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Royalty Rates for Standard-Essential Patents

District Court Determines "RAND" Royalty Rate for Motorola Patents Using a Modified *Georgia-Pacific* Analysis Looking to Comparable Standard-Essential Patent Pool License Agreements

SUMMARY

Many patents that are essential to a technological standard — so-called "standard-essential patents" — are subject to a commitment that they be licensed on "reasonable and non-discriminatory" ("RAND") terms. Last week, in the first decision of its kind, a district court in *Microsoft Corp.* v. *Motorola, Inc.*,[1] determined a RAND royalty rate for two of Motorola's (now Motorola Mobility) standard-essential patent portfolios. The court set out a methodology based on the widely used *Georgia Pacific* factors modified to account for the nature of Motorola's RAND commitments and the importance of its patents to the standards and to Microsoft's implementation of the standards. Finding that the most relevant comparable royalty rates were found in patent pool licenses for the same standards, the court concluded that a fixed per-unit royalty rate was more appropriate than the percentage-of-selling-price rate offered by Motorola — and that the amount of the RAND royalty was substantially less than 1% of the rate that Motorola had originally sought. The decision sets the stage for a trial on Microsoft's claim that Motorola's original royalty offer was not made in good faith, and thus constituted a breach of Motorola's RAND commitment.

BACKGROUND

Voluntary industry standards play an important role in the world economy, 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 "patent hold-up" by asserting a patent to obtain a higher price for using the technology than would have been possible before the standard was set. Standard-setting organizations ("SSOs") have relied on voluntary licensing commitments, which generally take the form of an agreement by each contributor to the standard to license its standard-essential patents on RAND terms, in order to mitigate the possibility of patent hold-up. Although litigation over the meaning and enforceability of RAND commitments has intensified in recent years, no U.S. court prior to *Microsoft* v. *Motorola* had issued a decision determining the appropriate RAND royalty rate for a particular standard-essential patent portfolio.[2]

In addition to an extensive cellular patent portfolio, Motorola (which was acquired by Google in 2012) owns patents that it claims are essential to the implementation of the H.264 video compression or 802.11 wireless standards. During the development of those standards, Motorola made commitments to the SSOs for those standards to license its essential patents "on reasonable terms and conditions" to an "unrestricted number of applicants" on a "worldwide and non-discriminatory basis."[3]

In October 2010, Motorola sent letters to Microsoft asserting that certain Microsoft products, including Windows and the Xbox 360, incorporated the H.264 and 802.11 standards and thus infringed Motorola's patents. Motorola offered to license its H.264 and 802.11 patent portfolios, each for a royalty rate of 2.25% of the end price of the applicable licensed product. Microsoft then initiated a breach of contract action in the United States District Court for the Western District of Washington, claiming that Motorola's license offers breached Motorola's RAND commitments to the SSOs.

In a February 2012 decision, Judge James L. Robart held that Motorola's RAND commitments created enforceable contracts between Motorola and the SSOs that were enforceable by Microsoft as a third-party beneficiary. He also held that the RAND commitment required Motorola's initial offer to Microsoft to be made in good faith, although not on RAND terms, so long as a RAND license eventually issued.

In a June 2012 decision, Judge Robart ruled that a judge or jury could only decide whether Motorola's opening offers were made in good faith by comparing them to a RAND royalty. Accordingly, in November 2012, the court held a bench trial to determine a RAND royalty for Motorola's standard-essential patents. Its Findings of Fact and Conclusions of Law were issued on April 25, 2013.

THE DISTRICT COURT'S DECISION

Judge Robart began his analysis with a discussion of the basic principles that determine a RAND royalty rate.[4] He noted that a "RAND royalty should be set at a level consistent with the SSOs' goal of promoting widespread adoption of their standards." For this reason, a proper rate-setting methodology must "recognize and seek to mitigate the risk of patent hold-up" and must "address the risk of royalty stacking by considering the aggregate royalties that would apply if other [standard-essential patent] holders made royalty demands of the implementer." At the same time, a RAND royalty should be set at a level that would induce owners of valuable technology to include such technology in the standard, by guaranteeing that they will receive reasonable royalties. Finally, the RAND commitment "should be interpreted to limit a patent holder to a reasonable royalty on the economic value of the patented technology itself, apart from the value associated with incorporation of the patented technology into the standard."

In light of these principles, Judge Robart accepted Motorola's suggestion that RAND terms could best be determined by simulating a hypothetical bilateral negotiation under the RAND obligation.[5] He noted that courts have a great deal of experience in conducting hypothetical bilateral negotiations to determine reasonable royalties in patent infringement actions using the factors set out in *Georgia-Pacific Corp.* v. *United States*,[6] and that this approach has been sanctioned by the Federal Circuit. However, Judge Robart concluded that the *Georgia-Pacific* factors require modification to reflect the RAND commitment. First, to the extent *Georgia-Pacific* requires consideration of royalties received by the patentee under other license agreements, such purported comparable agreements "must be negotiated under the RAND obligation or a comparable negotiation." Thus, only "license agreements where the parties clearly understood the RAND obligation, and ... patent pools, will be relevant to a hypothetical negotiation for" standard-essential patents.[7] Second, the competitive relationship between the patent owner and prospective licensee, which might otherwise be considered under *Georgia-Pacific*, is not relevant to the RAND royalty determination because a patent owner subject to a RAND commitment is required to license all implementers. Third, to the extent *Georgia-Pacific* requires consideration of the value of the patented technology, that value must be limited to the value of the technology itself (to both the standard and the implementer), but should not include any added value as the result of the incorporation of the technology into the standard. Finally, the overall licensing landscape vis-à-vis the standard and the implementer's products must be considered, including the number of other standard-essential patent holders and the royalty rate each might seek from the implementer.

