

CRA COMPETITION POLICY DISCUSSION PAPERS 8

**The European Commission's draft Technology Transfer Block
Exemption Regulation and Guidelines: A significant departure from
accepted competition policy principles**

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The European Commission's draft Technology Transfer Block Exemption Regulation and Guidelines: A significant departure from accepted competition policy principles

Introduction and conclusions

The draft Technology Transfer Block Exemption Regulation (TTBER) and Guidelines recently published by the European Commission (EC) represents a distinct departure both in form and in substance from the previous TTBER. It also constitutes a radical departure from the basic economic and antitrust enforcement principles that have been widely accepted in the professional literature, that are at the core of practice in OECD countries, and that form the basis of the 1995 US guidelines dealing with licensing of intellectual property (IP). As might be expected, most of the initial commentary on the draft TTBER and Guidelines has focused upon how the new draft documents differ from the old TTBER and upon how the new TTBER and Guidelines would be significantly more restrictive of licensing agreements.

By contrast, this paper focuses upon the underlying principles and methodology of competition analysis that the EC has applied in drafting the TTBER and Guidelines. A clear comprehension of these principles and methodology is critically important both for understanding the thinking behind the draft TTBER and for assessing future enforcement action by the EC in the many licensing cases not covered by the draft TTBER but in

which the EC will nevertheless follow the logic of its Guidelines in making enforcement decisions.

We will demonstrate that the approach taken by the EC is a radical departure from the standard accepted competition practice of fully respecting both IP and the right fully to transfer IP through licensing, provided that the licensing agreement does not extend the monopoly power granted by the IP or restrict competition in ways essentially unrelated to the transfer of these IP rights. The Commission has adopted an approach that attempts to trade off the competitive gains of making the licensing rules less restrictive against the disincentive effects for innovation and involvement that this may create. This weighing of positive and negative effects is carried out under the framework of Article 81(3). In actual practice, however, the Commission appears to give little or no weight to the positive incentive effects of the value granted by the IP rights for the creator of the IP or of the effect of that value as an incentive for future invention and investment. As a result it will seriously erode IP rights and protection under IP law.

If adopted as presently written, this competition policy will:

- Significantly erode the value of IP

- Reduce technology transfer through licensing in favour of other transfer mechanisms (outright sale, vertical integration)
- Cause a misallocation of resources because of distortions caused by the restrictions placed on the transfer of technology through licensing
- Shift investment in R&D out of the EU to other jurisdictions such as the US
- Ultimately reduce invention and entrepreneurial endeavours in the EU by weakening the IP rights which were originally designed to promote both activities.

In this paper we set out the fundamental approach to licensing accepted by competition authorities and then compare it to the approach preferred by the Commission. We derive our presentation of the Commission's approach directly from statements in the Guidelines. We develop the argument concerning why the approach being pursued by the Commission in the draft Guidelines will lead to seriously negative economic consequences. We argue there is wide agreement that if, for some reason, the IP laws need to be changed, competition authorities should not accomplish such modification through *ad hoc* decisions about licensing. Further, while it is not the main thrust of this paper, we argue that national courts with little experience in competition law and economics cannot, in practice, implement the TTBER and the Guidelines. Without a system of notification whereby potential licences can be cleared by the Commission, the uncertainty for all parties to a licence will be so great that many potential licences will be abandoned in favour of other alternatives. In summary, we conclude that the draft TTBER and Guidelines are unworkable and constitute bad competition policy that will ultimately impose high costs upon the EU economy.

Background

Because of our previous relationship with the Commission it is important to disclose fully the history of that relationship. Charles River Associates (CRA) won, through an open tender, a small contract to assist the Directorate General for Competition in its review of the application of Article 81(1) and (3) to patent pools and to the cross licensing of IP. In fulfilment of that contract, CRA were to perform four tasks. The first task was one of general fact-finding concerning the use of multiparty licensing, with a view to answering questions about what industries use them, whether they are common practice, what business problems they are designed to solve, and how frequently competition issues arise as a result of multiparty licensing. The second and third tasks were to survey the economic and legal literature related to licensing and to survey and to compare the treatment of multiparty licensing by the competition authorities in different countries in the OECD. The fourth task was to develop a framework for analysing competition issues that arise in the context of multiparty licensing and to relate that framework to the development of guidelines or to creation of a block exemption. This work culminated in a report entitled

Multiparty Licensing dated 22 April 2003¹. We are the senior authors of that report.

