

2003

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Recommended Citation

O'Rourke, Maureen A. and Brodley, Joseph F., "An Incentives Approach to Patent Settlements: A Commentary on Hovenkamp, Janis and Lemley" (2003). *Minnesota Law Review*. 778.
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Commentary

An Incentives Approach to Patent Settlements: A Commentary on Hovenkamp, Janis & Lemley

Maureen A. O'Rourke[†] and Joseph F. Brodley^{††}

Professors Hovenkamp, Janis, and Lemley have attempted to clarify one of the most vexing issues facing antitrust and intellectual property law today: What analytical framework should antitrust authorities and courts use in considering whether patent settlement agreements in infringement cases violate the antitrust laws?¹ The issue is complex because many ostensibly anticompetitive restraints in settlement agreements are perfectly legal if the underlying patent right is valid. Unfortunately, in some cases, the relevant patents are either invalid or not infringed.² Thus, the antitrust analysis hinges

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1. Herbert Hovenkamp et al., *Anticompetitive Settlement of Intellectual Property Disputes*, 87 MINN. L. REV. 1719, 1725-28 (2003). The Hovenkamp, Janis, and Lemley analysis applies equally to copyright law. As they note, however, the difficult cases are unlikely to be copyright ones. *See id.* at 1736-38. Thus, this Commentary concentrates only on patent settlement agreements.

2. Estimates of the invalidity percentage vary depending on the time period surveyed. *See, e.g.*, ROBERT L. HARMON, *PATENTS AND THE FEDERAL CIRCUIT* 1135 (5th ed. 2001) (finding that the Federal Circuit held 72% of the patents litigated before it valid and 28% invalid between the date of the court's creation and the end of the year 2000); John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q.J. 185,

on resolution of an intellectual property question.

Hovenkamp, Janis, and Lemley rightly emphasize that in many cases, the relevant decision maker can avoid evaluating the validity of the intellectual property right at issue.³ Their analysis is most interesting when it discusses those cases in which validity of the patent right determines the lawfulness of the settlement under the antitrust laws.⁴ This Commentary focuses on such cases.

Part I begins by discussing recent patent law reforms that might help decrease the number of invalid patents the Patent and Trademark Office (PTO) issues and also reduce the costs associated with those invalid patents that do issue. These changes include earlier publication of patent applications and improved ability of third parties to initiate a patent reexamination procedure. By decreasing the probability that the holder of an invalid patent may use it to extract anticompetitive settlement terms, such reforms may lessen the need for antitrust scrutiny of patent settlement agreements.

Part II begins by noting the incentive distortions that patent settlements can create in infringement disputes, and suggests measures to counteract such incentive distortions and to strengthen private incentives to challenge invalid patents. Specifically, this Part suggests requiring disclosure to the antitrust agencies of settlements that appear to create the greatest antitrust risk, reinvigorating the longstanding rule against licensee estoppel. We also briefly discuss the merits of awarding bounties for successful challenges to patent validity and awarding attorney's fees to successful challengers.

Part III focuses on the analysis of settlements when validity of the patent rights is uncertain. Concentrating

194-205 (1998) (surveying all final, written validity decisions from either the district courts or the Federal Circuit from 1989-96, and finding that the courts held 54% valid and 46% invalid); Robert P. Merges, *Commercial Success and Patent Standards: Economic Perspectives on Innovation*, 76 CAL. L. REV. 803, 822 & nn.71-72 (1988) (citing sources stating that appellate courts invalidated nearly 66% of litigated patents between 1921 and 1973, while between 1982 and 1985, the Federal Circuit invalidated 44%); Kimberly A. Moore, *Forum Shopping in Patent Cases: Does Geographic Choice Affect Innovation?*, 79 N.C. L. REV. 889, 918 (2001) (surveying every patent case going to trial between 1983 and 1999, and finding that courts held 67% of the litigated patents valid and 33% invalid).

3. Hovenkamp et al., *supra* note 1, at 1723 & n.9.

4. *See id.* at 1725-27, 1734-65.

particularly on the problem of exit payments, this Part discusses different ways in which agencies not known for their patent law expertise can determine the probability of patent invalidity and the existence of an antitrust violation. The alternatives include direct assessment of patent validity in the antitrust proceeding, possible use of objective indicators to determine patent validity, and a legal rule that would modify the incentives of the economic actors to motivate them to act in the public interest in settling patent infringement cases. Hovenkamp, Janis, and Lemley would combine the use of an objective indicator—the exit payment—with direct assessment of validity. We agree on the exit payment indicator, but would opt for a legal rule that avoids the necessity of proving patent validity.

I. PATENT REFORMS TO REDUCE INVALID PATENTS

Antitrust issues normally arise in patent infringement settlements when patents are invalid or not infringed. Antitrust problems could be greatly reduced by eliminating invalid patents from the patent system. Thus, a threshold question is whether patent reforms could eliminate or reduce the large number of erroneously issued patents, and thereby drastically reduce the need for antitrust scrutiny.

