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Focus on Intellectual Property

The Intersection of Antitrust and Intellectual Property Law

Stuart D. Gurrea and Tessie Su comment on the balance between the exclusionary rights granted to an intellectual property owner and the antitrust statutes' prohibition against certain exclusions. They note the similarity in the courts' reasoning in *Kodak* and *Xerox*. Anticompetitive practices facilitated by asserted intellectual property rights are subject to standard antitrust scrutiny.

Patent Damages: Lost Profits or Reasonable Royality?

Robert B. Petersen and Jonathan A. Neuberger challenge several patent damages myths: the choice between a lost-profits method and a reasonable-royalty method is solely a legal decision; existing royalty rates are reasonable royalty rates; litigants can choose between lost-profits damages and reasonable-royalty damages; and reasonable-royalties damages are never higher than lost-profits damages. All are untrue, and this realization can have a significant effect on patent damages.

Reasonable Rates for Telephone Subscriber Listings

Stephen E. Siwek and Gale Mosteller discuss a recent FCC case in which a telephone company's cost study failed to justify the 65 cents per subscriber listing it charged a competing directory publisher. The company also did not account for revenues from subscribers that helped cover its database costs. The FCC ruled that the company could charge no more than the presumptively reasonable rate of 4 cents per listing.

The Intersection of Antitrust and Intellectual Property Law

By Stuart D. Gurrea and Tessie Su

The debate over the proper balance between an intellectual property owner's right to exclude and the antitrust law's prohibition against exclusionary conduct has gained wide attention since *Kodak* and has intensified with *Xerox*. Ongoing Federal Trade Commission/ Department of Justice hearings on *Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy* have highlighted the need to harmonize the doctrines in order to maximize societal gains from both competition and innovation. Since both antitrust policy and intellectual property law are intended to enhance efficiency–the former through the preservation of a competitive environment for firms, and the latter by providing incentives for innovation–questions arise as to the nature of the conflict between the two concepts and how to reconcile them to serve the common goal.

Intellectual property law establishes property rights and provides incentives to innovate by allowing intellectual property owners to receive returns from their innovations for a period of time. The optimal scope of these rights is the fundamental issue. From an innovation policy perspective, how should inventors be enabled to receive returns from innovation (and thus provide the incentives for innovation) and yet allow the necessary diffusion of knowledge, which is the basis for future innovation? Granting patents with too broad of a scope might impede improvement over existing innovations. From an antitrust perspective, how should competition be protected in light of laws that grant monopolies?

The tension between the underlying antitrust and intellectual property concepts is best illustrated in two cases familiar to antitrust practitioners: *Image Technical Service, Inc., et al. v. Eastman Kodak Co.* and *CSU v. Xerox.* Both cases involve circumstances in which competitors sought access to patented components or diagnostic software in order to compete in maintenance service markets. In each case, the litigation concerned whether the defendant's refusal to sell aftermarket proprietary components to independent service organizations, with which it competed in the service market, violated antitrust law by leveraging alleged market power from the parts market to the service market.

Some commentators argue that the Federal Circuit's decision in *Xerox* (in favor of defendant) conflicts with the Ninth Circuit's earlier decision in *Kodak* (in favor of plaintiffs). A closer look at the Federal Circuit Court's opinion in *Xerox,* however, reveals that the same principle may have been used in both courts. In *Xerox*, the Court stated: "In the absence of any indication of illegal tying, fraud in the Patent and Trademark Office, or sham litigation, the patent holder may enforce the statutory right to exclude others from

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Patent Damages:
Lost Profits or Reasonable Royalty?

By Robert B. Petersen and Jonathan A. Neuberger

Patent damages are not substantively different from other economic damages. Patent damages are, however, the subject of an abundance of confusing discussions. The federal patent damages statute states that damages for infringement should be "adequate to compensate for the infringement, but in no event less than a reasonable royalty." An important legal decision concerning patent damages, *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.,* discusses patent damages and concludes that "[w]hen actual damages, e.g., lost profits, cannot be proved, the patent owner is entitled to a reasonable royalty." Another important patent damages decision, *State Ind., Inc. v. Mor-Flo Industries, Inc.,* declares that "the floor for a damage award is no less than a reasonable royalty."

