforced if the patent owner did not behave "equitably" in obtaining the patent from the patent office. It is also my understanding that our major trading partners do not regulate the way patent owners conduct themselves in obtaining patents by rules that prevent enforcement of the patent. Infringers in Japan and Europe may not escape liability by showing that the patent owner engaged in "fraud or inequitable conduct in procuring or enforcing the patent." Again, if that is correct, the United States is an anomalous exception. The Courts made up the most significant fraud and inequitable conduct rules in the 1960's and early 1970's. As in the case of the misuse doctrine, Japanese and European lawmakers have decided not to follow us down that path. Again, we should ask ourselves why they have not.

The rules in the United States relating to licensee challenges to the validity of patents have no counterpart in Japan and a less onerous counterpart in the EEC. Agreements that a licensee will not challenge the validity of a patent are enforceable in Japan. While the rule is somewhat different in the EEC, I have been told that EEC law has not prevented the parties to agreements from reducing risk and litigation expenses to the same extent that United States law has.

For this reason, I would proceed with H.R.4086 with great caution.

The Patent Misuse Rule

I will not explain here the history of the mistaken economic notions that led the Supreme Court to create the misuse rules. Many of my thoughts about the economic significance of the patent misuse rule are set out in my testimony before the Subcommittee on Patents, Copyrights and Trademarks of the Committee on the Judiciary of the United States Senate at hearings on S.1841 (98th Cong. 2nd Sess., April 3, 1984). At those hearings, I supported a bill to change the antitrust law and the patent misuse rules in the United States. The essence of S.1841 was to (1) provide that license agreements would not be judged under so-called per se rules for antitrust purposes and (2) retain the unique American misuse rule and change the misuse standard so that Courts would decline to enforce the patent only if the patent owner's conduct violated the antitrust laws. The Courts have moved in that direction on

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patent misuse. The United States Court of Appeals for the Seventh Circuit and the United States Court of Appeals for the Federal Circuit have declared that, unless decisions of the Supreme Court require them to do otherwise, they will apply antitrust standards to define whether patent misuse renders a patent unenforceable. Those decisions are highly beneficial. Their application should be expanded, not restricted as H.R.4086 may do.

If the antitrust laws create a proper set of limits for exploiting patent rights, then any other set of limits must be wrong. If Congress decides that it is most efficient if people drive only 55 miles per hour on the highway, it would be inefficient for the Supreme Court to declare that automobile owners will have no remedies against car thieves if they drive over 35. The misuse rule is a 35 mile an hour speed limit on productivity gains from technical innovation in the United States.

Eliminate The Patent Misuse Rule

The misuse rule operates as an "exclusionary rule" for patents. Under the exclusionary rule, criminals are freed in order to control the police. Under the patent misuse rule, infringers are freed in order to control the patent owner. The antitrust and contract laws are adequate to control patent owners. The economy gains nothing from freeing infringers. Rather, the economy suffers a significant cost -- the whole purpose of the patent system is defeated for a time as the value of inventions is captured by others.

The United States would be best off by following our major trading partners and abolishing the patent misuse defense. If we abolish the misuse defense, patent owners licensing their patents in violation of the antitrust laws would remain subject to antitrust remedies and the general contract rule that prevents them from enforcing the illegal provisions against their licensees. Freeing the licensees from an enforceable obligation to perform the undesirable agreement will eliminate any economic harm in the cases where the patent owner is deemed to have attempted to achieve some anti-competitive effect by coercing some conduct by the licensee. The licensee may engage in the conduct under the contract rule. In addition, antitrust penalties are adequate to deter both that type of agreement and agreements in which patent owners, or a patent owner and his "licensees" might attempt to secure freedom from

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competition with each other under the guise of a license. We have not had any example of patent owners and "licensees" attempting to do that in many years. However, the risk is real and antitrust penalties are adequate to deter it. Indeed, it was antitrust law, not patent misuse law, that stopped that practice.

This is not a radical idea. That is how we treat all other property rights in the United States. Congress has said that patents are supposed to be treated like personal property. My proposal is simply that we do what Congress long ago said we should do.

If you reject that idea, I offer the following general comments on the specific provisions of Section 2 of H.R.4086.

