

THE INTERSECTION OF IPR AND COMPETITION LAW

*Studies of recent developments in
European and U.S. law*

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FOREWORD

After having first made some initial, fairly general, observations, the 2007 Masters of European Affairs at Lund University were given the task of investigating the current status of the relationship between intellectual property rights (IPR) and competition law.

We discussed the matter in class. IPR were analyzed and competition law concerns were presented. First the European position, which was then contrasted with the American counterpart. Jeffery Atik, Sayre Macneil Fellow and Professor at Loyola Law School, Los Angeles set aside time to join us in Sweden and gave us the American view during an intense week.

Students went on field trips. They met with John Hedenström of McNeil, who explained the practical intricacies of real life patenting. Ingmar Magnusson of Gambro challenged the students with a discussion on bundling and competition law and Stefan Rosell of the former Pharmacia and Sten Trolle of the Lund University Technology Group discussed licensing and its limits.

These practical insights were coupled with mock agreement negotiations and in depth research on precise topics both in smaller groups and on an individual basis.

On behalf of the Faculty of Law at the Lund University, I would like to take this opportunity to thank all our external participants for their enthusiastic and immensely valuable support and contributions to the class. A special thanks is due to Mr. Philip Horowitz, who proof read all the material and suggested many corrections and improvements.

And thanks to you, Masters. As in previous years, you have gone those extra miles required to make for an interesting class.

The result of all these efforts is presented this book, subsidized by the Swedish Competition Authority.

Lund, June 2007

Hans Henrik Lidgard

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ABBREVIATIONS

AIDS	Acquired Immunity Defect Syndrome
CFI	Court of First Instance
CMT	Community Trade Mark
CPR	Prop. Reg. on Community patent (2001)
DOJ	United States Department of Justice
EC Treaty	Treaty of Rome (1957) or Treaty establishing the European Community (TEC)
EC	European Community
ECJ	European Court of Justice
EFTA	European Free Trade Agreement
EPC	European Patent Convention
EPO	European Patent Organization
EU	European Union
FDA	United States Food and Drug Adm.
FTC	United States Federal Trade Com.
HIV	Human Immune Deficiency Virus
IP	Intellectual property
IP (1995) Guidelines	U.S. Antitrust Guidelines for Licensing of IPR
IPR	Intellectual property rights
M&A	Merger(s) and acquisition(s)
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
R&D	Research and Development
RPM	Resale Price Maintenance
SIEC	Significant Impediment of Eff. Comp.
SSNIP	Small but Significant Non-transitory Increase in Price by a hypothetical monopolist
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
TTBER (2004)	EC Technology Transfer Block Exemption Regulation
TTBEG (2004)	EC Technology Transfer Guidelines
UK	United Kingdom
UPA	U.S. Patent Act
U.S.(A.)	United States (of America)
USC	United States Code
WTO	World Trade Organisation

SUMMARY

The notion underlying the recognition of intellectual property rights is the establishment of a limited monopoly for the rights holder, which will allow this person (or his assigns) to capitalize from the creative efforts made. It is not only fair to reward creative individuals, but it is also a fundamental right to be on a par with the rights of ownership of any kind of property. The U.S. Constitution underscores the importance of the whole matter and grants Congress the power:

to promote the Progress of Science and useful Arts,
by securing for limited Times to Authors and Inventors
the exclusive Right to their respective Writings and
Discoveries.¹

The market economy depends on open competition. Society develops through the myriad decisions made by each and all. To secure free competition these decisions must be unhampered by anticompetitive agreements, abuse of market power or structural changes as well as distorting measures such as discriminatory state aid and advantages for state owned monopolies. Anti-trust legislation is a cornerstone in U.S. policy² and in Europe Article 81 EC (prohibition on anticompetitive agreements) constitutes

a *fundamental provision* which is *essential* for the
accomplishment of the tasks entrusted to the Community
and, in particular, for the functioning of the internal
market.³

¹ US Constitution, Article I Section 8.

² Antitrust law in general and the Sherman Act in particular, are the Magna Carta of free enterprise. They are as important to the preservation of economic freedom and our free enterprise system as the Bill of Rights is the protection of our fundamental personal freedoms *United States v. Topco Association*, 450 US 596, 610 (1972).

³ C-126/97, *Eco/Swiss China Time Ltd v Benetton International NV*, 1 June 1999, ECR I-3055 (emphasis added).

What then is the relation between these two areas of law? Can the monopoly created by IPR be reconciled with the need to create a competitive economy?

The 2007 Masters of European Affairs were given the task of investigating the current interpretation of the relationship between IPR and competition law. Have courts and authorities on either side of the Atlantic been able to find a reasonable balance between IPR protection and competition law requirements? Where exactly should the dividing line be drawn in the various situations that arise?

Context and History

Historically, it seems as if the relationship has been one of a never-ending tug-of-war, with society at times emphasizing the dynamic value of innovation by allowing better protection for it, but then replacing this permissive policy with stringent antitrust enforcement aimed at securing a more competitive market. In the U.S., policy often shifted with Presidents – Republicans emphasizing innovation and Democrats pursuing the aims of competition law. The EU position has also varied. Initially, the attitude to IPR was favorable and competition law was regarded as inapplicable, but the position gradually changed and the Commission began to attack reasonably harmless activities. The pendulum gradually swung back during the late 90s with the modernization of EU competition law.

It will be argued that competition law and IPR are developing in parallel towards a state in which they become complementary. Both bodies of law are equally important and depend on one another if optimal welfare is to be achieved. In this light, the question of hierarchy becomes less relevant. IPR is *a priori* essential in promoting competition, whereas competition law will correct any excessive behavior *a posteriori*. IPR can integrate competition concerns (“internalization”). As a control mechanism, competition law will still serve as a final check and ensure that the right balance is struck. Only then will the law most efficiently encourage and support innovation and thereby a dynamic and sustainable development of the economy.

IPR and Parallel Trade

IPR grants a monopoly, but this proposition still has its limits. Exclusivity vanishes the moment the rights holder, or someone with his/her consent, puts the protected product on the market. This “exhaustion theory” has gradually attained widespread acceptance in Europe. The alternate idea, that the rights remain intact, but that the rights holder is presumed to grant an “implied license”, is gradually being replaced by the exhaustion theory. The principle also appears well known and accepted in the U.S., even if for historical reasons the development has been less straightforward.

Whether the exhaustion theory applies in international trade has been a more controversial issue.

In the WTO context, developing countries have advocated the principle of international exhaustion as a model that promotes real and fair competition. High-income states were afraid that this would damage their welfare and hinder their policies and long-term technology development. The TRIPS Agreement itself offers little guidance other than the fact that the dispute settlement mechanism is not available to resolve the issue.

The idea of international exhaustion for all types of IPR is in any event hardly capable of implementation due to the differences in the market structure and specific needs of developing countries. Regional exhaustion can be achieved by way of trade agreements, which consolidate relationships between states with similar social, economic and legal backgrounds. Parallel trade within such regions encourages competition between the Member States. On the other hand, market segmentation between regions with differing economic development allows the attainment of political goals such as assisting developing countries through the sale of goods there at lower prices.

Antitrust Restrictions in Licensing Agreements

Licensing-out of IPR generates revenue and licensing-in of IPR opens up new opportunities. While these relationships are often pro-competitive, antitrust concerns may nonetheless arise. It is thus necessary to ensure that a balance is struck between allowing licensing on terms which promote innovation and preventing the IPR holder from unfairly stifling competition.

Although the respective ways the EU and the U.S. analyse licensing agreements under antitrust principles are converging, differences remain. As the single market concept is of paramount importance in the Union, competition law is allowed to interfere with the exercise of IPR. Such concerns do not arise to the same extent in the U.S. The difference is evident in the treatment of restrictions in licensing agreements.

For example, the EU is rigid in characterizing parties as either competitors or non-competitors and enforces different substantive rules depending upon how the parties are classified. Special emphasis is placed on agreements containing hard-core restrictions such as resale price maintenance, quota allocations and market sharing. Non-compete obligations and grant-backs are likewise viewed with suspicion. The equivalent U.S. position is based on a very broad rule-of-reason approach under which licensing activities have attracted less attention.

The conclusion is that a balance between competition law and IPR has not been struck in EC law. The single market imperative demands that concerns other than IPR be given priority. In the U.S., the balance is closer to being achieved, with a slight bias in favor of intellectual property law.

IPR and Dominance

Under certain circumstances IPR can confer a dominant position on the market, requiring regulation through competition law. The existence of IPR has long been distinguished from the exercise of such rights by the ECJ. In recent case law the ECJ has tended to move towards a less formalistic and more circumstantial evaluation.

The Treaty does not expressly prohibit the existence or acquisition of a dominant position, but only its abuse. A company occupying a dominant position may be held liable for abusive conduct if exclusive in-licensing strengthens a prior dominance. This follows from the “special responsibility” a dominant company has not to impair genuine and undistorted competition. With regards to out-licensing, the European Courts have established that dominant companies may have an obligation to out-license under “exceptional circumstances”. A refusal could lead the Court to order a compulsory license.

The U.S. achieves a balance by expressly prohibiting monopolies, but then provides a shield from antitrust scrutiny for the lawful exercise

of patent rights (when within their scope) regardless of the presence of an anticompetitive effect.

Dominance on an innovation market requires another approach. IPR spur companies to innovate and implementing competition law restrictions could be premature at this point. Competition law will prevent any abuse once a product hits the market. Moreover, it is argued, it is difficult to define innovation markets due to the various uncertainties surrounding potential innovations and therefore they should not be analyzed as independent and separate markets.

IPR, Mergers and Innovation

IPR can be one of the most valuable assets in a merger. EU and US law both treat IPR as they would any other corporate asset when evaluating the likely effects on competition. A correct economic assessment is therefore essential if a merger fails to be approved or denied.

A policy which is more protective towards IPR tends to diminish competition and creates more static markets; whereas prioritizing competition laws leads to a more dynamic market. Mergers may alter conditions of competition in innovation markets. Innovation is a dynamic process and therefore requires a dynamic analysis if one wishes to identify the impact M&A activity will have on it. When reviewing anti-competitive activity in innovation markets, the traditional methods of merger review will often be of limited efficiency. Here, the innovation market approach can indeed serve as a valuable tool for the competition authorities.

EC competition law focuses on dominance when assessing mergers. Thus pre-merger and post-merger market shares are determined. If the merger will significantly impede competition in the common market, it will be prohibited. The Commission does take IPR into account when assessing mergers, but it is not a central issue and has yet to be explicitly discussed in the Commission's decisions.

U.S. antitrust law evaluates mergers in relation to the relevant markets, focusing on the effects on market concentration and efficiency gains from the transaction. While IPR are legally treated the same as any other form of property, the reality is that if significant IPR exist, the evaluation will focus on those rights, their effects on existing markets and their potential for dominating a new market.

I. History and Context

The relationship of the antitrust or competition laws to patent, copyright and other parts of IP law has been a matter of debate among scholars and practitioners for over a century. These kinds of intangible property were first recognised as instances of a distinct species, IP, as recently as 1845, in the U.S. Nowadays, almost every jurisdiction protects IP which embraces several subject matters which could be said to be a product of the mind or intellect. The holders of such rights are generally entitled to exercise various exclusive rights in relation to the subject matter. The three most common IPRs are patents, trademarks and copyrights.

Patents reward inventions which are new, susceptible of industrial application and involve an inventive step by granting the inventor an exclusive right to exploit the invention commercially; generally for a period of twenty years from the filing of a patent application. Trademarks ensure their owner an exclusive right to utilise the mark when putting a product on the market. Trademarks thus guarantee the identity and origin of the product and enable consumers to distinguish that product from products with another origin. Within the EU, trademarks are registered for a period of ten years from filing of the application, with the possibility of renewal. Finally, copyrights apply to a variety of creative and artistic work such as literary, dramatic and musical works, sound recordings and films. The objective, again, is to protect the owner of artistic work from reproduction without its consent, generally for a period equivalent to the lifetime of the owner plus an extra seventy years.

IPRs became particularly important during the scientific and technological development of the first decades of the 20th century. Since then, society has become more and more diversified, economies more open and trade more international. In this context of a globalized economy and the development of ever more innovative technologies, the relation between IPRs and competition law will be all the more relevant and the questions of their interplay more intricate and complex.

When studying the objectives of IPRs and competition law one might, on first sight, expect a clash of interests. One seems aimed at establishing what the other tries to prevent. While competition law aims at opening up markets and encouraging effective and fair competition, IPRs can be used in ways that recreate boundaries, foreclose competitors and separate markets. Within the context of the establishment of a single European market, this problem could become extremely sensitive.

The purpose of this section is to identify the base concepts of both competition law and IPRs and to determine whether there is indeed a conflict between them or whether they essentially pursue the same goal. Could it be said that instead of contradicting each other they rather choose different paths to the same goal of maximizing consumer welfare? If this question is to be answered in the affirmative, can we consequently conclude that there now exists a fair balance between competition and IPRs?

The first chapter is an introduction to the interface between the two bodies of law. The first part takes a look at the historical background of the two concepts and their relationship. Following this historical overview, the second part focuses on contemporary legislation in the EU and the U.S. and compares the tensions arising within these differing legal environments. The interface issue will then be discussed from three different perspectives: a competition perspective; an IP perspective and finally a law and economics perspective. By choosing these different angles, this section will hopefully provide a general context and a good starting point for further and deeper analysis of the interface issue in the following section.

1. HISTORICAL AND LEGISLATIVE OVERVIEW

BY MUHAMMAD SARWAR CHAUDHRY & LENA KOTER

The different subject areas within the IP field originated in different places and at different times. It is likely that all of them can be traced back to the grants of royal privilege which seems to have operated in most of medieval Europe. The Venetians are credited with passing the first properly developed patent law in 1474. In England the Statute of Monopolies of 1623 swept away all monopolies except those made by the “true and first inventor” of a “method of manufacture”. Revolutionary France recognized the rights of inventors in 1791 while the U.S. had already enacted a patent law in 1790. These patent laws were nothing like today’s complex systems. They were mercifully short, simply recognizing the rights of the inventor. Patent law then spread throughout Europe in the first half of the nineteenth century⁴. Statutory forms of trade mark law only made their appearance late in the second half of the nineteenth century, even though trade marks had been in use for much longer⁵. The English courts had long before developed protection for trade marks through the action of passing off⁶. For a variety of reasons, this proved unsatisfactory and statutory systems of trade mark registration began to make their appearance in Europe: France 1857, England 1862 and 1875, the U.S. 1870 and 1876 and Germany 1874.⁷ Copyright follows a similar pattern, modern copyright law beginning in England with the Statute of Anne of 1709.

It must be noted that what proliferated in Europe during the second part of the nineteenth century were purely national IP regimes,

⁴ *Machlup, F., Penrose, E., “The Patent Controversy in the Nineteenth Century”, 10 (1950) Journal of Economic History, pp. 1, 3.*

⁵ *Schechter, F., “The Rational Basis Of Trademark Protection”, 40 (1927) Harvard Law Review, pp. 813-833*

⁶ *Ricketson, S., The Law of Intellectual Property (Law Book, Sydney, 1984) p. 599.*

⁷ *Ladas, S., Patents, Trademarks, and Related Rights: National and International protection, Vol. 1, Harvard University Press, Cambridge, 1975, p. 8*

although there was much borrowing and cross-pollination between states. The principles of patent law to be found in the English Statute of Monopolies were gradually recognized in other states. The English devised the first law on designs in 1787, but they were influenced by the French design law of 1806 when they reformulated their law in 1839. Outside of Europe, IP was primarily influenced by the colonial nexus. So, for example, although to a large extent self-governing, the colonies of Australia enacted copyright and patent statutes that were essentially faithful copies of English models.

The first use of the term “intellectual property” appears to be an 1845 Massachusetts Circuit Court ruling in the case *Davoll et al. v. Brown*⁸, in which Justice *Woodbury* wrote that “only in this way can we protect intellectual property, the labours of the mind, productions and interests as much a man's own...as the wheat he cultivates, or the flocks he rears”.

1.1. IP legislation

The U.S. Constitution

As early as the Constitutional Convention of 1787, the U.S. protected IPR giving the federal power the ability to “secure, for limited times, patents and copyrights”.⁹ The Constitution authorized the Congress to enact laws to protect these rights and defined the scope of its patent power. The federal regulation of patents and copyrights prevails over state regulation if the latter interferes with the objective of the patent power. In contrast, the main trademark statute is based on the Interstate Commerce Clause¹⁰ and there needs to be some nexus to interstate commerce for such laws to be valid.¹¹ However, as the constitutional patent clause is rather broad, it too would have little

⁸ *Woodbury & Minot*, CCD Mass. 7. F. Cas. 197, 1845

⁹ U.S. Constitution, Article I, Section 8, Part 8.

¹⁰ *Id.*, Part 3.

¹¹ *Miller A., Davis M*, Intellectual Property; Patents, Trademarks and Copyright in a nutshell, 2nd ed, West Publishing co., 1990, p. 7-8

effect without legislation. In the end, all IPRs has been further developed by statute and case law.

The EC Treaty

IPR provisions in the EU context primarily concern the relationship between the Community and the Member States. These are also competent to deal with matters of IP protection. One of the main objectives of the EC Treaty is the creation of a common market between the Member States¹² providing for the harmonious and balanced development of the economic activities of the Community. If IPRs were based solely on the earlier system of territorial exclusivity this would seem to be incompatible with the objectives of the common market. Furthermore, the EC Treaty seeks to establish a system that ensures competition in the internal market is not distorted.¹³ The enforcement of IPRs affects both competition and the free movement of goods and has an impact on intra-Community trade and the comparative market structure.¹⁴ It must then be decided how one can protect both the common market and national industries i.e. how can one balance the systems of Community and national law while simultaneously protecting both competition and IPRs.

At the start, the Member States tended to object to their national IP laws being guided by Community rules and principles. Under Article 295, the ECJ will considers IPRs as being like any other form of property and it will agree that the Member States are competent to specify IPR rules.¹⁵ The only explicit reference to IP protection found in the EC Treaty was in Article 30, which, with reference to Article 28, deals with the applicability of the Community principle of free movement of goods and services to national IPR. In fact, it provides exceptions to the fundamental principle of free movement of goods. It defines the national operating of IPR systems as quantitative restrictions, but ones that are exempted from the application of the rules concerning free movement of goods; however the exemption is limited,

¹² EC Treaty, Art. 2

¹³ EC Treaty, Art. 3 (g)

¹⁴ *Govaere I.*, The Use and Abuse of Intellectual Property Rights in E.C. Law, Sweet & Maxwell, London 1996, p. 42.

¹⁵ Case C-350/92 *Kingdom of Spain v. Council of the European Union* [1996] ECR I-1985

as the Commission still has the competence to act under Article 85. Thus IPR are, in principle, subject to Community law. Following the *Simmenthal*¹⁶ case, Article 30 permits Member States to derogate from the principle of free movement of goods if the derogation attains one of the objectives enumerated in the Article.

Patents

The European Patent Convention was signed in 1973 and is still in effect, and has been adopted by most European countries, including all EU Member States. The EPC established the EPO and provided an autonomous legal system under which European patents are granted. Such a patent is not a unitary right, but a group of essentially independent nationally-enforceable and nationally-revocable patents,¹⁷ which in practice appears as a highly disorganized bundle of patent rights. The system of registration appears to be dispersed and expensive. Furthermore, enforcement is carried out through national courts in individual countries and can lead to differing statements in similar or identical situations. Due to the impracticality of the present system, the European Commission has been trying for years to establish a system of Community patent¹⁸ and a centralized Community tribunal.

A Proposed Regulation on Community patents was filed in 2001 with the aim of complementing the national legislations on the Community level. As the Competitiveness Council failed to agree on the details of the Regulation, it has not yet come into force. Once established, a Community patent would provide a patent right that would be consistent across Europe and would thus fulfill one of the key principles of the internal market - that the same market conditions should exist throughout Europe. At the present stage different patent rights in different countries distort this.

While the EU is attempting to establish a unified patent system, the U.S. is striving to modernize its patent legislation. The U.S. Patent

¹⁶ Case 35/76, *Simmenthal SpA vs. Italian Minister for Finance*, [1976] ECR 1871, par. 14, see also: *Govaere*, fn 14, p 42-43

¹⁷ EPC, part 1, ch. 1, art. 2

¹⁸ The term "European patent" under EPC should not be confused with the Community patent. Apart from the fact that it is a mere bundle, the EPO is not a EU body and the parties to the EPC are not the same as the EU member states.

Act¹⁹ was amended in 1999 by the American Inventors Protection Act (AIPA)²⁰. Recently there were two proposals submitted to further amend the patent legislation; they would upgrade the system and bring a number of additional changes to it, though as between themselves they do not differ much. The main change would be the use of the "first to file" method of awarding patents, which is used by most countries, including the European ones, instead of the existing "first to invent" standard. Furthermore, interested individuals could enter a "protest" against a pending patent application before a board of administrative judges within the Patent Office, rather than in the traditional court system.²¹

Trademarks

In contrast to the case of patent law, the EU did establish a unified system for the protection of trademarks on the Community level, which runs parallel to the national legislations. Trademarks may be registered in an individual country or by the Office for Harmonization in the Internal Market (OHIM) and thus across the whole EU, by way of the CTM. The Community leaves jurisdiction to national courts in disputes concerning the infringement and validity of CTM. The CTM concept originated in 1964 in a draft of a Convention on European Trademark Law. The establishing 1993 Council Regulation on the Community Trade Mark²² and 1989 First Council Directive on Trade Marks²³, which took essentially the same approach, although the Regulation is more extensive, have frequently been amended. There were two Commission Regulations issued in 1995²⁴ and 1996²⁵ implementing

¹⁹ US Patent Act, USC, Title 35.

²⁰ The American Inventors Protection Act was enacted in 1999 as Public Law 106-113 and amended by the Intellectual Property and High Technology Technical Amendments Act of 2002 (Public Law 107-273) in 2002.

²¹ *Crouch, D.*, Patent Reform: Patent Act of 2005, Patently-O blog entry, 2005, http://patentlaw.typepad.com/patent/2005/06/patent_reform_p.html (Last visited on May 8, 2007)

²² Council Regulation (EC) No 40/94 on the Community trade mark, OJ L 11

²³ First Council Directive of 21 December 1988 to approximate the laws on the Member States relating to trademarks (89/104/EEC).

²⁴ Commission Regulation (EC) No 2868/95 of 13 December 1995 implementing Council Regulation (EC) No 40/94 on the Community trademark.

the 1993 Council regulation and laying down the rules of procedure of OHIM. The most recent was the 2004 Council Regulation (EC) on the Community trademark.²⁶

Contrary to other IPRs, trademarks within U.S. were traditionally protected by State law, only, using an unfair competition theory. In 1946, Congress passed the U.S. Trademark Act, known also as the Lanham Act²⁷, which creates federal protection and registration for trademarks, the system being administered by the United States Patent and Trademark Office. State law can still provide its own protection of trademarks, complementing the federal system.²⁸

In 2003 the U.S. and the EC (besides the Member States signing independently) both signed the Madrid Protocol on Trademark Registration, an international treaty that allows a trademark owner to seek registration in any of the countries that have joined the Madrid Protocol by filing a single unified application, called an “international application”.²⁹

1.2. Evolution of Antitrust Laws

The U.S. Constitution mentions IPRs, but not antitrust. This may well be due to the fact that the U.S. is, to a very large extent, a single state with a single market. When its economic system was establishing itself, the U.S. was a very open country, willing to attract as many investors as possible and it thus wished to encourage innovation and production and did not devote much attention to the protection of competition. On the other hand, the EU is a union of states, still

²⁵ Commission Regulation (EC) No 216/96 of 5 February 1996 laying down the rules of procedure of the Boards of Appeal of the Office for Harmonization in the Internal Market (Trade Marks and Designs).

²⁶ Council Regulation (EC) No 422/2004 of 19 February 2004 amending Regulation (EC) No 40/94 on the Community trademark.

²⁷ Lanham Act, USC, Title 15, §§ 1051-1127.

²⁸ *Miller, Davis*, fn 11, p. 146-155

²⁹ *Ray, D, Taylor, A*, DLA PIPER: The Madrid Protocol—International Trademark Registration Made Easier, Jan 03, 2003, <http://www.dlapiper.com/global/publications/detail.aspx?ref=snapshot&pub=292> (Last visited on May 8, 2007)

endeavoring to create a common market and to protect competition in the initial stage.

The U.S. development

In the U.S., an early case examining monopolies was *Proprietors of the Charles River Bridge v. Proprietors of the Warren*³⁰ which was decided in 1837. The Supreme Court rejected the Charles River Bridge Company's claims of entitlement to a monopoly by virtue of the grant of a state charter. The Court stated that there was no implied grant of a monopoly in their contract with Massachusetts. The court went on to discuss how allowing such grants would be harmful to the economy and the growth of the nation.

The period from the *Charles River Bridge* case to the enactment of Sherman Act was full of economic crises. Many felt that the cause of this was due to large corporations, railroads especially, not being sufficiently regulated.³¹

The main antitrust statute concerning competition and licensing in the U.S. is still the 1890 Sherman Act³² which also was the first federal statute to limit monopolies. Sections 1 and 2 of the Act prohibit any form of agreements which restrain trade or commerce³³ and declare any monopolies as illegal.³⁴

One of the first tests of the effectiveness of the Sherman Act was the 1895 case of *United States v. E.C. Knight Co.*, relating to a sugar trust³⁵. The Court held that the purchase of stocks of four Philadelphia area sugar refineries to create a trust was not an illegal restraint of trade. The Court further stated that the manufacture of sugar was not interstate commerce. The acts of buying and selling alone were viewed by the Court as constituting the definition of commerce. This holding

³⁰*Proprietors of Charles River Bridge v. Proprietors of Warren Bridge*, 36 U.S. 420, 549 (1837)

³¹ Hamill, S.P., From Special Privilege to General Utility: A continuation of Willard Hurst's Study of Corporations, 49 Am. U. L. Rev. (1999) 81, 114

³² Sherman Act, officially known as Act of July 2, 1890, ch. 647, 26 Stat. 209, as amended, codified at USC, Title 15, §§ 1- 7.

³³ Sherman Act, Sect. 1.

³⁴ Sherman Act, Sect. 2.

³⁵ *United States v. E.C. Knight Co.*, 156 U.S. 1 (1895)

set back antitrust enforcement until 1904 and the *Northern Securities case*³⁶. This case involved the merger of two railroads, the Northern Pacific and the Great Northern, under a holding company called the Northern Securities Company. These two railroads were the main competitors in their region of the country. The court held that there is a violation of the Sherman Act when there is a merger between firms that were previously competitors. A noted dissent by Justice Holmes declared that Congress did not have the power to regulate the activities in this case. Another anti-trust case came up before the U.S. Supreme Court in 1911, which is the equally famous *Standard Oil case*³⁷. The Court declared that the trust had a “complete mastery over the oil industry”. It was held that Standard Oil had worked to dominate the oil industry by the exclusion of others by unfair means. The trust was ordered to be broken up.

The Sherman Act was regarded as too broad and general to be effective. In 1914, both the Federal Trade Commission Act and the Clayton Antitrust Act³⁸, were passed. The time between 1920 and 1935 was however a period of lower antitrust enforcement. This period has been considered by some - those favouring more enforcement - to have provided a virtual “moratorium from the Sherman Act”. In the late 1930s, cartels began to be associated with totalitarian regimes, especially those coming to power in Europe and Asia. This sentiment was reflected in *United States v. Socony-Vacuum Oil Co*³⁹. This was one of the cases that set the foundations for the “per se” doctrine of antitrust violations. Further legislative enactments were the Robinson-Patman Act⁴⁰ of 1936 and the Hart-Scott-Rodino Antitrust Improvements Act⁴¹ of 1976.

³⁶ *Northern Securities Co. v. U.S.*, 193 U.S. 197 (1904)

³⁷ *Standard Oil Co. v. United States*, 221 U.S. 1 (1911)

³⁸ The Clayton Antitrust Act of 1914, (October 15, 1914, ch. 323, 38 Stat. 730, codified at 15 U.S.C. § 12-27, 29 U.S.C. § 52, 29 U.S.C. § 53).

³⁹ *United States v. Socony-Vacuum Oil Co*, 310 U. S. 150, 223 (1940)

⁴⁰ Robinson-Patman Act or Anti-Price Discrimination Act, 15 U.S.C. § 13.

⁴¹ Hart-Scott-Rodino Antitrust Improvements Act (Public Law 94-435), known commonly as the HSR Act) is a set of amendments to the antitrust laws of the US. The context in which the HSR Act is usually cited is 15 U.S.C. § 18a, title II.

The European development

To some Europeans, around the beginning of last century, the American system was attractive: it seemed to be a dynamic solution favouring flexible industries but one which was still prepared to meet the demands of and protect society as a whole. But changes in Europe only came slowly and gradually. The unfair trading acts passed at the beginning of the century primarily protected businesses against the unfair activities of others: the aim was not the protection of society as a whole. In the 1940s, after the Second World War, an economic system based on free competition became the norm, with Germany leading the way. But rather than applying the U.S. system of “per se” prohibitions, most European countries emphasized a so-called “abuse principle”. No specific types of collaboration and contract were prohibited as such, but the authorities were allowed to intervene whenever a practice had harmful effects⁴².

In 1950 the Agreement on the European Coal and Steel Community (ECSC) was provided with anti-trust provisions largely inspired by the “per se” prohibition principle. That collaboration, however, only applied to a limited sphere of goods. When the Coal and Steel Collaboration in 1958 was extended to cover all kinds of products and goods through the Treaty establishing the European (Economic) Community, it was unsurprising that the principles developed during the earlier period of development were adopted. During the subsequent 50 years, these principles have become established as an important factor in the European economic development⁴³.

The principle rules governing competition in the EU are to be found in the EC Treaty, articles 81 and 82.

Article 81 prohibits any agreements, which may affect trade and disturb the free movement of goods in the common market within the Member States and declares them to be null and void⁴⁴. Article 81(3) allows for individual and block exemptions, which enable parties to escape the prohibition of the first two paragraphs of the Article. Article 82 prohibits abuses of dominant position, though not the existence of

⁴² *Lidgard, H.H.*, Competition Classics : Competition at All Levels, course material University of Lund 2006/2007, p. 6

⁴³ *Ibid*, pp. 6-7

⁴⁴ Art 81 (1),(2) EC

dominance as such. Later sections, which will not be considered here, control state subsidies and the acts of state-run businesses.

Regulations and guidelines

The U.S. antitrust agencies have published several antitrust law Guidelines, which often relate to IP law, so as to inform the business community and antitrust practitioners of the approach and practice the Agencies take in their enforcement of the antitrust laws. These Guidelines treat IP as comparable to any other forms of property, take the rule of reason approach to patent licensing and build on the principle that unconstrained patent licensing increases the value of the patents and encourages innovation thus recognizing the pro-competitive benefits on licensing arrangements.⁴⁵ Most relevant here are the US Antitrust Guidelines for the Licensing of Intellectual Property⁴⁶ (“IP (1995) Guidelines”) published in 1995 jointly by DOJ and the FTC.

A year later the EC published the Technology Transfer Block Exception or TTBER.⁴⁷ A replacement Regulation (“TTBER (2004)”) was published in 2004⁴⁸ and was accompanied by the Technology Transfer Guidelines (“TTBEG (2004)”).⁴⁹

⁴⁵ *Gilbert, R*, Antitrust policy for the licensing of intellectual property: An international comparison, *International Journal of Technology Management* 2000 - Vol. 19, No.1/2, p. 210.

⁴⁶ 1995 US Antitrust Guidelines for the Licensing of Intellectual property, issued by the US Department of Justice and the Federal Trade Commission, April 6, 1995

⁴⁷ TTBER (1996) (Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85 (3) of the Treaty to certain categories of technology transfer agreements), OJ L 31

⁴⁸ TTBER (2004) (Commission Regulation (EC) No 772/2004 of 27 April 2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements), OJ L 123

⁴⁹ TTBEG (2004) (Commission Notice - Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements), OJ No C 101, 27.04.2004

1.3. Conclusion

It can be seen that different types of IP originated in different places and at different times. Antitrust law was first introduced in a somewhat modern sense in the U.S. by the mid 19th century. The interplay between the anti-trust laws and IP rights was discussed for the first time in the U.S. in the first half of 20th century, while the matter arose more slowly in Europe. EU antitrust jurisprudence and the conflict between competition law and IPRs which it gave rise to only goes back to 1966.

We have seen the differences between the EU and U.S. IP and competition regulations. In some areas the two systems take different approaches while in others, the results are much the same. While the U.S. is a single market, the EU is a Union of several different markets, which wants to establish a common market, so it needed to focus on the protection of competition. On the other hand, IPR are primarily of national importance: it is understandable that, because of their importance, the U.S. included them in the Constitution as is the fact that the EU Member States try to keep as much IPR law within their national competence as possible.

2. AN ANTITRUST PERSPECTIVE

BY MARIJE BORGHART

Competition benefits consumers because it tends to lead to the optimum choice of products and services in terms of price, quantity, quality and consumer choice.⁵⁰ By encouraging competitive behaviour, competition law thus seeks to maximize consumer welfare. IPRs stimulate innovation by protecting inventors, thereby encouraging them to bring new or improved products and processes onto the market, which also benefits consumers. Hence, on first sight competition law and IPRs do not seem to clash.⁵¹ However, in the discussion on the interface between competition law and IP law, signs of conflict cannot be ignored. Generally, one seems to be aimed at what the other essentially tries to prevent. While competition law seeks to achieve economic efficiency by promoting competition and free operation of the market, IPRs create monopoly rights that can be used to frustrate this.⁵² This raises the question whether a hierarchy exists between the two concepts; will one prevail over the other in situations of conflict?

This chapter analyses the dilemma from a European competition perspective. The analysis will start with an assessment of the European Community system and the fundamental role played by competition. Second, the discussion will look at the characteristics of IPRs and why they can form obstacles in the way of Community objectives. As explained above, the purpose of this section is to provide a primarily historical background and it is the following sections which will elaborate a legal analysis. Thus there will only be room here for rather brief descriptions of situations in which it is generally agreed that

⁵⁰ To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy, Federal Trade Commission, October 2003, p. 3.

⁵¹ Dutch Competition Authority (NMA) report, *Is de Mededingingswet ICT-proof?* May 2002, p. 23.

⁵² *Cotter T.F.*, "Intellectual Property and the Essential Facilities Doctrine", 44 *Antitrust Bulletin* 1, 1999, p. 227.

competition law should be able to interfere with IPRs; all subject matters touched upon will be analyzed in further detail below. Even still, the conclusion can, I hope, already be drawn that the apparent superiority of competition law prevails, at least in certain situations. It will also become clear why this conclusion is formulated so tentatively.

2.1. Competition as a fundamental principle

A high degree of competitiveness and convergence of economic performance are stated to be among the fundamental objectives of the European Community.⁵³ Article 3(1)g EC clarifies that this goal shall be achieved through the institution of “a system ensuring that competition in the common market is not distorted”. Article 4 then instructs Member States and the Community to adopt “an economic policy which is based on close coordination of national economic policies, on the internal market and on the definition of common objectives”. This should be “conducted in accordance with the principle of an open market economy with free competition”. Member States have a duty to take all appropriate measures to ensure the achievement of these Community objectives.⁵⁴ Hence, it is obvious that the competition rules lie at the core of the Treaty provisions “creating the dynamic tool that would modernize European trade and industry”⁵⁵.

In *Eco/Swiss v Benetton*⁵⁶ which concerned an arbitration award, the ECJ confirmed the fundamental significance of the EC competition system. It stated that:

“Article 81 constitutes a fundamental provision which is essential for the accomplishment of the tasks entrusted to the Community and, in particular, for the functioning of the internal market.” Therefore, “where its domestic rules of procedure require a national court to grant an

⁵³ EC Treaty, Article 2

⁵⁴ Articles 10 and 98 EC Treaty

⁵⁵ *Lidgard, H.H., Competition Classics*, fn 42, p. 21.

⁵⁶ Case C-126/97, *Eco Swiss China Time Ltd v Benetton International NV*, 1999 ECR I-3055.

application for annulment of an arbitration award where such an application is founded on failure to observe national rules of public policy, it must also grant such an application where it is founded on the failure to comply with the prohibition laid down in Article 81(1) EC.”⁵⁷

The Court characterized the competition rules as fundamental principles of law which have the force of public policy. The case almost has a constitutional ring to it and supports the setting aside of other considerations.⁵⁸

European competition law has thus acquired an essential position within the Community which is also distinct from that within most national systems. That said, during the period of EC developments, national competition laws have developed in parallel. Furthermore, Article 81 and 82 EC, the key competition articles, create binding norms for all natural and legal persons in the Member States and they prevail over national law in case of conflict.⁵⁹

In broad terms and in the light of its central importance for the European Community and the achievement of the common goals, EC competition law is primarily intended to: (1) enhance efficiency, maximize consumer welfare and achieve the optimal allocation of resources; (2) protect consumers and smaller firms from large aggregations of economic power; and (3) create a single European market and prevent frustration by activities of private undertakings.⁶⁰ As we shall see, IPRs and the legal monopoly they create can conflict with these objectives in several ways. However, with competition being classed as a fundamental principle of law and bearing in mind the role assigned to it within the EC, this could allow for the setting aside of other considerations, including IPRs.

⁵⁷ Id. par. 36-37.

⁵⁸ *Lidgard, H.H.*, *Competition Classics*, fn 42, p. 27.

⁵⁹ For the so called direct effect see Case C-127/73 *BRT v. SABAM*, 1974 ECR 51, for supremacy see Case C-14/68 *Walt Wilhelm v. Bundeskartellamt*, 1969 ECR 1.

⁶⁰ *Craig P. & De Burca G.*, *EU Law*, Oxford University Press, 2003, p. 936-937.

2.2. Why IPRs create problems

Today, the importance of IPRs is uncontroversial. These rights are critical for the efficient functioning of markets and essential for the creation, production and distribution of IP to be undertaken in ways that benefits society as a whole.⁶¹ Traditionally, however, within the EC IPRs were at best mainly regarded as non-tariff barriers to trade. Indeed, because of their apparent anti-competitive effects, the very existence of IPRs was even regarded as suspicious. During recent decades attitudes changed and their beneficial economic effects has been emphasized.⁶² Nevertheless, while the realization of free competition is one of the fundamental principles of the EC Treaty, this legal instrument does not contain specific provisions granting significant protection for IPRs.

From an antitrust perspective, the problem with IPRs is that they are based on the principle of territoriality and confer exclusive rights on the IP owner. It is clear that both characteristics conflict with the objectives of the EC as described in the previous paragraph. Territoriality is difficult to reconcile with the objective of creating a single market, whereas the conferring of exclusive rights might pose problems in terms of the rules on competition.

Territoriality – property rights versus the single market

Even though international conventions exist for all IPRs, and some EC harmonisation measures exist,⁶³ these rights are still to a large extent granted nationally on the basis of criteria which are not

⁶¹ *Gans J., Williams P. and Briggs D.*, Intellectual property rights: A Grant of Monopoly or an Aid to Competition?, 37 *The Australian Economic Review* no 4, 2004, p. 444.

⁶² *Govaere*, fn 14, p. 2.

⁶³ European attempts have not been very successful. The European Patent Convention is not the result of a EC effort. The 1989 EC Patent Convention and the 1984 European Trade Mark Convention have not entered into force. The First Council Directive 89/104/EEC of 21 December 1988 relating to trade marks and Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade mark do not supersede national legislation in the field, although they have a substantial impact on trade mark development.

necessarily the same in all Member States. Different competitive conditions therefore prevail in different Member States.⁶⁴ The scope of the average IPR is thus geographically limited to the territory of the Member State granting the protection; they can be relied on only in that Member State and are not affected in their essence by the fact that parallel rights may exist in other countries⁶⁵.

As mentioned, the philosophy within the EU is that competition between goods coming from different Member States should neither be prevented nor distorted. Such goods should be able to move freely, so that those which are most favoured by customers will be most successful. This can clearly be impeded by private parties using their national IPRs to partition the market.⁶⁶ For example, a licensee of a patent will possess an exclusive right to market the product in its area. It will often also have a proprietary right to prevent the import of the product into its own territory from elsewhere. A series of such licenses can result in a number of fragmented and isolated markets within which trade and competition are obstructed.⁶⁷

To prevent companies from recreating national boundaries, a principle of exhaustion was invoked; a classical example of a situation in which EC rules try to limit the negative impact of national IPRs in favor of competition.⁶⁸ Exhaustion implies that once the IP owner has consented to putting the protected product on the market in one Member State, he may no longer invoke his IPR in another Member State to restrain the importation of that product.⁶⁹ Allowing citizens to

⁶⁴ *Govaere*, fn 14, p. 13-16.

⁶⁵ OECD report 1998, Competition Policy and Intellectual Property Rights, DAFFE/CLP(98)18, p. 296.

⁶⁶ “The national rules relating to the protection of industrial property have not been unified. The National character of the protection of industrial property and the variations between the different legislative systems are capable of creating obstacles both to the free movement of goods and to competition within the common market.” Case 24/67, *Parke, Davis & Co. v Probel, Centrafarm and Others*, [1968] ECR 55

⁶⁷ *Ullrich H.*, IP-antitrust in context: approaches to international rules on restrictive uses of intellectual property rights, 28 Antitrust Bulletin 2003, p. 843. See for further detail Sections II and III of this book.

⁶⁸ For a more detailed discussion on the free movement of goods and IPR see Section II of this book.

⁶⁹ Case 15/74, *Centrafarm BV v. Sterling Drug*, [1974] ECR 1147 See further Section II of this book.

partition the common market by invoking national provisions would, according to the ECJ, be contrary to the essential purpose of the EC Treaty.⁷⁰ Some of the most powerful effects of EC competition law on IP have thus come about not primarily through Articles 81 and 82, but by way of the rules on free movement of goods.⁷¹

As shall be shown in Section II of this book, these rules have had a strong effect on national IPRs, by disallowing barriers to parallel imports. Gradually, however, attitudes have changed and the purported obstacles to free movement arising from IPRs have been perceived as less dangerous. Some rights have been harmonized by way of directives and the Commission and ECJ have, to some extent, diminished the pressure.⁷² Nevertheless, the prevailing view is still that, in the light of the required functioning of the common market, competition law should rule over IPRs.

Exclusive rights – monopoly versus competition

The idea behind IPRs is to give their creator a right to the benefits arising from his efforts. Lacking protection, inventors would not be stimulated to develop new or improved products or processes and might even be hesitant to disclose new discoveries. Products would not reach the consumer or at least not as fast. Protection of intellectual efforts is in the interests not only of the inventor, but also of society at large.

Nevertheless, by being able to exclude others from exploiting IPR, the rights holder can be said to hold a monopoly on this right. Indeed, monopoly, or diminishing competition, is the very subject matter of IPRs.⁷³ IPRs do not confer significant monopoly power per se⁷⁴ but they may give rise to significant market power when there are no substitutes on either the demand or supply side of the market. In other words, entry barriers are created.

⁷⁰ Id. par. 12.

⁷¹ *MacQueen H.L.*, 'Towards utopia or irreconcilable tensions? Thoughts on intellectual property, human rights and competition law, 2 SCRIPT-ed issue 4, 2005, p. 460

⁷² Id.

⁷³ Case 237/87, *Volvo AB v Erik Veng Ltd*, [1988] ECR 6211

⁷⁴ OECD report 2005 Intellectual Property Rights, DAF/COMP(2004)24, p.18.

The grant of a legal monopoly can become incompatible with the fundamental objective of open, fair and competitive market conditions. A monopoly created by IPRs might lead to monopoly pricing. Cartelization is also likely to happen if the rights holder, rather than exploiting the right himself, grants licenses to third parties to operate the monopoly. Such grants could very well lead to exclusionary practices.⁷⁵ Based on such considerations, competition authorities in Europe have rightly been suspicious of IP protection.

Until about 1990, the Commission perceived competition rules as mainly protecting competitors, rather than competition as such, i.e. the consumer. As a consequence, it was widely thought that exclusion was anti-competitive, and justifications based on free-riding arguments were not easily accepted. This approach has changed and recent Commission documents are more likely to refer to the goal of consumer welfare. From having taken a rather formalistic attitude in which competition law was automatically seen as prevailing, the Commission now takes a more open-minded approach and is more sensitive to economic arguments.⁷⁶ Nevertheless, Gitter notes that EC authorities still tend to protect market entrants at the expense of IPRs, especially where small or medium sized firms are involved.⁷⁷

2.3. Approach of the ECJ

In the absence of adequate harmonisation of IP law, the relationship between IPRs and Community principles has primarily been determined by ECJ case law. As mentioned earlier, during the 70s, the emphasis was on the free movement of goods and competition within Europe rather than on IPRs. The ECJ nevertheless tried to achieve a balance between the objective of creating a single market

⁷⁵ On dominant position see further Section IV.

⁷⁶ *Korab V.*, The Interface Between Intellectual Property Rights and Competition in Developed Countries, in: 2 SCRIPT-ed issue 4, 2005 p. 432. See also *Brunswick Corp v Pueblo Bowl-O-Mat Inc*, 429 US 477, 488 (1977).

⁷⁷ *Gitter D.*, “The conflict in the European Community between competition law and intellectual property rights: a call for legislative clarification of the essential facilities doctrine”, 40 American Business Law Journal 217, 2003, p. 24.

with workable competition on the one hand and the national law protecting the inventor on the other.

A distinction was made between the existence of an IPR and the exercise thereof. Initial case law established that the existence of these rights as such does not fall within the scope of EC competition law. The exercise of these rights could, however, very well be attacked.⁷⁸ In other words, competition law could not call into question the existence of the property right or related legislation, but these rights could certainly be exercised in an unacceptable way and such exploitation should be controlled. In *Consten and Grundig*,⁷⁹ the first case to raise the matter in this way, the Court concluded that:

“the injunction to refrain from using the rights under national trade mark law in order to set an obstacle in the way of parallel imports does not affect the grant of those rights but only limits their exercise to the extent necessary to give effect to the prohibition under Article 85(1) EC.”

What is the precise meaning of this existence/exercise distinction? Property is typically made up of a bundle of rights, powers, privileges and duties. These constitute the very meaning of property. To say that the Treaty only restricts the exercise while the rights etcetera comprising the property remain totally undamaged is at least questionable. Competition law seems able to touch on the whole package and thereby affect more than just the exercise of one's right.⁸⁰ The key seems to be that the Court felt it had to allow competition law to constrain what a rights holder can do with its right, so as to protect the fundamental rationale of the Community.

⁷⁸ “Since the existence of the patent right depends solely at present on internal laws, only the use made of it could fall within the ambit of Community law where that use contributes to a dominant position, the improper exploitation of which would be liable to affect trade between Member States.” Case 24/67 *Parke Davis*, fn 66

⁷⁹ Cases 56 & 58/64 *Consten & Grundig v. Commission*, [1966] ECR 299

⁸⁰ *Craig P. & De Búrca G.*, fn 60, p. 1088. For a more detailed analysis of this topic see Section IV.

The essential facilities doctrine

A clear way of pointing out the contradictions inherent in any effort to reconcile competition law and IPRs is the essential facilities doctrine. This doctrine provides that a company which has a dominant position in the provision of facilities which are essential for the supply of goods or services on another market abuses its dominant position when it denies others access to goods or services offered by it on an upstream market, such goods or services being indispensable for competing with it on a downstream market. The specific requirements established in this regard by the ECJ in judgments such as *Magill*⁸¹ and *IMS*⁸² will be discussed in detail in Section IV.

What should be stressed at this point is that this is again an attempt to balance the need to recognize the existence of non-discriminatory national provisions and the need to prevent their exercise from creating obstacles to unimpaired competition. Indeed, at first sight, this approach appears to respect property rights and the fact that they can only be effective if they imply some monopoly power, while also allowing for an exception when this monopoly is so large as to result in an unacceptable loss of welfare.⁸³ Yet, while intending to benefit consumers by increasing competition in downstream markets, the essential facilities doctrine is a direct challenge to the concept underlying IPRs.⁸⁴ What is at stake are certain “facilities” and the special obligation of a dominant firm to deal with competitors.⁸⁵ The monopolist status seems determinative here, and it is difficult to see

⁸¹ Cases C-241/91 P & C-242/91 P, *Radio Telefis Eireann (RTE) and Independent Television Publications Ltd (ITP) v Commission*, [1995] ECR I-743 (*Magill*)

⁸² Case C-418/01, *IMS Health v. NDC Health*, [2004] ECR I-5039

⁸³ *Régibeau P. & Rockett K.*, The Relationship Between Intellectual Property Law and Competition Law, An economic approach, University of Essex and CEPR – Revised, June 2004. Available at <http://www.essex.ac.uk/economics/discussion-papers/papers-text/dp581.pdf> (Last visited May 8 2007), p. 29.

⁸⁴ *Gitter*, fn 77, p. 2.

⁸⁵ “In certain cases a dominant undertaking must not merely refrain from anti-competitive action but must also actively promote competition by allowing potential competitors access to the facilities which it has developed.” Opinion of AG Jacobs of May 28 1998, Case C-7/97 *Oscar Bronner* [1998] ECR I-7791, [1999] ECR I-7802

how a denial of the monopoly does not equally deny the exclusivity lying at the very essence of the right.⁸⁶

In conclusion, compulsory licensing can be a fast and effective means of extending competition to a market,⁸⁷ but it could have clear disadvantages for innovation and competition if applied too easily.⁸⁸ Although this remedy is not uncontroversial and opinions with regard to it have been diverse,⁸⁹ the fact remains that the ECJ decided that competition law can and should impose significant limits on a rights holder's control and use of its property.

Competition controls the exercise of IPRs

From the foregoing we can derive that in case IPRs truly offer market power, they can become fairly contradictory to competition objectives. Early case law learns U.S. that the general rule is that the provisions on competition are fully applicable to IPRs.⁹⁰ Although, as mentioned, in theory the “essence” of IPRs is not affected by the rules on competition and nor is the “normal exercise” of those rights, abusive exercise of those rights cannot escape the power of the competition rules. The Court did not make clear what this “essence” really means, but has taken a case by case approach.

An IPR in and of itself will thus never infringe Article 81 or 82⁹¹ but as soon as a license is given or a concerted practice is established the question arises whether Article 81 will apply.⁹² Similarly, an IPR

⁸⁶ OECD report 1998, fn 65, p. 9.

⁸⁷ OECD report 2005, fn 74, p. 9.

⁸⁸ See further Section IV.

⁸⁹ *Reichenberger M.*, “The role of compulsory licensing in unilateral refusals to deal Have the United States and European Approaches Grown Further Apart after IMS?”, 31 *Journal of Corporation Law* 2, 2006, p. 562 et seq.

⁹⁰ Cases 56 & 58/64 *Consten & Grundig*, fn 79: “Article 36, 222 and 234 of the EEC Treaty do not exclude any influence whatever of Community law on the exercise of national intellectual property rights. The Community rules on competition do not allow the improper use of rights under national trademark law in order to frustrate the Community law on cartels.”

