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The author assesses the antitrust implications of recent transactions involving thousands of patents.

The Great Patent Purchase

BY EVAN HOFFMAN SCHOUTEN

Introduction

When a consortium of technology leaders, including Apple Inc., Microsoft Corp., Sony Corp., and Research In Motion Ltd., proposed a winning bid of $4.5 billion for 6,000 patents owned by Nortel Networks Inc. (also known as the Rockstar-Nortel transaction), the *Wall Street Journal* referred to the deal as ''the largest intellectual property auction of all time.'' Only a month later, in August 2011, the deal was dwarfed by Google's $12.5 billion acquisition of Motorola Mobility Inc.—and 17,000 patents.

These transactions have sparked protests from industry players and focused regulatory attention on the transfer of IP assets and their potential antitrust implications.

Despite the protests, on February 13, after an extensive investigation into the transactions' likely effects on competition and innovation, the U.S. Department of Justice and the European Commission approved both transactions. With these approvals, the Nortel transaction may go forward.

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The proposed Google-Motorola transaction, however, remains stalled, awaiting a final disposition from the Chinese, Taiwanese, and Israeli antitrust agencies. The Chinese, in particular, appear to be in no rush to conclude their investigation.

Despite being governed by disparate laws and regulations, all of the agencies have focused on the potential impact on both competition and innovation, highlighting the uneasy alliance between IP law and antitrust guidelines. As the Justice Department explained, the proposed transactions ''highlight the complex intersection of intellectual property rights and antitrust law and the need to determine the correct balance between the rightful exercise of patent rights and a patent holder's incentive and ability to harm competition through the anticompetitive use of those rights.''

While patents essentially award their holders a ''legal monopoly'' over the technology and products enabled by protected IP in order to encourage innovation, competition policy strives to eliminate monopolies and their impact on output and pricing. Of course, one needs to be careful with language here: the fact that a patent conveys its owner a ''legal monopoly'' need not imply that the patent confers market power from an antitrust perspective.

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Cause for Concern

It is useful to look back to try to understand why both the Nortel and Motorola transactions have attracted so much regulatory attention. In both cases, the key issue among the regulators appeared to be the potential for the acquirers to use their new patents to raise rivals' costs. This is of particular concern with IP involving wireless standards, as control and access to standards can enable—or prevent—rivals from participating in the market under certain economic conditions.

Wireless devices are useful only to the extent to which they can interact with one another, allowing users to communicate with others through a variety of different applications, including, for example, phone, email, and mapping. Wireless devices are examples of products that benefit from what economists call ''positive network externalities.'' Where positive network externalities exist, ''the value of connecting to the network depends on the number of *other* people who are already connected to it.''[1]

What has this to do with potential antitrust concerns? In the presence of network externalities, it is often the case that industry participants—both suppliers and consumers—are better off when the parties establish technology standards that ensure interoperability. This often involves collaboration among competitors—behavior that may at least preliminarily appear to be contradictory to our antitrust laws and regulations.

For example, if Apple, RIM, Microsoft, Google, and others were to set prices jointly, this would be *per se* illegal, because such an agreement would almost certainly lead to increased prices and less competition. And we know that consumers are nearly always worse off when rivals coordinate on prices.

In contrast, if Apple, RIM, Microsoft, Google, and others collaborate to establish standards (for example, specified technical protocols) that they all agree to follow so that wireless devices are able to with one another and meet competitive performance benchmarks, the size of the network expands to the benefit of consumers. Moreover, consumers then don't have to worry about picking the wrong technology and can count on future competition among vendors so that they can avoid lock-in.

In other words, a consumer can switch across products at relatively low costs. While such agreed-upon standards are generally pro-competitive—that is, they benefit competition and consumers—they can also provide firms with the opportunity for anticompetitive behavior. For example, after a standard is set, the firm whose patent becomes essential to the standard (known as a Standard Essential Patent or SEP) may decide to extract a payment higher than that which was attributable to the value of the patented technology before the standard was set.

In such a case, the firm is said to ''hold up'' its rivals. Such behavior, if permitted, is likely to distort innovation and raise prices.

