AT&T After the Divestiture

Some less publicized but significant changes are examined; areas of conflict, uncertainty may arise

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It is universally known that on January 1, 1984, the American Telephone and Telegraph Company (AT&T) was divested of its ownership interests in the 22 Bell Operating Companies (BOCs). *See, United States v. AT&T,* 552 F. Supp. 131 (D.D.C. 1982, *aff'd sub nom. Maryland v. United States,* 103 S. Ct. 1240 (1983). *See also, United States v. Western Electric Co., Inc.,* 569 F. Supp. 1057 (D.D.C. 1983). The divestiture marks the culmination of almost a decade of litigation involving AT&T and the Department of Justice. Quite aside from the obvious and dramatic changes the divestiture brings to the manner in which telecommunications services are provided in the United States, the Bell System break-up also brings about dramatic changes in the way AT&T patents (defined to also include nonpatented technical information) will be licensed to the divested BOCs and third parties. Those who desire to license such patents directly from AT&T or sublicense them from the BOCs must become conversant with these changes.

THE 1984 DIVESTITURE: TERMINATION OF COMPULSORY LICENSING OF AT&T PATENTS

By way of background, under a consent decree entered into by AT&T and the Department of Justice in 1956, AT&T was required to grant to *all* applicants nonexclusive licenses for existing and future AT&T patents and to provide the technology necessary for manufacturing equipment for which the license was acquired. *See, United States v. Western Electric Co., Inc.,* 1956 Trade Cases (CCH) 71, 134 (D.N.J. 1956). The primary impetus for these compulsory licensing provisions was the recognition that AT&T possessed an overwhelmingly dominant position in both the telecommunications and electronics technology markets, and would be able to use ratepayer-financed revenues to support research and development.

More recent developments, however, led District Court Judge Harold Green, who is presiding over the divestiture, to conclude that termination of the compulsory licensing provisions of the 1956 consent decree would not be inconsistent with the public interest. This conclusion was reached over the objections of AT&T's equipment manufacturing and long distance competitors.

The court took note that AT&T increasingly faced significant competition from domestic and foreign competitors due to the advent of rapid technological advancement in the fields of telecommunications and electronics technology over the past three decades. Thus, it was reasoned that on this basis alone the need for compulsory licensing had diminished. *See,* 552 F. Supp. at 176. Additionally, the court recognized that the historic method by which the BOCs helped finance research and development by AT&T's Bell Laboratories, namely, through BOC payments to AT&T under so-called "license contracts," must of necessity come to an end upon divestiture. As a consequence, AT&T would lose a source of income that in the past in part funded research and development activities. *id.* at 176.

In these circumstances, the court concluded that AT&T would be in a significantly disadvantaged market position compared to its competitors if it were required after divestiture to grant licenses to all who desired them. In other words, it discerned a fundamental inconsistency in requiring AT&T on the one hand to fund its own research and development without BOC support, while remaining the only company in the United States obligated to license its patents on a nonexclusive basis to all interested competitors. *Id.*

THE BOC LICENSING EXCEPTION

The court also recognized, however, that the BOCs, as a practical matter, would not be able to properly perform their basic exchange telecommunications and access functions immediately after divestiture without sufficient patent and research resources. *See,* 552 F. Supp. at 177. To remedy this potential anomoly, the divestiture plan finally approved by the court requires that AT&T grant the BOCs royalty-free licenses to all existing AT&T patents and all patents issued to AT&T for a period of five years following divestiture. AT&T is also to provide non-patentable technical information of the kind that has been funded in the past by the license contracts. *Id.* at 177. AT&T's compulsory licensing obligation, however, extends only to those "lines of business" that the BOCs are otherwise permitted to provide by the divestiture plan. The court also anticipates that the BOCs would benefit from these licensing rights if any of the line of business restrictions should be lifted "at any time during the life of the particular patent, not simply during the five years after divestiture." *See,* 569 F. Supp. at 1086, n. 117. (Moreover, as will be discussed later, the line of

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business restrictions also appear to affect the scope of the BOCs' sublicensing authority.)

Specifically, the BOCs are essentially limited by the divestiture plan to the provision of exchange telecommunications services and exchange and information access services. In addition, the BOCs may market customer premises equipment ("CPE"), but cannot establish their own manufacturing operations for such CPE. 552 F. Supp. at 186-94. At any time, however, each BOC remains free to petition the court for approval to provide new services upon a showing that there is "no substantial possibility" that the BOC could use its monopoly power to "impede competition in the market it seeks to enter." *Id.* at 195.

The scope of this BOC licensing arrangement evolved after considerable controversy. Originally, AT&T and the Department of Justice in effect agreed to limit the scope of the BOC's licensing rights to only certain BOC lines of business, such as basic exchange services and directory advertising. Their agreement, however, by no means settled the matter. The court, after additional deliberation, reached the conclusion that a broader license arrangement than that proposed by the parties is necessary if the BOCs are to be able to effectively discharge their judicially authorized obligations. Accordingly, the court decided to require that AT&T grant the BOCs royalty-free licenses to *all* existing patents and those issued to AT&T within five years after divestiture to the extent that they relate to the products or services which the court authorizes the BOCs to sell or provide. *See,* 569 F. Supp. at 1082-86.