⁹¹ Case 24/67 *Parke Davis*, fn 66

⁹² For specific application of competition rules to IPR related agreements see the TTBER (2004), fn 48, further discussed in Section III.

does not in itself confer a dominant position,⁹³ but Article 82 could be applicable if the utilization of the IPR has both allowed the creation of one coupled with “improper” exploitation of the protection⁹⁴ though the Court has abstained from giving clear indications as to when this will happen.⁹⁵ It has though provided examples of practices by companies in a dominant position using IPRs to strengthen this position or to control secondary markets, which should be controlled by Article 82.

Although detailed description of these cases falls outside the scope of this chapter, such situations include the cases where: (1) a dominant company acquires exclusive licenses and forecloses competition;⁹⁶ (2) a dominant company employs IPRs to control an upstream market and thereby also a downstream secondary market;⁹⁷ (3) a dominant company prevents the emergence of new products by using IPRs or terms in license agreements,⁹⁸ or (4) a dominant company uses weak patents or patents which should not have been granted⁹⁹.

2.4. Conclusion

The language of the EC Treaty, historical attitudes towards nationally-based IPRs and the fear that IPRs will tend to divide the single competitive market have each contributed to the current state whereby competition tends to prevail over IPRs. Although the importance of IPRs is increasingly recognized and the attitudes towards them is more relaxed, within an environment where market integration is the main objective, competition policy will naturally be favoured.

⁹³ Case 78/70 *Deutsche Grammophon v Metro*, [1971] ECR 487

⁹⁴ Case T-198/98 *Micro Leader Business v. Commission* [1999] ECR-II 3989. Microsoft applied lower prices on the Canadian market than on the Community market. Potentially excessive Community prices.

⁹⁵ *Govaere*, fn 14, p. 104.

⁹⁶ Case T-51/89 *Tetra Pak Rausing SA v. Commission* [1990] ECR II-309.

⁹⁷ Cases C-241/91 P & C-242/91 P *Magill*, fn 81

⁹⁸ Case C-418/01 *IMS*, fn 82

⁹⁹ Commission Decision of 15 June 2005, *Generics/AstraZeneca* COMP/A.-37.507/F3.

However, this is not to say that competition is by definition superior to IPRs. Strictly speaking, there is no rule of precedence; one prevails over the other depending on the situation. The interface between competition and IPRs is complex, since the competition authorities must not only balance the need to stimulate investment and innovation on the one hand with the need to ensure competition for the benefit of consumers on the other, but also face the challenge of facilitating a single market. The question is thus how to minimize the anticompetitive effects of IPRs while respecting its existence and the social goals it is meant to promote. A right balance has to be found when applying competition law and policy to IPRs. Indeed, this question seems to be more relevant nowadays than proclaiming that one prevails over the other. The fact that competition law will often prevail within the Community is more a result of the Community aims and intents than of a general rule that competition stands higher on the hierarchical ladder.

3. AN IPR PERSPECTIVE

BY MADELEINE CLAESSON

As explained above, IPRs confers legal monopolies and such exclusivity may lead to market power and monopoly as defined by competition law. The restrictive effects on competition that IPRs can give rise to causes an obvious tension between the two bodies of law, and the question is whether competition law may take away what IP law grants. The purpose of this chapter is to analyse the interface between IPRs and competition law from an IPR perspective. Such a perspective will not seek to argue for IPR precedence over competition law, but instead wants to ensure that the value and pro-competitive effects of IPRs are taken into account in the balancing of competition rules and IPRs.

I will review the EC Treaty provisions and argue against any priority of competition law. I shall also compare the EC and the U.S. position towards the interface. Further, two different legal methods of solving the conflict will be discussed: cross-interpretation and internalisation.¹⁰⁰ From the IPR perspective it is essential to point out that finding a balance remains the fundamental aim, equally when applying these methods. Care is needed if competition rules are to interfere with IPRs with a view to protecting the existence of IPRs and overall incentives to innovate.

3.1. The role of IPRs

In both the EC and the U.S. it is by accepted that there is a core component of each type of IPR that cannot be intruded upon by

¹⁰⁰ The notions are taken from the thesis of *Schovsbo J.*, Grænsefladespørgsmål mellem immaterialretten og konkurrenceretten, Jurist- og Økonomforbundets Forlag, Copenhagen, 1996.

competition rules.¹⁰¹ When IP legislation is enacted it is evidently the intention of the legislature that the IPRs must be exercisable against third parties, who threaten to violate these rights, because otherwise the legislation would not have any effect. So some core rights must be upheld if an IPR is to exist at all.¹⁰² This core can, for example, be the right to exclude others from making use of the invention, trademark or other IPR, to license it, to be the first to put the product benefiting from the IPR on the market and generally to commercialize the product.¹⁰³

Crossinterpretation

The method of crossinterpretation purports to solve the conflict between IPRs and competition rules by determining if and how far competition principles and rules can be applied “within” the IPR system. Competition rules work as a “correction tool” and are used in concrete conflicts to correct the exercise of IPRs: an example might be forcing an IPR holder to grant licenses.¹⁰⁴

Internalisation

By the internalisation method, conflicts between competition and IPRs are resolved “up-front” through legislation. Competition policies are taken into account when framing IP law and the lawmakers specify both the function of the IPRs and how to control their use and exploitation. The solution to antitrust concerns is thus to be found only within the IP legislation itself. This method is advocated by Schovsbo. IPRs are effectively immune to the normal competition rules and competition authorities must accept the IP legislation as it is. It is argued that internalisation promotes legal certainty and clearer rules on the relationship between IPRs and competition.¹⁰⁵

¹⁰¹ By for example: *Gitter*, fn 77, p. 3, *Govaere*, fn 14, p. 114 and Schovsbo, fn 100, p. 14.

¹⁰² *Tritton*, G., *Intellectual Property in Europe*, 2nd ed., Thomson Sweet & Maxwell, London, 2002, p. 574.

¹⁰³ *Eklöf*, D, *Upphovsrätt i konkurrens – särskilt om tvångslicensiering*, Stockholms universitet, 2004, p. 249

¹⁰⁴ *Schovsbo*, fn 100, p. 12.

¹⁰⁵ *Id*, p. 11.

3.2. The EC position

The key issues here are the extent to which the EC competition rules can and should restrain IPRs granted by the Member States and the division of competence between the EC and its Member States. The following brief review will inquire whether there is a norm hierarchy solving the conflict, and how the ECJ has dealt with the interface issue.

Precedence of EC competition law – a solution?

In many states, Sweden, for example, IP law and competition law stand on an equal basis and have the same status.¹⁰⁶ However, the principle of Community law's supremacy over national law means that the EC rules take precedence over both national IP and competition law. This could seem to be unproblematic, but the relations between EC law, competition law and IP law are more complex than that.¹⁰⁷ The EC Treaty does not establish that the competition rules have priority over IPRs, and does not even contain any specific rules on the relationship between IPRs and competition law. Article 295 of the EC Treaty protects national property rights and Article 30 exempts national industrial and commercial property rights from the rules prohibiting quantitative restrictions. Thus, these rules guarantee property rights and Article 295 can be interpreted as implying that any action that would lead to an elimination of property rights recognised under national law will be incompatible with the EC Treaty. The ECJ has however been rather vague in its comments on the relevance of Article 295 to the protection of IPRs¹⁰⁸. Still, it would seem that the Member States and the EC have concurrent competence on IPRs and establishing a hierarchy of laws does not appear to solve the conflict between competition and IP law, especially as they are both needed for maximising welfare.¹⁰⁹

¹⁰⁶ *Eklöf*, fn 103, p. 234.

¹⁰⁷ *Id.*, p.235.

¹⁰⁸ See e.g. the discussion by the CFI in Case T-184/01R *IMS Health v Commission* [2002] ECR II-3193, par. 143.

¹⁰⁹ *Eklöf*, fn 103, p.235.

Harmonisation

Seemingly, the best solution is harmonisation of the national laws, which would also prevent conflicts that may arise when IPRs have different meaning and scope of protection in different Member States. The problem is the Member States' lack of political willingness to put the interests of the EC above national interests. When enacting the Treaty of Rome, the Member States wanted to retain rights relating to IP protection for the stimulation of national technical progress and economic growth.¹¹⁰ But despite the obvious importance of nationally granted IPRs to the Member States, several harmonisation measures have in fact been introduced at the EC level.¹¹¹ The EC has also played an important role in harmonising IP rules for new technologies, such as computer programs and databases. A reason for this was that it proved difficult to protect these new and rapidly developed technologies within the framework of existing IP law in the Member States. Harmonised EC laws have been said to strengthen the EC's competitive position against the U.S. and Japan, and encourage industrial and economic development.¹¹² Nevertheless, even harmonised secondary legislation did not replace the Member States' existing IP laws nor their competence in the field. The question of norm hierarchy remains, as does the issue of the relationship between the Community competition rules and all legislation on IPRs. When enacting harmonised IP legislation, the EC has to take competition policy into account if it wishes to avoid conflicts in the future.¹¹³

Approach by the ECJ

In order to solve the interface issue, the ECJ has developed the existence/exercise dichotomy¹¹⁴ and the concept of the specific subject

¹¹⁰ European Parliament Fact Sheets, Intellectual, Industrial and Commercial Property, published 10/05/2006, http://www.europarl.europa.eu/facts/3_4_4_en.htm and *Govaere*, fn 14, p.42.

¹¹¹ *Govaere*, fn 14, p. 51. Examples of harmonised legislation are Council Regulation (EC) No 40/94 on the Community trade mark, OJ L 11 and Council Regulation (EC) No 6/2002 of 12 December 2001 on Community Designs.

¹¹² *Id.*, p. 57-58.

¹¹³ *Gitter*, fn 77, p. 22

¹¹⁴ The existence/exercise dichotomy was first mentioned in Cases 56 & 58/64 *Consten & Grundig*, fn 79, and Case 24/67 *Parke Davis*, fn 66

matter. These notions ensure that EC competition law can only impact on national IP law when it comes to the exercise of IPRs. Here, the ECJ has adopted the crossinterpretation method, since competition rules are used to correct and restrict the exercise of IPRs granted by national legislation.¹¹⁵ However, the distinction between existence and exercise of IPRs and the idea of the specific subject matter have both been criticized as being unclear and unworkable concepts. It is difficult to draw a line between existence and exercise since an IPR is in essence composed of the various ways in which an exclusive right can be exercised.¹¹⁶ The concept of specific subject matter was created in order to determine what might be considered as belonging to the scope of an IPR and to delineate between normal use and misuse.¹¹⁷ This supports the idea of a core or essential part of the rights recognised by national law, which cannot be curbed by competition law. However, the ECJ has in certain key cases effectively devalued an IPR granted to the IP holder.¹¹⁸ From an IP perspective, the interference of competition rules may be acceptable in cases of misuse of IPRs, as the normal use of the exclusive rights is not encroached on. But it can be difficult to make a clear distinction between normal and abusive use of IPRs. If the rules are unclear and the principles inconsistent, there will be legal uncertainty and IPR holders cannot be sure where the line is drawn.¹¹⁹ This may in turn result in fewer incentives to innovate and create.¹²⁰

Internalisation in the EC legislation

To cope with the above difficulties, Schovsbo sees internalisation as a solution; there are examples of a trend towards increased internalisation in the EC. One of the most obvious examples is the Design Regulation and its so called must fit- and must match-clauses,

¹¹⁵ *Schovsbo*, fn 100, p. 13.

¹¹⁶ *Keeling, D.T.*, Intellectual Property Rights in EU Law, Volume I, Oxford University Press, 2003, p.57 and *Govaere* fn 14, p. 302.

¹¹⁷ The concept has been introduced through Case 78/70 *Deutsche Grammophon*, fn 93, and Case 15/74 *Centrafarm BV v Sterling Drug*, fn 69

¹¹⁸ Cases C-241/91 P & C-242/91 P *Magill*, fn 81 and discussion by *Govaere*, fn 14, p. 168-190.

¹¹⁹ *Schovsbo*, fn 100, p. 16.

¹²⁰ These notions will be further discussed in Section IV.

which provides that design rights do not protect spare parts and technical solutions, all this with a view maintaining competition.¹²¹ The Trademark Regulation¹²² with its provision on regional exhaustion of rights shows a clear balance between the recognition of the market-controlling aspects of trademarks and the aim of achieving effective competition in the single market.¹²³ Another example of internalisation is the Database Directive¹²⁴, which contains rules on the prevention of unauthorised extraction and re-utilisation of the contents of a database. It now seems as if the EC is moving to a more concrete and stronger form of IP protection which is based *ab initio* on competition considerations. The internalisation technique has however been criticised for creating something of a straitjacket; with dynamic markets it might be important to be able adjust the rules to new competition situations. It is obviously difficult for the legislator to predict concerns that might arise in the future, let alone construct provisions that will regulate them.¹²⁵

3.3. The U.S. position

The U.S. Department of Justice's Task Force on Intellectual Property has stated that IP "is one of the most valuable forms of property that exists [...] intellectual property is a significant source of the growth of the American economy and a key driver of global economic activity. As the U.S. and more countries around the world move from an industrial to an information-based economy, the importance of protecting intellectual property will only continue to increase."¹²⁶ This is a rather good expression of the U.S. view on IPRs.

¹²¹ Council Regulation (EC) No 6/2002 on Community designs, OJ L 3, 5.1.2002, Article 8.

¹²² Council Regulation (EC) No 40/94 on the Community trade mark, OJ L 11, Article 13.

¹²³ *Schovsbo*, fn 100, p. 162.

¹²⁴ Directive 96/9/EC of the European Parliament and of the Council of 11 March 1996 on the legal protection of databases.

¹²⁵ *Eklöf*, fn 103, p. 345.

¹²⁶ Progress Report of the Department of Justice's Task Force on Intellectual Property, June 2006, p. 13.

IPRs are protected by rules in the U.S. Constitution¹²⁷ and could therefore be said to have a stronger position in the U.S. than in the EC; they have some priority over antitrust laws. The U.S. has a more liberal approach and explicitly emphasises the value and importance of strong protection for IPRs so as to stimulate innovation, economic growth and common welfare.¹²⁸ Recently, Congress has even enacted legislation granting further and stronger protection of IPRs.¹²⁹ However, despite this, antitrust laws may still restrict the use of IPRs in cases of anticompetitive abuses and misuse.

When first examining U.S. IP law, one might conclude that competition policies are not taken into account, except to the extent that all protection is limited in time and there are strict criteria for obtaining an IPR. Thus, the concept of internalisation does not exist in the U.S. doctrine, and the relationship between competition rules and IPRs is not dealt with within the IP laws. Some guidance can be found in the IP 1995 Guidelines claiming that the “rule of reason” should be used in approaching the antitrust/IP intersection.¹³⁰ The Guidelines imply that unilateral exercise of IPRs should never result in antitrust liability. They do point out that the possession of market power is not itself an offence under antitrust law and such market power does not impose on the IPR owner any obligation to grant any license.¹³¹

The interface issue has been dealt with through case law and the courts’ solution is based on the crossinterpretation technique, where competition restraints within the “scope of the patent” is allowed, while anticompetitive effects arising from an IPR holder’s conduct beyond the statutory grant could be unlawful and restricted by antitrust law.¹³² In several cases the U.S. Supreme Court has held that there exist an untouchable core of rights¹³³ and the U.S. approach towards the interface can be said to be built on this. For example, the Patent Act¹³⁴

¹²⁷ U.S. Constitution, Article I, Section 8, Part 8.

¹²⁸ IP (1995) Guidelines , fn 46 § 1.

¹²⁹ Progress Report, fn 126, p. 29.

¹³⁰ IP (1995) Guidelines , fn 46, § 3.4.

¹³¹ Id. § 2.2

¹³² *Schorsbo*, fn 100, p. 14.

¹³³ For instance in *Dawson Chem. Co. v. Rohm & Haas Co.*, 448 U.S. 176, 215 (1980) and *Stewart v. Abend*, 495 U.S. 207, 228-29 (1990).

¹³⁴ US Patent Act, 35 U.S.C. §§ 1-376.

does not contain any provision on compulsory licensing for private parties and several cases have discussed whether the IPR holder can be considered to violate antitrust laws by exercising the rights granted to him or her (including refusal to deal). In the *Xerox* case, the court held that an IPR owner's refusal to sell did not exceed the scope of the patent and that the exercise of patent rights or copyrights cannot violate the antitrust laws.¹³⁵ In *Mallinckrodt* the court held that if a restriction of competition is within the scope of the patent grant, this is related to the subject matter of the patent claims. Only if the patent holder's conduct exceeds the scope of the patent granted, will the court apply the rule of reason to determine whether the practise has anticompetitive effects.¹³⁶ Accordingly, as long as IPRs are exercised correctly and within their scope, competition law will not limit the use of IPRs.

3.4. A comparison

The EC has now moved closer to the U.S. approach on the interface between competition law and IPRs and adapted the aim of balancing the two bodies of law and taking economic considerations into account. Both legal systems recognize core components of IPRs that cannot be encroached on by competition law: only the exercise of IPRs can be restrained, if this use is abusive or has anticompetitive effects. It has been argued that the EC still has stricter rules on competition than does the U.S., especially concerning the possibility of compulsory licensing. However, as the creation and maintenance of the single market is so fundamental for the EC, this could explain the different positions on this and other matters.

It could be questioned whether there are really such big differences between the U.S. and the EC positions. Both systems use competition rules to restrict or "correct" the exercise of IPRs. The EC uses an existence/exercise distinction while the U.S. looks at the "scope of the IPR". However, the EC development seems to be moving towards increased internalisation, whereas U.S. IP law does not contain any antitrust considerations. This might lead to antitrust law being applied as an external correction tool to a larger extent than in the EC. It might

¹³⁵ *CSU, L.L.C., et al. v. Xerox Corporation*, 203 F.3d 1322 (10th Cir. 2000).

¹³⁶ *Mallinckrodt Inc v Mediapart Inc*, 90-1138, 90-1272, 976 F.2d 700 (1992), at 708.

even be said that the EC has come farther than the U.S. in balancing IP and competition laws and in developing rules based on and economic analyses of the relationship.

Striking the right balance

Both within the EC and in the U.S. it has been held that there exist no inherent conflict between IPRs and competition law since both bodies of law serve the aim of promoting innovation and increasing consumer welfare.¹³⁷ Nevertheless, since competition policy and IP rules have different means of achieving these objectives it seems apparent that conflicts will arise. It is therefore necessary to balance the two bodies of law. In both the U.S. and the EC there are ongoing discussions on how to find the proper balance. An example of this is the FTC report of 2003, which discusses how to promote innovation by finding the proper balance between competition and patent law and policy.¹³⁸ In the report the benefits of internalisation are reviewed. In another context, the U.S. Supreme Court has stated that “[t]he Patent Clause itself reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition...”¹³⁹ In other words, in the system of IP protection there exist a form of self-regulation which balances competition restraints, access to IP and incentives to invent.¹⁴⁰ On comparing IPRs with ordinary property rights, we see that the latter are not limited in time as are IPRs. Other inbuilt limits include the rigorous conditions for obtaining a patent and the rules on publicising. Copyright law includes some competition efficiencies since it does not grant a monopoly on ideas or facts, but only protects the way in which an idea is expressed.¹⁴¹ These examples show that that internalisation is making headway in the U.S. too.

¹³⁷ The US view can for instance be seen in *Atari Games v Nintendo*, 897 F.2d 1572, 1576 (Fed. Cir. 1990). and the IP (1995) Guidelines, fn 46. The EC position is stated in the TTBE (2004), fn 49, p. 2-42.

¹³⁸ Federal Trade Commission report: To Promote Innovation, fn 50

¹³⁹ *Bonito Boats Inc. v. Thunder Craft Boats Inc.*, 489 U.S. 141 (1989), at paragraph 146.

¹⁴⁰ *Anderman, S.*, EC Competition Law and Intellectual Property Rights, Oxford University Press, 1998, p. 248.

¹⁴¹ *Govaere*, fn 14, p. 305.

Failure to strike the right balance

There exists a serious risk that incentives to innovate are harmed if there is a failure in striking the right balance between competition and IP law. If IPRs are granted too easily, for instance when the criteria for receiving such rights are very low or when patents are given for obvious inventions, competition is hampered because competitors will not be able to use the obvious “invention” in producing other products. On the other hand, if competition rules are applied too broadly and restrict not only anti-competitive behaviour but also conduct that increases consumer welfare in the long run, the incentive to innovate will be reduced. It could be argued that compulsory licensing destroys the balance that exists within the IP itself. The core right of preventing others from using the invention is restricted and it could be said that the company is being punished for its own success. Even though compulsory licensing may favour competition on a short-term basis, the result in the long run will be less incentive to innovate and invest in R&D.¹⁴² Schovsbo is of the opinion that compulsory licensing must not become a commonly-used tool, but should only be used in exceptional circumstances as an “emergency brake” for abusive conduct.¹⁴³

3.5. Conclusion

From an IPR perspective, the impact of competition rules on IPRs is a sensitive issue. If competition law can reduce the protection granted by IPRs, there is a serious risk that incentives to innovate will be lost. On the other hand, IPRs can be used abusively to close markets and eliminate current and potential competitors, and monopoly markets may reduce innovation and competition. Such abusive exercise of IPRs must be controlled in order to maintain competition – the question is how this is to be done in a balanced way with clear rules for the IP holders to follow.

With the crossinterpretation method, the idea of unimpaired protection for the core or essential rights is acceptable. Competition

¹⁴² *Reichenberger*, fn 89, p. 549 and *Gitter*, fn 77, p. 23.

¹⁴³ *Schovsbo*, fn 100, p. 275.

rules are applied in order to restrict abusive conducts beyond this. The problem is the lack of legal certainty in the very concept of a core right.

Internalisation could be a better method for clarifying the borders between IP and competition law. If conflicts can be solved beforehand, and IP holders know what they are allowed to do, I believe that a secure investment climate is created and innovation encouraged. However, finding the appropriate balance between the two bodies of law is a difficult task even if they wish to reach the same objectives of encouraged innovation, effective competition and common welfare.¹⁴⁴

My overall conclusion is that the competition rules should be applied restrictively and carefully and that any short-term inefficiencies that arise from restrained competition must be accepted and seen as the price society needs to pay if it is to reap the reward of long-term economic growth resulting from a high degree of innovation.

¹⁴⁴ *Gitter*, fn 77, p. 24.

4. A LAW AND ECONOMICS PERSPECTIVE

BY PATRICK WILDGEN

A law and economics perspective on the problems arising from the intersection of IPR and competition law can be valuable by providing a scientific analysis of legal frameworks. In areas like competition law and IP law, which analyse conduct also studied by economists, the testing of legal regimes against economic models can serve as a way to predict behaviour and, if need be, to allow the proposal of adaptations of legal norms, evaluate the efficiency of legislation and finally analyze the effects for the welfare of society. It can act as a justification for legal and policy choices and also serve as a basis for their criticism.

The goal of this chapter is to give a brief introduction to the subject in relation to competition law and IP law and their intersection. A proper analysis would require an analysis expanding on the efforts made by *Régibeau* and *Rockett* in their classic paper of 2004¹⁴⁵, but this goes far beyond the scope of the present work. It will introduce basic ideas and theories used in economic analysis in the respective fields and hint at the problems that can arise.

4.1. The economic environment

The rise of the school of Law and Economics is probably one of the most important developments in legal theory in the second half of the 20th century.¹⁴⁶ The modern application of economic analysis to legal principles was initiated by the American economists Ronald Coase and

¹⁴⁵ *Régibeau P. & Rockett K.*, fn 83

¹⁴⁶ *Cooter R & Ulen T*, *Law and Economics*, 4th ed., Pearson Addison Wesley, Boston, 2004.

Guido Calabresi.¹⁴⁷ In his founding article¹⁴⁸ on the problem of social cost in 1960 Coase dealt with the efficiency of the assignment of property rights by the State.

To understand this, certain important concepts need to be discussed. These are monopoly, efficiency, and innovation.

From a narrow interpretation, a monopolistic market is determined by two factors. It consists of only one supplier and entry barriers to the market are impenetrable; the monopolist is not subject to any risk of competition. The broad interpretation describes monopoly power as merely the power to fix prices.

The efficiency of a competitive market is classed as static in nature, whereas dynamic efficiency introduces the idea that monopolies, which are never statically efficient (they never use resources in an optimal way) can still be efficient, and even preferred over competitive firms.¹⁴⁹

Static efficiency is linked to production processes which are said to be productively efficient if it is not possible to produce the same amount of output using a lower cost combination of inputs and if it is not possible to produce more output using the same combination of inputs. A second perspective is allocative efficiency (Pareto efficiency) which establishes that a situation is efficient if it is impossible to change it so as to make at least one person better off without making at least another person worse off. Based on this assumption, Caldor-Hicks efficiency is achieved if benefits exceed costs on a cost-benefit-analysis and it is possible for the beneficiaries to compensate the losers.¹⁵⁰

Dynamic efficiency relates to investment decision. The question to be answered here is whether the social benefits exceed the opportunity cost of resources invested.

Coase applied the economic efficiency test to the legal system. In the Coase Theorem he established that if transaction costs equal zero,

¹⁴⁷ Calabresi G., Some Thoughts on Risk Distribution and the Law of Torts, 70 Yale L.J. 499, 1961.

¹⁴⁸ Coase R., The Problem of Social Cost, Journal of Law and Economics, v. 3, n°1 pp. 1-44, 1960.

¹⁴⁹ <http://www.theshortrun.com/classroom/glossary/micro/monopoly.html> (Last visited on March 2007)

¹⁵⁰ Dahlman C, Glader M, Reidhag C, Rättsekonomi: en introduktion, Studentlitteratur, 2005, p 54-56, 144-151

all property allocations are equally efficient as any imbalance will be corrected by the right holders through bargaining. In the absence of transaction costs the State cannot propose any more efficient solution through intervention. But if there are transaction costs, State action may prove more efficient as long as the social cost of this intervention does not exceed the social benefits.

The third relevant concept in the context of IPR and competition law is innovation. Today's analysis relies on work done by Schumpeter at the beginning of the 20th century where he defined innovations as 'the economic applications of inventions and discoveries which give the impulse of change to the entire economy'.¹⁵¹ Indeed in the innovation process a distinction can be drawn between two instances: (1) the instant of invention, moment of the production of the knowledge, and (2) the instant of innovation properly speaking, where the knowledge is offered to the market.¹⁵² This process is encouraged by competition between companies¹⁵³ on the one hand and IPRs on the other. As such, "Innovation is more and more the central arena in which competition plays out. [it] is the hot issue for the foreseeable future."¹⁵⁴ The importance for the economic development of innovation has only recently been acknowledged on the European level by the Lisbon agenda from March 2000 and translated by the Competitiveness and Innovation Framework Programme.¹⁵⁵

¹⁵¹ <http://www.minotstateu.edu/econ/drhuenneke/schumbiz.html> (Last visited on April 1 2007)

¹⁵² *Richard, F.* (1998) *Recherche Invention et Innovation*, Paris : Economica (quoted in *Moroz, D.*, Production of Scientific Knowledge and Radical Uncertainty : The limits of the Normative Approach in Innovation Economics, 20 Eur. Journal of Law and Economics pp 305-322, (2005) p.307).

¹⁵³ *Anker Lund V.*, Absorptive capacity and innovative performance: A human capital approach, 15 Econ. Innov. New Tech., 2006, p.514.

¹⁵⁴ *Pitofsky R* (Chairman of the Federal Trade Commission), in Antitrust for the Digital Age, Business week, 15/05/2000

¹⁵⁵ Decision No 1639/2006/EC of the European Parliament and of the Council of 24 October 2006 establishing a Competitiveness and Innovation Framework Programme (2007 to 2013) OJ L 310, 9.11.2006, p. 15–40.

4.2. Law and Economics

Economic principles will now be applied to the areas of IPR and Competition law. We will try to determine whether either of them, taken separately, is efficient.

The economics of Competition Law

The modern concept of competition was developed by the Neo-classical school of economics, chief among them being *Vilfredo Pareto* (1848-1923) at the end of the 19th century. The concept of a market with perfect competition is characterized by atomicity (large number of substitutes), homogeneity (all products are perfectly substitutable), transparency (perfect and complete information), equal access and free access to the market (no entrance barriers). In such an environment market forces act freely, and demand and supply will end up in a perfect equilibrium. Prices will be the result of market forces; economic actors such as single companies or consumers do not have an individual influence. The market price is thus an external factor to the economic actors. The model establishes that the market price at equilibrium is the lowest price possible.

This remains a model which can be used as a benchmark for “real world” economic situations as required notably in competition or antitrust policy. In reality, the issue is one of effective rather than perfect competition. When seeking an answer to whether competition is efficient, many factors come into play, each providing only a part of the picture. The existence of rivalry between different actors is an indicator that there is competition but the question is how much rivalry is needed to have effective competition? From the companies’ point of view, a certain freedom of action must be guaranteed. On the other hand, some restrictions are inherent to community life and thus to a competitive market.

Competition can be lacking when a single company can influence prices. Even here, there can still be effective competition as can be deduced from models such as Monopolistic competition, Cournot or Bertrand Competition. These show that even in monopoly or oligopolistic situations, prices can still tend downwards. Another approach tests against production costs, a method used by the European

Commission among others in their assessments.¹⁵⁶ Even this criterion can fail to be useful in instances where the actual production costs are very low compared to development cost (e.g. software or pharmaceuticals). For this reason it is important to look at dynamic features such as innovation as well as static efficiency. These are of course very difficult to evaluate as tied to forecasts of future developments and consequent benefits or costs for the society.

In the European competition system, an important factor is consumer welfare, with the ultimate question being: what benefits the consumer?¹⁵⁷ Although a legitimate choice, it nevertheless raises the question whether the answer always necessarily coincides with the welfare of society as a whole. In the U.S. similar goals are pursued and the underlying concept may be the protection of the economically weakest actors so that they can still participate in competition.

Even though competition law is always based on an economic assessment which has been overt in the U.S. for some time, Europe has only applied economic analysis to the field in the past twenty years. This major shift was caused by the 1990 introduction of the Merger Regulation.¹⁵⁸ Looking at statistics of legal fees in Europe, the percentage going to economic analysis in competition issues is estimated to be around 15%, the same as in the U.S.¹⁵⁹

Turning to the application of economic analysis to the law itself, there has been a clear shift from the very formalistic approach first taken by the European Competition authorities to a more economics-based one. Analysis is becoming more and more sophisticated and includes use of various economic concepts and tests in any assessments

¹⁵⁶ Commission Notice – Guidelines on Vertical restraints 2000/C 291/01 OJ 13/10/2000

(126) ‘Entry barriers are measured by the extent to which incumbent companies can increase their price above the competitive level, usually above minimum average total cost, and make supra-normal profits without attracting entry. Without any entry barriers, easy and quick entry would eliminate such profits. In as far as effective entry, which would prevent or erode the supra-normal profits, is likely to occur within one or two years, entry barriers can be said to be low.’

¹⁵⁷ See e.g. art 81(3) EC providing that a restriction of competition can be accepted as long as the consumers receive a ‘fair share’ of the progress made.

¹⁵⁸ Council Regulation (EEC) No 4064/89, 21 December 1989, on the control of concentrations OJ L 395, 30/12/1989.

¹⁵⁹ For a more detailed discussion see : *Neven D.*, Competition Economics and Anti-trust in Europe, Economic Policy Oct. 2006 pp.741-791.

e.g. the SSNIP test (Small but Significant Non-transitory Increase in Price by a hypothetical monopolist).¹⁶⁰

The Economics of IP law

From a legal perspective property is a bundle of rights related to a resource. It includes freedom of exercise on the one hand and their protection on the other.¹⁶¹ Property rights are dynamic concepts which evolve in time with the respective markets and societies. Their point remains the same though: they encourage production, discourage theft and reduce protection costs. By moving from the industrial age to an information society, the most important development in the whole area of property rights has been that pertaining to IPRs. The question to be solved is how to bundle these rights in order to guarantee an efficient use of the resources available. Should the State intervene, and how?

Contrary to the competition rules, IPRs were not originally based on economic theories. It is only with the development of the school of law and economics that a discussion of the economic dimension of IPRs has been launched. The problem is that the conventional theories mainly work with static analyses. IPRs are by nature a dynamic concept as their point is to incite investors to take risks and invest in innovation by providing them with a prospect of getting some return.¹⁶²

A second characteristic of an IPR is that it disseminates information. From a macro-economic point of view information disclosure is to be preferred over secrecy, as it promotes fast development and economic progress. As such IPRs could thus be considered as public goods for the reason that they produce socially useful information. Individuals thus want to protect their innovations by a secrecy which would increase transaction costs, if not make bargaining impossible. This is the reason why general bargaining

¹⁶⁰ Commission Notice on definition of the relevant market for the purposes of Community Competition Law, OJ C372 9/12/1997.

¹⁶¹ *Cooter & Ulen*, fn 146, p 77-78.

¹⁶² 'The prospect of reward' as incentive for technological development is part of the theories developed by utilitarian classical economists such as J. Bentham, A. Smith, J-B. Say, J. S. Mill., J.B. Clark ; See *Andersen B.* If 'Intellectual Property Rights' is the answer, what is the question? Revisiting the patent controversies, *Econ. Innov. New Techn.*, 2004, Vol. 13(5), pp. 417-442, p 423.

theory does not work for IPRs and the consequent social costs are notable. The State must thus intervene to provide a legal framework which allows bargaining and transactions to occur. IP law proposes an exclusive property right but limited in duration and in breadth.

The duration of the exclusivity, contrary to “normal” property rights, is limited to a number of years after registration depending on the type of IPR concerned. The breadth of a patent defines what exactly is covered by the protected right. Here a distinction can be drawn between the “leading breadth” of an invention which provides protection against imitation and “lagging breadth” providing protection from improvements.¹⁶³

4.3. Relation between IPR & Competition law¹⁶⁴

Innovation is now the key area within which IPR and competition law intersect. Even if both are working towards the same end, friction cannot be completely excluded.

The case for independence of IP law and Competition law

The foregoing analyses of IPR and Competition law favour the argument developed by Régibeau and Rockett, namely that they are independent.

Firstly they are independent as to their role. IP law assigns and defends property rights regarding assets that might have economic value. Competition law regulates the use of IPRs, but only if these property rights are the source of market power. As such there is no *prima facie* difference between IPRs and “normal” property rights. The

¹⁶³ O'Donoghue T., Scotchmer S., and Thisse J., “Patent Breadth, Patent Life and the Pace of Technological Progress”, 7 *Journal of Economics and Management Strategy*, 1998, pp. 1-32.

quoted by Régibeau P. & Rockett K., fn 83

¹⁶⁴ The following section is mainly based on the analysis made by Régibeau P. & Rockett K., fn 83

only time IPRs and competition law can enter into conflict is when IPR develop into a source of market power. As will be shown below, there is no general presumption that this will happen but this point must be analysed on the basis of the specific economic context and IPR involved.

It can further be argued that IP law and competition law are complementary. As we have seen earlier, the former takes account of the specificities of IP as compared to “normal” property rights and provides them a precise legal framework. The systems found in the U.S. and the EU are generally economically justifiable and manage to balance leading breadth, lagging breadth and duration in an efficient way. So it is IP law that gives the IPRs a specific place. Competition law on the other hand aims and should aim at minimizing the adverse consequences of monopoly power.¹⁶⁵

Secondly IP law and competition law are independent as to their stage of intervention in the lifecycle of property rights. Whereas IPRs are assigned just after the asset has been created, competition law intervenes at a later stage, namely, when the asset has been exploited and produces its effect on the market. This temporal factor has to be kept in mind when trying to criticize the current frameworks. Note that competition law intervenes at a moment where there is much more information available on the actual economic effects of the IPR than when the IPR is assigned.

But even if they are independent, from an economic point of view they can be put under a common umbrella namely the stimulation of the economy and economic growth. Competition law tries to act on static factors, that is to say, the exploitation of assets which can be valued whereas IP law gives incentives to create assets whose values are largely dependent on future, dynamic factors.

As Régibeau and Rockett conclude, competition rules should be applied to monopoly power created by IPRs in the same way as in any other context, without exceptions.¹⁶⁶ The main reason is that IP law by its very nature takes into account the specificities of IPRs. A second review of these specificities by competition law would seriously risk jeopardizing the efficiency and balance they provide.

¹⁶⁵ Monopoly power in a broad sense.

¹⁶⁶ Régibeau P. & Rockett K., fn 83

Problem areas arising from the interface of IPR and competition law

Even though IP law and competition law are independent and complementary, this does not mean that there are no problems arising in their intersection, as experiences in both the U.S. and Europe have shown. The following paragraphs introduce a selection of the problems raised by the monopoly power resulting from IPRs, more specifically patents and copyrights. Trademarks are excluded as they are per se pro-competitive as conveying information to consumers and thus contributing to the transparency of the market.

A patent very directly creates a legal monopoly over information on an invention or an improvement. This legal monopoly only becomes an economic concern if it provides market power to the patent holder which can hamper competition.

1. Mergers are a situation where companies strengthen their market power by putting their efforts together. This is desirable as long as it contributes to upholding competition and efficient use of the assets and resources. Even though IPRs are very likely to play a decisive role in the assessment of mergers, on looking at the practice of the competition authorities, Régibeau and Rockett concluded that IPRs are very much neglected. As noted above, there is no reason to treat IPRs more leniently in the case of mergers.¹⁶⁷

2. Licensing. As noted earlier in the chapter, individuals would, in the absence of transaction costs automatically resolve an inefficient allocation of IPRs in accordance with bargaining theory. This would take the form of R&D cooperation and licensing agreements. Competition law nevertheless imposes conditions on such practices and creates transaction costs. Looking at the EU competition system, and as discussed elsewhere in this section, special block exemptions (BER) have been created to allow certain of these practices, showing that competition law recognizes the dynamic pro-competitive effect of such agreements. By providing a clear exemption system, transparency and security as to which actions are allowed are achieved and transaction costs reduced. Contrary to Régibeau and Rockett's conclusion that the lenient treatment installed by the BER is confusing from an economic

¹⁶⁷ This will be further discussed in Section V

perspective, I argue that it can be economically justified as encouraging the market to regulate itself instead of promoting litigation.¹⁶⁸

3. Other undesirable effects such as collusion or foreclosure can result in cases of cross-licensing and patent-pooling. In both case IPRs are combined with each other and thus tend to create market power.

Copyrights also create a de facto monopoly on a creation, but this rarely creates market power as such given that their breadth is very limited. The problem is more particular if copyright relates to an inventive step, such as in the computer software problematic well illustrated by the *Microsoft* case.¹⁶⁹ Indeed the software market is often determined by a network effect. The more users use a product, the more the value of the product increases, the more the market power of the copyright holder also increases. In very general terms the question arises whether copyrights are the right protection for this new type of creation.

4.4. Conclusion

The separate analysis of competition and IPRs shows that both seek a common goal, namely the sustainable development of our economies. IPRs provide the right incentives for innovation and for a dynamic development of the market (by bringing in new elements); competition law ensures that the market remains diversified from a more static point of view (by balancing existing forces). As such, they are complementary and promote innovation. It can be affirmed that the current systems in both the U.S. and the EU can be considered efficient in attaining their goals. As to the development of law and economics, the authorities, lawyers and courts are becoming more and more aware of the mutual implications of both fields. With an increasing integration of empirical economic analysis into legal systems and practice, it is certain that the remaining inconsistencies and specific problem areas will soon be addressed.

¹⁶⁸ Licensing will be further discussed in Section III.

¹⁶⁹ Case COMP/C-3/37.792 *Microsoft*, Commission decision of 24 March 2004

Context and History

Joint Conclusion

The different chapters have shown that the respective concepts of competition law and IPRs arose in different contexts. Over time, they developed independently and the question arose as to whether or not they were in conflict with each other and if so, whether one or other should prevail. The purpose of this first section was to provide an answer to these questions by analysing the interface between competition law and IPRs from different perspectives.

Starting with the analysis of the development of the European and American legal systems, one can conclude that each of competition law and IP law are based on the same principles in both systems. The differences mainly arise from the specific characteristics of the EU. With the key objective being to establish a single market, the emphasis has always been placed on competition. Recently, however, the view has changed and the EC has moved towards a more economic approach, in which the importance of innovation and IPRs is expressly acknowledged.

It is argued that competition law and IP law are developing in parallel towards a state in which they complement one another. Both bodies of law are equally important and mutually depend on each other as the economy tries to achieve optimal welfare. In this light, the question of hierarchy becomes less relevant. IPRs are essential in promoting competition a priori, whereas competition law will correct any excessive behaviour a posteriori. As a control mechanism, competition law must take the legitimate and complementary goals of IPRs into account and strike the right balance. Only then, can both of them encourage and support innovation and sustain the development of our economies.

II. IPR, Parallel Trade and Competition

The purpose of IPRs is to support their creator's right to benefit from his work, and to stimulate inventive and creative activity. IPRs provide their owner with a degree of market power since he may prevent others from using the right. Exhaustion and parallel trade reduce this monopoly right and tend to enhance competition. The antitrust rules focus on the enhancement of economic efficiency by promoting and safeguarding competition and punishing anti-competitive behaviour. Their real goal, however, is to secure consumer benefits such as lower prices, wider choice and more innovation. Thus, as elaborated in section II, both IPRs and competition law pursue the same goal but by opposite means. If they can sometimes conflict, they also tend to complement each other.

This section will focus on the interaction between IPR and competition in the light of the exhaustion rules and parallel trade.

The principle of exhaustion states that the original rights owner cannot invoke his rights against importation of the goods after he has marketed the product himself or it has been put on the market with his consent. However the scope of the rule is not the same for each market: this section will focus on three different approaches to the exhaustion principle (and their impact on parallel trade). It will analyze regional exhaustion, developed within the EU, national exhaustion, as developed in the U.S., and the exhaustion models based on a global perspective, in each case taking account of the legal, economic and political dimensions. Finally, the interaction between exhaustion rules and parallel trade on the one hand and competition on the other will be analyzed in order to establish a balance. We will pay special attention to the pharmaceutical sector as the tensions are especially strong and evident in issues relating to their importation; we will highlight the practices used by companies to deter parallel imports.

1. A EUROPEAN PERSPECTIVE

BY NATALIA ŁAWNICZAK

IPRs and free movement rules coexist in the European market. Both of them deserve to be protected. IPRs have a dual nature. From the economic point of view they guarantee holder's right to put products on the market for the first time and thus to be sure of reward for his efforts. From a societal point of view they encourage technical and artistic progress in society and discourage counterfeit goods.

The free movement rules are necessary for the single market in EU and oppose barriers between Member States. Conflicts between IPRs and free movement are inevitable when parallel import issues are discussed. Parallel trade is a lawful form of trade in goods between Member States of the EU, but on the other hand it seriously impairs exercise of IPRs.¹⁷⁰ It is clear, when trade between Member States is involved, that the unlimited protection of free movement undermines IPRs and correspondingly, the unlimited protection of IPRs undermines free movement. A balance is needed together with rules which respect both the free market and IPRs. The current relationship between IPRs and free movement has been established by the case law of the ECJ and subsequent Community legislation.

The purpose of this chapter is to look at recent case law and changes in the ECJ's attitude towards the relationship between free movement of goods and IPRs. Are these changes favoring the rights holder or market integration and, consequently, parallel trade?

¹⁷⁰ COM/2003/839 final, Commission Communication on parallel imports of proprietary medicinal products for which marketing authorisations have already been granted

1.1. Free movement and IPR

The principle of free movement of goods is one of the fundamental principles of the EU. Articles 28 and 29 EC prohibit national measures, which are quantitative restrictions on import and export, and measures having an equivalent effect to quantitative restrictions. In *Dassonville* the ECJ provided a definition of measures having equivalent effect to quantitative restrictions, stating that “all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having equivalent effect to quantitative restrictions”.¹⁷¹ Goods put on the market in one Member State can be freely exported from that State and can be imported into another Member State. However, national rules that fall within the scope of Article 28 EC can be justified inter alia on grounds of the “protection of industrial and commercial property” under Article 30 EC. The ECJ interprets the scope of these derogations narrowly and only accepts restrictions which are proportionate to the risk presented by the import/export and do not constitute means of arbitrary discrimination or disguised restriction on trade between Member States. We can therefore assume that the EC Treaty has given a green light to parallel imports, which can be limited only under exceptional circumstances.

Territoriality of IPR and free movement

IPRs have a territorial character, which means that the conditions and scope of their protection are governed by the national law. The protection they provide only exists within the territory of the state concerned and, thus, every time a right holder wants to put a product into a new market he will have to apply for protection under the law of the state concerned. Prior to the harmonization of the IP laws at the Community level, Member States were free in deciding the scope of protection. The term of protection could thus be shorter in one Member State than in other Member States, or even non-existent.¹⁷²

¹⁷¹ Case 8/74, *Benoît and Gustave Dassonville*, [1974] ECR 837.

¹⁷² In the light of Article 295 EC, the right to property including IPRs is the subject to national legislation and cannot be prejudiced under the interpretation of Treaty rules. However, this Article cannot be invoked in favour of spurious IPRs.

Due to these dissimilarities, it was unavoidable that an IP holder would try to take advantage of provisions which enable him to hinder the trade between Member States. Such rules will fall under the notion of measures having an effect equivalent to quantitative restrictions within the meaning of Article 28 EC.¹⁷³ An example arises when a patentee relies on national law to block parallel imports of his own products, marketed elsewhere in the EU. When a proprietor can prevent such imports, there is clearly an obstacle to free movement. The question remains whether these actions can be justified as necessary for “protection of industrial and commercial property” under Article 30 EC. These provisions are vague so the ECJ had to interpret them. In doing so, the Court tried to strike a balance between preserving the key features of IPRs and ensuring free movement of goods and it finished by limiting the exercise of IPRs under the exhaustion doctrine. Much of the IPR sector is harmonized as, for example, trademarks¹⁷⁴ and designs.¹⁷⁵ Harmonization has not undermined the principle of territoriality, but has encouraged or obliged all Member States to adopt new common measures.

A methodology

In its attempt to find a compromise, the ECJ has stated variously that the Treaty does not affect the existence, but only exercise of rights; that Article 30 EC safeguards only rights which constitute the specific subject matter of the rights; and, finally, that rights cannot be invoked when they are exhausted. It has been noted that the ECJ has not acted entirely consistently with respect to the various tests that it has elaborated. The overall impression is that the Court is still searching for the best theory to apply to this difficult area.¹⁷⁶

¹⁷³ *Barnard, C.*, The substantive law of the EU. The four freedoms, 2004, Oxford University Press, p. 156.

¹⁷⁴ Council Regulation (EC) No 40/94 on the Community trade mark, OJ L 11, 14.1.1994, p. 1-36.

¹⁷⁵ Council Regulation (EC) No 6/2002 on Community designs, OJ L 3, 5.1.2002, p 1-24.

¹⁷⁶ *Keeling, D.T.*, Intellectual Property Rights in EU law, Volume I, 2003, Oxford, p. 51.

EXISTENCE OF IPRS AND THEIR EXERCISE

The ECJ started its analysis by making a distinction between the existence and exercise of IPRs. This was done first in the *Consten and Grundig* case. According to this judgment neither Article 30 nor Article 295 EC exclude all influence of Community law on the exercise of national industrial property rights.¹⁷⁷ The test was clarified in *Deutsche Grammophon* where the ECJ stated: “while the EEC Treaty does not affect the existence of intellectual property rights, there are circumstances in which the exercise of such rights may be restricted by the prohibitions laid down in the EEC Treaty”.¹⁷⁸ The distinction was criticized by many authors as vague, artificial, unhelpful and unworkable.¹⁷⁹ However, the main point seems to be that whatever limitations Community law imposes on the exercise of an IPR, it must not destroy the substance of the right; it should not produce a confiscatory effect. Although the ECJ gradually stopped referring to the existence/ exercise dichotomy when interpreting Articles 28 and 30 EC, the test remains important.¹⁸⁰

SPECIFIC SUBJECT MATTER OF IPR

The existence and exercise test was not clear because it still did not explain to what extent the exercise of the right should be permitted; supplementary criteria were necessary. Consequently the ECJ stated that national rules restricting free movement can be justified when they are necessary to safeguard “the specific subject matter” of that right in question.¹⁸¹ A difficulty is that the definition of the specific subject matter of a right had to be modified with every new case, to fit the particular problem under consideration and justify the solution given to it.¹⁸² Various cases have shown that the specific subject matter doctrine allowed the ECJ to arbitrarily define the scope of the right. The lack of

¹⁷⁷ Cases 56 & 58/64 *Consten & Grundig v. Commission*, [1966] ECR 299, para 346.

¹⁷⁸ Case 78/70 *Deutsche Grammophon v Metro*, [1971] ECR 487

¹⁷⁹ Tritton, G., Articles 30 and 36 and Intellectual Property: Is the Jurisprudence of the ECJ Now of the Ideal Standard? 1994, 10 EIPR, p. 422, 423; 10 and Korah, V., Dividing the Common Market through National Industrial Property Rights, 1972, 35 MLR, pp. 634 and 636.

¹⁸⁰ Banks, K. and Marenco, G., Intellectual property and the Community rules on free movement: Discrimination unearthed, EURLR 1990, 15(3), pp. 224 and 226.

¹⁸¹ C-78/70, fn 178, para 11.

¹⁸² Banks and Marenco, fn 180, pp. 230 and 232.

consideration of the amount of protection required also makes the specific subject matter concept a difficult tool to work with.¹⁸³ Nonetheless, the specific subject matter doctrine clarified the rationale behind the protection of the right and specified how far it could go.¹⁸⁴ The definitions of the various rights supplied by the ECJ made it easier to understand the nature of rights in question. Furthermore it stopped the ECJ blindly applying the exhaustion principle, especially in cases concerning trademark confusion¹⁸⁵ and has been invoked in order to invalidate such formalistic judgments.¹⁸⁶

1.2. Exhaustion of rights

When the proprietors of a patent manufacture goods incorporating the patented technology and market them under a trademark it is logical that potential purchasers can do what they want with these goods. It would be economically unreasonable if the holder could then invoke his rights and claim infringement in case of resale or importation of these goods. An IPR holder has a right to be rewarded on putting his products on the market: such claims would give him a chance to get double, unjustified benefits. In order to avoid these effects the ECJ developed the principle of exhaustion. According to this, the proprietor of an IPR protected by national legislation may not rely on the Member State's legislation in order to oppose the importation of a product which has lawfully been marketed in another Member State by, or with the consent of the proprietor of the right himself or a person legally or economically dependent on him.¹⁸⁷ We can highlight the necessary conditions for application of the exhaustion: namely the "consent of the right's holder, which covers the products concerned" and "lawful

¹⁸³ *Keeling, D.T.*, fn 176, pp. 64-65.

¹⁸⁴ Case C-10/89, *SA CNL-SUCAL NV v HAG GF AG*, [1990] ECR I-3711, Advocate General's opinion, para 14.

