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The Impact of the Draft EC Horizontal Guidelines on Intellectual Property Rights and Innovation

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I. INTRODUCTION

The European Commission's *Draft Guidelines on the Application of Article 101 of the Treaty on the Functioning of the European Union to Horizontal Co-Operation Agreements* (the "Draft Guidelines") have attracted a multitude of comments from many interested parties. This has been particularly the case in relation to Chapter 7 of the Draft Guidelines that addresses "standardization agreements"—*i.e.*, agreements that arise in connection with the development of technical standards that incorporate technology subject to intellectual property rights ("IPRs"). The reason for such a reaction to Chapter 7 may be because the Draft Guidelines seek to address the complex and often controversial issues that exist under competition and intellectual property laws, especially when patented technology is included in technical standards.

This paper will ask whether, in doing so, the Draft Guidelines seek to define problems and propose solutions in a manner that may be interpreted as reflecting a bias against the legitimate and pro-competitive exercise of intellectual property rights. It concludes that, as currently drafted, the Draft Guidelines may, in fact do so, and by so doing may cause the contrary result than intended. Rather than providing certainty for IPR-related conduct in the standards context so that effective standardization may proceed most efficiently, they may undermine the pro-competitive use of IPR in standards and thereby diminish technical innovation through the standards process.

II. THE DRAFT GUIDELINES

The Draft Guidelines set forth prescriptive parameters that, if satisfied, would allow standards-setting organizations ("SSOs") to be within a safe harbor relative to claims under Article 101 of the EC's Treaty. In doing so the Draft Guidelines specifically focus on SSO policies relating to the use of IPR and rules for the disclosure and licensing thereof. Thus, for example, to qualify for safe harbor treatment ¶ 281 of Chapter 7 would require SSO policies to obligate members to undertake "reasonable efforts" to disclose IPR that may be relevant to a standard. Paragraph 282 would require all holders of essential IPR in technology that may be adopted as part of a standard to commit to license such patents, whether or not such IPR is in fact essential to implementation of the standard. Example 2 of paragraph 316 further provides that where such disclosure and licensing obligations are merely encouraged by an SSO rather than being mandatory (as is the case currently for most if not all of the IPR policies of major SSOs worldwide), then the policies and conduct thereunder would not only be outside of the safe harbor but may likely be a violation of EC competition law, even under Article 101(3)—*i.e.*, the analog to U.S. antitrust law's rule of reason—and even though such a conclusion of likely anticompetitive effect assumes many uncertain factors including whether inclusion of IPR in a

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standard confers dominance or monopoly power in favor of the IPR owner, whether the IPR owner's conduct is exclusionary, and whether in fact any anticompetitive effect actually was caused by the challenged conduct.

The rationale for this prescribed approach is what the Draft Guidelines identify as the risks of "hold up" and "excessive royalties." In other words, the risks sought to be addressed is the possibility that IPR owners will "hold up" parties seeking to implement a technical standard that requires use of the IPR owner's intellectual property by charging a royalty or other fee that is "excessive." Under this view, the "hold up" would occur because the standard by its nature would have eliminated alternative technical options, and users of the standard will have already invested in the implementation of the standardized technology.

In explaining these risks, the Draft Guidelines, however, include no discussion that, as a general matter, the use of proprietary technology in standards is pro-competitive, and that effective enforcement of intellectual property rights is generally recognized as resulting in competitively positive effects. Nor do the Draft Guidelines explain that the risks of "hold up" and "excessive pricing" are in large measure theoretical, and where an actual potential for competitive risk exists, conduct giving rise to such risks can be addressed on a case-by-case basis, without the need for any regulatory involvement. Further, the Draft Guidelines are silent on the fact that in numerous instances where IPR-related conduct in the standardization context had been legally challenged under competition or antitrust laws, no violation of the applicable law was ultimately found.

Thus, rather than a significant and systematic risk of anticompetitive conduct, competition or antitrust law challenges to the use of IPR in standardization may reflect commercial disputes more than anything else, and would weigh strongly against regulation of such conduct, or the adoption of provisions such as reflected in the Draft Guidelines. Also weighing against the adoption, or need, for such regulatory guidance is the fact that there is no known instance where "hold up" conduct or what has been alleged as "excessive royalties" has prevented the successful adoption of a technical standard that is inclusive of essential IPR.

But even if the adoption of guidelines is deemed appropriate, there remain important questions whether the Draft Guidelines, in seeking to address a largely unproven concern by applying highly controversial theories, are properly directed, and whether they present a balanced approach that appreciates fully the complexities of the standardization process—which are made even more complex by the need to ensure that competition law and IPR law principles act in a complementary manner. It does not appear that they are.

