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*ANTITRUST ENFORCEMENT AGENCIES: THE BUREAU OF COMPETITION OF THE  
FEDERAL TRADE COMMISSION AND THE ANTITRUST DIVISION OF THE DEPARTMENT  
OF JUSTICE*

HEARING BEFORE THE

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PREPARED STATEMENT OF JAMES V. DELONG, VICE PRESIDENT AND GENERAL  
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It is a pleasure to be here today to discuss the role of intellectual property in our economy, and, more particularly, the interaction between intellectual property and antitrust enforcement.

The importance of this topic is immense. Nobel Prize winning economist Douglass C. North concluded that "the failure to develop systematic property rights in innovation up until fairly modern times was a major source of the slow pace of technological change." Once better-specified property rights raised the rewards for innovation, he said, the rate of invention and consequent economic progress increased rapidly. North also noted that "more important than patent law per se is the development and enforcement of a body of impersonal law protecting and enforcing contracts in which property rights are specified."[\(see footnote 94\)](#)

The behavior of current financial markets bears out North's view about the economic importance of intellectual property. Two scholars at the Brookings Institution calculate that as of 1978 the book value of property, plant, and equipment owned by publicly-traded non-financial corporations equaled 83 percent of the long-term financial claims on the company (i.e., the value of outstanding bonds and common stock). The comparable figure for 1998 was 31 percent. In other words, as of 1998, 69 percent of the value of companies was based on patents, trademarks, copyrights, brand names, know-how, trade secrets, and other products of the human mind.[\(see footnote 95\)](#) Given the run-up in markets in the past couple of years, heaven knows the figure for the year 2000. For many companies in the high tech sector, for which the tangible assets consist of a couple of desks, a computer, and two 20-somethings with an idea, all of the value is intellectual.

Considering this immense economic impact, it is not surprising that intellectual property has become a subject of intense interest within the legal profession. It has gone from "boutique backwater" (in the phrase of Robert Merges of the University of California) to the hottest of specialties. (As proof, billing rates for IP specialists are up 20 percent this year, say the legal newspapers.)

Intellectual property has also become a focus of interest for academicians. Their motives are largely scholarly, but they and their university employers also have strong financial incentives. The Bayh-Dole Act of 1980 expanded the ability of those who conduct research with government funds to patent the results, and the beneficiaries have been getting more entrepreneurial ever since.

This growing obsession with intellectual property has brought a number of serious issues to the fore. In February of this year, the Board of Science, Technology, and Economic Policy (STEP) of the National Academy of Sciences held a superb two-day conference on *Intellectual Property Rights: How Far Should They Be Extended?* The session brought together a mix of corporate employees, government officials, academicians, and lawyers. While it focused primarily on patents, it was wide-ranging in both approach and content, and the proceedings, when NAS publishes them, will certainly be worth the close attention of this committee. ([see footnote 96](#))

Important issues about intellectual property raised at the NAS conference and in other forums include:

Most people agree substantially on the basic values to be fostered by the nation's intellectual property protection system. These include producing and distributing knowledge, encouraging disclosure of new technology by awarding exclusivity to its inventor, rewarding creativity without allowing appropriation of society's "cultural commons," balancing the contradictory interests in favor of exclusivity and against monopoly, and minimizing the transaction costs of the system. As usual, the devil is in the details of how to design a system that makes appropriate trade-offs in cases of conflict.

High tech issues are stressing the system. Since 1982, when appellate jurisdiction over all patent appeals was given to the U.S. Court of Appeals for the Federal Circuit, there has been a *de facto* lowering of the bar on standards of patentability. This expansion has occurred contemporaneously with the increase in applications for patents on computer software, business methods, biotech, and other complex intellectual products that do not always fit well into a system originally oriented toward gadgets.

