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LCII/TILEC Conference Report: The Future of Open and Collaborative Standard Setting

by

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On May 29th and 30th, the Liege Competition and Innovation Institute (LCII) at the Université de Liège teamed up with the Tilburg Law and Economics Center (TILEC) to host a conference in Brussels on the topic: "Innovation, Research and Competition in the EU: The Future of Open and Collaborative Standard Setting" (final program available here).

The conference gathered reputed academics, including J. Farell, S. Haber and B. Heiden, judge Dr. K. Grabinski (German Supreme Court), M. König (Acting Head of Unit, DG GROW, EC), Y. Ménière (Chief Economist, European Patent Office) and many other panellists and speakers who shared their experience from the trenches of standards setting (CEN-CENELEC) and IT patent licensing (Ericsson, Orange, Technicolor, and others).

The conference turned out to be extremely rich in content and led to stimulating discussions. As a "new entrant" in the debate, I retain the following.

I. Patent Hold up v. Patent Hold out: Where is the Market Failure?

Dr. Grabinski, distinguished judge of the BGH – the court which addressed the issue of Standard Essential Patents ("SEPs") in the first place in Europe – reminded us that patent law is based on a "**deal"**, between the Inventor (or, nowadays, the innovating firm) and Society, whereby the former accepts to **disclose** his invention in exchange for an **exclusive right** of exploitation, limited in time. He asked whether the "*deal*" is still working as far as modern technologies are concerned, taking into account the specificities of standards and SEPs. Judge Grabinski asked *himself whether we need a new deal, a new patent law.*

The deal *may* be broken due to **abuses** by **either party**: innovators or implementers. *Michael König* from the EU Commission stated that both types of abuses exist, and may require the regulator to intervene –even through the implementation of soft law instruments.

The first type of abuse, pointed out by legal scholars in the last decades, is the **abuse by**

patent holders taking undue advantage of the standard setting process. This early research foresaw a risk of failure on the products market: patent thickets, **patent hold up** through royalty stacking, … And I must say that, for a general IP and contract lawyer as myself, the idea that a company has to license in hundreds of patents just for one technical feature of a product incorporating many features (like a smartphone), is something *puzzling*. It seems that patents are licensed "by weight" as if they were oranges.

But *Prof. Haber* worked very convincingly at breaking this thesis into pieces: patent hold up, at the expense of technological products manufacturers, is a myth just like the peaceful character of Mayas: it is founded on several fallacies.

In Europe, implementers have no interest in voluntarily taking a license because product removal is limited and eventual damages compensatory

The evidence brought, we must admit, is heavy. There is, apparently, no tangible evidence of innovation stagnation in the sector of SEP-intensive IT products like computers and mobile phones. It is obvious to anybody that smartphones become every day more sophisticated and efficient; prices are decreasing (at least for comparable products); new entrants are coming on the products market; and the royalty yield on such products is also very far below the level that was predicted by the initial proponents of the "Patent Hold-Up Theory": 3,5 % of the price of the product, not 79 %! (3,5 %, a figure which by coincidence happens to be the percentage of investment in R&D by Apple, whereas some innovators in ICT technologies spend up to 30% of their revenues in R&D).

Several speakers suggested that failure might currently be happening on the *technology market*, rather than on the products market: **Patent Hold out,** rather than patent hold up. Patent hold out is, admittedly, also likely to jeopardize the initial "*patent deal*" reminded by judge Grabinski.

The key factors why the deal appears to be broken, or at least in trouble, were pointed out by *Prof. Bowman Heiden (CIP)*: not only is enforcement of patents against local implementing companies almost impossible in some protectionist jurisdictions, but even in Europe or the US, injunctive relief becomes more hardly available to SEP owners. The "Antitrust defence" flourishes, and becomes far more important than the traditional limitations provided for by patent legislation.

Having worked myself recently on the question of quantification of damages, I share the view that, in such situation, implementers have no interest in voluntarily taking a license in the patents that they practice: the risk of their sales being stopped is indeed limited and if they are eventually sued –and do not settle–, the damages they will have to pay are compensatory in nature (at least in Europe); in other words, not much more than the royalties due under a voluntary license…

Prof. Heiden explained that when bargaining license conditions and delaying the conclusion of licenses become systematic (and not merely "circumstantial"), "**Patent Trespass**" arises: a **royalty gap** appears which, in the long term (if the phenomenon becomes "systemic") might lead to the exit of Innovators; there is a failure on the technology market. In support of this warning, Heiden Bowman produced an appealing table, showing that Licensing coverage fell from 73% to 39 % over the last ten years (2006-2016). *Patrick Hofkens,* from Ericsson, confirmed that implementers come less and less spontaneously to Patent holders to take a license. The reluctance of car manufacturers to take licenses was also pointed out during the panel discussion, which is of course a concern in the era of "connected cars".

Another factor that could lead to a failure on the Technologies market, besides the unavailability of injunctions, is the proposal to use **SSPPU** as the basis for royalties' calculation. *Ian Corden, from Plum Consulting*, warned that the change of policy of IEEE-SA in this respect, in 2015, could lead to a decline of investments in R&D in Europe of up to 8%, which would lead also to a decrease of GDP. This would not be compensated, he said, by the reduction of the price of handsets and telecom services.

Mrs. Hamelin, from Orange, stressed that when considering upcoming **5G** standard for telecommunications, what matters is before all quality of services and interoperability; prices have decreased and will probably continue to decrease.