III. THE DRAFT GUIDELINES' MAY BE INTERPRETED AS PRESENTING AN UNBALANCED PERSPECTIVE

Laudably, the Draft Guidelines observe that unbiased and balanced SSO IPR policies are essential to accommodate the inherent tensions that might arise among stakeholders with different business interests and strategies. *See* Draft Guidelines at ¶¶ 270-274. Such tensions invariably arise given the varied interests of standards participants, including specifically with respect to the use of IPR. Thus, owners of IPR have the incentive, and the right, to seek and obtain an adequate return on their innovation investments in developing IPR. If they are unable to do so, their incentives to continue their inventive efforts and to make their technology available to the standardization process will be diminished. This is why SSO policies expressly recognize the interest of IPR owners to achieve such economic reward.

Other standards participants, however, may simply wish to gain access to technology regardless of whether it is protected by IPRs. At a most basic level, such participants would prefer no restrictions on their use of IPR-protected technology, and may be most concerned with their own short-term interests of avoiding any cost (whether in monetary or other terms) of gaining access to standards-essential IPR. SSO IPR policies carefully avoid depriving IPR owners of their rights, whether through compulsory licensing requirements or defining specific terms upon which standards-essential IPR must be licensed, and instead have relied upon an approach by which IPR owners are encouraged to commit to license standards-essential IPR on fair, reasonable and non-discriminatory (“FRAND”) terms. The negotiation of such terms is then left to the IPR owners and prospective licensees, with the availability of breach of contract lawsuits in the event of claims by the prospective licensee that the parties were unable to agree because the IPR owner has not complied with its FRAND commitment.

This is a simplified description of the varied stakeholder interests involved in standardization, but this basic balanced approach has worked well, as evidenced by the facts that licensee fees have not prevented the flourishing of any technology, and the rarity of instances in which breach of contract actions as described above have been filed. The paucity of legal challenges should not, however, be viewed as a call for greater enforcement or regulatory involvement. To the contrary, it reflects the successful operation of the current environment and the ability of IPR owners and prospective licensees to commercially resolve differences and allow the standards process to permit technological advancement.

Of course, there exists the potential for anticompetitive conduct and effects under the foregoing approach, and recognition of this theoretical risk in agency guidelines is appropriate. But the Draft Guidelines place primary emphasis on such risks for “hold up” and “excessive royalties” without any case law to rely on. They do not mention the positive contribution made by IPR in standardization or the enormously successful experience of standardization, (especially in IPR-rich industries such as the information, communication, and technology arenas), and thus this emphasis could (and has) been interpreted as suggesting that the use of IPRs in standards poses a far greater risk of anticompetitive effects than actually exists or can be empirically shown, (*see, e.g.*, ¶¶ 260, 262, 275 and 280). This alone may suggest an enforcement or regulatory focus by the EC that is less than supportive of intellectual property rights.

Thus, for the Guidelines to reflect a truly balanced approach, they might observe that anticompetitive risks may arise under applicable competition and antitrust laws when IPR in standards or otherwise is used in a manner outside the scope of the statutes establishing such rights, and then identify the specific instances where such risks may be more likely than not. Such guidance should be set forth based on objective criteria, rather than on theoretical likelihoods of anticompetitive effects. In addition, the Guidelines might make clear the complexity of the issues involved and while establishing well-prescribed safe harbors, also make equally clear that conduct that is outside a safe harbor may also be entirely consistent with competition law.

Further, well-balanced Guidelines would provide a full explanation that the use of IPR in standards may (and has proven to) lead to significant pro-competitive benefits. For example, it might be explained that patented technology may afford technologically optimal standardized solutions at the lowest cost, even if the payment of a license fee or royalty is required. Thus, a non-patented alternative may lack requisite performance capabilities, may be unable to interoperate with other essential aspects of a standard, may have less durability, and may require greater expenditures to implement, maintain and replace. Further, it could be explained that

IPR-essential technology, when included in standards, allows for the greater dispersion and availability of that technology. Downstream standards-based products and services have access to such technology and new and existing competitors are able to provide products and services to customers.

It is also notable, and the Draft Guidelines could be revised to reflect that the risks of “hold up” and “excessive royalties” may be constrained by the inherent nature of standardization and the interests of IPR owners themselves. First, standards development is a “repeat game.” Thus, an IPR owner that engages in abusive conduct in one instance may lessen the chances that the consensus of an SSO will allow its technology will be included in later versions of the same standard or in new standards. Second, it is most common that IPR owners in the standards context are also IPR licensees. As a result, abusive conduct by the IPR owner may only redound to its detriment when it requires a license to another firm’s standards-essential IPR. Third, IPR owners who contribute their technology to the standards process will be able successfully to realize an appropriate reward for their inventions only if licensees are willing to agree to the terms made available. Accordingly, even though an IPR owner may seek to obtain “more” than a licensee may wish to pay, that amount cannot be so prohibitively expensive to act in essence as a *de facto* refusal to license, which might be construed as inconsistent with a commitment by the IPR owner to make available licenses on FRAND terms.

