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Royalty Rates for Standard-Essential Patents

In Second Decision of Its Kind, District Court Determines RAND Royalty Rate for 19 Patents Essential to 802.11 WiFi Standard

SUMMARY

Many patents that are essential to a technology standard—so-called “standard-essential patents”—are subject to a commitment that they be licensed on “reasonable and non-discriminatory” (“RAND”) terms. Last week, the district court in *In re Innovatio IP Ventures, LLC Patent Litigation*,¹ determined the RAND royalty rate for 19 patents essential to the 802.11 WiFi standard. Following a bench trial, the court held that the RAND royalty would be 9.6 cents for each device containing a WiFi chip, approximately 1% of the royalty that the patent holder, Innovatio, had sought.

Innovatio was the second district court decision to determine a RAND royalty rate, following last April’s decision in *Microsoft Corp. v. Motorola, Inc.*² Like *Microsoft*, the *Innovatio* court applied a methodology based on the *Georgia Pacific* hypothetical negotiation factors modified to account for the RAND encumbrance on the patents. In contrast to *Microsoft*, however, the court in *Innovatio* did not rely on comparable patent pool license royalty rates to establish the RAND royalty. Instead, the court adopted a royalty rate based on the profit margin for a WiFi chip and the relative importance of the *Innovatio* patents to the WiFi standard.

BACKGROUND

Voluntary standards play an important role in many industries, by ensuring interoperability among complementary products and interchangeability between competing products. Once such a standard is established, it may be prohibitively difficult to switch to an alternative technology, and concerns have been raised that the owner of patented technology incorporated into a standard may engage in so-called

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“patent hold-up” by attempting to obtain a royalty rate in excess of what would have been possible before the standard was set and the patented technology incorporated into the standard. To address this concern, standard-setting organizations have generally relied on a commitment by each contributor to the standard to license its standard-essential patents on RAND terms. Although litigation over the meaning and enforceability of RAND commitments has intensified in recent years, until earlier this year no court had issued a decision determining the appropriate RAND royalty rate for a particular standard-essential patent portfolio.

Last April, in the first decision of its kind, the district court in *Microsoft* determined a RAND royalty rate for two of Motorola’s (now Motorola Mobility) standard-essential patent portfolios relating to the H.264 video compression and 802.11 WiFi standards. The court developed a methodology based on the widely used *Georgia Pacific* factors modified to account for the nature of Motorola’s RAND commitments, and the level of importance of the Motorola patents to the standards and to Microsoft’s implementation of the standards. After finding that the most relevant comparable royalty rates were charged by patent pools licensing patents relevant to the same standards, the court considered the pool per-patent rate and the significance of the patents at issue to the standards, and concluded that a fixed per-unit royalty rate from about 1 cent to 20 cents was appropriate—an effective rate substantially less than 1% of the rate that Motorola had originally sought. Sullivan & Cromwell’s summary of the *Microsoft* decision is available at http://www.sullcrom.com/Royalty_Rates_for_Standard_Essential_Patents/.

In the recent decision, Innovatio began in 2011 to sue hotels, coffee shops and restaurants claiming infringement of more than 20 WiFi patents with more than 400 claims relating to the 802.11 WiFi standard, reportedly seeking a settlement amount of about \$2,500 to \$3,000 per defendant. In 2012, various WiFi device manufacturers, including Cisco, Motorola, Netgear, HP and Sonicwall, responded by suing Innovatio for a declaratory judgment of non-infringement and invalidity. These multiple actions were consolidated before Judge Holderman in the Northern District of Illinois. Following discovery, the district court judge decided to evaluate the potential damages available to Innovatio before proceeding to the merits of Innovatio’s infringement claims. In a decision issued in July, the court held that each of the 19 patents still at issue in the litigation was essential to the 802.11 WiFi standard and thus subject to a RAND obligation.³

SUMMARY OF THE DECISION

Following a bench trial, the district court ruled that the collective RAND royalty rate for Innovatio’s 19 remaining asserted patents was 9.6 cents for each device containing a WiFi chip, about 1% of the royalty that Innovatio had sought.

Consistent with the approach in the *Microsoft* case, the court’s analysis began by considering a hypothetical bilateral negotiation between the patent owner and the accused infringer that would have occurred shortly before the 802.11 standard was established, and at a time when the parties knew both

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that the patents are essential to the standard and that the patent holder was bound by the RAND commitment. The court concluded that, as a practical matter, this analysis proceeds in three steps: First, “a court should consider the importance of the patent portfolio to the standard, considering both the proportion of all patents essential to the standard that are in the portfolio, and also the technical contribution of the patent portfolio as a whole to the standard.” Second, “a court should consider the importance of the patent portfolio as a whole to the alleged infringers accused products.” Third, “the court should examine other licenses for comparable patents . . . , using its conclusions about the importance of the portfolio . . . to determine whether a given license or set of licenses is comparable.”

