

# The Fracturing of Global FRAND Patent Licensing

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Standard essential patent (SEP) owners have long licensed their patent portfolios, including both SEPs and non-SEPs, on a global basis. But recent divergence, including in China and other jurisdictions, regarding what royalty base is appropriate to use when licensing SEPs will pressure licensors to move away from offering “all-in” worldwide licenses and toward a model in which terms are negotiated on a country-by-country basis. Fissures in the fair, reasonable and nondiscriminatory (collectively, FRAND) licensing landscape due to these complex negotiations already are apparent, and the thin and shrinking margins in the industry will only cause them to grow.

## Traditional FRAND Licensing

Standard-setting organizations (SSOs) produce technical standards that allow for interoperability of products made by different manufacturers. Historically, companies that participate in the formation of standards commit to licensing patents essential to these standards on either a reasonable and nondiscriminatory or FRAND basis. These commitments seek to ensure that companies will not unfairly leverage their SEPs after inducing an SSO to adopt that company’s patented technology.

In the wireless communications industry, numerous SSOs have promulgated standards that govern the operation of wireless devices. Companies like Qualcomm have long successfully monetized their patent portfolios for both SEPs and non-SEPs, traditionally requiring prospective chip purchasers to enter into global patent licenses for Qualcomm’s entire patent portfolio before agreeing to sell them chips. Generally, these global patent licenses have used the average selling price (ASP) of the final product (e.g., a smartphone) as the royalty base upon which royalties are calculated. Other SEP holders, like Ericsson, also have focused on monetizing their patent portfolios. Recognized problems of SEP licensing programs include patent hold-up, where a SEP holder demands excessive royalties after a standard is adopted, and royalty stacking, where the sum of royalties that licensees pay to various SEP licensors is greater than the aggregate reasonable royalty that a licensee ought to pay for the entire standard.

## The Meaning of FRAND in China

On March 2, 2015, China’s National Development and Reform Commission (NDRC) issued Administrative Penalty Decision (2015) No. 1, which found that Qualcomm’s conduct in both the wireless SEP license market and baseband chip market was anti-competitive. The NDRC found fault with several aspects of Qualcomm’s conduct, including (1) charging royalties for expired wireless SEPs and failing to provide a patent schedule of relevant SEPs while requiring licensees to sign long-term or indefinite-term license agreements, (2) requiring licensees to cross-license their portfolios to Qualcomm without paying value for those licenses, (3) bundling SEPs and non-SEPs in its patent licenses, and (4) requiring licensees to agree not to challenge the patent license agreement as a condition for receiving baseband chips.

Based on these findings, the NDRC ordered Qualcomm to undertake certain actions when licensing patents to Chinese manufacturers. It ordered Qualcomm to materially lower the effective royalty by applying the royalty rate to a base of 65 percent of ASP rather than the historical base of 100 percent — a government-mandated discount of 35 percent. Additionally, the NDRC ordered Qualcomm to (1) provide a list of patents when licensing SEPs to Chinese manufacturers, (2) not require licensees to cross-license their non-SEPs nor require them to cross-license SEPs without paying reasonable consideration, (3) not insist on a high royalty fee and calculate the royalty fee for SEPs based on the ASP of the whole device, and (4) not bundle SEPs and non-SEPs without justification.

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## The Meaning of FRAND in Other Jurisdictions

Even before the NDRC decision, diverging views of how to calculate royalties had begun to emerge. In *Ericsson Inc. v. D-Link Sys., Inc.*, 773 F.3d 1201 (Fed. Cir. Dec. 4, 2014), the Federal Circuit discussed methods of calculating damages and determining FRAND royalty rates. The court held that where the entire value of an end product cannot be attributable solely to the patented feature, “courts must insist on a more realistic starting point for the royalty calculations by juries—often, the *smallest salable unit* and, at times, even less” (emphasis added). The court also held that “[j]ust as we apportion damages for a patent that covers a small part of a device, we must also apportion damages for SEPs that cover only a small part of a standard.” Thus, “the royalty for SEPs should reflect the approximate value of that technological contribution, not the value of its widespread adoption due to standardization.”

Relatedly, on February 8, 2015, the Institute of Electrical and Electronics Engineers, Inc. (IEEE) and its Standards Association updated their licensing policy, in part because of the vast difference in estimates of “reasonable” between licensees and licensors. The IEEE update stated that a reasonable royalty should be the value attributable to a SEP, excluding the value of that SEP’s inclusion in an IEEE standard, and that a factor to consider when determining the reasonable rate is the value of the relevant functionality of the smallest salable compliant implementation that practices the essential patent claim.

## Implications of the NDRC Decision

China’s use of 65 percent of ASP as a royalty base varies significantly from the smallest salable unit royalty base reflected in *Ericsson*, various other federal district court decisions and the IEEE update. Because the smallest salable unit that implements wireless technology standards is often the chip, the effective

difference in royalty base between the discounted base and the smallest salable unit base is the difference between \$260 (about 65 percent of ASP of an average phone price of \$400) and \$20 (approximate chip cost). Meanwhile, SEP licensors continue to insist on a royalty base of ASP (\$400 in this example). This difference in royalty base assures that licensors and licensees have vastly different expectations of what constitutes a “reasonable” royalty. Significantly, it now is likely that FRAND will vary by jurisdiction.

Rather than one global license for all patents owned by a licensor, the NDRC decision will require licensors to execute separate license agreements for at least China and the rest of the world, and to differentiate SEPs from non-SEPs in China. As licensors and licensees undertake these negotiations, licensees may naturally seek to limit licenses to countries where the licensor has SEPs rather than on global sales and may prefer to litigate the issue in select jurisdictions. Licensors, of course, have business models that require them to successfully monetize their patent portfolios and a revenue history that they will be hard pressed to abandon. Under these circumstances, it is difficult to find a middle ground short of litigation. Recent lawsuits between Apple and Ericson and between ASUS and InterDigital demonstrate that these competing interests already are leading to significant — and in the case of Apple, multijurisdictional — litigation. Licensing paradigms going forward are only likely to further fracture as additional jurisdictions and SSOs weigh in on the meaning of FRAND.