To protect against this, most standard setting organizations (industry-specific groups comprised of firms that establish rules to jointly govern the use of select IP rights) require that before a standard is set, firms agree to make disclosure and licensing commitments with respect to patents that would become essential. These firms must also agree upfront to licensing terms that are ''reasonable and non-discriminatory,'' or ''RAND,'' for short.

Similarly, in Europe, firms typically agree upfront to licensing terms that are fair, reasonable, and non-discriminatory (or ''FRAND'').

The possibility that the proposed acquisition of Nortel patents would enable RIM, Microsoft, Apple, or Google to exploit their position as the owners of SEPs to hold up or exclude rivals was a central issue for the DOJ and the European Commission even prior to their February 13 decisions—a concern likely reinforced by the fact that the 17,000 patents Google hopes to purchase through the Motorola Mobility transaction are said to include hundreds of SEPs relevant to wireless devices.

The agencies' specific concerns were that post-transaction, the acquiring firms might be able to charge supracompetitive licensing rates, compel prospective licensees to grant them the right to use the licensees' differentiating intellectual property, charge licensees the entire portfolio royalty rate when licensing only a small subset of the patent holder's SEPs in its portfolio, or use the threat of an injunction to prevent or exclude competitors' products using those SEPs from entering the market.

Ultimately, although the regulatory agencies concluded that neither of the proposed transactions would likely substantially lessen competition for wireless devices, both agencies also indicated a commitment to closely monitor the behavior of the parties post-transaction.

Market Share and Harm to Rivals

With regard to RIM and Microsoft's acquisition of Nortel patents, the agencies concluded that neither firm had a market share in mobile platforms large enough such that a strategy based on increasing licensing costs to rivals would be profitable. In other words, if RIM and Microsoft were to increase licensing fees on their new SEPs (e.g., raise their rivals' costs in order to make them less competitive), they would likely lose more money due to the reduced volume of purchases of their rivals' devices than they would gain in increased sales of their own wireless devices.

In contrast, the agencies recognized that both Apple and Google *would* have a share of mobile platforms large enough to benefit significantly from raising their rivals' costs. In essence, any losses that the companies might suffer on the patent side by charging supracompetitive licensing rates (and thus potentially cause licensees to sell fewer devices and/or to stop licensing from them), Apple and Google could readily recover through increased sales of iPhones or Androids.

Despite their concerns, both agencies ultimately approved the proposed transactions, based on the following factors:

- Motorola Mobility already had a long and aggressive history of extended disputes with Apple, Microsoft, and others. In other words, because Motorola Mobility was already following a less-collaborative, more aggressive path, Google's acquisition of Motorola Mobility would be unlikely to alter that policy materially.

[1] Shapiro and Varian, ''Information Rules: A Strategic Guide to the Network Economy,'' Harvard Business School Press, 1999.

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- Both Apple and Microsoft publicly committed not to seek injunctive relief on any SEPs they acquired in the transaction, acknowledging that such behavior would be contrary to the FRAND agreements in place. The agencies concluded that these commitments significantly reduced the possibility that either Apple or Microsoft would use the threat of an injunction to hold up or exclude competitors, inhibit innovation, or reduce competition.
- Google also committed to refrain from seeking injunctive relief for the infringement of SEPs against counterparties; however, it agreed only to refrain from injunctive relief for disputes involving future license revenues and, even then, placed conditions on the behavior of the counterparty. For example, to avoid an injunction, the counterparty must agree not to challenge the validity of Google's patent, to pay the full disputed amount into escrow, and to refrain from enjoining Google. Because Google's commitment was much less inclusive than Apple and Microsoft's, and thus did not provide the agencies with the same level of assurance, both announced their intention to continue to monitor the use of SEPs in the wireless device industry.

IP Litigation in the Wireless Industry: What's Ahead?