The preceding excerpts might lead one to conclude that: (1) patent damages can be estimated using either a lost-profits analysis or a reasonable-royalty analysis; (2) the reasonable-royalty analysis is a fallback position; and (3) reasonable-royalty damages will always be less than (or, at most, equal to) lost-profits damages. The errors of reaching those conclusions, however, illustrate the confusion of how reasonable-royalty and lost-profits analyses interrelate.

A patent bestows upon the patentee monopoly rights to a unique product or process for a period of time. A commercially viable patent may give the patent holder a degree of market power. Responding to market forces, the patentee decides how best to exploit that power. Patent infringement diminishes the patentee's ability to exploit any market power afforded by the patent. The patentee must share the market with infringers, which reduces the patentee's profits through lost sales or lost royalty payments. While infringement actually can have seemingly positive competitive effects–greater competition, expanded market size, lower market prices–infringement also reduces the patentee's profits and undermines incentives to invest in developing products or processes that merit patent protection.

A first step in a patent damages analysis is to understand the market in which the patent is used. Is the patentee a producer, a licensor, or both? Does the patentee have actual or potential competitors? What types of products do competitors sell and are these products close substitutes for the patented product? Answers to questions like these indicate how infringement affects the patentee's ability to profit from its patent and, thus, by how much the patentee's profits are reduced by infringement.

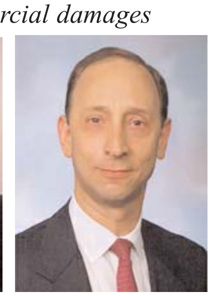
The *Panduit* decision identified four factors that patentees had to satisfy for a lost-profits analysis. These factors related to demand for the patented product, the absence of acceptable non-infringing substitutes, the patentee's ability to meet demand, and the profits it would have earned on diverted sales. Historically, failure to satisfy these factors meant that the lost-profits method could not be used and a reasonable-royalties analysis had to be substituted. More recent Federal Circuit decisions, such as *Rite-Hite, et al. v. Kelley Company, Inc.,* have clarified that the *Panduit* factors are one way, but not the only way, to prove lost-profits damages. The Federal Circuit has reiterated that the goal of damages analysis is to make the patentee whole. Sound analytical ways to identify this make-whole amount face no judicial limitation.

The reasonable-royalty approach, which entails a hypothetical negotiation between patentee and infringer, may be significantly different from the lost-profits approach. Regardless of differences between the approaches, however, a market analysis is still crucial. Such an analysis helps to define the extent of the relevant product market, identify the degree of competition in that market, and estimate the profit potential of the patent, among other factors. Once determined, the reasonable royalty rate is used to calculate damages due to lost royalty payments.

Despite the implication in *State Ind., Inc. v. Mor-Flo Industries, Inc.,* there is no reason to believe that reasonable-royalty damages will always be less than lost-profits damages. Licensing a patent may divert sales away from the patentee. As a result, the patentee has an incentive to ensure that reasonable royalty payments are at least as large as the profits lost on diverted sales. Reasonable royalty rates based on sound economic theory can be quite large (e.g., 15-20 percent or more), perhaps significantly greater than existing royalty rates negotiated outside of litigation. It is entirely possible, then, that the revenues generated by a reasonable royalty, and reasonable-royalty damages if infringement occurs, can exceed lost-profits damages.

The common perception about patent damages is that a reasonable-royalty analysis produces lower damages than a lost-profits analysis. In fact, economics and market conditions will dictate how patent damages should be estimated. Such considerations also may lead to the result that reasonable-royalty damages actually exceed lost-profits damages. Economics and market conditions, therefore, are at least as important as legal decisions in determining how patent damages should be calculated.

Vice Presidents Robert B. Petersen and Jonathan A. Neuberger specialize in intellectual property and commercial damages matters. Dr. Petersen also specializes in employment issues and has testified in state and federal court. Dr. Neuberger's testifying and consulting work includes patent infringement, tax, valuation and finance issues.



