

January 10, 2019

# District Court Holds That FRAND Commitment Does Not Require Licensing at Chip Level

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## E.D. Texas Holding Is Contrary to Recent N.D. California Decision

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### SUMMARY

On January 7, 2019, in *HTC Corp. v. Telefonaktiebolaget LM Ericsson*,<sup>1</sup> Judge Rodney Gilstrap of the U.S. District Court for the Eastern District of Texas held, “as a matter of French law,” that the FRAND commitment embodied in the ETSI (a standard-setting organization) intellectual property rights policy does not require a FRAND license to be based on the “smallest salable patent practicing unit” (“SSPPU”) of HTC cell phones.<sup>2</sup> In reaching this conclusion, Judge Gilstrap relied on the express terms of the ETSI policy, as well as evidence regarding prevailing industry practice “to base FRAND licenses on the end-user device and not on the SSPPU.”<sup>3</sup> Judge Gilstrap’s decision is contrary to a decision of the Northern District of California regarding other standard-setting organizations’ rights policies, which was the subject of our memo to clients dated November 8, 2018.

### BACKGROUND

Standardization of technology enables product compatibility across consumer products by setting requirements for a given technical system. These standard requirements may be patented, and can result in owners of standard-essential patents (“SEPs”) being able to extract disproportional royalties. To combat this problem, standard-setting organizations (“SSOs”) created intellectual property rights (“IPR”) policies that, in exchange for participating in and benefiting from a standard, require SEP holders to license SEPs on terms that are “fair, reasonable, and nondiscriminatory,” or “FRAND.” The legal scope of FRAND commitments imposed by SSOs on SEP holders has been widely disputed, particularly in the telecommunications space.<sup>4</sup>

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One disputed issue is whether the non-discrimination aspect of the FRAND commitment requires the owner of an SEP to treat every potential licensee in the distribution chain identically—that is, for example, whether the commitment precludes the patent owner from structuring its license policy to grant licenses only at the higher-value end-user-product level, and not at the component or chip level. Two months ago, on November 6, 2018, in *FTC v. Qualcomm*,<sup>5</sup> the U.S. District Court for the Northern District of California held that it did. In granting the Federal Trade Commission’s motion for partial summary judgment, Judge Lucy H. Koh held that FRAND licensing obligations imposed by two SSOs on participating patentees required Qualcomm to license its patents essential to practicing 3G and 4G/LTE telecommunications standards to competing modem chip suppliers. Thus, Judge Koh found, Qualcomm’s policy of licensing to only handset manufacturers, and not chip suppliers, was a breach of that commitment. In reaching that conclusion, the court relied on the text of the IPR policies of the relevant SSOs as well as Ninth Circuit precedent, which Judge Koh found required Qualcomm to license to “all applicants” or “all comers.”<sup>6</sup>

In the most recent case to address the issue, HTC Corporation and HTC America, Inc. (collective, “HTC”), which manufacture and market cellular telephone handsets, filed suit alleging that Telefonaktiebolaget LM Ericsson and Ericsson, Inc. (collectively, “Ericsson”) failed to offer a license to the Ericsson SEPs on FRAND terms.<sup>7</sup> The Ericsson patents at issue are asserted to be essential to the 2G, 3G, 4G, and WLAN telecommunications standards and thus subject to the FRAND policy of the European Telecommunications Standards Institute (“ETSI”).<sup>8</sup> Among other things, HTC claimed that “the FRAND assurance required Ericsson to . . . offer licenses based on estimated profit on the smallest salable patent-practicing unit (SSPPU) on the phones”;<sup>9</sup> the SSPPU in such devices is the baseband processor that provides wireless functionality.<sup>10</sup>

The ETSI IPR policy underlying Ericsson’s FRAND commitment is governed by French law.<sup>11</sup> On October 29, 2018, Ericsson filed a motion for determination of foreign law under Federal Rule of Civil Procedure 44.1, asking the court to resolve whether, under French law, Ericsson’s FRAND commitment required royalty rates for its SEP licenses to be based on the SSPPU.<sup>12</sup>

