

More of a Burden than a Solution? Potential Impacts of a New European Framework for Standards and Patents

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Executive Summary

- > Incentivising innovation and ensuring competition on the market at the same time can be conflicting.
- > The European Commission intends to create a new European Framework for Patents and Standards, but it remains unclear what exactly are its goals.
- > The public consultation reveals diverging views of private actors vis-à-vis public authorities.
- > Fair, reasonable, and non-discriminatory licensing of patents essential to standards is not clearly defined in the Commission's proposal, leaving room for abuses, whereas the current system provides a toolbox that industry actors regard as well-functioning.
- > The Commission's focus might be displaced, potentially leading to negative consequences for the market and the consumers.

In the era of rapidly advancing technologies and global corporations, striking the balance between protecting the Intellectual Property Rights of inventors and securing fair competition on the market poses a challenge to decision-makers and the industry alike. Multiple interests and priorities are at stake – companies invest heavily in R&D activities to gain a competitive advantage, expecting a high return on their inventions, while implementers want to access patented products at low prices. Once patents are included in industry standards and become Standard Essential Patents (SEPs) or when patent holders enjoy a dominant position on the market, Intellectual Property law interacts with competition concerns, having a potential

impact on innovators, producers and, ultimately, the consumers.

Recently, the discussion on rules for licensing of patents essential to standards in the EU has appeared on the agendas of both the European Commission and the Court of Justice. In 2014, DG Enterprise and Industry (now DG Internal Market, Industry, Entrepreneurship and SMEs) published an extensive report on Patents and Standards. Together with the ensuing public consultation, it is part of the process designed to create a common European framework for the licensing of patents essential to standards. At the same time, in July 2015, the Court of Justice issued a judgment in the *Huawei v. ZTE* case, taking a stance in the discussion on the rights and obligations of patent holders and licensees by ruling on the issue of injunctions being sought by dominant companies against SEP implementers.

While the Commission has embarked on an ambitious path of creating a legislative proposal, it appears unclear what exactly are the issues that it aims to tackle and how the new set up would improve the existing arrangements. This Policy Brief argues that it could be better for consumers if the current policies were left in place, allowing the market to respond to new challenges and create solutions appropriate in each sector or even in individual cases. More rules might constitute a burden, rather than a solution.

What is at stake?

In designing the new policy, the Commission recognises that standardisation plays an essential role in assuring interoperability across devices, especially crucial in the ICT sector. The stakes appear high if we consider that standards such as 3G and GSM in mobile telephony can include over 23,500 SEPs (Jones 2014). Moreover, SEP holders see standardisation as a source of profit – for example, Apple's revenue per patent in 2014 exceeded

\$16,500 (Lloyd 2015). This further motivates companies to partake in the standard-setting process but simultaneously puts pressure on licensees in the negotiations of royalties. Industry actors also agree that appropriate compensation for SEPs is essential to maintain innovation incentives. Yet those equally concerned are consumers or the 1.15 million users of mobile phones in Europe who prefer affordable prices for their devices (Statistica 2016).

The Commission aims to ensure efficient licensing of SEPs by improving the system of patent declaration, promoting patent pools, assuring well-functioning dispute resolution mechanisms, harmonising transfer of SEP ownership, and clarifying Fair, Reasonable and Non-discriminatory (FRAND) conditions for licensing. However, two important issues arise: first, how should appropriate compensation fees be established? And second, how should negotiations of these royalties be conducted?

Defining Fair, Reasonable and Non-discriminatory (FRAND) conditions

Regarding the definition of compensation terms, Standard Setting Organizations (SSOs) typically require holders of SEPs to agree, during the standard-setting process, to license their IPR on FRAND terms. To date, however, no clear definition of the meaning of FRAND has been established. Deciding upon FRAND rates is a complex issue, in terms of not only the actual price determination but also the negotiation toolkit available to both licensors and licensees.

According to the Commission's report, there are several characteristics that a FRAND licensing system should have. First of all, it should result in appropriate royalty fees for SEP holders. Secondly, there should be a set of clear negotiating rules, giving both the licensors and the licensees sufficient time to consider the other's proposals. Thirdly, the parties need to have recourse to third-party arbitration, be it by courts or alternative dispute mechanisms. In essence, a well-functioning framework would stimulate innovation by all industry participants and not only the dominant undertakings. However, this can only be achieved through limiting the financial and time-related costs of possessing SEPs as well as implementing them. Consequently, this ties in with the ultimate logic behind both IP and competition policies, namely benefiting consumers by providing a wide choice of high-quality products at reasonable prices.

The Court of Justice has consequently avoided tackling the definition of FRAND terms, as seen in the *Huawei v. ZTE* judgment. The lack of clear guidelines for quantification of FRAND royalties leaves room for abuses

and consequently licenses being sold at prices that are either too low for SEP holders or too high for implementers. As pointed out by Intel, the violations of FRAND commitments might endanger the standardisation process as well as negatively impact competition and innovation in a given sector. Those harmed will be end consumers who could face increased prices and ensuing welfare losses.