The basic criteria governing patentability are sound—novelty, non-obviousness, and utility—but there are questions about their application in practice. The most fundamental objection is that PTO regards patent *applicants* and *holders* as its constituency, and pays little attention to the interests of patent *users*. This is a problem: PTO should be recognizing the interests of both users and patentees, and should be careful not to allow people to claim ideas that are part of our society's cultural commons. It should not be throwing its weight entirely on the side of the patentees, especially since patent grants carry a presumption of validity into judicial review and

are judged on an "arbitrary and capricious" standard.

Problems of possible expropriation of society's cultural commons also arise in the context of copyright.[\(see footnote 97\)](#) Many observers object strongly to last year's extension of the length of copyrights on works that were about to fall into the public domain; they see this action as an expropriation by the Congress of property that belonged to the public.

Who "owns" the investment of time that consumers make in learning a particular program? In the fascinating 1995 case *Lotus v. Borland*, the First Circuit held that the menu command hierarchy is a "method of operation" and is thus not copyrightable.[\(see footnote 98\)](#) See particularly the concurring opinion's comment: "A new menu may be a creative work, but over time its importance may come to reside more in the investment that has been made by users in learning the menu and in building their own mini-programs—macros—in reliance upon the menu." This is an important concept: the principle of protecting intellectual property does not require that companies be allowed to appropriate the sweat equity of the program's users.

Commissioner Q. Todd Dickinson argues that PTO has little discretion over patentability. The Supreme Court made clear in the 1980 *Chakrabarty* decision that "anything under the sun that is made by man" can be patented, and the Federal Circuit emphasized that this includes business methods in *State Street* (1998).[\(see footnote 99\)](#) Federal Circuit judges echo Dickinson's view, saying that it is the *laws*, not the judges, that are pro-patent. Dickinson notes that many concerns about patentability are really concerns about access to patents and about transaction costs. He thinks these issues can and should be kept separate; access can be guaranteed without artificially narrowing the scope of patentability.

Positions on the issues are quite fluid. Most companies that are greatly concerned about the patent system are both holders and users of patents. Their uncertainty as to where their self-interest lies leads to a refreshing willingness to judge the system in terms of long-term principle instead of short-term advantage.

In some industries, particularly software, lawyers are advising clients *not* to search for prior art. There is immense uncertainty over which patents are valid. If a company finds earlier patents and makes an erroneous judgment that they can be ignored, then it can be hit with penalties for willful violation. If it does not find the earlier patents, then the penalties for infringement are less. So—don't look.

Companies are greatly concerned about the deadly combination of legal uncertainty over patent scope and validity and huge damages for infringement. Many companies have paid hundreds of millions of dollars. Most patents can be invented around, given certainty about their scope, but it is easy for companies to get mousetrapped. The \$900 million that Polaroid collected from Kodak in 1991 is a case in point; Kodak had engaged in what the trial judge called a model process designed to avoid infringement, and still got nailed. In addition, it costs at least \$2 million to fight a patent case, so there is considerable support for such devices as alternative dispute resolution and the use of expert panels on issues of patent validity.

Patents are not the most important way in which companies protect IP. Secrecy is more heavily

relied on. Companies also rely on lead times, complementary capabilities, and market position. Different industries use patents in quite different ways, depending on particular characteristics. Some examples of the differences between conventional manufacturing, computer software, biotech, and electronics are:

— In conventional manufacturing, purchasing a component off the shelf buys the right to use all the intellectual property embodied in it. This makes life much simpler than is the case in software or biotech, where everything is built from scratch and there are few off-the-shelf components.

— Software companies are dominated by short product cycles. They are skeptical of software patents because the scope and validity are uncertain and the timing of the patent review process is too long. They patent defensively, in case someone accuses them of infringement.

— Biotech companies rely heavily on patents to safeguard their values. They also tend to file for patents even when products do not appear useful as a safeguard against the possibility that new utilities will be discovered in the future.

— The semiconductor industry is covered by so many patents that everyone is always infringing something. So companies use the system defensively, accumulating portfolios of patents to use as bargaining chips with others in the industry.

— Individual companies also follow varying philosophies in dealing with their intellectual property. Some want to maintain a monopoly, some engage in selective licensing, some go into the licensing business. Again, industry characteristics play a big role in the decision.