Reasonable Rates for Telephone Subscriber Listings

By Stephen E. Siwek and Gale Mosteller

Telephone directory publishers, whether affiliated with the local telephone company or not, need access to up-to-date telephone subscriber listing information (“SLI”: names, addresses, telephone numbers, and yellow pages classifications) to produce complete and accurate telephone directories. As noted in *Feist Publication v. Rural Tel. Serv. Co.,* telephone companies obtain these listings “quite easily” during the order-taking process for telephone service. In the 1996 Telecommunications Act, Congress required all local telephone companies to make available to all publishers any listings that the telephone company publishes in any directory using “nondiscriminatory and reasonable rates, terms and conditions.” In 1999, the FCC adopted rules to implement that statutory provision and established “presumptively reasonable” rates for listings. Although telephone companies are not required to charge those rates because they may have higher costs, they must be prepared to defend any higher rate. If a directory publisher files a complaint about a rate with the FCC, the telephone company has the burden of justifying its rate with “credible and verifiable cost data” and other information.

> “In *McLeodUSA*, the FCC decided in favor of the competing directory publisher and required the presumptively reasonable rate of 4 cents per listing.”

A recent FCC decision clarifies the burden faced by telephone companies that charge high rates for listings sold to their competitors in the telephone directory publishing business. In *McLeodUSA Publishing Company v. Wood County Telephone Company,* the FCC decided in favor of the competing directory publisher and required that Wood County charge the presumptively reasonable rate of 4 cents, rather than 65 cents, per base file listing. Wood County provided inadequate cost data to support its higher rate and did not take into account its listings revenues from telephone subscribers. In its decision, the FCC reiterated that because the telephone company has easier access to its critical cost information, it must bear the burden of proof.

In Wood County’s cost study, one cost element was a fee charged by its third-party publishing agent for providing listings. Wood County failed to justify the fee and even indicated that in the alternative it could provide unformatted listings directly to MacLeodUSA at lower incremental cost. The FCC found that a telephone company must provide support to show the reasonableness of the agent’s fee. Otherwise, the FCC reasoned, agents and telephone companies might cooperate to charge anticompetitive rates to directory publishers. The types of evidence that might be used to support an agent’s fees include a showing of competitive bids or rates charged by other publishing agents for similar services.

Another cost element in Wood County’s study was the cost of creating and maintaining the listings database. Wood County included time spent by customer service representatives and directory clerks in its database costs. Because customer service representatives spend most of their time doing work other than creating listings data, only a portion of their time may be allocated to database costs. Wood County had conducted a study of time spent per telephone service order by customer service representatives, but it did not identify the portion of that time devoted to creating listings data in the course of taking a service order. Rather, Wood County presented perfunctory estimates from a senior customer service representative and from two directory clerks. The FCC found that the say-so of these

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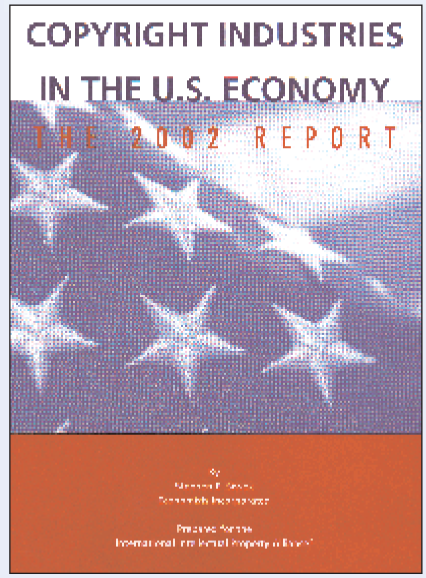
Copyright Industries Study: 2002 Report



Principal Stephen E. Siwek has authored the latest in his series of nine reports for the International Intellectual Property Alliance (IIPA) on the economic contribution of the U.S. copyright industries. The study finds that the “core” copyright industries (those like the motion picture, recording, publishing and software industries that create copyrighted materials as their primary products) contributed over $500 billion in value added to the U.S. gross domestic product in 2001. In addition, the core copyright industries have grown more than twice as fast as the rest of the economy since 1997, and three times faster since 1977. Employment in the core copyright industries has tripled since 1977. Foreign sales and exports from the core copyright industries increased by 145% to $89 billion in 1991-2001. A copy of the report is available from IIPA at www.iipa.com.