The PTO inevitably issues patents on inventions that do not meet the statutory requirements for protection.⁵ This is not surprising. A system that never erred would be cost-prohibitive.⁶ Thus, the issue is not whether policy makers can construct a perfect system, but instead whether they can make cost-effective improvements to the one that already exists. Invalid patents impose costs on the public in the form of higher prices and restricted output without the public's receiving the benefit of the patent bargain—a new, useful, and nonobvious invention. Recent enactments that require early publication of the patent application and expand reexamination procedures

5. See *supra* note 2 and accompanying text (discussing the invalidity rate of issued patents).

6. See generally Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 NW. U. L. REV. 1495, 1497, 1531-32 (2001) (arguing that because most patents are neither litigated nor licensed, it is cheaper to determine validity in those cases that do arise than invest in making the PTO's examination process more accurate).

should help to expose more invalid patents.⁷ Congress and the PTO should also consider whether other cost-effective reforms exist that would enhance the probability that invalid patents will not cause anticompetitive harms. Several steps have been taken in this direction, and others are possible as we suggest below.

A. PUBLICATION OF PATENT APPLICATIONS

In the American Inventors Protection Act of 1999, Congress amended the Patent Act to provide for publication (with certain exceptions) of a patent application eighteen months after its filing.⁸ The PTO just recently implemented the appropriate publication procedures, so it is too early to tell how many inventors will stay in the patent system, particularly when they have weak patent claims. Under the previous rule, patent applicants could maintain their inventions as trade secrets⁹ throughout the application process (likely two to three years). If an applicant never received a patent, it could still retain trade secrecy protection for the invention. If the PTO issued a patent, the publication that occurred on issuance would void trade secrecy protection but the inventor would then hold the patent along with its presumption of validity.¹⁰

Publication eighteen months after filing the patent application, as the Act now requires, will void trade secrecy protection before the applicant has obtained a patent.¹¹ Thus, the new publication rule should force applicants to more realistically assess their patentability prospects. Possibly then, the PTO may issue fewer invalid patents because the applicants themselves will remove weak applications from the system rather than risk losing trade secrecy protection. Earlier publication also provides third parties with an opportunity to

7. See *infra* notes 8-12, 15-19 and accompanying text.

8. 35 U.S.C. § 122(b) (2000).

9. This assumes, of course, that the inventions met the requirements for trade secret protection under relevant state law. Some would not, making patent protection the only alternative available. Many, however, would qualify as trade secrets, giving the inventors the option of choosing between trade secret and patent protection.

10. 35 U.S.C. § 282 (stating that a "patent shall be presumed valid").

11. Obviously, an invention may not be protected under trade secrecy law if it is no longer a secret. See *id.* § 1839 (defining "trade secret" as information that "derives independent economic value . . . from not being generally known to . . . the public or other persons").

challenge an application before patent issuance. For example, third parties may provide prior art references of which the PTO would otherwise be unaware. This should help the PTO to make more informed and more accurate decisions on patentability.

Unfortunately, these benefits may not be realized if non-trivial numbers of patent applicants take advantage of statutory exceptions that permit "opting out" of the publication requirement. Under the amended Patent Act, an application will not be published "[i]f an applicant makes a request upon filing, certifying that the invention disclosed in the application has not and will not be the subject of an application filed in another country, or under a multilateral international agreement."¹²

In a recent speech before the American Intellectual Property Law Association, acting Assistant Attorney General R. Hewitt Pate noted that even those who disagree on whether there is a "crisis" of too many patents too easily granted" can agree on certain desirable improvements to the system.¹³ Among these would be a mandate to publish all applications within eighteen months after filing.¹⁴ Certainly, the salutary effect publication would have on the rate of issuance of invalid patents is more likely to be realized if all applications, rather than only selected ones, are published.

B. REEXAMINATION OF PATENT VALIDITY

The patent reexamination procedure offers another, albeit post-issuance, method that helps to clear invalid patents from the system.¹⁵ It permits anyone to petition the PTO to review

12. *Id.* § 122(b)(2)(B)(i). The Act also provides that applications no longer pending, those subject to a secrecy order, certain provisional applications, and design patent applications will not be published. *Id.* § 122(b)(2)(A).

13. R. Hewitt Pate, Address Before the American Intellectual Property Law Association (Jan. 24, 2003), at <http://www.usdoj.gov/atr/public/speeches/200701.htm>.

14. *Id.* Pate also noted that there is general agreement on a "mandate to issue or deny patents within 18 months." *Id.* The effect such a requirement would have on patent validity is debatable. Indeed, by forcing examiners to rush their decisions, it may result in the PTO's issuing more invalid patents. Further, it would remove any incentive for applicants themselves to remove weak applications from the system because aligning the date of decision with the date of publication means that applicants would no longer have to choose between trade secrecy and patent protection.

15. 35 U.S.C. §§ 301-307, 311-318.

the validity of an issued patent if a substantial basis for questioning the patentability of the invention arises after the PTO issues the patent.¹⁶ In the past, third parties rarely sought reexamination because certain limits in the process made reexamination a risky procedure for the petitioner.¹⁷ Specifically, third parties could not appeal an adverse decision to the Federal Circuit and could not ask the examiner to review prior art already submitted.¹⁸ Recent changes removing these limits should make reexamination a more viable option for third parties.¹⁹

Some disagree, arguing that reexamination remains too risky a strategy because the PTO effectively sits in review of itself and is unlikely to reverse its own decision to grant a patent.²⁰ The prospect of an appeal to the Federal Circuit may not be sufficient to induce third parties to request reexaminations in any significant number.²¹ It is not to their tactical advantage to be in the position of the "losing" party on appeal.²² Still, though, more reexaminations are likely to occur than under the prior system.²³ The recent changes to the reexamination process therefore appear to be a cost-effective move toward removing at least some invalid patents from the system.