¹⁸⁵ Case C-9/93, *IHT Internationale Heiztechnik GmbH and Uwe Danzinger v Ideal-Standard GmbH and Wabco Standard GmbH*, [1994] ECR I-2789.

¹⁸⁶ Cases C-267/95 and 268/95, *Merck v Primecrown Ltd*, [1996] ECR I-6285, Advocate General's opinion, paras 107 and 135.

¹⁸⁷ The principle of exhaustion was formulated by the ECJ in Case 78/70, *Deutsche Grammophon*, fn 178.

marketing within a Member State”. Without these, there can be no exhaustion.

First criterion - consent of right holder

Consent must be expressed in a firm way and cannot leave any room for uncertainty regarding the holder’s intentions. In *Davidoff*, the ECJ interpreted the concept of consent thus: “the consent of a trademark proprietor to the marketing within the EEA [...] may be implied, where it follows from facts and circumstances [...] unequivocally demonstrat[ing] that the proprietor has renounced his right to oppose placing of the goods on the market within the EEA.”¹⁸⁸ Thus, consent cannot be inferred because the proprietor of a trademark has not communicated his opposition to further marketing, or his goods carry no warning of a prohibition of them being placed on the market by purchasers.

The right holder may communicate his consent directly. He may also express consent through another person who is entitled to act on his behalf. However, the meaning of the concept is not always as clear as it appears at first sight. A number of relationships must be considered. A holder of a right may give his consent by various agreements, in particular by license agreements, assignments or exclusive distribution agreements.

The consent expressed in an assignment agreement has been a source of some uncertainty in cases relating to trademarks. A right holder cannot invoke his rights in order to prevent importation of products manufactured within the terms of the agreement. However the situation is more complicated when two companies were economically linked in the past but are now independent. The question was whether one company could oppose the other’s imports into its territory. The ECJ was initially circumspect and solved this problem in favour of the parallel trader, stating that the trademark holder cannot prohibit marketing of a product where the trademark has a common origin.¹⁸⁹ The case returned to the ECJ a few years later, and ECJ then concluded that, in a situation when the original single ownership was broken as a result of state action (post-war confiscation of an enemy-owned company), their common origin could not prevent a proprietor from

¹⁸⁸ Cases C-414/99 to 416/99, *Zino Davidoff SA v A & G Imports Ltd and Levi Strauss & Co. and Others v Tesco Stores Ltd and Others*, [2001] ECR I-8691, para 47.

¹⁸⁹ Case 192/73, *Van Zuylen frères v Hag AG*, [1974] ECR 731.

opposing the import of goods originating from the other proprietor, in so far as they were liable to lead to confusion.¹⁹⁰ The key issue here was the “absence of any element of consent” since the division was undertaken by state authorities. *Ideal Standard* went much further and applied this reasoning to a voluntary division of companies. The ECJ stated that consent was not the only relevant criterion and other factors should be taken into account, including the likelihood of confusion.¹⁹¹

AGREEMENTS V. COMPETITION RULES

Agreements may infringe the competition rules and must be analyzed in the light of Article 81 EC. It was established by the ECJ in *Consten and Grundig* that free movement rules have to be reviewed in the light of the competition rules.¹⁹² Even if an agreement is compatible with Articles 28 and 30 EC, it may still fall within the scope of Article 81 EC.¹⁹³ As an example, in a case where the IPR was not exhausted since goods were only put on the market outside the EEA, its exercise was prohibited as that it manifestly affected competition within it.¹⁹⁴ On the other hand, an agreement which has limited impact on competition may not be justified if it significantly jeopardizes free movement of goods.¹⁹⁵

One significant question is what happens if the product is marketed in breach of the agreement and thereby without consent? Does the holder have a right to oppose such imports? The first step is an analysis of the agreement under 81 EC and under the Block Exception Regulations.¹⁹⁶ If the agreement falls within the scope of Article 81 EC and is not exempted, it - or the offending term - is void and should not produce any effects. In this situation a holder cannot rely on lack of consent because consent cannot be nullified by an unlawful clause in

¹⁹⁰ Case C-10/89, *SA CNL-SUCAL NV v HAG GF AG*, fn 184.

¹⁹¹ Case C-9/93, *IHT v Ideal-Standard GmbH*, [1994] ECR I-2789.

¹⁹² Cases 56/64 & 58/64, *Consten & Grundig*, fn 177

¹⁹³ Case 51/75, *EMI Records Limited v CBS United Kingdom Limited*, [1976] ECR 811, paras 28 and 38.

¹⁹⁴ *Hays, T.*, Anticompetitive agreements and extra-market parallel importation, EURLR 2001, 26(5), pp. 484-487.

¹⁹⁵ Case C-306/96, *Javico International and Javico AG v Yves Saint Laurent Parfums SA (YSLP)*, [1998] ECR I-1983, paras 12, 17 and 22.

¹⁹⁶ See i.e. Commission Regulation (EC) No 772/2004 of 27 April 2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements, OJ L 123, 27.04.2004, p. 11-17.

the agreement. Rights may then be exhausted. If the licensee is in breach of a valid agreement then there is no exhaustion and the holder can act.¹⁹⁷

CAN CONSENT BE NULLIFIED BY OTHERS FACTORS?

Notwithstanding the holder's consent, should the exhaustion principle be inapplicable on the ground that the first sale took place in circumstances which prevented the rights holder from obtaining his due reward? The ECJ dealt with this problem in *Centrafarm BV v Sterling Drug Inc*¹⁹⁸, where governmental measures prevented the IPR holder from fixing his own prices for pharmaceuticals and concluded that differences in governmental measures do not preclude the application of exhaustion. The ECJ reached the same conclusion in a copyright case where a holder could not invoke his rights when he had put a product on the market in the EU, even if his protection was weaker in some Member States.¹⁹⁹ This reasoning was criticized by Advocate General Warner, pointing out its lack of clearness.²⁰⁰

A more interesting case is one where a patent holder could not get any reward because his patent protection was not recognized under national law. In the first *Merck* case, the ECJ said that a patent holder could still be said to have consented to the first marketing even though his products were not protected in the Member State. He had to bear the responsibility for his choice.²⁰¹ The contradictory character of this judgment, which significantly undermined the basic nature of the patent resulted in the ECJ being invited to reconsider its view. However, the court disregarded the opinion of Advocate General Fennelly and took the same view in the second *Merck* case.²⁰² This reasoning was highly controversial and has been heavily criticized.²⁰³ It is said to be against

¹⁹⁷ *Keeling, D.T.*, fn 176, p. 89.

¹⁹⁸ Case 15/74, *Centrafarm BV v. Sterling Drug*, [1974] ECR 1147

¹⁹⁹ Cases 55/80 and 57/80, *Musik Vertriebs-GmbH et K-tel International v GEMA*, [1981] ECR 147.

²⁰⁰ *Id.*, Advocate General's opinion, para 178: "There cannot be exhaustion of rights where no rights exist".

²⁰¹ Case 187/80, *Merck v Stephar BV*, [1981] ECR 2063, paras 11 and 14.

²⁰² Cases C-267/95 and 268/95, *Merck v Primecrown Ltd*, [1996] ECR I-6285, and opinion of Advocate General, paras 107 and 135.

²⁰³ *Tritton, G.*, fn 179. p. 486 and *Keeling, D.T.*, fn 176, p. 108: "To speak of an intellectual property rights being exhausted by a first sale in a country where no such rights exists is little short of perverse."

the very nature of the patent since exhaustion was possible even though the patentee was not rewarded for his innovation. Patentees would indeed be discriminated against since the manufacture of products in countries with weaker or no protection would be disadvantaged; in practice this leads to market partitioning.²⁰⁴

Second criterion: “put on the market”

The ECJ dealt with this condition in *Peak Holding* where it stated that when a proprietor merely imports goods with the intention of selling them, offers them for sale or advertises without actually selling them in the EEA, these acts alone do not exhaust his rights.²⁰⁵ The rationale is that such acts do not transfer to third parties the right to dispose of the goods bearing the trademark and do not allow the proprietor to realize the economic value of the trademark.

The doctrine of exhaustion of rights only applies to the type of goods to which the consent applied. If the holder agreed to market one kind of goods, one cannot presume that the consent covered all goods manufactured by the holder. The ECJ held that there must be consent to the import of each separate kind of goods; consent for the one actually marketed is not enough.²⁰⁶

Finally, the doctrine of exhaustion does not apply when the product was put on the market outside the EEA. In *Silhouette* and *Sebago* the ECJ ruled out the possibility of international exhaustion and limited its scope to the EEA. It firmly stated that when a product is put into circulation outside the EEA the rights owner can oppose parallel trade.²⁰⁷ For exhaustion to be applicable, the proprietor of the rights has to put the product on the market within a Member State or a party to the EEA Agreement.²⁰⁸

²⁰⁴ Korab, V., Intellectual property rights and the EC competition rules, 2006, Hart Publishing, p. 9.

²⁰⁵ Case C-16/03, *Peak Holding AB v Axolin-Elinor AB, formerly Handelskompaniet Factory Outlet i Löddeköping AB*, [2004] ECR I-11313, para 41.

²⁰⁶ Case C-173/98, *Sebago Inc. and Ancienne Maison Dubois & Fils SA v G-B Unic SA*, [1999] ECR I-4103.

²⁰⁷ Case C-355/96, *Silhouette International Schmied GmbH & Co. KG v Hartlauer Handelsgesellschaft GmbH*, [1998] ECR I-4799.

²⁰⁸ Geographical scope of exhaustion extended to Iceland, Liechtenstein and Norway. Agreement on the European Economic Area, OJ L 1, 3.1.1994, p. 3-36.

1.3. Limits to exhaustion

In order to secure the basic functions of patents, copyrights and trademarks, the ECJ has limited the applicability of the exhaustion principle in respect to compulsory licenses, rights of performance or transfer of the goods.

Concerning compulsory licensing, a patent holder does not lose his rights when he is obliged by law to market his products in a Member State. In *Pharmon BV v Hoechst* the ECJ stated that in the case of compulsory licensing the inventor still has the right to determine freely and voluntarily under what conditions he wants to market his products.²⁰⁹ However, this exception could not be invoked in a case where the patentee considered himself bound by an ethical obligation to satisfy a demand for his product in a Member State where pharmaceutical products were not patentable.

In case of copyrights, the ECJ stated in *Warner Brothers* that the right of an author consists of the exclusive right to reproduction and the exclusive right of performance.²¹⁰ The exhaustion principle applies fully to the first right. The application of the principle works differently in the case of commercial exploitation, whether by way of rental, performance or showing works in the public. The difference comes from the very nature of copyright works; they can be used repeatedly and thus it is objectively justifiable to guarantee an author remuneration which reflects the number of occasions on which they were presented in public or hired out. This was confirmed by the ECJ in the *Jean-Louis Tournier* case which indicated that public performance of a protected musical work by means of sound recordings without payment of royalties infringes copyright, even where royalties have already been paid to the author for the reproduction of the work in another Member State.²¹¹ This rule has been developed in subsequent judgments. In *Laserdisken* the author could prohibit copies of a film from being offered for rental in a Member State even though rental had been authorized in the territory of another Member State.²¹² The reasoning was however based on Directive 92/100/EEC on rental right and

²⁰⁹ Case 19/84, *Pharmon BV v Hoechst AG*, [1985] ECR 2281.

²¹⁰ Case 158/86, *Warner Brothers Inc. and Metronome Video ApS v Erik Viuff Christiansen*, [1988] ECR 2605.

²¹¹ Case 395/87, *Ministère public v Jean-Louis Tournier*, [1989] ECR 2521.

²¹² Case C-61/97, *Foreningen af danske Videogramdistributører v Laserdisken*, [1998] ECR I-5171.

lending right and on certain rights related to copyright in the field of intellectual property.²¹³

The exhaustion principle has other limits. One relates to transit of products. In *Rioglass and Transremar* the ECJ stated that if the transit does not involve any marketing of the goods it does not infringe the specific subject matter of the trademark and should be allowed.²¹⁴ However, the trademark proprietor could oppose the offering for sale or sale of goods placed under an external transit procedure or a customs warehousing procedure.²¹⁵ The ECJ has allowed a restriction if the goods in transit have been subject to an act of a third party while they were placed under an external transit procedure that necessarily entailed them being put on the market in that Member State of transit.²¹⁶

Disturbing parallel trade

In emphasizing the free movement of goods and developing the doctrine of exhaustion, the ECJ gave a green light to parallel imports. Price differentials are the incentive for parallel importers to purchase products where prices are relatively low and sell them in Member States where they are higher. But price differences do not depend only on the IPR holder's will. There are many others conditions which might be taken into account, including consumer demand, brand image, taxation and distribution costs - although it might be argued that such differentials should be ironed out by the single market. But in the pharmaceutical sector, the problem is more significant, and has a different basis since the final price of medicines is subject to national regulations.²¹⁷ It seems to be intelligible that the pharmaceutical companies do not wish to supply the entire Community market at the lowest price imposed by national regulation in a single Member State. The words of Judge Laddie "This is not a moral tussle between the

²¹³ OJ L 346, 27.11.1992, p. 61-66.

²¹⁴ Case C-115/02, *Administration des douanes et droits indirects v Rioglass SA and Transremar*, [2003] ECR I-12705.

²¹⁵ Case C-405/03, *Class International BV v Colgate-Palmolive Co*, [2005] ECR I-8735.

²¹⁶ Case C-281/05, *Montex Holdings Ltd v Diesel SpA*, [2006] n.y.r.

²¹⁷ Harrold, L. and Gross, N., Fighting for pharmaceuticals profits, EIPR 2002, 24(10), p. 497.

good and the bad, the small and the large. It is a fight over profits by competitors” fully expressed the importance of the issue.²¹⁸

Repackaging

Repackaging is the process undertaken by a parallel importer in order to comply with different national regulatory rules or practices as regards, for example, the number of pills per packet. The process may consist of removing branded goods from their original containers, repackaging them or reaffixing the original trademark to a new package.

The ECJ has dealt with repackaging issues in several judgments, but some uncertainty still remains. In *Hoffmann-La Roche*²¹⁹ the right holder claimed that repackaging impaired the quality of products and destroyed the guarantee of the origin. The ECJ stated that the trademark proprietor might be justified in preventing imports of repackaged goods into Member States. However, such rights cannot be relied upon when they lead to artificial portioning of the market. Repackaging was allowed if it did not affect the product, the right holder had been informed and the new package contained information about the repackaging. These conditions were clarified and developed in *Bristol-Myers Squibb*. Repackaging should be permitted when necessary for market access. On the other hand it should be prohibited when its sole aim was to secure a commercial advantage. In addition, the presentation of the repackaged product must not be such as might damage the reputation of the trademark and of its owner.²²⁰

The ECJ elaborated on the “necessity requirement” in *Merck v Paranova*²²¹ and *Boehringer Ingelheim*²²², which both concerned the

²¹⁸ Laddie, J. in *Boehringer Ingelheim KG v. Swingward Ltd*, [2000] F.S.R. 529, at para 9.

²¹⁹ Case 102/77, *Hoffmann-La Roche & Co. AG v Centrafarm Vertriebsgesellschaft Pharmazeutischer Erzeugnisse mbH*, [1978] ECR 1139.

²²⁰ Case C-427/93, *Bristol-Myers Squibb v Paranova A/S*, Case C-429/93, *C. H. Boehringer Sohn, Boehringer Ingelheim KG and Boehringer Ingelheim A/S v Paranova A/S*, and Case C-436/93, *Bayer Aktiengesellschaft and Bayer Danmark A/S v Paranova A/S*, [1996] ECR I-3457.

²²¹ Case C-443/99, *Merck Sharp Dohme GmbH v Paranova Pharmazeutika Handels GmbH*, [2002] ECR I-3703.

²²² Case C-143/00, *Boehringer Ingelheim KG and others v Swingward Ltd and Dowelhurst Ltd*, [2002] ECR I-3759.

replacement of packaging instead of a mere re-labeling. The Court said that this requirement is satisfied when effective access to the market concerned is hindered, for example when packages bearing the same trademark differ in different Member States; when national legislation forces an importer to market a product in a particular type of package; or, finally, because of strong resistance from a significant proportion of consumers to the re-labeled pharmaceutical product.²²³

However, other situations are still unclear. In the light of the questions which have arisen in the new *Boehringer Ingelheim KG* case (now pending), the ECJ has the opportunity to say more on the “reputation requirement”, and “the prior notice requirement and severity of sanctions in case prior notice is missing.”²²⁴ Although the ECJ has not yet given its judgment, the AG has submitted his opinion. Firstly, he indicates that whether any “reboxing” is of good or bad quality may have an impact on reputation though any repackaging might be justified given legitimate grounds. Secondly, when an importer has complied with all conditions but has failed to give due notice, he infringes the trademark by every subsequent importation. It is for the national court to determine the appropriate sanction, which should be proportionate, effective and dissuasive.²²⁵

A more complex issue is when an importer affixes a trademark to the product. In *American Home Products Corporation* case the ECJ stated that affixing a trademark on products is an exclusive right, which belongs only to the holder of the right. He can thus prevent importers from using the trademark, if the sole reason behind this is not an intention to artificially divide markets.²²⁶ The conditions submitted by the ECJ in this judgment were ambiguous and unjustifiably favorable towards trademark owners, and the Court did not clarify what constitutes an intention to divide markets. Secondly, as long as the trademark owner could set out a good reason, for example an economically based one, for using different marks in different

²²³ Kontrakos, P., In search of common vocabulary in free movement of goods: the example of repackaging pharmaceuticals, EURLR 2003, 28(1), pp. 59-63.

²²⁴ Case C-348/04, *Boehringer Ingelheim and Others*, n.y.r.

²²⁵ Id., Advocate General's opinion, 6 April 2006.

²²⁶ Case 3/78, *Centrafarm BV v American Home Products Corporation*, [1978] ECR 1823.

countries, any intention to divide the markets would be excluded.²²⁷ The ECJ set out clearer conditions for affixing trademarks in *Pharmacia & Upjohn*. It stated that “where the repackaging with reaffixing or replacement of the trade mark is necessary to enable the products to be marketed by the parallel importer in the importing Member State, there are obstacles to intra community trade giving rise to artificial partitioning of the markets between Member States, whether or not the proprietor intended such partitioning”.²²⁸ This attitude is more balanced and in line with the methodology used in repackaging cases.

Advertising

There are other functions of trademarks that cannot be disregarded. Trademarks are used to present a product, to advertise it and make it well-known among consumers and this means consumers connect the product and its quality with the producer. Thus, the means of presentation are of the highest importance to a trademark owner and he should be entitled to prevent advertising by unauthorized dealers, which may damage the trademark's reputation.²²⁹ In this way, owners have attempted to control advertising carried out by distributors of imported goods in an attempt to make parallel imports less lucrative. The ECJ has tried to find a compromise between the interests of the owner and the “unauthorized” dealer, who obtains goods from a parallel trader, by stating that a holder can use a claim of trademark infringement to prevent a reseller from advertising, if he can prove that the advertising seriously may damage his commercial reputation.²³⁰

²²⁷ *Urlesberger, F. Ch.*, Legitimate reasons for the proprietor of a trademark registered in the EU to oppose further dealings in the goods after they have been put onto market for the first time, [1999] CMLR 36 p. 1211.

²²⁸ Case C-379/97, *Pharmacia & Upjohn SA v Paranova A/S*, [1999] ECR I-6927.

²²⁹ Case C-337/95, *Parfums Christian Dior SA and Parfums Christian Dior BV v Evora BV*, [1997] ECR I-6013.

²³⁰ Case C-63/97, *Bayerische Motorenwerke AG (BMW) and BMW Nederland BV v Ronald Karel Deenik*, [1999] ECR I-905.

1.4. Conclusion

By developing the principle of exhaustion the ECJ tried to find a balance between the need to attain a single market and the need to ensure that benefits of IPRs are not compromised. The principle seems to be on the one hand a balance between the exercise of IPRs and free movement of goods, and on the other, a remedy against the negative effects of the territorial nature of IPRs. It prevents the right holder from enjoying double benefits once he has put a product on the market.

The reinforcement of parallel trade is the most obvious result of the principle of exhaustion. This has been especially noticeable in the pharmaceutical sector. The ECJ initially leaned towards a very broad definition of the principle of exhaustion and firmly supported parallel traders. Its approach has been more balanced in recent years.

The shortcomings of parallel trade, not only in respect of loss of benefit to IPR holder but also in terms of reduction of new inventions, were soon noticed. One can say that the aim of the exhaustion principle was to eliminate discrimination, and that it has been regarded as giving rise to discrimination of a different kind, against the companies who suffer from parallel import. Manufacturers have turned to other tactics when trying to limit parallel trade.²³¹ However, in doing so they have fallen foul of the competition provisions of the EC Treaty, namely Article 81, prohibiting anti-competitive agreements, and, where relevant Article 82, prohibiting the abuse of a dominant position.

²³¹ *Stothers, C.*, Who needs intellectual property? Competition law and restrictions on parallel trade within the EEA, *EIPR* 2005, 27(12), pp. 458-466.

2. A U.S. PERSPECTIVE

BY MATTEO SOLE

In the U.S., “grey-market” imports are genuine goods produced under the protection of an IPR whether a trademark, patent or copyright, placed into circulation in one market, and then imported into a second market without the authorization of the local owner of the IPR (including local licensees). These goods compete with the trademark owner’s authorized goods in the second country. Often, the price of the parallel import is significantly lower than that of the authorized good. As the price appeals to consumers, parallel imports cost authorized retailers lost sales. In addition, because parallel imports are not intended for the second country’s market, the products may have different features or meet different quality standards than the authorized goods. Such differences can damage the goodwill consumers’ associate with an IPR, especially in the case of trademarks.

Different countries address the issue of parallel imports differently. We will see how U.S. statutes and case law have tried to deal with them. The principle of exhaustion, whether on a national or international basis, will be examined in the light of recent developments and we will also assess the requirements for a product to be classed as a parallel import. The issue of “material differences” will highlight how U.S. territorial restrictions apply and what the law is and how, if at all, U.S. companies seek to use the law to their advantage to create restrictions and limit parallel trade.

The scope of the principle of exhaustion in U.S. differs according to the right in question. We find a tendency towards international exhaustion in the case of trademarks and copyrights. However in relation to patents in U.S. we can observe two features differing strongly from EU law: the scope of protection is much broader, furthermore for some pharmaceuticals, parallel trade is entirely forbidden and companies do not have a parallel trade issue at all.

The trademark statute applicable in the U.S. is the Lanham Act. It offers protection as it prohibits the unauthorized sale of goods bearing a registered trademark where there is a likelihood of confusion, mistake

or deception of purchasers.²³² While the statute does not implicitly bar importation of genuine goods, it precludes unauthorized importation of goods bearing a registered trademark where there is some “material difference” between the foreign grey goods and the authorized domestic goods.²³³

2.1. First Sale Doctrine

Within its borders, the U.S. enforces the First Sale Doctrine, under which rights are exhausted when the product is purchased outside the vertical distribution chain. The First Sale Doctrine is intended to protect a buyer’s interest in goods they have purchased. For example, under the doctrine, once the trademark owner has sold its goods, it has exhausted its trademark rights in those goods. In this way, companies cannot prevent customers from re-selling goods anywhere in the country. The doctrine is also designed to balance trademark protection, on the one hand, with free competition, on the other.

In *Sebastian-International, Inc. v. Longs Drug Stores Corporation*,²³⁴ the U.S. Court of Appeals observed that the doctrine “preserves an area for competition by limiting the producer’s power to control the resale of its product.” The First Sale Doctrine’s ability to control imports was challenged in the Supreme Court in *Quality King*.²³⁵ The case involved the importation of copyright protected hair care products that were exported from the U.S. with the consent of the copyright holder (L’anza), and then imported to the U.S. by Quality King Distributors without the consent of the copyright holder. The Court held that a party, which produced copyrighted material in the U.S. and sold it to a party abroad, could not use the Copyright Act to

²³² Section 32 of the Lanham Act, 15 U.S.C. § 1114 bars the use of any “reproduction, counterfeit, copy or colorable imitation” of a federally registered mark, and section 43, 15 U.S.C. § 1125, prohibits the use of any false designation of origin likely to cause consumer confusion.

²³³ *Gamut Trading Co. v. International Trade Commission*, 200 F.3d 775 (Fed. Cir. 1999).

²³⁴ *Sebastian-International, Inc. v. Longs Drug Stores Corporation*, 53 F.3d 1073, 1075 (9th Cir. 1995).

²³⁵ *Quality King Distributors, Inc. v. L’anza Research International, Inc.*, 523 U.S. 135 (1998).

block the re-importation of the product into the U.S. This decision has essentially blocked any attempt to use U.S. copyright law to halt parallel imports of genuine goods originally manufactured in the U.S. and exported. Justice Ginsburg, in a short opinion, did confine the impact of the decision to copyrighted goods manufactured in the U.S. that make a “round trip journey” back to that country after being distributed in a foreign market.

In *Curtiss Aeroplane*²³⁶ it was held that a U.S. patent holder, by consenting to the use of its patent in Canada, had exhausted its right to control the importation of the resulting aircraft into the United States. This was perceived by many in the U.S. to be the start of an international exhaustion rule but this was changed in the *Jazz Photo*²³⁷ case where it was stated that the sale of products by a patent holder in another country did not exhaust U.S. patent rights; “United States patent rights are not exhausted by products of foreign provenance. To invoke the protection of the first sale doctrine, the authorized first sale must have occurred under the United States patent”. *Jazz Photo* also shows the limits of the doctrine: it held that the user of a single-use camera was not allowed to remove the film, process it, replace the battery, or package it in a new cardboard container, based on labelling on the camera warning the purchaser that the camera should not be opened. The ITC held that these steps amounted to reconstructing the camera and consequent infringement of the patents. The defendant had claimed that the challenged activities simply extended the useful life of the cameras and constituted a “repair” rather than a reconstruction of the patented item.

²³⁶ *Curtiss Aeroplane v. United Aircraft*, 266 F. 71 (2d. Cir. 1920).

²³⁷ *Jazz Photo Corp. v. International Trade Commission*, 264 F.3d 1094 (Fed. Cir. 2001).

2.2. Exceptions to the First Sale Doctrine

The Tariff Act Section 526(a)

The Tariff Act Section 526(a) contains an exception to the First Sale Doctrine by virtue of which U.S. customs may seize parallel imports if the goods being imported were manufactured outside the U.S. and the original “authorised” good is manufactured in the U.S. The trademark must be registered and the owner must be an American citizen or corporation.

This provision was narrowly interpreted by the Supreme Court in 1988 in the case of *K-Mart*.²³⁸ The Court addressed the regulations of the Customs Service implementing the statute as they had prohibited imports only where a domestic firm had “purchased the right to register and use the trademark from an independent foreign trademark owner”, but allowed importation “where the goods were manufactured abroad by a foreign manufacturer affiliated with the U.S. trademark owner or where a foreign licensee was authorized by the U.S. manufacturer to register and use the mark abroad”²³⁹ (the “authorized use” exception). The Court upheld the regulation, holding that the refusal to limit imports where both the foreign and the U.S. trademark were owned by the same business entity or where the foreign and domestic trademark owners were parent and subsidiary companies or otherwise subject to “common ownership and control” was a permissible interpretation of the statute. The Court added that in the case of “articles sold under the trademark produced abroad by a foreign branch or subsidiary of a U.S. trademark owner, the goods when imported were not of “foreign manufacture” under the statute, and that in the case of articles produced abroad by a U.S. subsidiary of a foreign trademark owner, both the foreign “owner” and its U.S. subsidiary were the same for the purpose of granting consent to import.”²⁴⁰

In simpler words, the ban on parallel imports is subject to the “common-control exception”. This rule will allow trademark owners to limit parallel imports, except when both the foreign and U.S.

²³⁸ *K Mart Corporation v Cartier*, 486 U.S. 281 (1988).

²³⁹ *Id.*

²⁴⁰ *Id.*

trademarks are owned by the same entity or when the foreign and U.S. trademark owners are in a parent-subsidary relationship as mentioned above.

The Material Difference Doctrine

A trademark holder cannot act against domestic resellers of products put on the market by him or with his permission. The idea behind this is that the trademark holder - and producer - is able to ensure the quality of the product and to make money on the first sale, and thus no longer has a right to control the further distribution of that product. If a U.S. trademark holder sells trademarked products abroad, a third party may buy these products and import them into the U.S.²⁴¹ The Lanham Act can sometimes be used to block imports even if products were manufactured abroad by the trademark holder or an affiliate. If the American consumer would consider the foreign product different from the domestic product, the imported products are deemed “not genuine”. It is not uncommon for a product to have different ingredients or to be of different quality in different countries.

A material difference is one that consumers would notice and consider relevant in their buying decision. There is no need to protect the consumer against confusion when the imported goods are identical to the goods of the trademark holder. However, where the foreign goods have materially different characteristics, consumers will likely be confused as to the quality and nature of the product bearing the mark, which will in turn erode the goodwill created by the U.S. source.²⁴² This difference can lead a consumer to believe that they have not purchased a genuine product. This is a situation where a genuine product or parallel import can be subject to territorial restriction. The purpose of the material difference test is therefore to determine whether the importation of the goods is likely to injure the trademark owner’s goodwill. In applying the material difference test, courts have not limited the inquiry to physical differences. They have successfully asserted that differences in the written materials or labelling accompanying the product are “material.”

The law concerning what constitutes a “material difference” has evolved over recent years (mainly to the benefit of IPR holders). Under

²⁴¹ *Zadra-Symes & Basista*, Using U.S. Intellectual Property Rights to Prevent Parallel Imports, *EIPR* 1998, 223.

²⁴² *Iberia Foods Corp. v. Rolando Romero, Jr.*, 150 F.3d 298, 303 (3d Cir. 1998).

*SKF USA Inc. v. International Trade Commission*²⁴³ decision, the material differences test has expanded to include non-physical differences between genuine and grey market goods, significantly improving the chances of owners protecting their IPRs against unauthorized importation and sale of grey market goods.

In *OAA Inc. v. Granada*²⁴⁴, OAA licensed the right to manufacture and distribute Cabbage Patch Dolls in Spain to one company and the rights in the U.S. to another one. The Spanish Dolls contained birth certificates, instructions and adoption papers - all written in Spanish, the U.S. dolls coming with the same documents, but in English. Granada began distributing the Spanish dolls in the U.S. and purchasers began complaining to OAA because they did not understand the Spanish documents. The Court of Appeals found Granada had infringed OAA's trademark rights, stating that the differences "upset the settled expectations U.S. purchasers had about what they would receive" when they purchased the dolls. Effectively, this says that the Spanish dolls were not genuine so far as U.S. consumers were concerned.

The threshold for finding a material difference is rather low since consumers consider a number of features when purchasing. Among the product features that have been found to be material are differences in the way a product smells,²⁴⁵ differences in packaging including the addition or absence of marking and differences in ingredients.²⁴⁶

Section 42 of the Lanham Act was interpreted by the Court of Appeals in *Lever Bros.*²⁴⁷ almost a year after *K-Mart*. There were material differences between the products produced by the U.S. and the British manufacturers, even though both were part of the same corporate group. There were specific findings of fact that consumers were confused as to the qualities of the products and had complained to the U.S. producer. The Customs Service had relied upon the same regulation as in the *K-Mart* case and had refused to prohibit importation because the two companies were under "common control" and the products were "genuine"; they refused to consider consumer confusion, the physical differences between the products or the

²⁴³ *SKF USA Inc. v. International Trade Commission*, 423 F.3d 1037 (Fed. Cir. 2005).

²⁴⁴ *Original Appalachian Artworks, Inc. v. Granada Electronics, Inc.*, 816 F.2d at 73 (2d Cir. 1987).

²⁴⁵ *Lever Bros. Co. v. United States*, 877 F.2d 101, 108 (D.C.Cir. 1989).

²⁴⁶ *Societe Des Produits Nestle, S.A. v. Casa Helvetica, Inc.*, 982 F.2d 633 (1st. Cir. 1992).

²⁴⁷ *Id.*, at para 17.

domestic market-holder's non-consent to importation. The Appeals Court held that this interpretation of the statute defeated its purpose and was contrary to its intent and noted with approval the position of the Customs Service that a trademark owner cannot infringe its own mark, stating: "If a U.S. trademark holder itself imports goods or licenses another to do so, the markholder's conduct or authorization makes the goods authentic, whether they are better, worse, or the same as the U.S. markholder's domestic products."²⁴⁸

The Lever Rules

In response to the *Lever Bros* case new rules, the so-called Lever Rules, were adopted and importation of goods bearing genuine trademarks into the U.S. may now only be restricted if they "physically and materially differ" from articles authorized for sale in the U.S. by the U.S. trademark owner. The restriction is extremely narrow, and is not a bar to importation: it merely requires that the materially and physically different goods be labelled in accordance with the regulation prior to entry.²⁴⁹

In *Gamut*²⁵⁰ the Federal Circuit went one step further and upheld a U.S. ITC decision excluding Kubota tractors intended for the Japanese market from importation into the United States. In addition to structural differences and the lack of English-language manuals, the court cited lack of service and maintenance as a material difference.

The threshold for "materiality" is essentially based on consumers' viewpoint. Courts look to see whether consumers would consider the difference to be relevant when purchasing a product. All that needs to be shown is that consumers would be likely to consider the differences between the foreign and domestic products to be significant or relevant when purchasing the product. There is only a presumption of consumer confusion whenever the difference between the genuine product and the allegedly grey market product is such that a consumer would likely consider it relevant in a purchasing decision.

²⁴⁸ Id.

²⁴⁹ Id.

²⁵⁰ *Gamut*, 200 F.3d 775, fn 233.

2.3. Conclusion

A trademark owner cannot complain about parallel imports identical to its authorized U.S. goods, unless they place geographic and resale restrictions, as well as penalties for breaching these restrictions, in their distribution agreements. The contractual restrictions may provide the trademark owner with grounds for a breach of contract claim, but he will not be able to rely on it to enforce trademark claims against subsequent purchasers and other third parties.

Under the first sale doctrine, once a trademark owner makes his or her first authorized sale of a trademarked item, the owner has exhausted his or her rights in the item sold. Therefore, a subsequent sale of the product by a third party will not constitute an infringement, even if the sale is not authorized by the trademark owner. While the first sale doctrine protects the sale of genuine goods, materially different goods are not considered genuine goods.

As noted above, there are competing arguments for prohibiting or allowing the parallel imports. Manufacturers and distributors argue that they should be able to control the use of their IPR and, of course, that parallel imports diminish the value of their IPR and provide unfair competition that free-rides on marketing and advertising expenditures made by legitimate sellers. The converse opinion is that parallel imports benefit consumers as they create price competition; they are genuine and bear legitimate marks; and consumers should thus not be confused as to the source or origin of the goods purchased.

Where does the balance lie? It seems that the U.S. protects its interests by broadly interpreting a strict rule. This creates a barrier to parallel trade, is unfair to many parallel importers and goes against the whole notion of competition. The job of the judiciary is hard, as they need to balance U.S. interests with strong support of trade. Their task seems to be to make the law restrictive enough so it will not have a major impact on competition.

3. THE GLOBAL DIMENSION

BY OLGA ALFER

The implications of using the exhaustion principles will depend on whether a state applies national, regional or international exhaustion. The concept of national exhaustion provides that the IP owner cannot control further sales of goods he has put on his domestic market with his consent; but he still has the right to oppose importation of original goods marketed abroad. Regional exhaustion means that the IP owner can no longer oppose parallel imports within the larger region in question but he may still preclude importation of goods originally marketed outside the region. Under a concept of international exhaustion, once the product has been put on sale anywhere in the world by the IP owner or with his consent, the IPRs are exhausted.

The issue of the choice of exhaustion regime has not been explicitly addressed in international instruments. TRIPS left the adoption of an exhaustion model to the discretion of states, and the issue remains controversial. Exhaustion rules affect the national interests of states, competition on the international and national level and both global and domestic welfare. The question has legal, political and economic aspects. Thus, for the sake of finding the optimal exhaustion model it is necessary to conduct political and economic analyses which would define the scope of national interests and set out the positive and negative effects of different exhaustion regimes which should also consider the interests of individual rights holders.

The purpose of this work is to discuss global exhaustion and parallel trade from three different perspectives – legal, economic and political. It will observe existing legal regulatory frameworks, discuss the subject from an economic point of view, taking full account of welfare issues and the position of IPR owners, and then look into the political dimension of IPR exhaustion and parallel trade. Such a combined approach may be helpful in determining the optimal strategy to be adopted within the WTO.

3.1. International exhaustion

The WTO Member States did not manage to agree on the exhaustion regime within WTO, so exhaustion principles have been applied predominantly at the national and regional (EU) level. Nevertheless there are certain WTO provisions regarding IPR and free movement of goods that are worth taking account when speaking of the global dimension of exhaustion of rights.

International level

There are several Articles in TRIPS that are related to the free movement of goods but Article 6 is the only provision that deals with the exhaustion principle. It provides: “For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 and 4 above nothing in this Agreement shall be used to address the issue of the exhaustion of IP rights.” This Article has been widely interpreted as an “agreement to disagree” giving WTO members the freedom to decide on national, regional, or international exhaustion.²⁵¹ To put the matter in a more positive way, where states permit parallel imports in a way other countries think may violate TRIPS, they cannot raise this issue as a dispute within WTO unless there is a violation of the non-discrimination principles provided Articles 3 and 4 of TRIPS. The Doha Declaration, adopted in 2001, further clarifies that members are free to choose how to deal with exhaustion though it also stresses that TRIPS’ principles should be implemented and interpreted in a way that supports public health - by promoting both access to existing medicines and the creation of new drugs.

Another TRIPS provision related to free movement is Article 31, which regulates access to medicines in developing countries, by allowing for the possibility of providing compulsory license in case of national emergency or extreme urgency. Article 31(f) further stipulates that products made under compulsory licensing must be predominantly for the supply of the domestic market.

²⁵¹ *Fink, C*, Entering the Jungle: The Exhaustion of Intellectual Property Rights and Parallel Imports, Competitive Strategies for Protection of Intellectual Property, pp. 173-191, available at <http://www.fraserinstitute.ca/publications/index.asp?snav=pb>.

The above provision is of little use to countries that have little or no manufacturing capacity and are dependent on the importation of generics. They received some assistance by way of a decision taken August 30th 2003 when WTO members made it easier for developing states to import cheaper generics albeit made under compulsory licensing, if they are unable to manufacture the medicines themselves. Moreover, exporting constraints were waived for developing and least-developed countries so that they could export within a regional trade association, if at least half of the members were categorized as least-developed countries at the time of the decision. The mechanism set up by the August agreement is based on a drug-by-drug, country-by-country and case-by-case decision-making process.²⁵²

Regional level

As was discussed in chapter 1 above, the EU applies a regional exhaustion system providing some barriers to parallel imports from outside the EU borders but, broadly speaking, not restricting such trade within them.²⁵³ It is primarily the ECJ's case law that has developed

²⁵² The goal of the 2003 waivers was to amend TRIPS, and a decision to do this was reached in December 2005. The amendment, which is a direct transposition of the waivers, would enter into force when two thirds of the members accept it. Only a limited number of countries including Canada, Norway, China, India and the European Union, have adopted legislation to implement the August 30th Decision. Even so, not a single government has notified the TRIPS Council of their intention to use the mechanism to import medicines under compulsory licenses. Moreover, some international organizations, like Médecins Sans Frontières (MSF), already declared that the August 30th agreement is unworkable, and so is the national implementing legislation. They pointed out additional restrictions in national implementing legislation that go beyond the decision (e.g. Canadian implementing law imposes additional bureaucratic constraints and limits for drug quantity and exports). See Neither Expeditious, Nor a Solution: the WTO August 30th Decision is Unworkable, Study by Medicins Sans Frontiers, <http://www.accessmedmsf.org/documents/WTOaugustreport.pdf>.

²⁵³ The free flow of pharmaceuticals between EU member states, however, could be made subject to public policy exception following recent CFI judgement in T-168/01, *GlaxoSmithKline Services v Commission*, OJ C 294, 2.12.2006, p. 39. Appeals against the CFI judgement have been brought by the Commission in Case C-513/06 P, *European Association of Euro Pharmaceutical Companies and Asociación de exportadores españoles de productos farmacéuticos*, OJ C 42, 24.02.2007, p. 13

the EU regional exhaustion rule,²⁵⁴ which later was embodied in secondary legislation.²⁵⁵ The principle of regional exhaustion for trademarks has been codified in the First Council Directive on Trademarks²⁵⁶ and 1993 Regulation on the Community Trademark.²⁵⁷ In addition, as a result of the Agreement on the EEA between the EU, Iceland and Norway, for the purposes of the Directive on Trademarks the reach of the exhaustion principle extends to these two countries, even though they are entitled to determine their preferred model of exhaustion for themselves.²⁵⁸ However, as the ECJ explicitly pointed out in *Silhouette*²⁵⁹ and reiterated in subsequent cases, the regional exhaustion rule does not imply international exhaustion. One might have a case where, for example, parallel imports in transit between two non-EU Member States enter a EU Member State, and are seized in the EU Member State as parallel imports that violate the rights of the trademark owner in the Member State.²⁶⁰

Other regional trade agreements are mostly silent on the exhaustion issue. The North American Free Trade Agreement (NAFTA) has no relevant provision. The provisions of chapter 17 on NAFTA²⁶¹ regulating IP issues can though be interpreted as giving the Member States freedom to choose their preferred regime. The question of parallel imports is likewise not explicitly addressed in the Treaty of Asunción establishing the Southern Cone Common Market (MERCOSUR) among Argentina, Brazil, Paraguay, and Uruguay.²⁶²

²⁵⁴ Principal cases: Case 15/74 *Centrafarm BV v Sterling Drug*, fn 198; Case 187/80, *Merck v Stephar BV*, fn 201; and Case C-355/96, *Silhouette*, fn 207

²⁵⁵ See e.g. Council Directive 92/100/EEC on rental right and lending right, OJ L 346, 27.11.1992, p. 61–66; Council Directive 91/250/EEC on the legal protection of computer programs, OJ L 122, 17.5.1991, p. 42–46 and Directive 96/9/EC on the legal protection of databases, OJ L 77, 27.3.1996, p. 20–28.

²⁵⁶ Council Directive 89/104/EEC of 21 December 1988 to approximate the laws of the Member States relating to trade marks, OJ L 40, 11.2.1989, p. 1–7.

²⁵⁷ Council Regulation (EC) on Community Trademark, fn 174, Art. 13(1).

²⁵⁸ *Mag Instrument Inc. v. California Trading Company Norway*, Ulsteen (1997) EFTA Court, Case E-2/97[1998] 1 CMLR 331.

²⁵⁹ Case C-355/96, *Silhouette*, fn 207

²⁶⁰ C-383/98, *The Polo/Lauren Company, L.P. v. PT Dwidua Langgeng Pratama International Freight Forwarders*, [2000] ECR I-2519.

²⁶¹ NAFTA, chapter 17 <http://www.sice.oas.org/trade/NAFTA/chap-171.asp>.

²⁶² *Fink*, fn 251, pp. 173-191.

National level

As was discussed in chapter 1 above, the U.S. applies the first-sale doctrine, under which rights are exhausted when purchased outside the vertical distribution chain: exhaustion operates at the national level. Under this doctrine companies cannot prevent the re-selling of goods originally manufactured anywhere in the country; the U.S. courts have interpreted the conditions under which parallel imports from outside the U.S. could be banned. The landmark cases have been *K-Mart*²⁶³ where the Supreme Court held that the Tariff Act of 1930 prohibits the importation of any merchandise of foreign manufacture which bears a U.S. trademark owned by a U.S. citizen or corporation and who is domiciled in the U.S., unless the importing company is under “common control” with it. The Customs Regulations in the U.S. have recently been amended in light of the *Lever Brothers*²⁶⁴ case. Trade mark owners can now apply for the restriction of otherwise acceptable grey market goods that bear genuine trade marks that are identical to those appearing on articles authorized by the U.S. trade mark owner for importation or sale in the U.S. if they are materially different to the U.S. goods. However, in the area of copyright, the U.S. Supreme Court in *Quality King*²⁶⁵ unanimously ruled that the first sale doctrine applies to copyrighted goods produced in the U.S. and sold in foreign markets.

In contrast to the U.S. position, the 1997 decision by the Supreme Court of Japan in the *BBS* case²⁶⁶ confirmed the lawfulness of parallel imports of patented products unless restrictions are clearly displayed on the products. In 1998 New Zealand became the first OECD country to adopt a system of international exhaustion with respect to copyright. In 2003 New Zealand amended its Trade Marks Act to state that a registered trade mark is not infringed by the use of the trade mark in relation to goods that have been put on the market anywhere in the world under that trade mark by the owner or with his or her express or implied consent.²⁶⁷

²⁶³ *K-Mart Corp. v. Cartier*, fn 238.

²⁶⁴ *Lever Brothers Co. v. United States*, 371 U.S. 207 (1962).

²⁶⁵ *Quality King*, fn 235.

²⁶⁶ *BBS*, Supreme Court of Japan, Decision on Case No. Heisei 7(wō)1988 delivered on July 1, 1997

²⁶⁷ Portal of the Ministry of Economic Development, New Zealand, available at http://www.med.govt.nz/templates/Page_____1230.aspx#P50_7771.

In non-OECD countries, the rules regarding parallel imports differ widely. According to surveys on copyright made by the International Intellectual Property Alliance in 2002-2005, Mexico and Peru provided protection against parallel imports while in Singapore, Venezuela and Morocco parallel imports were allowed. The exhaustion regimes of Argentina and Chile were unclear and seemed to follow other Latin American countries in not imposing restrictions on parallel imports.²⁶⁸

3.2. Economics perspective

In conditions of international exhaustion, goods move freely between countries and prices are presumably set according to the laws of supply and demand. Limiting parallel imports could lead to price discrimination as this creates certain barriers to free trade and might also influence competition on both local and international markets. There is thus a need to balance the interests of manufacturers and consumers, and if this cannot be achieved, there is a choice as to which interests to give priority. Consumers benefit from low prices, but they are also interested in quality and choice in goods and services provided with products. Manufacturers are concerned to recover their R&D investments and receive profit as incentive for future research, development and production. All these are affected by allowing or banning the arbitrage of goods protected by different IPRs.

Welfare effects: free trade doctrine v price discrimination

Which model – free trade or price discrimination – would be more beneficial for national and global welfare? There are many studies assessing the impact on welfare of permitting or, alternatively, banning parallel trade. However, many studies are based on specific assumptions, and may not be applicable in all cases. This chapter will comment on the most common assumptions regarding the impact of parallel importation on welfare in an international context.

²⁶⁸ IIPA special country reports, available at <http://www.iipa.com/countryreports.html>.

International exhaustion and a free trade model

The free trade doctrine, based on the model of comparative advantage, provides that the elimination of barriers to the movement of goods across national borders could be beneficial for global welfare because it encourages specialization and efficiency in production and distribution. According to the model of comparative advantage, different countries would be better off specializing in the commodities they can produce at relatively low costs; these goods will compete on international markets and, as a result, global equilibrium prices will be established. Moreover, the profit returning to the developers of the product will be maximized through opportunity to sell the product internationally at equilibrium prices.²⁶⁹ Manufacturers would also be under pressure to become more efficient.

In a free-trade model, parallel imports serve to ensure that there is an adequate level of competition for patented products. This could be especially important for boosting the welfare of small, developing countries, where competition from substitute goods may be limited and competition policies are often absent or undeveloped.²⁷⁰

Supporters of the free trade approach say that allowing IPR owners to charge and maintain different prices in different markets for the same goods and services is artificial and has negative effects on the allocation of resources.²⁷¹ They also claim that international price discrimination limits the possibility for developing countries to invest in own production and ties them to reliance on investments from developed nations.

Why the free trade model cannot stand

Supporters of price discrimination argue that the model of comparative advantage is wrong in the way it assesses welfare effects. Price discrimination may arise from a number of other factors, including retail price discrimination, controlled prices and vertical regulation. In many of these cases, price discrimination could even have beneficial effects for international and national welfare.

²⁶⁹ *Abbott, F. M.*, First Report (Final) to the Committee on International Trade Law of the International Law Association on the Subject of Parallel Importation, *Journal of International Economic Law*, 1998, 1: 607–36.

²⁷⁰ *Fink*, fn 251, pp. 173-191.

²⁷¹ *Abbott*, fn 269.

Further, on global markets, manufacturer sets prices according to demand elasticity, charging higher prices in larger markets with more inelastic demand. Economic modeling has shown that a manufacturer would maximize its profit selling goods not only at high-price markets, but also serving low-income markets at lower costs – as long as the price it can charge exceeds its marginal costs. In circumstances where parallel imports between high-income and low-income countries are not allowed the producer will set different prices in these markets. As a result, consumers in both markets benefit and the manufacturer realizes additional returns to apply to its R&D costs.

Alternatively, in a free trade model with a uniform global price, the manufacturer would simply choose the profit-maximizing price in the integrated market. In this situation, the manufacturer might continue to supply the low-income market at a higher price and in lower quantity or just pull out of the market. The results, compared to the price discrimination model, would be the loss of benefit for consumers in low-income countries and lost profits for the manufacturer.²⁷² This modeling might be of relevance for global marketing of pharmaceuticals, where many countries have high willingness to pay for medicines. In this case, there is a risk that developing, and especially the least-developed countries, would not be best served by pharmaceutical companies.

Governments may intervene in markets by controlling prices or regulating private businesses' returns. This has indeed been especially common in the pharmaceutical industry. Such regulations can be found in both developed and developing nations. This results in significant price variability.²⁷³ In this case, to allow parallel trade could defeat the purpose of state regulations, which is to make medicines affordable to domestic low-income consumers - as some might be reexported - and there would be little justification for effectively extending such a national policy to foreign consumers.²⁷⁴ In this context, banning or controlling parallel exports in goods whose prices are heavily regulated arises from the need to defend the importing state. Parallel exports from price-controlled markets could also lead to lower worldwide profits for

²⁷² Economic modelling of this kind was provided by *Maskus*, see *Maskus, K. E.*, Parallel imports in pharmaceuticals: implications for competition and prices in developing countries, Final Report to World Intellectual Property Organization, April 2001.

²⁷³ *Id.*

²⁷⁴ *Fink*, fn 251, pp. 173-191.

IP owners, and they might decide to stop serving price-controlled markets altogether.²⁷⁵

The CFI in its ruling in the *GlaxoSmithKline*²⁷⁶ case recognized the specific nature of the pharmaceutical industry, which could result in justifying restrictions of parallel imports in certain cases. The CFI held that the restriction of parallel imports in the pharmaceutical sector, where governmentally controlled prices harm competition, could be subject to a public policy exemption under the EU competition rules. They stated that was due to the special nature of the pharmaceutical sector, which is not driven by classical market forces.²⁷⁷

Vertical price control, which concerns collusive behaviour among exclusive dealers in products protected by IPRs, may be a common problem in poor countries where distribution systems are not developed and are concentrated among a small number of firms. Moreover, vertical control over the operations of licensees may be difficult or impossible in foreign markets with weak systems of enforcement of private contracts banning sales outside the authorized distribution chain. In this case, prohibition of parallel imports to other states may have ambiguous impacts on social welfare. Parallel imports may increase competition in the home country and other high-income markets and benefit consumers there through lower prices. However, permitting parallel importation would reduce the supply available on the foreign market, and this would result in higher prices for consumers in that country. A conclusion might be that the exhaustion model may be more beneficial for the welfare of states within regional trade agreements rather than internationally.