The Misuse Provisions Of H.R.4086

Section 2 of H.R.4086 says a patent owner who engages in conduct "constituting misuse or illegal extension of the patent shall be denied relief under this title for infringement of the patent until such misuse or illegal extension terminates and the consequences of such misuse or illegal extension have been dissipated." That sounds like a sweeping charter to the Courts to continue to do what they have been doing. Indeed, one may argue that it gives them an even broader charter, because it encompasses conduct called "misuse" and conduct described as "illegal extension of the patent." It is unclear from that language whether those are the same thing or two different things. If they are different things, someone may convince a Court that Section 2 provides an unlimited charter for the Courts to say what is "illegal extension" and that the Court should do so even if the conduct would not be "misuse." The next two subsections do not clarify that issue. Paragraph 2 says "... the term 'misuse or illegal extension' of a patent means, except as provided in paragraph (3), includes -" This may be a printing error. The term "means" is, of course, different from the term "includes." I cannot tell from the bill which Congress means.

If the intent of the bill is to confine "patent misuse and extension" to one class of activities which are sometimes misuse, and another class of activities which are not misuse, Section 2 is a step toward more sensible policy. The ultimate economic effects depend on how the Courts interpret the "unreasonableness" requirement for finding

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misuse. However, unless the Courts totally ignore the "unreasonableness" requirement, the bill under that view permits patent owners to use certain terms that are now wrongly prohibited in all situations. The bill probably provides a net economic benefit under that view.

If Congress is leaving to the Courts discretion to find "misuse or illegal extension" even though the patent owner's conduct is not prohibited under paragraph 2, then it is unclear to me that Section 2 is a step toward more sensible policy. If the Courts interpret the Section to prevent a finding of misuse if the patent owner's only conduct is of a type covered by paragraph 2 and the conduct is found "reasonable" under paragraph 2, then we have moved in a sensible direction.

Under either view, the economic effect of Section 2 depends on how the Courts define "reasonableness" under paragraph 2. Section 2 does not tell the Courts how to go about deciding "reasonableness." If they are told to apply antitrust standards, we have a reasonably well defined set of rules that will permit us to predict the impact of their decisions. If Congress is telling the Courts to apply some other standards, and that is what many will argue Congress seems to be doing here, the results of Section 2 will be highly unpredictable. However, as I indicated earlier, I agree with the notion underlying the "reasonableness" requirement of paragraph 2, namely, the types of conduct defined in that paragraph may be economically beneficial to the country, and that conduct should not always be prohibited, as it is today.

The first paragraph of Section 2 of the bill says a patent owner, who engages in "misuse or illegal extension of the patent" shall be denied relief. The next two subparagraphs provide definitions of "misuse or illegal extension," but each definition is qualified to say the definition applies only "for purposes of this title," namely Title 35, the Patent Act. The intent of that language is presumably to leave the antitrust prohibitions unaffected by the bill. It has always been unproductive to have patent owner conduct judged by two separate standards. The penalties for violating either of those standards is sufficiently severe to prevent patent owners from violating either of them. Today, there is much conduct that sensible antitrust law regards as economically beneficial, but that is prohibited by misuse doctrines. The purpose of the Section is to restrict somewhat the area of the misuse prohibitions. However, the bill seems to say that its

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standards will have nothing to do with whether patent owner conduct violates the antitrust laws. This will have its principal impact on two areas the bill touches on specifically. First, it will have the effect of rendering ineffectual the limitations to the prohibition against tying agreements for misuse purposes. The misuse rule will be that there is misuse for "tying the sale of a patented product to an unpatented staple ... except to the extent that the patent owner does not have market power." The antitrust prohibition may condemn a tying arrangement that would not constitute misuse under that standard. Antitrust violations may be established without showing market power in the market for the tying product. Moreover, antitrust law has not expressly incorporated any distinction based upon the staple or non-staple character of the tied product and has also, by and large, rejected the notion that there is no tying if the tied product is also patented. Therefore, even after this bill, antitrust law will continue to prohibit conduct Congress is apparently trying to permit. The second principal area where the "for the purposes of this title" limitation will apply is to the permission for conduct by which a patent owner "grants licenses which impose territorial or field of use restrictions on the patented product or process." That broad permission, if applied to antitrust law, would be undesirable. Suppose ninety percent of the automobile manufactures in the world agreed that each would be granted a license under a patent owned by one of them for a new type of nonskid brake pad cover, that each would use the pad, and each would agree to accept a license in an exclusive territory of the United States for automobile sales. It would be plainly undesirable to preclude antitrust law from asking whether that license is merely a sham instrument for an agreement to divide markets having no pro-competitive benefits.

