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US District Court Issues First Decision Calculating a FRAND Royalty for Standard-Essential Patents

Why this case is important:

- First decision to set a framework for determining a FRAND royalty; and
- Provides guidance for calculating the value of a SEP, affecting (1) SEP holders and potential licensees negotiating FRAND rates; and (2) patent holders deciding whether to declare a patent essential to a standard.

On April 25, 2013, Judge Robart in the Western District of Washington issued findings of fact and conclusions of law in *Microsoft Corp. v. Motorola, Inc.*, No. C10-1823. This decision appears to be the first where a district court has calculated a "fair, reasonable, and non-discriminatory" (FRAND) royalty rate for a standard-essential patent (SEP).

Background

Motorola, Inc., Motorola Mobility, Inc., and General Instrument Corporation (collectively, Motorola) hold patents deemed essential to standards covering wireless networking and video coding technologies. When a standard-setting organization adopts a standard, it often requires holders of SEPs to commit to license those patents on FRAND terms to any potential licensee that wishes to practice the standard. This practice addresses the concern that the SEP holder will use the threat of excluding potential infringers from practicing the standard to extract royalties that would not be available if the patent were not essential to the standard. Motorola's patents in this case were subject to FRAND commitments.

Various Microsoft Corp. (Microsoft) products, including Windows and the Xbox, implement the wireless networking and video decoding SEPs. Motorola offered to license the SEPs to Microsoft at the rate of 2.25 percent of the end-product price. In response, Microsoft sued Motorola for breach of its contractual FRAND promises to the standard-setting organizations, claiming that 2.25 percent was not a FRAND royalty rate.

In earlier proceedings, the court concluded that Motorola's FRAND commitments were enforceable contracts and that Microsoft could enforce those commitments as a third-party beneficiary. The court also held that Motorola's initial offers had to be made in good faith but did not need to be on FRAND terms, as long as the parties eventually agreed to a license on FRAND terms. A jury trial is scheduled for August 2013.

Determining a Royalty Rate and Range

Before the jury could determine whether Motorola's initial offers were made in good faith, the court needed to determine: (1) a FRAND royalty range for Motorola's SEPs; and (2) the specific FRAND royalty rate for Motorola's SEPs within that range. For this purpose, the court held a bench trial in November 2012 and issued its order on April 25, 2013.

In the decision, Judge Robart employed a modified version of the *Georgia-Pacific* factors typically used by courts to determine a reasonable royalty in the patent infringement context. Judge Robart noted that application of the *Georgia-Pacific* framework to the SEP context required modifications to a number of factors, particularly to take into account "the importance of the SEPs to the standard and the importance of the standard and the SEPs to the products at issue."

First, Judge Robart evaluated Motorola's patent portfolios to determine their importance to the applicable standard and to Microsoft's products. This approach mitigated so-called "royalty stacking" risks, which are a concern when there are numerous entities holding SEPs. Thus, the court first determined the amount Microsoft would pay for all SEPs related to the technology and then determined what portion of that amount should be attributed to Motorola's patents.

The court noted that, given the large number of entities holding patents essential to the two standards, if each patent holder demanded 2.25 percent, Microsoft's products would quickly become unprofitable. This stacking concern was heightened because Motorola's patents only provided minimal contribution to the standard or to Microsoft's product.

Then, taking the relative importance of Motorola's contribution into account, the court determined the royalty rate and range with reference to comparable licenses. At this second step, Judge Robart closely scrutinized licenses that Motorola offered as comparable. After evaluating the terms of the licenses and the circumstances underlying the agreements, the court found most to have limited value in the analysis, and also noted the stacking issues raised by the royalty rates Motorola demanded.

Microsoft presented licenses to patent pools — typically created by SEP holders to license the pooled patents in a single package — as comparable. Although the court noted that the practical realities of patent pool licenses prevented them from being adopted as *de facto* FRAND rates, the court found that the patent pool licenses served as good indicators.

To determine the rate and range for the video coding patents, Judge Robart used the patent pool structure as a guide and then devised a formula for setting a reasonable royalty. The formula accounted for overall value to the SEP holder from participating in a patent pool, both in the form of the royalties that the SEP holder would receive from participation in the patent pool as well as the licenses to the other patents in the pool. Applying the formula to the case, Judge Robart reached a FRAND rate of 0.555 cents per unit for the video coding patents and held that a FRAND range would be 0.555 to 16.389 cents per unit.

For the wireless networking patents, Judge Robart referred to an applicable patent pool, a similar licensing agreement that Marvell Semiconductor, Inc. ("Marvell") entered into with ARM Holdings ("ARM") that included software and access to the patents used in making standard-compliant chips, and a licensing valuation model developed for Motorola by InteCap, Inc. Using these three sources as benchmarks, the court set the FRAND rate for the wireless networking patents at 3.471 cents per unit and held that a FRAND range would be 0.8 to 19.5 cents per unit.

Notably, the FRAND rates and ranges set by Judge Robart are below the royalty rates initially offered by Motorola. Motorola's licensing expert had calculated expected royalties based on Motorola's original 2.25 percent demand and concluded that the offer approximately translated to between \$3.00 and \$5.13 per unit, subject to caps. Taking into account the rates and ranges determined by the court, the jury will determine at trial whether Motorola's initial offer was made in good faith.

Impact of This Decision

With standardization of increasingly complex technology becoming more widespread, decisions regarding potential and current standard-essential patents will be increasingly important to a company's intellectual property strategy.

Judge Robart's decision sets forth the first framework tailored to setting a FRAND royalty. Although only time will tell if other courts approve of and adopt Judge Robart's approach, it could have far-reaching effects on how companies evaluate standard-essential patents. For patents already declared standard essential, the patent holder and potential licensees can refer to Judge Robart's analysis when making initial license offers and negotiating FRAND licenses. Perhaps even more importantly, companies holding patents that could potentially be declared standard essential can look to the court's decision to guide the decision-making process when determining whether to declare the patent essential and subject it to a FRAND obligation.

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