3.3. Business perspective

Restrictions on parallel trade provide holders of IPRs with the ability to establish a profit-maximizing price at local markets and therefore raise their overall profitability. Consequently, companies may increase their investments in inventive activities and this may lead to an accelerated pace of industrial innovation and increased production of

²⁷⁵ Id.

²⁷⁶ T-168/01, *GlaxoSmithKline*, fn 253

²⁷⁷ Id., p. 39.

new technical, literary and artistic works. This argument applies predominantly to IPRs such as patents and copyrights that stimulate inventive and creative activities.²⁷⁸ The other reasons why business is interested in upholding the system of national exhaustion relate to the need to maintain quality control, brand reputation and product safety.

Effects on research and development

The monopoly granted to IPR holders lets them recover R&D costs and gain profit as an incentive for future inventive activity. Thus lower prices and reduction in profits would in the long term limit incentives for further innovation, slowing down technical progress and product development. Development of new medicines usually involves significant investment. If prices were set equal to, or even below, the marginal cost of production, the pharmaceutical companies would not be able to recover their investments, the economic incentives for R&D would disappear and fewer drugs would be developed.²⁷⁹

Moreover, exporters engaged in parallel trade do not have to undertake the significant investment costs of developing new medicines and contribute little to dynamic drug introduction. Their form of competition usually aims at drugs that have proven to be successful, and their only focus is on price markups.

If parallel trade is permitted under a compulsory license arrangement, this will not only deny the licensor some profit in the foreign market but also deny him profit in his home market where he enjoys patent protection. The practical consequence will again be reduction of investment in research for products that might be subject to compulsory license.

Free-riding

Another concern of manufacturers is that parallel trade would make it possible to free ride on the investment, marketing and service costs of authorized distributors. These distributors incur costs in building their territorial markets through advertising, discounting, and post-sale service maintenance. These costs are likely to be quite significant in the area of prescription pharmaceuticals. To earn a return on those

²⁷⁸ Id.

²⁷⁹ Maskus, fn, 272, p. 23.

investments, they must charge a price markup over marginal procurement costs. Such enterprises would prefer to be protected from competition from parallel importers, who simply can buy the goods abroad without incurring similar costs. This is the primary motivation for permitting privately contracted exclusive territories in the first place. But as was pointed out earlier, enforcement of vertical restraints in developing countries could often be problematic.²⁸⁰

Quality and different standards

Segmentation of markets may protect investments in marketing as well as services that may be associated with the sale of certain goods before and after sales. Parallel importers may not provide these services. It could be argued that such services can be provided independently of the product, though the authorized dealer often offers sales-support activities. Territorial sales restraints are therefore in the interest of consumers, since the threat of parallel imports leads firms to relinquish any marketing and sales-support activities. At the same time, this argument is only relevant if support services have territorial application, and many companies now offer worldwide support.

Second, parallel imports from different territories may differ in quality from goods sold through official distribution channels, and this may result in the deception of consumers. This is often the case when the trademark owner supplies different markets with products of different quality, but sells them under the same trademark. On the other hand, if adequate information is provided, parallel imports of different quality may actually increase the choice of consumers and thus be beneficial.

3.4. Political perspective

The political perspective on international exhaustion reflects the position of governments and international organizations regarding the exercise of IP rights. There are two major aspects here. First, the so called moral aspect relates to the obligations of developed countries to reduce poverty and improve access to – often patented - medicines in

²⁸⁰ Id.

view of, for example, the HIV/AIDS crisis in poor nations. The other important aspect concerns the need to protect the welfare of richer countries and the long-term technological development that might be hindered by parallel trade. Thus, in their policy-making, governments must take into account both the short- and long-term economic effects of their chosen exhaustion regime.

A solution to the health crisis?

In 2002, 42 million adults and five million children suffered from HIV and AIDS and 95% of those people lived in developing countries. This health crisis influences the economic growth of these countries by significantly reducing the health status and the productivity of the affected population.²⁸¹ The fiscal cost of the disease is also significant; for example, the estimated cost of treatment in 2005 was 0,9% of South Africa's and Botswana's GDP and 6,5% for Malawi's.²⁸² According to the WHO, 74% of AIDS medicines are still under monopoly (patents) and 77% of the African victims still have no access to AIDS treatment.²⁸³ To make the drugs more affordable (both under international ethical pressure and the possibility of compulsory licensing) many pharmaceutical firms have reduced their prices for HIV/AIDS treatments in poor African countries and have sold them at or even below marginal costs. Even though the proposed prices are many times lower than in developed countries, the cost burdens of these drugs in relative terms might for a developing country be similar to or higher than those of a developed.²⁸⁴

²⁸¹ Economic studies suggest that by 2010, the South African GDP might be 17 percent lower than it would be without AIDS, removing \$22 billion in output from the economy. In Botswana, there could be a 13-15 percent reduction in the income of the poorest households. *Ganslandt, M., Maskus K. E. and Wong, E. V.*, Developing and Distributing Essential Medicines to Poor Countries: The DEFEND Proposal, Working Paper No. 552, 2001, Research Institute of Industrial Economics.

²⁸² Access to Essential Drugs: Kenya, South Africa and Botswana, Botswana, South Africa, The U.S. and Canada, Brazil, Nigeria, Developing World Bioethics 2 (1), 2002 1-4.

²⁸³ Investing in a comprehensive health sector response to HIV/AIDS: Scaling up treatment and accelerating prevention" (WHO HIV/AIDS plan, January 2004 - December 2005), http://www.who.int/3by5/en/HIV_AIDSplan.pdf.

²⁸⁴ *Ganslandt, Maskus and Wong*, fn 281, p. 10.

On 20 June 2001, a group of developing countries submitted a proposal to the TRIPS Council for a special discussion on IP and access to medicines.²⁸⁵ In this proposal, the developing countries affirmed the importance of Article 6 as an instrument for health policies and considered that Article 6 should be implemented in such a way as to ensure the broadest flexibility for Members to resort to parallel imports.

Developing countries, especially least-developed countries and smaller economies, underline the significance of parallel importation as a way of increasing access to medications, where the prices charged by patent holders for their products are unaffordable or where there is no local manufacturing capacity. Developing countries claim that international exhaustion of rights could even have the effect of increasing competition on domestic markets. Pharmaceutical markets in developing countries are often of monopolistic or oligopolistic character and the manufacturer can either limit the volume of medicines for sale or establish excessively high prices. Allowing parallel trade may be beneficial to prevent anticompetitive practices on behalf of patent owners. Where the prices of pharmaceutical products are lower in a foreign market, authorities may permit importation of such products into the national market to allow drugs to be sold at more affordable prices. Patent owners would only compete with other legitimate products. Following such considerations, many African countries adopted legislation, in line with TRIPS provisions, which permits parallel importation of drugs from other countries.

State policy in developed countries

The reduced prices discussed above cause a leak of cheap medicines from poor countries into the high-price markets of developed states. For example, the European authorities have repeatedly uncovered large quantities of medical products destined for Africa being sold in the EU. The Council Regulation to avoid trade diversion into the EU of certain key medicines provides a limited solution to the problem of re-importation of cheap medicines from low-income countries by prohibiting the re-importation of such products into the Community.²⁸⁶ In the U.S., state authorities has retained strict national

²⁸⁵ TRIPS and Public Health, IP/C/W/296, 19 June 2001,

http://www.wto.org/English/tratop_e/trips_e/paper_develop_w296_e.htm

²⁸⁶ Council Regulation (EC) No 953/2003 to avoid trade diversion into the European Union of certain key medicines, OJ L 135, 3.6.2003 p. 5 -11.

requirements regarding approval of drugs for sale on the U.S. market and has significantly restricted parallel imports under the Federal Food, Drug and Cosmetic Act. Along with that, there have been several on-going initiatives to allow parallel importation of drugs from Canada and some other developed countries. Such legislation was passed in 2006 by Congress but vetoed by the President.²⁸⁷

Consumer protection is another concern of governments in high-income states. The issue is often cited as a reason to ban parallel imports, especially in cases of trademark protection and in relation to highly regulated goods. There have been several counter-arguments to this claim. For example, in the OECD-led discussion on the issue, Sweden and Consumers International argued that policy makers should trust consumers in making their own choices.²⁸⁸ However, they agreed that this would require keeping consumers well informed about the origin and quality of products. One way to reach such goal could be a system of distinctive labeling indicating the origin of goods. This would to some extent resolve the problems arising from the need to customize products in order to satisfy local tastes and preferences.

Governments must also consider employment effects when assessing the impact of international exhaustion on national economic welfare. Employment effects may be of particular interest to states where the concentration of businesses engaged in work leading to IPRs or in exploiting existing IPRs, is rather high.²⁸⁹

3.5. Conclusion

International exhaustion rules inevitably interfere with the exclusive market position granted by the monopoly rights created by IP. States should cooperate to create a regime which balances IPRs, free movement and competition, taking the needs of developing countries into account. Excessive IP protection may harm consumers, while insufficient IP protection might lead to loss of economic welfare.

²⁸⁷ See the Consumer Project on Technology, <http://www.cptech.org/ip/fsd/health-pi-us.html>.

²⁸⁸ Executive summary of the discussion on international exhaustion, OECD Joint Group on Trade and Competition, COM/daffe/comp/td(2001)91/final.

²⁸⁹ Id.

Access to medicines - policy proposals

The optimal solution to the problem of ensuring mutually beneficial global access to medicines requires a combination of the efforts of generic drug producers, governments and international organizations on national, regional and international levels.

It would be possible, under the TRIPS compulsory licensing rules, to allow developing countries having manufacturing capacity to produce local versions of medicines and resell them to developing countries. This will increase competition, improve access to medicines and contribute to the national welfare of the developing countries. Along with that, local manufacturing will be an additional incentive for governments to improve both IP and competition legislation and its enforcement, and prevent the flow of counterfeit medicines.

Another possibility could be a policy combining public purchase of patent rights in target countries and a provision of medicines at very low cost. A proposal exists whereby a public international organization would purchase the license rights for designated areas and distribute drugs at low cost with a required co-payment from local governments. Costs would be funded mainly by increased foreign assistance from the developed nations, but these costs would be low in relation to current aid budgets.²⁹⁰ Alternatively, governments of developed countries could purchase the license rights at market prices and then re-distribute the drugs cheaply to developing nations. Equally important, there must be strict controls on parallel exports of these drugs out of the target states as well as controls of parallel imports of these drugs into rich nations. Such trade restraints would be necessary to support the locally beneficial price discrimination in this case.²⁹¹

Along with that, national governments would have to improve legislation on the protection of rights, as well as the enforcement of parallel export bans and the prevention of counterfeiting. Developing countries must be encouraged to participate in efforts to prevent illegal movements of drugs across borders and ensure that drugs priced for their consumers do not leave their countries. This could be accomplished in a variety of ways, including distinctive packaging.²⁹²

²⁹⁰ *Ganslandt, Maskus and Wong*, fn 281, p.10.

²⁹¹ *Maskus*, fn 272.

²⁹² *Lanjouw, J. O.*, A Patent Policy Proposal for Global Diseases, June 2001, <http://www.brookings.edu/comm/policybriefs/pb84.htm>.

Different exhaustion regimes for different IPRs

Due to the different nature of IPRs, where some of them involve significant R&D investment, the solution could be to favour a wider exhaustion principle for trademarks - which involve less R&D - while leaving in place the restrictions on patented and copyrighted goods.²⁹³ The use of trademarks can still be regulated through private means, such as exclusive distributor agreements. Such an approach needs care as many goods are protected by several types of IPRs at the same time.

Moreover, allowing parallel importation of patented goods may depend on the nature of the commodity in question, specific market features and political circumstances. For instance, parallel importation of medicines that are governmentally subsidized may significantly worsen the welfare of the importing country. At the same time, parallel importation of cheap generics between developing countries may be permitted in order to secure access to medicines.

Territorial scope of exhaustion

Current analysis suggests that the maximization of national welfare might be balanced with the interests of manufacturers by limiting exhaustion to regional trade agreements rather than applying it internationally. Such an approach would ensure that low-income markets are served at accessible prices and that the interests of manufacturers in recovering R&D costs are not impaired. Moreover, the proposed approach, combined with assistance regarding the establishment of local drug manufacturing in developing countries, would partially address the problems of access to medicines in the poorest nations. This would provide access to cheap generics for countries with no manufacturing capacity and increase the welfare of such states with production capacity. However, such a model needs to ensure that the generics did not leak back to the developed countries.

²⁹³ Prior the adoption of the principle of Community exhaustion of trademarks, Finland applied international exhaustion of trademarks without extending the principle to other IPR. It reported that it experienced no particular problems concerning this differentiation. See <http://www.aippi.org/reports/q156/gr-q156-Finland-e.htm>

4. EXHAUSTION & COMPETITION

BY NATALIA ŁAWNICZAK & OLGA ALFER

The previous chapters have provided analyses of the relations between IPR and free movement rules from three different perspectives: European, U.S. and global. This chapter focuses on the competition perspective. As will be shown, right holders who react to parallel trade may find themselves restricted by the relevant competition rules.

4.1. EU perspective

The competition provisions of the Treaty cannot be interpreted in isolation from the main objectives of the Community, among them the creation of a single market. The significance of the market integration objective has clearly been a strong incentive for the European Commission to apply an unusually broad interpretation of the concept of “agreement” under Article 81 EC. One consequence is that the distinction between unilateral conduct and unlawful anti-competitive agreements has become appreciably less well-defined. However, in the light of recent judgments, we can observe a shift and a growing interest in economic theory: the holder’s economic and commercial interests now play an important role and can to a degree be invoked as justification for anti-competitive agreements.

Dual pricing

Dual pricing means that higher prices are imposed on wholesalers in respect of products which are to be exported than on products which are to be sold on the purchaser’s market. In *Glaxo Wellcome*, the company introduced such conditions and subsequently notified them to

the Commission, seeking confirmation that the conditions fell outside the scope of Article 81(1) or were within the Article 81(3) exemption. The Commission found that the new sales conditions would restrict competition under Article 81(1) and did not meet the conditions for an exemption.²⁹⁴ The CFI stated that the application of rules on dual pricing, even if falling within the scope of Article 81(1), may be justified under Article 81(3). The Commission had not sufficiently justified its conclusion. Parallel trade could lead to efficiency by altering Glaxo's capacity for innovation and the conditions could thus provide an efficiency gain.²⁹⁵

Refusal to supply

Refusal to supply means that a company refuses to supply distributors with more than is sufficient for their national markets. The Commission decided in *Bayer AG* that this type of behaviour constituted an agreement with all relevant distributors and was in breach of Article 81.²⁹⁶ However, the CFI held that there was no evidence that Bayer had asked its distributors not to export or that it monitored the final destination of products supplied to them. It was *de facto* a unilateral conduct. The judgment confirmed that manufacturers can legitimately restrict parallel imports under Article 81 as long as they act unilaterally and avoid entering into an agreement or a concerted practice.²⁹⁷ *Syfait* raised the issue of refusal to supply by a dominant manufacturer.²⁹⁸ The Advocate General concluded: "a restriction of supply by a dominant pharmaceutical undertaking in order to limit parallel trade is capable of justification as a reasonable and proportionate measure in defence of that undertaking's commercial interests".²⁹⁹ Unfortunately the ECJ held that it did not have jurisdiction to rule and so the question remains open.

²⁹⁴ Commission Decision, 2001/791/EC, OJ L 302. 17.11.2001, p. 1-43.

²⁹⁵ Case T-168/01, *GlaxoSmithKline*, fn 253.

²⁹⁶ Commission Decision 96/478/EC, OJ L 201, 9.8.1996, p. 1-81.

²⁹⁷ Case T-41/96, *Bayer AG v Commission*, [2000] ECR II-3383.

²⁹⁸ Case C-53/03, *Synetairismos Farmakopoion Aitolias & Akarnanias (Syfait) and Others v GlaxoSmithKline plc and GlaxoSmithKline AEVE*, [2005] ECR I-4609.

²⁹⁹ *Id*, Advocate General's opinion, para 100.

Withdrawal of marketing rights

In order to sell medicines, both the owner and the parallel importer need a marketing authorization in each country in which the product is sold. Public authorities are not allowed to terminate the validity of the license if protection of public health is not endangered.³⁰⁰ The cessation of the authorization may, however, be requested by the right holder.

In *Paranova Läkemedel* such a withdrawal covered not only products sold by the trademark holder, but also products imported through parallel trade. The ECJ stated that the holder's withdrawal of the marketing authorization does not entail a withdrawal of the parallel import license granted for the medicinal product in question, when this product is still lawfully sold on the market of the importing Member State, unless there is a risk to the health of humans.³⁰¹ In the same spirit, the Commission attacked *AstraZeneca* for misusing its marketing authorization and blocking market access for parallel imported medicines. AstraZeneca's surrender of market authorization for an old product and simultaneous launch of a new but similar product constituted an abuse of a dominant position.³⁰² The purpose of a market authorization was regarded as the right to sell a medicine, and not to exclude competitors.

4.2. U.S. & International models

As stated in chapter 3 above, the first sale doctrine applies in U.S. law in a way that is often comparable to the European exhaustion doctrine. However, a U.S. patent owner may prevent exhaustion of its patent rights by contractually imposing geographical restrictions on resale with words such as "Importation into the U.S. is prohibited" or "This product is licensed for use and resale only in [the country of initial sale]". In contrast to the EC competition law, these practices are accepted under U.S. antitrust law.

³⁰⁰ Case C-172/00, *Ferring Arzneimittel GmbH v Eurim-Pharm Arzneimittel GmbH*, [2002] ECR I-6891, para 33.

³⁰¹ Case C-15/01, *Paranova Läkemedel AB v Läkemedelsverket*, [2003] ECR I-4175.

³⁰² Commission Decision, 2006/857/EC, OJ L 332, 30.11.2006, p. 24–25.

When assessing international exhaustion and free movement in a competition context, reality and widely-varying political and economic conditions market structures must be taken into account. Differing market structures, as well as distinct law enforcement and social frameworks may create an obstacle to free worldwide trade and fair competition. It does not seem possible to justify international exhaustion on a global level from a competition perspective, since the global community lacks defined structural and regulatory goals, commitment to free movement of people and capital, and a globally defined competition policy. In this light it would be more reasonable to suppose that parallel trade itself would increase competition within regions with sufficient level of social, economic and legal development.

In 2001 only 87 out of 142 WTO members had competition rules embodied in their legislation. Most developing countries would find it difficult to establish effective competition laws because of weak enforcement capabilities. The market structures in most developing states have a monopolistic or oligopolistic character and are historically characterized by a high degree of state intervention.³⁰³ Adoption of national exhaustion regimes may result in further market segmentation between the developing states, which would have an adverse effect on their welfare. Alternatively, permitting international exhaustion seems impossible but regional trade agreements would facilitate competition.

The EU authorities have recognized the urgent need of access to affordable essential medicines for treatment of communicable diseases in the poorest developing countries.³⁰⁴ The Regulation to avoid trade diversion into the EU of certain key medicines prohibits re-importation of such lower priced products into the Community.³⁰⁵ The importation of pharmaceuticals is also restricted under U.S. law.³⁰⁶ Unless for

³⁰³ The Role of "Special And Differential Treatment" at the Trade, Competition and Development Interface, OECD Joint Group on Trade and Competition, COM/TD/DAFFE/CLP(2001)21/FINAL.

³⁰⁴ Council Regulation (EC) No 953/2003 to avoid trade diversion into the European Union of certain key medicines OJ L 135, 3.6.2003, p. 5-11.

³⁰⁵ *Atik, J. and Lidgard, H.H.*, Embracing price discrimination: TRIPS and the suppression of parallel trade in pharmaceuticals, University of Pennsylvania Journal of International Economic Law, Vol. 27, p. 1043, 2006, pp. 1073-1075.

³⁰⁶ *Moore, J. A.*, Parallel Trade, Unparallel Laws: An Examination Of The Pharmaceutical Parallel Trade Laws Of The United States, The European Union

personal use, no prescription drugs can be imported into the U.S. without being in full compliance with the requirements the Food and Drug Administration (FDA) asks of any medicine.³⁰⁷ Even if the manufacturer has a FDA approval for a drug, the version produced for foreign markets usually does not meet all of the requirements of the U.S. approval, and is thus going to be unapproved.³⁰⁸ U.S. policy-makers examined the possibility of lowering the current barriers to importation of prescription drugs in 2000, but nothing was ever passed.³⁰⁹

And The World Trade Organization, *Richmond Journal of Global Law and Business*, 2006.

³⁰⁷ Federal Food, Drug, and Cosmetic Act, 21 U.S.C. 331(d), 355(a).

³⁰⁸ *Liang, B. A.*, Parallel trade in pharmaceuticals: injecting the counterfeit element into public health, *North Carolina Journal of International Law and Commercial Regulation*, Inc, 2006, pp. 859-865.

³⁰⁹ Federal Food, Drug and Cosmetic Act, 21 U.S.C. 384. The amendment would permit the importation of prescription drugs into the US, provided that the Secretary of Health and Human Services certified that such importation would not present safety problems and would result in savings to U.S. consumers.

IPR, Parallel Trade and Competition Joint Conclusion

Over the course of development of the WTO rules, the countries of the world have sought to find the balance between IPR, free movement and competition. Their failure to come to a common agreement regarding the balance between them has resulted in debates over exhaustion models and compulsory licensing remedies. Disagreements regarding exhaustion regimes largely due relate to differences in development and policy goals. Developing countries advocate the principle of international exhaustion while high-income states have feared that this would harm their national welfare, state policies and long-term technology development. Businesses have had their own concerns regarding recovering R&D costs and securing profit, especially in high-investment areas such as pharmaceuticals. Manufacturers and distributors argue that they should be able to control the use of their trademarks and that parallel imports diminish their value and provide unfair competition, with competitors “free-riding” on their marketing and advertising expenditures.

The EU is committed to the free movement of goods and sees parallel trade within the Community as necessary for the attainment of a single market. At the same time, it does not allow parallel imports from outside the community. The U.S. approach is more cautious: they interpret strict national exhaustion rules very broadly, but this creates significant obstacles to parallel importation in many cases. These policies of give rise to barriers to international imports and conflict with the notion of competition on global markets. Dual pricing and refusals to sell and license invariably create competition policy concerns when the activity is combined with IPR.

International exhaustion for any type of IPR is currently not implementable due to different market structures and the specific needs of developing countries. A balance between the restriction of parallel

trade - called for by political and economic reasons - and the promotion of competition, can better be found by applying the principle of regional exhaustion within trade agreements. This would consolidate states with similar social, economic and legal levels of development. Parallel trade within such regions would also encourage competition between the Member States. On the other hand, the market segmentation produced by such agreements would allow governments to achieve certain political goals such as assisting developing countries through securing the sale of goods there at lower prices.

III. Antitrust Restrictions in License Agreements

Though once assumed to be necessarily at odds, IP law and competition law are, as we have seen above, now thought to share a common purpose: the protection and promotion both innovation and competition. Among the most significant areas where these areas of law intersect is the field of IPR licensing.

Many companies presently rely on the licensing-out of IPRs to generate revenue and in-license IPRs as a way of entering new markets.³¹⁰ While these relationships are often pro-competitive, antitrust concerns may arise in such commercial dealings.³¹¹ It is necessary to ensure that a careful balance is struck between allowing licensing which promotes innovation on the one hand and preventing a licensor from unfairly stifling competition on the other.

Because IPR licensing is likely to involve multi-national parties, the analysis of license agreements under antitrust law is an issue of international importance. Despite the fact that divergent national policies have the potential to disrupt cross-border commerce, an international consensus has yet to be reached in regard to what principles should apply in evaluating the competitive impact of the manner in which IPRs are exploited or transferred.³¹²

The following chapters discuss the antitrust analysis of IPR license agreements from both the American and European perspectives with a

³¹⁰ Quest, B., The growing importance of licensing, Nov 2000; available at <http://scientific.thomson.com/free/ipmatters/ipmanage/8204381>

³¹¹ *Gordon, G.*, Analyzing IP License Restrictions under the Antitrust Laws: A General Outline of Issues; available at <http://www.dechert.com/library/Analyzing%20IP%20License%20-%20GGordon%205-02.PDF>.

³¹² *Abbot, A.*, Intellectual Property Licensing and Antitrust Policy: A Comparative Perspective; available at <http://www.questia.com/PM.qst?a=o&d=5002110757>.

particular focus on restrictions in license agreements. The first chapter compares the European TTBER (2004) and corresponding TTBERG (2004) to the U.S. IP (1995) Guidelines. The remaining chapters focus on the treatment of restrictions on license agreements, again comparing the American and European approaches. Chapters 2 and 3 examine price-fixing and market allocation, respectively, as examples of the treatment of hardcore/*per se* restrictions. Chapter 4 explores the issue of grant-back provisions. The Conclusion considers whether either the EU or the U.S. has reached a balance between competition law and IP law in regard to IPR licensing.

1. THE ANTITRUST ANALYSIS OF IPR LICENSE AGREEMENTS UNDER EU AND U.S. LAW

BY MICHAELA ZABBO

The laws of IP give rise to a situation where the right to exclude others from exploiting the protected subject matter is granted. The holder of an IPR may however choose to license out the protected matter. Though competition and innovation are generally fostered through IPR licensing, some agreements are aimed at raising prices or at excluding competitors from the market. Arrangements of this nature tend to suppress competition and raise antitrust concerns. The antitrust evaluation of IPR licensing serves to ensure that power acquired through IP law is not abused in such a way that it disrupts optimal levels of production and consumption.³¹³ This must be carried out in such a way that property rights are not stripped from inventors at the expense of antitrust policies but IP owners are not allowed to stifle competition in the name of IP law. The challenge in doing so, however, is determining what differentiates the legitimate exercise of IP rights from conduct that goes too far in constraining competition.³¹⁴

The aim of this chapter is to explore the current European and American positions on analyzing IPR license agreements under

³¹³ *Kaiser, H.*, Antitrust Issues in Licensing: A Brief Introduction to the Interface Between Antitrust and Intellectual Property, Practising Law Institute, Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series, Oct.-Dec. 2006.

³¹⁴ *Delrahim, M.*, US and EU Approaches to the Antitrust Analysis of Intellectual Property Licensing: Observations from the Enforcement Perspective, Remarks by Makan Delrahim, Deputy Assistant Attorney General Antitrust Division, U.S. Department of Justice, Presented at American Bar Association, Section of Antitrust Law Spring Meeting, Washington, D.C., April 1, 2004.

antitrust law. The European TTBER (2004) and the U.S. IP (1995) Guidelines and relevant case law is also examined.

1.1. EC Block Exemption & Guidelines

The European Commission first adopted its Technology Transfer Block Exemption Regulation in 1996.³¹⁵ This version of the regulation focused heavily on a structural approach to examining technology license agreements i.e. certain types of provision were always prohibited, while others were white-listed. The impact of such terms would not be taken into account. The 2004 revision and the accompanying TTBER (2004) move away from the structural approach towards an economic effects-based model.³¹⁶

The Role of Article 81 of the EC Treaty

Article 81(1) of the EC Treaty prohibits agreements that “have as their object or effect the prevention, restriction or distortion of competition within the common market.” Article 81(3) of the EC Treaty then provides that even if an agreement falls within the criteria set out in Article 81(1), the agreement may be valid if in fact it contributes to improving the production or distribution of goods or to promoting technical or economic progress while allowing consumers a fair share of the resulting profits.³¹⁷ Furthermore, under the *de minimis* doctrine, an agreement is not blocked by Article 81(1) EC if it does not have an appreciable impact on competition or inter-state trade.³¹⁸ This

³¹⁵ *Lidgard, H. H., Atik, J.*, IPR and Technology Transfer: Reading Material, Spring 2007, at p. 226.

³¹⁶ *Delrahim, M.*, International Antitrust and Intellectual Property: Challenges on the Road to Convergence, Remarks by Makan Delrahim, Deputy Assistant Attorney General Antitrust Division, U.S. Department of Justice, Presented at the American Bar Association, Section of Antitrust Law Conference on Antitrust & Intellectual Property: the Courts, the Enforcers, and the Business World, San Francisco, California, May 21, 2004.

³¹⁷ Article 81(3) of the EC Treaty

Craig P. & De Burca G., EU Law, Oxford University Press, 2003 p. 963.

rule presumes that an agreement between parties with a market share of less than ten percent for actual or potential competitors and a market share of less than fifteen percent for non-competitors, does not appreciably restrict competition.³¹⁹ However, the inclusion of a hardcore restriction in any such agreement renders this benefit void.³²⁰

The application of Article 81 EC in assessing IP license agreements is outlined in the TTBER (2004).³²¹ Paragraph 8 states, “in the assessment of license agreements under Article 81 it must be kept in mind that the creation of intellectual property rights often entails substantial investment and that it is often a risky endeavor. In order not to reduce dynamic competition and to maintain the incentive to innovate, the innovator must not be unduly restricted in the exploitation of intellectual property rights that turn out to be valuable.”³²²

EC Technology Transfer Block Exemption Regulation

The TTBER (2004) applies to technology license agreements between two undertakings for the manufacture or provision of goods or services incorporating the licensed technology. Pure research and development agreements are not covered and multi-party agreements are also excluded from the exemption.³²³ Only those arrangements involving patents, know-how, software copyright licensing and/or a combination licensing of these particular IPRs are covered under the regulation.³²⁴ Trademark and copyright licensing are covered only if they are licensed as ancillary to a patent, know-how or software copyright license agreement.³²⁵

³¹⁹ *Id.*, p. 963.

³²⁰ *Id.*, p. 964.

³²¹ Commission Notice: Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements (2004/C 101/02), Official Journal C 101, 27/04/2004 P.2-42.

³²² *Id.*

³²³ *Fullwood, L., Kerr, L.*, Guide to The Technology Transfer Block Exemption; available at: <http://www.out-law.com/page-7091>.

³²⁴ Commission Regulation (EC) No 772/2004 of 27 April 2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements, Official Journal L 123, 27/04/2004 P. 11-17, Article 1(1)(b).

³²⁵ *van Weert, W., Ragolle, F.*, The New EU Technology Licensing Rules, available at: <http://www.les-benelux.org/level1/news/ttber.pdf>.

An important feature in the TTBER (2004) is that agreements involving competitors are treated differently to those involving non-competitors.³²⁶ Non-competitors enjoy a more liberal approach than competitors and the classification, which remains in force for the duration of the agreement regardless of a status change, must be made at the time the parties enter into the license agreement.³²⁷ The test for determining whether parties to an agreement are competitors turns upon whether, in the absence of the agreement, the parties would have been actual or potential competitors. Parties will be deemed to be non-competitors if: (1) without the agreement the parties would not have been actual or potential competitors in any relevant market, (2) the parties own blocking technology that either cannot be exploited without infringing on another technology or neither technology owned can be exploited without infringing upon the other technology blocking position, or (3) one of the parties owns breakthrough technology that renders the technology of the licensee obsolete or uncompetitive (in most instances).³²⁸ Conversely, if the parties are both active on the same product or technology market, the parties will be deemed to be competitors.

So long as the licensed intellectual property rights have not lapsed, expired or been declared invalid or, in the case of a know-how license, remain confidential, the agreement enjoys the protection of the block exemption. Should the know-how become public knowledge through fault of the licensee, the block exemption continues to apply for the term of the agreement.³²⁹

The Safe Harbour and Market Share Ceilings

Under TTBER (2004), agreements are exempted from antitrust liability under Article 81 EC, so long as the parties to the agreement do not exceed the market-share thresholds specified in Article 3 of the Regulation and the agreements do not contain any of the hardcore restrictions described in Article 4. In other words, agreements in line with Article 3 and Article 4 of TTBER (2004) are exempted from the prohibition rule of Article 81(1) EC and are automatically valid and

³²⁶ Id.

³²⁷ *Fullwood, L., Kerr, L.*, fn 323.

³²⁸ *Dubois, P.-A.*, 'Technology licensing and competition policy in Europe; available at: http://www.buildingipvalue.com/06EU/167_171.htm.

³²⁹ Id.

enforceable.³³⁰ On the other hand, if the parties do not qualify under the block exemption or if the agreement contains provisions prohibited by it, the legality of the agreement must be scrutinised under Article 81(1) and (3).³³¹

An agreement between competitors will be valid under the block exemption if the combined market share of the parties does not exceed 20 percent on the affected relevant technology and product markets.³³² As between non-competitors, an agreement will be exempted so long as the market share of each party does not exceed 30 percent of the affected relevant technology and product market.³³³

The market share test is an ongoing evaluation. If a relevant market share threshold is exceeded, the benefit of the block exemption expires two calendar years from the year in which the threshold was first exceeded.³³⁴ This means that licensing parties must monitor their relative market shares on a continual basis and consider whether the agreement could be defended under Article 81(3) EC if the benefit of the block exemption is lost.³³⁵

Hardcore Restrictions

An agreement that contains any of the hardcore restrictions listed in Article 4 will not be exempted from antitrust liability under Article 81 EC. Furthermore, even when included in an agreement that otherwise falls outside the scope of the block exemption, the inclusion of any hardcore restriction will create a presumption that the agreement is anti-competitive and thus will not be defensible under Article 81(3) EC. Hardcore restrictions will not be regarded as severable even if the agreement contains a severability clause.³³⁶

The list of hardcore restrictions differs according to whether the agreement in question is between competitors or non-competitors. Non-competitors are permitted more leeway given that there is a lower likelihood of their contractual provisions having an adverse affect on

³³⁰ *van Weert, W., Ragolle, F.*, fn 325.

³³¹ *Dubois, P-A.*, fn 328.

³³² TTBER (2004), fn 324, Article 3.

³³³ *Id.*

³³⁴ *Fullwood, L., Kerr, L.*, fn 323.

³³⁵ *Dubois, P-A.*, fn 328.

³³⁶ *Id.*

competition.³³⁷ The hardcore restrictions for competitors include: restricting a party's ability to determine prices when selling to a third party (resale price maintenance); reciprocal output/production caps; restricting the licensee's ability to exploit its own technology or carry out further research and development and certain allocation of markets or customers between parties (subject to a fairly complex set of exceptions). For non-competitors, the hardcore restrictions also include resale price maintenance as well as certain restrictions on passive sales and restrictions on sales to end users through selective distribution systems.³³⁸

Excluded Restrictions

In addition to hardcore restrictions, the block exemption also defines excluded restrictions.³³⁹ These restrictions are not prohibited and do not prevent the application of the block exemption, but their inclusion in an agreement forces the parties to have the agreement assessed under Article 81(3) EC. Unlike hardcore restrictions, excluded restrictions will not affect the validity of an agreement provided that they can be severed from the rest of the agreement.³⁴⁰ The major excluded restrictions include grant-back clauses, no challenge clauses and restrictions on use of technology.³⁴¹

Other Typical Restrictions

The TTBER (2004) is silent on many other types of provisions typically found in license agreements. These restrictions include tying and bundling obligations, non-compete restrictions and post-termination royalty obligations. The TTBER (2004) stipulate that these types of obligations will be permitted under the block exemption on condition that they can otherwise be justified from the perspective of competition analysis.³⁴²

³³⁷ *Fullwood, L., Kerr, L.*, fn 323.

³³⁸ TTBER (2004), fn 324, Article 4.

³³⁹ *Id.*, Article 5.

³⁴⁰ *Dubois, P.-A.*, fn 328.

³⁴¹ TTBER (2004), fn 324, Article 5.

³⁴² *Dubois, P.-A.*, fn 328.

Case Law

There is no judgment under EC law that explicitly deals with a pure licensing situation.³⁴³ In the case of *Windsurfing International Inc. v. EC Commission*, however, the ECJ indicated how it will determine whether licensing terms infringe Article 81 EC.³⁴⁴

The *Windsurfing* case involved conditions set by the patent owner in its license agreements for a particular rig used in conjunction with a windsurfer. Windsurfing International only owned the patent for the rig yet it imposed conditions on licensees relating to quality control, tying, licensed-by notices, and no-challenge clauses. As these conditions did not relate to the specific subject matter of the rig patent, the ECJ found that the protection of Article 81 did not apply.³⁴⁵

The key factor for determining if an agreement term might fall within Article 81 is whether it relates to the specific subject matter of the IPR being licensed; if it does not the term will be condemned. Such terms will only stand if they can be exempted under Article 81(3) EC or a block exemption.³⁴⁶

1.2. U.S. IP (1995) Guidelines

The U.S. antitrust laws were enacted with the purpose of promoting competition and protecting the public from unfair and predatory trade practices.³⁴⁷

As earlier mentioned in this book, the Federal Trade Commission (FTC) and Department of Justice (DOJ), on April 6, 1995, jointly issued the IP (1995) Guidelines defining the antitrust enforcement policy pertaining to both domestic and international licensing of IP protected by patents, copyrights, trade secrets and know-how.

³⁴³ Lidgard, H. H., Atik, J., fn 315, p. 225.

³⁴⁴ Case 193/83, *Windsurfing International Inc. v Commission*, February 25 1986, [1986] ECR 611

³⁴⁵ Craig, P & de Burca, G., fn 318, p. 1114.

³⁴⁶ Id.

³⁴⁷ *McTamaney, R.*, United States Antitrust Guideline; available at: <http://www.clm.com/publication.cfm/ID/11>.

Trademark rights are not included in the IP (1995) Guidelines.³⁴⁸ Although the IP (1995) Guidelines are not law and are in no way binding on the courts, they set forth the antitrust enforcement policies of the FTC and DOJ and should be considered by businesses when structuring licensing arrangements.³⁴⁹

The IP (1995) Guidelines embody three basic principles. First, IP is analogous to any other form of property, and hence, the same general antitrust principles apply, though important distinctions are recognized by the authorities, i.e. that IP is easily misappropriated. Second, IPRs are not presumed to create market power in the antitrust context. Third, IP licensing is generally considered to be pro-competitive.³⁵⁰

Rule of Reason Analysis

The approach to evaluating license agreements outlined in the IP (1995) Guidelines mandates that “in the vast majority of cases” the actual economic effects of a license be measured; a mere assessment of the terms of an agreement is unacceptable.³⁵¹ Under this system, a “rule of reason” is used to determine whether a provision within a license agreement is likely to have anticompetitive effects and, if so, whether that provision is reasonably necessary to achieve competitive benefits that outweigh the anticompetitive effects.³⁵²

³⁴⁸ 1995 US Antitrust Guidelines for the Licensing of Intellectual Property, issued by the US Department of Justice and the Federal Trade Commission, April 6, 1995.

³⁴⁹ Weinschel, A., Antitrust Issues in Licensing Intellectual Property, Practising Law Institute, Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series, PLI Order No. 8816, June, 2006.

³⁵⁰ IP (1995) Guidelines, fn 348, §2; The Biojudiciary Project, Antitrust Law, 2007, available at: <http://biojudiciary.org/subpage1.asp?tid=111>.

³⁵¹ Delrahim, M, US and EU Approaches to the Antitrust Analysis of Intellectual Property Licensing: Observations from the Enforcement Perspective, fn 314; IP (1995) Guidelines, fn 348, §3.4.

³⁵² IP (1995) Guidelines, fn 348, §3.4; See also: *Federal Trade Commission v. Indiana Federation of Dentists*, 476 U.S. 447 (1986); *NCAA v. Board of Regents of the University of Oklahoma*, 468 U.S. 85 (1984); *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979).

The existence of anticompetitive effects is dependent on whether the parties stand in a horizontal or vertical relationship and whether the arrangement involves exclusivity.³⁵³

For purposes of analysis under the IP (1995) Guidelines a horizontal relationship exists when the licensor and licensee “would have been actual or potential competitors in a relevant market in the absence of the license.” A vertical relationship is one in which the parties have a complementary relationship, for example, a product manufacturer and distributor.³⁵⁴ The IP (1995) Guidelines indicate that a horizontal arrangement is not necessarily anticompetitive and that a purely vertical relationship does not assure that no anticompetitive effects will occur as a result of the arrangement. Establishing the nature of the relationship of the licensing parties “is merely an aid in determining whether there may be anticompetitive effects arising from a licensing arrangement.”³⁵⁵

In regard to exclusivity, the IP (1995) Guidelines also provide that, “[g]enerally, an exclusive license may raise antitrust concerns only if the licensees themselves, or the licensor and its licensees, are in a horizontal relationship.” As to non-exclusive licenses, the IP (1995) Guidelines state, “a non-exclusive license of intellectual property that does not contain any restraints on the competitive conduct of the licensor or the licensee generally does not present antitrust concerns even if the parties to the license are in a horizontal relationship, because the non-exclusive license normally does not diminish competition that would occur in its absence.”³⁵⁶

Per Se Rule Analysis

Though the rule of reason is the preferred method of analysis, a *per se* rule is applied when the “nature and necessary effect [of a licensing arrangement is] plainly anticompetitive” and the agreement “lacks any efficiency-enhancing integration of economic activity ... Naked price-fixing, output restraints, and market division among horizontal competitors, as well as certain group boycotts and resale price

³⁵³ IP (1995) Guidelines, fn 348, §4.1.2.

³⁵⁴ *Id.*, §3.3.

³⁵⁵ *Id.*

³⁵⁶ *Id.*, §4.1.2.

maintenance” are specified in the IP (1995) Guidelines as plainly anticompetitive and thus per se unlawful.³⁵⁷

Analysis Within Markets Affected by Licensing Arrangements

Per §3.2 of the IP (1995) Guidelines, the competitive effect of a licensing arrangement is to be evaluated in three different markets: goods markets, technology markets, and innovation markets.³⁵⁸

A relevant goods market may be defined for final or intermediate goods made using the intellectual property or for goods used as inputs in concert with the intellectual property to produce other goods.³⁵⁹

“Technology markets consist of the intellectual property that is licensed (...) and its close substitutes--that is, the technologies or goods that are close enough substitutes significantly to constrain the exercise of market power with respect to the intellectual property that is licensed.”³⁶⁰ The IP (1995) Guidelines further specify that a technology market will be defined only when the intellectual property is marketed separately from the product in which it is used.³⁶¹

Because a “licensing arrangement may have competitive effects on innovation that cannot be adequately addressed through the analysis of goods or technology markets,”³⁶² the IP (1995) Guidelines also look to innovation markets. An innovation market encompasses the research and development aimed at developing new and/or improved goods or processes and the close substitutes for that research and development. Innovation markets are only defined when “the capabilities to engage in the relevant research and development can be associated with specialized assets or characteristics of specific firms.”³⁶³ In light of the fact that defining an innovation market and assigning market shares is difficult, the antitrust authorities will consider all relevant evidence,

³⁵⁷ *Weinschel, A.*, fn 349.

³⁵⁸ IP (1995) Guidelines, fn 348, §3.2.

³⁵⁹ *Weinschel, A.*, fn 349.

³⁶⁰ IP (1995) Guidelines, fn 348, §3.2.2.

³⁶¹ *Weinschel, A.*, fn 349.

³⁶² IP (1995) Guidelines, fn 348, §3.2.3.

³⁶³ *Id.*

including assessments by other market participants and research and development expenditures.³⁶⁴

The Antitrust “Safety Zone”

In accordance with the “safety zone” established in §4.3 of the IP (1995) Guidelines, certain licensing arrangements enjoy antitrust immunity. Save for extraordinary circumstances, a licensing arrangement will not be challenged so long as it (1) is not facially anticompetitive and (2) involves parties that collectively account for no more than twenty percent of each relevant market significantly affected by the restraint.³⁶⁵

However, the FTC and DOJ emphasize that a licensing arrangement is not anticompetitive merely because it falls outside the scope of the safety zone. In fact, they stress that “the great majority of licenses falling outside the safety zone are lawful and procompetitive.” It is further stressed in the IP (1995) Guidelines that the purpose of the safety zone is to provide IPR owners “with a degree of certainty in those situations in which anticompetitive effects are so unlikely that the arrangements may be presumed not to be anticompetitive without an inquiry into particular industry circumstances.”³⁶⁶

Case Law

The prevailing American point of view is that antitrust enforcement policies must be carefully designed so they do not interfere with or discourage the legitimate exploitation of IPRs through technology licensing, among other means.³⁶⁷ Furthermore, because the economic return that results from such licensing is what encourages innovation, the American stance is that antitrust law should only come into play when IPR owners go beyond the legitimate exercise of their IPRs.³⁶⁸

Judicial activity in the area of IP licensing has been sparse, but an example of the DOJ position can be found in the case of *United States*

³⁶⁴ *Weinschel, A.*, fn 349.

³⁶⁵ IP (1995) Guidelines, fn 348, §4.3.

³⁶⁶ *Id.*

³⁶⁷ *Delrahim, M.*, US and EU Approaches to the Antitrust Analysis of Intellectual Property Licensing: Observations from the Enforcement Perspective, fn 314.

³⁶⁸ *Id.*

*v. Microsoft Corp.*³⁶⁹ Here, the DOJ charged Microsoft with illegally maintaining its monopoly in operating systems for personal computers through restrictive license agreements with personal computer manufacturers and, furthermore, that the agreements were unreasonable restraints of trade in violation of the Sherman Act. This case was settled by consent decree and Microsoft is now prohibited from including certain unreasonably restrictive provisions in its contracts with such manufacturers.³⁷⁰

1.3. Conclusions

The recent adoption of the TTBER (2004) and accompanying TTBERG (2004) has brought the EU and the U.S. significantly further toward convergence in the antitrust analysis of IPR license agreements. Both the IP (1995) Guidelines and the 2004 TTBER (2004) create safe-harbors and both identify naked price-fixing, output restraints, and market division among horizontal competitors as *per se* unlawful or hardcore restrictions. Both approaches also weigh the procompetitive benefits and the anticompetitive effects when evaluating licensing restrictions as can be seen in both the *Windsurfing* case and *United States v. Microsoft Corp.*³⁷¹

There are, however, significant differences between the regimes, some of which, perhaps, are unavoidable due to the nature of the single market imperative of the EU.³⁷² It is unsurprising that competition law tends to take precedence over IP law as the achievement of the single market is an overriding aim to be promoted and protected under EC law. In the U.S., where no such market concern exists, the scale appears tipped in favor of IPRs.

³⁶⁹ *United States v. Microsoft Corp.*, 87 F. Supp. 2d 30 (D.D.C. 2000).

³⁷⁰ Bingaman, A., Competition And Innovation: Bedrock Of The American Economy, Remarks by Anne K. Bingaman, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Before the University of Kansas Law School, University of Kansas, Lawrence, Kansas, September 19, 1996.

³⁷¹ Delrahim, M., US and EU Approaches to the Antitrust Analysis of Intellectual Property Licensing: Observations from the Enforcement Perspective, fn 314.

³⁷² *Id.*

2. RESALE PRICE MAINTENANCE

BY VICTORIA BENIS

When manufacturers sell their products to independent distributors or retailers, they may specify the resale price that retailers must charge to consumers. This practice, referred to as resale price maintenance (“RPM”), is frequently an issue between manufacturers and their distributors, as well as between licensors and licensees where the transfer of technology is involved.

As indicated in the preceding chapter, despite some convergence of the EC TTBER (2004)³⁷³ and the U.S. IP (1995) Guidelines there are still areas where differences remain.³⁷⁴ This chapter looks at the extent to which there is a common approach under the U.S. and EU approaches to RPM while examining the major differences in the treatment of price-fixing in license agreements. In addition to comparing the treatment of RPM in the TTBER (2004) and IP (1995) Guidelines, relevant case law will also be examined.

2.2. The common approach

Both the TTBER (2004) and the IP (1995) Guidelines provide restrictions on RPM.

The TTBER (2004) Approach

Article 4 of the TTBER (2004) contains a list of hardcore restrictions of competition, and the first one on the list concerns price-

³⁷³ TTBER (2004), fn 324.

³⁷⁴ IP (1995) Guidelines, fn 348.

fixing. Article 4 targets both competing and non-competing undertakings (a horizontal and vertical relationship respectively). Article 4(1) deals with competing undertakings and Article 4(2) with non-competing undertakings.

Article 4(1) (a) refers to “the restriction of a party’s ability to determine its prices when selling products to third parties”, which is clearly a prohibition of RPM.³⁷⁵ Article 4(2) (a) also refers to RPM through the expression “the restriction of a party’s ability to determine its price when selling products to third parties, without prejudice to the possibility of imposing a maximum sale price or recommending a sale price, provided that it does not amount to a fixed or minimum sale price as a result of pressure from, or incentives offered by, any of the parties”.³⁷⁶

The TTBER (2004) provide further clarification on what it considers as hardcore and prohibited.³⁷⁷ Price-fixing can occur either directly through an agreement establishing the exact price to be charged or indirectly in a more discreet manner. It is explained that indirect price-fixing can be achieved in several ways, such as: fixing the margin, fixing the minimum level of discounts, linking the sale price to the sale prices of competitors or reciprocal running royalties when the license is a sham to conceal horizontal price-fixing.³⁷⁸ The TTBER (2004) underline that reciprocal running royalties are interpreted as price-fixing when the agreement is devoid of any pro-competitive aim, such as the creation of any value, and therefore has no business justification. In such a case, the agreement does not constitute a genuine licensing arrangement.³⁷⁹

The IP (1995) Guidelines Approach

In the IP (1995) Guidelines, article §5.2 deals with RPM. This Article provides that resale price maintenance is illegal when

³⁷⁵ TTBER (2004), fn 324, Article 4(1)(a) for agreements between competitors.

³⁷⁶ *Id.*, Article 4(2)(a) for agreements between non-competitors.

³⁷⁷ TTBER (2004), fn 321, paragraphs 79-81 and 97.

³⁷⁸ *Peeperkorn, L., Kjølbye, L., The New Technology Transfer Block Exemption Regulation and Guidelines*, published in the volume: *European Competition Law Annual 2005, The interaction between Competition Law and Intellectual Property Law*, *Ehlerlann, C-D & Atanasiu, I.*, (editors), Hart Publishing, Oxford/Portland, Oregon.

³⁷⁹ TTBER (2004), fn 321, paragraph 80.

“commodities have passed into the channels of trade and are owned by dealers”.³⁸⁰ It has been held *per se* illegal for a licensor of an intellectual property right regarding a specific product to fix a licensee’s resale price of that product.³⁸¹ The Article further adds that the *per se* rule against RPM must be enforced by the Agencies in the IP context.³⁸²

EU/U.S. Convergence on Price-fixing

As shown above the U.S. and the EU both prohibit RPM. The economic justification is obvious: Customers may pay more for the product without receiving any real benefit. RPM may lessen competition by restricting the ability of the retailer to compete on price. It is likely to lead to higher prices for consumers and higher margins for retailers, while protecting inefficient retailers who might not succeed in a truly competitive environment.³⁸³ The U.S. and the EU also share the same ultimate goal in prohibiting RPM: the promotion of consumer welfare while preserving the incentive to innovate.³⁸⁴ Nonetheless, the prohibition has not developed in the same way in the two legal systems.