After we completed the basic work of reviewing the literature including the US and other countries' guidelines on the antitrust treatment of licensing agreements, we expressed to the Commission what we believed to be a well accepted principle: namely, that in the application of competition policy to licensing, the policy should fully respect IP rights and the transfer of those rights through licensing, but should also protect

against extension of the limited monopoly power granted by the IP laws and/or the addition of other restrictions on competition law through licensing agreements. The basic test of whether this principle is satisfied is to ask: would the licensing agreement limit competition that would have existed without the licensing agreement? Clearly a licensing agreement that prohibits competition between the licensee and licensor in some unrelated market violates that condition and would therefore be prohibited under this principle. Another way to look at this is to ask: would any competition that would have existed if the IP owner developed the technology himself as a monopoly producer be eliminated by the licensing agreement?

The Commission's competition staff did not agree that this was an accepted principle that should be followed. A debate on the issue ensued over a period of several months, and the report that was ultimately produced presents our findings and views on these issues, rather than those of the Commission's staff (in particular the competition staff involved in the project). At the same time, we did gain considerable insight into the thinking of the key competition staff involved, and their preferred approach to these issues. This has been of great benefit in facilitating understanding of the basis for the Commission's statements in the draft Guidelines, which provide direct evidence of their approach.

Accepted antitrust principles

It is well understood that there is a tension, but not a fundamental contradiction, between the IP laws and the competition laws. Both seek to promote economic efficiency and growth and to enhance consumer welfare. The IP laws do this by creating limited monopoly rights, so that the value of cre-

ating IP is increased as an incentive to invention and to the subsequent commercial development of an invention in the form of new products. As such, the IP laws are part of a long run strategy for dynamic economic growth and efficiency. It is worth noting that every major developed economy has strong IP laws.

On the other hand, competition laws seek to promote economic efficiency, thereby raising output and benefiting consumers through lower prices for existing products. Thus, the two sets of laws have a common objective of greater economic prosperity for consumers. The tension, however, comes from the fact that the IP laws are part of society's long-run strategy to produce wealth and prosperity, whereas competition policy often focuses more upon short-run objectives. In the short run, IP laws are in conflict with the short-run competition objective of low prices for consumers. Even limited monopoly rights raise prices in the short run. However, the entire reason for allowing creators of new products to charge high prices and earn high returns is to compensate them for their inventive activity and for the considerable risk involved. This serves to encourage others to innovate and invest in the commercialisation of new products in the future, when they too will be allowed to earn high returns.

The importance of strong intellectual property laws

There has long been debate about whether stronger or weaker IP laws would be preferable in promoting innovation and growth. The trend recently has been to strengthen IP protection. Without doubt, the general consensus is that strong IP laws play an important role in any developed dynamic economy. However, there is a small body of recent literature that suggests that this

may not be the case. This literature views the IP laws as causing problems such as patent thickets or contributing to the problem of the “anti-commons,”² in which overlapping mutually-blocking patent rights³ are seen as causing the under-utilisation of valuable and productive assets. Also, firms may be patenting for strategic purposes both to create patent fences and as bargaining chips in negotiation and litigation. In order to respond to the Commission’s comments about these issues we reviewed this literature. Based upon this review we state:

What we conclude from this is that the evidence supports the idea that protecting potentially important IP, particularly the major advances that will be the basis upon which important new products are based, plays an important role in investment in the development of new innovative technology. The literature, in our opinion, does not support the idea that IP protection can be assumed to be of marginal importance, nor does it support the conclusion that the IP laws are not important to the dynamic efficiency and growth of the modern economy. Therefore, we strongly believe that competition policy and enforcement should fully respect IP rights in applying competition law to licensing and, in particular, to multiparty licensing.⁴

