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MEMORANDUM

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To DG Competition

From WilmerHale Antitrust and Competition Group

Re **DG COMP Draft proposal for a revised block exemption for technology transfer agreements and for revised guidelines**

[1] WilmerHale welcomes the opportunity to comment on the Commission's draft revised block exemption regulation on the application of Article 101 TFEU to technology transfer agreements (the "draft BE") and the accompanying proposal for revised Guidelines (the "draft Guidelines") (together the "draft documents").

[2] Cormac O'Daly, John Ratliff, Frédéric Louis, Hartmut Schneider and Svetlana Chobanova are the principal authors of these comments. The views expressed are personal and do not necessarily reflect the views of WilmerHale or its clients regarding any specific issue or proceeding.

[3] We do not aim to comment on all the proposed changes, but focus rather on the particular issues that appear most important to us, based on our Group's experience and discussion with clients. A number of our comments refer to our reply to the Commission's consultation in this area in December 2011 to February 2012 (the "Previous Consultation").[1]

[4] In general, we have found the existing technology transfer block exemption and Guidelines to be complex, but useful instruments for assessing the competitive impact of technology transfer agreements. In our opinion, for the most part, the existing texts only require relatively minor changes. In particular, we welcome the proposed clarification on the

[1] This reply is available at http://ec.europa.eu/competition/consultations/2012_technology_transfer/index_en.html.

relationship between the technology transfer block exemption and the research and development block exemption and some of the additional guidance in the draft Guidelines on patent pools.

[5] Our biggest concerns are with the tightening of the current rules for application of the block exemption, in particular the treatment of grant-backs and termination rights following a challenge to validity. We also question the draft Guidelines' proposed language regarding "pay-for-delay" settlements. Finally, we suggest that the draft Guidelines' section on patent pools should be further revised.

A. Relationship with research and development block exemption

[6] One of the main difficulties in this area has been the relationship between the rules applying to technology transfer and those applying to R&D. Sometimes it is difficult to determine which, if either, of the block exemptions is applicable. The current apparent overlap between the fields of the two block exemptions and Guidelines (see e.g., Example 2 in paragraph 147 of the Horizontal Guidelines) can cause difficulties, especially to the extent that the two systems diverge (e.g. the different market share thresholds and definitions of "potential competitor").

[7] The draft documents propose that normally the R&D block exemption should be applied, not the technology transfer block exemption, if the R&D block exemption is applicable to the "subject matter" of the licence (Article 9 and Recital 7 draft BE and paragraphs 46 and 58 *et seq* of the draft Guidelines). The draft BE also provides that it can still apply even if the licensee is carrying out "further research and development" provided this leads to the production of contract products (Recital 7).

[8] We understand that this means that typically the R&D block exemption would apply to licensing agreements in the life sciences/biotech area if only a compound, rather than a "contract product", is identifiable or near being ready for marketing.

[9] We like the clarity that is provided in the draft documents and believe that they suggest a workable approach. Given, however, that many agreements in this area are complex and it is

often difficult to conclude definitively whether a particular block exemption applies, we hope that DG COMP and other enforcers will demonstrate flexibility and a pragmatic approach towards agreements which may straddle both the technology transfer and R&D block exemptions.

B. Market share thresholds

[10] Under Article 3(2) of the draft BE, the 20% market share threshold normally applicable to agreements between competitors would also apply to agreements between non-competitors, if the licensee already owns a technology that is substitutable for the licensed technology, but does not license this out, but rather uses it for in-house production.

[11] We question whether this change is necessary and, in any event, we think this could prove complicated to apply in practice.

[12] More generally, as noted in our reply to the Previous Consultation, the market share thresholds can be difficult to apply. First, obtaining reliable market data to calculate accurate market shares is often difficult. Second, the very concept of the "technology market" can sometimes be a very opaque one, which makes calculating shares on that market even more difficult than is usually the case. Third, since market shares provide a static view of competition, they are not as relevant to dynamic technology markets as the future constraints on the licensed technology.