THE GRANT OF SUBLICENSES BY THE BOCS TO THIRD PARTIES

As a separate matter, the court decided to permit the BOCs to grant sublicenses of the AT&T patents to third parties. There is, however, a significant limitation on the BOCs' right to sublicense. This may create uncertainty and conflict in the future. Specifically, the BOCs may grant sublicenses only to the extent they will use the technology covered by the particular patents in the provision of their authorized products and services. *See,* 569 F. Supp. at 1087. As explained, the BOCs are generally limited to the provision of exchange telecommunications services and exchange and information access services, and must receive approval for any other services they seek to offer. They are also prohibited from engaging in the manufacturing of CPE.

Succinctly stated, the court concluded that the BOCs may grant sublicenses consistently with the divestiture plan to the extent the BOCs will use the technology covered by the particular patents in their provision of authorized products and services.

The BOCs may not, however, grant sublicenses with respect to any other AT&T patents, for two reasons: (1) because they may not, absent special permission, engage in new lines of business (for example, the sale of patent rights simply as a business venture unrelated to their own use of the technology); and (2) because AT&T's manufacturing competitors are not entitled, as such, to the fruits of AT&T's research. *See,* 569 F. Supp. at 1087. *See also,* 552 F. Supp. at 176-77.

By way of example, the court applied these principles in the case of customer premises equipment (CPE). It held that the BOCs must have the right to sublicense CPE patents to manufacturers of their choice so that the BOCs are to be able to develop a CPE product line distinct from that of AT&T. 569 F. Supp. at 1087. The court explained that without CPE patent rights and the ability to market a distinctive product line, the BOCs may not be able to provide the effective counterbalance that the court has sought to establish to AT&T's market strength in CPE marketing. *Id.* at 1088.

The court also anticipated that the BOCs' authority to sublicense patents will place them in a position to negotiate lower equipment purchase prices and thus reap the benefits of the AT&T technology which the BOCs have previously financed through the license contracts. By way of further explanation, the court stated that sublicensing of patents should permit the BOCs to benefit from increased competition among their suppliers and thereby tend to reduce the price of CPE purchased by the BOCs for resale. It also expressed an expectation that greater competition among CPE manufacturers will lower wholesale prices paid by the BOC, and result in lower retail prices. *Id.* at 1088. In light of these market and business considerations, the court concluded that sublicensing of AT&T's CPE patents to manufacturers of CPE would be a legitimate part of the BOCs' CPE marketing business. *Id.*

There are, however, problems relating to the scope of the BOCs' sublicensing authority that are likely to arise in the future as the BOCs' lines of business develop. The divestiture plan permits the divested BOCs to reorganize into seven separate regional operating companies. *Id.* at 1062. These geographic limitations, when read together with the court's sublicensing analysis, raise questions as to whether a regional operating company may only grant a sublicense which covers the services or products provided in its own operating area. What this means, for example, is that third parties considering whether to sublicense a patent from a BOC may have to obtain several sublicenses in order to achieve more than regional market coverage. Alternatively, third parties may decide to seek a license to the AT&T patent from AT&T itself in order to achieve more than regional market coverage.

Moreover, over AT&T's objections, the court has observed in passing that in the CPE area (as opposed to exchange service and directory advertising operations), AT&T's foreign patents could be helpful to the BOCs as a means to enable them to purchase CPE manufactured entirely or in part by foreign companies for ultimate BOC resale. *See,* 569 F. Supp. at 1086, n. 116. Thus, left unresolved is the question of the full extent to which the BOCs may be able to legitimately make use of AT&T's foreign patents, and the technology they represent, in connection with their authorized services.

The Bell System break-up dramatically alters the way in which AT&T patents have been licensed to third parties for almost 30 years. AT&T is no longer required to grant nonexclusive licenses to all applicants; rather, obtaining a license to an AT&T patent directly from AT&T will now present the same difficulties as

obtaining a license from any other company.

Nonetheless, AT&T is required for a transition period to grant the BOCs royalty-free licenses to all existing AT&T patents and all patents issued to AT&T during the five years following divestiture. The BOCs may, with certain restrictions, sublicense AT&T patents to third parties. The major limitation on BOC licensing or sublicensing of an AT&T patent is that the BOC must use the technology only in connection with a product or service which the court's divestiture plan permits the BOC to provide.

In light of these changes, it remains to be seen how the licensing arrangements will work in actual practice. One can reasonably expect that AT&T, the BOCs, and competitors of both will be carefully monitoring the uses of AT&T patents, and that areas of conflict and uncertainty will arise as to whether their uses conform to the guidelines fixed by the court. Furthermore, third parties who seek to obtain the use of AT&T patents will have to be sensitive to these new realities as they consider entering appropriate licensing arrangements with either AT&T or the BOCs.