Whatever one’s views may be concerning the importance of intellectual property laws and whether they are optimally designed or should be modified, there has been general agreement that if they are to be modified, it should be accomplished through legislative action taken in response to a sound and thorough analysis of the effects of any proposed change. Moreover - and of particular importance for the Commission’s Guidelines - it is also generally agreed that the IP laws should not

be systematically eroded by competition authorities on an *ad hoc* basis in their pursuit of the short-term competition objectives of lower prices and profits. This view was well stated by Professor Michael Katz, recently Deputy Assistant US Attorney General for Antitrust. He states,

Even if one concludes that someone should engage in fine-tuning intellectual property rights to reflect competitive conditions or other market characteristics, that someone need not be a competition policy authority. Present antitrust laws and enforcement institutions have not been created with this role in mind. Moreover, coordination with the Patent and Trademark Office is essential to implementation of a sound overall policy. Absent legislation, using antitrust policy to fine tune intellectual property laws would very likely create more problems that it would solve.⁵

Modern competition policy clearly has adopted the position that the IP laws should be fully respected and should not be eroded or modified by the initiatives of competition authorities acting alone on a case-by-case basis. This is particularly pertinent to the case of licensing. The traditional approach has been to allow licences to convey the full monopoly rights granted by the IP laws, but not to allow terms and conditions that would either extend these monopoly rights beyond those originally created by the IP or would limit competition in ways essentially unrelated to the purpose of the licensing agreement. There is far too much evidence that the IP laws serve a critical function to allow the competition authority to decide on a case-by-case basis whether they should be weakened and by how much.

What is the appropriate role for the competition authority

History is replete with examples of licences that include terms essentially unrelated to the transfer of the full monopoly rights contained in the IP being licensed. For example, on occasion there have been clauses requiring the licensee to refrain from competing in other unrelated markets, clauses containing illegal tying arrangements masquerading as a licence, and blatant pooling of competing technology in order to form a cartel.⁶ Protecting against such terms and conditions, which are not required for the full transfer of the monopoly rights granted by IP laws, have been and should be the accepted and proper role for competition authority intervention and enforcement.

In general, however, terms of a licence that restrict the use of that licence - such as the requirement that the licence be exclusive, and mandating territorial or field of use restrictions - would not be questioned, since in most cases of licensing between non competitors these terms should not exclude competition that would have existed if the IP owner had exploited the IP rights himself.⁷ Licences between competitors raise some special issues, but even here there are many cases where exclusive licences would not eliminate competition that otherwise would have existed. Whether related to exploitation of the IP in general or to exploitation of the IP in a particular geographical area or specific field of use, exclusivity is critical to the value of the licence and therefore to the value of the IP to any owner whose best option is to licence it. Thus, a policy that attacks exclusivity in any of these forms will inevitably reduce the value of the IP involved, whenever licensing is an important alternative.

Accordingly, one can immediately understand how the TTBER and the Guidelines, which severely restrict these options, will lower the value of IP and weaken the incentives it provides to future innovation and to investors in the commercialisation of innovation. Moreover, if we allow the competition authority to revisit such licences after the fact - for example once a licensee becomes a successful monopolist as provided for by the IP laws - such an approach will significantly reduce the value of IP, weaken the IP laws' protections, and reduce the incentives to develop and invest in new technologies. In addition, it will greatly detract from licensing as a mechanism for technology transfer, because of the great uncertainty caused by the threat of competition intervention, either in the short run, or in the longer term after a new product has been developed and successfully created its own market.

Allowing the owners of IP rights to transfer the full monopoly rights of their IP is also important for ensuring efficient use and development of the IP. This point is thoroughly discussed in our Report, but the basic idea is simple and intuitive.⁸ In many, if not most cases, the owner of the IP is not in a position fully to exploit the development and commercialisation of that IP in all potential product and geographic markets. Thus, the best option for the IP owner will often be to manufacture and sell IP-based products in some markets and to give other firms exclusive licences for the manufacture and sale of products stemming from the IP in the remaining geographic markets. However, if the IP owner cannot give exclusive licences with such restrictions, these licences, and therefore the value of the IP, will be worth less in the remaining markets.