In all, the Draft Guidelines might benefit if they do not, as they currently do, focus only on the potential short-term and static effects of potentially (yet certainly not conclusive) higher costs and supposed competitive risks. Instead, while the possibility of anticompetitive effects may exist, the Draft Guidelines would do a greater service if they were to give guidance and take into account the long term and dynamic benefits and pro-competitive effects that are the typical result arising from the use of IPR in standards. Otherwise, the Draft Guidelines could be understood as being less than supportive of IPR which, in turn, may lead to the unfortunate conclusion that participation in the standardization process will decrease the ability of firms to recoup their research and development investments through effective licensing, and thus diminish incentives to continue to make such investments—or at least to contribute the fruits of such efforts for broad dissemination through standardization. *Ex post* regulatory intervention might also diminish the incentives for third party investment in research and development, because of a reduced ability to realize an adequate return on investment, and thus curtail an important source of risk capital particularly to small- and medium-size enterprises.

IV. THE DRAFT GUIDELINES MAY BE CONSTRUED AS CAPPING ROYALTIES BASED ON BENCHMARKS OR UNCERTAIN PRINCIPLES ESTABLISHED BY REGULATORS

Perhaps the most direct challenge by the Draft Guidelines to IPR, and incentives for firms to invest in developing IPR, may be the Draft Guidelines’ comments regarding “excessive” or “abusive” royalties. Whether in the standards context or otherwise, a fundamental right of an IPR owner is to establish the terms upon which it will make its IPR available by license. This right flows from the right of an IPR owner to exclude others from using its invention. As commented, SSO IPR policies accommodate these fundamental rights by avoiding compulsory licensing requirements and rather seek to encourage the availability of licenses. A FRAND obligation also is not to the contrary. FRAND does not either establish specific licensing terms or cap the royalties or other fees that may be sought by an IPR owner. Rather, an IPR owner that makes a FRAND commitment agrees to make licenses available, and license terms are subject to

negotiation between the IPR owner and each prospective licensee. This allows both licensors and licensees to settle upon terms that are satisfactory for purposes of their individual business needs and strategies. Such an approach is also consistent with basic economic principles underlying intellectual property law, which rely upon market-driven negotiations between licensors and licensees to determine the value and consideration to be exchanged under a license.

If the Draft Guidelines are construed as suggesting that the fees and royalties allowed will be subject to regulatory review or determination, however, the balanced approach for IPR licensing now reflected in SSO IPR policies would be threatened.

First, any attempt to regulate royalties or fees to determine what may be “excessive” or “abusive” is not realistic or even possible. IPR licenses include varied monetary and non-monetary terms, all of which impact each other and define the overall “value” of a license for both licensor and licensee. For a regulator to focus solely on the monetary terms of a license would eliminate the licensing freedom of both licensors and licensees to achieve the most satisfactory exchange of consideration in their particular negotiation.

Second, competition law agencies may be least well-suited to determine what is an “excessive” or “abusive” royalty or fee, particularly in the absence of any settled, accepted methodology for doing so, as commented below.

Third, resolving disputes regarding the appropriateness of a royalty or license fee under competition law would subject IPR owners to the risk of liability, damages, and fines should they guess wrong about the fees that regulators will permit them to charge, as determined in proceedings to which the IPR owner may have little or at least inadequate rights to see all of the evidence and allegations made against them and, further, have no right to compel the production of evidence by complainants or third parties. Conversely, there would be no countervailing risks to prospective licensees in the event their claims fail. This will greatly bias negotiations in favor of licensees.

Fourth, some have questioned whether the EC’s “excessive pricing” theories of liability should even be considered in the context of IPR. The EC recognizes that “excessive pricing” may be challenged under Article 102, but it is not a principle that has been recognized in connection with collaborative conduct addressed by Article 101. Furthermore, in the Article 102 context, the “excessive pricing” theory of liability has been applied only in very rare circumstances in connection with tangible goods because of the difficulty of determining that the price for a good is in excess of its value. Such an assessment will be even more difficult for intangible IPR.

