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District Court Enters The FRAND Fray

Brianne L. Kucerik

Weil, Gotshal & Manges LLP

A number of federal court decisions and recent enforcement actions by the U.S. antitrust agencies have highlighted the importance of abiding by commitments to license patents that have been declared essential (SEPs) on "fair, reasonable, and non-discriminatory" (RAND or FRAND) terms. There has been, however, no specific guidance by the courts or agencies on how to determine a FRAND royalty rate or range – until now. The U.S. District Court for the Western District of Washington recently issued a 207-page opinion taking on the FRAND task. *Microsoft Corp. v. Motorola, Inc*., Case No. C10-1823JLR (W.D. Wash. April 25, 2013) (opinion by U.S. District Judge James L. Robart).

Background

Since it can be difficult or even impossible to change a standard once it has been adopted, the holder of intellectual property rights in technology incorporated in and purportedly essential to a standard may possess the power to demand unreasonable royalties or licensing terms from industry participants that utilize the standard. To avoid this scenario, the U.S. antitrust agencies have encouraged standard-setting organizations (SSOs) to require patent holders to disclose and agree to license their technology on FRAND terms *before* the standard is implemented.

Brianne L. Kucerik *is an Associate in the Antitrust/Competition practice of Weil, Gotshal & Manges LLP. Based in the Washington, DC office, her practice focuses on private litigation, transactional matters and general antitrust litigation.*

Brianne L. Kucerik

However, even though a patent holder may commit to license SEPs on FRAND terms, there can be substantial disagreement over what constitutes a "fair, reasonable, and non-discriminatory" royalty rate. Prior to *Microsoft v. Motorola*, no court or agency had defined a FRAND rate or set forth a methodology for establishing such a rate.

A Framework For Determining FRAND

In *Microsoft v. Motorola*, Microsoft sued Motorola for breach of contract, alleging that Motorola had an obligation to license on FRAND terms two of its patent portfolios that are incorporated in wireless communications standards and that Motorola breached its FRAND obligations through two offer letters seeking annual royalties in excess of $4 billion.

In a prior order, the court held that Motorola's commitments to the SSOs required it to make its initial offer to license its SEPs to Microsoft "in good faith" (i.e., "initial offers do not have to be on RAND terms so long as a RAND license eventually issues") and that, to determine whether the offer was in good faith, the offer should be compared "with a reasonable RAND royalty rate and, because more than one rate could conceivably be RAND, a reasonable RAND royalty range." A bench trial was held on this issue in late 2012, and the court issued its decision on April 25, 2013.

Setting the background for its analysis, the court noted that SSOs "play a significant role in the technology market" by setting common technological standards that facilitate interoperability. Interoperability standards "lower costs by increasing product manufacturing volume" and "increase price competition by eliminating switching costs for consumers who want to switch from products manufactured by one firm to those manufactured by another." However, these benefits cannot be achieved without broad implementation. As a result, SSOs "seek to develop standards that incorporate technology that will make the standard attractive to implementers, while at the same time ensuring a feasible price to those same implementers to promote broad implementation."

The court also noted that SEP holders "enjoy significant potential benefits to having their technology incorporated into a standard independent of the potential royalty income from licensing patents that they own" and "obtain substantial leverage to demand more than the value of their specific patented technology," which may lead to patent holdup or improper royalty stacking.[1] FRAND commitments are designed to protect the standard-setting process and protect adopters of the standard by preventing holdup and improper royalty stacking.

Please email the author at brianne.kucerik@weil.com with questions about this article.

Based on these findings, the court held that a FRAND "royalty rate should be set at a level consistent with the SSOs' goal of promoting widespread adoption of their standards" and should consider and "seek to mitigate" the risk of patent holdup and royalty stacking while at the same time ensuring that "holders of valuable intellectual property will receive reasonable royalties on that property."

To arrive at FRAND rates, the court relied on established law on patent damage calculations, the 15 so-called *Georgia-Pacific* factors,[2] modified to suit the different circumstances of FRAND. The court noted that, as in the *Georgia-Pacific* analysis, a "judicial simulation of a hypothetical, bilateral negotiation under the RAND obligation logically will lead to a royalty rate that both parties would have found to be reasonable." However, the simulation "must be adjusted to account for the purpose of the RAND commitment" for two reasons. First, while the owner of a patent that is not subject to a FRAND commitment "has monopoly power over its patent and may choose to withhold licensing," a SEP owner is obligated to license its patents on FRAND terms. Second, the implementer will need to negotiate licenses with multiple SEP owners in order to fully implement the standard and will take that into account when negotiating the royalty rate.

