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# Considering Whether Ex Ante Joint Negotiations within Standard Setting Are "Reasonably Necessary"

Anne Layne-Farrar*

In the ongoing debate over intellectual property (IP) within standard setting, the issue of patent holdup has loomed large. Under holdup, a firm that has a patented technology which is included in a standard can use the fact that negotiating a new standard around another technology may be difficult, time-consuming, and expensive. In this case, the patent holder may be able to extort more in licensing fees than its patent is worth, or in other words, may be able to "holdup" the licensee by charging just less than the costs of switching to another standard.

One proposal aimed at solving the holdup problem is for the members of the standard-setting organization ("SSO") to jointly negotiate licensing terms before any decisions are made about which technologies to include in the current standard. The patent holders for all candidate technologies would negotiate licensing deals ex ante, but only those chosen would then have contracts to enforce ex post. While joint negotiations over prices are typically taboo because of antitrust price-fixing concerns, the joint ex ante negotiation proposal for standards gained agency support in the United States in early

* The author is a Director at LECG in the Chicago office. This article is based on the author's remarks presented at the ABA Section of Antitrust Law's 2008 Spring Meeting panel, "Standards Development Organizations: Deterring Misuse Without Deterring Innovation" and a paper of the same title (with Gerard Llobet & A. Jorge Padilla).

2007 when, in a joint report, the U.S. Department of Justice and U.S. Federal Trade Commission announced that they would evaluate such negotiations under the rule of reason, as opposed to considering them per se illegal.

Before we can understand whether or not the joint negotiation proposal would be beneficial and achieve its goal of preventing holdup, it is important to understand the motivations behind the proposal. At the root of the concern over patent holdup is tension over different business models among SSOs. Vertically integrated firms—those with research and development (R&D), patents, and downstream manufacturing operations—are seen as being held in check by cross-licensing. They cannot holdup other patent holders because they too need to license their rival's patents. On the other hand, upstream specialists, sometimes called non-practicing patent holders, are seen as being free of the cross-licensing constraint and, therefore, are willing and able to attempt patent holdup.

Ex ante negotiations are viewed as a way of maintaining competition among patent holders in order to keep royalty rates down. Before any vote over which technology to include in a standard, different technological options can compete with one another for inclusion in a standard. The presence of viable substitutes prevents patent holders from charging holdup rates. If a patent holder attempts to charge more than its patented technology is worth, SSO members can simply support another competing technology for inclusion in the standard. The joint aspect of the proposal is seen as a further mechanism to strip upstream patent holders of "market power", so that royalty rates are as low as possible.

While the ex ante joint negotiation proposal may hold some surface appeal—especially the ex ante aspect of it—it glosses over some very important economic fundamentals of licensing within standards. First, not all patented technologies face viable substitutes. If a patented technology arrives at a standard as the only feasible technical solution, then in selecting that technology for the standard the SSO is not augmenting the patent holder's market power at all. Charging a royalty rate that is relatively higher than other inferior technologies is not holdup—it is earning a justified return on a risky investment that resulted in a highly valuable technology.

Second, SSOs frequently have pivotal IP buyers. These are members who hold disproportionate voting rights within the SSO and can therefore block a technology's inclusion in a standard and firms with considerable clout in the marketplace that are necessary for the standard's commercial success. Once these pivotal players obtain reasonable rates, the "non-discriminatory" component of the "Reasonable and Non-Discriminatory" ("RAND") licensing commitment that most SSOs request of their members helps ensure that other less pivotal players receive reasonable rates as well. The holdup debate thus far has emphasized the "R" in RAND, but has almost entirely ignored the "ND". In my research, however, I find that non-discrimination commitments can play a crucial role in achieving low, but fair licensing rates.[1]

Third, SSOs typically have more IP buyers than IP sellers, and often have considerably more. This means the conditions for an anticompetitive buyer boycott could be ripe if the SSO institutes joint negotiations. It is clearly in the interest of all of the

[1] *See, in particular*, Anne Layne-Farrar, Gerard Llobet & A. Jorge Padilla, Are Joint Negotiations in Standard Setting "Reasonably Necessary"? (working paper, LECG and CEMFI) (May 2008), *available at* http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=232826.

downstream members (vertically integrated or otherwise) to keep upstream members' royalty rates as low as possible in order to keep their own costs down and to increase their own downstream profit margins. These are legitimate concerns for all firms, but we need to be vigilant in ensuring that collusion is not used to force sub-competitive royalty rates under the guise of preventing holdup. If licensee collusion did occur, then patent holders would be under-compensated. But if patent holders are not obtaining a reasonable return on their risky innovation investments, then ex ante joint negotiations will reduce their incentives to innovate and to participate in cooperative standard setting—to the ultimate detriment of the quality of the standard and the welfare of the consumers relying on it.

This raises a fundamental question: Do we really want low royalties or do we instead want lots of product introductions with low prices for end-consumers? I would posit that we want the latter. Recall that royalty rates and other licensing costs are only one of many input costs of the final good sold in the marketplace. Other costs include labor and capital expenditures, along with marketing and distribution costs. Moreover, the extent to which an input cost like royalty rates is passed on to end-consumers depends crucially on the competitive dynamics in the downstream market. We should therefore focus on low royalties only to the extent that we think it gets us closer to our goal of more innovative end-products sold at reasonable prices. By focusing solely on low royalties, without considering the impact on innovation and the effect in the marketplace for

consumers, we run the risk of getting distracted with side issues, of getting stuck down in the weeds, and of losing sight of the bigger picture.

This brings me to the question posed in the title of this article: Are joint negotiations "reasonably necessary" to achieve the ultimate pro-competitive goals of cooperative standard setting? Certainly joint negotiations are not always bad and licensees will not always collude. Then again, licensees do not always practice holdup. In my research, however, my coauthors and I have found that joint negotiation is likely to lead to under compensation in a number of plausible circumstances. Recognizing the legitimate needs of both licensors and licensees, I see more risks than rewards in joint ex ante negotiations. There are other, more moderate means of limiting the threat of patent holdup; joint negotiations therefore are not reasonably necessary.