The antitrust agencies might also consider whether they

16. Congress amended the Patent Act in 1999 to permit reexamination on request by third parties. *Id.* §§ 311-318. For both applicant and third party initiated reexaminations, the PTO Director is to "determine whether a substantial new question of patentability . . . is raised by the [reexamination] request." *Id.* § 303(a) (ex parte reexamination), 312(a) (inter partes reexamination).

17. Jenna Greene, *Streamlined: Law Reforming Patent, Trademark Processes Likely to Get President's Signature this Month*, DAILY BUS. REV., Oct. 15, 2002, at A7, 2002 WL 102273575 (noting that 1999 legislation provided for third parties to participate in reexaminations but that the so-called inter partes proceeding had "been a complete flop—it has been used in only three cases").

18. *Id.*

19. Patent and Trademark Office Authorization Act of 2002, Pub. L. No. 107-273, §§ 13105-13106 (Nov. 2, 2002).

20. Mark A. Lemley, Remarks at the Symposium on the Interface Between Intellectual Property Law and Antitrust Law, University of Minnesota Law School, Feb. 8, 2003.

21. *Id.*

22. *Id.*

23. See *supra* notes 15-19 and accompanying text (discussing the changes to the reexamination system).

should seek reexamination themselves. The Patent Act provides for reexamination at the request of "any person,"²⁴ a term which presumably encompasses the Federal Trade Commission (FTC) and Antitrust Division of the Department of Justice (DOJ).²⁵ Unfortunately, the agencies may lack the resources and expertise to mount any meaningful number of challenges.

In summary, the recent innovations regarding publication and reexamination should result in a decline in the number of invalid patents. In addition, the PTO and Congress ought to consider whether additional cost-effective measures exist that might further decrease the probability that the PTO will issue invalid patents. For example, the PTO should continue to scrutinize examiner compensation schemes with an eye toward improving them in ways likely to lead to better PTO performance.²⁶ Nevertheless, as noted at the outset, the PTO will inevitably issue some invalid patents, and it will do so even if it and Congress take all possible cost-effective measures to decrease the number of such patents.²⁷ Thus, publication and reexamination will not be sufficient in themselves to remove the need for more effective screening of patents and antitrust scrutiny.

II. CHALLENGING INVALID PATENTS IN SETTLEMENT CASES

The law generally favors settlements because they conserve public administrative and judicial resources, and also enable the parties to save time and expense, avoid the uncertainty of a litigated outcome, and employ their resources in other productive ventures.²⁸ The same considerations apply to patent infringement cases, which can be extraordinarily complex, lengthy, and expensive.

Without settlement, the alleged infringer risks entry of a permanent injunction restraining it from marketing its product

24. 35 U.S.C. § 311(a) (2000).

25. Lemley, *supra* note 20.

26. Robert P. Merges, *As Many as Six Impossible Patents Before Breakfast: Property Rights for Business Concepts and Patent System Reform*, 14 BERK. TECH. L.J. 577, 606-09 (1999) (suggesting, inter alia, higher salaries for senior examiners and redesigned bonus systems).

27. See *supra* notes 2, 6 and accompanying text.

28. See e.g., Hovenkamp et al., *supra* note 1, at 1721.

(and recouping the costs already expended in its development) until the patent's expiration, and a judgment ordering payment of damages in the amount of the patentee's lost profits plus interest and costs.²⁹ The patentee in turn risks a finding of invalidity or noninfringement—a finding that is particularly costly to the patentee because it operates against the world.³⁰ All comers, not just the defendant, may now practice the invention without compensation to the patentee.

Patent settlement agreements can also benefit consumers. Settlement agreements are often pro-competitive. For example, when they enable market entry or provide for cross-licensing of complementary and blocking technologies, settlement agreements can lead to the adoption of more efficient production techniques. Consumers may benefit from the resulting availability of more output at lower prices.

Settlement, however, dramatically changes the incentives of the patentee and alleged infringer. Prior to settlement, the parties' interests are adverse, and that adversity promotes the public interest in policing patent validity. After settlement, the parties' interests are congruent: Both seek to extend the patent to its broadest possible scope regardless of its enforceability.³¹ This alignment of incentives is particularly dangerous when the alleged infringer is one of only a few likely to challenge the patent. As Professors Hovenkamp, Janis, and Lemley note, a patent settlement agreement can effectuate a cartel or create or maintain a monopoly in an innovation or product market.³²

A. NOTIFICATION OF SETTLEMENTS

The secrecy of settlement agreements makes it difficult for antitrust enforcers to uncover possible violations and to know whether anticompetitive settlements are widespread. To be sure, as Hovenkamp, Janis, and Lemley explain, section 135(c) of the Patent Act requires the filing of interference settlements

29. 35 U.S.C. §§ 283-84.

30. *Blonder-Tongue Labs., Inc. v. Univ. of Ill. Found.*, 402 U.S. 313, 328-50 (1971) (holding that a patentee may not assert validity of a patent previously declared invalid by a federal court in a suit against a different defendant unless the patentee can show lack of a full opportunity to litigate validity in the prior suit).

31. See, e.g., Robert J. Hoerner, *Antitrust Pitfalls in Patent Litigation Settlement Agreements*, 8 FED. CIR. B.J. 113, 114 (1998).

