Avoiding Potential Antitrust Pitfalls in Patent Royalty Terms

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Royalty arrangements have considerable attractions for patent holders, but they can raise antitrust concerns. The tip for the practitioner is to identify and document the pro-competitive advantages and reasons for the arrangement.

Microsoft’s and Intel’s recent and continuing battles against licensees and governmental antitrust enforcers exemplify the increased antitrust focus on intellectual property licensing terms. The Microsoft case has gained perhaps the most publicity, but many intellectual property holders face complex antitrust questions when they try to determine what restrictions and license terms they can negotiate with their licensees.

Many of the per se illegality standards have begun to fade as antitrust law has come to recognize the potentially pro-competitive bases for some restrictions. Courts increasingly apply tra-
ditional Rule of Reason antitrust analysis to determine whether licensing terms, such as royalty provisions, unreasonably restrain trade in violation of the Sherman Act.

Royalty terms, particularly innovative terms that create financial disincentives for dealing with the patentee’s competitor, may avoid per se illegality but still raise antitrust concerns. A “patent empowers the owner to exact royalties as high as he can negotiate with the leverage of that monopoly” Brulotte v. Thys Co., 379 U.S. 29, 33 (1964). But the Supreme Court and lower courts have held that some royalty schemes potentially can constitute patent misuse or illegally restrain trade. Moreover, federal antitrust enforcers have become increasingly concerned with whether an arrangement results in less innovation.

Consider, for example, the following royalty schemes:
• Royalties based on the total output of a licensee regardless of the use of the patent;
• Access fees charged regardless of the amount of usage;
• Discounted royalties for those licensees who agree not to use patents of the patent holder’s competitor; and
• Discounted royalty rates for those licensees who agree to license a package of patent licenses.

This list is intended as illustrative rather than exhaustive, but analyzing these four types of royalty schemes highlights the potential antitrust pitfalls. Because the market power of the patentee and the effect of the royalty terms on competition affect the legality of such terms, drafters of patent licenses need to design such terms carefully. The judicial decisions provide few clear rules of “do’s and don’ts.”

This article discusses several practical ways to reduce potential antitrust exposure from the use of royalty incentives in licensing one’s patent rights.

AN OVERVIEW OF FEDERAL ANTITRUST LAW • Sections 1 and 2 of the Sherman Act provide the most common bases for federal antitrust challenges to intellectual property licensing arrangements. If read literally, Sherman Act section 1 prohibits all contracts, combinations or agreements that restrain trade, but the Supreme Court has long read the statute to prohibit only those agreements that unreasonably restrain trade. Section 2 of the Sherman Act prohibits monopolization, attempts to monopolize, and conspiracies to monopolize. To begin the antitrust analysis of patent royalty terms, we review how courts interpret those two statutory prohibitions. In addition to the federal antitrust laws, a patent license or royalty term could violate state antitrust laws. Those individual state statutes are not discussed here, although many states follow federal precedent. See, e.g., Cal. Bus. & Prof. Code §§16700 et seq.; N.Y. Gen. Bus. Laws §§340-47.

Sherman Act Section 1


Assuming the agreement requirement for a Section 1 claim is met, courts apply one of three possible analyses to determine whether an agreement unreasonably restrains trade.

Per se Illegality

First, the Supreme Court has held that certain agreements (for example, price fixing and allocation of territories) are deemed never to have pro-competitive effects and, therefore, are auto-
matically, or per se, illegal. See Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717 (1988). For example, the manufacturer of a patented product cannot require its customers to resell the product at a specified price. See Mallenckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 704, 709 (Fed. Cir. 1992). Similarly, holders of competing patents cannot agree on the royalty they will charge their respective licensees. Each of these examples involves an agreement to fix a price that is per se illegal.