International issues grow more pressing, as global companies lobby hard for harmonization. The U.S. is the only nation with a "first to invent" standard; everywhere else the patent goes to the "first to file." Other problems revolve around the considerable variations in national practices with respect to IP patents.

This is a formidable list of fascinating and complex issues, and it could, of course, be extended. This brief treatment only scratches the surface.

The list of conundrums will keep growing. Inevitably, when technology changes people must go back and rethink and refine concepts of property rights. [\(see footnote 100\)](#) With respect to real estate, for example, it used to be said that the owner of land possessed everything from the center of the earth to the top of the heavens. Then the airplane was invented, and the extent of rights to land was made more precise, to reflect the realities of the new technology. The invention of the railroad forced courts to grapple with the impact of smoke and pollution on neighboring land owners. [\(see footnote 101\)](#) The spread of the cell phone is creating much the same set of concerns, as society considers where to put the necessary towers. The technological turmoil we are now undergoing is requiring us to rethink and refine concepts of intellectual property rights.

Obviously, government must be heavily involved in this process. No matter what view one takes about the derivation of property rights, even if one believes that they are a product of

natural law and not within the power of governments to withhold, governments must always define them at the margins and enforce them. This is especially true for intellectual property, which is more dependent on government than physical assets. Land or machinery exists independently, whatever a government says, and can be protected by fences and force, but a patent or copyright exists only within the context of a system of law.

This necessary involvement of government is a bit worrying, because over the past few decades neither the Congress nor the executive agencies have demonstrated much respect for property rights. As I recently wrote:

Those immersed in the topic [of property rights] think that governments at all levels—local, state, federal, and international—have become cavalier in attitude and action, not just willing but eager to ignore both the letter and the spirit of the commandment in the Fifth Amendment to the U.S. Constitution that says "nor shall private property be taken for public use without just compensation." In consequence, the right to own and use private property, a right that constitutes one of our most crucial civil liberties, essential to the economic efficiency of our society and to its moral ordering and legitimacy, is being undermined. ([see footnote 102](#))

This Committee can bear witness to this concern, based on its long struggle to enact the Civil Asset Forfeiture Reform Act (H.R. 1658). And it seems doubtful that Congress will pass the Private Property Rights Implementation Act (H.R. 2372), a law which would force governments to give landowners with a grievance the opportunity to be heard in court. In fact, H.R. 2372 seems to do little except enact the ethical obligation of all attorneys not to abuse legal processes. The fact that Congress will not pass, and the President will not sign, such a law is extremely disquieting.

I have written at length about problems of property rights in the monograph quoted above and in my book *Property Matters*, cited earlier, so let me say only that both Congress and the federal agencies need to take Professor North's point most seriously. We cannot maintain our prosperity and freedom if the government regards property rights as subjects of whimsy to be cut and trimmed according to political interest rather than as matters of enduring principle.

Of course, one of the ways in which governments meddle with property rights, for better or worse, is through antitrust enforcement.

The tectonic shift in the foundations of the economy embodied in the current revolution in information and communications technologies has profound implications for antitrust. Initially, one is tempted to assume that surely there is a large role for antitrust enforcement here. Many of the concerns discussed above relate to values that underlie, at least in theory, our antitrust laws, primarily the importance of avoiding monopoly and maintaining competition. The current turmoil over patents on business methods is a prime example; the precise concern is fear that some firms will be given a monopoly over important ways of doing business, such as on-line auctions or click-through technology. Even leaving aside the issue whether such patents would be justified under the novelty and non-obviousness standards, there is a reluctance to let property rights extend so far that they create monopolies over whole methods of doing business.

Further reflection leads to the conclusion that antitrust intervention into this ongoing technological revolution should be extremely cautious, however. The current structure of antitrust doctrine, with its century-long accumulation of barnacles from the industrial revolution, the New Deal, and post-World War II era, is not up to the task.

