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9th Circ. FRAND Ruling Brings Options For Patent Licensees

Law360, New York (August 17, 2015, 10:34 AM ET) -- Standard-essential patents, which are necessary for ensuring that affected products work compatibly with one another, pose significant challenges for technology companies. First and foremost, these companies wrestle with whether competitors that participate in forming industry standards will, in fact, license patents covering the standard on fair, reasonable and nondiscriminatory terms and how to calculate FRAND royalty rates.[1] Technology and manufacturing companies in virtually every industry — e.g., cellular telephone, mobile handsets, Wi-Fi, chip sets, data networking, etc. — factor the risk and value of SEPs into their strategic road maps and business plans for industry compliant products in the United States as well as abroad.[2]



Russell Tonkovich

On July 30, 2015, the U.S. Court of Appeals for the Ninth Circuit issued an important decision that provides guidance on how to determine FRAND royalty rates and what consequences may follow when a patentee fails to comply with its obligation to license patents on FRAND terms. In this closely watched case, *Microsoft Corp. v. Motorola Inc. et al.*, 2015 WL 4568613 at *28 (9th Cir. 2015), the court held that Motorola breached its commitment made to standard-setting organizations to license its SEPs on FRAND terms. It further ruled that Microsoft, a user of these industry standards in its products, has standing as a third-party beneficiary to enforce Motorola's commitment. The Ninth Circuit's ruling provides potential licensees with various options for resolving disputes about the appropriate FRAND royalty for SEPs. Thus, as discussed in this article, the Microsoft decision will affect the dynamics between SEP owners and potential licensees and raises various strategy issues that will need to be considered.

Standard-Setting Organizations and the FRAND Commitment

Standard-setting organizations set technical standards so that products implementing those standards will work compatibly with each other. Examples of standards include Wi-Fi (802.11), video playback (H.264), and cellular communications (4G LTE).[3] Manufacturers that sell standard compliant products need to obtain a license to use the SEPs covering the standard or face risk of patent infringement. Because manufacturers often need, as a practical matter, to incorporate standards into their products, SEP owners have significant leverage to demand higher license rates than the patented technology may otherwise be worth if it were not part of the standard. To address this imbalance and increase accessibility to standards, many SSOs require that participants in the standard-

making process agree to license their SEPs to any party on FRAND terms.

Background of the District Court Action

In October 2010, Motorola sent Microsoft two letters offering to license its SEP portfolios relating to the 802.11 and H.264 standards for 2.25 percent of the selling price of Microsoft's end products. *Id.* at *3. Microsoft subsequently filed suit in November 2010 in the Western District of Washington, alleging that Motorola's offer letters constituted a refusal to license its SEP portfolios on FRAND terms and a breach of its FRAND commitments. *Id.* Motorola countersued for patent infringement in the Western District of Wisconsin and the U.S. International Trade Commission to enjoin Microsoft's use of its SEPs. *Id.* Microsoft then amended its complaint to allege that Motorola had breached its contractual obligations to offer FRAND licenses for its SEPs to any interested licensee by suing Microsoft for infringement and seeking to enjoin its use of Motorola's SEPs. *Id.* at *4.

The Washington district court held that (1) Motorola's FRAND commitments created an enforceable contract between Motorola and the standards setting organizations, (2) Microsoft has standing to enforce this contract as a third-party beneficiary, (3) Motorola's commitments to the standard-setting organizations require that its initial offers be made in good faith but the initial offers do not have to be on FRAND terms as long as a FRAND license results, and (4) Motorola was not entitled to injunctive relief. *Id.*

Procedurally, the district court adjudicated the case in two stages. First, the district court held a bench trial to determine the FRAND rate for Motorola's H.264 and 802.11 patent portfolios. *Id.* The court determined that it must decide what FRAND means before it can be determined if Motorola breached its obligation to license on FRAND terms. *Id.* After a detailed analysis of the value of the Motorola's SEP portfolios, the court determined that the FRAND royalty rate for Motorola's H.264 portfolio of 15 SEPs was \$0.00555 per end product with an upper bound of \$0.16839 per end product. The court further determined that the FRAND rate for Motorola's 802.11 portfolio of 11 SEPs was \$0.0371 per end product with a range of \$0.008 to \$0.195 per end product. *Id.*

Second, the court held a jury trial on the breach of contract claims, in which Microsoft was able to introduce the FRAND rates determined in the bench trial. *Id.* For damages, Microsoft sought its attorneys' fees and costs in defending the lawsuits in which Motorola was seeking an injunction, as well as the costs of relocating its distribution facility from Germany to the Netherlands in response to Motorola's seeking an injunction in the German courts for infringement of its SEPs. *Id.* The jury returned a verdict for Microsoft for \$14.52 million, which included \$11.49 million for relocating its distribution center and \$3.03 million for litigation fees and costs. *Id.* Motorola appealed the district court's decision to the Federal Circuit, which, in response to a motion by Microsoft, transferred the appeal the Ninth Circuit. *Id.* at *5.