³⁸⁰ *Dr Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 408 (1911).

³⁸¹ *United States v. Univis Lens Co.*, 316 U.S. 241 (1942), *Ethyl Gasoline Corp. v. United States*, 309 U.S. 436 (1940).

³⁸² The term “Agencies” refers to the U.S. Department of Justice and the Federal Trade Commission. Their role is to analyze licensing restraints under the rule of reason. They assess whether the restraint in question can contribute to an efficiency-enhancing integration of economic activity. If the type of restraint is one that has been accorded *per se* treatment, the Agencies will challenge the restraint under the *per se* rule. See IP (1995) Guidelines, fn 348, §3.4.

³⁸³ Gurnani, H., Xu, Y., Resale Price Maintenance Contracts with retailer Sales Effort: Effect of Flexibility and Competition, Naval Research Logistics, Feb 2006, 53, 5, p. 449.

³⁸⁴ Delrahim, M., The Long and Winding Road: Convergence in the Application of Antitrust to Intellectual Property, presented at the George Mason Law review Symposium, 6 October 2004, available at: http://www.usdoj.gov/atr/public/speeches/205712.htm#N_31.

2.3. Evolution of RPM prohibitions

Evolution in the European Union

The RPM prohibition was initially established by Article 81(1) of the EC Treaty, which provides that an agreement which “directly or indirectly fix[es] purchase or selling prices or any other trading conditions” (as RPM does) is prohibited because of its incompatibility with the common market.³⁸⁵ The 1999 Regulation on Vertical Agreements (agreements between non-competitors) also prohibits price-fixing and Article 4(a) has the same wording as will later appear in the restriction on price-fixing in Article 4(2)(a) of the TTBER (2004).³⁸⁶ This indicates that the prohibition on RPM was not created just for license agreements; rather the Commission has always viewed price-fixing suspiciously. The EU authorities generally take a strict approach to direct horizontal price collaboration and will rarely find an acceptable argument for exempting it as can be seen in various decided cases.³⁸⁷

The TTBER (2004) replaced the 1996 Technology Transfer Block Exemption Regulation (“TTBER 1996”), and the “black list” of the TTBER 1996 evolved into the current hardcore restrictions. The prohibition of price-fixing was already enforced in 1996, but no distinction was made between competitors and non-competitors, who were treated in a similar way. This is not the case with the TTBER (2004).

The Commission has also revised its approach to what it considers to be “illegal price-fixing” between competitors. The Draft Revised TTBER (which should have replaced the TTBER 1996) provided that

³⁸⁵ Article 81(1) of the EC Treaty

³⁸⁶ Commission Regulation (EC) 2790/1999 of 22 December 1999 on the application of Article 81(3) of the treaty to categories of vertical agreements and concerted practices, Article 4(a): “the restriction of the buyer’s ability to determine its sale price, without prejudice to the possibility of the supplier’s imposing a maximum sale price or recommending a sale price (etc)”.

³⁸⁷ Joined cases 48/69 etc, *Imperial Chemical Industries Ltd v. Commission* (“ICP”), July 14, 1972, [1972] ECR 619; Commission Decision 84/405/EEC, *Zinc producer group*, August 6, 1984, OJ L 220; Joined cases C-89/85 etc, *A. Ahlström Osakeyhtiö v. Commission* (“Wood Pulp IP”), March 31, 1993, [1993] ECR I-1307. All these cases concern traditional price-fixing between producers.

when competitors cross-license technologies and calculate royalties on the basis of individual product sales, such arrangements are considered to be price-fixing agreements.³⁸⁸ In the Commission's view, the amount of royalty could have a direct impact on the marginal cost of the product and thus a direct impact on prices. This approach however met with criticism as it was common practice to use these kinds of arrangements. So, in the final TTBER (2004) and TTBER (2004), reciprocal running royalties are regarded as prohibited price-fixing only when it is made clear that running royalties to be paid on the basis of all product sales are irrespective of whether the licensed technology is being used ("sham licensing").³⁸⁹ This acknowledges the common way of calculating royalties and no longer hinders pro-competitive cross-licensing. There is indeed no reason to suspect collusion every time this method of calculating "running royalties" is used.³⁹⁰

Evolution in the United States

The American evolution must be assessed from the case law. Price-fixing has long been considered unlawful *per se*, as demonstrated in many early judgments.³⁹¹ Patent licenses were however treated as exceptions to the general rule against RPM³⁹². For instance, in the *General Electric* case, the Supreme Court held that an owner of a

³⁸⁸ Draft Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements, OJ C 235, 01.10.2003, p. 10-54, paragraph 77. For royalty obligations, see TTBER (2004), fn 321, paragraph 156 ff.

³⁸⁹ Reciprocal running royalties are royalties calculated on the basis of individual product sales. See *Monti, M.*, The New EU Policy on Technology Transfer Agreements, Speech/04/19, Paris, January 16 2004, Ecole des Mines. Available at: http://www.cerna.enscm.fr/cerna_regulation/Documents/ColloqueAntitrust2004/Monti.pdf.

³⁹⁰ *Dolmans, M., Pilola, A.*, The New Technology Transfer Block Exemption: A Welcome Reform, After All, *World Competition Journal*, 2004, vol. 27(3), p. 356.

³⁹¹ *U.S. v. Socony-Vacuum Oil Co. Inc.*, 310 U.S. 150 (1940); *U.S. v. Trenton Potteries*, 273 U.S. 392 (1927); *Ethyl Gasoline Corp v. U.S.* 309 U.S. 436 (1940), fn 381

³⁹² *O'Connor, K.*, A Primer on Vertical Restraint Law applied to Intellectual Property: Is Microsoft Really a Vertical restraints Case?, March 17, 2005, available at: <http://www.gklaw.com/docs/publications/375.pdf>, p. 3.

See also *United States v. General Electric*, 272 U.S. 476 (1926); *Columbia Pictures Corp. v. Coomer*, 99 F.Supp. 481 (E.D.Ky.1951). Resale price maintenance was permitted for copyrighted goods although agreements on release prices were unlawful.

product patent may condition a license to manufacture the product on the fixing of the first sale price of the patented product.

Subsequent lower court decisions have attempted to distinguish the *General Electric* decision in various contexts.³⁹³ They have held RPM agreements unlawful in virtually every context that has been considered, thereby reducing the value of *General Electric*. Moreover, the IP (1995) Guidelines clearly provide that the government will challenge price-fixing agreements in the intellectual property context.³⁹⁴

Before 1997, both minimum and maximum price-fixing were *per se* unlawful. Nevertheless, the *Khan* case (see below) allowed the latter, and nowadays, only the setting of minimum resale prices in an agreement between licensor and licensee is *per se* unlawful.³⁹⁵

2.4. Remaining differences

Despite the common approaches of the EU and the U.S., differences remain, particularly concerning maximum RPM. Although price-fixing in license agreements is prohibited in both jurisdictions, exceptions have differentially modified the scope of the *per se* illegality:

Maximum Resale Price Maintenance

It has long been settled that a vertical agreement (between non-competitors) setting minimum resale prices is *per se* illegal under

³⁹³ See *Royal Indus. v. St. Regis Paper Co.*, 420 F.2d 449, 452; *Newburgh Moire Co. v. Superior Moire Co.*, 237 F.2d 283, 293-94 (A grant of multiple licenses each containing price restrictions does not come within the General Electric doctrine); *Cummer-Graham Co. v. Straight Side Basket Corp.*, 142 F. 2d 646, 647 (An owner of an intellectual property right in a process to manufacture an unpatented product may not fix the sale price of that product); *Barber-Colman Co. v. National Tool Co.*, 136 F.2d 339, 343-44.

³⁹⁴ IP (1995) Guidelines, fn 348, § 5.2.

³⁹⁵ *State Oil Co. v. Khan*, 522 U.S.3 (1997).

Section 1 of the Sherman Act.³⁹⁶ Nonetheless, it was only in 1968 in *Albrecht v. Herald Co* that the Supreme Court held maximum RPM to be *per se* illegal.³⁹⁷ However, in the years since *Albrecht*, many courts have questioned the accuracy of the decision.³⁹⁸

Finally, in *State Oil Co v. Khan* the Supreme Court reversed itself and declared that maximum price-fixing was no longer a *per se* violation of the antitrust laws.³⁹⁹ The *Khan* case involved an agreement between State Oil and its supplier which essentially obligated the supplier to charge no more than the suggested retail price for the gasoline, which was set by State Oil. The Court found no economic justification for applying a *per se* rule to such an agreement, finding rather that a “rule of reason analysis will effectively identify those situations in which vertical maximum price-fixing amounts to anticompetitive conduct.”⁴⁰⁰

From an economic point of view, maximum RPM could enhance efficiency: for instance, by providing the mark-up for retailers, maximum price-fixing creates an incentive for them to compete by providing services and maintain quality, eliminating free-riding by discounts.⁴⁰¹ Moreover, economic theory has shown that consumers can benefit from such restraints because prices may remain at a low level, by preventing a licensee charging a monopoly price in a given territory.⁴⁰² Both anti- and pro-competitive effects should be taken into account in analyzing the restrictions in a license agreement; a comprehensive inquiry into market conditions may also be needed.⁴⁰³

³⁹⁶ See *Dr Miles Medical Co v. John D Parkes & Sons, Co* (1911), fn 380; See also Perlman, S., Swenson, L., Balancing Antitrust Issues and Intellectual Property Rights: A Practical Guide for Biotech/Pharma Companies in Managing their IP Portfolios, Mayer, Brown, Rowe & Maw LLP (edition), 2003, p. 8.

³⁹⁷ See *Albrecht v. Herald Co*, 390 U.S. 145. 390 U.S. 145 (1968).

³⁹⁸ *Atlantic Richfield Co v. USA Petroleum Co*, 495 U.S. 328 (1990). In this case, the Supreme Court held that vertical maximum price-fixing may have pro-competitive inter-brand effects.

³⁹⁹ *State Oil Co. v. Khan*, 522 U.S. 3 (1997).

⁴⁰⁰ *Id.*, part C, paragraph 6 of the judgment.

⁴⁰¹ Gurnani, H., Xu, Y., fn 383, p. 450.

⁴⁰² Delrahim, M., fn 384.

⁴⁰³ The U.S. Supreme Court agreed on using the rule of reason as one of the principles to apply in antitrust cases. See: *Standard Oil Co. of New Jersey v. United States*, 221.U.S (1911).

The European Community takes a different approach. The TTBER (2004) draws a distinction between agreements among competitors (horizontal agreements) and agreements between non-competitors (vertical agreements). In the former situation, as explained above, any price-fixing (minimum and maximum) is unlawful. However, between non-competitors, maximum RPM or recommended RPM is allowed.⁴⁰⁴ Non-binding price-recommendations and maximum RPM are always acceptable if they do not amount to a concerted practice.⁴⁰⁵

One can wonder why the Commission still bans maximum RPM between competitors. Certainly, it may have anti-competitive effects, when it prevents competitors from adding value to the licensed product or investing in pre- or post- sales service.⁴⁰⁶ Nevertheless, these potential negative effects could have been controlled by including it in the “excluded restrictions list”⁴⁰⁷, and by weighing pros and cons in individual situations.

The Colgate Doctrine

In the U.S., the *Colgate* doctrine states that when a supplier announces that it will sell only to retailers that adhere to specified minimum resale prices, and the retailer thereafter buys the product and adheres to the price restriction, no antitrust agreement is formed, although the arrangement could be called an agreement within the law of contracts.⁴⁰⁸ The *Colgate* doctrine allows sellers to announce the

⁴⁰⁴ See respectively Article 4(1) (a) for competitors and 4(2) (b) for non-competitors.

⁴⁰⁵ *Lidgard, H.H.*, Competition Classics : Competition at All Levels, course material University of Lund 2006/2007, p. 106.

⁴⁰⁶ *Dolmans, M., Pilola, A.*, fn 390, p.356.

⁴⁰⁷ See TTBER (2004), Article 5; The “excluded restrictions list” was previously called the “grey list”. When a license contains a clause in this list, there is no presumption for or against the illegality of such a clause. An individual assessment of the pro- and anti-competitive effects is required. If it is found to violate Article 81 of the EC Treaty, it does not prevent the application of the TTBER (2004) to the rest of the agreement. Only the clause in question is unenforceable.

⁴⁰⁸ See *United States v. Colgate & Co.*, 250 U.S. 300, (1919). For comments, see *Lopatka, J., Page, W.*, State Action and the Meaning of Agreement under the Sherman Act: An Approach to Hybrid restraints, *Yale Journal on regulation*, Summer 2003; 20, 2, p. 293-294.

conditions under which they will continue to deal with buyers.⁴⁰⁹ The *Colgate* doctrine will thus protect the seller from per se liability. Nevertheless, when a seller and a buyer subsequently enter into an agreement to abide by suggested minimum resale prices, or a buyer is persuaded or coerced to comply with these minimum prices, there may be a violation.

A parallel can be drawn with the result of the European *Adalat* case.⁴¹⁰ Bayer AG, the parent company of one of the main pharmaceutical groups in Europe, was alleged to have adopted a policy limiting parallel imports of its drug “Adalat” from Spain and France (where the price was low because of the government price control of pharmaceuticals) into the United Kingdom. The Bayer group changed its supply policy and its French and Spanish subsidiaries gradually reduced supplies to wholesalers there, leaving them only enough products to supply their home customers, and not parallel importers as well. Some of the wholesalers affected by this practice complained to the Commission, which opened an investigation procedure concerning the alleged infringement of Article 81 EC. The Commission established the existence of an unlawful agreement between Bayer and its wholesale customers from “the conduct of the wholesalers” who apparently had “not only understood that an export ban applies to the goods supplied, but (...) aligned their conduct on this ban.”⁴¹¹ For the Commission, the export prohibition infringed Article 81(1) of the EC Treaty.

The Commission followed a long line of cases establishing that a unilateral policy adopted by a supplier can constitute an agreement or concerted practice if the customer acquiesces to that policy, tacitly or not.⁴¹² However, in October 2000, the CFI found that the necessary evidence of an agreement on the wholesaler’s part was missing: the wholesalers showed an attitude excluding the possibility of tacit acquiescence. The CFI therefore rejected the contention that it was

⁴⁰⁹ Id., p. 295.

⁴¹⁰ See Case T-41/96, *Bayer AG v Commission*, ECR [2000], p. II-03383 and Joined Cases C-2/01 P and C-3/01 P, *Bundesverband der Arzneimittel-Importeure and Commission of the European Communities v. Bayer AG*, January 6, 2004, ECR [2004], p. I-23, paragraph 144.

⁴¹¹ Case T-41/96, *Bayer AG v Commission*, fn 410, paragraph 116; Also quoted in Taylor, P., *Competition Law Review*. Issue 1, January 2001, available at: http://www.lawexchange.org/news/papers_article.asp?X=12.

⁴¹² Id. See also Case C-277/87, *Sandoz prodotti farmaceutici SpA v Commission*, ECR [1990] I-00045.

sufficient to establish that the parties continued to maintain their business relations in order to prove the existence of an agreement.⁴¹³ The ECJ confirmed that the concept of an agreement under Article 81 needs a “concurrence of wills” between the parties. The maintenance of business relation is not an evidence of such a meeting of minds.⁴¹⁴

Although *Adalat* restricts the scope of the doctrine of an unlawful unilateral “agreement”, the approach still remains stricter than the *Colgate* doctrine. According to the *Colgate* doctrine, it is sufficient for a manufacturer to dictate a price that a distributor must follow for there not to be an agreement (no issues of tacit acquiescence arise), whereas *Adalat* requires the parties to prove the absence of explicit or tacit acquiescence - it is also unclear that it is applicable in a situation truly akin to *Colgate* i.e. one where a manufacturer conditions dealing on RPM.

2.5. Conclusions

Both the TTBER (2004) and the IP (1995) Guidelines treat general price-fixing as unlawful.

There are differences however. The TTBER (2004) introduced a distinction between competing and non-competing undertakings. Maximum or recommended RPM is allowed for non-competitors, whereas it is still unlawful for competitors. Since *Khan*, maximum price-fixing in the U.S. is never illegal *per se* but is always analyzed on a case by case basis under the rule of reason. The *Colgate* doctrine allows RPM if it is the result of unilateral activity. In EU, *Adalat* has restricted the scope of claims that a unilateral “agreement” exists, but as soon as there is any agreement, Article 81 applies.

So despite the fact that both legal systems regard RPM as essentially unlawful, where licensing agreements are concerned, there remain significant differences between them.

⁴¹³ Press Release No 01/04, January 6, 2004, Judgment of the ECJ, Joined Cases C-2/01P and C-3/01P, see fn 410.

⁴¹⁴ *Id.*

3. MARKET ALLOCATION

BY EMMA LUNDGREN

Market allocation in license agreements involves a restriction on competition which may be highly important if licensing is to happen. The purpose of this chapter is to discuss whether the prohibition of market allocation in license agreements, and its exceptions, manages to balance the interests of competition law and IPRs, with respect to both the European TTBER (2004) and the U.S. IP (1995) Guidelines.

The discussion will be limited to the categories of IPRs which fall within the scope of the above EU and U.S. regulations. It will exclude any agreement below the market share threshold of the TTBER (2004) or within the “safety zone” of the IP (1995) Guidelines.

3.1. Market Allocation and Competition Law

Certain practices in agreements between contracting parties have been found to be so manifestly restrictive of competition that they cannot be allowed. One of these is market allocation. Market allocation takes place when the parties to an agreement decide to share or divide markets between them.⁴¹⁵ This type of restriction is often used in license agreements as a condition for the use of the licensed technology.

Market allocation agreements try to eliminate price competition and result in reduced customer choice. Where IPRs are involved, by excluding others from using protected technology, there will be no competition from products implementing the same technology, unless there is more than one licensee in the same territory or market. These effects could all have negative consequences for consumers. For the

⁴¹⁵ *Whish, R.*, Competition Law, 5th Edition, Oxford University Press 2005, p. 477.

purposes of EC law, market allocation agreements are not only detrimental to competition, but also to the single market imperative.⁴¹⁶

Article 81(1) EC

Article 81(1)(c) of the EC Treaty expressly states that market sharing is a practice “in particular” prohibited because it is incompatible with the common market.⁴¹⁷ However, if significant pro-competitive effects outweighing the restrictions are found, and proved, by the party alleging them, the agreement may nonetheless be exempted under Article 81(3) EC.⁴¹⁸

There are several reasons for the EC Treaty’s specifically mentioning market sharing as a prohibited practice which would restrict competition. The Commission wishes to make all conduct inhibiting market integration illegal. Moreover, it is fairly easy for parties to agreements to separate national markets from each other.⁴¹⁹ Extensive case law shows the European Courts’ negative attitude towards market sharing in general.⁴²⁰

The Sherman Act

In contrast to the EC Treaty, the U.S. antitrust laws do not specifically list any restrictions as unlawful. The Sherman Antitrust Act simply states that contracts including restraints of trade are prohibited.⁴²¹

Most agreements restricting trade in the U.S. will be evaluated under the rule of reason, much as EC law weighs the pros and cons of license agreements.⁴²² There are, however, a number of practices

⁴¹⁶ *Whish*, R., fn 415, p. 478.

⁴¹⁷ There are additional requirements of Article 81(1) EC which also have to be met for its application.

⁴¹⁸ *Whish*, R., fn 415, p. 149.

⁴¹⁹ *Id.*, p. 478.

⁴²⁰ *Id.*, p. 479; see eg. Commission decision 85/74/EEC, *Peroxygen Products*, OJ L 35; Commission decision 91/297/EEC, *Soda-ash – Solvay/ICI*, OJ L 152; and Commission decision 1999/60/EC, *Pre-Insulated Pipes Cartel*, OJ 1999 L 24.

⁴²¹ US, 15 U.S.C.A. § 1,

<http://www.usdoj.gov/atr/foia/divisionmanual/ch2.htm#a1>.

⁴²² IP (1995) Guidelines, fn 348, § 3.4.

which will be considered per se illegal. Market allocation schemes among competitors are per se violations of U.S. antitrust law under the Sherman Act.⁴²³ This prohibition has been established through case law.⁴²⁴

3.2. Market Allocation in License agreements

As previously stated, market allocation schemes in general are not tolerated under either EC or U.S. law. When these restrictions appear in license agreements, they are regarded with as much skepticism. However, there are several ways in which allocation of markets can be made, e.g. by specifying technical fields of use or territories, and some may be less restrictive than others and therefore require further analysis.

The EC Technology Transfer Regulation – Hardcore Restrictions

The TTBER (2004) deals with market allocation by stating a main rule in the hardcore restrictions of Article 4 and a list of exceptions to that rule. The classification of a restriction as hardcore in EC law is “based on the nature of the restriction and experience showing that such restrictions are almost always anticompetitive”.⁴²⁵ The lists of exceptions to this prohibition contain practices which have been found not to pose a significant threat to competition; in fact some of them may be necessary for the sufficient exploitability of IPRs, to keep incentive to invest and to innovate. A distinction is made not only between competitors and non-competitors, but also between reciprocal⁴²⁶ and non-reciprocal agreements.

⁴²³ <http://www.usdoj.gov/atr/foia/divisionmanual/ch2.htm#a1>.

⁴²⁴ See eg. *U.S. v. Topco Associates, Inc.*, 405 U.S. 596, 92 S.Ct. 1126 (1972).

⁴²⁵ TTBER (2004), fn 321, paragraph 74.

⁴²⁶ For a definition of reciprocal agreement, see TTBER (2004), fn 324, Article 1(c).

3.3. Allocation between competing undertakings

Article 4(1)(c) of the TTBER (2004) provides that agreements between competing undertakings shall not be exempted under the TTBER (2004) where they “have as their object [...] the allocation of markets”.⁴²⁷ The TTBER (2004) further categorically state that “[a]greements whereby competitors share markets [...] have as their object the restriction of competition.”⁴²⁸ If a license agreement, otherwise within the scope of the TTBER (2004), contains a clause allocating markets, the entire agreement will fall outside the block exemption.⁴²⁹

There are exceptions to this which can be divided into the following categories: technical fields of use; exclusive licenses; and sales restrictions. The exceptions for captive use and alternative source of supply will not be discussed.

A technical field of use restriction is a restriction which limits the right of the licensee to exploit the IPR in specified technical fields, leaving the licensor free to use its right in other areas.⁴³⁰ Articles 4(1)(c)(i) and (ii) TTBER (2004) allows this type of restriction in case of an obligation on the licensee to produce only within a specific technical field of use, or where a technical field of use or territory has been exclusively reserved for either the licensee or the licensor. Reciprocal exclusive licenses with field of use restrictions are prohibited.⁴³¹

A restriction on technical field of use may only go as far as the licensed technology; any restriction on the licensee’s ability to use its own technology constitutes illegal market sharing.⁴³² Field of use restrictions may be necessary to promote pro-competitive licensing since they may be an efficient way of providing an incentive to invest

⁴²⁷ TTBER (2004), fn 324, Art. 4(1)(c).

⁴²⁸ TTBER (2004), fn 321, paragraph 84.

⁴²⁹ TTBER (2004), fn 324, Art. 4(1), Recital 13 and TTBER (2004), fn 321, paragraph 75.

⁴³⁰ *Anderman, S.*, Technology Transfer and the IP/Competition Interface, European University Institute – Robert Schuman Center for Advanced Studies 2005 EU Competition Law and Policy Workshop/Proceedings, p. 11.

⁴³¹ TTBER (2004), fn 321, paragraph 181.

⁴³² *Id.*, paragraph 90.

and develop the technology.⁴³³ Such provisions are generally not implemented simply to allocate markets.⁴³⁴

Territorial exclusivity is a restriction which may be required in various circumstances for it to be economically viable for the licensor and licensee to come to an efficiency enhancing agreement in the first place.⁴³⁵ This type of provision in an agreement might be essential for a licensee in trying to recoup high investment costs after entering a new market and would therefore be the only way in which new technology will be licensed at all.⁴³⁶

Even before the TTBER (2004) the ECJ had, in the *Nungesser* case, concluded that an exclusive license as such does not infringe Article 81(1) EC.⁴³⁷ However, a distinction was made between open exclusive licenses and licenses assigning absolute territorial protection, the latter being prohibited but not the former.⁴³⁸ This was then implemented in Article 4(1)(c)(iii) of the TTBER (2004) which contains an exception for market allocation agreements which puts an obligation on the licensor not to license the technology to other licensees in a particular territory. This provision applies whether the agreement is reciprocal or not, but it may not affect the ability of the parties to exploit their own technology. The provision allows for an appointment of the licensee as sole licensee for a specific territory.⁴³⁹ Reciprocal exclusive licensing, where the parties agree to exclude third parties from the territory, is prohibited.⁴⁴⁰

The fourth exception in Article 4(1)(c)(iv) concerns restrictions on active and/or passive sales in non-reciprocal agreements into an exclusive territory reserved for the other party.⁴⁴¹ Incentives to invest in and develop the licensed technology may depend on this type of restriction. For example, the licensor may wish not to be subject to competition from its licensee if it has a weak position on the market,

⁴³³ Id., paragraphs 91 and 182.

⁴³⁴ Id., paragraph 86.

⁴³⁵ *Whish*, R., fn 415, p. 736.

⁴³⁶ TTBER (2004), fn 321, paragraph 165.

⁴³⁷ Case C-258/78, *Nungesser KG & Kurt Eisele v Commission*, [1982] ECR 2015.

⁴³⁸ Id., paragraph 53.

⁴³⁹ TTBER (2004), fn 321, paragraphs 88 and 164.

⁴⁴⁰ Id., paragraph 163.

⁴⁴¹ Id., paragraph 87.

and the licensee may want to be able to be protected in a specific territory if it has had to invest significantly to enter the market.⁴⁴²

The fifth exception in Article 4(1)(c)(v) involves restrictions in non-reciprocal agreements of active sales by the licensee into an exclusive territory allocated by the licensor to another licensee who was not a competitor of the licensor at the time of the conclusion of the agreement. This is a type of restriction likely to give incentives to exploit licensed technology more efficiently. It seems that it is not a major concern when a licensee, who is a competitor of the licensor, is restricted in selling actively into a territory reserved for another licensee who was not a competitor at the time of the first agreement. The problem here may be that different licensees agree not to sell at all in the territories of others, which would constitute cartelization.⁴⁴³

3.4. Allocation between non-competing undertakings

For non-competing undertakings the provisions of Article 4(2)(b) apply, which prohibit restrictions “of the territory into which [...] the licensee may passively sell the contract products”.⁴⁴⁴ The prohibition of restrictions in license agreements between non-competitors is considerably less strict than between competitors due to a generally accepted perception that these agreements pose a less significant risk to competition.⁴⁴⁵

In contrast to the *Nungesser* case⁴⁴⁶ which prohibited absolute territorial protection, the TTBER (2004) has made an exception to this rule for non-competitors. Article 4(2)(b)(ii) allows for restrictions on passive sales into the territory of other licensees for a period of two years after the conclusion of the agreement. The reasoning behind this rule is that a licensee will often invest substantially in entering a new market and if there is not some protection against other licensees, there may be no license in the first place.⁴⁴⁷

⁴⁴² Id., paragraphs 86 and 170.

⁴⁴³ Id., paragraph 89.

⁴⁴⁴ TTBER (2004), fn 324, Art. 4(2)(b).

⁴⁴⁵ TTBER (2004), fn 321, paragraph 26.

⁴⁴⁶ Case C-258/78, *Nungesser KG & Kurt Eisele v Commission*, fn 437.

⁴⁴⁷ TTBER (2004), fn 321, paragraph 101.

The IP (1995) Guidelines – Per Se Restrictions

The IP (1995) Guidelines have taken quite a different approach, simply stating that certain practices will be given a *per se* assessment and that horizontal market allocation is an example.

The U.S. equivalent of the hardcore restrictions are the restraints to which the *per se* rule applies. U.S. case law has stated that some restraints have a “nature and necessary effect so plainly anticompetitive” that no investigation of the effects of the agreement on competition has to be made.⁴⁴⁸ The attitude towards market allocation, and its evaluation under the *per se* rule, has somewhat changed over time. Case law shows how the courts have gone from a strict and formalistic assessment to allowing some consideration of the restrictions.

The *Topco* case⁴⁴⁹ of 1972 illustrates how formalistically and rigidly the Supreme Court treated market allocation in the past. The defendant, Topco, argued that it needed territorial restraints in order to maintain its business and to be able to compete with larger undertakings.⁴⁵⁰ The Court stated that there was a developed doctrine in which certain business relationships were *per se* illegal without the Court having to consider their possible reasonableness.⁴⁵¹ Therefore, the Court concluded that the horizontal territorial restraints of the agreements were *per se* illegal⁴⁵² despite the contention that there were in fact grounds for the restraints and that it was even increasing competition.⁴⁵³

Some years later, in *Continental v Sylvania*⁴⁵⁴ the Supreme Court held that *per se* illegality is only appropriate where the practice is manifestly anticompetitive.⁴⁵⁵ Further, it wanted to “make clear that departure from the rule-of-reason standard must be based upon

⁴⁴⁸ *Federal Trade Commission v. Superior Court Trial Lawyers Association*, 493 U.S. 411 433 (1990).

⁴⁴⁹ *U.S. v. Topco Associates, Inc.*, fn 424

⁴⁵⁰ *Id.*, at 596.

⁴⁵¹ *Id.*, at 607.

⁴⁵² *Id.*, at 609.

⁴⁵³ *Id.*, at 610.

⁴⁵⁴ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549 (1977).

⁴⁵⁵ *Id.*, at 50.

demonstrable economic effect rather than [...] formalistic line drawing.”⁴⁵⁶ Thus, the rigid ruling of *Topco* was abandoned.

The assessment of agreements containing market allocation made by the FTC or DOJ under the IP (1995) Guidelines will follow a two-step analysis. First, it will be determined whether the restriction truly includes horizontal market collaboration between competitors, and therefore is “potentially *per se* illegal”.⁴⁵⁷ Second, it will be considered whether the restraint could “contribute to an efficiency-enhancing integration of economic activity”.⁴⁵⁸ This is all in line with the case law previously reviewed. *Topco* clearly prohibits horizontal market allocation as such, whereas *Continental v. Sylvania* and *Broadcast Music v. Columbia* leaves room for analyzing the specific circumstances of the case, something which has been expressed in the IP Guidelines in § 3.4. Although the assessment has become more lenient, “naked” horizontal market sharing will almost always be found *per se* illegal due to its lack of efficiency-enhancing integration of economic activity.

As can be seen from both case law and the IP (1995) Guidelines, U.S. antitrust law permits restrictions on territory and exclusivity as long as IPRs is not simply used as a means of allocating market between competitors in order to diminish competition on the market. This is in line with the *Palmer v. BRG of Georgia* case⁴⁵⁹ which stated that licensing arrangements simply used as a cover up for market allocation schemes are *per se* illegal. The IP (1995) Guidelines also contrasts restrictions based on territory to those of field of use; but if either arrangement is merely a way to disguise a market allocation scheme it will be considered *per se* illegal.⁴⁶⁰ Furthermore, the purchasing of exclusive licenses will generally only be a cause for concern when they are reciprocal;⁴⁶¹ as we have seen, exclusive patent licenses are allowed under the Patent Act.⁴⁶² That kind of license is more likely to be analyzed under merger rules.⁴⁶³

⁴⁵⁶ *Id.*, at 58-59.

⁴⁵⁷ IP (1995) Guidelines, fn 348, § 3.4 and *Coben, W., Zanfagna, G.*, Inside the competitor collaboration guidelines: the forest among the trees, 2000 U. Chi. Legal F. 191, at 200.

⁴⁵⁸ IP (1995) Guidelines, fn 348, § 3.4.

⁴⁵⁹ *Palmer v. BRG of Georgia*, 498 U.S. 46, 111 S.Ct. 401 (1990).

⁴⁶⁰ IP (1995) Guidelines, fn 348, Example 7.

⁴⁶¹ *Id.*, § 4.1.2.

⁴⁶² US, 35 U.S.C. §261.

⁴⁶³ IP (1995) Guidelines, fn 348, § 5.7.

3.5. Conclusions

Market allocation puts restrictions on trade which are, under most circumstances, unacceptable and it is therefore unsurprising that both EC and U.S. laws have taken a strong position against them. However, only practices which put serious restraints on competition should be prohibited so that there is a balance between protection of competition and the rights of the IP holder.

The EU approach, which essentially prohibits all reciprocal market allocation agreements between competitors, may have its rationale in the fact that the protection of competition has a slightly higher priority in the EU than do the rights of the IP holder. This is not to say that there are not exceptions, where the incentives on investment and innovation are clear. Moreover, the prohibition of certain practices between non-competitors indicates the more restrictive approach of the EC rules. The single market imperative of the EU also seems to have had a significant impact on the drafting of the TTBER (2004). Where there is a threat to the integration of the market, as for example with restrictions on active/passive sales where absolute territorial protection is granted, the rules are significantly stricter than for field of use restrictions which cannot be used to divide markets to the same extent.

The U.S. IP (1995) Guidelines, on the other hand, will only prohibit agreements between competitors when they, after assessment, have been found to have the object of restricting competition. After the abandonment of a strict *per se* assessment, which ruled out all agreements allocating markets on the horizontal level, a more effects-based assessment has been adopted which will only disallow agreements where “naked” market allocation is found, or where the parties are using an IPR as a cover for market allocation. This can be traced in the evolution of the relevant case law. The rights of the IP holder seem to be given more weight when assessing agreements containing territorial restrictions.

The overall conclusion is that EC law is still fairly strict on any use of IPRs which may inhibit competition, whereas the U.S. takes a more lenient approach to market allocation. The approach of the EU can be explained in large parts by the need to integrate the markets of the Member States into one single market. When, or if, the European common market becomes fully integrated, one will perhaps see a shift towards a more lenient attitude to IPRs in license agreements, with a more equitable balance between competition and IPR licensing in both legal systems.

4. GRANT-BACK OBLIGATIONS

BY THI TUYET NGYUEN

License agreements generally bring benefits to the parties involved. However, licensing also poses a risk for the licensor in that he may lose some control over the licensed technology to the extent that the licensee improves it; he may even have to pay to use such improvements. To forestall this, the licensee may be required to share any advances or improvements in the licensed technology with the licensor. These agreements are called grant-back obligations. Additionally, the parties may negotiate a grant-back arrangement to ensure unified control over a process patented in its entirety which would be more valuable than the value of the component patents.⁴⁶⁴ Grant-backs can thus be used to maximize the overall efficiency of a licensing relationship. It has been claimed that 43% of license agreements in the U.S contain such grant-back obligations.⁴⁶⁵

License agreements in general, and grant-back obligations in particular, aim to extend market position in the licensed technology and any development of it. Although grant-backs may be allowed to help the IPR holder control his monopoly, they also raise competition concerns, so the compatibility of grant-back clauses with competition law must be examined. This chapter first discusses the purpose of and possible types of grant-back obligations. The respective positions of EU competition law and U.S. antitrust law on grant-backs are then discussed. Finally, a short analysis of the effect of grant-backs on innovation markets is made to help give a full understanding of the issue.

⁴⁶⁴ *Schmallback, R.*, The validity of Grant-back clause in Patent Licensing Agreement, University of Chicago Law Review, No.42, p. 735.

⁴⁶⁵ *Id.*

4.1. Grant-back obligations

Innovation is a dynamic process, which may take place in different stages.⁴⁶⁶ The first stage is the initial creative process that results in an IPR. It can be considered as a “primary” innovation. Subsequently, if the IPR holder license out the right to use and/or develop the IPR to a licensee, the licensee will use the licensed technology in various activities. Such activities may result in improvements to the licensed technology, which can be regarded as “secondary” innovations.⁴⁶⁷

A grant-back obligation is a provision in a license agreement that requires the licensee to grant a license on any improvements related to the licensed technology back to the licensor. It can be considered as a sub-license agreement where the original licensee becomes the licensor and vice versa.

Grant-back obligations vary in scope. There can be exclusive grant-back provisions under which there is an obligation on the licensee to grant the licensor an exclusive license for an improvement, and there can also be non-exclusive grant-back provisions where the licensee retains the right to use or license the improvement of licensed technology to a third party. In the case of a cross-license agreement, a grant-back obligation can be reciprocal which means that the licensor is also required to grant a license for its own improvements to the licensee, or non-reciprocal, in which case no such obligation rests on the licensor.⁴⁶⁸ Note that a grant-back obligation will also be defined by the nature of the improvement and whether it is severable from the licensor’s original technology or not.⁴⁶⁹

Grant-back obligations force the licensee to grant a license to the licensor for the right to use improvements which are derived from the licensed technology. Although this new license agreement is organized around the “secondary” innovation, it may also have an effect on the “primary” innovation. Competition law evaluates the grant-back obligations’ effect on both stages. The pro- or anti-competitive effect of such an obligation depends on the restrictive or permissive attitude of

⁴⁶⁶ *Ohlsson, E.*, Improvements of licensed technology; the evaluation of grant-back obligations under EU competition, Master thesis 2006, p. 52

⁴⁶⁷ *Id.*

⁴⁶⁸ TTBE (2004), fn 321, paragraph 109.

⁴⁶⁹ *Id.*, paragraph 109 which defines a ‘severable improvement’ as an improvement that can be exploited without infringing the licensed technology.

competition authorities. If the grant-back obligations are allowed, they may affect the licensee's incentives to innovate by reducing the licensee's rights to exploit its improvements. However, if the secondary innovation is promoted restricting the grant-back obligations, this might be harmful to the licensor's technology and could involve loss of control over the exploitation of its own licensed technology. It is therefore important to take the market relating to both the primary and the secondary innovation into consideration (if they are separate) and create a suitable balance between them.

The economic approach to grant-back obligations is more complex⁴⁷⁰ since grant-backs have some effects that seem to discourage innovation and others that seem encourage it. Grant-backs are designed to ensure the licensor's right to access developments to the licensed technology. However if the grant-backs are free of royalties, this would make them less desirable to the licensee and he would also lose the right to control his own improvements. The effect on innovation markets (in the strict sense) is also apparent as the licensor and the licensee would become competitors on such markets.

4.2. The EU position

Article 5 of the TTBER (2004) sets out provisions that are not prohibited and that do not automatically cause the rest of the agreement to lose the benefit of the block exemption. Instead such provisions require an individual assessment balancing pro- and anti-competitive effects.⁴⁷¹

The Scope of Article 5 of TTBER (2004)

An exclusive grant-back obligation on a licensee to the licensor for its own severable improvements to or new applications of the licensed technology is not exempted. The reason is that an obligation to grant the licensor an exclusive license to severable improvements is likely to reduce the licensee's incentives to innovate as it prevents him from

⁴⁷⁰ *Cho, J.*, A dynamic analysis of licensing, the 'boomerang' effect of grant-back clause, *International economic law review*, Vol. 43, No. 3, August 2002.

⁴⁷¹ *Wood, D., Davies, I.*, A new framework for EU technology transfer agreement in Europe, *IAM magazine*, June/July 2004, Issue 6, available at: <http://www.howrey.com/docs/Framework TTBE062004.pdf>.

exploiting his improvement, including licensing to third parties.⁴⁷² Exclusive grant-backs were first addressed in *Davidson Rubber*,⁴⁷³ in which the Commission required the parties to modify the grant-back provisions, making them non-exclusive. According to the Commission's, "the exclusive character of a license relat[ing] to industrial property rights may restrict competition and be covered by the prohibition in Article 81 (1) EC."⁴⁷⁴

The Regulation also excludes reciprocal grant-back obligations from exemption, where by the licensor is also required to grant its own improvements to the licensee. The TTBE (2004) state that the risk of negative effects on innovation is higher in the case of cross licensing between competitors where a grant-back on both parties is combined with an obligation on both parties to share with the other improvements of its own technology.⁴⁷⁵ The mutual sharing of improvements may prevent outside competitors from gaining a competitive advantage in the market.⁴⁷⁶

In *Bayer/Gist Brocades*⁴⁷⁷ the Commission had analyzed a grant-back obligation in a specialization agreement in a rather different way. The parties entered into a mutual supply arrangement and Gist-Brocades licensed its technology to Bayer on a non-exclusive basis. Among other things, the agreement contained an obligation on both parties to cross-license any improvements of the manufacturing process. The Commission found that Article 81(1) EC applied to the entire agreement, including the reciprocal grant-back obligation. Despite this, the agreement was exempted under Article 81(3) EC. The Commission found that the reciprocal grant-back provision in respect of any improvements to the existing processes and of new manufacturing processes was an indispensable part of the specialization scheme, since it permitted the optimum use of the manufacturing capabilities. The specific reason for its finding was the non-exclusive characteristic of the provision: the licensee could license the improvements to other firms.

⁴⁷² TTBE (2004), fn 321, paragraph 109.

⁴⁷³ Commission decision 73/237/EEC, *Davidson Rubber Company*, OJ 1972 L 143/31.

⁴⁷⁴ *Lidgard, H. H., Atik, J.*, IPR and Technology Transfer: Reading Material, Spring 2007, p. 213.

⁴⁷⁵ TTBE (2004), fn 321, point 111.

⁴⁷⁶ *Ohlsson, E.*, fn 466, p. 38.

⁴⁷⁷ Commission Decision 76/172/EEC *Bayer/ Gist-Brocades*, OJ 1976 L 30/13.

In contrast, under the TTBER (2004), non-exclusive grant-back obligations which contain severable improvements are block-exempted. This approach had previously been suggested in *Raymond/Nagoya*.⁴⁷⁸ Here, the Commission ruled on the validity of an obligation imposed on Nagoya, the licensee, to assign any improvements in the licensed technology to Raymond, the licensor. The Commission requested that the obligation be modified to cover the grant back of a non-exclusive license only. The TTBER (2004) also exempts non-reciprocal grant-back obligations because they may promote innovation and the dissemination of new technology.⁴⁷⁹

A grant-back obligation for non-severable improvements is exempted regardless of whether it is exclusive or reciprocal because non-severable improvements cannot be exploited by the licensee without the licensor's permission. This type of obligation is not restrictive of competition within the meaning of Article 81(1) EC.⁴⁸⁰

It is also important to note that grant-back obligations falling within Article 5 of the Regulation are not to be deemed automatically severable from the agreement in which they appear. The ECJ has concluded that the question of whether Article 81(1) EC applies to a clause in a license agreement only, depends on whether it is severable from the whole contract. This is to be determined by the national courts in accordance with national law.⁴⁸¹

Individual Assessment

As noted above, when a license agreement contains grant-back restrictions which do not automatically fall outside the scope of exemption, an individual assessment of the provision is required. The Commission states that in the assessment of an exclusive grant-back obligation, the market position of the licensor on the technology market and the market position of the licensor's technology will be taken into consideration when assessing anti-competitive effects.⁴⁸² The stronger the position of the licensor, or the licensor's technology, the more

⁴⁷⁸ Commission decision 73/238/EEC, *Raymond & Co and Nagoya Rubber Co. Ltd*, OJ 1972 L 143/39.

⁴⁷⁹ TTBER (2004), fn 321, paragraph 109.

⁴⁸⁰ *Id.*

⁴⁸¹ Case C-319/82, *Société Vente de Ciments et Bétons de l'Est SA v. Kerpen & Kerpen GmbH undertaking Co.KG*, ECR 4173, paragraphs 11-12.

⁴⁸² TTBER (2004), fn 324, paragraph 110.

likely it is that the licensee's incentives to improve will be reduced, since the licensee's improvements potentially constitute an important source of innovation and future competition, and this would be lost to him.

The actual compensation for grant-backs is not considered by the TTBER (2004), but the Guidelines states that both the existence of payment and the amount paid may be relevant factors in the context of an individual assessment under Article 81 EC. Substantial and fair payments may increase, or at least not reduce the incentive to innovate. In *Velcro SA v. Aplix SA*⁴⁸³ the Commission ignored a provision providing for reasonable compensation for the grant-back of improvements but its views seem to have changed by the time of the TTBER (2004).

Potential Problems

The first problem relates to the distinction between severable and non-severable improvements in considering which grant-back obligations are exempted. As noted above, the TTBER (2004) exempts grant-back obligations for non-severable improvements regardless of whether they are exclusive or non-exclusive.

Problems only appear in the case of an exclusive grant-back obligation for non-severable improvements. The rationale behind the exemption is that without the consent of the licensor, the licensee cannot exploit the licensed technology's improvements in any event. However, a problem arises when the grant-back obligations exceed the period of protection of licensed technology. The improvements made to the original technology will have acquired an independent market value. However, in such situations, exclusivity would permit the licensor of the original technology still to control the use of the improvement. The licensee would thus be deprived of the independent market value of its own improvements. Consequently, abandoning the distinction between severable and non-severable should be considered.⁴⁸⁴

⁴⁸³ Commission Decision 85/410/EEC, *Velcro SA v. Aplix SA*, July 12, 1985, OJ L 233/22.

⁴⁸⁴ Comments of the Working Group "Competition Law of Licensing Agreements" at the Max Planck Institute for Intellectual Property, Competition and Tax Law; available at: http://ec.europa.eu/comm/competition/antitrust/technology_transfer_2/max_planck_en.pdf.

Such an approach was adopted by the Commission in its decision in *Delta Chemie/ DDD*, in which the parties were ordered to modify the know-how license agreement which prohibited DDD from using DC's know how after the expiry of the original technology.⁴⁸⁵ After modification, the clause stipulated that the right of the licensor to use the licensee's improvements would cease with the termination of the license agreement. This clearly improved the licensee's ability to use its own improvements; before it, the licensee had not been entitled to exploit improvements made to the licensed technology after the termination, whereas the licensor had been able to continue using the improvements.

Although Article 5 applies similarly to both horizontal and vertical relationships, another issue that arises is whether the effect of a grant-back obligation depends on the nature of the competitive relationship between the licensee and the licensor. It is clear that if the licensee and the licensor are competitors, a non-reciprocal grant-back may have more of an anti-competitive effect.

4.3. The U.S. position

Rule of Reason

The evaluation of grant-back obligations under antitrust law in the U.S. was first addressed in the leading case *Transparent-Wrap Mach. Corp. v. Stokes & Smith Co.*⁴⁸⁶ In this case, Transparent-Wrap held a series of patents on a machine that made, filled and sealed cellophane packages for candy, nuts and the like. Transparent-Wrap granted Stokes & Smith an exclusive license. The licensee had an obligation to assign back the rights to patents for any improvements to the licensed technology that it might develop. Stokes & Smith thereafter developed patents within the scope of the clause, but refused to grant them back to Transparent Wrap. After failing to settle the dispute through negotiation, the parties brought an action for interpretation of the contract. The question under consideration was whether the grant-back clause was *per se* unlawful and unenforceable.

⁴⁸⁵ Commission Decision 88/563/EEC, *Delta Chemie/ DDC*, OJ L 309/34.

⁴⁸⁶ *Transparent-Wrap Mach. Corp. v. Stokes & Smith Co.*, 329 U.S. 637, 642 (1947) ("Transwrap").

The Court of Appeals for the Second Circuit found that the grant-back obligations violated the policy underlying the federal patent law. They would enable the patentee to extend the scope of the lawful patent monopoly as he would have exclusive rights to the improvements even after the expiry of the original patent. When addressing these facts, the Supreme Court took a different view and held that a grant-back of rights to any licensee improvements to his licensor was not illegal.⁴⁸⁷ In rejecting *per se* illegality, the Court recognized that a grant-back obligation was being used to extend the original patent monopoly. However, the court explained that:

One who uses one patent to acquire another is not extending his patent monopoly to articles governed by the general law and as respects which neither monopolies nor restraints of trade are sanctioned. He is indeed using one legalized monopoly to acquire another legalized monopoly.⁴⁸⁸

Consequently, the Court implied that using one patent to acquire another did not amount to an unlawful extension of a patent monopoly. A grant-back is not in violation of public policy regarding patents but is sanctioned by it.⁴⁸⁹

The second argument was regarding the compatibility of grant-back obligations with antitrust law. In this respect, the Supreme Court again found that grant-back clauses were not *per se* illegal. However, the Court did suggest that, under proper circumstances, “the use of a condition or covenant in a patent license that the licensee will assign improvement patents may give rise to violations of the antitrust laws.”⁴⁹⁰ Based on this judgment, the lower courts have defined some of the circumstances under which a grant-back clause may be held illegal, including those where:

- the licensee is forced to accept a license with a grant-back because it has no reasonably available alternatives;
- the grant-back clause threatens to significantly discourage the licensee from innovation, development or improvement of the licensed item;

⁴⁸⁷ Id., at 648.

⁴⁸⁸ Id., at 644.

⁴⁸⁹ Id., at 642-645.

⁴⁹⁰ Id., at 648.

- the scope of the grant-back clause extends far beyond the scope of the underlying patent, suggesting that the grant-back clause is being used to expand the licensor's entitlement beyond the entitlement inherent in the underlying patent and;
- the grant-back clause is used to conceal or foster a cartel arrangement among the license participants.⁴⁹¹

The judgment in *Transparent-Wrap Mach. Corp. v. Stokes & Smith Co* thus established that the rule of reason was to be used when analyzing the effects of grant-back obligations. Thus, both pro- and anti-competitive effects should be taken into account when analyzing restrictions in a license agreement, and it must be determined which of these effects predominates.⁴⁹²

This approach is now the official policy of the U.S. federal antitrust enforcement agency. The IP (1995) Guidelines acknowledge that grant-backs can have pro-competitive effects, because they provide a means for the licensee and the licensor to share the risks in the license agreement and reward the licensee for making further innovation based on the licensed technology. The pro-competitive effects are more pronounced in the case of non-exclusive grant-back obligations.⁴⁹³ Under the IP (1995) Guidelines, grant-backs may be deemed anti-competitive only if they discourage the licensee from engaging in research and development. If the grant-back reduces a licensee's incentive to innovate, the agencies will consider whether the obligation still increases the licensor's incentive to disseminate the licensed technology or either party's incentives to innovate in the first place or gives rise to any other pro-competitive effects.⁴⁹⁴

⁴⁹¹ Tempel, S., Boyle, P., Terzanken III, J., Alberston, S., Antitrust/ Intellectual Property law issue for the transactional lawyer, available at: <http://www.abanet.org/buslaw/newsletter/0003/materials/tip2.pdf>.

⁴⁹² See also: Han, J., Study on intellectual property licensing under antimonopoly law in the U.S., Europe, Japan and Korea, 2005, p.107.

⁴⁹³ IP (1995) Guidelines, fn 348, § 5.6.

⁴⁹⁴ Id.

4.4. Conclusions

The competitive effects of grant-back obligations have been the center of much discussion. The TTBER (2004) and the accompanying TTBEG (2004) develop an analytical framework that is similar to the framework described in the IP (1995) Guidelines. However important differences remain.⁴⁹⁵

Although both systems have considered license agreements in general and grant-back obligations in particular from an economic point of view, differences in the way they approach the matter still exist.

