

Why US Should Help European Efforts to Fix SEP Licensing

By **David McAdams and David Katz** (October 19, 2023)

The U.S. Patent Office, the National Institute of Standards and the International Trade Administration are all currently seeking input to establish U.S. policy on foreign standard-essential patent licensing regulatory regimes — after the European Commission proposed a regulation to reform SEP licensing.

Many companies that license SEPs have argued that there is no need for SEP licensing reform and the market functions fine. These comments were echoed by the European Parliament's Committee on International Trade, which published a draft opinion claiming the evidence of problems in SEP licensing justifying this reform was inconclusive.

That is not the case. The commission's proposed reform, proposed in April, is needed to address a fundamental problem with SEP licensing stemming from the asymmetry and obscurity of information about SEPs, a problem with particularly profound effects for small- and medium-sized enterprises.

By enhancing transparency and clarity in the SEP-licensing process, the proposed regulation should increase economic efficiency and foster an environment in which makers of SME devices can confidently adopt any standard and SEP holders can be fairly compensated for their technical innovations.

Given that the proposed regulation should help establish balance to the currently broken SEP licensing regime, U.S. policymakers should recognize the need for this reform and direct their energy to supporting and improving it.

The Unequal Power Dynamics of SEP Licensing

Technical standards, such as cellular, Wi-Fi and Bluetooth, play an important role in modern technology by providing consistent protocols and guidelines ensuring compatibility and safety of many products and processes.

Successful technical standards can help facilitate a synchronized operational environment among multiple suppliers, from telecommunications protocols to manufacturing techniques, helping to fuel competition and innovation.

Technical standards promote downstream competition and innovation by setting a baseline that encourages multiple manufacturers to develop competing products with differentiating features, which fosters a rich ecosystem of options.

Despite these benefits, standardization is not without risks. Standardization is a collaborative process where industry participants, working through a standard setting organization, select specific solutions to technical problems to establish uniform protocols.

In nearly all cases, these technical problems have many possible solutions and



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frequently,[1] the most difficult part of the standard-setting process is forming a consensus on which of the competing solutions to adopt.[2]

Whatever solution the SSO chooses becomes indispensable to the standard. Consequently, patents essential to the selected solutions gain significant market power. Developing standard compliant products comes at a cost.

Companies investing in standard-compliant products are anchored to the relevant standard, which can diminish their bargaining power in licensing negotiations. SEP holders that approach device-makers after they have invested in developing and bringing to market a standard-compliant product therefore have the power to extract royalties that exceed the genuine, inventive value of the intellectual property.

This tactic, a type of patent holdup, preys on device-makers that are bound to a standard, with the SEP holder demanding royalties the device-makers would not have agreed to before the standard was set.

Holdup power would be reduced if license negotiations concluded before product development began. But this is not feasible as many SEP holders refuse to enter license agreements until after a product has been developed and entered the market,[3] at which point the manufacturer can no longer walk away from negotiations.[4]

Outside of royalty-free standards, which have a simple transparent process to license the standard, such as Bluetooth, anyone developing a product with standardized features necessarily makes themselves vulnerable to the possibility of holdup down the road.

This can inhibit standard adoption and prevent the full societal benefits of a standard from being realized.

To mitigate the risk of holdup, many SSOs require contributors to commit to licensing their declared-essential patents on fair, reasonable and non-discriminatory, or FRAND, terms. This commitment, when adhered to, eliminates the risk of patent holdup for device-makers, while still ensuring that SEP holders are fairly compensated for their technical innovations.

Unfortunately, some SEP holders circumvent their FRAND commitments and engage in holdup. The availability of injunctive relief against device-makers is well recognized as enabling patent holdup in SEP licensing, but it is not the only cause.

SEP licensing is riddled with a profound information asymmetry that undermines the effectiveness of FRAND commitments. Even determining how many patents have been declared essential to a particular standard,[5] let alone what part of the standard they are essential to,[6] is a tall order.[7]

Studies have found that a substantial fraction of declared-essential patents, as high as 90% for some standards, are actually not essential.[8] Sorting through all this complexity, for tens or even hundreds of thousands of declared-essential patents, is incredibly costly.