32. Hovenkamp et al., *supra* note 1, at 1739-65.

and collateral agreements with the PTO.³³ The PTO, however, does not make a finding of validity when it accepts a section 135 filing. It will send copies of filings to the FTC on request, allowing the FTC to assess whether the settlement implicates antitrust concerns. The FTC, however, does not receive notice of what filings have occurred, making it virtually impossible for it to request copies of filings that might be of interest. In addition, antitrust authorities lack standing to enforce compliance with section 135(c).³⁴ For these reasons, some believe that non-compliance with that section's requirements is widespread.³⁵

Furthermore, patent interference settlements represent only a subset of patent settlement agreements. An interference proceeding is one between two applicants to determine priority.³⁶ Many settlements arising from infringement litigation do not involve interference proceedings. Currently, there is no requirement that parties file settlement agreements not involving interference proceedings with any enforcement agency.

Hovenkamp, Janis, and Lemley note that then-acting

33. *Id.* at 1734 & n.50.

34. *United States v. FMC Corp.*, 717 F.2d 775, 780-87 (3d Cir. 1983) (employing the analysis set forth by the Supreme Court in *Cort v. Ash*, 422 U.S. 66, 78-85 (1975), and holding that no implied right of action in favor of the United States exists to permit it to enforce 35 U.S.C. § 135(c)).

35. See Joel L. Klein, Address Before the American Intellectual Property Law Association (May 2, 1997), at <http://www.usdoj.gov/atr/public/speeches/1123.htm>. Klein noted that § 135(c)'s filing requirement was intended to deter anticompetitive agreements but also stated,

I still can't help but wonder whether the statute is fully effective in ensuring filings. The PTO is not in a position to police the requirement that there be no unfiled side agreements. Nor are third parties And [the] only way we're likely to find out about a failure to file is through serendipity in an already-opened investigation. . . .

What this means, then, is that the only people who are likely to know about a violation of Section 135(c) and to be able to do something about it are the parties to the settlement themselves. . . . [T]o hinge law enforcement on changes of heart by violators places more hope in redemption of the human spirit than one in my position can afford to have.

36. 35 U.S.C. § 135(a) (2000) ("Whenever an application is made for a patent which, in the opinion of the Director, would interfere with any pending application, or with any unexpired patent, an interference may be declared The Board of Patent Appeals and Interferences shall determine questions of priority of the inventions and may determine questions of patentability.").

Assistant Attorney General Joel Klein proposed a prenotification system for patent cross-licenses to permit merger review (since patent cross-licensing involves an acquisition of assets subject to the Clayton Act).³⁷ It is important to add that at the same time Klein also proposed a similar notification system for settlements of infringement disputes.³⁸ This proposal deserves careful attention because it would help dispel the secrecy that prevents antitrust authorities from identifying and understanding the extent of anti-competitive settlement agreements. Indeed, only a year before, William Baxter, a former assistant attorney general for antitrust, had indicated agreement with such a proposal.³⁹

In his proposal, Klein identified an essential problem: A broad range of agreements—from licenses to cross-licenses to settlements—simply escape the attention of antitrust regulators.⁴⁰ He suggested that rather than requiring that all such agreements be filed, antitrust authorities should start by requiring notification of a limited category of infringement cases. The authorities could monitor the cases, and either assume the defendant's role if they believe a settlement is anti-competitive, or provide the court with comments. With the benefit of information provided by the antitrust authorities, courts might be better equipped to reject a settlement against the public interest.⁴¹

To avoid unduly burdening settling parties, the Klein proposal would require filing of only those settlements that meet specified criteria. Without explicitly defining these criteria, Klein enumerated the factors that might be considered. These included (1) the size of the parties, (2) their share of the relevant market, and (3) the economic significance of the infringement and the products and services involved.

Professors Hovenkamp, Janis, and Lemley's analysis suggests an additional general criterion that antitrust

37. Hovenkamp et al., *supra* note 1, at 1734 n.51.

38. Klein, *supra* note 35.

39. See William F. Baxter, *Comment*, in *COMPETITION POLICY AND INTELLECTUAL PROPERTY RIGHTS IN THE KNOWLEDGE-BASED ECONOMY* (Robert D. Anderson & Nancy T. Gallini eds., 1998); see also Klein, *supra* note 35 (arguing for a notification system and noting that "Bill Baxter made a similar proposal just last year").

40. See Klein, *supra* note 35.

41. *Id.*

authorities might utilize in defining the scope of notification: products that rest on only one basic patent ("single product patents").⁴² They note that settlements involving single product patents are less likely to be pro-competitive by removing blocks to further innovation.⁴³ This suggests that settlements involving single patent products may raise greater antitrust risks, an inference strengthened by the fact that patents contribute most to profits in such single product industries as pharmaceuticals, chemicals, and agriculture.⁴⁴ Consistent with Klein's proposal, Hovenkamp, Janis, and Lemley's analysis also suggests that market power in the product or innovation market is another criterion important to the likelihood of an anti-competitive settlement.⁴⁵ Any notification system should therefore also set a threshold level of market power or market share that would trigger the filing requirement.