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### THE COURT’S DECISION

The district court, held that, as a matter of French law, “the ETSI IPR policy neither *requires* nor *precludes* a license with a royalty based on the SSPPU.”<sup>13</sup>

Judge Gilstrap began by noting that the FRAND commitment is “solely [] contractual [in] nature” and that, in interpreting a contract under French law, the court must first look to “the express terms of the contract.”<sup>14</sup> Only if the terms are ambiguous does French law permit reliance on the “common intent of the parties” at the time of contract;<sup>15</sup> if that common intent cannot be discerned, the court is to interpret the contract in the way “in which a reasonable person placed in the same situation” would.<sup>16</sup> In addition,

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French law may imply certain terms into the contract based on, among other things, “customary practices in a particular field.”<sup>17</sup>

Turning to Clause 6.1 of the ETSI IPR policy, the court noted that it provided, in relevant part, that an SEP holder must be “prepared to grant irrevocable licenses on [FRAND] terms and conditions . . . to *at least* . . . a license to produce any system, or device fully conforming to a STANDARD, *including* the right to make or have made customized components and sub-systems to the licensee’s own design for use in the production of any system, or device fully conforming to a STANDARD[.]”<sup>18</sup> The court read Clause 6.1 as “simply stat[ing] that *at a minimum* an SEP-holder must offer companies the right to not only make any systems or devices that conform to a standard, but also the right to make any components or sub-systems used to make such systems or devices.”<sup>19</sup> The court explained that, “[c]ritically, there is nothing in the text that says *if* or *when* an SEP-holder must offer a license to make a system or device versus the right to make the components or sub-systems thereof.”<sup>20</sup> In other words, Judge Gilstrap held, Clause 6.1 is silent on whether an SEP holder must license based on a device or based on components.

The court then considered whether a preference for or against SSPPU-based licensing could be based on the ETSI IPR policy’s reference to FRAND “terms and conditions.”<sup>21</sup> The court found the term “FRAND” to be ambiguous, because it was not defined in the policy.<sup>22</sup> Accordingly, the court looked to the expert testimony offered by Ericsson showing that, at the time the ETSI IPR policy was developed, “licensing chip suppliers or using a component such as the chipset as a basis of reference for calculating FRAND royalties [was] not in line with industry practice in the mobile telecommunications industry.”<sup>23</sup> Thus, he found, both at the time the policy was developed and today there was a “general industry” practice of “offer[ing] licenses based on the price of the end-user device, and not on the component-level.”<sup>24</sup> Judge Gilstrap also relied on expert testimony that the ETSI IPR policy “was understood not to upset that practice” as well as “the affirmative representation” of ETSI, as embodied in the ETSI Board’s *Guide on Intellectual Property Rights*, that its IPR policy had “no specific preference for any licensing model.”<sup>25</sup>

Given the evidence of prevailing practice and “the absence of any express requirement to base a FRAND royalty on a component, rather than an end-user device,” the court held that “a reasonable person” either at the time the ETSI policy was adopted or today, “would not interpret FRAND to mean that the license *must* be based on the SSPPU.”<sup>26</sup> Thus, the court found, “the ETSI IPR policy neither *requires* nor *precludes* a license with a royalty based on the SSPPU.”<sup>27</sup> Rather, whether a license meets the requirements of FRAND “will depend on the particular facts of the case[.]”<sup>28</sup>

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## IMPLICATIONS

Judge Gilstrap’s decision stands in stark contrast to the decision of Judge Koh in the *FTC v. Qualcomm*, which, if it withstands appeal and is broadly construed, could upend many standard licensing practices of

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SEP owners. Conversely, Judge Gilstrap's decision is consistent with multiple existing licensing programs and observations by courts and commentators that the FRAND commitment requires only that similarly situated licensees be treated similarly, but does not require that every potential licensee in the distribution chain be treated identically. These conflicting interpretations of the FRAND commitment are highly fact-specific; careful consideration must be given to the language of the governing SSO IPR policy, as well as prevailing industry practice, in determining whether a licensing practice is consistent with a particular FRAND requirement.