In a recent survey, almost all licensees reported insufficient information regarding FRAND royalties — 100% — and the SEP landscape — 97% — as major problems, while only a small fraction of SEP holders reported problems in these areas.[9]

When negotiating with SEP holders, manufacturers face a substantial informational disadvantage in assessing the relevance and validity of that licensor's SEP portfolio for their

product.

SEP licensing's information asymmetry is exacerbated because many SEP holders will only license end-device makers and refuse to license component manufacturers, which are more knowledgeable about the technology than end-device manufacturers.[10]

More than half of SMEs, who typically buy standard-supporting components, indicated in a survey that they lacked the technical knowledge even to begin negotiating a FRAND rate.[11]

Licensing component manufacturers would reduce total negotiation costs because significantly fewer component manufacturers exist than end-device manufacturers, but aggressive SEP monetizers nonetheless insist on licensing at the end-device level where the information asymmetry is greatest.

SEP holders seeking supra-FRAND royalties have additional reasons to target small emerging device-makers. These companies have the least information regarding FRAND licensing and are most vulnerable to the threat of injunctions given their limited resources.

Even though it may cost SEP holders more to negotiate licenses with SMEs than the royalties the licenses will generate, these licenses provide SEP holders inflated benchmark rates they can use in future licensing disputes with larger manufacturers to justify supra-FRAND royalty demands.[12]

In the recent *Apple Retail UK Ltd. v. Optis Cellular Technology LLC* litigation in the U.K. Supreme Court, Optis used licensing agreements with smaller companies to justify a royalty demand more than 50 times what the court ultimately held to be FRAND,[13] forcing the court to conclude that no company "could stay in business paying Optis' rates." [14]

This incentive to target SMEs further deepens the negative impact of information asymmetry in SEP-licensing.

SEP Licensing as a Market for Lemons

Information is the bedrock of efficient markets. If buyers and sellers are equally well-informed about product quality, terms can be reached that benefit both parties to the transaction and that promote efficient investments to maximize gains from trade.

Unfortunately, information in SEP-licensing is highly asymmetric, with licensors knowing much more than licensees. Consequently, the SEP-licensing market is what economists refer to as a market for lemons.

In 1970, George Akerlof showed how asymmetric information undermines market efficiency in a classic paper "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," earning him the 2001 Nobel Prize in Economics.

In a lemons market, products range in quality from superior "peaches" to inferior "lemons," but only sellers know which products are high versus low quality.

Akerlof's key insight was that this information asymmetry undermines the overall efficiency of the market and harms both buyers and high-quality sellers while potentially benefiting low-quality sellers:

- Harm to buyers: Buyers are harmed because they have no way to purchase high-quality products without also either (1) paying for low-quality products they do not want or (2) incurring extra costs to verify product quality before they complete any transaction.
- Harm to high-quality sellers: Buyers' lack of confidence in product quality forces high-quality sellers to (1) withdraw from the market (the most famous case, referred to as "market failure"), (2) lower their price or (3) incur extra costs to demonstrate the quality of their product.
- Potential benefit for low-quality sellers: So long as product quality is difficult for buyers to determine, low-quality sellers can benefit by selling their lemons at inflated prices.

In the current SEP-licensing environment, fully verifying the quality of a SEP portfolio is all but impossible, a dynamic which some licensors exploit to seek and receive supra-FRAND royalties.

Not only does this increase the cost of standard-compliant products, it also deters some device-makers from adopting standards and erodes the credibility of all licensors, including those that actually offer FRAND terms.

The Commission's SEP Regulation: A Framework for Solving the Lemons Problem

The commission's proposed regulation includes four basic reforms that, despite some provisions with problematic drafting,[15] should help to create transparency and provide additional information for SEP licensees.

By reducing the information asymmetry between SEP licensors and licensees, these reforms will promote a more efficient SEP-licensing market and more vibrant adoption of technological standards.

SEP Registry

After a standard is published, SEP holders must register their SEPs before the SEPs can be enforced in Europe.[16] SEP holders that fail to timely register their SEPs cannot claim infringement damages for uses that occur before registration.

This system should incentivize SEP licensors to register their patents, ensuring the registry provides a robust view of the relevant patent universe.