With respect to the particular constraints Congress would be imposing by Sections 2 and 3, my view is that the bill is somewhat too limited in what it would permit and too broad about what it would prohibit. First to the permitted category.

Activities That Are Not Misuse

Congress would say in H.R.4086 that a patent owner is not "considered to have engaged in conduct constituting misuse or illegal extension," because the owner did one of six things. The statute is unclear about whether he may do all of the six acts without misuse, and whether any of six

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acts may be combined with other acts to permit a finding of misuse.

Assuming those ambiguities are clarified, the first three sections simply repeat the current substance of Section 271(d) of the Patent Act. One lesson that we should have learned about any attempt to microregulate patent license agreements was that, after Congress enacted Section 271(d) in 1952, it took about thirty years, until the 1980s, for the Supreme Court to explain what that section meant, and even then the Court was split 5-4. It is fair to say that, to this day, we still do not know exactly what that section means. The only apparent change eliminates the personal pronoun "his" from the statute, presumably to make clear that female patent owners have the same privileges in that regard as male patent owners.

The fourth type of permitted conduct is that a patent owner "refuses to license or use any rights to the patent." I assume that means any rights "granted by" the patent. Except for a few District Court decisions, there has never been any serious question about whether it constitutes misuse for a patent owner not to use the invention protected by the rights and not to license the rights. Those rights are the most fundamental rights that must be given to any property owner, if a free market in those rights is to function. It is desirable to set them out legislatively. I would expect no direct economic benefit from that permission, because I assume patent owners are not granting unprofitable licenses today solely to avoid misuse problems. The bill would prevent future judicial lawmaking to the contrary and that is desirable.

The next section of permission relates to royalties. This area of permission is long overdue and economically sound, assuming that the Courts do not treat the language too narrowly. The language says that one never misuses a patent by charging different royalties to different licensees, royalties that are too high, and royalties that are unrelated to whether the licensee uses the rights granted under the license. The language of the third exception is "imposes an obligation on a licensee of the patent to pay royalties that ... are in amounts not related to the licensee's sale of the patented product or a product made by the patented process" If one wanted to assert the proposition that I think Congress intends, Congress should say "agrees to an obligation on a licensee of the patent to pay royalties that are unrelated to any activities that would constitute infringement but for the

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license." The current language is also too narrow in that it excuses the patent owner from that type of royalty provision only if he "imposes" such an obligation on the licensee. That curious wording leaves it open to an enterprising lawyer to say that if the licensee requested the provision, it was not "imposed" on him and, therefore, the patent owner is not entitled to the permission of the statute.

Assuming the bill gets the Courts out of the business of regulating royalty arrangements, that is an exceedingly valuable development. The current rules never did make economic sense. I applaud a proposal to get rid of them. However, I am mystified about why the freedom to define the type of consideration a patent owner may receive for waiving his rights is treated differently, when the payments do not correspond with the term of a patent. One of the prohibited items reads, when the language is put together, something like the following: "any patent owner who engages in conduct constituting ... unreasonably entering into a royalty agreement that provides for payments beyond the expiration of the term of a patent, except when the parties have mutually agreed to such payments after the issuance of the patent ... shall be denied relief under this title for infringement" It never has been patent misuse in the United States to charge royalties that continue after the term. In 1964, the Supreme Court said the obligation to pay after all the licensed patents expired was unenforceable. It did not say that agreement rendered the patent unenforceable. Most lower Court decisions have recognized that such an agreement does not jeopardize the enforceability of the patent. It seems to me a clear step backwards for Congress to make this type of an agreement misuse in certain circumstances. The ability of the patent owner to impose economic harm by collecting royalties based on activities after the patent expires is no greater than his ability to do so based upon activities that do not involve infringement during the term. Both ought to be permissible, since they are highly unlikely to do harm and permit benefits to be achieved by reducing uncertainty and transaction costs.

The permission regarding royalties is also too narrow, because Congress should provide freedom to agree to royalty obligations that do not depend on the validity of the patent. I have explained elsewhere why that would be economically beneficial.