It is not clear who should decide on the meaning of FRAND terms. SSOs deem the parties involved and courts to be responsible for establishing FRAND royalty fees through negotiations or arbitration, in case of disputes. Similarly, the Court of Milan in the *Samsung-Apple* case notes that SEP holders are the only ones who can suitably establish a FRAND royalty because they possess all the information about the value of the patent. This view is challenged by Microsoft which suggests that SSOs should adopt a set of guidelines regarding the factors to be taken into account in determining FRAND compensations.

Another challenge is to establish an appropriate methodology for defining FRAND licenses. The companies involved in public consultation believe royalty rates should reflect the value of patented inventions and not be seen as source of profit. Microsoft suggests that cost-based methods should not be used to determine FRAND royalty rates and instead only the value of the invention should be decisive. At the same time, Apple puts forward the concept of "smallest salable patent practicing unit" that helps avoid excessive profit being extracted from competitive advantage or the fact that the patent becomes an SEP.

To many, the current framework can sufficiently protect the rights of patent-holders as well as implementers in definition of FRAND rates. Serious criticism of the Commission's report comes from Qualcomm, pointing out its methodological shortcomings and substantial flaws. Qualcomm's main argument revolves around the idea that in fact, the current IPR policies of SSOs provide a well-functioning framework for standards and patents. This view is supported by the IP Federation which highlights that any changes to the current FRAND licensing model need to be "based on empirical evidence of systemic problems" which seems to be lacking. According to the European Telecommunications Standards Institute, there has not been any confirmed case in Europe of patent-holders' commitments that would be either unfair or unreasonable. Even though there is no obligations to inform SSOs about licensing terms, such a statement might indicate that in fact the existing IPR policies of SSOs in Europe lead to royalties that are Fair, Reasonable, and Non-Discriminatory.

The right to seek injunctions against implementers

The Commission also intends to clarify the tools that should be available to holders of SEPs in the process of royalty negotiation. CEN and CENELEC emphasise that the right to obtain injunctions is an essential tool available to patent holders in disputes with unwilling licensees. However, as pointed out by Microsoft, the right to obtain injunctions against implementers of SEPs, based on the failure of negotiations of FRAND royalties should be “extremely limited”. For example, dominant firms in possession of SEPs might seek to abuse their position on the market to exploit unreasonable royalties from weaker competitors. The *Huawei v. ZTE* judgment clarifies that seeking injunctions by dominant firms for their SEPs is only possible under special circumstances. These include a notification about SEP infringement by the patent holder, willingness of both parties to negotiate, presentation of a “specific, written offer for a license on FRAND terms” and a diligent response to that offer by the implementer.

Similarly to the Court’s view, Apple emphasises that both the licensor and the licensee need to be “willing” in the negotiation of FRAND-rates, implying transparency, robust methodology and information-sharing in the process. These conditions underline the fact that ensuring consistent enforcement methods of FRAND commitments by establishing transparent royalty negotiation rules might be more important than defining FRAND terms.

Nevertheless, the question remains to what extent injunctions constitute a genuine concern for the efficiency of SEP licensing. While the clarification from the Court provides some legal certainty, many more essential concerns have not been addressed. It has been observed that in the UK, for example, preliminary injunctions are rarely sought or granted, due to possible damage actions, should the injunction be declared invalid. This example shows that not only are injunctions an exceptional tool in patent disputes between holders of SEPs and licensees but also there already exist effective retaliation measures, such as damage actions, where abuses of injunctions are detected. It seems that the existing rules on injunctions work rather well in assuring efficient licensing of SEPs.

The less, the better?

The Commission’s strategy can be criticised for being too broad and lacking focus. While attempting to provide a comprehensive framework for patents and standards, it covers areas that do not need regulation and leaves out the most contentious issues, including a clear FRAND definition. The risk is that instead of improving the current system, the Commission could fail to find consensus on unsubstantial issues and therefore might not be able to deliver on the pressing problems.

If we consider that the current system is working well, the recommendation for the Commission would be to put its legislative process on hold and let the market and SSOs work out their best practices. However, as that is unlikely to happen, the Commission could benefit from taking a step back and redefining the exact goals that its framework should achieve. The possible alternatives include a detailed top-down definition of FRAND terms and more power of SSOs in the process of negotiations of licenses or less focus on creating binding commitments and more transparency of the royalty-definition process and better dispute resolution tools instead.

The companies concerned worry about their returns for R&D, in the case of SEP holders, or costs of production for implementers. However, the ultimate impact of royalty rates is on consumer welfare which can be harmed by inefficient and protracted procedures. Since the framework for standards and patents is not currently on top of the Commission’s agenda, the industry players as well as SSOs and public authorities are given a chance to ensure that when the legislative proposal emerges, it will bring a change for the better, rather than worsen the apparently well-functioning status quo. The challenge is multifaceted, the policy goals are ambitious, and the stakes high.

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