U.S. antitrust law utilizes the rule of reason to evaluate the pro- and anti-competitive effects of grant-back obligations. The IP (1995) Guidelines clearly indicate that grant-back obligations can have pro-competitive effects. This positive approach is not mentioned in the TTBER (2004), which focuses on the anti-competitive effects of grant-back clauses. In the end, even if the approach differs, the end results are not all that different.

The conclusion that can be drawn is that the 2004 EU Technology Transfer Block Exemption Regulation and the U.S. 1995 IP Antitrust Guidelines indicate that there has been some convergence regarding the competition policy of the two jurisdictions: this applies to license agreements in general and grant-back clauses in particular. From a long-term perspective, this convergence in the evaluation of technology licensing will likely facilitate increased diffusion of technology between them.

⁴⁹⁵ *Gilbert, R.*, *Converging Doctrines? US and EU Antitrust Policy for the Licensing of Intellectual Property*, p. 3.

Antitrust Restrictions in License Agreements

Joint Conclusion

Although the EU and the U.S. are starting to apply antitrust principles to license agreements in similar ways, fundamental differences remain. As the EU is founded on achieving a single market, competition law must take precedence over IP considerations; such concerns do not arise in the U.S. This difference is clearly evident in the treatment of restrictions in license agreements.

When imposing hardcore restrictions, the EU rigidly characterizes parties as either competitors or non-competitors and enforces different substantive rules according to how the parties are classified. In the U.S., however, in the enforcement of *per se* restrictions, the equivalent of EU hardcore restrictions, the concern is whether the relationship is between horizontal or vertical levels.

Thus, the argument can be made that under EC law a balance has not been struck between competition law and IP and this may not even be possible due to the single market imperative. In the U.S., on the other hand, it can be argued that achieving such a balance is very close to having been struck, although there still seems to be a slight bias in favor of IP law.

IV. IPR and Dominance

IPR tends to give rise to monopolies and dominant positions: Even if sometimes rather narrow, more substantive ones may be detrimental to consumer welfare and economic well-being. Thus, a balance has to be struck between the right to exercise IPRs and the need to prevent abuse of such dominance. The purpose of this Section is to consider five relevant areas of the law.

In the first chapter, the existence/exercise distinction employed by the ECJ is analyzed in the light of Treaty Articles and pertinent case law. In the second chapter, Article 82 EC is considered in relation to in-licensing and out-licensing of the rights conferred by intellectual property law. The U.S. perspective is dealt with in chapter three. In the fourth chapter, IPRs and dominance are examined in connection with innovation issues. The innovation market concept will be defined and used to take a closer look at a hypothetical scenario where a company has received a patent on a new product that confers dominance on an innovation market. In the final chapter, the relationship of patent misuse and antitrust law infringement is considered from both an U.S. and EU perspective.

1. THE EXISTENCE/EXERCISE DISTINCTION: HELPFUL, CONFUSING, OR MERELY OBSOLETE?

BY RICKARD VERNET

The extent to which an owner of an IPR can exercise his rights and limit competition has long been debated. The ECJ has contributed by saying that while the existence of an IPR cannot constitute abuse of a dominant position under Article 82 EC, the exercise of it can.

The aim of this chapter is to examine this distinction between existence and exercise, its theoretical foundations, effects and continuing relevance. The focus will be on the relationship between IPR and Article 82 EC. To some extent, the approach will be functionalistic. The importance of strong IPR for economic and technological growth cannot be overestimated. Further, industrial and commercial actors require clear and predictable legal rules and distinctions if they are to maximize their efficiency. Thus, the theories employed by the ECJ will be assessed on these criteria – how well do they protect IPR, and do they generate predictable results?

1.1. Competing or Converging Interests?

The aim of IPRs is to protect the interests of their creators and to allow them to collect the economic benefits of their achievements. The aim of competition law has always been consumer welfare. This is

notably the case in the U.S. where antitrust law is expressly used to promote maximum efficiency and minimize deadweight loss.⁴⁹⁶

European competition law pursues other aims as well.⁴⁹⁷ As a crucial part of the process of creating the internal market, the EC institutions have been extremely hostile to the geographical partitioning of markets, especially when they follow existing State borders.

Thus, while IPR and competition law do serve the same general aim, economic growth and efficiency, it is clear that they sometimes come in direct conflict with each other. An efficiency maximizing balance needs to be found, and as one observer comments: “The challenge for antitrust law as to intellectual property is to craft a regime which establishes constraints on IPR owners which are predictable, rational and not discouraging.”⁴⁹⁸

1.2. IPRs and dominant positions

One of the main purposes of competition law is to prevent a dominant undertaking using its market power in an abusive and overly anticompetitive manner. In the EC, this is covered by Article 82.

As noted above, any IPR will always lead to a legal monopoly. The essence of the IPR is to exclude others from taking advantage of the protected subject matter. The monopoly may confer a dominant position within Article 82 but this depends on both the relevant product and the geographical limits.⁴⁹⁹ There may be other products which are substitutable. Note also that a dominant position does not require an

⁴⁹⁶ Kobak J., Running the Gauntlet: Antitrust and Intellectual Property Pitfalls on the Two Sides of the Atlantic, 64 Antitrust Law Journal, p 341.

⁴⁹⁷ Turney J., Defining the Limits of the EU Essential Facilities Doctrine on Intellectual Property Rights: The Primacy of Securing Optimal Innovation, 3 Northwestern Journal of Technology & Intellectual Property, p 182f.

⁴⁹⁸ Forrester I., Regulating Intellectual Property via Competition? Or Regulating Competition via Intellectual Property? Competition and Intellectual Property: Ten Years on, the Debate still Flourishes, p 4, available at <http://www.iue.it/RSCAS/Research/Competition/2005/200510-CompForrester.pdf>.

⁴⁹⁹ Case 27/76, *United Brands Co v Commission*, [1978] ECR 207.

absolute monopoly on the relevant market, but only a major position (which could be as low as 50%).⁵⁰⁰

It is, however, clear that mere dominance never can be considered illegal. There must be some kind of abuse of the dominant position. Were it not so, IP would be indefensible. What this means is that the holder of the IPR must have exercised the right in a way which has not only a negative impact on competition in general, but also an exclusionary or exploitative one. In the context of IPRs, this was expressed in *Parke Davis*.⁵⁰¹

for the prohibition under Article 86 [now Article 82] to apply it is ... necessary that three elements shall be present together: the existence of a dominant position, the abuse of this position, and the possibility that trade between member-States may be affected thereby.

The relevant question is thus: what can be considered an abuse?

The existence/exercise distinction

The solution first proposed by the ECJ in the seminal judgment of *Consten and Grundig*⁵⁰² is an interesting one which has also been strongly criticized. Grundig, a German manufacturer, had granted Consten an exclusive distribution right and agreed to bar any parallel import into France. This was reinforced by Consten being granted the sole right to the relevant trademarks within the French territory. The Commission issued an injunction preventing the parties from relying on their rights under national law, without actually touching the rights as such. The Court, accepting the action taken by the Commission, drew a distinction between the grant or existence of a national IPR, which was not subject to the provisions of the EC Treaty, and the exercise of such a right, which was.

While the *Consten and Grundig* case dealt with an agreement restricting competition, and thus infringements of Article 81 EC, it is clear that the same reasoning applies in cases of actions by a dominant undertaking.⁵⁰³

⁵⁰⁰ Case C-62/86, *Akzo Chemie BV v Commission*, [1991] ECR I-3359.

⁵⁰¹ Case 24/67, *Parke Davis & Co. v Probel, Centrafarm and Others*, [1968] ECR 55

⁵⁰² Cases 56 & 58/64 *Consten & Grundig v. Commission*, [1966] ECR 299

⁵⁰³ *Groves P*, Intellectual Property and the Internal Market of the European Community, Graham & Trotman, London, 1993, p 6.

The distinction was subsequently expressed more clearly in *Parke Davis*, mentioned above. In this case a parallel importer acquired a generic version of a drug in Italy with the intention of bringing it onto the Dutch market. The drugs were patent protected in the Netherlands, but such protection was unavailable in Italy. Parallel import was prevented by Parke Davis, the holders of the Dutch patent, who applied for an injunction to stop the infringement of their patent. The ECJ stated that while the existence of a patent right depends on national law and thus cannot be within the jurisdiction of the Court, the exercise of such a right could be scrutinized. As has been noted above, the ECJ proceeded by explaining that while the abuse of a patent would be subject to competition law, the mere fact that the patentee receives special protection does not imply that Article 82 EC is satisfied.

The specific subject matter doctrine

It seems clear that the existence/exercise distinction is established case law, and that it will be employed in those cases where an IPR limits competition within the Community. The question that arises is thus: what should be considered a part of the original grant, and what should be considered an exercise of it?

It seems as if the ECJ does not consider it within its power to proclaim an IPR, granted under national law, invalid. But to draw the distinction there would be pointless. An IP grant that cannot be exercised at all has no real value, and to draw the line at this point would risk rendering the grant meaningless. Instead, the Court has referred to what should be considered an exercise of the specific subject matter of the right and an exercise which is outside that.

The subject matter test originates from the *Sterling Drug*⁵⁰⁴ case, where the Court listed what the specific subject matter of a patent was:

...the guarantee that the patentee...has the exclusive right to use an invention with a view to manufacturing industrial products and putting them into circulation for the first time, either directly or by the grant of licenses to third parties, as well as the right to oppose infringements.

Even though the case dealt with the free movement of goods, and the rule is based on the exception in Article 30 EC, this has been applied to exercises of IPR under Article 82 EC. The effect of this

⁵⁰⁴Case 15/74, *Centrafarm BV v. Sterling Drug*, [1974] ECR 1147

seems to be that the exercise of certain “core” rights cannot constitute abuse of a dominant position. As shall be seen below however, this idea (which will be referred to as the “traditional” approach) is perhaps not as relevant today.

The broader picture – Primacy of EC law

It should be noted, at this point, that the existence/exercise distinction is by no means a stranger in the judicial landscape drawn by the ECJ. On the contrary, it fits in rather well with the approach taken by the Court on the overall relationship between national and Community law. The essence of the Court’s seminal ruling in *Costa v. ENEL*⁵⁰⁵ is well known: EC law holds primacy over national legislation. Measures adopted by Member States cannot supersede nor be inconsistent with the Community legal system. This obviously impacts on the approach towards IP.

As noted earlier, Article 295 EC clearly stipulates that the laws governing the ownership of IP are within the domain of the individual Member States. Following the *Costa v. ENEL* reasoning however, the rights of an IPR holder cannot be in conflict with one of the basic objectives of EC law, in this case the aim of preventing disruption of free competition within the common market.

Bearing the primacy doctrine in mind, the Court’s remark in *Consten and Grundig*; that Articles 30 and 295 of the EC Treaty (on the exceptions to free movement in the case of IP and the inviolability of the national property rights systems, respectively) do not reserve all power to regulate all aspects of patent law to the national legislature, to the exclusion of any Community action in the matter, might be debatable but is hardly surprising.

1.3. Problems with the traditional distinction

The most basic criticism of the existence/exercise distinction is that it is artificial and confusing. The very essence of an IPR is to exclude others from taking advantage of the subject matter protected. If the

⁵⁰⁵ Case 6/64, *Costa v. ENEL*, [1964] ECR 585.

holder of the right is unable to exercise his rights under the grant, then the grant itself becomes more or less insignificant. There is no real point in legally being the sole owner to a specific right, if one is unable to exercise that right. Korah notes that

“In legal theory, it is impossible to draw the line between existence and exercise, except at the extremes. Analytically, the existence of a right consists of all the ways in which it may be exercised.”⁵⁰⁶

The distinction becomes even more confusing as the ECJ have not produced clear guidelines as to where existence ends and exercise begins. Obviously, this creates problems, as industrial and commercial actors cannot predict the judicial evaluation of their activities. Korah continues:

“In ruling that an important difference rests on a distinction which cannot be drawn by logical analysis, the Court created a very flexible instrument for it to develop the law and reduce the possibilities of dividing the common market through the use of national or regional intellectual property rights.”⁵⁰⁷

Thus, it seems as though the ECJ has deliberately been applying a confusing and illogical distinction in order to allow itself flexibility.

In the conflict between IPRs and competition, it has been proposed that the exercise of an IPR could never constitute an abuse of a dominant position, and that the existence/exercise distinction and subject matter test simply derive from confusing legal rights with de facto monopolies.⁵⁰⁸ IPRs are legal rights, which the rights holder should be able to exercise as freely as any other property he may enjoy, while the latter are freedoms to behave in an arbitrary fashion arising from pure market power. Where the distortion of competition is due to the exercise of legal rights, and not from market power per se, Article 82 EC cannot be applicable. What an IPR means is precisely a right to exclude, and such a right does not equal market power.⁵⁰⁹ It could also

⁵⁰⁶ *Korah V*, An Introductory Guide to EC Competition Law and Practice, 8th edition, Hart Publishing, Oxford & Portland, Oregon, 2004, p 292.

⁵⁰⁷ *Id.*

⁵⁰⁸ *Miller C.*, Magill: time to abandon the "specific subject-matter" concept, 16(10) European Intellectual Property Review, p 415.

⁵⁰⁹ *Easterbrook F.*, Intellectual Property is Still Property, 13 (1) Harvard Journal of Law and Public Policy, p 108.

be argued that only patents are likely to create market power to any significant effect.⁵¹⁰

It could also be stressed that, in applying the existence/exercise distinction, the Court goes against the wording of Article 295 EC. This should be seen as another highly debatable example of the judicial creativeness of the Community courts, especially since it could be argued that Article 295 EC has effectively been rendered a nullity in relation to IPRs.⁵¹¹ It is not far-fetched to claim that this should be done by legislative powers, not the Court.

However, not all commentators have been quite so skeptical about the distinction and its effects. It has been argued that the underlying reason for adopting the distinction - to create an effective and flexible tool for resolving conflicts between national and EC law - is enough to justify it.⁵¹²

1.4. Still a valid distinction?

In the *Volvo*⁵¹³ case, the Swedish car manufacturer had refused to supply Veng with a license for design rights for certain spare parts. Was this to be considered an abuse of Volvo's dominant position? The Court began by affirming that the right to prevent others from manufacturing selling, or importing formed part of the specific subject matter of the exclusive right. Thus, an obligation to license would deprive the owner of the subject matter of his IPR, and a refusal to grant a license therefore could not in itself constitute an abuse of a dominant position.

This seemed like an affirmation of the traditional principle presented above, that exercise of "core" rights does not constitute abuse. The Court continued, however, by making a very important distinction, stating that a dominant undertaking could nonetheless be considered in breach of Article 82 EC simply by refusing to license, if

⁵¹⁰ *Forrester I.*, fn 498, p 7.

⁵¹¹ *Korab V.*, The interface between intellectual property and antitrust: The European experience, 69 Antitrust Law Journal, p 801.

⁵¹² *Westkamp G.*, Balancing database sui generis right protection with European monopoly control under Article 82 E.C., 22(1) European Competition Law Review.

⁵¹³ Case 237/87, *Volvo AB v Erik Veng (U.K.) Ltd*, [1988] ECR 6211

certain abusive conduct were shown. It thus took a big step away from its established case law by declaring that even reliance on “core” rights could be considered abusive.⁵¹⁴ However, this did little to clarify the ECJ’s position, it rather seemed a paradoxical approach likely to increase uncertainty.

The famous *Magill*⁵¹⁵ case blurred these concepts even more. Here, an Irish publisher wanted access to the TV program listings made by the broadcasting companies, in order to publish these listings in a weekly magazine. The broadcasting companies sought a court order opposing this and *Magill* claimed that they were abusing their dominant positions. It is interesting to look at the judgment of the CFI, AG Gulmann’s opinion, and the final judgment from the ECJ, as they all take different positions in regards to the traditional distinction.

The CFI, following the traditional approach to some extent, declared that the right to refuse to license fell within the specific subject matter of the copyright. It continued however, by saying that the right holders, under these circumstances, should be required to license their rights anyway. The judgment from the CFI is quite similar to that of the ECJ in *Volvo*, in that it follows the subject matter doctrine, but then makes an exception to it.

On appeal to the ECJ, AG Gulmann disagreed with the reasoning of the CFI, and said that as the exclusive right to reproduce a copyrighted work was part of the specific subject matter of copyright, and as the exclusive right to refuse licenses is a corollary of that right, the right to refuse licenses must be part of the specific subject matter. The opinion was thus in line with the specific subject matter concept, that identifies the core rights which the IP owner enjoys and whose exercise is not affected by the Treaty rules. The thrust of the argument was that the interest of free competition should prevail over the interests of the rights holder only when the exercise of the IPR is not necessary to fulfill its essential function.

The ECJ, however, chose to walk down a different road. It stated that while that “a refusal to grant a license, even if it is the act of an undertaking holding a dominant position, cannot in itself constitute

⁵¹⁴ *Opi S.B.*, The Application of the Essential Facilities Doctrine to Intellectual Property Licensing in the European Union and the United States: Are Intellectual Property Rights still Sacrosanct?, 11 Fordham Intellectual Property Media & Entertainment Law Journal, p 453.

⁵¹⁵ Cases C-241/91 P & C-242/91 P, *Radio Telefís Éireann (RTE) and Independent Television Publications Ltd (ITP) v Commission*, [1995] ECR I-743 (*Magill*)

abuse of a dominant position”, such a refusal by a dominant undertaking could be considered abusive under certain circumstances. First, there was no actual or potential substitute for the weekly TV guide offering information on the programs for the week ahead, for which there was a definite consumer demand. The broadcasting companies’ refusal to provide the “indispensable raw material” prevented the emergence of a new product that would have competed with their own guides. Second, the Court found no business justification for the refusal. Third, the broadcasting companies, through their refusal, had reserved for themselves a monopoly in the secondary market of weekly TV guides. Thus, the TV broadcasting companies had abused their dominant position under Article 82 EC.

While a more sophisticated analysis of the doctrines applied by the ECJ in *Magill* would be beyond the purpose of this paper, the ruling is nonetheless interesting in the context at hand, as the Court makes no mention of either the existence/exercise dichotomy or the specific subject matter of the copyright. The key question is whether the distinction was still used, albeit not explicitly, whether the omission was merely an inconsistency, or whether the Court actually did override its old case law. If the judgment in *Magill* is followed, it seems as though the existence/exercise distinction will have little relevance in determining whether the exercise of an IPR constitutes abuse under Article 82 EC. Rather, the Court will seem to have moved towards a more circumstances-based approach.⁵¹⁶

Magill, as shall be seen in subsequent chapters, seems to have set a precedent. It was followed by the *IMS*⁵¹⁷ case in 2004, which also dealt with essential facilities. In its judgment, the ECJ referred to *Volvo* and *Magill*, but made no mention of either the existence/exercise distinction or the specific subject matter of the IPR. On the other hand, Judge Vesterdorf, president of the CFI, raised the distinction in a lecture in 2002, giving the impression that it may be premature to declare it obsolete.

It is at this level that the supposed distinction between the existence and the exercise of an intellectual property right becomes problematic, because the issue is whether or not the exercise of the specific subject matter of the right can ever, in itself, effectively

⁵¹⁶ *Vinje T.*, Harmonising Intellectual property laws in the European Union: Past, present and future, 17(8) European Intellectual Property Review, p 376.

⁵¹⁷ Case C-418/01, *IMS Health v. NDC Health*, [2004] ECR I-5039

constitute an abuse by the owner of the dominant position flowing from the existence of the right.⁵¹⁸

These words would affirm that the existence/exercise distinction lives on within the Community courts, if not always in an explicit way.

1.5. Conclusion

The existence/exercise distinction was created by the ECJ as a way to balance the interests of promoting dynamic evolvement through the protection of IP and the prevention of disruption to free competition on the common market. This judicial solution should be seen as an attempt to limit the extent to which the national rules on IP could be used to undermine attempts to complete the single market by partitioning markets along national borders, while at the same time avoiding stripping IPRs of all substance.⁵¹⁹

While it is obvious that a balance has to be found, the traditional theory applied by the ECJ can be criticized from a number of perspectives.

First of all, the distinction between existence and exercise is fictitious, and contains an inherent contradiction. Exercise is the very essence of a right. Further, the distinction is confusing, since it is not based on any tangible or definite criteria. Rather, it is an extremely flexible tool in the hands of the ECJ even if it makes it hard for outside actors to predict the outcome of an evaluation. The distinction has also weakened the impact of Article 295, though it was never clear that this conferred any rights on individuals or businesses.

Secondly, by allowing the mere exercise of IPR to be scrutinized, the Community runs the risk of protecting competitors rather than consumers. It should be obvious that competition law should never intervene unless the ultimate benefits to consumers outweigh the rights of the IPR holder. The existence/exercise distinction does not seem to open up for such an evaluation. Due to the large costs of technological advances, some markets will naturally tend to give rise to

⁵¹⁸ *Vesterdorf, B.*, Role of copyright and related rights as a policy as compared to other policies, Speech at Santiago de Compostela (2002), available at http://ec.europa.eu/internal_market/copyright/conferences/conference-speech-vesterdorf_en.htm. 2002-06-

⁵¹⁹ *Craig P. & De Búrca G.*, EU Law, Oxford University Press, 2003, p 1119

concentrations of market power. Any regulatory fragmentations of these markets may lower efficiency to the disadvantage of consumers.⁵²⁰

It is clear that the existence/exercise doctrine applied by the Community courts is not wholly satisfactory. However, with the judgments in *Volvo*, *Magill*, and *IMS*, it seems as if the ECJ is now less keen on articulating the distinction. It might be argued that the Court is moving away from any clarification of the distinction, towards an even more uncertain position. It might be that we will see a more circumstances-based evaluation in the future, where the effect on consumers is the deciding factor. On the other hand, the quote taken from Judge Vesterdorf (albeit, outside the court setting) shows that the distinction lives on, and might still be the theoretical foundation for deciding conflicts between IPR and Article 82 EC.

The long-term solution to the general conflict between IPR and Article 82 EC is not judicial, but legislative. In a number of cases, the ECJ has held that until harmonization has taken place, and as long as IPR are governed by national laws, these laws will always be capable of creating obstacles to competition within the internal market. As one observer summarizes:

“If rights are harmonised, this finally erodes the dichotomy's necessity since here existence and exercise correspond.”⁵²¹

The long-term solution would thus be the replacement of national rights with Community-wide IPRs. While this work is ongoing today, it is hard to predict when it will be realized.

⁵²⁰ *Turney J.*, fn 497, p 183.

⁵²¹ *Westkamp G.*, fn 512.

2. IN & OUT LICENSING AND THE DOCTRINE OF SPECIAL RESPONSIBILITY: A EUROPEAN PERSPECTIVE

BY XIN SONG

As discussed above, the balance between IPRs and Article 82 EC has always been a controversial issue. Article 82 EC does not prohibit the existence or acquisition of a dominant position, but only to its abusive exploitation.⁵²² A dominant company always has to be cautious, no matter whether it receiving an exclusive in-licensing or refusing to out-license.

On the one hand, the holders of IPRs should have the exclusive right to decide whether they will exploit that right by themselves, and if not, with whom to cooperate. The obligation to grant a license to anyone who requests access to “essential facilities” would reduce their value. If these exclusive rights can be easily watered down, the incentive to innovate will vaporise. On the other hand, exclusive rights may lead to abuse. What if the holders strengthen their dominant position by buying up competition by exclusive in-licensing? What if they try to eliminate competition in a downstream market by an arbitrary refusal to license an “essential facility” others would need to compete on the market in question?

⁵²² *Korah V.*, An Introductory Guide, fn506, p. 121.

2.1. In-licensing

Tetra Pak I Case

Tetra Pak acquired an exclusive license to a new sterilization process for packaging milk cartons through the acquisition of Liquipak. This new process had been developed by Liquipak and its exclusive distributor Elopak. The exclusive patent license was carefully designed to benefit from a block exemption under the Patent Regulation⁵²³ and contained nothing going beyond the restrictions stated in that Regulation.

Elopak complained to the Commission but before any formal decision was made, Tetra Pak abandoned all claims to exclusivity in the relevant license. Although any abuse was thus brought to an end, the Commission considered that a formal decision should still be issued with a view, *inter alia*, to clarifying its position on the relevant point of law. It concluded that “Tetra abused its dominant position by the acquisition of an exclusive license which had the effect of strengthening its already dominant position, further weakening existing competition and rendering even more difficult the entry of any new competition”.⁵²⁴

Tetra Pak sought annulment of the decision before the CFI, arguing that Articles 81 EC and 82 EC cannot be interpreted in such a way that they contradict each other, because they seek to achieve the same aim.⁵²⁵ In particular, market conduct could not be prohibited under Article 82 EC when it would have been authorized under 81(3) EC.

The CFI disagreed, holding that in the scheme for the protection of competition established by the Treaty the grant of exemption, whether individual or block exemption, under Article 81(3) EC cannot render inapplicable the prohibition set out in Article 82 EC. Moreover, in view of the principles governing the hierarchical relationship of legal rules,

⁵²³ Commission Regulation (EEC) No 2349/84 of 23 July 1984 on the application of Article 85(3) of the Treaty to certain categories of patent licensing agreements, OJ L 84/219.

⁵²⁴ Case T-51/89 *Tetra Pak Rausing SA v. Commission* [1990] ECR II-309, paragraph 8.

⁵²⁵ Case 6/72, *Europemballage Corporation and Continental Can Company Inc. v Commission*, [1973] ECR 215, paragraph 25.

grant of exemption under secondary legislation could not, in the absence of any enabling provision in the Treaty, derogate from a provision of the Treaty, in this case Article 82 EC.⁵²⁶

The CFI also ruled that one of the main purposes of the block exemption is to secure legal certainty for parties to an agreement as regards the validity of that agreement under Article 81 EC so long as the Commission has not withdrawn the benefit of the block exemption. But that does not discharge undertakings in a dominant position from the further obligation to comply with Article 82 EC.⁵²⁷

Special Responsibility

The block exemptions thus cannot shield a dominant company from being examined under Article 82 EC. In *Michelin*⁵²⁸, it was held that a dominant undertaking has a special responsibility not to allow its conduct to impair genuine undistorted competition on the common market.

We can conclude that dominant companies must be careful in accepting exclusive in-licensing agreements and certainly cannot rely on the fact that the agreement would otherwise satisfy all the conditions of a group exemption.⁵²⁹ As there is no negative clearance procedure under Article 82, a dominant company also has to evaluate the conduct itself.

2.2. Out-licensing

In *Volvo*⁵³⁰, the ECJ established that that a refusal to grant a license cannot in itself constitute an abuse of a dominant position.⁵³¹ Additional conditions need to be met. On a case-by-case basis - *Volvo*,

⁵²⁶ Case C-62/86, *Akzo Chemie*, fn 500, paragraph 25.

⁵²⁷ *Id*, paragraph 37.

⁵²⁸ Case 322/81, *NV Nederlandsche Banden Industrie Michelin v Commission*, [1983] ECR 3461, paragraph 57.

⁵²⁹ *Lidgard, H. H., Atik, J.*, IPR and Technology Transfer: Reading Material, Spring 2007, page 266.

⁵³⁰ Case C-237/87, *Volvo*, fn 513

⁵³¹ *Id*, paragraph 8.

*Magill*⁵³², *Tiercé Ladbroke*⁵³³, *Oscar Bronner*⁵³⁴, *IMS*⁵³⁵ and *Microsoft*⁵³⁶ - the doctrine of “exceptional circumstances” has been established and developed.

EU case law

The Volvo Case. Volvo held a registered design for the front wings of Volvo series 200 cars in the UK and refused to grant a license to Veng. The latter then marketed the same body panels in the UK without authority from the proprietor.

The ECJ did not expressly say whether Volvo was in a dominant position or not. It ruled that an obligation imposed upon the proprietor of a protected design to grant licenses to third parties, even in return for a reasonable royalty, would lead to him being deprived of the substance of his exclusive right, and that a refusal to grant such a license could not in itself constitute an abuse of a dominant position.⁵³⁷

For such a refusal by an undertaking holding a dominant position to be an abuse, additional conditions would have to exist. According to the ECJ, such additional elements could be the arbitrary refusal to supply spare parts to independent repairers, the fixing of prices for spare parts at an unfair level or a decision no longer to produce spare parts for a particular model even though many cars of that model are still in circulation, provided always that such conduct is liable to affect trade between Member States.⁵³⁸

The concept of additional conditions was discussed in the famous *Magill* case – here the notion of exceptional circumstances was established.

⁵³² Cases C-241/91 P & C-242/91 P *Magill*, fn 515.

⁵³³ Case T-504/93, *Tiercé Ladbroke SA v Commission*, [1997] ECR II-923

⁵³⁴ Case C-7/97, *Oscar Bronner GmbH & Co. KG v Mediaprint Zeitungs- und Zeitschriftenverlag GmbH & Co. KG, Mediaprint Zeitungsvertriebsgesellschaft mbH & Co. KG and Mediaprint Anzeigengesellschaft mbH & Co. KG*, [1998] ECR I-7791.

⁵³⁵ Case C-418/01, *IMS*, fn 517

⁵³⁶ Commission, Case COMP/C-3/37.792 — *Microsoft*, 24 May 2004, relating to a proceeding pursuant to Article 82 of the EC Treaty and Article 54 of the EEA Agreement against Microsoft Corporation.

⁵³⁷ Case C-237/87, *Volvo*, fn 513, paragraph 8.

⁵³⁸ *Id.*, paragraph 9.

The Magill Case. RTE, ITV and BBC were the major broadcasting channels and each published their own programme guides containing only their own individual programme listings in Ireland and Northern Ireland. Magill attempted to publish a comprehensive weekly TV guide which was not available on the market at that time but was prevented from doing so by all the three broadcasting stations. Magill lodged a complaint with the Commission, which considered the refusal to provide the information in question as an unlawful abuse of a dominant position under Article 82 EC. The decision was upheld by both the CFI and the ECJ.

Mere ownership of an IPR does not automatically create a dominant position. However, the basic information on programmes was the only source for an undertaking, like Magill, which wished to publish a comprehensive weekly TV guide. In these circumstances, RTE and ITP, as the agent of ITV, along with the BBC, enjoyed a de facto monopoly over the information used to compile listings for television programmes.⁵³⁹

The ECJ confirmed the judgment in *Volvo* – the exclusive right of reproduction forms part of the author's rights, so that a refusal to grant a license cannot in itself constitute abuse of a dominant position. However, the exercise of an exclusive right by the proprietor may constitute an abuse of a dominant position in exceptional circumstances – the notion was reaffirmed.⁵⁴⁰

The Court went on to specify the exceptional circumstances here. First, the refusal prevented the appearance of a new product which the appellants did not offer and for which there was a potential consumer demand. Second, there was no justification for such refusal. Third, the appellants reserved to themselves the secondary market of weekly television guides by excluding all competition on that market since they denied access to the basic information which was the raw material indispensable for the compilation of such a guide.⁵⁴¹

Tiercé Ladbroke Case. Tiercé Ladbroke was a company in Belgium, whose business consisted of allowing its customers to bet on horse races run abroad. It asked the French horseracing organizers to grant a license for broadcasting their horse races in its betting outlets in Belgium, but was refused. Ladbroke filed a complaint with the

⁵³⁹ Cases C-241/91 P & C-242/91 P *Magill*, fn 515, paragraphs 46-47.

⁵⁴⁰ *Id.*, paragraphs 49-50.

⁵⁴¹ *Id.*, paragraphs 54-56.

Commission arguing that a license for broadcasting the races would be necessary for taking the bets and thereby for doing business on a downstream market, and that the refusal was discriminatory because similar rights had been granted to other competitors.

The CFI stated that Ladbroke could not rely on the *Magill* judgment to demonstrate the existence of the alleged abuse since the situation was different. In *Magill*, the refusal to grant a license prevented Magill from creating a market in comprehensive television guides. But here the applicant was not only present in, but had the largest share of the main betting market on which the product in question, namely sound and pictures, while the owners of the IPRs were not present on that market at all. The refusal to supply could not be regarded as involving any restriction of competition on the Belgian market.⁵⁴²

Further, the non-transmission of sound and pictures did not prevent Belgian bettors from continuing to bet on French races.⁵⁴³ That is to say the sound and pictures were not essential. The refusal to supply the applicant could not fall within the prohibition laid down by Article 82 EC unless (1) it concerned a product or service which was either essential for the exercise of the activity in question, in that there was no real or potential substitute; or (2) it was a new product whose introduction might be prevented, despite specific, constant and regular potential demand on the part of consumers.⁵⁴⁴ The CFI thus closely followed the ECJ judgment of *Magill* and did not seek to extend it.

Oscar Bronner Case. The Austrian newspaper group Mediaprint enjoyed a large market share and established a nationwide home-delivery scheme for delivering its newspapers directly to subscribers in the early hours of the morning. Bronner, the publisher of a small daily newspaper, requested access to the national home delivery service, offering reasonable payment but was refused. Bronner went to the Austrian court, claiming that the refusal was an abuse of a dominant position under Article 82 EC. Furthermore, postal delivery, which generally did not take place until the late morning, did not represent an equivalent alternative to home-delivery, and, in view of its small number of subscribers, it would be entirely unprofitable for it to organize its own home-delivery service. The Austrian court referred the matter to the ECJ for a preliminary ruling.

⁵⁴² Case T-504/93, *Tiervé Ladbroke S.A.*, fn 533, paragraph 130.

⁵⁴³ *Id.*, paragraph 87.

⁵⁴⁴ *Id.*, paragraph 131.

The Court confirmed the *Magill* judgment and held that refusal by the owner of an IPR to grant a license, even if it is the act of an undertaking holding a dominant position, cannot in itself constitute abuse of a dominant position. However, the exercise of an exclusive right by the proprietor may involve an abuse in exceptional circumstances: (1) the refused access is indispensable to the business of the applicant and there will be neither an actual nor a potential substitute for it; (2) the refusal cannot be objectively justified; and (3) the refusal is likely to exclude all competition in a secondary market in question.⁵⁴⁵ The “new product” condition in *Magill* seems to have been set aside.

IMS Case. IMS is a leading company providing pharmaceutical information services. It collects data about pharmaceutical sales and processes it in a specific self-developed structure called the brick structure. This structure has become the normal industry standard and over the years its clients adapted their information and distribution systems to it. Later NDC started to offer comparable data in the market using a very similar structure to the one developed by IMS. The German courts ordered NDC to stop offering data processed in this way as a breach of copyright. NDC requested a license of the brick structure but was refused by IMS.

The ECJ ruled that where an undertaking holds a dominant position and owns an IPR in a brick structure indispensable to the presentation of regional sales data on pharmaceutical products in a Member State, the refusal to grant a license to use that structure to another undertaking which also wishes to provide such data in the same Member State, constitutes an abuse of a dominant position within the meaning of Article 82 EC where the following conditions are fulfilled: (1) the undertaking which requested the license intends to offer, on the market for the supply of the data in question, new products or services not offered by the owner of the IPR and for which there is a potential consumer demand; (2) the refusal is not justified by objective considerations; (3) the refusal is such as to reserve to the owner of the IPR the market for the supply of data on sales of pharmaceutical products in the Member State concerned by eliminating all competition on that market.⁵⁴⁶

Microsoft Case. Microsoft refused to provide Sun with interoperability information enabling the latter to design work group

⁵⁴⁵ Case C-7/97, *Oscar Bronner*, fn 534, paragraph 41.

⁵⁴⁶ Case C-418/01, *IMS*, fn 517, paragraph 52.

server operating systems which could compete effectively with Microsoft's own systems. In order to allow Sun to provide for such seamless integration, Microsoft only had to provide technical documentation and not the software code for Windows itself. The Commission held that Microsoft's refusal risked eliminating competition in the relevant market of work group server operating systems.

Microsoft argued that the IP at hand derived from the investment of significant cost and effort and that disclosure would prejudice the protection of the result of this huge investment. Indeed, the disclosure would negate the protection and eliminate future incentives to invest in the creation of more IP.⁵⁴⁷ In other words, Microsoft argued that it was justified in refusing to supply on the grounds that it would eliminate its incentives to innovate.⁵⁴⁸ Microsoft thus considered that it had an objective justification to the refusal to license, as per the exceptional circumstances doctrine.

The Commission stated that there was a serious risk that Microsoft would succeed in eliminating all effective competition in the work group server operating system market and this would also have a significant negative effect on its incentives to innovate as regards its client PC and work group server operating system products. If Microsoft supplied Sun with the interoperability information, such competitive pressure would increase the pressure on Microsoft to innovate.⁵⁴⁹ Furthermore, the possible negative impact on Microsoft's incentives to innovate was outweighed by the positive impact on innovation in the industry as a whole.⁵⁵⁰ The Microsoft justification based on its incentives to innovate was rejected.

The case was appealed but is still pending. We will see in due course what will happen to the Commission's reasoning regarding incentives to innovate.

⁵⁴⁷ Case COMP/C-3/37.792 *Microsoft*, fn 536, paragraph 709.

⁵⁴⁸ *Vezoso S.*, The Incentives Balance Test in the EU Microsoft Case: a Pro-innovation "Economics-based" Approach, European Competition Law Review, Commission Decision, E.C.L.R. 2006, 27(7), 384.

⁵⁴⁹ Case COMP/C-3/37.792 *Microsoft*, fn 536, paragraph 725.

⁵⁵⁰ *Id.*, paragraph 783.

Exceptional Circumstances Test

The seed for the notion of exceptional circumstances was found in *Volvo* and was later established in *Magill*. Three conditions were set up, which were the: (1) prevention of a new product with a potential consumer demand; (2) without any objective justification; and (3) restriction of entry into a secondary market, the license refused being indispensable to entry. It is not clear from the judgment whether these conditions are concurrent or alternative.⁵⁵¹

In *Tiercé Ladbroke*, besides the “new product” condition, the CFI added a new one: the IPR to be licensed must be indispensable for the competitor to exercise his activity in that there is no real or potential substitute for it. In *Oscar Bronner*, although not a pure case of IPRs, the ECJ ignored the new product condition and adopted the *Tiercé Ladbroke* new condition instead. This seems to confirm that the condition that there be a new - blocked - product and the condition of indispensability are alternatives but one of them must be concurrent with the other two conditions “no justification” and “exclusion of all competition in a secondary market”.

In *IMS*, it is rather the *Magill* judgment that was followed. The exceptional circumstances consisted of:

- (1) the undertaking which requested the license intends to offer new products or services not offered by the owner of the IPR and for which there is a potential consumer demand, or, the refused access is indispensable to the business of the applicant and there will be neither actual nor potential substitute for it; and
- (2) the refusal is not justified by objective considerations; and
- (3) the refusal is such as to reserve to the owner of the IPR a secondary market by eliminating all competition on that market.

It seems that (1) and (3) of the exceptional circumstances have frequently been addressed by the European Courts, but the issue of justification has been left almost untouched. In *Microsoft*, the Commission launched a balance of incentives test. If upheld by the Courts, this test of the objective legitimacy of a denial to grant a license

⁵⁵¹ *Derclaye E.*, The IMS Health Decision and the Reconciliation of Copyright and Competition Law, *European Law Review*, Case Comment, E.L. Rev. 2004, 29(5), 687-697.

would be the most notable contribution of the *Microsoft* case to EU competition law.⁵⁵²

When all the exceptional circumstances are satisfied, a refusal to license by a dominant company will be held to be an abuse of a dominant position.

Doctrine of Essential Facilities at EU level

The theory behind the exceptional circumstances test is arguably an “essential facilities” one. The origin of this doctrine is a U.S. case, the *Terminal Railroad Association* case⁵⁵³ of 1912. The essential facilities doctrine has been helpful in opening up competition, particularly where access to a downstream market results from legal monopolies, other state intervention, or a facility's owner using its legal monopoly to monopolize a downstream market.⁵⁵⁴ However, in *Magill*, the use of the doctrine was implicit. The Court used the word “indispensable” but not “essential facilities”. The term “essential facilities” has in fact never been mentioned expressly.

In *Oscar Bronner*, the Court might be said to have provided a restrictive application of the essential facilities doctrine when allowing Mediaprint's refusal to grant Bronner access to its home-delivery scheme. Other methods of distributing daily newspapers, such as by post and through sale in shops, might be less advantageous. However, they did exist and were being used by the publishers. It was not impossible for Bronner to establish its own nationwide home-delivery scheme either alone or in cooperation with other publishers. In order to establish that the creation of such a system was not a realistic potential alternative and that access to the existing system was indispensable, it was not enough to argue that it was not economically viable by reason of the small circulation of the Bronner newspaper.⁵⁵⁵ The ECJ held that it is not enough to show that use of the facility would be desirable, it must be necessary.⁵⁵⁶

⁵⁵² *Vezyoso S.*, fn 548, at 383.

⁵⁵³ *United States v. Terminal Railroad Association*, 224 U.S. 383 (1912).

⁵⁵⁴ *Errard S. J.*, Essential Facilities in the European Union: Bronner and Beyond, Columbia Journal of European Law, Summer 2004, Page 505.

⁵⁵⁵ Case C-7/97, *Oscar Bronner*, fn 534, paragraphs 43-45.

⁵⁵⁶ *Korah V.*, An Introductory Guide, fn 506

As Advocate General Jacobs stated in his opinion in this case, if access to facilities were allowed too easily there would be no incentive for a competitor to develop any facilities of its own. Thus while competition might be increased in the short term it would be reduced in the long term. Moreover, the incentive for a dominant undertaking to invest in efficient facilities would be reduced if its competitors were able to share the benefits upon request. Thus the mere fact that by retaining a facility for its own use, a dominant undertaking has an advantage over a competitor, cannot justify forcing access to it.⁵⁵⁷

2.3. Conclusion

Article 82 EC does not prevent the existence or acquisition of a dominant position but rather its abuse. Where IPR, and its licensing in particular is concerned, the acquisition of an exclusive license may be held abusive as a dominant undertaking has a special responsibility not to allow its conduct to impair genuine undistorted competition on the common market; the same if it refuses to grant a license where the exceptional circumstances under the essential facilities doctrine apply.

It seems that key is the doctrine of special responsibility. When it comes to in-licensing, a dominant company has a special responsibility not to strengthen its position and not to impede or delay the emergence of new competitors through an exclusive license agreement. When it comes to out-licensing, a dominant company must grant an out-license when the IPR is an “essential facility” for a competitor to compete on a secondary market. That is to say, the obligation to allow access to essential facilities can also be considered as a special responsibility of a dominant company. That might be the reason why the European Courts have used the doctrine but not the term “essential facilities”. The expression “special responsibility” achieves the same objective.

⁵⁵⁷ Case C-7/97, *Oscar Bronner*, fn 534, Opinion of Mr Advocate General Jacobs delivered on 28 May 1998, Paragraph 57.

3. REFUSAL TO DEAL AND THE THE ESSENTIAL FACILITY DOCTRINE: U.S. PERSPECTIVE

BY BRENDAN GREALLY

The intersection of IPR and the need to maintain competition within the common market has produced some interesting case law in the EU. In the end, the policy of keeping the market free from anti-competitive abuses tends to outweigh an individual's or a company's right to exercise their IPRs. This policy can even lead to the use of compulsory licensing in order to remedy an abusive situation. In the U.S., the case law has evolved quite differently. U.S. courts are much less likely to impose compulsory licenses and give great deference to IPRs. Cases have however involved situations where a company's refusal to deal with a competitor can lead to a breach of competition law. The scenario is even more complex when the clash is between competition law and IPRs.

In the EU, recent case law has seen the use of the essential facility doctrine as a rationale for issuing a compulsory license and thus maintaining a competitive market.⁵⁵⁸ In stark contrast, the U.S. has continued to move away from using the essential facility doctrine. In fact, in the recent *Trinko* case, the U.S. Supreme Court refused to acknowledge or adopt the doctrine.⁵⁵⁹

⁵⁵⁸ Case C-418/01, *IMS*, fn 517

⁵⁵⁹ *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398 (2004).

3.1. Refusal to Deal

Refusal to deal means that under specific circumstances an undertaking in a monopoly position refuses to supply a competitor or former customer. In the U.S., the courts have been hesitant in finding such refusals to be in violation of antitrust laws. This is illustrated by *SCM* where the court found no duty to deal in respect of a legally obtained patent.⁵⁶⁰

SCM. After Xerox came to control Carlson's patents and all of the xerographic improvement patents, it enjoyed an absolute monopoly in the plain-paper copying segment of the industry.⁵⁶¹ In 1964 Xerox granted SCM limited licenses under its patents to manufacture coated-paper copiers but refused to extend them to plain-paper ones. SCM averred that Xerox's acquisition of certain patents and subsequent refusal to license those patents excluded SCM from competing effectively in a relevant product market and submarket dominated by Xerox, and that this constituted an antitrust violation.

The Second Circuit Court stated that the primary purpose of the antitrust laws, to preserve competition, can be temporarily frustrated by a holder's exercise of the patent's exclusionary power during its term.⁵⁶² But where a patent holder merely exercises his "right to exclude others from making, using, or selling the invention," such conduct is expressly permitted by the patent laws.⁵⁶³ Where a patent has been lawfully acquired, subsequent conduct permissible under the patent laws cannot trigger any liability under the antitrust laws.⁵⁶⁴ On the Court's finding that the patent was lawfully obtained, the refusal to license was found to be permissible and not in breach of §2 of the Sherman Act.⁵⁶⁵ The court favored a validly granted patent over a temporary problem for a competitor in the market.

Xerox. In *Xerox* the court went further in examining claims against a patent holder and carved out some exceptions where an antitrust

⁵⁶⁰ *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195 (2d Cir. 1981).

⁵⁶¹ *Id.*, at 1197-2000.

⁵⁶² *Id.*, at 1203.

⁵⁶³ *Id.*, at 1204.

⁵⁶⁴ *Id.*, at 1206.

⁵⁶⁵ *Id.*, at 1209.

violation could exist.⁵⁶⁶ In 1984, Xerox established a policy in which they refused to sell parts unique to its series 10 copiers to independent service organizations (“ISOs”), unless they were also end-users.⁵⁶⁷ One of these ISO’s was CSU. Xerox expanded the policy in 1987 to include all new products and their existing series 9 copiers. Eventually, a settlement was reached between Xerox and a group of ISOs by which Xerox agreed to suspend its restrictive parts policy for six and one-half years and to license its diagnostic software for four and one-half years. However, CSU opted out of the settlement and took action claiming that Xerox was in breach of the Sherman Act. They maintained that through setting the price of their patented parts higher for ISOs than for end-users, they were attempting to force the ISOs to raise their prices. This was done to eliminate competition on a secondary market, the relevant service market.

The district court found in favor of Xerox stating “that if a patent or copyright is lawfully acquired, the patent or copyright holder's unilateral refusal to sell or license its patented invention or copyrighted expression is not unlawful exclusionary conduct under the antitrust laws, even if the refusal to deal impacts competition in more than one market.” This judgment was upheld by the Federal Circuit. However, the Court did not hold that a patent holder enjoyed absolute immunity and it went on to indicate circumstances where an antitrust violation could be found.⁵⁶⁸

The Court stated that a patent holder would not be immune from antitrust liability where there was: “(1) licensing through an arrangement that ties patented and unpatented products...; (2) refusing to license a patent obtained through a fraud on the Patent Office; and (3) using the patent in a scheme of sham litigation.”⁵⁶⁹ The Court held that none of the three exceptions applied here and that Xerox was thus not in violation of the antitrust laws.

Data General. In *Data General* the Court went further in expanding upon the situations where a refusal to supply protected IP could be found to be a violation of the antitrust laws. Data General (DG) and Grumman were competitors in the market for the service of

⁵⁶⁶ *In re Independent Service Organizations Antitrust Litigation*, 203 F.3d 1322 (Fed. Cir. 2000).

⁵⁶⁷ *Id.* at 1324.

⁵⁶⁸ *Id.* at 1326.

⁵⁶⁹ *Jacobs M.*, Symposium Intellectual Property Licensing by the Dominant Firm: Issues and Problems, 55 DePaul L. Rev. 1177, 1181 (2006).

computers manufactured by DG. DG had approximately 90% of the secondary service market while Grumman was the leading third party maintainer with approximately 3% of the available business.⁵⁷⁰ Initially, DG affirmatively encouraged the growth of third party maintainers with relatively liberal policies concerning third party access to service tools. But later, with the goal of maximizing revenues from its service business, DG began to refuse to provide many service tools, including the very important new software diagnostic for its computers, to third party maintainers.⁵⁷¹ DG sued Grumman for copyright infringement and trade secrets infringement and Grumman filed an antitrust counterclaim challenging DG's refusal to license the diagnostic software.⁵⁷²

In reaching its decision the Court addressed the policy behind IP legislation and stated “that in passing the Copyright Act, Congress itself made an empirical assumption that allowing copyright holders to collect license fees and exclude others from using their works creates a system of incentives that promotes consumer welfare in the long term by encouraging investment in the creation of desirable artistic and functional works of expression.”⁵⁷³ The court then went on to hold that “while exclusionary conduct can include a monopolist's unilateral refusal to license a copyright, an author's desire to exclude others from use of its copyrighted work is a presumptively valid business justification for any immediate harm to consumers.” The court found that DG's desire to exercise its rights under the Copyright Act was a presumptively valid business justification.⁵⁷⁴ However, the court left open the possibility that there may be situations in which this presumption may be rebutted. This rebuttable presumption played a key role in the decision *Kodak II* case.

Kodak (II). The presumption that the invocation of an IPR is a valid business justification has been rebutted in cases where it is shown to be a mere pretext.⁵⁷⁵ In *Kodak II* the court held that neither the aims of IP law nor the antitrust laws justify allowing a monopolist to rely

⁵⁷⁰ *Data General Corp. v. Grumman Systems Support Corp.* 36 F.3d 1147, 1152 (1ST Cir. 1994).

⁵⁷¹ *Id.* at 1154.

⁵⁷² *Id.* at 1155.

⁵⁷³ *Id.* at 1186-87.

⁵⁷⁴ *Id.* at 1187

⁵⁷⁵ *Image Technical Services, Inc. v. Eastman Kodak Co.* 125 F.3d 1195 (9th Cir. 1997)

upon a purported business justification to mask anticompetitive conduct.⁵⁷⁶

Several independent service organizations (ISOs) sued Kodak, alleging that their policy of not supplying replacement parts to ISOs prevented them from competing on the market and claiming that it was a breach of §1 and §2 of the Sherman Act.⁵⁷⁷ Kodak had previously supplied the parts but had changed its policy as competition had increased. As a result of this change, ISOs could not obtain the parts needed to compete with Kodak in repairing the machines.

In deciding the case the court found that “the proffered business justification played no part in the decision to act.”⁵⁷⁸ The court held that the “Kodak's parts manager testified that patents “did not cross [his] mind” at the time Kodak began the parts policy.” Finally the court decided that “it is more probable than not that the jury would have found Kodak's presumptively valid business justification rebutted on the grounds of pretext.”⁵⁷⁹ Even though Kodak held valid patents, only sixty five of the thousands of items which were summarily refused to the ISOs were patented.⁵⁸⁰ This fact and the evidence suggesting that invoking the IPRs was just a pretext to protecting their competitive advantage allowed the court to find an antitrust violation.