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The final type of permitted conduct is to "grant licenses which impose territorial or field of use restrictions on the patented product or process." The bill is unclear whether this permission applies when the restrictions relate to a product that is not patented but was made by a patented process or by use of a product patented. The bill is also unclear whether the permission applies to a product that had been sold and some Courts might say the patent rights "exhausted" themselves. If the bill does not address those issues, the fifth area of permission seems to involve no economic gain over current law. If it would be amended to include them, the economic gains would be clear. As I mentioned earlier, if this permission provided an exemption from antitrust liability, it is too broad. It does not appear to do so.

Activities That Are Sometimes Misuse

The list of prohibited conduct relates generally to tying arrangements, agreements not to deal in "competing goods," package licensing, post-expiration royalties, agreements relating to price and certain grantback provisions. On the whole, the list of prohibitions seems to broaden, rather than restrict, the area of permissible provisions. The key word is "unreasonably." "Unreasonableness" is a prerequisite under the bill to misuse under each type of activity other than tying. I do not understand why it was not applied to tying. It is inconceivable to me that there is any justification for a reasonableness test for the others and not for tying arrangements. In any event, if the purpose of the term "unreasonably" is to invoke in shorthand fashion the standard of antitrust law, it seems to me that Congress should simply refer to the antitrust laws, apply antitrust standards to all types of conduct, and enact a bill like that proposed in 1983, S.1841. If the intent is to do something else, then the Courts are going to have a terrible time figuring out what the "something else" is, and the economic impact of the bill is uncertain. It is terribly difficult to articulate some set of standards other than those developed under antitrust law, although the Courts have proved willing and able to do so.

The first prohibition relates to tying arrangements. Misuse would be defined as "tying the sale of a patented product to an unpatented staple or the production of an unpatented product to the use of a patented process, except to the extent that the patent owner does not have

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market power." I assume that "tying" means an agreement by which a patent owner sells a patented product only on condition that the buyer purchase an unpatented product or licenses the patent only on that condition. In some senses, the definition of the bill seems to make it easier to prove misuse. In others, it seems to make it more difficult. The general prohibition against tying is economically unsound and has been recognized as such by serious students of the patent system for many years. However, one can conceive of situations in which the law might sensibly prohibit certain kinds of tying arrangements. The antitrust law is moving toward a sensible tying test that, if applied to the sale of patented products and the licensing of the patent, would be economically desirable. The current standards are economically harmful. The prohibition on tying in H.R.4086 is a step in the right direction, if it means there is no reason to worry about economic harm, unless the patent owner has market power in the sale of the patented product or in the licensing of patents in some market for rights. However, even if he does have market power, there are many situations in which there ought to be no prohibition. The other prerequisites to illegality should be that (1) the patent owner has a reasonable prospect of acquiring market power in the market for the unpatented product for uses other than with the patented product, (2) there is a sensible reason for treating (a) the patented product and unpatented product or (b) the license and the "unpatented" product as separate products, and (3) there is no justification for the agreement (such as being the low cost method of insuring that the buyer or licensee uses the right quality products or pays in proportion to use). This paragraph is also a step in the right direction to the extent that it implies that a patent owner may expressly provide in licensing a combination or a process patent, that the licensee purchase from him a product that, if sold without authority, would constitute contributory infringement. The Supreme Court came close to saying that that was permissible in the early 1980's. However, I am still somewhat unsure about that result. That is plainly economically desirable. The bill is somewhat vague in its reference to "tying ... the production of an unpatented product to the use of a patented process" I assume that the intent is to say that a patent owner may not tie the purchase of an unpatented product to a license to use a patented process. The limitation to an unpatented "staple" product would also be entirely sensible in the context of process patents. Finally, "tying" is not a terribly well defined term. An agreement that simply includes a license and an obligation to purchase does not constitute tying,

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unless the patent owner conditions the purchase on granting the license. The law on what "conditioning" means is somewhat unclear, but there is some requirement in that regard. If Congress is going to continue this prohibition in its current broad form, I would be a little more explicit about what tying means.

