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A BRIEF ANALYSIS OF POLICY AND LITIGATION

Court Rejects Standards for Debit Card Interchange Fee Cap

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Lona Fowdur is a Senior Economist with EI. She specializes in Applied Industrial Organization, and has analyzed issues involving antitrust and regulation in a wide variety of industries.

Judge Richard J. Leon of the U.S. District Court for the District of Columbia recently ruled that the Federal Reserve Board (FRB) overstepped its statutory authority by setting too high a cap for debit card interchange fees. These fees are payments from merchants to merchant-acquiring banks that are transmitted to card networks and that the networks then remit to the bank that issues the card. The Durbin Amendment to the Dodd-Frank Act requires the FRB to set a ceiling on such fees. The FRB argued that certain transaction-specific costs ought to be included when setting the cap because debit card transactions could not occur without generating such costs. Plaintiffs, including trade associations and merchant groups, argued that the Amendment did not allow the FRB to include these costs, and the judge agreed.

Interchange fees have traditionally been set by card networks, like Visa and MasterCard that vie for the business of card issuers and merchants. Higher interchange fees increase banks' incentives to issue the network's card, and banks may respond by offering their customers incentives, such as lower fees, to carry and use the card. Higher fees, however, also deter merchants from accepting the network's card, which makes the card less valuable to potential users and lowers the volume of transactions on the network. Lower interchange fees have the opposite effect; banks have less incentive to issue the network's card, but more merchants accept the card.

As the use of debit cards has grown, so has the volume of interchange fees. Merchant groups complained to Congress that collusion between the networks was resulting in excessive interchange fees. These complaints led to the passage of the Durbin Amendment.

It is unclear what effect, if any, lower interchange fees will have on consumers. Ultimately, customers pay the costs of using debit cards either through retail prices or through debit account fees. Whether lowering the interchange-fee cap benefits consumers depends on the degree to which merchants pass through their cost savings to consumers in the form of lower prices and the extent to which banks increase their fees on debit accounts to compensate for their loss of revenue.

Also In This Issue

USTR Disapproves USITC 337 Ruling on Apple v. Samsung

Robert D. Stoner describes a recent decision by the U.S. Trade Representative (USTR) to nullify an exclusion order from the U.S. International Trade Commission (USITC) that would have barred the import of certain Apple smart phones and tablet computers. The USITC found that those products infringed on a standard-essential patent that Samsung had agreed to license on a fair, reasonable and non-discriminatory (FRAND) basis. The USITC also determined that Samsung had abided by its FRAND obligation. The USTR apparently differed on the latter point. Considering whether a firm has abided by its FRAND commitment requires a highly fact-intensive investigation of the negotiating process.

Judge Rules that Apple Conspired to Raise E-Book Prices

Clarissa A. Yeap discusses the judge's opinion in the recent e-books case. The judge found that Apple facilitated collusion among five major publishers. The primary mechanism of the collusion among Apple and the publishers was the Apple Agency Agreement, which Apple entered into separately with each of the five publishers. The agreement included a Most-Favored-Nation (MFN) clause that stated that each publisher was required to lower the price of every e-book on Apple's retail website to match the lowest price offered by any other retailer. The judge found that the MFN clauses were the key provision that enabled the conspirators to shift the industry as a whole to higher retail prices.

USTR Disapproves USITC 337 Ruling on Apple v. Samsung

Robert D. Stoner

The U.S. Trade Representative (USTR), in a virtually unprecedented move, recently disapproved an earlier U.S. International Trade Commission (USITC) determination issuing an exclusion order under Section 337 of the Tariff Act. The order would have excluded certain Apple Inc. smart phones and tablet computers from being imported to the United States. Those products allegedly infringed a standard-essential patent owned by Samsung Electronics. The conflicting decisions hinged on whether Samsung had violated its obligation to license that patent on a fair, reasonable and non-discriminatory (FRAND) basis as it had promised to do when the patent was embedded in the standard. The USITC effectively ruled that Samsung did not violate its FRAND obligations. By contrast, the USTR decision effectively found that the USITC had not demonstrated that Samsung had made a bona fide FRAND offer, thereby reasoning that the USITC determination contravened the public interest in having firms with standard-essential patents abide by their FRAND commitments.