In particular, the court found:

- When analyzing other royalties received by the patentee for the licensing of the patents at issue in the suit (*Georgia-Pacific* factor 1), only those royalties that were negotiated under the FRAND obligation, or a comparable negotiation, "where the parties clearly understood the RAND obligation" should be considered. In addition, the court suggested that patent pools "will be relevant to a hypothetical negotiation for SEPs."
- Since the licensor has made a commitment to license its patents on FRAND terms, *Georgia-Pacific* factors 4 and 5 (whether the patentee had a policy of licensing or refusing to license) are not applicable.
- When analyzing the impact of the patented technology on the licensor's and licensee's sales (*Georgia-Pacific* factors 6 and 8), "it is important to focus the analysis … on the value of the patented technology apart from the value associated with incorporation of the patented technology into the standard."
- Similarly, when analyzing *Georgia-Pacific* factors 10, 11, and 13 (the nature of the patented technology, the extent to which the infringer has made use of the technology, and the portion of the realizable profit that should be credited to the technology), "it is critical to consider the contribution of the patented technology apart from the value of the patent as the result of its incorporation into the standard, the latter of which would improperly reward the SEP owner for the value of the standard itself."
- When considering the utility and advantages of the patent over old modes or devices (*Georgia-Pacific* factor 9), the "focus is on the period *before* the standard was adopted and implemented" and "the alternatives that could have been written into the standard instead of the patented technology." [emphasis added]
- Finally, when considering *Georgia-Pacific* factor 15 (the amount that a licensor and a licensee would have hypothetically agreed upon just prior to infringement if both had been reasonably and voluntarily trying to reach an agreement), a FRAND determination must account for the fact that "the SEP owner would have been obligated to license its SEPs on RAND terms which necessarily must abide by the purpose of F/RAND commitment of widespread adoption of the standard through avoidance of hold-up and stacking." Thus, the analysis must consider "the contribution of the patented technology to the capabilities of the standard, and in turn, the contribution of those capabilities of the standard to the implementer and the implementer's products" as well as "other SEP holders and the royalty rate that each of these patent holders might seek from the implementer based [on] the importance of these other patents to the standard and to the implementer's products."

The court applied this analysis to the Microsoft/Motorola dispute and found that Motorola's patented technology did not contribute substantially to the relevant standards and did not play a significant role in the overall functionality of Microsoft's products. In addition, the court found that a related patent pool rate, as opposed to the individual license rate proposed by Motorola, was "a strong indicator of a RAND royalty rate" for one of Motorola's patent portfolios "[b]ecause the characteristics of the [patent pool] closely align with all of the purposes of the RAND commitment" and Microsoft and Google (Motorola's parent) were both members of the pool. The court also found that another related patent pool rate was one of three "indicators" of the FRAND rate for the other Motorola patent portfolio at issue.

Using these indicators, the court set a FRAND royalty rate of 0.555 cents per unit (with a range of 16.389 cents to 0.555 cents) for one Motorola SEP portfolio and a FRAND royalty rate of 3.471 cents per unit (with a range of 19.5 to 0.8 cents) for another Motorola SEP portfolio, resulting in approximately $1.8 million in annual royalty payments. This is far lower than Motorola's proposed royalty rate of 2.25 percent of the end product price, or approximately $4 billion per year.

Future Ramifications For FRAND

Although this is only one district court opinion on determining FRAND, and industry observers believe Motorola will almost certainly appeal, other courts analyzing SEP holders' FRAND obligations likely will use the decision as a guidepost. The decision suggests that because "more than one rate could conceivably be RAND," a FRAND range must be determined on a case-by-case basis by evaluating a hypothetical negotiation between the parties. Also, by focusing its analysis on the parties' positions prior to implementing the standard, the decision suggests that courts, like the U.S. antitrust agencies, recognize the potential harmful impact that patent holdup and other anticompetitive conduct can have on the standard-setting process and will take those factors into account when determining the appropriate FRAND royalty range.

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1 Royalty stacking issues arise when multiple parties hold IP declared essential to practice a particular standard, and each party seeks to obtain royalty payments from a licensee.

2 *See Georgia-Pacific Corp. v. United States Plywood Corp.,* 318 F. Supp. 1116 (S.D.N.Y. 1970).