**Rule of Reason Analysis**

For vertical non-price agreements—those between firms at different production levels (such as manufacturer and distributor)—courts typically apply a fact-intensive analysis, known as the Rule of Reason. See Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977). Most patent license terms are subject to a Rule of Reason analysis. This approach balances the pro-competitive and anti-competitive effects to determine whether the agreement unreasonably restrains trade. If the restriction is, on balance, unlikely to limit output or increase prices, the antitrust claim fails. Many courts have held that firms lacking market power by definition do not have the ability to raise price above the competitive level. See, e.g., Assam Drug Co. v. Miller Brewing Co., 798 F.2d 311 (8th Cir. 1986). Therefore, firms with small market shares can impose non-price vertical restraints with little antitrust risk. Similarly, although “tying,” forcing the buyer of one product to buy a distinct product, remains subject to the per se rule, there is no violation if the seller lacks market power in the tying product. See Eastman Kodak Co. v. Image Tech. Servs., Inc., 504 U.S. 451 (1992).

**“Quick Look”**

Courts have developed more recently a third type of analysis, known as the “quick look.” Federal Trade Commission v. Indiana Federation of Dentists, 476 U.S. 477 (1986). Under this type of analysis, when a restraint has obvious anti-competitive effects, the court will nonetheless take a “quick look” for pro-competitive justifications for the restraint. Generally, this analysis is undertaken when the agreement at issue is among competitors in an industry having unusual market structure characteristics or one in which some competition among competitors is essential to production. See NCAA v. Board of Regents, 468 U.S. 85 (1984); Chicago Professional Sports Limited Partnership v. National Basketball Association, 961 F.2d 667 (7th Cir.), cert. denied, 506 U.S. 954 (1992).

Recently, in California Dental Assoc. v. Federal Trade Commission, the Supreme Court warned that courts should limit the quick look analysis to those cases where the anti-competitive effect is clear. 119 S. Ct. 1604 (1999). Thus, if the quick look identifies a potential pro-competitive reason for the restraint, the court applies the full Rule of Reason analysis. Restraints without any pro-competitive justification are found to violate Sherman Act section 1 without proceeding to the balancing step of the Rule of Reason.

**Sherman Act Section 2**

Sherman Act section 2 prohibits conduct undertaken by a single firm to monopolize or attempt to monopolize. 15 U.S.C. §2. Unlike section 1, section 2 does not require proof of an agreement or conspiracy.

**Patent Rights as Monopoly**

Not every monopoly violates the antitrust laws. Patent law trumps antitrust law to the extent that a patent grants the patentee a legal monopoly—an exclusive right to exclude others from producing or selling a particular process or product. A patent holder is entitled to enjoy the monopoly profits created by its patent. Brulotte v. Thys Co., supra, at 33 (“A patent empowers the owner to exact royalties as high as he can nego-
tiate with the leverage of that monopoly”); United States v. Westinghouse Elec. Corp., 648 F.2d 642, 647 (9th Cir. 1981) (“The right to license the patent, exclusively or otherwise, or to refuse to license at all, is the ‘untrammeled right’ of the patentee”); but compare Image Technical Serv., Inc. v. Eastman Kodak Co., 125 F.3d 1195, 1218-20 (9th Cir. 1997) (monopolist cannot refuse to license patented parts for anti-competitive reasons). The patent provides no antitrust protection, however, if the patentee obtains a monopoly not by skill, business acumen, or luck but instead by predatory acts or by obtaining a patent monopoly by combination or acquisition.

When Are the Acts “Predatory”?  
A firm illegally attempts to monopolize when it commits some predatory act (e.g., predatory pricing) that creates a dangerous probability that the firm will obtain a monopoly. See Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447 (1993). The “dangerous probability” aspect is a critical element of any attempt to monopolize claim. Id. If the alleged wrongdoer does not already have a fairly large market share, a court is likely to find that there exists no dangerous probability that the party will obtain a monopoly as a result of the predatory acts. Courts have not set a specific threshold for how large a share a firm must have to create a dangerous probability of success. See Domed Stadium Hotel, Inc. v. Holiday Inns, Inc. 732 F.2d 480 (5th Cir. 1984). Moreover, a large market share cannot create a dangerous probability of a monopoly unless barriers prevent new competitors from entering the market if the firm tried to raise prices above the competitive level.

The “Tension” Between Antitrust and Patent Laws  
One of the difficulties, or tensions, that courts have encountered in antitrust/patent matters is determining when patent protection immu-