[13] The draft documents do not address these concerns. In the circumstances, we would like to have seen the market-share thresholds being raised (e.g. to 40% for non-competitors), or even abolished for licences between non-competitors. Article 102 TFEU would, after all, still apply to firms that abuse their dominant positions.

[14] As we noted in our reply to the Previous Consultation, the Commission's indication in paragraph 131 of the current guidelines (that if "four or more independently controlled technologies" exist in addition to the parties' technologies, there is unlikely to be a competitive concern) is often a useful complement to the market share thresholds.

[15] We welcome the proposal in the draft Guidelines to recognise this expressly as a "safe

harbour" (paragraph 144), but regret that four independent technologies are still required. We believe this is too strict and is unrealistic in many markets. We therefore submit that this number should be reduced to three. That said, we note the statement, in paragraph 145 of the draft Guidelines, that just because the safe harbour does not apply does not mean either that (1) the agreement infringes Article 101(1), or (2) that Article 101(3) is not applicable.

C. Proposal to remove ability to limit passive sales

[16] Currently agreements between non-competitors can restrict passive sales by a licensee into another licensee's exclusive territory or customer group during the first two years of the agreement (Article 4(2)(b)(ii) of the block exemption). Such a restriction will no longer be exempt under the draft BE. Rather, the draft Guidelines state that restrictions on passive sales may be allowed if "objectively necessary" "for a certain duration" (paragraph 116). The "frequently asked questions" document published on the same day as the draft BE indicates that the proposed change aims to align the treatment of passive sales under the technology transfer rules with the rules in block exemption Regulation 330/2010 on vertical agreements (i.e. para. 61 of the Guidelines on Vertical Restraints).

[17] Whilst we can see why the Commission may argue for a similar approach here, we are not in favour of this change. Licences are different to distribution agreements and we believe that the clearer protection afforded to licensors and licensees under the current technology transfer block exemption is warranted and encourages pro-competitive licensing. What we are concerned about is the uncertainty as to whether the "objective necessity" can be shown (and for how long) in a particular case, in comparison to the clarity of the current block exemption protection for two years.

D. More restrictive rules for exclusive grant-backs and removal of the "severable" versus "non-severable" distinction

[18] The existing block exemption distinguishes "severable" exclusive grant-backs (i.e. those capable of being exploited without infringing upon the licensed technology) and "non-severable" exclusive grant-backs of improvements to the licensed technology and excludes only the former

from the exemption. The draft BE proposes to exclude all exclusive grant-backs from the exemption, so they would all have to be analysed individually for compliance with Article 101 (Article 5(1)(a)).

[19] We question whether this proposed tightening of the block exemption for exclusive non-severable improvements is necessary and submit that the existing rules strike the correct balance. The proposal appears not to respect what we understand to be the valid distinction between severable and non-severable improvements, namely that in the case of a non-severable improvement a licensor can already prevent the licensee from using the improvement. Thus a grant-back of a non-severable improvement actually adds little, if anything, to the recognised scope of the licensor's underlying intellectual property right.

E. Proposal to align treatment of no-challenge and termination provisions

[20] The current block exemption excludes provisions that prevent the licensee from challenging the validity of the licensed technology from its scope (so these have to be analysed individually for compliance with Article 101), but allows for the agreement's termination if the licensee challenges the licensed technology's validity. Article 5(1)(b) of the draft BE proposes to extend the exclusion to provisions allowing the licensor to terminate the licence.

[21] We believe this change is not warranted. First, the existing balance between the rights of licensors and licensees is reflected in many licences and in the R&D block exemption. We believe that a licensor should be entitled to terminate a licence if the licensee challenges the licensed technology's validity. Second, the proposed change appears to be rooted in the desire to eliminate invalid intellectual property rights, which is a valid concern, but we think that the existing distinction between no-challenge and termination provisions already adequately enables this. Third, we believe that the proposed change will have the unwanted effect of allowing licensees to threaten challenges to validity merely because they want to renegotiate the licence. Given that many licensors are smaller "technology" companies, we think this should not be encouraged.