Although the U.S. Department of Justice and European Commission have both determined that the existing standards are procompetitive and that neither the Rockstar-Nortel nor the Google-Motorola transactions will likely substantially reduce competition, we should not expect a lull in private litigation. To the contrary, IP litigation among industry participants is on the rise, increasing by roughly 25 percent a year since 2006.[2]

Why has such an innovative industry become so litigious? A quick look at the potential size and profitability of the market should provide the answer.

Since the introduction of the iPhone in 2007—and perhaps even prior to that—there has been a standards war with respect to wireless devices. Notably, even though news outlets have focused on smart phones, a wide variety of popular consumer electronics (e.g., video game consoles, GPS devices, and video players) rely on the very same standards that are at issue in the smart phone battles.[3]

The financial stakes are enormous: less than three years after introducing the Android smart phone platform, Google suggested that the company could generate $10 per Android device per year—driven almost entirely by advertising.[4] With 850,000 new Android devices activated each day,[5] the dollars potentially involved are staggering. Access to the palms of consumers' hands (and to their pockets) has the potential to disrupt multi-billion dollar industries.

Despite the magnitude of the numbers above, this is still a young industry, and what is at stake for industry participants is largely undefined. Perhaps for this reason, actions taken to prevent, defend, or initiate litigation have been significant.

As IP is increasingly treated as a commercial asset, patent-driven transactions are becoming common practice. This has led to an increased number of lawsuits among rivals and technology partners alike. It may also

Other Forces Shaping the Mobile Broadband Market

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The standards-setting process is central to the evolution of telecommunications networks and mobile broadband services, and competition authorities can be expected to monitor the conduct of the owners of large patent portfolios. However other forces shaping the mobile broadband market now and in the future, including carriers and content providers, can also be expected to oppose attempts by technology patent owners to exercise market power.

The largest U.S. wireless carriers—including Verizon Wireless, AT&T, T-Mobile (and its parent Deutsche Telekom), Sprint, MetroPCS, Clearwire, and U.S. Cellular—are members of 3GPP, the umbrella organization uniting mobile telecommunications standards-setting bodies. These carriers benefit from a transparent and competitive process for developing network technologies, which expand the market through interconnectivity across carriers and users. Wireless carriers face powerful incentives to ensure that technology patent owners are not able to exercise market power that would increase the cost of network equipment (a key input to the carrier business) and the cost of mobile devices.

Content providers also play a significant role in the mobile telecommunications industry.

Smart phone users have been particularly interested in accessing sports content, a fact reflected in the prices that providers of such content have been able to command. For example, in 2010 Verizon Wireless won the right to be the exclusive mobile distributor of live NFL games in a deal valued at $720 million.

More recently, during the first weekend of the 2012 NCAA Men's Basketball Tournament it was reported that 20 percent of all tournament-related web traffic was accessed via smart phones and tablets. The popularity of sports and other consumer content delivered over mobile devices gives content owners a powerful incentive to resist potential efforts by technology patent owners to raise the price of mobile devices through the exercise of market power.

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[2] Rao, Leena, ''294 Patent Lawsuits Were Filed in August 2011; Mobile Handset Complaints Up 25 Percent Yearly,'' *Techcrunch*, September 10, 2011, available at http://techcrunch.com/2011/09/10/294-patent-lawsuits-august-2011.

[3] http://www.ipwatchdog.com/2012/03/07/smartphone-patent-wars-giving-patents-bad-rap/id=22612/

[4] http://tech.fortune.cnn.com/2010/07/28/schmidt-one-billion-android-devices/

[5] http://googlemobile.blogspot.com/2012/02/androidmobile-world-congress-its-all.html

indicate—as many experts have suggested—that, in an attempt to prevent litigation, firms will become more interested in acquiring patents for defensive reasons.

Some closing questions to consider: If IP transactions are largely defensive, should regulators be concerned with competitive effects in product markets? Or is creating patent balance among major industry participants an end in and of itself?

Is there a struggle for a share of intellectual property that is oddly separate from the competition defined by price and product, and instead driven by risk of litigation? And, if so, could one view the Justice Department and the European Commission rulings on the proposed transactions in the same Statement as evidence that regulators view these transactions as providing adequate balance of power among the key industry participants?

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