The USTR endorsed a view expressed in an earlier policy statement by the U.S. Department of Justice (DOJ) and the Patent and Trademark Office (PTO) that exclusion orders based on standard-essential patents should be issued only in very limited circumstances. That statement, in language quoted by the USTR, suggests that such orders may be issued if the firm that wishes to use the patent refuses to pay a FRAND royalty or to negotiate to determine FRAND terms. Whether that exception applies depends on the parties' behavior in negotiations. Did the patent holder try to "hold up" the would-be licensee, using the leverage created by the inclusion of its patent in the standard to receive a high royalty? Or did the patent holder negotiate in good faith and fulfill its FRAND obligation while the would-be licensee rejected a legitimate FRAND offer, perhaps even engaging in "reverse hold up" to gain a strategic advantage? On that point, the USITC and USTR differ.

The USITC found that Samsung bargained in good faith and fulfilled its FRAND obligations, with no indications of hold-up. It indicated that, if anything, Apple had engaged in reverse hold up. Apple challenged the validity of Samsung's asserted patents and the existence of infringement before it took a license. In effect, the USITC found Apple refused to accept a FRAND offer or to negotiate a FRAND license. The USITC also found that it was reasonable for Samsung to offer Apple a reduced royalty rate if Apple would agree to license some of its patents to Samsung as part of a comprehensive cross-licensing arrangement. The USITC observed that cross-license arrangements are consistent with industry practice. Moreover, the USITC indicated that Apple may have unjustifiably insisted on a lower royalty rate from Samsung similar to that achieved by licensees who had given Samsung other considerations, such as cross-licenses, in addition to royalties.

EI Principal Robert Stoner has consulted in a number of matters concerning standard-setting organizations and standard-essential patents.

> "Some have argued that the USITC may not be the best venue to address licensing issues related to standard-essential patents."

The USITC position was controversial. One commissioner dissented from the finding that Samsung had made FRAND terms available to Apple. Observers who have objected to the USITC position make two major arguments. First, some of Samsung's offers allegedly involved unrealistically high royalty rates. Such offers would have resulted in a very high aggregate Apple royalty when combined ("stacked") with royalties on other asserted standard-essential patents. Some have noted the challenges in determining if an offer meets the terms of a FRAND obligation, particularly if other standard-essential patents also must be licensed.

Second, some observers have questioned the USITC's determination that Samsung's offer involving cross-licensing constituted a legitimate FRAND offer. The USITC noted that cross-licensing is common. Some commentators have also stated that offers involving cross-licensing can be FRAND offers. Nonetheless, determining whether an offer involving cross-licensing is FRAND can depend on numerous factors that are specific to the industry, parties, technologies and

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Judge Rules that Apple Conspired to Raise E-Book Prices

Clarissa A. Yeap

EI Senior Economist Clarissa A. Yeap specializes in empirical microeconomic analysis in the assessment of liability and damages in antitrust, intellectual property and class action matters.

After a closely-watched trial, Judge Denise Cote of the Southern District of New York ruled that Apple had colluded with the five largest publishers in the United States to raise e-book prices. In Judge Cote's opinion, Apple played a pivotal role by providing the mechanism for collusion in the form of Apple Agency Agreements that included a Most-Favored-Nation (MFN) clause. That collusion, a per se violation of the antitrust laws, caused e-book prices to jump from an average of $9.99 per book to $12.99 or $14.99 in the space of a few weeks. The five publishers, Hachette, HarperCollins, Macmillan, Penguin and Simon & Schuster, had all previously reached settlements in this case without admitting wrongdoing. Apple was the only defendant that proceeded to trial and has already announced its intention to appeal Judge Cote's ruling to the Second Circuit.