Antitrust theory and practice is based on complex and often unstated assumptions about capital and its mobility and about the workings of markets. When the most important capital takes the form of ideas, electrons, or light waves rather than machinery or equipment, it is not clear why anyone should expect the old assumptions to hold. When the Internet expands markets geographically to encompass the whole nation or even the whole world, and increases their speed to the pace of email, the gap between old assumption and new reality widens further.

For example:

An important characteristic of most physical property is that its use must be exclusive, limited to one or a few people at a time, and, often, that it is exhausted by use. For much intellectual property, neither of these things is true. Once a software program is created, an infinite number of people can use it at the same time. And they do not wear it out no matter how many times they run it.

Many heavy industries are characterized by high initial investment costs followed by low variable costs for the production of each individual unit, but intellectual property takes this characteristic to new levels. An author may spend 10 years producing the first copy of a book or a computer company may spend lay out hundreds of millions of dollars paying programmers to write millions of lines of code. But, once the first copy is produced, turning out the second, the tenth, or the ten-millionth may cost only pennies.

Two hundred years ago, markets were localized. The railroad, the telegraph, and the catalogue sales company greatly expanded the possibilities, making the nation into a single market for many goods. Now, the Internet is expanding geographical markets and extending these expanded markets to an increasing variety of goods.

These changes present formidable challenges to applying antitrust doctrine to intellectual property issues, especially considering the complexity of the issues listed earlier in this statement. The challenges would be daunting even if antitrust doctrine had worked well for the economy before the current technological turmoil. In fact, however, antitrust as a body of doctrine was already in severe trouble.

To understand this, it is useful to go back about 25 years, to the 1970s. During that decade, the antitrust analysts of the Chicago School leveled devastating critiques at antitrust doctrine. To take one crucial example, as Robert Bork noted in 1979 the system had several different definitions of the core term "competition," and the meaning tended shift back and forth.[\(see footnote 103\)](#) At any given time, and in any given case, the definition reflected the balance of political forces, not a coherent body of legal thought.

By the 1980s, the Chicago School analysts had largely persuaded the courts that the antitrust

emperor had no clothes, and few of the old assumptions remained standing. Familiar legal doctrine in one area after another was found to be either inadequate or positively harmful.[\(see footnote 104\)](#) For example, antitrust enforcers were very slow to understand the business rationales behind many kinds of vertical restrictions, and suppressed many arrangements that would actually have helped small companies hold their own against big ones. To this day, the enforcement agencies are ambiguous about whether the fact that a merger produces increased efficiencies is a defense of the merger or an additional ground to prevent it.

For a decade or so after 1980, antitrust enforcement retreated to the areas on which almost all analysts agree—enforcing the rules against price fixing or merger-to-monopoly.

At contemporary conferences on antitrust, participants often debate whether pre-existing antitrust doctrine is adequate to deal with this "new economy," based on technology and intellectual property. This debate is based on a false assumption, that the doctrines were adequate for the *old* economy. They were not.[\(see footnote 105\)](#)

In the 1990's, antitrust has revived, spurred in large part by the upheaval of the new economy. But so far as I know the basic criticisms leveled at standard doctrines were never answered. In the past decade, the old ideas have simply been trotted out to do service once again. It reminds one of the year 1099, when the Spanish Christian forces stuffed the body of their dead hero, El Cid, strapped him to his horse, and sent him out to battle the Moors.

To be sure, one sees references to "post-Chicago" analysis and to other concepts that purport to justify a new activism. So far, however, there does not seem to be enough substance in these to provide a basis for serious public policy. They represent unproven hypotheses. There is certainly not enough to be sure of complying with what should be the first rule of antitrust policy, as it is of medicine: "First of all, do no harm."