Ninth Circuit's Affirmance of the District Court's Decision Regarding FRAND Rate

On appeal, Motorola argued that the district court lacked the legal authority to decide the FRAND rate in a bench trial while preserving the breach of contract determination for a separate jury trial. *Id.* at 8. The Ninth Circuit rejected Motorola's contention, as Motorola had affirmatively consented to the bench trial for the FRAND issues. *Id.* at *9-10. However, the Ninth Circuit expressly declined to address the issue of whether, absent consent, a jury should have made the FRAND determination. *Id.* at *10.

Second, Motorola argued that the district court's determination of the FRAND rates, which applied a Georgia-Pacific analysis, violates Federal Circuit precedent on damages. Motorola's main contention was that the district court did not appropriately apply Georgia-Pacific factor 15, which requires setting the hypothetical negotiation at "the time the

infringement began," because the district court relied, in part, on evidence regarding the present day value of Motorola's SEP portfolios. *Id.* at *11. The Ninth Circuit again rejected Motorola's argument.

The Ninth Circuit noted that the underlying action was for breach of contract, not patent infringement. *Id.* at *10. In particular, Microsoft's theory was that Motorola had breached its contracts by maintaining its demand for a 2.25 percent royalty and proceeding with its patent infringement lawsuits to enjoin Microsoft. In this context, the Ninth Circuit held that the district court's modified use of Georgia-Pacific factor 15 to consider the present-day value of the SEP portfolio was appropriate. As the court explained, "the district court could reasonably have concluded that it was appropriate to include the present-day value of Motorola's SEPs as a factor in calculating the RAND rate-and-range for use in the breach-of-contract proceeding." *Id.* at *12. Further, the Ninth Circuit reasoned that Motorola never identified the appropriate date of the hypothetical negotiation, expressly relied on evidence that would not have been available at an earlier hypothetical negotiation date, and failed to show any prejudice from the district court's analysis. *Id.* at *12-13.

Third, the Ninth Circuit rejected Motorola's arguments that the district court had erred in its conclusions about which licenses were relevant indicators of the appropriate FRAND rate. *Id.* at *13-16. For example, the Ninth Circuit found that the district court's reliance on the rates charged by "patent pools" was appropriate. *Id.* at *13-14. As the court noted, patent pools are a collection of two or more owners of SEPs that, as members of the pool, package and license their SEPs together. *Id.* at *14. The district court used the royalty rate of patent pools for 802.11 and H.264 SEPs as one data point in its analysis. *Id.*

Further, crediting Motorola's experts, the district court recognized that patent pools generally license at lower rates than would be the case in a bilateral agreement and multiplied the patent pool rates by a factor of three. *Id.* The Ninth Circuit also rejected Motorola's argument that the district court erred by not relying on Motorola's bilateral licenses, which were broader agreements that were reached to settle litigation or included licenses to both SEPs and non-SEPs. *Id.* at *15-16.

Ninth Circuit's Affirmance of the Jury Verdict on Breach of Good Faith and Fair Dealing

The Ninth Circuit also affirmed the district court's denial of Motorola's motion for judgment as a matter of law, and held instead that the evidence was sufficient to support a finding that Motorola had breached its duty of good faith and fair dealing. *Id.* at *16-18.

The district court found that a reasonable jury could find breach based on (1) Motorola's opening offers, (2) its pursuit of injunctive relief, or (3) the combination of these two factors. *Id.* at *16. The Ninth Circuit found that there was substantial evidence to support a verdict that Motorola breached its duty of good faith and fair dealing by pursuing injunctive relief. *Id.* at *17-18. By threatening to enjoin Microsoft from practicing the 802.11 and H.264 standards until it agreed to a rate significantly higher than the FRAND rate, Motorola was inducing a "hold-up," which refers to pressuring a user of a standard into accepting a FRAND rate higher than what was objectively merited. Motorola's actions thereby frustrated the very purpose of the FRAND contract. *Id.* at *17.