In the following cases, the plaintiffs argue that a facility is essential to maintaining competitive on a market and refusal of access to it is a violation of the antitrust laws.

3.2. The Essential Facility Doctrine

The essential facility doctrine is used in refusal to deal situations where one party maintains control over a facility that is essential for another party to remain competitive in a relevant market. It has been used by many courts but not adopted by the U.S. Supreme Court. There is sound logic behind the essential facility doctrine; however a specific

⁵⁷⁶ Id. at 1219.

⁵⁷⁷ Id. at 1201.

⁵⁷⁸ Id. at 1219.

⁵⁷⁹ Id. at 1219-20

⁵⁸⁰ Id. at 1220.

set of circumstances needs to be present for its application to be appropriate.

Origins of the Essential Facility Doctrine

The essential facility doctrine was indeed born out of U.S. jurisprudence. The first case involved an agreement between railway companies⁵⁸¹ involving the ability to control a bridge that could be used to exclude railway companies not party to the agreement. The United States Supreme Court held that not allowing the other companies access to the bridge would lead to driving them out of the relevant market, why the Court required the members of the agreement to share the bridge. The second case, *Associated Press*, involved denial of access to news stories.⁵⁸² The Court held that such information was crucial to the market and that competitors could not function without access to it.⁵⁸³

Later cases in the U.S. expanded and refined the reach of the essential facility doctrine. In *Otter Tail Power Co.* the Supreme Court held that, in certain situations, forced access to power grids may be necessary to improve competition.⁵⁸⁴ In *Aspen Skiing* a situation arose where three ski mountain resorts which had previous dealt with a smaller solo operator refused to deal with their former business associates. The four ski resorts had previously shared ski passes and tickets but now the three dominant resorts were refusing to deal, much to the detriment of the smaller resort. The Court held that this was anticompetitive in that there was no commercial justification for the refusal to deal and ordered them to work together.⁵⁸⁵

The US courts have established that a plaintiff relying on the essential facility doctrine must show “(1) control of the essential facility by the monopolist; (2) a competitor’s inability...to duplicate the essential facility; (3) the denial of the use of the facility...and (4) the feasibility of providing the facility.”⁵⁸⁶

⁵⁸¹ *United States v. Terminal Railroad Association*, fn 553.

⁵⁸² *Associated Press v. United States*, 326 U.S. 1 (1945).

⁵⁸³ *Id.*

⁵⁸⁴ *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973)

⁵⁸⁵ *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985)

⁵⁸⁶ *MCI Commc'ns Corp. v. AT&T*, 708 F.2d 1081, 1132-33 (7th Cir. 1983).

This doctrine is dealt with on a case by case basis and the issues are very fact specific. The most important cases will be subject to detailed analysis.

Case law

Intel. In *Intel* a Federal District Court used the essential facility doctrine to find a violation of §2 of the Sherman Act. Intel refused to supply Intergraph Corp. with advanced central processing units (CPUs) and technical information.⁵⁸⁷ Intel is the world's largest manufacturer of high-performance computer microprocessors.⁵⁸⁸ Intergraph had started using Intel's CPUs in their computers, based on assurances that they would work in the computers and that they would be supplied with the CPUs by Intel.⁵⁸⁹ Intel changed their development system when they created the new Pentium II microprocessor⁵⁹⁰ Due to this change; computers intending to use the new microprocessor had to conform to Intel's technical requirements if they were to use the new Pentium II. Intergraph and Intel engaged in a patent dispute which had nothing to do with the new requirements⁵⁹¹ and Intergraph also filed claims against other Intel customers. Intel responded by refusing to give Intergraph the critical information on the technical requirements that it had previously supplied. As a result of not having this information, Intergraph was not able to release their products at the same time as their competitors.⁵⁹²

The Court found that Intel held a monopoly in the CPU market.⁵⁹³ The Court used the essential facility doctrine in their reasoning, finding that "reasonable and timely access to critical business information that is necessary to compete is an essential facility."⁵⁹⁴ The Court addressed the issue of an antitrust violation stating that a "monopolist's unilateral refusal to deal violates § 2 of the Sherman Act where such conduct unreasonably handicaps competitors or harms competition." The Court

⁵⁸⁷ *Intergraph Co. v. Intel Co.*, 3 F. Supp. 2d 1255 (N.D. Ala. 1998), vacated, 195 F.3d 1346, 1367 (Fed. Cir. 1999).

⁵⁸⁸ *Id.* at 1259.

⁵⁸⁹ *Id.* at 1264.

⁵⁹⁰ *Id.* at 1261.

⁵⁹¹ *Id.* at 1267.

⁵⁹² *Id.* at 1269.

⁵⁹³ *Id.* at 1275.

⁵⁹⁴ *Id.* at 1278.

held that Intel was refusing to deal in an essential facility, further stating that “Intel’s refusal to supply advanced CPUs and essential technical information to Intergraph likely⁵⁹⁵ violates § 2 of the Sherman Act, because they are not available from alternative sources and cannot be feasibly duplicated, and because competitors cannot effectively compete in the relevant markets without access to them.”⁵⁹⁶

The decision was overturned by the Federal Circuit Court on the grounds that Intel and Intergraph were not competitors in any relevant market.⁵⁹⁷ Despite the fact that it was overturned, the *Intel* decision is a good example of the application of the essential facility doctrine. However, recent case law has shown that the United States Supreme Court is less likely to adopt such a position, as exemplified by the decision in *Trinko*.

***Trinko*.** The most recent U.S. case touching on the essential facility doctrine was decided in 2005. In *Trinko* the Court looked at whether the essential facility doctrine should be applied in a case where the dominant telecommunications company was being accused of failing to comply with their duties under the Telecommunications Act of 1996.⁵⁹⁸ Under the Act, Verizon was required to share their network with competitors.⁵⁹⁹ A local telephone customer, the law firm of Curtis V. Trinko, brought a claim alleging that Verizon was discriminating against AT&T, their service provider.⁶⁰⁰ AT&T was a competitive local exchange carrier (CLEC) which was granted access to the network under the Telecommunications Act.⁶⁰¹ The suit claimed that Verizon “has not afforded CLECs access to the local loop on a par with its own access.”⁶⁰² In essence they were claiming that Verizon was slow to fix network problems for the CLECs, while talking care of their own customers, making it difficult for CLECs to compete on the local market.

⁵⁹⁵ This was only held within the forum of a motion for a preliminary injunction and not held as a substantive violation. *Id.* at 1258.

⁵⁹⁶ *Id.* at 1278.

⁵⁹⁷ *Intergraph Co. v. Intel Co.*, 195 F.3d 1346, 1362 (11th Cir. 1999).

⁵⁹⁸ *Trinko*, fn 559.

⁵⁹⁹ *Trinko*, fn 559, also 47 U.S.C. § 251(c) (2000).

⁶⁰⁰ *Id.* at 404.

⁶⁰¹ *Id.* at 402.

⁶⁰² *Amended Complaint at P 21, Trinko v. Bell Atlantic Corp.*, 123 F. Supp. 2d 738 (S.D.N.Y. 2001).

The Court held in favor of Verizon and appears significantly to have weakened the essential facility doctrine. It stated that it “has never recognized such a doctrine” and “finds no need either to recognize it or to repudiate it here.”⁶⁰³ The Court did state that “the Court’s conclusion would not change even if it considered the “essential facility” doctrine crafted by some lower courts to be established law. The indispensable requirement for invoking the doctrine is unavailability of access to the “essential facility”; where access exists, as it does here by virtue of the 1996 Act, the doctrine serves no purpose.”⁶⁰⁴ This case illustrates the latest developments of the essential facility doctrine at the highest court level. If it does not sound the death knell for the essential facility doctrine, it shows a distinct unwillingness to embrace it.

3.3. Conclusion

In the U.S. the courts have, on the whole, given greater deference to upholding IPRs in situations where they are legally obtained and rights are not invoked as a mere pretext when a monopolistic advantage is being sought. Case law has established a sliding scale from *SCM*, where exercising the exclusionary rights of a validly obtained patent did not create a breach of the antitrust laws, to situations such as *Kodak II* where the intent of the parties can be used to rebut the presumption that invoking IPR is a valid business justification.

The essential facility doctrine has also been used, in particular in cases where a monopoly in one market can effect competition in another. The most recent U.S. Supreme Court decision, *Trinko*, casts doubt as to the future use of the doctrine in the U.S.

As the case law evolves, we will see what effects the *Trinko* decision will actually have on refusal to deal and claimed essential facility doctrine cases. One would hope that the courts will find a way to strike a balance that will still foster competition, even if there will always be a tendency to protect genuine IPRs and their genuine use.

⁶⁰³ *Trinko*, fn 559, at 411.

⁶⁰⁴ *Id.*

4. ABUSE OF DOMINANCE

CONCERNS ON AN INNOVATION MARKET

BY INGRID LIDGARD

Innovation is encouraged, especially in the western world, where it is believed that society thrives on the continuous development of goods and services. Within the European Union, the Lisbon Strategy, adopted by the European Council in March 2000, provides a good example of the acknowledgement of innovation's effect on economic growth. The aim is to become the most competitive and dynamic knowledge based economy in the world by 2010.⁶⁰⁵

Innovation is encouraged in different ways by state aid or by grants and prizes. It is however within the private sector that most innovation occurs and there is an ongoing debate on how best to stimulate innovation – is it through a highly developed system of IPRs or is it best boosted through a free competitive environment?

Senior OECD economist Giuseppe Nicoletti says that “the innovative effort of firms in a competitive environment is best exploited when intellectual property right protection guarantees that innovators receive sufficient rewards, and when scope for the strategic use of innovations to limit competition is restricted.”⁶⁰⁶

Innovation has been defined as the search for, and the discovery, development, improvement, adoption and commercialization of, new processes, new products, and new organizational structures and procedures.⁶⁰⁷ It is a complex and costly search and involves a good deal of uncertainty and risk taking.⁶⁰⁸ Advocates for an IPR system say

⁶⁰⁵ http://ec.europa.eu/growthandjobs/key/index_en.htm.

⁶⁰⁶ Innovation and Technology Transfer, volume 3/03, *Competition, innovation and growth*, available at http://pharmalicensing.com/articles/disp/1058874726_3f1d25668dba1.

⁶⁰⁷ Gutterman, A.S., *Innovation and Competition Policy*, 1997, Cornwall, p 97.

⁶⁰⁸ Id., p 97.

that a patent or other IP is to be considered a reward for the risk taking involved. They claim that if companies did not receive such compensation innovation would be reduced.

Although an interesting topic, it is unfortunately outside the scope of this chapter to discuss whether IPRs are the best way to stimulate innovation as such. The aim is to discuss eventual problems with IPR and dominance on innovation markets. Consider the following situation:

A medium-sized company X has just patented the technology for a product that constitutes a new generation of products, believed to create a new demand. The product is at the moment known as Xtra and when the product goes on sale, it will create an entirely new market – an innovation market. There are no other foreseeable products that can compete with this product at this stage. It has also been established that this product is likely to become a huge success once it hits the market.

4.1. Market definition

In competition law it is always crucial to define the relevant market(s). It is impossible to claim certain behavior is abusive until dominance on a particular market has been established. Although most market analysis covers existing products it has at times also been useful to analyze the relevant technology markets and innovation markets. A focus on existing product markets only can be too narrow in some situations.⁶⁰⁹

It is important to explain the term *innovation market*. The U.S. IP (1995) Guidelines gives the following definition⁶¹⁰:

An innovation market consists of the research and development directed to particular new or improved goods or processes, and the close substitutes for that research and development.⁶¹¹

⁶⁰⁹ Glader M, Innovation markets and competition analysis, 2006, Cornwall, p 67.

⁶¹⁰ Id., p 72

⁶¹¹ 1995 US Antitrust Guidelines for the Licensing of Intellectual property, issued by the US Department of Justice and the Federal Trade Commission, April 6, 1995, § 3.2.3

In Europe the term was first introduced several years later. The TTBE⁶¹² (2004) formally included innovation markets as the third kind of relevant market, besides product and technology markets. The guidelines state that it is useful to define innovation markets where an agreement affects innovation aiming at creating new products and where it is possible at an early stage to identify research and development poles.⁶¹³ The term has since then appeared in some Commission decisions on mergers.⁶¹⁴

Other terms have been used by the Commission. In *Glaxo Wellcome/SmithKline Beecham*⁶¹⁵ the Commission defined the *future market*. It stated that, in the pharmaceuticals industry, a full assessment of the competitive situation requires that an examination of products which are not yet on the market but which are at an advanced stage of development is included. These products are often referred to as pipeline products that will be put on the market in the near future.

In *Upjohn/Pharmacia*⁶¹⁶ the Commission discussed the effects on competition in R&D situations and used the term *R&D market*. It came to the conclusion that the merged entity would, by virtue of its pooled skills and resources, become a competitive player on the worldwide R&D markets for developing and inventing certain active compounds and the pharmaceutical products resulting from this. It conducted an investigation of this market so as to rule out any possible competition problems.

If one were to measure these alternative market definitions along a time line, the innovation market would be the most abstract and distant market. Both the R&D market and the future market deal with competition problems that might occur within the foreseeable future. Several test phases will have been successfully conducted after the initial grant of the patent in question and there is a high likelihood that a product will reach the market. It is important to note this distinction before exploring the innovation market concept and its usefulness for the analysis of IPR and dominance.

⁶¹² Guidelines on the application of Article 81 of the EC treaty to technology transfer agreements OJ 2004 C 101/2.

⁶¹³ *Glader M*, fn 609, p 3.

⁶¹⁴ Commission Case No IV/M.2537 - *Philips/Marconi Medical Systems*.

⁶¹⁵ Commission Case No IV/M.1846 - *Glaxo Wellcome/SmithKline Beecham*, paragraph 70.

⁶¹⁶ Commission Case No IV/M.631 - *Upjohn/Pharmacia*, OJ 1995 C 294/9.

The term innovation market was introduced as an analytical tool in the investigation of competition in innovation and R&D. It relates to the research and development effort that is associated with the future introduction of innovations. The idea is to analyze “competition in innovation” in much the same way as product market competition is assessed.⁶¹⁷

To analyze competition in innovation is not an easy task: competition in general is often hard to measure. Do there have to be several competing R&D projects for an innovation market to be competitive? Is there a problem if there is no other competing company? IPRs are major assets that have the potential to affect an innovation market in an anti-competitive way. Should the grant of a piece of IP then be subject to restrictions?

4.2. IPR and dominance

As previously mentioned an IPR can create a monopoly situation for the firm who controls it. It is however clear that although an IPR can give rise to dominance, that in itself is not enough to constitute an abuse. § 2.2 in the American guidelines⁶¹⁸ state:

If a patent or other form of intellectual property does confer market power, that market power does not by itself offend the antitrust laws.

In the EU, the ECJ has stated that Article 82 EC is not always automatically applicable.⁶¹⁹ It is only when the use of a patent degenerates into improper exploitation the question of abuse can come into play.

A position acquired by way of successful product development and/or internal growth must *a priori* be considered legal,⁶²⁰ but it can

⁶¹⁷ Innovation policy study, <http://europa.eu.int/comm/enterprise/library/lib-competition/libr-competition.html>, p 57.

⁶¹⁸ IP (1995) Guidelines, fn 611.

⁶¹⁹ Case 24/67, *Parke Davis*, fn 501.

⁶²⁰ *Glader M.*, fn 609, p 310.

still give rise to special responsibilities. In *Commercial Solvents*⁶²¹ it was seen as an abuse for a company with a dominant position on the market for raw material to refuse to supply a particular user of the raw material without reasonable justification. A situation could equally arise where a company might be obliged to share its valuable intellectual property assets with others. This should only be considered in exceptional circumstances however as it diminishes the protection granted by an IPR.

The definition of the relevant market is, as stated earlier, a necessary component in establishing dominance in Article 82 EC cases. The unilateral behavior of a firm can only significantly distort the process of competition to the detriment of consumers where that firm holds market power. Since companies can be engaged in different activities, supply different products etc. it is first necessary to consider where a company holds market power in order to establish where it can distort competition.⁶²²

In the initial hypothesis, the company has not yet begun production, nor has it decided how it shall go about getting the product to market. Its options are open. What can be said is that this company has obtained a dominant position through its newly acquired patent. This dominant position is only present on an innovation market. In the following section Article 82 EC will be examined and any abuse issues dealt with.

4.3. Article 82 EC and the innovation market concept

Article 82 EC normally deals with situations where a product has been or is being sold on a specific market. If one looks at company X's situation the product has not yet been developed or sold and the dominance is regarded as existing on an innovation market. Article 82 EC will be applied in this context; we will review each item on the proscribed list.

⁶²¹ Joined Cases 6 & 7/73, *Istituto Chemioterapico Italiano & Commercial Solvents Corp. v Commission*, (Commercial Solvents), [1974] ECR 223.

⁶²² Innovation policy study, fn 617 p 54

Unfair selling prices

A company that has just obtained a patent for a new product will most likely be interested in maximising profits as soon as the product is put on the market. Are there reasons to be cautious when setting prices?

Article 82 EC states that it is an abuse to directly or indirectly impose unfair purchase or selling prices or other unfair trading conditions. What exactly does this mean? Under normal circumstances a company should be able to sell the product in a specific market at whatever price it chooses since parallel trade will come in and correct the imbalance.⁶²³ In *United Brands*⁶²⁴ the ECJ tried to ascertain whether or not the dominant company in question had used its position to reap benefits that would not have been possible if there had been effective competition. In order to determine the existence of unfair pricing it compared the production costs and the selling prices and concluded that there was an abuse. This approach has been followed by the Commission when assessing whether or not prices are fair.

Profitability is regarded as one of the things that indicate market power. Company X has not yet started production however, and it is hard to predict the expected return. Even if the product is a huge success, this might only last for a short time. An improved product could be introduced, making the old product obsolete. This is the risk of entering a dynamic market. A high selling price could be justified in this way.

If, however, the only reason for high prices was to eliminate possible rivals, the situation changes. Exclusionary conduct is aimed at rivals or potential rivals with a view to inhibiting their power to compete: it is however hard to prove.

Competition law will stop a company from setting excessive prices once it has hit the market as shown in *United Brands*. As regards pricing concerns in an innovation market, ultimately there are none. A company's pricing policy cannot affect anyone else at this stage.

⁶²³ *Lidgard, H.H.*, Competition Classics : Competition at All Levels, course material University of Lund 2006/2007, p 295

⁶²⁴ Case 27/76, *United Brands*, fn 499, paragraphs [248-252]

Limiting production, markets or technical development

Considering that company X has just been granted a patent on a new product it will probably be in its best interest to try to get production up and running as fast as possible.

Despite this there are two situations where this will not be the case and the issue of possible abuse arises. First of all the company may just want to secure a patent and not use it. This is known as defensive patenting and is seen as detrimental to innovation.⁶²⁵ Economists have spoken of “excess of protection” and a “patent thicket” that both obstruct the pace of innovation. Some members of the Commission’s Information Society Directorate General have suggested that a system of compulsory licensing would favour innovation in such a case.⁶²⁶ Compulsory licensing is already an option when the company has entered the market.⁶²⁷

If a company is going to produce its new patented product it would be unreasonable for it to be forced to license the protected information to others at so early a stage: there would be little incentive to get a patent in such circumstances. But the problem with defensive patenting still exists and is not easy to overcome. There will always be companies that patent a product or a process simply to stop others from using it and conducting further research of their own.

The second situation involves a company that is already dominant on a market and decides to try to inhibit ancillary innovation through the exercise of its dominance. This is a clear case of abuse and has been dealt with in a number of cases: *Intel*⁶²⁸, *Microsoft*⁶²⁹ etc. The *Intel* case clarified that it may be abusive to force various actors into royalty-free licenses, if the dominant party is thereby able to control innovations to such an extent that rivals effectively lose the ability to compete.

The innovation market concept is used as a tool in evaluating the existence of abusive behavior in such cases. It is used to determine whether there would have been more R&D had the company not

⁶²⁵ Openness to innovation, Innovation and Technology Transfer, volume 1/04.

⁶²⁶ Id.

⁶²⁷ Cases C-241/91 P & C-242/91 P *Magill*, fn 515.

⁶²⁸ Intel Corporation, Docket no. 9288 (complaint 1998, consent order 1999).

⁶²⁹ Case T-201/04, *Microsoft Corp. v Commission* (COMP/C3/37.792 – Microsoft).

chosen to use its dominance and discourage other companies. It is an interesting problem but it does not apply to the company X's situation.

Company X is dominant on the *innovation market* (not an earlier product market) and the question whether it can limit production and markets because of *that* dominance. An innovation market will probably not be affected by the way a company conducts its own research, so long as it is being done in a way which will promote itself. Defensive patenting will not be a problem since company X is a smaller company that will need to use its patent in order to survive. Indeed, a patent is an asset that most companies cannot afford to hide away unless they have already succeeded in becoming dominant in the area with the help of earlier patented inventions.

Applying dissimilar conditions to equivalent transactions with other trading partners (discrimination)

Once company X has received its patent, it can decide if it wants to develop the new product on its own or work with other companies. This could be by way of R&D or licensing agreements. The company is now dominant on an innovation market. Should it be allowed to license its product to trading partners on different terms?

Case law has considered the matter when it involved a product market and come to the conclusion that price discrimination can constitute an abuse. In the case of *Aéroports de Paris*⁶³⁰ it was considered discriminatory for Paris airport to charge some of its customers higher prices than others for entirely equivalent transactions. The same should apply on an innovation market. At a first glance there appears to be no justification for a company treating two partners differently.

But there may be mitigating circumstances. First of all there is no guarantee that the product will be successful. Secondly it is possible that competitors will come up with a better idea that could lead to a serious competitor to Xtra or even render it worthless. So company X can be justified in setting prices as it wishes. Once on the market, if dominance is established, the competition rules will certainly come into play.

⁶³⁰ Case T-128/98, *Aéroports de Paris v Commission*, [2000], ECR II-3929.

Making the conclusion of contracts subject to acceptance by other parties of supplementary obligations

Company X has just decided to license its patent to another company and this company is very interested. Can the company's dominance on the innovation market give it the power to ask for grant-backs, to tie its product to another, to demand favourable prices on a separate product etc.?

In the TTBEG (2004)⁶³¹ it is noted that some license agreements may affect innovation markets. This is especially the case when the agreement affects innovation aiming at creating new products and where it is possible at an early stage to identify research and development poles. Competing R&D poles exist when there are other companies whose R&D efforts can be identified as close substitutes for the parties' own. If there are enough R&D poles left for effective competition in innovation to be maintained then the terms of the agreement will not be a problem. The guidelines do not speak of possible abuse of dominance issues as their focus is on agreement between the parties.

If its patent is valuable then it is likely that company X will be able to make some demands. Even if it has a dominant position on the innovation market, there is no product and the company would have a hard time persuading another party to accept a highly unfair and unbalanced deal. Again, the agreement can come under scrutiny at a later stage if the product becomes as successful as was hoped. Note also that a large company with a major IPR portfolio will ask for more than a small research company with few assets.

4.4. Conclusion

Competition law work to prevent unlawful abuse on any relevant market. The mere fact that a company has patented a new revolutionary product that is likely to be the next big thing on an entirely new, separate market (hence leads in an innovation market) is not enough to trigger any concern. Problems are dealt with as soon as the product has

⁶³¹ TTBEG (2004), fn 612, §3 p 25

hit the market and is being sold to consumers. The alternative would create an uncertain environment for developers of new products.

Innovation markets should only be considered when it comes to research and development agreements, the licensing of patented technology/products to others or the merger of two companies with a similar focus on innovation. Since this chapter focuses on unilateral abuse I have not covered M&As. This is an area where the concept has been proved valuable and is frequently used.

Despite the fact that the concept is often used, innovation market analysis is still controversial among competition law scholars. One of the major issues is whether innovation markets can be defined with any degree of accuracy. The sources of R&D can be difficult to identify as discoveries can emerge from unexpected places. Thus, it may be impossible to identify or measure the competitors in innovation markets.⁶³²

Others are of the view that although it becomes harder to assess what will happen the more you look forward, the questions must be asked all the same.⁶³³ I believe that the innovation market concept is an analytical tool, useful in the right places but not something that should be analyzed on its own as a completely separate market of its own.

The Commission has stated that in the light of the uncertainties surrounding concentration and innovation, it does not apply competition policy to innovation markets directly. It uses the innovation market concept and tries to ground its decisions on the likely effects on the market of the future products involved.⁶³⁴

It might then be of little use to speak of abuse of dominance when a company is first granted an intellectual property right but it is nevertheless important to realise that “the fact that innovation can bring consumer benefits should not provide a license for innovative companies to engage in anti-competitive acts”.⁶³⁵

⁶³² *Gilbert R.*, Competition and Innovation, p 7, http://works.bepress.com/cgi/viewcontent.cgi?article=1011&context=richard_gilbert.

⁶³³ Promoting innovation in competition analysis, *Innovation and Technology Transfer*, volume 2/04.

⁶³⁴ OECD, Application of competition policy to high tech markets, 1997, p 90, <http://www.oecd.org/dataoecd/34/24/1920091.pdf>,

⁶³⁵ *Fisher, F., Rubinfeld, D.*, United States v. Microsoft: An Economic Analysis, 2000, p 9.

5. PATENT MISUSE AND ANTITRUST LAW INFRINGEMENT

BY DANIELLE WILLIAMS

The goal of this chapter is to consider the interrelation of misuse of the U.S. patent system and antitrust infringement liability. The focus is on parties with sufficient market power to have a dominant position (which is not a statutory term in the U.S., as is the case in the EU) on the relevant market. Determining what market power is necessary for the law to act and what the relevant market is are critical.⁶³⁶ It is also important to realize that the relationship between IPRs and antitrust laws is still developing and continues to elicit considerable debate amongst the legal community.⁶³⁷

Note finally that while all types of IPRs are subject to legal regulation and could lead to liability where misuse is alleged, patent misuse is the most important. We focus on patents as both courts and governmental agencies have paid particular attention to the exercise of patent rights, and most decided cases involve them.⁶³⁸ This is likely

⁶³⁶ *Hinsbaw T., Zakolski L.A., Foley A. M. H., Michie K.V., McKenna J. C., & Kennel J.R.*, Monopolies, Restraints of Trade and Unfair Trade Practices, 54 Am. Jur. 2d Monopolies and Restraints of Trade § 133 (2006); *Taylor R.P.*, Antitrust Issues in Licensing Intellectual Property Rights, 1538 PLI/Corp 411, 416 (2006).

⁶³⁷ *Taylor*, fn 636, at 423, comments, “[t]he benefit of this modernization of antitrust law, however, had not been applied fully to situations involving intellectual property rights. Much of the jurisprudence dealing with antitrust law as applied to patent and copyright owners predates the economic enlightenment of the 1980s and 1990s.”

⁶³⁸ *Weinschel, A.*, Antitrust Issues in Licensing Intellectual Property, Practicing Law Institute, Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series, PLI Order No. 8816, June, 2006, p 275, 283. For examples of copyright misuse as recognized by the courts, see Weinschel where among others, he references the following cases: *DCS Comm. Corp. v. Pulse Comm. Inc.*, 170 F.3d 1354, 1368 (Fed. Cir. 1999), cert. denied, 528 U.S. 923 (1999); *Alcatel USA Inc. v.*

due to the nature of a patent, which gives the exclusive right to manufacture, employ and sell a product or process - and, although the same could for copyright, the IP here (the mere expression of an idea) is more limited in its ambit. Trademarks seem ancillary to manufacture. Patent abuse is thus more likely to negatively to affect market.⁶³⁹

5.1. U.S. Stance on Patent Misuse & Antitrust Infringement

A finding of patent misuse and then of antitrust liability are responses to an infringement claim raised by a patent owner.⁶⁴⁰ As concisely noted in *Atari Games Co. v. Nintendo of America Inc.*, there may exist “a fine line” between actions protecting the legitimate interests of a patent owner and antitrust law violations.⁶⁴¹

However, the importance of which side of the “fine line” a party may fall on is no way trivial due to the remedies and potential liabilities involved. A finding of patent misuse does not necessarily invalidate a patent, it merely renders the patent unenforceable until the misuse has stopped and its effect on the economic market dissipated.⁶⁴² In some instances, attorney’s fees may also be awarded along with a finding of patent misuse.⁶⁴³ A finding of antitrust liability can lead to the imposition of far more severe penalties including treble damages.⁶⁴⁴ It is critical to determine whether a party is subject to antitrust liability.

DGI Techs., Inc., 166 F.3d 772, 792-93 (5th Cir. 1999); *National Cable Television v. Broadcast Music*, 772 F. Supp. 614, 651 (D.D.C. 1991)

⁶³⁹ *Id.*

⁶⁴⁰ *Atari Games v Nintendo*, 897 F.2d 1572, 1576 (Fed. Cir. 1990).

⁶⁴¹ *Id.*

⁶⁴² *Weinschel*, fn 638, at 286.; *Nobelpharma USA, Inc. v. Implant Innovations, Inc.*, 141 F.3d 1059, 1070 (1998)

⁶⁴³ *Nobelpharma*, fn 642, at 1070.

⁶⁴⁴ 15 U.S.C.A. § 15(a)

Legal Viability of Patent Misuse and Antitrust Infringement

Patent misuse exists independent of antitrust law. It is an equitable doctrine which disallows the patentee from using the patent outside its scope in restraint of trade or against the public interest.⁶⁴⁵ Patent misuse is not an independent cause of action and is used as a defense to patent infringement allegations, or to demands for the payment of royalties.⁶⁴⁶ Further, some courts have said that the defense can only be used when competition has been demonstrably adversely affected.⁶⁴⁷ Patent misuse was recognized by the legislature in 1988 with the passing of the Patent Misuse Reform Act, expressly setting several boundaries regarding acts which do not constitute misuse, including the refusal to license and the conditioning of the grant of a license on the acquisition or sale of other patented products.⁶⁴⁸

In contrast, antitrust liability was always rooted in statutes.⁶⁴⁹ The starting point was the Sherman Act⁶⁵⁰ which made any restraint on

⁶⁴⁵ *Black's Law Dictionary*, "Patent Misuse Doctrine" (8th ed. 2004); *Weinschel*, fn 638, at 286.

⁶⁴⁶ *Weinschel*, fn 638, at 287. Citing among others, *Mallinckrodt Inc v Mediapart Inc*, 90-1138, 90-1272, 976 F.2d 700 (1992) at 708; *Windsurfing Int'l, Inc. v. AMF, Inc.*, 782 F.2d 995, 1001-02 (Fed. Cir.), cert. denied, 477 U.S. 905 (1986).

⁶⁴⁷ *Id.*

⁶⁴⁸ The 1988 Patent Misuse Reform Act, 35 U.S.C.A. § 271, reads in pertinent part (d): No patent owner otherwise entitled to relief for infringement or contributory infringement of a patent shall be denied relief or deemed guilty of misuse or illegal extension of the patent right by reason of his having done one or more of the following: (1) derived revenue from acts which if performed by another without his consent would constitute contributory infringement of the patent; (2) licensed or authorized another to perform acts which if performed without his consent would constitute contributory infringement of the patent; (3) sought to enforce his patent rights against infringement or contributory infringement; (4) refused to license or use any rights to the patent; or (5) conditioned the license of any rights to the patent or the sale of the patented product on the acquisition of a license to rights in another patent or purchase of a separate product, unless, in view of the circumstances, the patent owner has market power in the relevant market for the patent or patented product on which the license or sale is conditioned." It should be noted that other parts of this Act, not relevant to this analysis, have been found to be unconstitutional.

⁶⁴⁹ 15 U.S.C.A. §§ 1-7.; 15 U.S.C.A. §§ 12-27.

⁶⁵⁰ The Sherman Act, 15 U.S.C.A. §§ 1-7.

trade or commerce illegal⁶⁵¹ and explicitly rendered unlawful any attempts to establish a monopoly, or the existence thereof, in any area of commerce or trade.⁶⁵² The Clayton Act⁶⁵³ amended the Sherman Act and made illegal acts that were detrimental to competition or contributed to the formation of a monopoly, including price discrimination, tying arrangements, exclusive dealing contracts, mergers and interlocking directorates.⁶⁵⁴

Patent Misuse and the Antitrust Liability Shield

The question then follows, how can patent law, which creates an exclusive right, coexist with antitrust law, which prohibits monopolies? The answer to this starts from the position that a patent owner who wishes to enforce his right of exclusivity within the scope of the patent is shielded from antitrust liability, with this shield subject to being removed in certain situations.⁶⁵⁵ Indeed, the patent owner's right can be enforced even if it could be said this leads to an anti-competitive effect.⁶⁵⁶ But if the owner of an IPR tries to enforce rights beyond those conferred by the patent's scope, no shield applies and antitrust laws and liability are fully applicable.⁶⁵⁷

Further, the shield can be removed in two other situations. First of all, in the landmark case of *Walker Process Equipment v. Food Machinery*⁶⁵⁸ it was established that the shield will be removed if the

⁶⁵¹ 15 U.S.C.A. § 1. "Trusts, etc. in restraint of trade illegal; penalty". Allowable penalties under the statute are discretionary to the Court fines and/or imprisonment.

⁶⁵² 15 U.S.C.A. § 2. "Monopolizing trade a felony; penalty". Allowable penalties under the statute are discretionary to the Court fines and/or imprisonment.

⁶⁵³ The Clayton Act, 15 U.S.C.A. §§ 12-27.

⁶⁵⁴ Id., §§ 12-27; *Harris, D*, TRIPS Rebound: An Historical Analysis of How the TRIPS Agreement Can Ricochet Back Against the United States, 25 Nw. J. Int'l L. & Bus. 99, 148 (2004), at 148-49.; *Black's Law Dictionary*, "Clayton Act" (8th ed. 2004).

⁶⁵⁵ *Nobelpharma*, fn 642, at 1067-1069.; *Glass Equipment Development, Inc. v. Besten, Inc.*, 174 F.2d 1337, 1343 (9th Cir. 1999); 35 U.S.C.A. § 271.

⁶⁵⁶ *Glass*, fn 655, at 1343.

⁶⁵⁷ *Chin, Y, & Walsh, K*, The Growing Interplay of Patent and Competition Law: Antitrust Pitfalls in Licensing, 877 PLI/Pat 439, 443 (2006), at 443.

⁶⁵⁸ *Walker Process Equipment, Inc. v. Food Machinery and Chemical Co.*, 382 U.S. 172, 86 S.Ct. 347 (1965).

patent was obtained by willful fraud.⁶⁵⁹ Fraud can consist of misrepresentation or omission.⁶⁶⁰ The second case occurs when an infringement suit is a sham intended simply to harm competition.⁶⁶¹ The definition of sham litigation encompasses the notion that the suit is “objectively baseless”, that no person could reasonably expect to succeed in court, and that litigation is “subjectively motivated” to hinder competition.⁶⁶² The existence of subjective motivation is not necessarily considered unless the suit is found to be unreasonably and baselessly brought.⁶⁶³

When evaluating a party’s liability under antitrust laws, there are some practices that are per se unlawful.⁶⁶⁴ § 3.4 of the IP (1995) Guidelines cites “naked price fixing, output restraints, and market division among horizontal competitors, as well as certain group boycotts and resale price maintenance” as restraints that are held unlawful per se.⁶⁶⁵ Most violations are evaluated using the “Rule of Reason”, however, which involves a balancing test⁶⁶⁶ and an inquiry into whether the conduct or practice in dispute unreasonably restrains competition.⁶⁶⁷

⁶⁵⁹ *Id.* at 179.

⁶⁶⁰ *Nobelpharma*, fn 642, at 1070.

⁶⁶¹ *Eastern Rail. Pres. Conf. v. Noerr Motor Frgt., Inc.*, 365 U.S. 127, (1961). Although in this case, the Court found no sham litigation present, the Court asserted this principle: “There may be situations in which a...action, is a mere sham to cover what is actually nothing more than an attempt to interfere with the business relationships of a competitor and the application of the Sherman Act would be justified.” This principle was further upheld in *Nobelpharma*, fn 642, at 1068.

⁶⁶² *Professional Real Estate Investors, Inc. v. Columbia Pictures Industries, Inc.*, 508 U.S. 49, 60, (1993); *Nobelpharma*, fn 642, at 1071.

⁶⁶³ *Id.*

⁶⁶⁴ See, § 3.4 US IP (1995) Guidelines, fn 611. *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977) at 49.

⁶⁶⁵ See, § 3.4 US IP (1995) Guidelines, fn 611.

⁶⁶⁶ As cited by *Taylor*, fn 636, at 413: “Under [the Rule of Reason] the fact-finder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing a restraint on competition. *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977).”

⁶⁶⁷ Now incorporated into § 3.4 US IP (1995) Guidelines, fn 611. *Chicago Bd. of Trade v. United States*, 246 U.S. 231 (1918) recognized this concept decades earlier. The Court recognizes that inherent in agreements, there are restraints. If any restraint were deemed illegal, this would pose major problems for the coexistence

The case *Nobelpharma*⁶⁶⁸ shows the consequences of being stripped of the antitrust liability shield. In this case, a patent involving a dental implant was held invalid on the grounds that it was secured by fraud, namely, by the failure to disclose the “best mode” in the patent application. One of the named inventors had previously authored a book regarding practices and clinical evaluations involving use of the dental implant, and did not disclose the existence of the book. Accordingly, the Court held the patent was acquired by fraudulent misrepresentation or omission. The Court confirmed the reasonableness of a finding of fraud because of an unexplained deleted reference to the book, and its initial disclosure to the patent agent suggesting awareness of potential relevance. As eloquently expressed in the opinion: “Inequitable conduct is thus an equitable defense in a patent infringement action and serves as a shield, while a more serious finding of fraud potentially exposes a patentee to antitrust liability and thus serves as a sword.”⁶⁶⁹ Here, the case was transformed from one of patent misuse to one of antitrust violation, entailing triple damages, illustrative of the seriousness with which an offense committed in securing a patent may be considered by the U.S. legal system.

5.2. A Comparative Look at the EU

The EU has the same need to balance IPRs and market competition⁶⁷⁰, but does so in a different way. As noted, dominance as such is not considered illegal.

In a case comparable to *Nobelpharma*, *AstraZeneca*⁶⁷¹, the Europa Press Release announced that the patent holder of a drug used for

of IPR and antitrust laws. In its reasoning, the Court commented, “Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.” This reasoning also noted in part by Taylor, at 413.

⁶⁶⁸ *Nobelpharma*, fn 642

⁶⁶⁹ *Id.* at 1072.

⁶⁷⁰ *Gitter D.*, “The conflict in the European Community between competition law and intellectual property rights: a call for legislative clarification of the essential facilities doctrine”, 40 *American Business Law Journal* 217, 2003, p 218

treating stomach ulcers, was fined sixty million euros by the Commission for abusing its dominant position on the market.⁶⁷² This was based on the fact that AstraZeneca provided misleading information which resulted in an extension of patent protection.⁶⁷³

This misleading information was given when applying for a Supplementary Protection Certificate, an additional legal privilege enjoyed by pharmaceutical patent holders.⁶⁷⁴ This application required the date of marketing authorization, and according to the Commission, the date provided by AstraZeneca was misleading, and in effect delayed generic drugs from entering the market. There is some dispute regarding the construction of the terms in the law requiring this date. AstraZeneca intends to appeal this decision, so the court may ultimately have a say in the matter.

This case and *Nobelpharma*⁶⁷⁵, though involving patent misuse, proceed through different respective legal analyses. In *Nobelpharma*, the fraudulent conduct was considered sufficient to remove the antitrust liability shield, thus subjecting the company to the antitrust laws. In contrast, the *AstraZeneca* case treated similar conduct as sufficient in itself to constitute an abuse of a dominant position, hence a competition law violation. Though different modes of analysis are undergone, both cases imposed severe monetary penalties.

5.3. Conclusion

In conclusion, while some differences exist between the U.S. and the EU, the same goal is sought: working out the relationship between

⁶⁷¹ Commission Decision of 15 June 2005, *Generics/AstraZeneca* COMP/A.-37.507/F3.

⁶⁷² Competition: Commission fines AstraZeneca 60 million for misusing patent system to delay market entry of competing generic drugs.” *Europa – Rapid – Press Releases*, IP/05/737, 15/06/2005, available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/737&guiLanguage=en>.

⁶⁷³ *Id.*

⁶⁷⁴ *Generics/AstraZeneca*, fn 671

⁶⁷⁵ *Nobelpharma*, fn 642

IPRs and antitrust/competition laws in such a way as to promote innovation and economic well-being.

The U.S. strikes a sound balance between IPRs and antitrust laws, generally allowing IPR holders to fully enjoy the rights conferred to them without fearing antitrust legal liability. At the same time, the U.S. protects fair play in cases like *Nobelpharma* where fraudulent behavior, (or, in other cases, sham litigation), will allow the antitrust laws to apply, a creative solution that allows both IPR and antitrust concerns to be satisfied.

The EU balances IPRs and competition law concerns by allowing dominance per se, and only disallowing its abuse. Legislation sets limits, and as demonstrated in the *AstraZeneca* case, attacks foul play, like fraud, in a manner similar to the U.S.

The U.S. arguably has a clearer approach, with the same rules for every IPR holder and monopolies per se prohibited. In contrast, the EU delineates specific rules for dominant companies that only need to be followed once dominance in the relevant market is established. Whether these two approaches will converge or diverge in the future should prove to be an interesting development.

IPR & Dominance

Joint Conclusion

Under certain circumstances IPRs can confer or help maintain a dominant position on the market, requiring regulation through competition law. This chapter has addressed the issue of dominance in the marketplace and its interrelation to IPRs.

The ECJ distinguished the existence of IPRs from their exercise. This distinction is arguably unfair and confusing, preventing those seeking to exercise legally conferred rights from enjoying a predictable outcome. However, it appears that in recent case law the ECJ has started to move away from this position towards a less formalistic and more circumstantial evaluation. The stance of the ECJ will gain increased clarity with future decisions, hopefully developing a more predictable and dependable decision making process for IPR holders.

The Treaty does not expressly prohibit the existence or acquisition of a dominant position, but only its abuse. This raises interesting issues when the licensing of an IPR is considered. A company occupying a dominant position may be held liable for abusive conduct if in-licensing is provided exclusively. This follows from the special responsibility a dominant company has to not impair competition. With regards to out-licensing, the European Courts have established the notion of exceptional circumstances on a case-by-case basis. When there are such circumstances, a refusal to license by a dominant company may be held an abuse and could lead the Court to issue a compulsory license as a remedy.

Furthermore, in order to maintain the balance between the free market and IPRs representing the fruits of R&D, the notion of the essential facility can be employed. This doctrine is nearly a century old, yet it is still not firmly grounded in either the EU or the U.S. It appears as though the U.S. has a slight bias in favor of IPRs, while the EU favors competition law interests, though future developments will provide further clarification.

Dominance on an innovation market requires another approach. It is unnecessary to be concerned with abuse of dominance on an innovation market when that dominance is the result of an acquired IPR. IPRs spur companies to innovate and implementing competition law restrictions would be premature. Competition law will prevent abuse once a product has hit the market. In any event, it is difficult to determine the innovation market in advance due to the uncertainty surrounding innovation, and it should therefore not be analyzed independently as a separate market. The innovation market concept is best used as a tool to assess the effect of licensing agreements, R&D and mergers.

Finally, these issues exist outside the EU as well, the U.S. facing the same question of how to best balance IP law and antitrust law interests. The U.S. successfully achieves such a balance by expressly prohibiting monopolies, but providing an antitrust shield for the legal exercise of patent rights within the scope conferred, regardless of the presence of any anticompetitive effect. Though the legal philosophy is slightly different - the EU allows dominance (including monopoly) but prescribes special responsibilities and proscribes abuses for dominant players - the goal of achieving balance is the same. The state of the law in both the U.S. and EU continues to develop, and it remains to be seen whether there will continue to be similarity in the two approaches, or whether they will diverge.

V IPR and Mergers & Acquisitions

IPRs are often among the most valuable assets involved in a merger. Where IPRs are linked to R&D, mergers have the potential to alter the conditions of competition in other than the products markets of the merging parties. Though EU and U.S. law both in principle treat IPR in the same way as any other type of property when evaluating the market impact of a merger, the emphasis placed on competition law in contrast to IP law varies.

A policy which promotes IPR tends to diminish competition and lead to static markets. Prioritizing competition laws, on the other hand, tends to lead to dynamic markets.

The question to be addressed in this section is whether the markets are better served by favouring competition law or IP law in the case of mergers involving IPR. It also seeks to explore whether a static or dynamic market is more conducive to innovation. Chapter 1 discusses IPR in a merger context under both EU and U.S. law, while chapter 2 is an examination of static and dynamic markets in mergers with an additional discussion of market analysis in innovation markets.

1. IPR AND MERGERS WITHIN THE EU AND THE U.S.

BY JUSTIN IANTOSCA & KATRIN NILSSON

As a result of the enlargement of the European Union, lower trade barriers and the economic monetary union, the number of mergers within the EU has been increasing. Such concentrations do not constitute a problem as long as they leave room for competitors and competition. However, concentrations which will be harmful to the European market must be prevented.⁶⁷⁶ The merger rules do not specifically treat the role of IPRs.

Antitrust law in the United States contains special provisions regarding the unique role of IPRs when assessing monopoly power.⁶⁷⁷ IPRs are still viewed as property; and it is important to once again reiterate that they do not automatically confer monopoly power, though it is possible that in certain situations a patented product can constitute its own separate market.⁶⁷⁸

In October 2003, the FTC issued a report on the balance between competition and IPRs where innovation is concerned. This contained a summary of existing problems in the area and ten recommendations for improvement.⁶⁷⁹

The FTC's recommendations focus on modification of the patent system, the Patent and Trademark Office, and new legislation. The report views "questionable patents" as a major obstacle to innovation which slows technological progress and reduces consumer benefits.⁶⁸⁰

⁶⁷⁶ *Lidgard, H.H.*, Competition Classics : Competition at All Levels, course material University of Lund 2006/2007, p. 366

⁶⁷⁷ *Czapracka, K.*, Where Antitrust Ends and IP Begins – On the Roots of the Transatlantic Clashes, 9 Yale J. L. & Tech. 44, P. 4, (2007).

⁶⁷⁸ *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 481-82 (1992).

⁶⁷⁹ *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy*, Federal Trade Commission, October 2003.

⁶⁸⁰ *Id.* at 7-10.

To combat such patents the report suggests legislation allowing reconsideration of a patent after it has been issued, and lowering the burden of proof required to successfully challenge a patent from “clear and convincing evidence” to “a preponderance of the evidence.”⁶⁸¹ These recommendations are important as they highlight problems with the patent process itself. A patent may be approved without proper review and with no possibility of challenging it later on. Additional recommendations include further protections against issuing obvious patents, modernizing and funding the PTO, balancing competition problems with consumer benefits in analyzing patentable subject matter, and expanding protections from patent infringements.⁶⁸²

Before discussing the relation of IPRs to mergers, we will examine the relevant competition and antitrust laws in both the EU and U.S. in relation to mergers and acquisitions.

1.1. Regulating mergers

The 2004 EU Merger Regulation

The Commission initially applied Articles 81 and 82 EC when assessing structural changes. The first Regulation regarding mergers came into force in 1989; it was replaced by the 2004 Merger Regulation.⁶⁸³

The 2004 Merger Regulation stipulates that concentrations are not compatible with the common market if they restrict or eliminate effective competition on that market or part thereof. Concentrations in which the concerned undertakings reach the thresholds specified in Article 1-3 should be notified to the Commission, and if there are anti-competitive concerns, the Commission must initiate proceedings and reach a decision on whether to allow the concentration or not.

⁶⁸¹ Id.

⁶⁸² Id. at 10-19.

⁶⁸³ Council Regulation 139/2004/EC of 20 January 2004 on the control of concentrations between undertakings, OJ 2004 L 24/1.

According to the 2004 Merger Guidelines⁶⁸⁴, the Commission must ensure effective competition, which brings benefits to consumers. In order to make a correct assessment, competition under pre-merger conditions must be compared with what is expected after the proposed merger.⁶⁸⁵ If a concentration leads to the restriction of competition, especially through the creation or strengthening of a dominant position, the Commission will decide such concentration incompatible with the common market. Furthermore, where a dominant position is strengthened or created, the Commission may attach conditions and obligations to its decision that have to be fulfilled if the concentration is to be permitted.

U.S. - Statutory provisions and case law development

The primary source of U.S. antitrust law is the Sherman Act, signed into law in 1890 and since modified to keep up with the changing business and competition environment.⁶⁸⁶ The purpose of the Sherman Act is similar to that of Articles 81 and 82 of the EC Treaty, namely, to prevent combinations or conspiracies that have the effect of restricting trade or commerce among states or nations.⁶⁸⁷

In 1914 the Clayton Antitrust Act expanded and clarified provisions of the Sherman Act. The most significant change was the prevention of the formation of monopolies that may affect trade. The Act further forbids individuals and corporations from acquiring shares of a company where the result will be an effect on commerce that would reduce competition or possibly create a monopoly.⁶⁸⁸ In 1950 the Clayton Act was modified by the Celler-Kefauver amendments which sought to prevent mergers that were “individually so minute as to make it difficult to use the Sherman Act test against them.”⁶⁸⁹ These amendments came at a time when the government was worried about corporate consolidations, which were a way for large corporations to

⁶⁸⁴ Commission Notice - Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (2004/C 31/03) 2004, Official Journal C 31/5

⁶⁸⁵ *Lidgard, H.H.*, Competition Classics, fn 676, p. 366 f.

⁶⁸⁶ 15 U.S.C. § 1-7 (2006), *The Sherman Act*

⁶⁸⁷ 15 U.S.C. § 1 (2006)

⁶⁸⁸ 15 U.S.C. § 18 (2006), *The Clayton Act*

⁶⁸⁹ *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 323 (1962).

acquire smaller competitors without regulation, thereby significantly reducing competition on the relevant markets. As shown in the case analysis below these amendments provide more protection to smaller companies and keep significant levels of competition alive.

1.2. Assessing Mergers

EU – a “Significant Impediment of Effective Competition” test (“SIEC-test”)

In assessing the competitive situation relevant to a proposed merger, the Commission first calculates market shares and concentration levels. Case law has established that high market shares are in themselves indicative of a dominant position. The “Significant Impediment of Effective Competition” test (“SIEC-test”) constitutes a legal basis for the Commission’s preventing anti-competitive behavior where dominance is not the issue, concentration levels being measured by the Herfindahl-Hirschman Index (HHI).⁶⁹⁰

A limited market share of the merging undertakings is thought not to impede effective competition and if the market share stays at or below 25% it will probably not be incompatible with the common market.⁶⁹¹ The SIEC-test has its greatest impact in cases where the collected market share is somewhere between 25-40%. Market shares over 40% have generally been seen as an impediment to effective competition under the dominance test and this will probably remain the case. A market share exceeding 50% leads to a presumption of dominance.⁶⁹²

There are other considerations, such as the degree of substitutability of the merging parties’ products and the market share of competitors, which must also be taken into account. When the merging

⁶⁹⁰ Under the EC Horizontal Merger Guidelines, fn 684; paragraph 16-21, the HHI ranges from 0-10000 where 10000 indicates a monopoly and a 100% market share and 0 indicates a market with near perfect competition. Accordingly, pre-merger HHI is calculated and then compared to the estimated post-merger HHI.