The second prohibited type of conduct is "unreasonably imposing as a condition of granting a license for a patent that the licensee may not produce or sell competing goods." Under current law, a provision in a license agreement, whether or not "conditioned," that the licensee not produce or sell competing goods is unlawful, but only if that agreement violates the antitrust laws. This is so because the Court of Appeals for the Federal Circuit has indicated that it will apply antitrust standards to conduct not expressly condemned by the Supreme Court, and the Supreme Court has never held that conduct to be misuse. The Supreme Court has said in dicta that it is. To the extent that this "prohibition" incorporates general antitrust standards, it would be an economically desirable provision. If it incorporates some other standard, I am not sure what the economic impact will be. However, unless "unreasonableness" is read out of the statute, the effects will be desirable. The "conditioning" limitation is unnecessary in any event.

The third prohibition relates to conduct "unreasonably imposing the condition of granting a license under one patent that the licensee accept another license under a different patent...." Assuming we could predict how the Courts will construe the term "reasonably," this statute may improve the economic efficiency of the law. The current misuse rule on package licensing operates without respect to reasonableness. Package licensing may have a number of beneficial effects that are sacrificed today. Hence, the change is likely to be desirable.

The fourth prohibition relates to payments beyond expiration. I commented on that earlier. I did not comment on the provision that would exempt from the prohibition an agreement for royalties that continue after the term and that was agreed to "after the issuance of the patent." I cannot conceive of any reason why the time of the agreement should make any difference. If it is not harmful for the parties to enter an agreement calling for such royalties after the patents issued, it is unclear to me how the same agreement can become undesirable if made before one or all

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of them issued. The effect is the same regardless of the agreement date.

The next prohibition is against "unreasonably entering into an agreement to fix prices or engage in resale price maintenance with respect to a patented product or process...." It is very difficult to predict the effects of this provision. On its face, it seems to go beyond current law by jeopardizing the enforceability of a patent based upon any price "fixing" agreement or "resale price maintenance agreement" with respect to a patented product or, somehow, a process. The law today probably does not jeopardize the enforceability of a patent based upon the patent owner entering into any price "fixing" agreement or engaging in "resale price maintenance." In that respect, the provision broadens the prohibited area of conduct. To the extent that the "agreement" referred to is a license agreement under the patent, then the prohibition may or may not be broader than the current misuse test depending on how the Court's construe "reasonably."

Finally, the act prohibits "unreasonably granting a patent license which requires the licensee to grant back to the licensor patent rights which the licensee may develop or acquire, except to the extent that the requirements to grant back a nonexclusive license with respect to improvements in the licensed product or process when alternatives exist to produce the product or process." The current law on grantbacks is not so mechanical. I am not aware of any decision in which a Court found a nonexclusive grantback to constitute misuse, whether or not it related to an "improvement" and whether or not alternatives exist to produce the "product or process," assuming that means the licensed product or process. If the Courts interpret the prohibition and exception to mean that all grantbacks not exempted are prohibited, the effect will be to preclude all grantbacks that are exclusive in any respect, that relate to things other than "improvements," or that arise when no alternatives exist to produce the licensed product or process. Those effects are decidedly negative. If it is not interpreted in that way, its effects are unclear, but are unlikely to involve significant economic benefits over current law.

Fraud Or Inequitable Conduct

As I mentioned earlier, there has been very little thoughtful analysis about the economic implications of the

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fraud and inequitable conduct rules. The Courts created those rules in the United States to regulate conduct in dealing with the patent office. Because that analysis has not been done, it is a mistake to enact legislation at this time. We should always keep in mind that the patent system operated quite well for a hundred and seventy-five years without the "inequitable conduct" rules currently in place. There should be no legislation until Congress or someone else has analyzed the effect of various rules on the total costs born by the patent owners and the government in prosecuting patent applications, the total costs born by patent owners and potential users in determining the validity and scope of patents after they issue, the total costs born by patent owners, others and the government litigating about those patents, and the costs patent owners and potential users bear from uncertainty about whether a patent should have been issued under the law. I expect that analysis to show that the current state of the law is undesirable. I also expect that it may be highly desirable for Congress to enact sensible standards so that they will not shift and change as they have over the last twenty-five years.