This may well cause the IP owner to rethink his options, with a view to maintaining the monopoly position granted by the IP laws in all markets. In that situation, one option would be to expand into all markets himself; a second would be to sell the IP to a multinational who could, in fact, exploit the technology worldwide in a monopoly position; a third option would be to produce and sell the product himself as a monopolist in some markets, but delay or forego production in other markets. The last option would be a likely one if the IP owner could reasonably expect to expand later and feared that to allow production under licensing agreements might erode his own monopoly position.⁹ Thus, prohibiting an IP owner from granting exclusive licences will not only reduce the value of the IP, but it will also distort its exploitation, causing inefficiency in the production and distribution of goods incorporating the new technology. It may also significantly limit deployment of IP-based products in areas where licensing rules prohibit exclusive licences. As a consequence, inventors and investors will be well aware that patents on new products subject to EC licensing rules will be worth significantly less, and therefore will be less likely to invest in innovative technologies and products. As a result, the Competition authority should limit themselves to preventing licensing agreements from extending the monopoly powers granted by the IP laws and adding restrictions on competition that would have existed in the absence of the licence.

There are other important reasons for Competition authorities to refrain from making the kinds of tradeoffs that the Commission is proposing in the draft Guidelines. While there are strong intuitive and empirical reasons for believing that IP rights provide important incentives for

innovation and investment in new products, we do not know enough about the relationship between the strength of IP rights and the incentive to invent and to invest in the development of inventions to be able to assess, with any reasonable degree of accuracy, what the ultimate effects of a case by case weakening of IP rights through restrictions on licensing will be. Certainly, this cannot be determined on a case-by-case basis, which would be required to implement the Commissions proposed approach.

There is simply no reliable basis for weighing the impact of the decision to weaken IP rights by restricting licensing agreements against the benefits of greater competition upon the long run incentives to innovate and invest. Any case-by-case analysis must of necessity be totally subjective and inevitably arbitrary. This problem is compounded by the fact that a bias toward opting for benefits that are immediate at the expense of longer run benefits that are more difficult to measure is all too common in regulation. The ultimate result of this regulatory bias is that short-term, highly visible benefits - in this case lower prices for consumers now - are given priority, and regulators give little weight to the longer run and more difficult to quantify benefits derived from increased future innovation and investment - new products and production processes in the future. This well known bias is blatantly apparent in the Commission's draft Guidelines.

The Commission's position and its implementation of the draft TTBER and Guidelines

The Commission's staff made it very clear that their preferred method of applying EU competition law to licensing agreements would be to weigh the competitive gains from restricting licens-

ing agreements that would weaken or eliminate IP protection against the potential costs that this weakening of the IP rights would engender by reducing investment incentives. In other words, in setting competition policy on licensing the Commission trades off the competition benefits from less restrictive licensing against any resulting loss of incentive to innovate. However, what became clear in our discussions with the Commission was that, in assessing the incentive effects, the Commission have already succumbed to the aforementioned bias and were giving little or no weight in their analysis to the long-run incentive effects upon future new product development and commercialisation. Rather they were primarily giving positive weight only to such incentives for investment as were required by the licensee to undertake development of the licence.

Essentially, if the Commission adopts their position reflected in the draft Guidelines, it will effectively be adopting the policy that IP laws can be overridden on the basis of competition objectives under Article 81(1) and (3) without any significant harm to the long-run incentives for innovation and investment in new products that the IP laws were created to provide. To the extent that investment incentives need to be considered, they will be factored into the analysis on a case-by-case basis. Implementation of the TTBER and Guidelines will put this policy and principle into effect in the EU. The Commission may well claim that we have misstated their position, but their position is manifest throughout the draft Guidelines. We now consider the Commission's statements with regard to how they will enforce Article 81(1) and (3) with respect to licensing agreements.