Furthermore, the Ninth Circuit stated that the timing of the injunctive actions supported the verdict because both actions were filed after Microsoft had filed its breach of contract suit, in which the court would determine the FRAND rates. *Id.* at *17-18. The Ninth Circuit also noted that the jury had heard evidence that the Federal Trade Commission expressed concern about Motorola seeking an injunction based on infringement of SEPs. *Id.* at *18. The Ninth Circuit, however, declined to expressly consider whether Motorola's opening offer could serve as a basis for the jury verdict of breach of the duty of good faith and fair dealing. *Id.* at *16.

Impact of Ninth Circuit's Decision in Microsoft v. Motorola

The Microsoft decision provides potential licensees with additional options in negotiating FRAND licenses. For example, if a potential licensee believes that the SEP owner is requesting a royalty rate that is significantly higher than the FRAND rate, the potential licensee has standing as a third-party beneficiary of the SEP owner's FRAND commitment to the SSO to seek relief from a district court under the theories of breach of contract and breach of the duty of good faith and fair dealing. The availability of this option may have several effects.

First, an action for breach will allow the potential licensee to obtain a district court decision determining the FRAND rate for SEPs outside the context of a patent infringement lawsuit. As explained in Microsoft, adjudicating the merits of the breach of good faith and fair dealing claim requires the determination of the FRAND royalty rate for the SEPs at issue. This may provide a less costly manner of obtaining court decision setting the FRAND rate for SEPs. Such an action also preserves the potential licensee's ability to challenge whether the declared essential patents are actually essential to the standard and are actually infringed by the licensee's products in the event the licensee desires to license a subset of the declared SEP portfolio.

Second, because obtaining a court ruling on the appropriate FRAND rate is an alternative to not reaching a license agreement in negotiations, the methodology applied by the district court and affirmed by the Ninth Circuit provides a legal framework for determining the FRAND rate in the absence of an agreement. This may serve to provide a starting point, or at least a ballpark range, for parties to pursue in the FRAND license negotiations.

For example, the district court determined that the royalty rate for Motorola's H.264 portfolio of 15 SEPs was \$0.00555 per end product (or approximately \$0.00037 per patent) with an upper bound of \$0.16839 per end product. *Id.* at *4. Similarly, the royalty rate for Motorola's 802.11 portfolio of 11 SEPs was determined to be \$0.0371 per end product (or approximately \$0.00337 per patent) with a range of \$0.008 to \$0.195 per end product. *Id.* While the actual rate determination will vary in different cases, the methodology for arriving at such FRAND rates and ranges may provide some rational starting point for the negotiation over FRAND royalties between SEP owners and potential licensees.

Third, the threat of litigation by SEP owners against potential licensees is potentially reduced by the Ninth Circuit's decision in Microsoft. Under Microsoft, any suit for injunctive relief for infringement of an SEP could constitute a breach of its duty of good faith and fair dealing. This will expose the SEP owner to damages, which may include the potential licensee's attorneys' fees and costs for defending against those actions. Therefore, the incentive for SEP owners to file patent infringement cases seeking injunctive relief is likely to be reduced. This could have a potential effect on FRAND royalty negotiations as it was often the case that license negotiations for SEPs occurred under the threat of patent infringement litigation by the SEP owner.

In conclusion, the Microsoft decision empowers potential licensees with another tool for arriving at a FRAND rate during license negotiations for SEPs. If parties negotiating FRAND rates are unable to reach an agreement, an alternative may be for the court to determine the FRAND rate using a methodology similar to that employed by the district court in Microsoft. The Ninth Circuit has provided appellate approval both for the methodology applied by the district court and the legal proceedings by which it determined the FRAND rates for the SEPs. The law in this area continues to develop and this decision will, at least, progress the conversation as courts continue to confront these FRAND licensing issues arising in patent infringement litigation or other contexts.

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[1] Some standards-setting organizations' agreements refer to fair, reasonable, and nondiscriminatory, or "FRAND" rates, while others use the terminology "RAND." FRAND and RAND generally have the same meaning in the world of SEP licensing, as the Ninth Circuit recognized in *Microsoft v. Motorola*, 2015 WL 4568613, fn2. We use these terms interchangeably in this article.

[2] See, e.g., Intellectual Property Owners Association ("IPO") August 5, 2015 letter sent to Japan Fair Trade Commission about the draft "Partial Amendment of the IP Guidelines" focusing on, inter alia, industry standards provisions recommending to clarify disclosure obligations for patents and pending patent applications and applying FRAND commitments to innocent transferees.

[3] See, e.g., IEEE standards policy at <http://standards.ieee.org/develop/policies/bylaws/sect1-3.html#2>.

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