The Klein proposal may encourage parties to enter into less restrictive settlement agreements. Parties may do so to avoid the filing requirement, a viable option particularly if certain types of provisions give rise to a need to file. Finally, only by obtaining a more complete picture of the nature and terms of patent settlement agreements may antitrust agencies obtain a realistic view of the extent of anticompetitive behavior in such agreements. The debate should therefore focus less on whether notification is desirable and more on how to define the subset of settlement agreements to which such a requirement would apply. Consideration of a settlement notification procedure is further illuminated by a proposed settlement disclosure form in a recent article by Robert Hoerner, a former Chief of the Evaluation Section of the DOJ's Antitrust Division.⁴⁶

The Klein proposal to enable the antitrust authorities to effectively challenge patent settlement agreements also helps to alleviate the free rider or "public goods" problem associated

42. Hovenkamp et al., *supra* note 1, at 1738.

43. *Id.*

44. Fed. Trade Comm'n/Dep't of Justice Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-based Economy: A Competition View of Patent Settlements (May 2, 2002), *available at* <http://www.ftc.gov/opp/intellect/020502trans.pdf>.

45. Hovenkamp, et al., *supra* note 1, at 1728.

46. See Hoerner, *supra* note 31, at 135-38.

with patent litigation. As noted above, a patent invalidity finding functions in favor of the world (including the defendant's competitors), not just the defendant who financed the litigation.⁴⁷ These competitors do not have to compensate the successful defendant for this benefit. As Attorney General Klein stated, allowing antitrust authorities to present arguments to a court overcomes the problem of defendants' limited resources and skewed enforcement incentives:

If [the antitrust agencies had a] right to be heard, we could ensure that meritorious defenses would not be abandoned, and questionable intellectual property claims would not triumph, without at least an opportunity for us to consider whether broader societal interests in competition warrant putting the claims to their proof, and to bring those considerations to the court's attention. Then, those broader interests would not be held hostage to the defendant's own economic interests, which may be subject to limited resources for litigation and a strong aversion to the consequences of defeat, no matter how remote the chances. . . .

[W]henever there is even a more than trivial possibility of infringement, the costs of litigation skew the parties' decisions, steering them away from a serious test of the bounds of the rights of the patentee . . . , and towards agreements that too often make teammates out of rivals. Since society picks up the tab for these agreements over the long run, I think it may be worth an investment of our resources up front to head them off where necessary.⁴⁸

B. MAINTAINING PRIVATE INCENTIVES TO CHALLENGE PATENTS: BOUNTIES, ATTORNEY'S FEES, AND LICENSEE ESTOPPEL

Paying bounties to those who successfully challenge patent validity also provides an alternative means of strengthening private incentives to challenge patents.⁴⁹ A bounty, of course,

47. See *supra* note 28 and accompanying text.

48. Klein, *supra* note 35, at 19-20.

49. *FTC/DOJ Continue Hearings On Antitrust/Intellectual Property*, 82 *Antitrust & Trade Reg. Rep. (BNA)* 442 (May 17, 2002). In the joint FTC-DOJ hearings, Professor Joseph Scott Miller suggested

a bounty mechanism that operates after a successful challenge has been mounted. Such a bounty should include disgorgement to the infringer [of] all the profits the patentee earned by using the invalid patent and would be available to only the first accused infringer to obtain a final judgment that the patent is invalid or unenforceable.

Id. at 444; see also John R. Thomas, *Collusion and Collective Action in the Patent System: A Proposal for Patent Bounties*, 2001 U. ILL. L. REV. 305, 340-52 (proposing that the PTO award prior art informants with a bounty assessed against applicants, thus "restoring order to our patent system and ultimately lowering its social costs").

would increase the expected return to challenging a patent. Such an idea, while theoretically sound, faces a host of practical questions: Who funds the bounty, calculates its amount, and pays for administration of the system?

A second alternative would be to award attorney's fees to those who mount successful challenges to patent validity. The Patent Act already authorizes an award of attorney's fees in "exceptional cases,"⁵⁰ but could be amended to require an award whenever a court holds the patent invalid. Mandatory attorney's fees for successful challengers may not be ideal, however, because they could discourage enforcement of valid patents due to the patentee's "strong aversion to the consequences of defeat no matter how remote the chances," as already alluded to by Attorney General Klein. Thus, mandatory award of attorney's fees to the successful challenger might further inhibit patentees, who would face the double risk of an erroneous invalidity finding and liability for attorney's fees. Requiring filing of certain agreements with existing agencies, and providing those groups with enhanced abilities to intervene in proceedings may be a less expensive and more evenhanded way to monitor anticompetitive settlements.

A third alternative to maintain private incentives to challenge patents is to maintain the Supreme Court's rule against licensee estoppel enunciated in *Lear, Inc. v. Adkins*.⁵¹ There, the Court recognized that "[l]icensees may often be the only individuals with enough economic incentive to challenge the patentability of an inventor's discovery. If they are muzzled, the public may continually be required to pay tribute to would-be monopolists without need or justification."⁵² Moreover, as discussed below, antitrust authorities face difficulties in assessing patent validity in settlement cases since the parties with the best information are those who have just settled.

Unfortunately, as Hovenkamp, Janis, and Lemley observe, the Federal Circuit has been "chip[ping] away" at this rule for some time.⁵³ In *Flex-Foot, Inc. v. CRP, Inc.*, for example, the

50. 35 U.S.C. § 285 (2000).

51. 395 U.S. 653, 668-75 (1969).

52. *Id.* at 670.