For example, examine the concept of "lock in," the idea that an inferior technology can get an advantage off the starting line and that thereafter society is "locked in" to it, unable to change. But no one has found real-world examples. The cases usually cited are the adoption of the QWERTY keyboard over the Dvorak, and the triumph of the VCR over the Betamax home recorder. The validity of both these examples has been demolished, and substitute anecdotes have not yet been found.[\(see footnote 106\)](#)

Similarly, "network effects" are cited, and "increasing returns to scale." Again, however, real examples are hard to find. Many "network effects" turn out to be variations on the familiar concept of economies of scale, not some new and exotic fruit of the new economy.[\(see footnote 107\)](#) As economist Lawrence J. White says: "In recent years the term *network industry* has become an expansive, all inclusive term that appears to embrace almost any composite good or service embodying complementary components. . . . Indeed, scholars have applied the terms *metaphorical networks* and *virtual networks* to describe the broader usages."[\(see footnote 108\)](#) In other words, "networks" has become a buzzword, not a true analytic concept.

The end result is that the 1970's criticisms of antitrust doctrine remain un rebutted. These doctrines:

Are based on static, not dynamic, economic models, and ignore the time dimension of decisions, the strategic responses available to competitors, and the frequent necessity for super-normal returns in complex industries.

Do not embody adequate and consistent definitions of the core term "competition."

Do not provide adequate definition of the core concept "markets."

Fail to recognize business justifications for many practices branded "anti-competitive."

Are confused over the difference between protecting consumers and protecting producers.

Are inadequate for dealing with industries where pay-offs on investments tend to be either zero (or negative) or quite large.

Do not place adequate value on "partial integrations" among firms—deals by which firms combine part of their operations but remain independent in other spheres with the goal of enabling small firms to be "the right size." ([see footnote 109](#)) (This is a particularly important failure, because technology is making partial integrations increasingly possible, and they are absolutely crucial to the new economy.)

To illustrate how serious these problems are, Bork's criticism of the amorphous nature of the term "competition" remains as valid today as it was 20 years ago.

Similar uncertainty surrounds another concept absolutely fundamental to antitrust thought, that of "market power." According to the DOJ/FTC guidelines on licensing intellectual property, the term means: "[T]he ability profitably to maintain prices above, or output below, competitive levels for a significant period of time." ([see footnote 110](#)) This simple sentence embodies a mountain of uncertainty. What is a "competitive" level, and by what principle is it defined? Is the reference to the economic model of perfect competition, Or to some other model? What is a "significant" period? In calculating a rate of return, what is in the cost base? For example, suppose a firm invests in three research projects, two of which come up empty while the third is a great success. Will the government count the rate of return as based on the costs of all three or only the third? And in calculating whether the return is above competitive levels (whatever that means) will it take account of the *ex ante* risk that all three efforts would fail? How, pray tell, does this "guidance" guide anyone?

Another example, provided by Professor Lawrence J. White, concerns the "essential facilities doctrine." White points out that courts and agencies have frequently granted competitors access to "essential facilities." This has happened for a railroad, a railroad terminal, the telephone system, real estate multiple listing services, news services, electricity, a skiing facility, and airline computer reservation systems. However, he notes: "[N]either the courts nor Congress has ever clearly specified what constitutes an essential facility for antitrust purposes. . . . One has little guidance." ([see footnote 111](#)) Again, if there is no adequate structure to explain such a doctrine in the old economy, how can one possibly extrapolate it to apply to the new and even more complex circumstances of this new age? Yet the term "essential facility" is bruited about

constantly in discussions of antitrust enforcement in the new economy, as if the term actually had some clear meaning.

My conclusion is simple. A system of thought that was not adequate for dealing with the old economy, based on heavy machinery and physical investment, provides a poor foundation for dealing with a new economy based on intellectual property. Extrapolating these inadequate doctrines to the new concept will create a system of enforcement by whim, not by law, and the consequences will be destructive.

A couple of months ago, I was at a conference where the technical director for a large, technology-based corporation was discussing some of his company's work. He described how a new technical development had suddenly and surprisingly led them to believe that the capacity of one of their crucial components could be increased by 50 percent.

I asked him: "How on earth do you make investment decisions if something like this can come out of left field and surprise even someone as sophisticated as you are?"

He smiled—rather grimly, I thought—and said (I paraphrase): "We spend a lot of time sitting around talking about that very topic, and without coming up with many good answers. And antitrust does not make it any easier. We have to worry that when we do guess right the government is going to decide that our rate of return is super-competitive and we are an evil monopolist. They will forget about our losers."