The one place the Guidelines briefly address the issue of long-term incentive effects upon innova-

tion is in paragraphs 8 and 9. However, even there it is clear that to the extent the Commission believes these long run effects are important, the Commission will decide how much IP protection is enough and trade off any long-term benefits from the monopoly rights granted under the IP laws against the benefits in terms of increased competition and lower prices. In short, when it comes to licensing agreements, the Commission is proposing to act upon its judgment regarding how much IP protection is "not unduly restrictive" of IP law, and to balance reductions in that protection against gains in competition. Paragraph 8 states:

The assessment under Article 81 does not focus on the ex post situation where the exclusive right may reduce the level of rivalry on the market. In order not to reduce dynamic competition it must be kept in mind that the creation of intellectual property rights often entails substantial investment and that it is often a risky endeavour. Many intellectual property rights have little commercial value. In order to maintain the incentive to innovate, the innovator must therefore not be unduly restricted in the exploitation of intellectual property rights that turn out to be valuable.¹⁰

The Commission goes on to say:

...This framework is sufficiently flexible to allow the Commission to take due account of the dynamic aspects of technology licensing.... Also, restrictive licence agreements may often give rise to procompetitive efficiencies, which must be considered under Article 81(3) and balanced against the negative effects on competition, which flow from such restrictive agreements.¹¹

These passages make it very clear that, in applying Article 81(1) and (3) to licensing, the Commission plans to trade off any beneficial incentive effects created by the licences against the restrictions to competition. This is consistent with their stated approach to applying competition policy to licensing agreements. What is remarkable, however, is that, in the rest of the Guidelines, they pointedly do not talk about long-run incentives. Instead, when the Guidelines talk about incentive effects at all, they talk about incentives required by the licensee for exploitation of the technology and not the incentives required to foster long-term innovation.¹² Further, they state that the incentive effects must outweigh the disadvantage of higher prices in the short run, which essentially means that the beneficial long-run effects are precluded from being decisive under the Commission's methodology for applying Article 81(1) and (3) to licensing policy.

However, once one goes beyond this statement, any mention of the importance of incentives for innovation in the future is conspicuous by its absence. Consider the discussion in Section 2.2 on the positive and negative effects to be considered in assessing exclusive licences between non-competitors. The Guidelines state:

Between non-competitors the restriction on the licensor not to license other licensees, in general or in respect of a particular territory or customer group attributed to the licensee, may have two main anti-competitive effects: (a) foreclosure of other (potential) licensees, and (b) reduced intra-technology competition between licensor and licensees and between licensees, in particular when combined with sales restrictions.

Exclusive licensing, however may also give rise to efficiencies. For instance, exclusivity may induce the licensee to invest more quickly in the exploitation of the licensed technology. It may also promote continuous investment by avoiding free riding. The extent to which free riding is an issue depends on the nature of the products incorporating the licensed technology and the extent to which the licensee is involved in marketing and the provision of pre-sales services. Where the licensee sells the products under his own brand, the scope for free riding is more limited than where the products are sold under a common brand.¹³

Note that the anticompetitive effects seen as important are that exclusive licensing would produce a monopoly in the technology in question and would exclude potential competitors who would like to have licences as well. These are two effects that IP law was intentionally designed to create as a significant incentive for innovation. The benefit of this goes largely to the IP owner, who receives higher licensing revenues because he can give an exclusive licence.

Against these negative impacts upon competition, the Commission views the major positive outcome that exclusive licensing will provide to be an incentive for the "licensee to invest more quickly in the exploitation of the licensed technology," and they consider this to be beneficial, because "it may also promote continuous investment by preventing free riding."¹⁴ A glaring omission, however, is any suggestion by the Commission that they would give any weight to, or even consider, the incentive effects of strong IP rights upon future innovation and investment in new products derived from the IP. While on occasion in the Guidelines the Commission professes respect for the IP laws, their analysis gives little indication that, in applying

competition policy to licensing, they will give any significant weight to maintaining the value of IP, which is its strength as a source of incentive to future innovators.

In Section 2, *The general framework for applying Article 81*, at paragraph 14,¹⁵ the Commission further clarifies its approach to regulating licensing agreements. It states:

In order to ascertain whether an agreement or its individual parts are restrictive of competition within the meaning of Article 81(1) it is relevant to ask the following two questions. The first question relates to the impact of the agreement on inter-technology competition while the second question relates to the impact of the agreement on intra-technology competition.