Historically, licensing programs that license only at the end-user device level have done so for multiple reasons, including: (i) a patentee's desire to license at a level in the product distribution chain at which its patents achieve the highest market value; (ii) the difficulty of determining whether a product is in fact licensed only once if licenses are granted to multiple components that ultimately comprise a consumer product; and (iii) difficult questions (that may be costly to resolve) that may arise regarding whether, for example, an invention is embodied in the chip, or the chip plus software, or requires the chip plus software plus other components of the device to constitute infringement. While Judge Gilstrap's decision did not specifically examine these motivations, his decision's reliance on evidence of industry practice supports the argument that such practices should be considered in interpreting the nature and extent of the FRAND commitment. It remains to be seen whether other courts will afford specific consideration to these arguments, or how they may be addressed on any appeal.

Given the contrast between Judge Koh's and Judge Gilstrap's decisions, the extent and/or conditions under which SEP owners can be compelled to license at the chip level, or must license end-user device manufacturers for a royalty based on the value of the chip, may ultimately be resolved by the appellate courts.

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ENDNOTES

- 1 *HTC Corp. v. Telefonaktiebolaget LM Ericsson*, 18-cv-00243, Dkt. No. 376 (E.D. Tex. Jan. 7, 2019).
- 2 *Id.* slip op. at 12.
- 3 *Id.* slip op. at 11.
- 4 See, e.g., *FTC v. Qualcomm Incorp.*, 17-cv-00220, Dkt. No. 797 (N.D. Cal. Nov. 6, 2018). Sullivan & Cromwell LLP issued a client memo discussing the *FTC v. Qualcomm* case and its implications. Memorandum from Sullivan & Cromwell LLP (Nov. 8, 2018), available at <https://www.sullcrom.com/files/upload/SC-Publication-District-Court-Holds-FRAND-Requires-Qualcomm-to-License-Competing-Chip-Makers.pdf>.
- 5 17-cv-00220, Dkt. No. 792 (N.D. Cal. Nov. 6, 2018).
- 6 *Id.* at 17 (quoting *Microsoft Corp. v. Motorola, Inc.*, 696 F.3d 872, 876 (9th Cir. 2012)).
- 7 *HTC Corp. v. Telefonaktiebolaget LM Ericsson*, 18-cv-00243, Dkt. No. 220 at 6 (E.D. Tex. Nov. 7, 2018). The case, originally filed in the Western District of Washington, was transferred to the Eastern District of Texas. *Id.* at 6–7.
- 8 *HTC Corp. v. Telefonaktiebolaget LM Ericsson*, 18-cv-00243, Dkt. No. 376 at 1.
- 9 *Id.* slip op. at 2.
- 10 Def.’s Mot. Under Fed. R. Civ. P. 44.1 for Determination of Foreign Law on Requiring SSPPU in Glob. Patent License Agreements, 18-cv-00243, Dkt. No. 212 at 1 (Oct. 31, 2018).
- 11 *HTC Corp. v. Telefonaktiebolaget LM Ericsson*, 18-cv-00243, Dkt. No. 376 at 5.
- 12 See *HTC Corp. v. Telefonaktiebolaget LM Ericsson*, 18-cv-00243, Dkt. No. 376.
- 13 *Id.* slip op. at 12.
- 14 *Id.* slip op. at 3.
- 15 *Id.* slip op. at 4.
- 16 *Id.*
- 17 *Id.*
- 18 *Id.* slip op. at 7 (emphases added).
- 19 *Id.* slip op. at 8–9.
- 20 *Id.* slip op. at 9.
- 21 *Id.*
- 22 *Id.*
- 23 *Id.* slip op. at 10 (citing Ericsson’s expert testimony).
- 24 *Id.*
- 25 *Id.* slip op. at 10–11.
- 26 *Id.* slip op. at 11.
- 27 *Id.* slip op. at 12.
- 28 *Id.*

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