II. FRAND

A successful deal between Inventors and Society also implies a successful deal between innovators and implementers. This requires **balanced licensing** conditions. Most participants agreed that the principle of FRAND conditions – a requirement imposed by most SSOs – is the key to such balance. But what is **FRAND**? That remains the basic question, and a difficult question.

Non-Discriminatory?

I could perceive a relative consensus during the conference in this respect: objective differences in situation justify different treatment:

- Not all applications are comparable (5G for a telephone v. 5G for a fridge)
- Different rates for different territories may be justified

Fair and reasonable?

This implies to discuss royalty rates… but also the royalty base

- **Royalty base: SSPPU v Entire Market Value**

Building on the lessons from Behavioral Economics and the notion of " anchoring effect ", *Prof. Axel Gautier* explained that the concept of SSPPU is " tricky " because it leads to " impressive " royalty rates – *e.g.*, 500% of the chip price-, which *could* be viewed as unfair *although* they are not. Judges are not mathematicians and will not necessarily believe in the "neutrality of multiplication".

- **Royalty rate**

Prof. Farrell explained that this can be determined using **benchmarks** and, as SEP patents are concerned, following a **"top-down" approach.** Tricky elements however can interfere: not only the **validity** of a given patent is often uncertain, but also its **essentiality** to the standard; indeed, there is no *ex ante* verification of patents declared to the SSOs and a phenomenon of over-declaration is observed… In other words, not all oranges are the same; some are rotten; and the basket also contains bizarre fruits, which are not useful to make juice.

Who sets the rate?

The preferred answer would be that the parties set the rate. However, this requires that they reach an agreement. Other players may well intervene: courts, regulators, SSOs.

- **The Courts**

Courts are the final decision makers to determine FRAND rates if no agreement can be reached between Innovators and Implementers. *Ironically*, we could say that a FRAND rate is… the rate determined by a Court… *Justice Birss* showed the way recently in the remarked *Unwired Planet v. Huawei* judgment (High Court of England and Wales), and judge Grabinski did not seem frightened by the task of having to fix FRAND conditions. However, courts are not necessarily well equipped to do that;

discovery is necessary, to determine a benchmark; the assistance of experts (in economics) is also needed; this implies costs and is time-consuming…

- **The Regulator(s)**

The EU Commission seemingly feels that there are market failures in technology licensing and is therefore considering to provide Guidance to stakeholders. Its goal would be, through a "soft" recommendation, to ensure a smooth access, on fair terms, to SEPs, while keeping the incentive for R&D investment. Addressing the "three pillars" where failures appear to occur would require: (i) transparency (*e.g.*, regarding declaration of patents to SSOs and essentiality), (ii) valuation (what is FRAND?) and (iii) a predictable enforcement regime. This is what *Mr*. König (DG Grow) explained.

I had however the feeling that the enthusiasm vis-à-vis this possible intervention of the Commission is limited, to say the least (adverse "*interferences*" are never welcome in telecommunications…). Judge Grabinski himself insisted that the Regulator should leave room for departure from the principles it could establish. In other words, it should be clear that courts are free to depart from those guiding principles to take into account the particular circumstances of the case before them.

- **SSOs**

We had confirmation that there is a growing competition amongst Standard Setting Organizations. The SSOs picture resembles a "*jungle*" said *Mr. Ganesh from CEN-CENELEC* (one of the oldest, European, SSO). There is an "SSO race for Internet of Things", said *Prof. Lundqvist.*

Is there **something to be improved** in the functioning of SSOs? And first of all, should we move *from "Standards" to "Rules"*? Should Standards be replaced by Rules, in order to diminish legal uncertainty? Are Rules less "costly"? Considering both "Promulgation Costs" and "Enforcement Costs", *Prof. Nicolas Petit* challenged the dominant view that Rules are indeed less costly –and therefore more efficient– when the situation to be addressed occurs frequently. In particular, one must take into account the existence of different kinds of "*rules*".

Another question, discussed during the Conference, was whether Government should exercise some control of the standardization process. Apparently, this is neither on the agenda nor desirable. Free competition between SSOs appears preferable, and, as *Prof. Haber* suggested, winning SSOs will be those which adopt rules allowing participants to obtain return on their investments. The goal of an SSO, *Prof. Farrell* observed in his keynote speech, is probably to increase the global welfare of its members. *Prof. Agnieszka Janczuk-Gorywoda* reviewed the legal implications under EU law of the delegation of powers by the Commission to SSOs.

Finally, *Raphaël De Coninck* (Charles River Associates) presented specific rules that could be adopted by SSOs to address the market failure issues pointed out during the conference. These include:

- Clarifying duties in negotiations (*Huawei*), to avoid Hold out;
- *Ex ante* commitment to, or indication of, maximum total stack, to avoid hold-up (if any, some replied in the assistance). This is something to be –at least partly– addressed collectively through aggregate royalty caps (caps binding the whole group of SEP holders for a considered standard);
- Arbitration related to FRAND;
- *Ex ante* disclosures to reduce transaction costs (over-declarations), but also testing random samples of patents to verify essentiality
- Patent transfer rules (purchasers

should be bound by FRAND commitments).

Personally, as an IP and contract lawyer, I found those suggestions particularly meaningful. However, Competition lawyers might be more sceptical, or at least, cautious, suggesting that SSO's are also subject to the application of competition law, and particularly of scrutiny under Article 101 TFEU that forbids agreements distorting competition.

Many more interesting reflections, analyses and theories were discussed during these two days. The presentations will be made available soon on the LCII and TILEC's websites on a "royalty free basis" (this is our FRAND commitment!).

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