F. "Pay-for-delay" patent settlements

[22] The draft Guidelines contain a new paragraph stating that "scrutiny is necessary" when a licensor provides an "inducement, financially or otherwise, for the licensee to accept more restrictive settlement terms than would otherwise have been accepted based on the merits of the licensor's technology" (paragraph 223). This appears primarily targeted at the pharmaceutical industry and payments from brand owners to generics manufacturers. We question whether it is appropriate to include such a statement in the Guidelines.

[23] In particular, the reference to the "merits of the licensor's technology" could be read as suggesting that DG COMP proposes to examine the strength and validity of the underlying patent to determine if the payment infringes Article 101. This is controversial given the difficulties inherent in assessing a patent's strength.

[24] We are concerned that DG COMP (like most competition practitioners) will not prove sufficiently well-equipped to examine the substantive requirements for granting a patent (such as novelty, inventive step and whether capable of industrial application) and assess the patent's strength. This would require a very specific and high level of expertise, in particular given the complex nature of many patents.

[25] Furthermore, currently in most cases Member State law, not EU law, governs the criteria for granting and invalidating patents and it appears difficult for DG COMP to be re-examining the validity of patents granted in the Member States. We believe that in a system such as the EU, the Member States' specialised courts are much better placed to rule on the validity of patents.

[26] We also question whether the Commission yet has sufficient experience of dealing with "pay-for-delay" cases to include a statement on this in the Guidelines. We recognise that since its pharmaceutical sector inquiry, the Commission has issued statements of objections and we are aware that in some Member States there is also enforcement activity, yet the Commission has not adopted any decisions in the area. Even in the United States, where patent settlements have already been the subject of a significant amount of antitrust litigation, there is still dispute over the correct standard that should be used to judge the legality of such settlements.

G. Patent Pools

[27] We note a number of proposed changes in the draft Guidelines. We welcome most of them, but still believe that this section of the Guidelines could benefit from further revision.

Positive changes

[28] First, we endorse the switching of the order of paragraphs 213 and 214 of the existing Guidelines (paragraphs 229 and 230 of the draft Guidelines). As currently ordered (213 and then 214), we think that the Guidelines risked being read as presuming patent pools' competitive harm, rather than emphasising their efficiencies.

[29] Second, while currently a licence from a patent pool to a third party licensee could in theory fall under the block exemption, the draft Guidelines exclude this on the basis that such licences are multi-party, not bilateral agreements (paragraphs 231 and 249). This clarification is helpful.

[30] Third, we note the guidance on what constitutes "essential" technology has been revised to cover not only technology that is essential to producing a product, but also technology that is essential to complying with a standard (paragraph 236). Given the increased importance of standards, this is an important change.

[31] Fourth, we welcome the draft Guidelines "safe harbour" for pools that fulfil certain conditions (paragraph 244). While none of these conditions is particularly controversial, some give rise to considerable discussion (e.g. what safeguards are "sufficient" to ensure that only essential technologies are in the pool?), so it may prove difficult to be certain that a pool falls squarely within the safe harbour.

[32] Fifth, in the guidance on pools that are outside the safe harbour, we strongly endorse the acknowledgment that it can be pro-competitive to include non-essential technologies in a pool, if, for example, the cost of assessing whether all the technologies are essential is high, due to the number of technologies involved (paragraph 247). The administrative burden of analysing multiple patents for whether they are complements or substitutes may sometimes vastly outweigh

the risk of non-essential patents being included in a pool. These substantial burdens can increase the costs of administering the pool to such an extent that they may have an adverse impact on the level of licensing fees, or even discourage the formation of certain pro-competitive pools.

Further recommendations

[33] Overall, however, we would again echo the comments in our reply to the Previous Consultation that the Guidelines' cautious approach to non-essential technologies is "not supported by the more recent economic literature" (see the study on competition law and patent law commissioned for the Previous Consultation at pages 4 and 98). Under certain circumstances not addressed in the draft Guidelines, it can be reasonable and efficiency enhancing to include non-essential and sometimes even substitute patents in a pool. For example, this may be necessary to provide additional legal certainty.

