

# Unfair and unreasonable

## The Commission is demanding that Microsoft license its intellectual property to its rivals for nothing

by *Philip Marsden\**

The European Commission is ordering Microsoft to give its intellectual property away to its rivals or face staggering penalty payments. A royalty rate of zero (or even close to zero) undermines intellectual property rights, is misguided competition policy and risks violating global trade rules. Rather than starting any new proceedings for fines for alleged non-compliance with its own vague obligations to charge “reasonable” royalties, the Commission should set out clearly what commitments this dominant firm must meet, and give it a chance to meet them. The threatened fine is all the more disturbing for its timing: with the Court of First Instance still to rule on whether Microsoft is even required to license the interoperability information at all, the Commission only adds pressure to an already controversial case.

### Undermining IP rights

Rather than await the judgment of the Court, due this September, the Commission ordered Microsoft to give rival software manufacturers the information they need to access its operating system and thus have their products benefit from the ubiquity of the Windows and now Vista desktops.

The Commission said that the proposed royalty rates would not be Fair, Reasonable and Non-Discriminatory (FRAND). Unfortunately, this term “FRAND” is not very helpful. It is controversial, even among IP experts. There is no objective or independent way for a defendant, or even for the Commission, to identify what it means. When the Commission insists on using it, however, the courts have provided some guidance on how to find what it might mean in a particular case. From the *Commercial Solvents*, *Hugin*, *Magill* and *IMS Health* cases, European competition case law has been clear: where the Commission asks a defendant to comply with an imprecise obligation, it must set up a procedure whereby both sides can work together to make the commitment more precise. Threatening a fine for non-compliance with an as-yet undefined commitment does not help move the case towards a solution.

As a start, the Commission should have elaborated a bit on what royalty would be fair, reasonable and non-discriminatory in this case. Instead, and under continuing pressure, it was up to Microsoft to suggest a series of prices, which the Commission rejected without providing any further guidance on how low it had to go. Microsoft’s most recent offer was a maximum royalty rate of 5.95%. PricewaterhouseCoopers was engaged to assess the reasonableness of this rate and found it to be 30% less than the average market value of the rights. Presumably, it also seemed fair and reasonable to licensees such

as Qwest, which recently agreed to pay royalties under this programme. Nevertheless, the Commission’s monitoring trustee Neil Barrett felt that rate was still too high, claiming that rivals need a 6% -10% rate of return or they would not be able to profit from the rights.

Obviously this assessment was disproved by licensees being willing to pay for access, and by PwC’s study. Moreover, it does not follow from the trustee’s finding that Microsoft’s rights should be *given away*. His argument was that there was nothing inherently innovative in Microsoft’s IP rights to justify a charge. This is odd – the rights have been awarded patents in several countries already so they have clearly been found worth protecting. Even if they had not qualified for IP protection, they are clearly trade secrets for which no requirement of “innovation” is needed. It is completely inappropriate for the Commission to demand that Microsoft show that they constitute genuine innovation over their obvious value as communication protocols for the desktop.

Ordering that such rights be given away is what is unreasonable. The IP rights in question obviously have some value, or rivals would invent them themselves. They can’t, because they do not know how to interoperate with Microsoft’s desktop, and it is only right that the creator of that desktop should charge them some fee for that access. The access depends on Microsoft’s commercially sensitive invention, which it is entitled to protect and charge for its use. More than this, however, who is the Commission to require and then judge that an IP right has innovative value or not? Is DG-Comp a patent authority now? Does it have experts in intellectual property on its case team? And even if it did, isn’t the fair, reasonable and non-discriminatory approach for a competition authority to liaise with the appropriate IT and IP departments to determine whether or not these IP rights should be given their usual protection, before such an obviously detrimental and irreversible order as giving the rights away is ordered?

The Commission deems the rights to be of no value, even though they cost a lot to develop. Moreover, it would be fair, reasonable and non-discriminatory to charge licensees by the value they ascribe to them. A FRAND price should consider this and require them to pay a sum linked to how much they value the rights. Obviously they want to make money from getting their products onto Microsoft’s desktop, and so it is only fair and reasonable that they pay something for that. That value could be linked to their projected revenues: Microsoft knows how much it would cost to interoperate with its operating system, they know how much they would

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make off that. Rather than a free-ride to profits, they should bargain for the rights.