As Douglass North said, property rights must be specified and predictable. This applies to intellectual property as well as to other kinds. And it certainly applies to antitrust enforcement, where uncertainty and whimsy are the enemies of both prosperity and freedom.

[\(Footnote 94 return\)](#)

Douglass C. North, *Structure and Change in Economic History*, W.W. Norton (paper ed.) (1981), pp. 158–65.

[\(Footnote 95 return\)](#)

Margaret Blair & Thomas A. Kochan, "Introduction," in *The New Relationship: Human Capital in the American Corporation* (Blair & Kochan, eds.), Brookings Institution (2000), pp. 1–2.

[\(Footnote 96 return\)](#)

The STEP Board is considering next steps for research and analysis. For more information on its long-term plans and on the publication of the conference proceedings, contact STEP at <[www4.nas.edu/pd/step.nsf](http://www4.nas.edu/pd/step.nsf)>.

[\(Footnote 97 return\)](#)

See Jesse Walker, "Copyright Catfight: How intellectual property laws stifle popular culture," *Reason* (March 2000) <[www.reason.com/0003/fe.jw.copy.html](http://www.reason.com/0003/fe.jw.copy.html)>.

[\(Footnote 98 return\)](#)

Lotus Development Corp. v. Borland International, Inc., 49 3d 807 (1st Cir. 1995), *aff'd per curiam by an equally divided Court*, 116 S. Ct. 804 (1996).

[\(Footnote 99 return\)](#)

*Diamond v. Chakrabarty*, 447 U.S. 303 (1980); *State Street Bank & Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998).

[\(Footnote 100 return\)](#)

James V. DeLong, *Property Matters: How Property Rights Are Under Assault—And Why You Should Care*, Free Press (1997), pp. 70–72.

[\(Footnote 101 return\)](#)

*Richards v. Washington Terminal Company*, 233 U.S. 546 (1914).

[\(Footnote 102 return\)](#)

James V. DeLong, *The Battle Over Property Rights Hits the Corporate Boardroom*, National Legal Center for the Public Interest (July 1999), p. 1.

[\(Footnote 103 return\)](#)

Robert Bork, *The Antitrust Paradox* (1979).

[\(Footnote 104 return\)](#)

See, e.g., James V. DeLong, "The Role, If Any, of Economic Analysis in Antitrust Litigation," 12 *Southwestern University Law Review* 358 (1981).

[\(Footnote 105 return\)](#)

For further discussion, see James V. DeLong, "The New Trustbusters," *Reason* (March 1999), p. 36 <[www.reason.com/9903/fe.jd.the.html](http://www.reason.com/9903/fe.jd.the.html)>.

[\(Footnote 106 return\)](#)

Stanley J. Liebowitz & Stephen E. Margolis, *Winners, Losers and Microsoft: Competition and Antitrust in High Technology*, Independent Institute (1999).

[\(Footnote 107 return\)](#)

Timothy J. Muris, "Is Heightened Scrutiny Appropriate for Software Markets?" in *Competition, Innovation and the Microsoft Monopoly: Antitrust in the Digital Marketplace* (Jeffrey A. Eisenach & Thomas M. Lenard, eds.), Progress and Freedom Foundation (1999), pp. 83–92.

[\(Footnote 108 return\)](#)

Lawrence J. White, *U.S. Public Policy Toward Network Industries*, AEI-Brookings Joint Center for Regulatory Studies (1999), p. 2.

[\(Footnote 109 return\)](#)

See Bork, *Antitrust Paradox*.

[\(Footnote 110 return\)](#)

U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines on Licensing Intellectual Property* (April 6, 1995), Sec. 2.2 <[www.usdoj.gov/atr/public/guidelines/ipguide.htm](http://www.usdoj.gov/atr/public/guidelines/ipguide.htm)>.

[\(Footnote 111 return\)](#)

White, *U.S. Public Policy Toward Network Industries*, pp. 27–28.