53. Hovenkamp et al., *supra* note 1, at 1743 n.99; *see, e.g.*, *Foster v. Hallco Mfg. Co.*, 947 F.2d 469, 474-77 (Fed. Cir. 1991) (holding that where litigation was concluded by entry of a consent decree acknowledging patent validity,

court distinguished *Lear* as a case that involved neither settlement nor a promise by the settling party not to challenge validity.⁵⁴ The *Flex-Foot* court explained,

Once an accused infringer has challenged patent validity, has had an opportunity to conduct discovery on validity issues, and has elected to voluntarily dismiss the litigation with prejudice under a settlement agreement containing a clear and unambiguous undertaking not to challenge validity . . . the accused infringer is contractually estopped from raising any such challenge in any subsequent proceeding. . . .⁵⁵

At least one textbook cites *Flex-Foot* as standing for the proposition that "a promise not to challenge the validity of a patent will be enforced if it is in a contract of a certain type, which presently includes settlement agreements."⁵⁶ Hovenkamp, Janis, and Lemley appear to agree with this restrictive reading of *Lear*, noting that "in any event, [the *Lear*] law does not permit a licensee who once challenged a patent's validity and settled that lawsuit to reopen the challenge."⁵⁷

If this, indeed, is what the Federal Circuit intends, it has gone too far in limiting *Lear*'s holding. Certainly, considerations of res judicata, finality, and preventing a settling party from engaging in successive holdups by re-opening validity challenges represent important public interests, but the public also benefits from removing invalid patents from the system.

Therefore, the *Flex-Foot* rule should be read literally: There, the court emphasized that the parties had an opportunity to conduct discovery.⁵⁸ Presumably, such discovery is likely to reveal much about probable patent invalidity. A limited rule permitting a settling party to re-open validity challenges when discovery has not occurred may be appropriate. Such a rule might be further limited by allowing re-opening of a settlement only when no other party is likely to

policies favoring finality of judgments and encouraging settlement outweighed those motivating the *Lear* Court); *Hemstreet v. Spiegel, Inc.*, 851 F.2d 348, 350-51 (Fed. Cir. 1988) (holding that where a court's settlement order dismissed the litigation and indicated that validity issues were finally concluded, the settlement order barred a later challenge to validity by the settling party under principles of res judicata).

54. 238 F.3d 1362, 1368-70 (Fed. Cir. 2001).

55. *Id.* at 1370.

56. DONALD S. CHISUM ET AL., PRINCIPLES OF PATENT LAW 1142 (2d ed. 2001).

57. Hovenkamp, et al., *supra* note 1, at 1739 n.99.

58. See *Flex-Foot*, 238 F.3d at 1370.

challenge the patent. In such cases, the policies underlying res judicata and finality should yield to that of sheltering the public from unwarranted patents and monopolies.

III. ANTITRUST ANALYSIS OF PATENT SETTLEMENTS WHEN VALIDITY IS UNCERTAIN

Antitrust analysis of patent settlement agreements presents no special difficulty when it is certain that the patent rights are either valid or invalid, as Hovenkamp, Janis, and Lemley clearly observe. The evaluation problem arises when the settlement agreement would violate the antitrust laws in the absence of valid patent rights and the validity of these rights is uncertain.⁵⁹ The issue has come to a head in recent pharmaceutical cases involving settlements between producers of established “pioneer” brands and generic substitutes.

In these cases antitrust legality has frequently focused on the issue of so-called exit payments or reverse payments under which the generic producer agrees to delay or even forgo competitive entry in return for a large payment from the pioneer. If the patent rights are valid, the settlement is likely to be lawful because, as Hovenkamp, Janis, and Lemley note, in that event the settlement is “[no] more anticompetitive than a likely outcome of the litigation.”⁶⁰ Similarly, if the patents are invalid or not infringed, the settlement agreement will most likely be unlawful. But in fact, often the validity of the patent rights is unclear. The difficult question posed in the pharmaceutical cases is how the issue of antitrust legality is to be resolved when patent rights are uncertain.

At least three alternatives appear possible. First, the antitrust court (or agency) could attempt to assess patent validity directly. Second, the court could use objective indicators to determine validity. Third, the court could adopt an incentive-modifying legal rule that would motivate the patentee and alleged infringer to act in the public interest, and thereby remove the need for the antitrust court to determine patent validity. Hovenkamp, Janis, and Lemley propose a combination of the first and second alternatives.

59. Hovenkamp, et al., *supra* note 1, at 1728-39. The uncertainty may go either to patent validity or infringement.

60. *Id.* at 1727. The settlement must also be a reasonable accommodation of the patent right. *Id.*

Specifically, Hovenkamp, Janis, and Lemley propose a two-pronged test under which exit payments would be presumptively illegal unless the infringement plaintiff shows “both (a) that the ex ante likelihood of prevailing in its infringement lawsuit is significant; and (b) that the size of the payment is no more than the expected value of litigation and collateral costs attending the lawsuit.”⁶¹ While we agree that an exit payment from the patent holder to an alleged infringer is a key indicator of questionable patent rights, we would exclude any requirement that patent validity be determined or estimated in an antitrust proceeding. Instead, in cases involving reverse payments we would rely primarily on the third alternative—private market forces operating under an incentives-modifying legal rule. Turning to the second prong of Hovenkamp, Janis, and Lemley’s affirmative defense, we agree that the payment by the infringement plaintiff of no more than its expected litigation costs would be permissible. We have doubts, however, about inclusion of “collateral costs.” Defendants in pharmaceutical cases have been quite inventive in enlarging collateral cost claims to include a range of costly uncertainties that they claim patent litigation introduces.⁶² It is difficult to conceptualize a workable rule that will appropriately distinguish between “permissible” and “impermissible” collateral costs.