⁶⁹¹ Id. at paragraph 18.

⁶⁹² Id. at paragraph 17.

parties have products that may be substitutes for each other on the same market, the Commission will look at the degree of substitutability between them to determine the resulting effects on the market.⁶⁹³ In cases where the merging firms have products with a high degree of substitutability (determined by surveys, purchasing patterns and cross-price elasticities) the resulting entity will have increased power to raise the price of the products, which is likely to impede competition.⁶⁹⁴ However; the Commission will be more inclined to accept the merger if products of third party rival firms are highly substitutable with the merging firms products, which would limit the merging firms' ability to manipulate prices to impede competition.⁶⁹⁵ The guidelines make a distinction between coordinated and non-coordinated anti-competitive effects and it is possible that anti-competitive effects can be outweighed by efficiencies.

Efficiency claims must satisfy three cumulative conditions: They must benefit consumers; be merger-specific; and verifiable. If these conditions are fulfilled a merger that would otherwise be seen as an impediment to competition will be allowed.⁶⁹⁶ The Commission has to ensure that consumers are not made worse off by the merger than they were prior to it and that the efficiencies are a direct consequence of the merger and cannot be obtained in another less anti-competitive way. The Commission must certify that the efficiencies are reliable and will take place.⁶⁹⁷

United States - overall market power

Under the Hart-Scott-Rodino Antitrust Act, if the value of a merger is above certain monetary thresholds it must be submitted to the Agency for review; over ninety-five percent of the time such mergers are approved as having no substantial negative effects on competition.⁶⁹⁸ The DOJ and the FTC (jointly the "Agency") issued a

⁶⁹³ Id. at paragraph 28.

⁶⁹⁴ Id.

⁶⁹⁵ Id.

⁶⁹⁶ Id. at paragraphs 76-88.

⁶⁹⁷ Id.

⁶⁹⁸ 15 U.S.C. §18(a) (2006), *Hart-Scott-Rodino Antitrust Act*, Commentary on the Horizontal Merger Guidelines, U.S. Department of Justice and Federal Trade Commission, March, 2006, available at <http://www.usdoj.gov/atr/public/guidelines/215247.htm>

set of Horizontal Merger Guidelines in 1992 (revised in 1997), explaining how the Agency analyzes potential mergers under the above statutes and in light of precedent. The Agency looks at the proposed merger's effect on market concentration, potential effects on competition, efficiency gains achieved by the proposed concentration, and if either party to the concentration is likely to fail if it remains on its own.⁶⁹⁹ In order to work with these requirements, it is also important to look at the existing case law for further guidance. By examining the flurry of cases that arose in the late 1960's, after the Celler-Kefauver amendments, one can see both the origins of the Guidelines and the way the courts and the Agency apply them.

The first step in evaluating any effects on competition in U.S. mergers is to determine the relevant market at issue, so that one may then analyze the competitive effects on that market. The Supreme Court case of *U.S. v. Grinnell Corp.* explained the way to determine the relevant market.⁷⁰⁰ One must look at any substitutes that may exist, taking into consideration consumer preference towards certain types of products versus similar, but not identical, alternatives.⁷⁰¹ Substitutes consist of options that consumers may turn to if there are increases in the price of the main product but all "commercial realities" faced by the consumers must be evaluated.⁷⁰²

Considering all of the product substitutes available one must then determine the geographic market for which the market share evaluation will be conducted. In determining the geographic market one must look at the areas in which business is currently conducted as well as the ease with which the company can enter new markets based on the current situation.⁷⁰³ This is a general description of the very complicated methods for determining relevant markets and, as shown in the case law, additional elements may be considered on a case-by-case basis. These depend on the industry in question and any submarkets or special concerns that must be addressed in that industry.

Under the U.S. system, a monopoly is seldom declared on a particular market based on market shares alone, unless the resulting share is particularly high. Unlike the EC Commission, the U.S. system does not emphasize the percent of the market share as much as it

⁶⁹⁹ *Horizontal Merger Guidelines*, fn 784

⁷⁰⁰ *U.S. v. Grinnell Corp.*, 384 U.S. 563 (1966).

⁷⁰¹ *Id.* at 571.

⁷⁰² *Id.* at 571, 572.

⁷⁰³ *Id.* at 575.

focuses on the entity's overall market power. Monopoly power is defined by the courts as "the power to control prices or exclude competition," and the courts have avoided stating any particular market share, presumably because of all the factors that must be considered.⁷⁰⁴ In the decision of the federal appellate court in the 1945 case *U.S. v. Aluminum Co. of America* it is stated that a ninety percent market share would be enough to constitute a monopoly but it is doubtful that sixty percent would be a high enough share to show a prima facie monopoly.⁷⁰⁵

The position of the courts was clarified to some extent in the 2005 federal appellate court decision of *U.S. v. Dentsply Intern., Inc.* where the court looked not only at market share per se but also at the actions of the company and its effects on the market as a whole.⁷⁰⁶ It was held that a company with a sixty-five to seventy percent market share over a period of ten years had a dominant position on the market, considering the duration of this market position and the fact that the second largest competitor had only a five percent share.⁷⁰⁷ The *Dentsply* case shows that the U.S. courts will look beyond market share, even if the share seems quite high, to examine the duration of a market position and the effects, or potential effects, on the market itself, and analyze situations on a case-by-case basis. When analyzing mergers within the U.S., the actors at hand must pay careful attention to the resulting market position in order to ensure that the resulting entity does not have a dominant market position that could be struck down, leading to significant litigation, financial hardship and penalties to the companies involved.

In the case of *U.S. v. Aluminum Co. of America*, the U.S. government wanted a divestiture of corporate assets, under the Clayton Act, after the Aluminum Co. (Alcoa) acquired a competitor (Rome) in the field of wire and cable products.⁷⁰⁸ In this case, Alcoa was the leading producer on the product market in question, with between twenty-seven and thirty-two percent of the relevant markets, and along with the next largest company in the market controlled over fifty percent of the market.⁷⁰⁹ The market share of Rome was under two

⁷⁰⁴ *U.S. v. E. I. du Pont De Nemours & Co.*, 351 U.S. 377, 391 (1956)

⁷⁰⁵ *U.S. v. Aluminum Co. of America*, 148 F.2d 416, 424 (2nd Cir. 1945)

⁷⁰⁶ *U.S. v. Dentsply Intern., Inc.*, 399 F.3d 181, 188 (3rd Cir. 2005)

⁷⁰⁷ *Id.*

⁷⁰⁸ *U.S. v. Aluminum Co. of America*, fn 705

⁷⁰⁹ *Id.* at 278.

percent but because of the high level of concentration within the industry, Rome was one of only nine major players.⁷¹⁰ The court analyzed the situation by looking at the market as a whole, and stated that even though Rome had a small market share it was an aggressive competitor and must be kept separate from Alcoa as an “important competitive factor” on the market.⁷¹¹ This case is significant as it shows that market share per se is not the most important factor in the court’s analysis of a merger’s effect on competition. It is clear that the effect on the market as a whole and any significant moves towards a monopoly will be at the forefront of a court’s analysis of corporate concentrations.

After the *Alcoa* case, the court expanded on its assessment of market position on relevant markets in the case of *U.S. v. Pabst Brewing Co.* In this case, the Supreme Court explained the importance of looking at regional markets as well as market trends when determining the effects of a corporate concentration.⁷¹² This case involved the acquisition by the tenth largest beer producer in the U.S. of the eighteenth largest producer; the combination had a regional market share of between eleven and twenty-three percent.⁷¹³ Additionally, the trend of the market at that time was towards concentration and the court stated that such trends are to be considered when evaluating the effects of corporate concentrations.⁷¹⁴ The court in *Pabst* reversed a decision allowing the acquisition and in doing so explicitly reaffirmed the fact that the Celler-Kefauver Anti-Merger amendment was enacted to prevent concentration in American businesses and maintain steady competition from smaller companies.⁷¹⁵ This case is important as it emphasizes the importance of both regional markets and market trends when evaluating effects on competition.

While the government initiated many of the early antitrust cases, it is possible for an individual, including a corporation, to bring antitrust actions in federal court. In the case of *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.* the Supreme Court set the requirements for individuals to

⁷¹⁰ Id. at 280.

⁷¹¹ Id.

⁷¹² *U.S. v. Pabst Brewing Co.*, 384 U.S. 546, 551-52 (1966)

⁷¹³ Id. at 551

⁷¹⁴ Id. at 552

⁷¹⁵ Id.

bring antitrust actions in federal court.⁷¹⁶ For an individual to bring an antitrust action one must be able to show an “antitrust injury” which is defined as “an injury of the type the antitrust laws were intended to prevent.”⁷¹⁷ Individuals must show that they are directly affected by the merger, which here means they must be competitors, or seeking to enter the relevant market, and the merger creates a monopoly position that limits competition on the market. It is important for individuals to know that they may have standing to oppose mergers if they can meet the criteria.

Where IPRs are involved, the U.S. antitrust laws seek to complement it, both having the same aim of “encouraging innovation, industry and competition.”⁷¹⁸ Possession of IP alone is unlikely to be considered as giving rise to a monopoly. The Agency issued a set of guidelines in 1995 which clarify the relation between IPRs and Antitrust law and the importance of looking at each situation on a case-by-case basis.⁷¹⁹ This report emphasizes the special characteristics of IPR and that these rights grant the holders the power to exclude certain parties from access to the IPR if they so choose.⁷²⁰ It is important to note that this report still recognizes the need to ensure that IPR holders in a merger do not foreclose the market or unreasonably raise the prices of items based on the IPR.⁷²¹

1.3. Assessing IPR merger cases

While it is agreed that the purpose of IP law is to encourage innovation it is still a challenge to find the best way to balance their interaction while ensuring incentives for innovation in a changing legal and technological atmosphere.

⁷¹⁶ *Brunswick Corp v Pueblo Bowl-O-Mat Inc*, 429 US 477 (1977)

⁷¹⁷ *Id.* at 489

⁷¹⁸ *Atari Games v Nintendo*, 897 F.2d 1572, 1576 (Fed. Cir. 1990).

⁷¹⁹ IP (1995) Guidelines , fn 611

⁷²⁰ *Id.* at 5.

⁷²¹ *Id.* at 9.

Europe - A Cautious approach

One important reason for proceeding with a merger is the wish to obtain IPRs. However, IPRs in the context of a merger can raise antitrust concerns.

The Commission assesses IPR transactions from an antitrust perspective, basing itself on Articles 81 and 82 EC.⁷²² In *Tetra Pak I* it was not even a merger as such but the acquisition of an IPR license that was assessed. The issue was whether a dominant company acquiring such a license could be seen to be infringing competition law.⁷²³

To determine whether a merger will lead to the creation or strengthening of a dominant position the Commission looks at the following factors, amongst others: the need to preserve effective competition, the new market position after the merger and the interests of consumers.⁷²⁴ Should the transfer of IPRs lead to a dominant position being created or strengthened and should such a position significantly impede effective competition in the common market or in a substantial part thereof, the merger in question is not compatible with the common market. In *Babyliiss* the trademark situation was the central feature in the assessment of the merger.⁷²⁵ Mergers with valuable IPRs are permitted if they are necessary for continued R&D success on the market, provided they do not eliminate innovation competition.

Since IPRs encourages investment in the development of new or improved products and competition does the same by putting pressure on firms to innovate, “both are necessary to promote innovation and ensure a competitive exploitation thereof.”⁷²⁶

The 2004 Merger Guidelines indicate something of a change. Rather than assessing the compatibility of the merger in terms of determining the relevant product market only and the effect the merger might have on it, assessment can also be made in relation to an

⁷²² Lebson, S. and Bryer, L., Intellectual Property Assets in Merger and Acquisitions, available at www.wipo.int/sme/en/documents/pdf/mergers.pdf, 2007-03-05, p. 4.

⁷²³ Glader, M., Innovation Markets and Competition Analysis – EU Competition Law and US Antitrust Law, Malmö, 2004, p.138.

⁷²⁴ Lebson and Bryer, fn 722, p. 5.

⁷²⁵ Case T-114/02, *Babyliiss SA v Commission*, [2003] ECR II-1279, paragraph 8.

⁷²⁶ Glader, fn 723, p. 91.

innovation market.⁷²⁷ No case shows how the new guidelines have been applied in this context. Even though innovation is a source of competition and a means of creating consumer value, earlier cases did not discuss it separately, but rather saw it as just one element in the product market analysis.⁷²⁸ IPR has always been a key issue where markets are based on R&D and mergers may very well change the conditions for competition on R&D markets, regarded as distinct from the product markets.⁷²⁹

The Commission has not yet produced a merger analysis explicitly focused on innovation. Such an analysis would be helpful in making the whole of merger law more understandable.⁷³⁰ The relevant circumstances needed in the assessment of the effects of a concentration on competition on each kind of market should be set in full.⁷³¹ However, the Commission is not obliged to provide reasons for everything it has taken into consideration in its assessment of a concentration.⁷³²

U.S. - IPR assessment as a natural component

The Agency will follow essentially the same analytical procedures for a merger with IPRs as it would for a conventional merger.⁷³³ However, proposed mergers involving IPRs are subject to special relevant market considerations because IPR based products might not yet be on the market and because IP can advance so quickly that it is difficult to predict the effect on a market, or even the market to evaluate.

The Agencies treat IP as it would any other property for the purpose of market analysis and does not presume market power based on the IPR alone.⁷³⁴ Any agreement that merges the IPRs of two entities, or the two entities themselves, will raise concerns that the

⁷²⁷ Id. at p. 6f.

⁷²⁸ Id. at p. 105.

⁷²⁹ Id. at p. 70.

⁷³⁰ Id. at p. 141.

⁷³¹ Case T-464/04, *Independant Music Publishers and Labels Association (Impala) v Commission*, [2006] ECR II-2289, paragraph 248.

⁷³² Id. at paragraph 281.

⁷³³ P (1995) Guidelines, fn 611

⁷³⁴ *Horizontal Merger Guidelines*, fn 784, § 2

agreement may reduce competition and it will focus its analysis on the results of such agreements.⁷³⁵ As the majority of Agency decisions on mergers related to IPRs come from the FTC and are related to patent rights, this chapter will look at two complicated decisions to gain insight into how the Agency assesses mergers with IPR.

In 1996, *Ciba-Geigy and Sandoz Ltd.* entered into a merger agreement with *Novartis*, in a deal which involved the relevant product markets of gene therapies, herbicides and flea control.⁷³⁶ Because of the complicated scientific nature of these markets and the long lead time for the introduction of new products on these markets, the FTC determined that the merger would substantially lessen competition by consolidating competing entities, eliminating competition on already highly concentrated markets and increasing barriers to the entry of new firms into these markets.⁷³⁷ The FTC ordered that the merger would only be approved if certain businesses were divested. Additionally a six-year period was established during which certain non-public R&D was to be held separate.⁷³⁸ Regarding the IPR itself, the FTC ordered the new entity to grant non-exclusive license rights to Rhone-Poulenc Rorer, Inc. (RPR) so that it would remain in a position to compete with the new firm.⁷³⁹

The Ciba-Geigy decision shows the give and take required by the Agency, when mergers will reduce competition. The merger with its gains in efficiency may be allowed if competition on the market is maintained and monopolies or high market concentration are prevented. A difference from non-IPR based mergers was the grant of a license to RPR, thereby helping a competitor by granting it access to the merged company's products. The U.S. emphasis on innovation and IPRs is displayed here by the Agency's insistence on keeping R&D separate for six years so that current work would not be lost.

A proposed merger of epic proportions, between the largest pharmaceutical company in the U.S., *Pfizer*, and another pharmaceutical giant, *Pharmacia*, came before the Agency in 2003.⁷⁴⁰ The result of the highly technical eighty-seven page decision is best summarized in the FTC press release regarding this case, which

⁷³⁵ *Horizontal Merger Guidelines*, fn 784, § 3.1

⁷³⁶ *In the Matter of Ciba-Geigy Limited, et al*, 123 F.T.C. 842, 843-46 (1997).

⁷³⁷ *Id.* at 851.

⁷³⁸ *Id.* at 865-874.

⁷³⁹ *Id.* at 874-878.

⁷⁴⁰ *In the Matter of Pfizer Inc. and Pharmacia Corporation*, FTC Docket C-4075

explains that this merger would lessen competition in nine pharmaceutical product markets that all contain very few competitors, usually only two or three.⁷⁴¹ The companies were required to divest products in these nine markets to maintain an acceptable level of competition on them. Consumers would thus benefit from a continued competitive environment.⁷⁴²

From these cases, and the many other decisions which follow the same pattern, it is apparent that the Agency will seek to maintain competitive markets, even if this means conditioning mergers on significant divestitures and licensing agreements. It can also be seen that there is a focus on ensuring the continuation of R&D projects so that new and improved products may continue to benefit consumers even if markets appear to be consolidating.

1.4. Conclusion

Merger cases involving IPRs can drastically alter entire markets because of the significant implications they have on them. IPRs can be of great importance in regards to creating incentives for mergers. A company's intellectual property portfolio is often the most valuable asset transferred during a merger and the centerpiece of competition analysis in almost every merger involving companies with IPR.

Both IPRs and structural changes, such as mergers, affect competition. The goal of the European market is to create a free and competitive market strengthening trade and creating benefits for consumers. IPRs give incentives for development and innovations and can increase competition.

The Commission looks at the transfer of IPRs when assessing mergers. The monopoly situation created from IPRs may very well be what gives a post-merger company too strong a position on the market, affecting competition negatively. This may especially be the case if the pre-merger undertakings concerned both have important IPRs within the same or neighboring relevant product markets giving them post-merger advantages. The level and effectiveness of competition depends on entry conditions, where innovations, and thus IPRs, are important

⁷⁴¹ *Pfizer, Pharmacia Will Divest Assets to Settle FTC Charges*, April 14, 2003
<http://www.ftc.gov/opa/2003/04/pfizer.htm>

⁷⁴² *Id.*

factors. Increased concentrations may impede innovation in regards to output, but they may also affect other variables in competition.

An analysis of innovation conditions in the relevant product market ought to be performed when assessing mergers and other concentrations. Otherwise, it will be difficult to have an accurate idea of what effect the transfer of IPR will have on.

The existence of IPRs in merger situations in the U.S. does not lead the Agency to presume market power exists, but reality shows that if there are significant IPRs involved in a merger it is most likely that competition on that market will be affected. In the U.S. economy, which promotes competition by large and small companies alike, there are major concerns surrounding mergers, above all in the pharmaceutical industry, and other like markets, which are heavily concentrated and dominated by a few large companies.

The unique nature of IPRs and their rapid evolution make it especially difficult to determine the relevant product markets and predict how new inventions will fit into existing markets, or whether they will give rise to a new market. The Agency faces the difficult task of assessing all the potential market effects and attempt to balance the business incentives of such mergers with the consumer benefits of a competitive market. It is easy to see how IPRs and mergers can combine to lessen competition, but difficult to find a solution that benefits both the merging entities and competition.

While IPRs themselves are designed to spur innovation there are problems as market consolidations can lead to lower incentives for innovations by companies already in monopolistic market positions. Mergers can limit competition in such cases, but in others, they allow entities to combine forces and produce innovations that they would otherwise lack the resources to develop.

The competition laws seek to improve competition and prevent situations where one firm controls entire markets. A prima facie they appear to be opposed to IP, but in merger situations they must combine to achieve the common aims of maximizing shareholder profits while maintaining a competitive and innovative market. In the U.S., IPRs, competitive markets, and innovation have always been fundamental features of the economy and it is unlikely that the lawmakers will do anything but seek to maintain those fundamentals.

2. INNOVATION & MERGERS

BY GITTE LINDGAARD & CAMILA RINGELING

The costs associated with R&D are often so high that a single company cannot bear them.⁷⁴³ It is thus important to find ways of reducing the costs of R&D. One way of “solving” the problem is to bring various assets under common ownership and control by a merger.⁷⁴⁴

In the light of this development, there has been support for such activities so as to allow companies to gain competitive advantages on the global market.⁷⁴⁵ However, the emphasis on facilitating innovation has created certain problems. Mergers are known to reduce competition in existing product markets; they can however be blocked by antitrust authorities, whose policies are based upon long-established research both theoretical and empirical. When dealing with innovation such theoretical or empirical work is lacking.⁷⁴⁶ Moreover, industries vary so much that a single theory cannot embrace them all.⁷⁴⁷

The importance of the concept of innovation and the effect of mergers on it and the pace at which it proceeds, is evident. It is however not so evident what role innovation is to play in merger reviews; is it even possible to anticipate the precise impact of a merger on innovation? Also uncertain is the “value” of R&D, in that it is far

⁷⁴³ Møllgaard, P and Lorentzen, J, Competition Policy and Innovation, Chapter 7.1. for Patrizio Bianchi and Sandrine Labory (eds.), International Handbook on Industrial Policy, Edward Elgard, Working paper 9-2005, p. 1.

⁷⁴⁴ Id.

⁷⁴⁵ Gómez-Acebo & Pombo et al. The Impact of EU Competition Legislation on Innovation, Enterprise DG, Nov. 2000, Summary of the study commissioned by Enterprise DG, p. 1;

http://ec.europa.eu/enterprise/library/lib-competition/doc/executive_summary.pdf

⁷⁴⁶ Gilbert, R, Competition and Innovation, chapter 26, Paper CPC07-069, Competition Policy Centre, January 2007, p.7; <http://repositories.cdlib.org/iber/cpc/CPC07-069/>

⁷⁴⁷ Id.

from certain that more R&D will always be beneficial. Increases in R&D may result in diminished returns.⁷⁴⁸

IPRs are often among the most valuable assets acquired in a merger, and must be taken into consideration in any event. Faced with a merger where competition and IPRs may collide, competition authorities will have to weigh them against each other in order to determine which is to prevail.

It is important to see how these decisions are affected by the economic market theories or models used, which might include oligopolistic collusion, generic unilateral effects and market dominance. Favoring IPRs over competition tends to favour a more static market structure, while fostering competition over IPR leads to the creation of a more dynamic one. But which is better for fostering innovation?

It is still not clear whether more competition leads to more innovation or if, on the other hand, a more monopolistic structure would enhance it.⁷⁴⁹ While using static theories were once the general rule, the need for a more dynamic approach is the current tendency in economic market studies⁷⁵⁰.

The purpose of this chapter is to analyze the static and dynamic theories of market structure and their application to mergers in both the EU and the U.S. Additionally, the European and American approaches to innovation and how it is dealt with in merger reviews will be explored. The first part discusses market structure in the merger

⁷⁴⁸ *Davis, R*, Innovation Markets and Merger Enforcement: Current Practice in Perspective, *Antitrust Law Journal*, Vol. 71, No. 2, 2003, p. 681.

⁷⁴⁹ *Rey, P*, Intellectual Property and Merger Control, European University Institute, Robert Schumann Center for advanced studies, 2005 EU Competition Law and Policy Workshop/ Proceedings. p. 5;

<http://www.iue.it/RSCAS/Research/Competition/2005/200510-CompRey.pdf>

⁷⁵⁰ There are many studies that suggest this: See *Cheong, K and Judd, K*, Mergers and Dynamic Oligopoly, Department of Economics, University of Hawaii at Manoa, Aug. 1992;

[http://www.economics.hawaii.edu/research/workingpapers/88-98/WP_97-](http://www.economics.hawaii.edu/research/workingpapers/88-98/WP_97-14.pdf)

14.pdf Also see *Kerber, W, and Vezzoso, S*, EU Competition Policy, Vertical Restraints and Innovation: an Analysis from an evolutionary Perspective, Philipps Universität Marburg. 2004. Also see *Jacquemin, A*, Theories of Industrial Organisation and Competition Policy: What are the Links? Working Paper, 2000. p. 7; [http://ec.europa.eu/comm/cdp/working-paper/industrial-](http://ec.europa.eu/comm/cdp/working-paper/industrial-organisation_en.pdf)

[organisation_en.pdf](http://ec.europa.eu/comm/cdp/working-paper/industrial-organisation_en.pdf)

context. The second part focuses on two tools available to the competition authorities when dealing with innovation, i.e. the potential competition theory and the innovation market theory. The final part examines the relation between innovation and mergers more specifically. Special emphasis will be on the innovation market theory, but with reference to the potential competition theory whenever appropriate. The aim of this chapter is to highlight some of the difficulties related to the interplay between innovation and mergers. It thus will not provide an exhaustive assessment of problems within the field but will rather offer an evaluation of the situation by focusing on certain selected aspects of it only.

There will be no distinction between different types of mergers and acquisitions. The same goes for “innovation”. An innovation market can be said to be subject to competition; R&D is an economic activity. It is not a “market” in the traditional sense however; nothing is exchanged before the innovation is produced and sold.⁷⁵¹ Innovation typically refers to both the process of innovation, i.e. the way innovation is designed and produced during the different stages leading up to a product, and the actual result of the innovation process, i.e. the new or improved product, process or service itself. For the purpose of this chapter, a distinction between these types of innovation will not be necessary. It must however be stressed that only innovation in relation to future markets/products will be dealt with.

2.1. Market Structure

There are widely differing theories as to which market structure is more conducive to innovation. The *Schumpeterian view* favours monopolistic structures while *Porter's* view emphasizes the role of competition. The extensive discussions relating to the matter cannot be fully covered in this brief study but some will be mentioned so as to illustrate the theories and their legal implications.

⁷⁵¹ López, E, New Anti-Merger Theories: A Critique, Cato Journal, Vol. 20, No. 3, 2001, p. 366.

The Economic Theories

The concepts of static and dynamic efficiency have been explained earlier in this book.⁷⁵² In the following, it will be showed how these concepts are applied to merger cases. Static merger analysis focuses on allocative efficiency through the effects on prices or output. In static merger analysis mergers are only considered positive if they generate efficiency gains that are large enough to compensate for the undesirable increase in market power. They are usually regarded as negative, hurting consumers and reducing general welfare in the market. But this theory is less clear when it comes to mergers and their impact on dynamic efficiency, through the merged company's ability to invest in R&D and innovate.

The *Schumpeterian* view⁷⁵³ considers that monopolists are in a better position to exploit R&D projects because they have the financial ability to invest and can better manage the risk involved in innovation. It also states that competition does not promote innovation because it dissipates the return on innovation and enhances the risk of imitation.⁷⁵⁴ In other words monopolistic structures are better equipped to innovate and competition would only discourage innovation. Due to the lack of protection of IPRs, the risk of imitation would lead to less R&D. In the absence of property rights investors would be prevented from capturing the values of their inventions, since there are information externalities.

Schumpeter also developed the concept of entrepreneurship. In his theories, *Schumpeter* argued that innovation and technological change comes from entrepreneurs. He came up with the German word *unternehmergeist*, meaning *entrepreneur-spirit*. He believed that such individuals are the ones who make things work in each country's economy. In the *Mark II* version of his theory, he pointed out that the ones who really foster innovation are the big companies which have the resources and capital to invest in research and development. Others have even effectively agreed that competition in the new economy takes the form of competition "for" the market rather than the traditional form of competition "in" the market.⁷⁵⁵

⁷⁵² See Section I, Chapter 4

⁷⁵³ *Schumpeter*, J, *The Theory of Economic Development*, 1934; *Capitalism, Socialism and Democracy*, 1942.

⁷⁵⁴ *Id.*

⁷⁵⁵ *Schmalensee*, R, *Antitrust Issues in Schumpeterian Industries*, 90 *Am. Econ. Rev. (Papers and Proceedings)* 192-193 (2000)

The opposite, dynamic, reasoning holds that competition is essential for innovation and growth. Competition forces firms to innovate in order to survive. It also points out that competition creates higher volumes of output, increasing the value of innovation. Another supporting argument is that when a monopolist innovates it is just “replacing” itself. Another innovator would not have this “replacement” factor and thus would have much more interest in investing in R&D. One of the most remarkable and complete studies supporting these ideas is that of *Michael Porter* who developed the *Theory of Productivity, Innovation and Unique Value*.⁷⁵⁶

Historically, some authors have claimed that static economic theory is ambiguous in its predictions. *Cournot's*⁷⁵⁷ analysis suggests that if a merger does not reduce costs and does not produce close to a monopoly, then the merging firms will lose profits. The *Cournot* view implies that regulators only need to prevent the formation of monopolies and that firms will pursue a non-monopolistic merger only if it reduced their costs. *Bertrand's*⁷⁵⁸ contrary analysis argues that firms will always be able to enhance market power and profits by merging and argues for a more activist merger regulation.

Legal Approach to the Theories

Any discussion on antitrust policy requires an understanding of the impact of mergers on consumer welfare and producer profits. Thus, market structure theories are important in the legislative process.⁷⁵⁹ Merger regulations rely heavily on economic theory to set review standards and facilitate the evaluation of potentially anticompetitive transactions.⁷⁶⁰

Competition authorities and the courts in both the EU and the U.S. have recently devoted much attention and effort to finding the

⁷⁵⁶ Weller, C, Ed., Porter, M, Staudhammer, P, Stern, S, Unique Value: Competition Based on Innovation Creating Unique Value, Innovation Press, 2005

⁷⁵⁷ Cournot, A, Recherches sur les Principes Mathematiques de la Theorie des Richesses, Paris: Hachette, 1838.

⁷⁵⁸ Bertrand, J, Theorie Mathematique de la Richesse Sociale, Journal des Savants, 67, 1883, pp. 499-508.

⁷⁵⁹ Cheong, K., fn 750 , p.1;

⁷⁶⁰ Bergman, M, Coate, M, Jakobsson, M and Ulrick, S, Comparing Merger Policies: The European Union versus the United States, March 2007. Potomac Papers in Law and Economics 07-01; <http://ssrn.com/abstract=975102>.

appropriate balance for encouraging innovation and keeping anti-competitive behavior to a minimum. But to what extent have these efforts enhanced innovation? And is a balance really possible? It is of great interest to look at both jurisdictions and get an overview of their approaches to market structure and effects on innovation.

As shown in extensive economic studies market structure can affect innovation and growth in very relevant ways - it can affect the expected returns from innovation and also affect the way firms will behave.⁷⁶¹

2.2. Market Analysis

Traditional market analysis focuses on market power in existing markets for goods or services. When dealing with innovation this approach may not be adequate, especially when the research is aimed at developing new products for which there is no existing market.⁷⁶²

Potential Competition or Innovation Market?

As an attempt to provide the antitrust authorities with an instrument for the protection of competition in the innovation process, the Innovation Market Approach was developed by the US antitrust authorities in the 1990s.⁷⁶³ Innovation markets are defined in the U.S. IP (1995) Guidelines as consisting of the R&D directed to particular new or improved goods or processes and the close substitutes for that R&D.⁷⁶⁴

The innovation market approach entails a departure from traditional market analysis, in that it attempts to define the competitive market for non-existing goods.⁷⁶⁵ It seeks to protect competition in the innovation

⁷⁶² Glader, M., fn 723, p. 7

⁷⁶³ Davis, fn 748, p. 680-681; more specifically in the IP (1995) Guidelines, fn 611; Proponents of innovation market analysis can however be found in cases pre-dating the IP (1995) Guidelines, see e.g. *Roche/Genentech*, 113 F.T.C. 1086 (1990), also see Glader, fn 723, p. 149.

⁷⁶⁴ See § 3.2.; it should be kept in mind that the IP(1995)Guidelines are limited to licensing agreements.

⁷⁶⁵ Davis, fn 748, p. 677ff

process;⁷⁶⁶ and it recognizes the dynamic nature of competition and the importance of innovation to economic growth,⁷⁶⁷ while trying to identify whether a future market would be anti-competitive.⁷⁶⁸

While the IP (1995) Guidelines are limited to licensing agreements, *Gilbert and Sunshine* have formulated another “branch” of the innovation market approach applicable to mergers.⁷⁶⁹ In their opinion, merger enforcement ought to involve an innovation market analysis in order to “assess the ability of a merged firm to reduce total R&D, its incentive to do so, and the consequences of a merger for the efficiency of R&D”.⁷⁷⁰

The *Gilbert and Sunshine* model, in principle, consist of five steps which include: identification of the merging parties’ overlapping R&D activities, identification of any alternative sources of R&D, evaluation of actual and potential competition from downstream products, assessment of the proposed merger’s potential competitive effects on investment and R&D, and an assessment of any efficiencies arising from the merger capable of outweighing any potential anti-competitive effects.⁷⁷¹

As an alternative to the innovation market approach, other commentators have suggested the Potential Competition Approach.⁷⁷² This approach is concerned with changes in potential competition in future product markets, while the former one focuses on actual competition in innovation markets.⁷⁷³ The potential competition approach focuses on two types of potential competition: actual potential competition or perceived potential competition. Focus is on price or output and may leave some elements of consumer harm, such as delayed introduction of products unexamined.⁷⁷⁴

⁷⁶⁶ Glader, fn 723, p. 6.

⁷⁶⁷ López, fn 751, p. 365

⁷⁶⁸ Pons, J., Innovation and Competition, EC Competition Policy/DGIV/speech/eight/en/ sp980xx.thm, February 1998.

⁷⁶⁹ Starek, R, Innovation Markets in Merger Review Analysis: The FTC Perspective, Federal Trade Commission, February 1996.

⁷⁷⁰ Davis, fn 748, p. 686 citing *Gilbert and Sunshine*.

⁷⁷¹ Glader, fn 723, p. 80f citing *Gilbert and Sunshine*.

⁷⁷² Gilbert, fn 746, p. 6 citing Hoerner.

⁷⁷³ Glader, fn 723, p. 217f.

⁷⁷⁴ Gilbert, fn 746, p. 7.

The potential competition approach extends antitrust policy to mergers between two companies who are currently not competitors but who would become competitors in the future if the merger were abandoned. In principle, the issues are identical to those related to mergers between competitors; the difference being that competitive harm will not occur immediately, but in the future.⁷⁷⁵

In theory, the potential competition approach can be useful when assessing both immediate and near-future competition effects⁷⁷⁶ but it is not so simple to appraise anti-competitive effects relating to innovation.⁷⁷⁷ The main problem is that an analysis of potential competition usually presumes that one of the merging companies is already established in the relevant market.⁷⁷⁸ It will then analyze the effects of a proposed merger on market entry.⁷⁷⁹ In relation to future markets, it will however be necessary to assess whether the parties concerned could become competitors on that market in the future and whether the merger will negatively affect this potential position.⁷⁸⁰

It thus seems that under certain circumstances an innovation market approach could be the better choice when assessing the effects of a merger on R&D performance. It will still be necessary to show the way in which the change in the market structure created by the merger will affect both R&D and the output of goods or services. This is not easy given that it may be difficult to identify the sources of R&D. Furthermore, it is always far from given that there is a link between R&D and the actual supply of new goods and services.⁷⁸¹

Same Approach, Different Labelling?

The U.S. antitrust agencies have clearly recognized innovation as an important element of competition and have expressed that protection

⁷⁷⁵ *Carlton, D*, Antitrust Policy Towards Mergers When Firms Innovate: Should Antitrust Recognize the Doctrine of Innovation Markets?, Hearings on Global and Innovation-Based Competition, October 1995.

⁷⁷⁶ *Glader*, fn 723, p. 69.

⁷⁷⁷ *López*, fn 751, p. 368 citing *Gilbert and Sunshine*.

⁷⁷⁸ *Gilbert*, fn 746, p. 6.

⁷⁷⁹ *Glader*, fn 723, p. 219.

⁷⁸⁰ *Id.* at p. 69.

⁷⁸¹ *Gilbert*, fn 746, p. 6f.

of innovation is one of their main goals.⁷⁸² The agencies' criteria for taking action under the innovation market approach has been to look at the impact of a merger on competitors' R&D activities, the impact of the merging companies' own R&D, and barriers to market entry.⁷⁸³

Unlike the IP (1995) Guidelines, the Horizontal Merger Guidelines⁷⁸⁴ do not apply the innovation market concept in relation to mergers. Merger reviews of innovation markets use the model applicable to mergers in traditional markets. Notwithstanding the lack of guidance in the Guidelines, it is generally accepted that, the U.S. antitrust agencies' approach to innovation effects in mergers is based on the innovation market approach.⁷⁸⁵

In 2006, the agencies released the Commentary on the Horizontal Merger Guidelines.⁷⁸⁶ The Commentary does not include any guidance on the definition of innovation markets. It does however include a list of recent enforcement actions brought by the agencies. Many of these cases refer to a reduction in innovation as one reason to challenge a merger; they also refer to the anticipated rise in prices associated with the merger and none of them rely solely on anticompetitive effects on an innovation market.

The agencies have thus been willing to challenge mergers on the ground that future innovation would otherwise be distorted. However, despite the general acceptance that the concept of innovation markets is

⁷⁸² *Davies, J, Scholossberg, R, Jaspers, M and Scholomiti, K*, Efficiencies – a changing horizon in horizontal merger control, Freshfields Bruckhaus Deringer, 2007, p. 6f.

⁷⁸³ *Brennan, M, Pray C, Naseem, A and Oehmke, J*, An Innovation Market Approach to Analyzing Impacts of Mergers and Acquisitions in the Plant Biotechnology Industry, *AgBioForum* 8 (2&3), 2005, p. 90ff; <http://www.agbioforum.org/v8n23/v8n23a05-pray.pdf>

⁷⁸⁴ *Horizontal Merger Guidelines*, U.S. Department of Justice and Federal Trade Commission, April 8, 1997.

⁷⁸⁵ *Addanki, S.*, Antitrust Analysis of High Technology Mergers: The Role of Potential Competition. Should Antitrust Enforcers Rely on Potential Competition Analysis or the Concept of Innovation Markets?, Federal Trade Commission Hearing on Global and Innovation-Based Competition, October 1995, <http://www.ftc.gov/opp/global/addani.html>.

⁷⁸⁶ *Commentary on the Horizontal Merger Guidelines*, U.S. DoJ and FTC, fn 698

used by the agencies, their precise position on innovation markets in horizontal merger analysis is far from apparent.⁷⁸⁷

In Europe, the Commission has generally maintained that competition policy is not directly applicable to innovation markets, in that innovation is connected with too high a degree of uncertainty. The European approach to analyzing competition in R&D has thus been less robust than that of the U.S.⁷⁸⁸

Traditionally, the Commission has not defined separate goods, technology and innovation markets, as is done in the U.S. The Commission's focus has been on companies with R&D directed towards the same specific goal,⁷⁸⁹ although the innovation market approach is effectively included by their consideration of possible effects on the future market in question.⁷⁹⁰

With the TTBEG (2004)⁷⁹¹, innovation markets were formally included as a third kind of relevant market.⁷⁹² Concerning mergers, it is still notable that there is no discussion of innovation issues in either the 2004 Merger Regulation⁷⁹³ or the associated Merger Guidelines.⁷⁹⁴

Despite the differences in terminology, the EU and the U.S. standards are largely consistent with one another, which have been the

⁷⁸⁷ *Addanki*, fn 785.

⁷⁸⁸ *Glader*, fn 723, p. 7.

⁷⁸⁹ *Temple Lang, J.*, European Community Antitrust Law: Innovation markets and high technology industries, *Fordham International Law Journal*, Vol. 20, 1997, p. 764f.

⁷⁹⁰ *Glader*, fn 723, p. 7.

⁷⁹¹ TTBEG (2004), § 25

http://eurlex.europa.eu/LexUriServ/site/en/oj/2004/c_101/c_10120040427en00020042.pdf

⁷⁹² The other two being product and technology markets, as in the case of the IP (1995) Guidelines, fn 611

⁷⁹³ Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings, *Official Journal of the European Union* L 24, 29/01/2004.

⁷⁹⁴ Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, *Official Journal of the European Union* C 31, 05/02/2004. The Guidelines do however include a reference to mergers that eliminate an "important competitive force", e.g. a merger between two pivotal innovators with pipeline products related to specific product markets, cfr. § 38.

result of an adaptation of EU policy to the more expansive American standards.⁷⁹⁵

At least in the U.S., it appears that the innovation market approach has prevailed, but this approach is still debatable and the results of applying it to antitrust analysis and enforcement need further examination. As an analytic tool, the system is still not fully developed either and many questions remain.

The approach taken in Europe is neither a pure innovation market approach nor a pure potential competition approach. The results are very similar to those reached by the use of the innovation market approaching the U.S.⁷⁹⁶

As noted above, the main difference between the two approaches is that the potential competition approach relates to future competition in an existing product, while the innovation market approach is preoccupied with competition in R&D leading to future competition in future products.⁷⁹⁷ This has led certain commentators to conclude that the innovation market approach is “merely a weak substitute for the potential competition approach”.⁷⁹⁸ In principle, the potential competition approach can be regarded as a branch of the usual antitrust policy aimed at companies in actual competition, while the innovation market approach has indeed developed out of it. The two approaches are thus complementary and not mutually exclusive. They are separate tools, but with many similar features. There is thus no objection to applying both at the same time⁷⁹⁹ and this may be the most helpful approach for the competition authorities

2.3. Assessing Innovation in Merger Cases

Despite the general acceptance, in both the EU and the U.S., of an innovation market approach to the assessment of mergers, it is far from given that the Commission and the U.S. agencies will use the tools

⁷⁹⁵ *Glader*, fn 723, p. 13f.

⁷⁹⁶ *Id.* at p. 6f.

⁷⁹⁷ *Carlton*, fn 775.

⁷⁹⁸ *López*, fn 751, p. 368f citing e.g. *Rapp*.

⁷⁹⁹ *Glader*, fn 723, p. 163, cfr. e.g. *Hoechst/Rhône-Poulenc* (FTC 2000).

uniformly. Furthermore, it must be kept in mind that the innovation market approach is not the only tool available to the authorities when assessing M&A.

In *Glaxo plc*,⁸⁰⁰ the FTC asserted that Glaxo's acquisition of Wellcome would create anticompetitive effects in the R&D relating to a non-injectable migraine drug. This innovation market concern was the sole basis for the FTC's attempt to bar the merger. In the consent order, the FTC required divestiture of all of Wellcome's relevant assets. On the other hand, in Europe, the Commission seemed to base its decision in *Glaxo/Wellcome*⁸⁰¹ on arguments resembling the potential competition approach, and approved the merger after having analyzed the likely effects on the relevant product market.

Conversely, in *Upjohn/Pharmacia*⁸⁰², the Commission repeatedly referred to R&D efforts in relation to future markets, noting that the parties were medium sized and that the costs for R&D and for implementing successful products were very high. The Commission was thus using the innovation market approach on some level, although it may be a somewhat Europeanized version of it.⁸⁰³ In the later case of *Glaxo/Wellcome/SmithKline Beecham*, the Commission refers to "the assessment of the impact of transactions on existing markets and on R&D markets, i.e. future markets".⁸⁰⁴

When dealing with pure innovation cases, the FTC has made it clear that the innovation market approach will be utilized to safeguard competition in future markets and ensure they are not closed off. However, if the future market is very distant, even a monopoly can or will be allowed.⁸⁰⁵

Most cases are neither about pure innovation market nor pure potential competition, but rather mix both concepts. An example is *Roche/Genentech*⁸⁰⁶. Here, the FTC challenged Roche's proposed

⁸⁰⁰ *Glaxo plc*, FTC File no. 951-0054, 60 Fed. Reg. 16, 139 (Mar. 29, 1995), see Glader, fn 723, p. 145.

⁸⁰¹ *Glaxo/Wellcome*, IV/M 555, 1995 (EC), see Glader, fn 723, p. 145.

⁸⁰² *Upjohn/Pharmacia*, IV/M 631, 1995 (EC), see Glader, fn 723, p. 152.

⁸⁰³ Glader, fn 723, p. 152.

⁸⁰⁴ *Glaxo/Wellcome/SmithKline Beecham*, COMP/M 1846, 2000, § 174, see Glader, fn 723, p. 8.

⁸⁰⁵ This was e.g. the case in *Genzyme/Novazyme*, see Glader, fn 723, p. 163f.

⁸⁰⁶ *Roche Holdings Ltd.* 113 F.T.C. 1086 (1990), see Glader, fn 723, pp. 148, 217f and 259

acquisition of a controlling share of Genentech. When defining the relevant market, the FTC included the parties R&D efforts, but treated them in the same way whether they applied to existing or future product markets, rather than as identification of an innovation market. This seems more of a potential competition approach. At the same time, it also provides an example of an early innovation market analysis. One of the defined markets – for therapy or treatment of HIV/AIDS – was indeed a true innovation market, since, at least at that time, there were no companies actually selling the therapies in question.⁸⁰⁷ Another example can seemingly be found in *Pfizer/Warner-Lambert*⁸⁰⁸ where the FTC found that competition would be lessened in both current product markets and future product markets.⁸⁰⁹

Despite the general tendency to challenge M&A by applying innovation markets, either alone or combined with potential competition, it does happen that the FTC focuses on potential competition alone. This was the case in *Amgen/Immunex*⁸¹⁰ and *Pfizer/Pharmacia*.⁸¹¹

Generally, it can be said that the FTC seems to have placed decisive emphasis on whether the anti-competitive effects of a M&A are capable of eliminating R&D competition relating to a particular technology, and create a dominant company able to raise prices unilaterally. As the result is the protection of competition regarding price, quality, service, and consumer choice for products to be marketed in the future it seems that the innovation market approach ends up resembling the potential competition approach.⁸¹²

The Commission's practice has evolved. Rather than taking competition to innovate into account in reviewing a product market, it now seems to put more emphasis on the analysis of competition in R&D as a separate market, certainly where the product market is clearly identifiable. This shift brings the European approach closer to

⁸⁰⁷ Glader, fn 723, p. 148.

⁸⁰⁸ *Pfizer Inc., and Warner-Lambert Company*, File no. 001 0059, Docket no. C-3957 (2000).

⁸⁰⁹ Glader, fn 723, p. 153.

⁸¹⁰ *Amgen Inc. and Immunex Corporation*, C-4053, 2002 (FTC), see Glader, fn 723, p. 141.

⁸¹¹ *Pfizer Inc. and Pharmacia Corporation*, C-4075, 2003 (FTC), see Glader, fn 723, p. 141.

⁸¹² Kerber, fn 750, p. 3ff.

the American approach,⁸¹³ although there is still some way to go before a full integration of the innovation market approach into the application of European merger control is a reality.⁸¹⁴

2.4. Conclusion

Merger regulation, IP, and competition law all foster rights that collide and must be assessed in each particular case. Regulation and case law affect the market structure and thus the creation of mergers and the importance of holding IPRs. The main goal is to promote innovation without anticompetitive practices. The theories of static and dynamic markets share this goal but seek to achieve it through a completely different economic reasoning.

The question whether a static or a dynamic market structure will bring about more innovation is still not resolved. Currently, there seems to be a tendency towards fostering a more dynamic system and allowing IPRs to be subject to competition rules⁸¹⁵.

Beyond the concerns of market structure are issues that arise from the nature of the innovation market. Innovation-based competition creates new challenges for antitrust policy. It has become more common for profit levels to be determined by companies' ability to compete in innovation, and antitrust policy and analysis therefore has to be adapted. As innovation issues are connected with a high degree of uncertainties, the evaluation of a proposed mergers' effect on innovation is speculative. A cautious approach seems needed: innovation, however, must be included in merger reviews. Despite any potential uncertainties this may entail, a case by case, or at least an industry by industry, evaluation of a proposed merger ends up appearing most appropriate.

American and European antitrust enforcement pursue different conceptual approaches to incorporate innovative efficiency considerations into merger analysis. At the heart of this development lies the U.S. authorities' implementation of new concepts, especially that of the innovation market, while the Commission does not seem to have any formalized innovation market doctrine. It has largely stayed

⁸¹³ *Glader*, fn 723, 6f.

⁸¹⁴ *Kerber*, fn 750, p. 3.

⁸¹⁵ See *Jacquemin, A.*, fn 750, p.7.

with the analysis of actual and future product markets combined with a variant of the potential competition doctrine.

The American approach to innovation-issues appears to be more proactive and future-oriented than the European although European procedures are changing, and coming closer to the U.S. At the same time, however, U.S. standards are evolving; and the gap may well remain.

The differences in approach between the EU and the U.S. may be of theoretical significance only; it seems that the EU and the U.S. authorities often reach similar results.

IPR and Mergers & Acquisitions

Joint Conclusion

EC competition law tends to focus on dominance when assessing mergers. Pre-merger and post-merger market shares are determined and if the merger will significantly impede competition on the common market, it will be prohibited or subject to conditions. The Commission does take IPRs into account when assessing mergers, but it is not a central issue and has yet to be explicitly discussed in the Commission's decisions. A company's IP portfolio is often the most valuable asset transferred during a merger, whereby it gives incentives for the merger. IPRs are also incentives for innovation and innovation enhances competition. It would thus be helpful if the Commission started to assess IPR in merger cases explicitly in order to make it more understandable why certain mergers are prohibited while others are not.

U.S. antitrust law evaluates mergers in relation to the relevant markets, focusing on the effects on competition levels, market concentration and efficiency gains from the transaction. While IPR are treated the same as any other form of property when evaluating mergers, the reality is that if significant IPR exist in a proposed merger, the evaluation focuses on them and their effects on existing markets or potential to dominate a new market. The Agencies will often require significant concessions in order to grant an approval. It is the balance between IPR, antitrust and innovation, which makes it difficult to maximize the beneficial effects of mergers involving IPR.

Innovation is a dynamic process and requires a dynamic analysis to adequately identify the impact of M&A on innovation. When reviewing anti-competitive merger activity in innovation markets, the traditional methods for merger review will often be of limited efficiency. The innovation market approach might serve as a useful tool here.

The object of the measurement is the level of innovation competition; the innovation market approach takes a forward-looking perspective and acknowledges the possibility of harm to future competition by mergers that result in a reduction in R&D activities.

As far as the EU is concerned, the Commission has made efforts to increase the economic component of its decisions. But IPR are still not explicitly considered in most of the Commission's decisions on mergers. Further, the use of evolutionary economic theories is still developing. Recent case law indicates that there is a tendency towards a more dynamic economic market analysis that allows IPRs to fall under competition rules. Whether this tendency will be developed further or whether the Commission will adopt a more favourable view of IPR remains to be seen. It is important to stress that IPRs are fundamental for some industries, such as the pharmaceutical sector, and the competition authorities now make a case by case analysis when finding the correct balance of rights for each merger case. This may lead to too much uncertainty.

U.S. merger regulation tends to follow a more static theory and this favours the protection of IP rights. The question whether this would exclude any analysis of innovation markets or allow them to be protected too is still not settled. There are complex and opposing economic theories which surround this issue.

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