In her written opinion, Judge Cote explained how Apple and the five publishers took advantage of the opportunity provided by Apple's launch of its iPad tablet to achieve their common interest in eliminating competition and raising prices for e-books. At the time of the conspiracy in late 2009 to early 2010, Amazon was the leading retailer of e-books and charged a retail price of $9.99 per book, which the publishers uniformly considered to be too low. At this time, Amazon and the publishers operated on a wholesale model where $9.99 was close to the average wholesale price of e-book content. Amazon, which wanted to gain market share in the expanding market for e-books and consequently gain dominance for its Kindle e-readers, was willing to earn low margins and even absorb losses on e-books priced above $9.99 at wholesale. The publishers were concerned that the low prices set by Amazon would become the standard for e-books and threaten the prices of books sold at brick-and-mortar outlets, particularly hardcover books that were priced substantially above Amazon's e-book price. The publishers also worried that Amazon's growing dominance would enable it to negotiate lower wholesale prices in the future or even compete directly in e-book publishing. Apple was preparing to launch e-book content on its iBookstore as a complement to its launch of the iPad. It had an interest in eliminating competition from low-priced e-books from Amazon and in limiting competition in retail e-books in the long term. When the publishers suggested the agency model as an alternative to the wholesale model, Apple recognized the opportunity to construct a form of agency contract that would cause an industry-wide shift to a world with higher prices for e-books. Apple could achieve this shift only with the cooperation of the five major publishers who accepted the terms of the agency contracts.

According to Judge Cote, "Apple seized the moment and brilliantly played its hand. ... It provided the Publisher Defendants with the vision, the format, the timetable, and the coordination that they needed to raise e-book prices." The primary mechanism of the collusion among Apple and the publishers was the Apple Agency Agreement, which Apple entered into separately with each of the five publishers. By moving from the wholesale model to the agency model, the publishers achieved their goal of regaining control over retail prices. The agency agreement included price tiers based on the pricing for other book formats and price caps at $12.99 to $14.99 for newly released books. Apple would receive 30% commissions from the sales of e-books. The 70% remaining to the publishers would range from $9.10 to $10.50, which was only slightly more, at best, and less at worst, than the $9.99 or higher wholesale price they were then receiving from Amazon and other retailers. The publishers were willing to accept these terms for the perceived long-term benefits of raising e-book retail prices, rather than for their short-term effect on profits. They were willing to cede a sizeable commission to Apple and agree to other terms because they understood that they could not unilaterally raise retail prices without the coordination provided by Apple and the timely coincidence of its iPad and iBookstore launches.

Judge Cote's opinion states that the MFN clauses in the Apple Agency Agreements were the key provision that enabled the conspirators to shift the industry as a whole to higher retail prices. The MFN clause stated that each publisher was required to lower the price of every e-book on

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USITC Order Dissaproved

products involved. (The patents proposed for cross-licensing, which are not standard-essential, are at the center of another dispute between Apple and Samsung. In that dispute, the USITC recently awarded Apple an exclusion order against certain Samsung products. That order is currently under review by the USTR.)

Some have argued that the USITC may not be the best venue to address licensing issues related to standard-essential patents. The USITC can only issue exclusion orders; it has no authority to award damages for infringement. Product exclusion may be a less desirable remedy when standard-essential patents are at issue, because whole categories of products could be banned based on the failure of a bilateral FRAND negotiation and the USITC's subsequent ex-post evaluation of whether FRAND commitments have been met. Perhaps for that reason, the DOJ-PTO statement urges the USITC to consider whether money damages rather than exclusionary relief is the appropriate remedy for infringement of a standard-essential patent.

Moreover, because the USITC does not assess damages in Section 337 matters, it may not be in the best position to determine what the appropriate royalty would have been in the event of infringement. The absence of that experience may make the USITC a less desirable venue for disputes involving FRAND negotiations, as the question of an appropriate royalty is related to the question of the reasonableness of an offer made in negotiations. (U.S. district courts are the primary venue for determining royalties and damages in patent infringement suits.)

