

# Is FRAND Efficient?

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# 2012 Academics' Letter to ITC re Injunctive Relief

- “Holders of SEPs put aside their rights to exclude when they agree to make their technology available on terms that are reasonable and non-discriminatory and imply that legal remedies (i.e. monetary damages) are adequate.”

By Electronic Filing  
July 9, 2012  
The Honorable James R. Holbein  
Secretary, U.S. International Trade Commission  
500 E Street, S.W.  
Washington, DC 20436

Re: *In the Matter of Certain Wireless Communications Devices, Portable Music and Data Processing Devices, Computers, and Components Thereof*, Investigation No. 337-TA-745

## **SUBMISSION OF 19 ECONOMICS AND LAW PROFESSORS**

### **The Statute Requires the ITC To Consider Competitive Conditions and Consumers**

19 U.S.C. § 1337(d)(1) states: “If the Commission determines, as a result of an investigation under this section, that there is a violation of this section, it shall direct that the articles concerned, imported by any person violating the provision of this section, be excluded from entry into the United States, unless, after considering the effect of such exclusion upon the public health and welfare, competitive conditions in the United States economy, the production of like or directly competitive articles in the United States, and United States consumers, it finds that such articles should not be excluded from entry.”<sup>1</sup> Congress intended public interest considerations to be “paramount” to the statute’s administration. S. Rep. No. 93-1298, 93rd Cong., 2d Sess. 193 (1974).<sup>2</sup> Under Commission Order, administrative law judges of the ITC now may take evidence on the public interest at the outset of a case, rather than waiting until the end.<sup>3</sup>

### **Our Qualifications To Talk about Competitive Conditions and Consumers**

In this submission, we consider one aspect of Section 337 (d)(1): the impact of

# Social Efficiency of Private Contract: The Standard Story of FRAND's Efficiency

- The baseline assumption in economic theory is that private contracting generally reaches socially efficient results
- The standard economic view of FRAND obligations supports such a view

# “Bad Faith” and “Hold Out”

- This standard view has been adopted by scholars and commentators across the policy spectrum
- The major debate has been the extent to which the parties negotiate in “good faith,” a standard contractual obligation
- But the underlying assumption is that if the parties bargain in “good faith,” generally FRAND terms are socially efficient

# Socially Inefficient Contracts

- Are FRAND commitments always socially efficient in the first instance?
- A large category of contracts are deemed void against public policy, and the standard economic view is that these contracts are generally socially inefficient

Thesis: FRAND Obligations May Increase Static Efficiency But Often May Decrease Dynamic Efficiency, Even With No Holdout

- FRAND may solve the holdup problem (though evidence of holdup appears weaker than commonly believed)
- However, FRAND, by lowering the awards to the patent holder, may decrease dynamic efficiency more than any gains in static efficiency
- Decreases in dynamic efficiency have been tied to “holdout”
- Here, I argue that these inefficiencies may arise from the standard selection process itself.

# Why SSOs May Create Effective Monopsony Power

- Hypothetical #1 (Monopolist): Suppose there is one innovator and many implementers.
- If the innovation is socially valuable, the innovator need not join an SSO and commit to FRAND as the implementers will adopt it as a de facto standard.
- The innovator will earn the non-FRAND profit on any licensing of the innovation.

# Why SSOs May Create Effective Monopsony Power

- Hypothetical #2 (Monopsonist): Suppose there are a few innovators with inventions of differing quality and just one implementer.
- If the innovation is socially valuable, it does not matter if the innovators/implementer join the SSO.
- The implementer will negotiate with each innovator and will balance the cost savings from lowest price against the potential loss in profit from choosing a technologically inferior alternative.
- Importantly, the implementer's choice may be dynamically inefficient, because what is most profitable for the implementer may not supply socially optimal, long-term innovation incentives.

# Why SSOs May Create Effective Monopsony Power

- Hypothetical #3: Now consider a hypothetical with a handful of innovators a large number of implementers.
- Assume that the social and private value of the implementers adopting one standard is very high (e.g., from network effects).
- At first blush, it would seem that there is no problem of monopsony because there are many implementers

# Why SSOs May Create Effective Monopsony Power

- My claim is that, contrary to the standard assumption, there is likely to be an ex ante monopsony problem in the standard selection process itself
- (1) The SSO selection process means it is very unlikely the SSO will adopt a non-member's technology as a standard
- (2) FRAND commitments by members are likely to cement the decision to adopt a member's technology as the standard unless the non-member technology is vastly superior

# Why SSOs May Create Effective Monopsony Power

- Like the monopsonist, the implementers— coordinating their “purchase” like a “buying cartel” through the SSO—may choose a lower quality innovation in exchange for lower (FRAND) royalty
- If the high-quality innovator knows this, it may be forced to join the SSO and agree to lower, FRAND royalties, which may be dynamically inefficient.

# The “Hold Down” Problem of SSOs

- These “hold down” costs may be offset by static and dynamic gains from eliminating holdup.
- In the absence of these offsetting benefits, FRAND obligations should be unenforceable as against public policy

Q & A Slides

# Potential Responses and Replies

- (1) SSO's do not act as monopsonists because the SSO merely chooses technical standards and do not “set prices”
  - Reply: SSO's do effectively set prices by discriminating against non-member innovations.
  - Even if SSO engineers are not guided by management to choose member technologies, the transaction costs of doing so will ordinarily be so high that non-member innovations are a substantial disadvantage.
  - Because FRAND is generally a lower price than non-FRAND, the enables an effective buying cartel on the part of the implementer

# Potential Responses and Replies

- (2) FRAND must provide sufficient incentives to innovate otherwise innovators would not become members.
  - Reply: This is true, but as noted above, privately sufficient incentives to innovate may be much less than the social optimally level of incentives. In other words, technology could be substantially better without FRAND.
    - The fact that implementers are also innovators does not solve this issue, because each potential FRAND member faces the same socially suboptimal trade-off, creating a collective action problem.

# Potential Responses and Replies

- (3) If a technology is so superior that it is clearly “the best,” then judges will take that account in awarding FRAND royalties
  - Reply: Perhaps, but if FRAND is to mean anything, then FRAND royalties will generally be less than “reasonable royalties,” and nearly always “lost profits,” absent FRAND.
    - And, clearly, FRAND will be less than the remedy provided by injunctive relief.

# Potential Responses and Replies

- (4) Judges will at least award under FRAND the amount the innovator would have earned licensing its technology prior to be selected as a standard-essential technology (“ex ante market rate”), and this is sufficient to incentivize innovation.
  - Reply: This is unlikely to be the case for many standard-essential technologies for three reasons.
    - 1. There is no “market-based” rate absent what judges award. The lower the rate awarded by judges, the lower the rate in the market.
    - 2. Many SEPs are ground-breaking technologies for which the social value far exceeds the private, market value. Providing mere private, “market-based” returns may thus be insufficient to generate optimal innovation incentives.
    - 3. As noted, this low rate would not include the benefits contributed by the technology to the value of the standard, potentially providing insufficient ex post incentives for the innovator to adapt and commercialize the technology to applicable standards and to educate the industry about the relevance of the technology to applicable standards.

# Potential Responses and Replies

- (5) The holdup problem justifies FRAND regardless of the dampening of innovator incentives. This is especially so because SEPs are inputs into downstream and improvement innovations.
  - Reply: This is an empirical claim without justification. Rather, the decrease in incentives must be balanced against the gains, which will vary from case to case, industry to industry, and so forth.