The first question the Commission will ask is:

- (a) Does the agreement restrict actual or potential competition that would have existed had no licence been granted? If so, the agreement is normally caught by Article 81(1) provided that trade between Member States is capable of being appreciably affected. For instance, where two undertakings established in different Member States cross licence competing technologies and undertake not to sell products in each others home markets, (potential) competition that existed prior to the agreement is restricted. Similarly, where a licensor imposes on his licensees not to use competing technologies and these obligations foreclose third party technologies, actual or potential competition that would have existed in the absence of the agreement is restricted.

If appropriately applied this is consistent with the standard approach taken to antitrust enforcement. It is the second question that takes us far beyond the bounds of current practice and that causes the substantial erosion of IP rights. In the second question the Commission asks is:

- (b) Does the agreement restrict competition that would have existed in the absence of its alleged restriction(s) of competition? This question relates to the issue of whether or not the restriction is objectively necessary for the conclusion of the agreement. If so, the agreement with its restraints is not caught by Article 81(1). This assessment is made on the basis of objective factors external to the parties themselves and not the subjective views and characteristics of the parties. The question is not whether the parties in their particular situation would have accepted to conclude a less restrictive agreement, but whether given the nature of the agreement and the characteristics of the market a less restrictive agreement would have been concluded by undertakings in a similar setting. For instance, territorial restraints in an agreement between non-competitors may fall outside Article 81(1), if the restraints are objectively necessary in order to penetrate a new market. Claims that in the absence of a restriction the supplier would have resorted to vertical integration are not sufficient. Decisions on whether or not to vertically integrate depend on a broad range of complex economic factors, a number of which are internal to the undertaking concerned. The initial choice to rely on co-operation rather than vertical integration anyhow generally indicates that vertical integration was not practicable.

Here the Commission asks: Is there less a restrictive agreement that the parties' might have accepted, assuming the more restrictive and preferred agreement were not available to them? If so, then the agreement will be analysed by the Commission under Article 81(3). The Guidelines state:

The pro-competitive effects of licence agreements must be balanced against the restrictive effects in the context of Article 81(3). When all four conditions of Article 81(3) are fulfilled, the restrictive licence agreement in question is valid

and enforceable, no prior decision to that effect being required.¹⁶

Therefore, under the draft Guidelines, not only must the incentives for innovation created by the IP laws be re-evaluated by the Commission and found to exceed the costs of restrictions on competition, but also, the agreement must be the one that is the least restrictive of inter-technology competition that the parties might have signed. Thus, if faced with the possibility of not being able to sign an exclusive agreement, the parties might be willing to sign a non-exclusive one, then that would be required by the Guidelines.

Moreover, judging from its statement in the same paragraph, the Commission would be unsympathetic to arguments that if forced to a nonexclusive licence, the parties would have turned to other alternatives such as vertical integration. The Commission's statement that "the initial choice to rely on cooperation rather than vertical integration anyhow already indicates that vertical integration was not practicable" is simply wrong. An exclusive licence may well be preferred to vertical integration, but vertical integration in turn may well be preferred to a nonexclusive licensing arrangement, which would be required by the Commission.¹⁷ Under the Commission's approach, a licensor who gave an exclusive licence rather than vertically integrating might later be faced with having the exclusivity challenged by the Commission, but no longer have recourse to vertical integration. Given this uncertainty and the Commission's procedure, one would expect many more IP owners to opt for non-licensing solutions, such as vertical integration, for exploiting their IP.

While the Commission pays lip service to the fact that they are going to weigh the positive benefits of restrictions in licences on innovation, it is clear

that its assessment of what is appropriate will, in most cases, be inconsistent with licences transferring fully the monopoly rights granted under the IP laws. The least restrictive condition virtually assures that. Further, there are other indications throughout the draft Guidelines that suggest that the effect of these "benefits" from restricting competition upon long-run incentives will not be given much weight by the Commission.