A. DIRECT ASSESSMENT OF PATENT VALIDITY

The most straightforward approach might appear to be for the court and the enforcement agencies to directly assess the validity of the patent rights. The proposal is not that the antitrust court should undertake a full patent adjudication, but that it should assess the probability that a patent court would hold the patent rights to be valid. Hovenkamp, Janis, and Lemley would simplify the inquiry by requiring only a determination whether the probability is “significant,” but any approach that would require an antitrust court or agency to determine patent validity raises a number of questions.

Determining patent validity in an antitrust proceeding

61. *Id.* at 1759.

62. *See, e.g., In re Cardizem CD Antitrust Litigation*, 105 F. Supp. 2d 682, 703-05 (E.D. Mich. 2000) (discussing and rejecting the defendants’ claim that the settlement agreement was functionally equivalent to a court-ordered preliminary injunction).

would greatly complicate antitrust litigation. The enforcement agencies lack expertise in patents. Their jurisdiction encompasses far too many industries for them to gain technical competence over the range of expected cases. Moreover, the agencies must often act within strict time constraints, which challenge them even when the issues include only antitrust matters. The parties with the greatest knowledge of the facts—the patentee and the infringer—are biased against the government or private antitrust plaintiff since both now seek to uphold the patent. Further, the issue to be decided by the antitrust court is inherently ambiguous: What is a “significant” probability of validity? 15%? 35%? 51%? What effect would determination of significant probability by an antitrust court have on subsequent patent validity litigation? Indeed, antitrust judges may be reluctant to second-guess how a patent court might rule in a pending infringement case. Finally, the antitrust enforcement agencies have to our knowledge uniformly maintained that patent validity determination in an antitrust case is not feasible.⁶³

These issues could conceivably be overcome if the antitrust suit could be consolidated with the patent infringement litigation. In fact this has effectively been accomplished by one government agency, the International Trade Commission (ITC), but is unlikely to be effective under the quite different conditions of an antitrust case. The ITC has long evaluated patent validity in the context of infringement complaints under the Tariff Act (called a “section 337” proceeding).⁶⁴ A section 337 proceeding involves the patentee, the alleged infringer, and an ITC attorney, and moves quite rapidly.⁶⁵ The ITC must

63. See generally Fed. Trade Comm’n/Dep’t of Justice Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-based Economy: A Competition View of Patent Settlements (May 2, 2002) and Practical Issues Encountered in Antitrust Analysis of Licensing Practices: The Problem of Dealing with Uncertain or Disputed Patent Rights (May 14, 2002), available at <http://www.ftc.gov/opp/intellect/index.htm>.

64. 19 U.S.C. § 1337 (2000). The ITC has been evaluating patent validity since at least 1974 when Congress passed the Trade Reform Act, which amended the Tariff Act of 1930 to allow the ITC to consider issues of patent invalidity and unenforceability. *Tex. Instruments Inc. v. Cypress Semiconductor Corp.*, 90 F.3d 1558, 1568 (Fed. Cir. 1996). We are indebted to David Balto for suggesting this alternative.

65. Telephone Interview with Ralph Mittelberger (July 26, 2002) (noting that discovery, trial, and decision by an administrative law judge takes about thirteen months, with the ITC decision likely following less than six months

approve any settlement as consistent with the public interest.⁶⁶ An informal survey revealed that in fiscal year 1998, twenty-six of twenty-nine section 337 investigations concerned an allegation of patent infringement.⁶⁷ Of the fifteen investigations terminated by the ITC in 1998, eight were terminated by settlement or withdrawal of the complaint, three were held to be violations, and four were dismissed either because the patent was invalid or not infringed.⁶⁸

It would be difficult, however, to transfer the ITC system to domestic antitrust enforcement. The ITC heavily relies on the parties to the section 337 proceeding to develop the evidence.⁶⁹ In the ITC proceeding, the parties are adversaries. In contrast, parties to a patent settlement agreement would be allies, placing the full burden of patent litigation on the FTC staff, a difficult challenge particularly in the absence of additional resources.⁷⁰ Moreover, the FTC probably could not adopt the ITC approach without statutory amendment giving it the power to sit as a patent court.

B. OBJECTIVE INDICATORS OF PATENT VALIDITY

As an alternative to adopting an ITC system for direct determination of patent validity in antitrust cases, antitrust regulators could attempt to identify proxies for patent validity—objective criteria or behavioral conditions that make economic sense only if the patent rights are invalid. As discussed, exit payments are a key indicator and point to illegality if the payment exceeds litigation costs—although commentators differ on the strength of the inference to be drawn. In addition, courts and enforcement agencies might focus on behavioral indicators such as continued competition by the alleged infringer, continued purchasing by customers aware of the infringement claims, and willingness of the alleged

later).

66. William P. Atkins, *Appreciating 337 Actions at the ITC: A Primer on Intellectual Property Issues and Procedures at the U.S. International Trade Commission*, 5 U. BALT. INTELL. PROP. J. 103, 110 (1996).