The court rejected Innovatio’s argument that the royalty should be based on a percentage of the end-price to the consumer of WiFi-enabled devices (such as a tablet, laptop computer or bar code scanner), relying on Federal Circuit law that the proper royalty base is “the smallest salable infringing unit with close relation to the claimed invention.”⁴ Judge Holderman held that the royalty should instead be based on the semiconductor chip used to provide WiFi functionality to each device, because “all of the features of the 802.11 standard are implemented on the WiFi chip” and “the instructions for using [the devices in the patent claims] are contained” on that chip. He noted that, because the royalty was based on the WiFi chip, the first and second steps of the rate determination methodology “effectively merge.” The purpose of a WiFi chip is, “by definition, to provide 802.11 functionality,” and therefore determining the importance of Innovatio’s patents to the standard also determines their importance to the accused products.

The court next proceeded to determine the importance of the 19 Innovatio patents to the 802.11 standard by examining whether there were alternative technologies that might have been used at the time the standard was established. Because those alternatives were lacking or not as effective as the patented technology, the court concluded that the patents were moderately to highly important to the standard (and thus to the accused products).

The district court rejected all of the licenses proposed by the parties’ experts as not comparable for various reasons, including the fact that the cited licenses were entered into under duress of litigation and/or were only a small part of a larger transaction. The Court also rejected consideration of the Via Licensing 802.11 patent pool license (on which the *Microsoft* decision had relied) as not comparable because the pool license was not widely adopted and did not allocate royalties based on the relative merits of the patents to the standard.

In light of the lack of comparable licenses, the judge adopted an alternative method presented by the defendants’ expert that was based on: (i) the average profit to a chip manufacturer for a WiFi chip, (ii) the number of patents essential to the standard (estimated at 3,000), and (iii) the court’s finding that the 19 Innovatio patents were of moderate to high importance among all essential patents. The court noted that taking the profit margin on the sale of a chip as the maximum amount available as a potential royalty “accounts for both . . . non-discrimination and royalty-stacking concerns.” Moreover, the court found,

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considering the profit margin on the chip, rather than the profit on the end product, “is appropriate because a RAND licensor . . . cannot discriminate between licensees on the basis of their position in the market;” thus the royalty for an end product manufacturer should be the same as for a chip manufacturer. Relying on evidence that the top 10% of electronic patents account for 85% of the value of electronic products, Judge Holderman calculated that 5.3% of the \$1.80 average per-WiFi-chip profit, or 9.6 cents on each device containing such a chip, should be attributed to the *Innovatio* patents as a RAND royalty.

IMPLICATIONS

The decision in *Innovatio* is only the second to set out and apply a methodology for determining a RAND royalty rate for standard-essential patents. In conjunction with *Microsoft*, it is likely to be at least addressed, if not followed, by other trial courts. While the *Innovatio* court’s approach was somewhat different than that applied in *Microsoft*, both methodologies led to similar effective RAND royalties.

The *Innovatio* decision has implications for, and may even deter, some pro-competitive conduct in the context of standard-setting activity. For example, to the extent the decision is read to depress the value of patents subject to a RAND commitment, patentees may have less incentive to engage in standard-setting activities that require such a commitment.

The district court’s decision also provides a roadmap of evidence that could be considered by a court in evaluating a RAND royalty rate, including, for example, testimony regarding the importance of the patents to the standard and alternative technologies that might have been considered instead, as well as evidence regarding product profit margins. However, because the decision in *Innovatio* relies at least in part on the existence of a single chip that implements all the features of the 802.11 standard, it may be difficult to directly apply in other contexts, such as where the standard is implemented in different ways in different end products, or over a group of interconnected end products.

Finally, to the extent that it can be read to limit the royalty available for a standard-essential patent subject to a RAND commitment, the *Innovatio* decision, like the *Microsoft* decision, may well affect the valuation of such patents in the secondary market.

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ENDNOTES

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- ¹ MDL Docket No. 2303, Case No. 11-C-9308 (N.D. Ill. Oct. 3, 2013) (Holderman, Dist. J.).
 - ² No. C10-1823JLR (W.D. Wash. Apr. 25, 2013). The court in *Microsoft* determined a RAND royalty range in order to evaluate whether a license offer made by Motorola to Microsoft was unfair and therefore a breach of Motorola’s RAND commitment.
 - ³ *In re Innovatio IP Ventures, LLC Patent Litig.*, ___ F. Supp. 2d ___, 2013 WL 387042 (N.D. Ill. July 26, 2013).
 - ⁴ *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 67 (Fed. Cir. 2012).

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