Standard-setting organizations themselves may be able to avoid future litigation by developing more explicit terms for licensing essential patents. For example, before a patent is embedded in a standard, the holder may be required to commit to royalty rates. Bilateral negotiations to work out different arrangements, such as those involving cross-licensing, would be allowed, but if they failed, the parties would use the royalty rates in the agreement rather than engage in extensive litigation. Given the uncertainties involved in the development of technologies and the use of standards, however, patent holders and standard-setting organizations may find it difficult to require explicit commitments concerning royalties.

If the USITC is to consider whether the parties in a Section 337 matter that involves a standard-essential patent have engaged in either hold up or reverse hold up, it must confront a number of difficult questions that require a highly fact-intensive, ex-post investigation of the negotiating process. The USTR decision instructed the USITC that to fully assess the public interest issues in cases involving standard-essential patents, it should develop a "comprehensive factual record" on the essential nature of the patent and the negotiating history of the parties. It should also make explicit findings assessing the degree to which FRAND obligations were met based on that record.

E-Book Prices

Apple's retail website to match the lowest price offered by any other retailer, even if the publisher did not control that other retailer's price. This meant that any price change by a retailer other than Apple would result in steep losses to the publishers after they paid Apple its 30% commission. The MFN clause ensured that the publishers would move all other e-book retailers to the agency model with the same pricing structure to avoid having to lower retail prices of e-books sold through Apple. Indeed, the publishers acted in concert to pressure Amazon to move to the agency model shortly before the launch of Apple's iPad and iBookstore. The publishers also offered Google, a new entrant to e-book retail in early 2010, the agency model as its only option for e-book content despite initial discussions that implied other options. This behavior ensured that there was no retail price competition for e-books, with retail prices effectively set by the Apple Agency Agreements. Apple achieved its goal of eliminating competition for its iBookstore and the publishers achieved their goal of maintaining high prices for e-books and protecting the value of print books.

Judge Cote found substantial direct and circumstantial evidence that "Apple not only willingly joined the conspiracy, but also forcibly facilitated it." The judge ruled that Apple was in per se violation of Section 1 of the Sherman Act as a direct participant in a horizontal price-fixing conspiracy. The judge later issued an injunction banning Apple from entering into distribution agreements with the publishers that include MFN clauses or other limits on discounting. Apple contends that because it was in a vertical relationship with the publishers, per se liability is inappropriate. It has vigorously challenged the ruling and plans to appeal.

EI News and Notes

Toshiba Defeats Allegations of Collusion

A jury in U.S. District Court in San Francisco found for Toshiba in a civil case where the plaintiff alleged that firm had fixed prices of liquid crystal display panels. EI Principal and Board Chairman Barry C. Harris analyzed both liability and damage issues and testified in deposition for Toshiba. He considered how Toshiba's costs, product offerings and status as a net purchaser of LCD panels affected its incentives to participate in the alleged cartel. Dr. Harris was assisted by Matthew B. Wright, Michael G. Baumann and Laura A. Malowane. Toshiba was represented by the law firm of White & Case.

Presentations on Copyright and Licensing and on the Challenges Facing the Music Business

Stephen E. Siwek recently made two presentations to a conference on "How to Make a Living From Music." The first was on "Copyright and Licensing Structure of the Music Business." The second was on "Global Challenges to the Music Business." The conference, which was held in Manila, was sponsored by the World Intellectual Property Organization, the Intellectual Property Office of the Philippines, and the Ministry of Culture, Sports, and Tourism of the Republic of Korea.

EI Honored for Work in Communications Regulation and Mergers and Acquisitions

Acquisition International has named EI "Communications Regulation Firm of the Year - Washington DC." In addition, Acquisition International presented EI with a Mergers and Acquisitions Award. That award celebrates excellence and commemorates the achievements of those involved in seeing a deal through to completion. Acquisition International is a monthly magazine published in London by AI Global Media Ltd. It describes itself as "the definitive magazine for VCs [venture capitalists], corporate finance advisers and top tier management."

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