[34] The draft Guidelines also continue to be mainly premised on the assumption that it is easy to distinguish complementary from substitute technologies, but in practice this is not always the case.[2] As the 2007 U.S. Department of Justice & Federal Trade Commission Report, *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition*, puts it: "In many cases, patents in a pool are not pure complements or pure substitutes, but display characteristics of both."[3]

[35] The draft Guidelines' attitude to non-essential patents also appears to be premised on the belief that their exclusion from the pool will lead to lower royalties (paragraph 237, which echoes current paragraph 217). As, however, the United States Court of Appeals, Federal Circuit recognised in *Philips v ITC*,[4] this is not always true; sometimes non-essential patents can be included in a pool without the licensing costs being higher.

[36] As we also noted in our reply to the Previous Consultation, our review of existing patent pools (at least outside the life science area) shows that most, if not all, existing pools are linked

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[2] The Guidelines recognize this to an extent in paragraph 218 (draft Guidelines 238), which addresses efficiencies stemming from integrating two technologies both of which would likely have been licensed in the absence of the pool.

[3] Available at http://www.justice.gov/atr/public/hearings/ip/222655.htm.

[4] *US Philips Corporation v International Trade Commission*, 424 F.3d 1179.

to an industry standard. This suggests that the Guidelines may not go far enough to encourage pro-competitive pools from forming where no established standard exists (and where the risk of patent thickets may be higher). For this reason, we would recommend that a stronger statement be included in the Guidelines to recognise that, in the absence of an industry standard, it may be possible to include non-essential technologies in pools without Article 101(1) being infringed.

[37] We note that paragraph 246 of the draft Guidelines continues to recommend that formerly essential technologies, which have become non-essential due to the emergence of new technology, normally should be removed from a pool (albeit an additional sentence adds that "there may be other ways to ensure that third party technologies are not foreclosed").

[38] While we understand the reasoning behind excluding such technologies from a pool, safeguards need to be in place to ensure that licensees who have invested (what may now be sunk costs) in the formerly essential, but now superseded, technology are not subject to hold up from the licensor whose technology is no longer in the pool. This is, moreover, another example of the questionable premise that removing certain technologies from the pool will necessarily lead to lower licensing fees; in fact the cost of an on-going essentiality review may well exceed any potential benefit from excluding certain technologies.

[39] We would be grateful for more guidance on independent experts. While the ideal scenario is that the expert be "truly" independent of the pool founders, this is not always achievable in practice. For instance, often the most appropriate expert may be someone who has a (past) connection to a founder. We think the Guidelines could usefully recognise this and recognise that sufficient contractual safeguards can be put in place to ensure the expert's independence.

[40] In addition, the common assumption is that one expert should be appointed per pool per jurisdiction, which is workable if there are not a huge number of patents that need to be analysed. We think the Guidelines could usefully address when it would be appropriate to appoint multiple experts and how these multiple experts should operate.

[41] Finally, we would welcome some additional guidance on how "FRAND" royalty rates should be set and guidance on how a patent pool should be allowed to enforce patents against third parties.

H. Other comments

[42] Article 1(c) of the draft BE now provides that if raw material and equipment purchase provisions in licence agreements are "directly and exclusively related to the production of the contract products", they can fall under the BE. This is a useful clarification.

[43] Under the proposals the licensing of software copyright merely for the purpose of the software's reproduction and distribution would no longer be covered by the technology transfer block exemption (because reproduction is not deemed to be production of a contract product). Instead licences allowing for reproduction of copyright would have to be assessed under the rules governing vertical restraints (Recital 7 and Guidelines, paragraph 52). We question whether this change is necessary.

[44] Finally, we would be grateful for more worked examples in the Guidelines. Compared to, for instance, the Horizontal Guidelines, the Technology Transfer Guidelines do not contain examples (apart from on market share calculation). The examples in other Commission guidelines are very useful.

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