Intersection of Antitrust and IP . . . (Continued from Page 1)

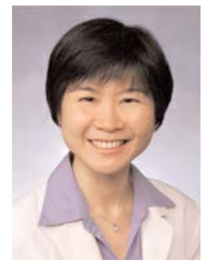
making, using, or selling the claimed invention free from liability under the antitrust law." The Court further noted that "*Kodak* was a tying case when it came before the Supreme Court… Conversely, there are no claims in this case of illegally tying the sale of Xerox's patented parts to unpatented products." In other words, the Federal Circuit agreed with *Kodak* that tying is not lawful even if facilitated by intellectual property, while it upheld Xerox's right to refuse to sell or license its patented products.

One interpretation of the Courts' message–that it is unlawful for intellectual property owners to leverage their market power through a tie–is that it can be broadened to include other types of anticompetitive conduct. Generally speaking, patent law grants intellectual property owners the property rights to their inventions, including the right to exclude, but it does not exempt intellectual property owners from antitrust liabilities. Anticompetitive practices, such as tying, exclusive dealing, pricing fixing and collusion, facilitated by the use of intellectual property, are subject to the same antitrust scrutiny that they would receive if they were facilitated by other means.

This principle was applied in *U.S. v. Microsoft* as well. Microsoft argued that its Windows licensing restrictions were legal because it was simply "exercising its rights as the holder of valid copyrights." The Court of Appeals for the D.C. Circuit dismissed the copyright defense saying that it "borders upon the frivolous," finding it "no more correct than the proposition that use of one's personal property, such as a baseball bat, cannot give rise to tort liability."

The Courts' positions in these cases are consistent: practices by intellectual property owners, including but not limited to tying, remain subject to antitrust scrutiny.

Senior Economist Stuart D. Gurrea contributed to EI's testimony at the FTC/DOJ hearings on competition and intellectual property. Senior Economist Tessie Su's research includes antitrust and intellectual property, innovation and merger synergies, and the interaction between innovation and human capital investments.



Reasonable Rates . . . (Continued from Page 3)

long-time employees did not provide adequate support for the time spent creating listings data.

In addition to inadequately estimating the cost of compiling its listings database, Wood County did not take into account its listings revenues from subscribers. Some subscribers, for example, pay a service order fee and recurring monthly fees to purchase additional listings. If a telephone company charges its database costs to both telephone subscribers and directory publishers, it may be able to recover more than the total cost of the database. In essence, overrecovering its costs would enable a telephone company to shift some of its costs to its competitors in directory publishing. Moreover, if a cost has already been paid by telephone subscribers, it would not be reasonable to charge directory publishers again. The telephone company has the burden of incorporating its listings revenues from subscribers to show that it needs the higher rate charged to publishers to recover its costs.

In summary, the telephone company has the burden of demonstrating that a rate higher than the presumptively reasonable rate of 4 cents per base file listing is needed to recover its costs of creating, maintaining, and providing telephone listings to directory publishers. Meeting this burden requires a cost study that achieves the standard of providing credible, reliable, and verifiable cost data. It also requires other information such as showing the extent to which a company's listings revenues from subscribers cover its database costs. The purpose of these requirements is to promote competition in directory publishing by insuring that telephone companies do not disadvantage competing directory publishers.

Principal Stephen E. Siwek, who was assisted by Senior Economist Gale Mosteller, submitted testimony for directory publishers in two complaints about overcharges for telephone listings: McLeodUSA Publishing Company v. Wood County Telephone Company *and* Yellow Book USA v. Broadwing and Cincinnati Bell Telephone. *In the latter case, the parties settled at 4 cents per listing.*

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