Fifth, criteria for assessing the appropriateness of a royalty or licensee fee are less than settled, and indeed may be considered unproven, controversial, and not ripe for inclusion in a guidelines document. The “recent experience” referred to by the Commission, on which the reforms in Chapter 7 are based, are not decisions establishing settled case law, but rather Article 102 investigations that have mainly ended in formal settlements, unilateral declarations, or closing of the investigations without any decision. Moreover, the possible analytical methods identified in the Draft Guidelines for determining the appropriateness of a royalty or license fee—*e.g.*, comparing the value of IPR prior to standardization to its value *ex post*—are at best theoretical concepts which have received far from universal support.

Sixth, the failure in the Guidelines to expressly recognize the rights of licensors, or the real possibility of “reverse hold-up” through action that denies inventors and their investors the

rewards they hoped to obtain in return for their investments, may bias in favor of licensees and against IPR owners the likely outcome of a competition law proceeding directed toward assessing the appropriateness of royalties or license fees.

In sum, if the Draft Guidelines were to impose a regulatory regime on licensing terms, and specifically on the amount of royalties or license fees that might be sought by an IPR owner, this could reflect a very significant challenge to innovation considerations. Will inventors and their investors commit resources to engage in risky R&D based on assurances that regulators will permit them to charge a fee they deem adequate? The Draft Guidelines, therefore, could stand substantial reconsideration in this regard as they currently go against the very notion of advancing competition through innovation and the development of knowledge-based economies.

V. THE DRAFT GUIDELINES' SAFE HARBOR MAY BE ILLUSORY

While the Draft Guidelines claim to seek to establish a safe harbor for SSO IPR policies, by seeking to impose prescriptive rules that are not consistent with most existing IPR policies, the actual effect of the Draft may be to increase exposure of SSOs and SSO participants, especially those firms who seek to contribute IPR to the standards process. This may be the case even though conduct outside the safe harbor will be subject to scrutiny under Article 101(3), and not be presumed anticompetitive. Just the risk and expense of a potential challenge could cause SSOs to either abandon their existing IPR policies, which reflect the consensus of their members and might not easily be changed, or expose IPR holders to greater challenges based on theories reflected in the Draft Guidelines.

This unfortunate possibility is illustrated most clearly by ¶ 316. As commented above, this paragraph provides that SSO policies that only encourage, and do not mandate, IPR disclosure and licensing would not only be outside the safe harbor, but according to the Draft would likely be in violation of Article 101. In other words, under the current provisions of the Draft most, if not all, IPR policies of major SSOs could be challenged as anticompetitive, even though there is no basis to suggest that such policies have resulted in any anticompetitive effects, and certainly not systematic or substantial ones.

The prescriptive approach of the Draft Guidelines would also remove from SSOs the opportunity to divine through the consensus of their members the most efficient and effective—for competition and other purposes—IPR policies. To date, this voluntary approach has succeeded well, and where modifications to IPR policies have been determined to be necessary, including because of perceived risks of anticompetitive effects, SSOs have taken steps to develop and implement such modifications. Equally notable, and conversely, the same concerns of “hold up” and “excessive royalties” as raised by the Draft Guidelines have been identified in SSOs. In almost every instance, however, the consensus determined that changes to existing IPR policies were not necessary, and that if specific conduct occurred of a potentially anticompetitive nature, existing remedies would be sufficient to address such conduct, whether through court proceedings or complaints to enforcement authorities.

VI. THE DRAFT GUIDELINES MUST BE CONSIDERED IN AN INTERNATIONAL CONTEXT

As a final point, the global impact of the Draft Guidelines must be considered. Technology licensing and standardization occurs on a worldwide scale and technology firms compete globally. Accordingly, any Guidelines ultimately adopted by the European Commission will be viewed as a baseline by firms.

Moreover, if the EC's Guidelines are inconsistent with the views of other jurisdictions, and seek to impose greater controls over the use and exercise of IPRs, it would create disharmony and forum shopping where there is a growing need for consistency to advance technological competition and the growth of innovation. Conversely, imposition of a restrictive IPR regime by the EC could also be taken by other jurisdictions, which have less advanced appreciation of the need for a strong IPR environment to advance competitive goals, as the basis to restrict rights of IPR holders in those jurisdictions even more than is threatened in the European Union.

VII. CONCLUSION

The attempt by the EC to provide some guidance and clarity in the area of standardization, and specifically as it involves the use of IPRs, should be welcomed. But, the issues involved are too important, complex, and comprehensive to use this as an opportunity to promote policy inclinations relating to IPR, especially where doing so may result in negative competitive and innovation-related consequences. No doubt there will be continued discussion of these issues, and it will be interesting to see if the Draft Guidelines can evolve into a useful tool.