An example of this may be found in Section 1.3, *Positive effects of restrictive licence agreements and the framework of analysing such effects*. The Commission, when addressing efficiencies in paragraph 139, talk about bringing together complementary technologies, greater efficiency from having a licensor exploit the technology, attainment of low cost and assembly of groups of technology, but makes no mention of greater efficiency through innovation. Further, the Commission states:

This means that the efficiency gains must fully offset the likely negative impact on prices and output caused by the agreement. It may do so by impacting on the cost structure of the undertakings concerned, giving them an incentive to reduce price, or by allowing consumers to gain access to new or improved products, compensating for any price increase.¹⁸

This is arguably consistent with giving positive weight to innovation and the new products they will create in the future. However, given that it must be shown that any restrictions are essential to the creation of new products and must be the most minimal restrictions required, and that this must fully offset any higher costs in the short run, it will be difficult to defend the protections and incentives created by the IP laws. Whether or not the Commission gives any significant weight to long

run incentives to innovate as provided by the IP laws, where licensing is concerned the Commission's draft Guidelines clearly have the Competition authorities overriding the IP laws as far as judgments about the strength and length of those protections.

Changing future enforcement based upon the success of a technology

The Guidelines make it clear that a licensing agreement originally considered legal subsequently might be re-evaluated depending upon the success of the technology or products that use it. This can be done in two ways. An agreement that was considered under the block exemption can be re-evaluated later if circumstances change, and the block exemption can be withdrawn in particular cases. We understand that the withdrawal of a block exemption, which currently exists as an option, has seldom if ever been used. While that could all change, we concentrate on the case where the firms involved in the licensing fall under the block exemption at the time of the licensing agreement, but through growth and changes in the market, fail to do so at some future point in time.

Article 8 of the draft TTBER makes clear that a licence that was originally covered by the TTBER will cease to be covered once the market share thresholds are breached, although it does allow for a grace period of up to 2 years. This is extremely troubling as a matter of competition policy. When licences are signed, it often is impossible to know what market the products incorporating the technology will be in or whether these products, if successful, will define their own market. For this reason it frequently may be difficult to tell whether two firms are competitors in a relevant market or whether at some time in the not-too-distant future the market and shares of that market will be such

that the licence is not covered by the block exemption. Therefore, even if it is covered by the block exemption today, there are no assurances about the future. This greatly increases uncertainty, and the presumption will surely be that if the technology is successfully implemented, the underlying licence will be subject to competition review and challenge. This will certainly have a chilling effect upon the willingness of IP owners to licence, upon the value of licences to both IP owners and the initial licensees, and upon the incentive to the creation of IP for licensing.

Take, for example, the case of a patent for a new pharmaceutical. At the time the licence is signed, an exclusive licence can be issued under the terms of the block exemption. Five years later, after the licensee has invested €100 million in testing and obtaining permission to put a new drug on the market, the company finds itself with a product with no close competition that earns hundreds of millions of Euros each year. It has 100% of the market, and that would make the licence subject to review by the competition authorities. While the firm would be dominant and perhaps subject to regulation under Article 82, opening the exclusive licence agreement to review by the competition authorities is particularly insidious. The authorities could determine that if the exclusivity of the licence were revoked and other licences issued consumers would benefit from lower prices. It would likely also determine that this more than offset any loss of incentives effects from the withdrawal of the exclusive licences, pointing to the fact that the company had had a few years of exclusivity and had made more than €1 billion over this period - surely, argues the Commission, this must be enough.

That kind of regulatory logic is in error. In most cases, as the Commission has recognized, new patents are not worth much. Perhaps one in a hundred will prove efficacious, be cleared for sale to the public and become a “blockbuster.” With these odds, a pharmaceutical company spending €10 million to develop the product must earn €1 billion on an expected present value basis just to break even. This is not an assessment that regulators can make, because they do not know the subjective probabilities of the investors that go into their decision to invest in the creation of the technology and in the development and commercialisation of that technology. Knowing that the competition authority can intervene and seriously limit the returns to the few really important new products from innovation will create a serious disincentive effect in a world where significant success is rare, but the payoff from such success is extremely high. In addition, consider the case of a new drug that is successful, capturing 40% of an existing market where the firm that developed and sells the drug has an exclusive licence from a non-competitor for the technology. In this case the firm might not be considered dominant, but antitrust authorities could attack its profits by reassessing the terms of the licence. This would be analogous to revisiting the merger of two firms that fell within the Guidelines for market shares, because the resulting firm grew substantially after the merger, even though it had not become dominant. Nowhere else do we find this type of retroactive reassessment of licensing agreements carried out because the firms involved have been successful, even if they are not dominant.