Essentiality Evaluations

Every year, the competence center implementing the regulation will evaluate the essentiality of a random sample of SEPs to provide an estimate of the essentiality rate of each portfolio.[17]

These evaluations allow licensees to negotiate from an informed position without conducting a costly and wasteful investigation of the licensor's portfolio and gives SEP holders an independent report of their portfolio's strength.

Aggregate Royalty Determination

Shortly after a standard is released, stakeholders can initiate a conciliation proceeding whereby an expert provides a nonbinding opinion of the total royalty burden for using a standard.[18]

This opinion helps product developers estimate the licensing burden if they adopt the standard and provides all stakeholders an estimate of the average FRAND royalty per essential patent, a useful reference point in negotiations.

Bilateral FRAND Determination

Before any SEP holder can bring legal proceedings in national courts, it must first engage in a FRAND determination process with the potential licensee.[19]

This process is designed to establish an acceptable FRAND royalty, but it is not binding on the parties or any court. Importantly, this ensures a potential licensee can obtain a third-party FRAND determination without the threat of an injunction.

This framework should help solve the lemons problem by enhancing transparency in SEP licensing. Because all SEPs the holder intends to enforce must be registered in a public database, anyone considering developing a standard-compliant product will know ahead of time with whom they may need to deal.

Because of the public information provided by the essentiality evaluations and aggregate royalty determination, licensees can negotiate with at least some degree of information and confidence that they understand what a fair and reasonable royalty would be for any given SEP portfolio.

The FRAND determination process complements these other reforms by curbing the potential for licensors to exert undue pressure or exploit any remaining informational advantage they may enjoy.

By establishing a preliminary royalty determination as a prerequisite to injunctive relief, the process ensures the parties can negotiate on a more balanced footing. This minimizes the risk of licensees being coerced into accepting unfair terms.

This proposal represents an important step toward solving the lemons problem and bringing informational balance to the SEP-licensing market. If adopted, the proposal will advance efficient outcomes and investments by fostering a more equitable and transparent SEP-licensing ecosystem.

The approach offers an innovative framework for SEP licensing based on a series of incremental improvements where the whole is significantly greater than the sum of its parts.

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[1] Expert Report of Friedhelm Hillebrand on behalf of Nokia at ¶ 11, Nokia Corp. v. Qualcomm Inc., 2330-VCS (Del. Ch. May 22, 2008).

[2] See, e.g., ETSI SMG Meeting No. 24, Dec. 15-19, 1997, ETSI/SMG (97) 5 Part A § 1.

[3] EC Impact Assessment Report at 12.

[4] Case AT.39985—Motorola—Enforcement of GPRS Standard Essential Patents, Comm'n Decision ¶ 320 (Apr. 29, 2014), https://ec.europa.eu/competition/antitrust/cases/dec_docs/39985/39985_928_16.pdf

[5] See Joachim Henkel, Licensing SEPs in the IoT, 51 Research Policy 1, 6 (2022).

[6] Many SEPs are not essential to every device that uses the standard. For example, in the cellular context, many patents are practiced only in network equipment.

[7] Optis Cellular Tech. LLC v. Apple Inc. ¶ 63 [2023] EWHC 1095 (Ch) (May 10, 2023). In some standards, as few as 10% of SEPs are specifically declared. Impact Assessment Report at 18.

[8] Impact Assessment Report at 19.

[9] *Id.* at 36.

[10] *Id.* at 155.

[11] *Id.* at 20.

[12] Optis at ¶ 470(ii)(b).

[13] *Id.* at ¶¶ 342, 494.

[14] *Id.* at 467(iv).

[15] Certain problems have been raised by many stakeholders relating to issues such as inadequate or imbalanced processes in the proposed bilateral and aggregate FRAND determination processes and loopholes in the SEP registry and evaluations. Many of these defects appear to have been addressed in amendments proposed by the

[16] See, e.g., European Commission, Proposal for a Regulation of the European Parliament and of the Council on standard essential patents and amending Regulation Arts. 19-25 (EU)2017/1001, COM(2023) 232 final, 2023/0133 (COD) (Apr. 27, 2023)

[17] See *id.* at Arts. 28-34.

[18] See *id.* at Art. 18.

[19] See *id.* at Arts. 35-60.