Inventors are the only group of people dealing with the United States government subject to such judicially-created rules and penalties based on the nature of information they provided or failed to provide the government. I have never understood why inventors have been singled out for such special attention. They are no less honest than anyone else. People request government action all the time in a wide variety of other situations without being subjected to any rules or penalties such as those applied to inventors. If the government and the economy is functioning well in other areas without rules like these, I have difficulty understanding why special rules are needed to prevent prospective patent owners from lying or withholding information from the government.

I also hope you will take into account that the unenforceability device is not the only option for providing correct incentives not to try to obtain an invalid patent. There is nothing to be gained by acquiring an invalid patent. The costs of doing so will probably prevent most of the conduct Congress is concerned about. However, let us assume it will not. What are the other safeguards? First, the Patent Act requires a patent owner to swear to one thing. He must swear that "he believes himself to be the original and first inventor of the process, machine, manufacture

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composition of matter, or improvement thereof, for which he solicits a patent." Congress has not asked inventors to do this and hoped that all men are angels and will swear truthfully. Rather, Congress imposed criminal penalties to deter those disposed to make willfully false statements to government agencies. Second, if patents are obtained through dishonesty, Congress provided in the Patent Act that a person accused of infringement of a patent may show that it should not have been granted based on the true facts and required the Courts to declare such a patent invalid. Congress also provided the Courts with discretion to award attorneys' fees to a prevailing party in an exceptional case. The Courts long ago found that fraudulent procurement made the case an exceptional one. Third, the enforcement of a fraudulently procured patent may give rise to treble damage liability to everyone damaged by those acts. Fourth, there are inherent safeguards against dishonesty that arise when one must deal in more than a single transaction with the person to whom one is contemplating lying. The costs of deceiving the patent office are not entirely external to the inventor. After he has been found out, his deception will come home to roost the next time he comes with an additional application. The result for an attorney working for such an inventor and who knew of the deception would be the same. In sum, H.R.4086 may contribute something if you ignore that the possibility of going to jail for dishonesty to the patent office may be sufficient to deter inventors and their lawyers. It may also contribute something if you assume that the high likelihood of having to pay an infringement defendant his attorneys' fees to expose the deception is not a sufficient deterrent. It may contribute something if you assume that antitrust liability for enforcing a fraudulently procured patent is not enough.

As I noted earlier, my information is that none of our major trading partners impose obligations anywhere close to what we do on applicants for patents, and we should very seriously consider whether it is sensible for us to continue to do so.

I will point out here only a couple of things about the current bill that seem to me plainly undesirable or open to very serious question.

First, it is entirely unclear to me that it makes economic sense to have any defense to enforcement of a patent based upon any standard other than the standard for common law fraud. Hence, the broad charter Congress would

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give the Courts in Section 3 of the bill to define "other inequitable conduct" seems to me open to very serious question.

Second, that paragraph provides that it is a defense that "a person engaged in fraud or another inequitable conduct in ... enforcing the patent." The only situations in which the Courts have denied relief to a patent owner because of conduct during the litigation has been where the patent owner suborned perjury or knowingly concocted and used false evidence. The standards that are applied for dealings in the patent office have not been applied to the patent owners' conduct in litigation, or in private negotiations with infringers, potential infringers or potential users. If this bill imposes some obligation on a patent owner not to conduct himself "inequitably" during litigation, during other types of enforcement efforts, and during private discussions or negotiations with infringers, potential infringers, or users, the bill will do enormous economic harm. There is absolutely no justification for that part of the bill.

Third, the bill would do nothing to clarify the standards applied in this area because the paragraph that might say what "fraud or another inequitable conduct" means says it is only defining what that conduct "includes." Hence, the bill will have absolutely no benefits, even if it is the standard articulated in the second paragraph of that section was the economically sensible one.

Fourth, the second paragraph says that fraud or inequitable conduct in procuring a patent includes "the intentional or grossly negligent failure of an individual to disclose to the Patent and Trademark Office information...." It is entirely unclear to me that a negligence standard or even a gross negligence standard is an efficient way to lower information costs and uncertainty costs of the kind I refer to. Indeed, it seems to me those standards are the wrong ones. However, I have not done the analysis to be confident. My current view is that a fraud standard is more likely to be the most efficient standard to apply. That is the standard applied in the other federal intellectual property systems -- the trademark and copyright systems.