The guidelines are unworkable

Finally, the TTBER and Guidelines are scheduled to be implemented by national tribunals. Given

the nature of the draft TTBER and Guidelines, experience from the history of US antitrust enforcement in the courts suggests that there will be years of inconsistent decisions pertaining to licensing agreements. The TTBER and Guidelines as they stand are not only bad competition policy, but are also unworkable. Therefore, the draft TTBER and Guidelines should not be implemented. The existing TTBER, whatever its failings, is both more workable and, as our analysis shows, generally consistent with accepted practice. While it is more formalistic, most of the white clauses were consistent with sound economic and antitrust principles. The current draft is an unwise extension of competition policy that will seriously erode IP rights and their promotion of a progressive, dynamically competitive and efficient economy. Its adoption would seriously set back the EC’s stated goals of making the economy of the EU more competitive in a rapidly evolving global economy.

Notes

1 *Multiparty Licensing*, 22 April 2003, can be found on the Commission's website at www.europa.eu.int and on the CRA website at www.crai.com.

2 The tragedy of the commons is a well-known economic analogy that highlights the fact that when property rights are not well-defined, resources get overused, resulting in an ultimate disadvantage to all concerned parties. Heller and Eisenberg say that the density of property rights in biotechnology creates the opposite, namely the "tragedy of the anti-commons" where a large and growing number of licences must be sought from patent owners - the "gatekeepers" - before their IP can be used. This issue, as well as patent thickets, is discussed in the *Multiparty Licensing* report at page 11.

3 *Blocking patents* are those that infringe upon each other, or prevent a patents use. This is either because they are complementary in a particular application (i.e. both are needed) or because one patent builds upon another.

4 *Multiparty Licensing*, page 71.

5 Michael L. Katz, "Intellectual property rights and antitrust policy; four principles for a complex world", *Journal on Telecommunications & High Technology Law*, Volume 1 issue 1, 2002.

6 For example one of the early US cases is the 1902 *E. Bement Sons v. National Harrow* case. The National Harrow Company was initially set up to pool 85 patents on spring tooth harrows from six different firms in order to resolve years of patent infringement litigation between them. The licensing terms stipulated the prices for licensed products, the requirements to sell only the licensed products, and that each firm was to use only the patents they had contributed to the pool, not the patents contributed by the other firms. Further examples are outlined in the *Multiparty Licensing* report, in the section covering the "History of Patent Pools and Competition Policy".

7 We note that the key question for licensing between competitors is whether they own competing IP rights - that is, technologies that are substitutes for each other. Firms that possess complementary IP rights do not generally present a problem from the perspective of IP licensing agreements. The importance of the relationship between

the technologies as the basis for identifying the potential for pro- or anti-competitive effects from licensing is discussed throughout the *Multiparty Licensing* report.

8 See *Multiparty Licensing*, page 59.

9 Expansion may include the option to expand existing "out of market" facilities and transport goods for inefficiently large distances.

10 Draft Commission Notice, Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements.

11 Guidelines to Draft Commission Notice, op cit., para 9.

12 In fact this issue is a standard principal-agent issue related to vertical agreements and the need to allow agents exclusive rights at times in order to align investment incentives. It is therefore unrelated to the issue of IP rights creating incentives to invest on the part of the "principal" firm.

13 Guidelines to Draft Commission Notice, op cit., para 153 and 154.

14 Guidelines to Draft Commission Notice, op cit., para 154.

15 Guidelines to Draft Commission Notice, op cit.

16 Guidelines to Draft Commission Notice, op cit., para 16.

17 Moreover, it is not at all unusual for both vertical integration and licensing to be used in parallel in order to optimise production. For example, software games for video playstation type gaming systems (such as the Sony Playstation) are often developed both in-house and externally by parties operating under licence. See *Innovation and Competition Policy*, OFT Economic Discussion Paper 3, March 2002, Part II (Case Studies), Chapter 3 at www.of.gov.uk.

18 Guidelines to Draft Commission Notice, op cit., para 141.

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