67. Memorandum from Stephanie Smith (July 15, 2002) (on file with authors).

68. *Id.*

69. Telephone Interview with Ralph Mittelberger, *supra* note 65.

70. *Id.*

infringer to indemnify its customers.⁷¹ Such commitments by industry participants, when they are made, point toward likely invalidity. But most frequently, such evidence is unlikely to be available. Infringers will not lightly assume the risk of damages, or even treble damages, if the patent rights are upheld.

A quite different indicator, suggested by George Priest, may help to identify disguised cartels without directly answering questions of patent validity. In his article, *Cartels and Patent License Arrangements*, Professor Priest attempted to identify cartels by focusing on royalty-free licenses and other market indicators in industry-wide licensing arrangements.⁷² His work foreshadowed the reverse payment cases, observing, "It is inconsistent for a licensor to allege that it is maximizing the return from its invention by controlling price and output if it charges no royalty. The same conclusion follows from evidence of royalty rebates or from otherwise unaccountable cash payments from the licensor to the licensee."⁷³ He emphasized that antitrust enforcers should monitor the relationship between price and royalty as well as output and market share, drawing "unambiguous inferences" from how these metrics behave.⁷⁴ For example,

[w]here a patent license involving competing firms increases the price of a product without substantially altering the product itself, the license is illegitimate. . . .

Where a patent is alleged to reduce manufacturing costs, the royalty should approximate the scale of the alleged cost reduction. . . .

[W]here there is unexpected competition subsequent to the execution of the license, price cannot fall by more than the royalty unless the licenses are illegitimate. . . .

[E]vidence that licensees . . . have reduced or ceased production

71. See Professor Joseph Farrell, Testimony at Fed. Trade Comm'n/Dep't of Justice Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy: A Competition View of Patent Settlements (May 2, 2002) and Practical Issues Encountered in Antitrust Analysis of Licensing Practices: The Problem of Dealing With Uncertain or Disputed Patent Rights (May 14, 2002), available at <http://www.ftc.gov/opp/intellect/020514trans.pdf>; cf. *United States v. Krasnov*, 143 F. Supp. 184, 193-95 (E.D. Penn. 1956) (finding a violation of sections 1 and 2 of the Sherman Act and noting that when the infringement defendant "showed any aggressiveness in the defense," the patentees abandoned suit to avoid adjudication of validity).

72. George L. Priest, *Cartels and Patent License Arrangement*, 20 J.L. & ECON. 309, 326-30 (1977).

73. *Id.* at 327.

74. *Id.* at 329.

because of higher costs suggests that the licensees are not receiving cartel rents. . . . More generally, evidence over time of significant variation of market shares among licensees strongly suggests legitimacy.⁷⁵

Since this approach does not require evaluation of patent validity, it provides a potentially useful tool to identify settlement agreements that are in fact disguised cartels.

C. INCENTIVE MODIFYING APPROACH

The basic problem in the reverse payment cases involving the pharmaceutical industry is the skewing of competitive incentives between brand name and generic drug manufacturers, which causes them to become collaborators rather than rivals in vindicating their patent rights. When these rights are invalid, the public interest suffers. Responding to this concern, the authors of this Commentary have argued that settlement agreements in Hatch-Waxman Act cases should be limited to delayed entry by the generic producer (and of course may also provide for payment of royalties by the generic manufacturer).⁷⁶ This provides a clearly less restrictive alternative to a settlement involving a reverse payment. The authors have also advocated adoption of at least a rule of presumptive illegality as to such payments, with the burden on the parties to justify the payment,⁷⁷ and the allowable defenses should be limited to litigation costs.

With these measures in place, the government or private plaintiff then would not have to prove patent validity, and the clarity of the rule would likely induce more pro-competitive settlement agreements. The parties with the best information—the patentee and alleged infringer—would use their own estimates of validity to negotiate a settlement within bounds. A weak patent would face little entry delay while a strong patent would face longer delay. “Limiting the ‘coin’ of settlements to delayed entry and the royalty to be paid is vastly superior to requiring proof of patent invalidity. . . . [It] removes the incentive distortion involved in reverse payments [and] provides the legal rule . . . most likely to lead to effective

75. *Id.* at 327-28.

76. Joseph F. Brodley & Maureen A. O'Rourke, *Preliminary Views: Patent Settlement Agreements*, ANTITRUST, Summer 2002, at 53, 55 (noting that FTC Commissioner Leary advocates such an approach).

77. *Id.*

administration and minimal antitrust regulation.”⁷⁸

CONCLUSION

Identification and policing of anticompetitive settlement agreements challenges legal ingenuity. This Commentary has suggested that viable strategies include taking cost-effective measures to decrease the number of invalid patents issued, implementing a notification requirement for patent settlement agreements, providing incentives to litigate validity, and permitting certain parties to re-open validity challenges after settlement. The Commentary has also evaluated alternative ways for antitrust agencies and courts to confront the problem of assessing patent validity in settlement cases. We agree with Hovenkamp, Janis, and Lemley on the need for at least a rule of presumptive illegality against exit payments in settlements. We would rule out, however, any justification for an exit payment—apart from savings in attorney’s fees—based on assessment of patent validity. Instead, we would rely on the less restrictive alternative of limiting the settlement terms to deferral of entry and the amount of the royalty to be paid by the licensee.

78. *Id.* at 56.