Indeed, in defending its decision to order Microsoft to provide interoperability information, the Commission told the Court of First Instance that they would not permit free-riding to chill innovation in the first place, because Microsoft would still be allowed to charge for such access (see Annex B.5 to the Commission's defence). Denying that now is a most UNFRANDLY response to what is still an unclear and unproven "problem". Taking away the right to charge for providing interoperability before the Court of First Instance has even found that interoperability should be required is completely inappropriate. Ordering penalty payments for "non-compliance" with such a controversial order – and one still subject to appeal – appears surreal.

### Distorting competition

But would the Commission's order benefit competition? To identify that, we would first expect to see some harm that needs to be remedied. What is the harm alleged here? Without free access to Microsoft's protocols, would competition really be "eliminated"? Or would rivals merely have to pay something for that access? Surely they should do so, since that will connect them to a valuable network. They may want to pay nothing at all but that surely isn't a credible "first offer" for any negotiator. Is it really true that any price above zero would be supracompetitive? If that is the Commission's argument, then where is the evidence that rivals are being priced out of the market?

Licensees are willing to pay a royalty and are still in existence. What of the actual complainants? Are IBM and Sun being eliminated by having to pay a fraction of the value to them of access to Microsoft's operating system? Hardly – they can pay for access or forgo the opportunity as they wish, but that should be their decision, not the Commission's. Either way, they will not be eliminated from the market.

This is an abuse of dominance case which, under current discussions about article 82, requires some evidence of likely harm to competition, and – one would hope – consumers, in order to justify intervention. So, where is the detailed showing of such harm? There isn't any. Charging a royalty does not keep rivals out of a market. It lets them in. Nor does it reduce consumer choice or increase prices. Presumably one expects to pay something for any added functionality and services the complainants may provide. And if no harm can be identified, where is the benefit to competitors, competition and consumers from this intervention? There is no measurable or likely benefit that can justify such undermining of intellectual property rights. Indeed, the only clear and obvious harm is to Microsoft, and its incentives to innovate.

The credibility of the Commission and any governments who support this bizarre approach are also at risk. Competition authorities should not override their sister patent authorities, let alone through cases like this. If governments actually think that intellectual property rights should be given away, then they should agree (and, in Europe, that requires most of them) to tighten up the patent laws. That does not allow them to take away rights granted in other countries, though – so even then, their interventions must be

cautious. Destroying patent rights through a competition case is not appropriate, and undermines the important policies underlying IP protection.

Expropriating Microsoft's property in this case is a reminder of the bizarre remedy in the *Media Player* case – where the Commission ordered the company to produce for the European market a degraded product with less functionality, but at the same price. That order offered no benefit to competition, was rejected by consumers and did not help rivals compete with Microsoft. Windows N (without Media Player) was the first product designed by a competition authority, and it roundly failed in the market, hardly spurring innovation and competition. Perhaps the Commission should have learned from that mistake before ordering that other intellectual property rights should be given away as well.

Ordering a successful incumbent to give its rivals a helping hand – by handicapping it with degraded products or taking away its trade secrets – subsidises less efficient competitors, and eventually sacrifices innovation, productivity and growth. It is hardly sensible competition policy.

### Tripping up on TRIPs

In addition to undermining the patent laws, the Commission's approach also violates international treaties. The World Trade Organisation's Treaty on Trade-Related Aspects of Intellectual Property Rights (TRIPs) only permits governments to order compulsory licensing in clearly defined conditions, one of which requires that there is adequate remuneration. No remuneration at all is clearly inadequate and smacks of expropriation, by the EC, of intellectual property rights that have been earned in many different markets, but which are now at risk everywhere.

The remedy sought is clearly disproportionate to any alleged harm, and amounts to a global and irrevocable destruction of Microsoft's intellectual property rights in this area. It is odd that the European Commission, usually such a stalwart proponent of global IP protection and even competition rules at the WTO, should choose an action that can only undermine both efforts.

### Conclusion

In sum, the Commission's latest step in the Microsoft saga undermines IP rights, and the incentives for innovation, competition and productivity that underlie those rights. Instead, the Commission should be underlining the importance of intellectual property protection; it should await the Court judgments that are on point and imminent; and in the meantime, it should tailor its interventions to address clear and likely harms to competition for the benefit of consumers.

### References

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