Fifth, the bill is directed only to fraud or inequitable conduct involving nondisclosure of information, and presumably leaves the law where it is with respect to inequitable conduct of the affirmative misstatement variety. Analysis may show that different standards ought to apply to

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those two types of conduct. However, I am not confident enough to say that now. Because Congress requires the applicant to make an oath or declaration to certain facts, its definition of the content of the oath effectively converts some potential nondisclosure offenses into misstatement-type offenses.

Sixth, fraud and inequitable conduct is said to include intentional or grossly negligent nondisclosure if three other conditions are satisfied, namely, the person has "actual knowledge," the person has a "duty to disclose," and the person "knows or should have known [that the information] would render the claim unpatentable." The next paragraph delegates to the Commissioner of Patents And Trademarks the responsibility for defining who has a "duty of disclosure" and to define "other matters necessary to avoid fraud as described in paragraph (1)." It seems to me that Congress is abdicating its responsibility for making policy in this very critical area by delegating responsibility to the executive branch. Part of the problem in this area has been that the standards have changed constantly for the last twenty-five years. Simply ordering the executive branch of government to do something seems to me to be a very poor way to run a patent system, even assuming that it is lawful for Congress to do so. The standards for the enforceability of patents should not be set by the executive branch. I leave to others the issue of whether or not that delegation is lawful.

Seventh, to the extent that Congress does take some responsibility for articulating a standard, its three part test probably will prove on analysis to be undesirable to the extent that it says that a patent is unenforceable if someone through gross negligence failed to disclose information that the person knew "or should have known" would render the claim unpatentable. I have a difficulty understanding what "should have known" means if it means something other than the Court decides whether or not the information, in fact, rendered the claim unpatentable. However, presumably it will be argued that it means something different. It is virtually impossible for me to tell whether the standard is gross negligence or negligence. Indeed, "should" is such a broad word that it may indeed be something else, such as strict liability for failure to disclose material information.

Eighth, the bill seems to be trying to limit the fraud and inequitable conduct defenses to those nondisclosure situations in which the information not

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disclosed would, in fact, have rendered the patent invalid. That is not the standard today. My feeling is that this change is a highly desirable change in the law.

H.R.4086 Should Change The Law
On Challenges To Patent Validity

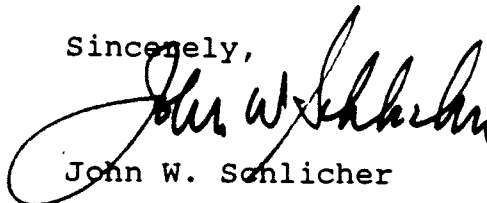
There is no reason for the law to regulate patent license provisions on challenging validity in the way Title XXXV of H.R.3 would have or in the way U.S. law does today. I explained the numerous problems with Title XXXV in the form of a story that I called "A Lear v. Adkins Allegory" that appeared in 68 Journal of the Patent Office Society 427 (1986). No one has explained why Title XXXV is the most desirable response to some bad law. The interests of licensees and the American people in challenging the validity of patents are identical. If licensees and patent owners wish to agree that the licensee will not challenge validity, that agreement makes both the licensee and the American people better off than if that agreement is prohibited. The licensee will not agree to forego a challenge unless it makes him better off. Since this agreement adversely affects no one, it is surprising to me that the law prohibits it and under Title XXXV of H.R.3 would continue to prohibit it. Section 296(a) of H.R.3 would say agreements not to contest validity are unenforceable. The only justification I have heard for that provision is that it "codifies" a decision of the Supreme Court. I explained in the story why that is wrong and will not explain it again here. Even if that section "codified" a Court decision, the decision was economically unsound. Congress should not perpetuate the error simply because the Supreme Court allegedly made it. That section was an enormously bad idea because it would preclude the most sensible legislation, namely a bill which would provide that an agreement by which patent owner and a licensee agree that the licensee will not challenge validity or that makes any other provision for the consequences of litigation on validity should be enforceable. Such an agreement is

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enforceable today if made in proper form after infringement litigation has commenced. The law should permit the parties to make the same agreement earlier.

Sincerely,

A handwritten signature in black ink, appearing to read "John W. Schlicher", written over the typed name.

John W. Schlicher

JWS: chp

cc: The Honorable Carlos J. Moorhead
The Honorable Daniel E. Lungren
The Honorable Henry J. Hyde

HD: Kasten.txt