Applying this modified bilateral negotiation methodology, Judge Robart first evaluated the value of Motorola's H.264 and 802.11 patent portfolios with respect to both the standards and the particular Microsoft products alleged to incorporate those standards. He accepted that all of the patented technology was essential to some aspect — either mandatory or optional — of the H.264 or 802.11 standards. He found, however, that the patented technology added only minimal value to the standards as compared to potential alternatives that might otherwise have been used. He also found that the patented technology provided little incremental value to Microsoft, because some of the patents covered optional aspects of the standards that were not incorporated into the relevant Microsoft products, while the product features covered by the remaining patents were relatively unimportant.

Judge Robart then considered whether the license agreements proffered by the parties as evidence of the RAND royalty rate were relevant to the hypothetical bilateral negotiation. He rejected the agreements offered by Motorola in support of its 2.25% royalty rate because they were (1) settlement agreements negotiated "under the duress of litigation"; (2) not negotiated in light of a RAND obligation; or (3) involved much lower total royalty amounts than Motorola was seeking from Microsoft.

In contrast, Judge Robart found two patent pool license agreements proffered by Microsoft to be highly relevant. Patent pool license agreements were likely to be comparable, he found, because they represent an attempt to set a royalty rate consistent with the purpose of the RAND commitment, namely, to promote widespread adoption of the relevant standard. He reasoned that, to be successful, pool licensors must strike a proper balance between a royalty that is high enough to induce a significant number of patent owners to contribute their patents to the pool, but low enough to ensure that licensees will implement the standard rather than use alternatives. He noted, however, that patent pools (1) tend to produce lower royalty rates than those that can be achieved through bilateral negotiations and (2) generally use a methodology to allocate royalties — based on the relative proportion of the licensor's patents in the pool — that does not consider the importance of a particular standard-essential patent to the standard or to the licensee's products. To account for these distinctions, in determining a RAND royalty rate based on a patent pool royalty rate other factors must be considered in addition to the mere "express" royalty received by the patent owner from the pool, including the value to the patent owner of unfettered access to the other intellectual property in the pool (*i.e.*, the "value of pool membership").

Judge Robart first evaluated the MPEG LA H.264 patent pool and found that the royalty rate paid by its licensees was an appropriate "indicator of a RAND royalty rate for Motorola's H.264 standard-essential patents."[8] The court reasoned that the pool contains important technology relative to the standard, indicating that the royalty rate was set at a level that encouraged key standard-essential patent owners to participate.[9] In addition, the pool has more than 1,100 licensees, indicating that the royalty is low enough to encourage widespread use of the standard.

In order to determine the RAND royalty rate for Motorola's H.264 standard-essential patents, the court first posited a hypothetical H.264 patent pool that would include the current pool patents, as well as Motorola's H.264 patents and all of the other patents that have been declared essential to the H.264 standard but that are not presently in the pool. Judge Robart then calculated a royalty rate based on Motorola's share of royalties that would be paid by Microsoft to this hypothetical pool, which amounted to an "express" royalty of 0.185 cents per unit. The court next determined the "value of pool membership" based on unchallenged evidence that Microsoft valued its membership in the H.264 pool at a level of twice the express royalties it received. The court held that the RAND royalty for Motorola's H.264 patents should be the sum of the express royalty and the value of pool membership, or three times the express royalty.[10] Judge Robart noted that this amount represented "the low end of the range of a RAND royalty rate for Motorola's H.264 standard-essential patent portfolio," but in light of the minimal value of that portfolio to the standard and to Microsoft's products he found no reason to believe that a hypothetical negotiation between Microsoft and Motorola would result in a higher rate. The court then set the upper bound for the RAND royalty rate range at the highest rate discussed during formation of the MPEG LA H.264 patent pool, reasoning that this was the highest rate that the pool licensors thought might both encourage licensees to adopt the standard and provide appropriate compensation to the licensors.

The court engaged in a similar process to determine the RAND royalty rate and range for Motorola's 802.11 standard-essential patent portfolio, relying on the Via Licensing 802.11 patent pool, as further limited by the rate paid by a Wi-Fi chip manufacturer for the intellectual property incorporated into its device, and the rate range set out in analysis of the value of a portion of Motorola's 802.11 portfolio created by a consulting firm, InteCap, at Motorola's request.

IMPLICATIONS

Judge Robart's decision in *Microsoft* v. *Motorola* is the first to set out and apply a methodology for determining a RAND royalty rate for standard-essential patents. As such, it is likely to be at least addressed if not followed by other trial courts. The decision has implications for, and may even deter, some pro-competitive conduct such as standard setting activities and pool or other joint licensing programs. Notwithstanding these potential drawbacks, Judge Robart's detailed and thoughtful discussion of the modifications to the Georgia-Pacific hypothetical negotiation factors as applied in the RAND context may well be very influential. It provides a way to address, for example, concerns that patent license rates are "too high" for products that may contain multiple standardized technologies. Ultimately, however, the issues raised in the decision will likely be addressed comprehensively by an appellate court.

The district court's decision also provides a roadmap of evidence that likely will be considered important by a court in evaluating a RAND royalty rate. The decision also may influence the type of information that is considered by parties during licensing negotiations for standard-essential patents subject to a RAND commitment. Comparable patent pool rates, among other potentially comparable agreements, probably should be carefully considered, or distinguished, by the parties to such a negotiation.

Judge Robart's decision also indicates that certain pitfalls may be associated with a decision to enter or not enter into a patent pool, or to engage in negotiations regarding pool formation. Because pool royalty rates, or even rates that were discussed during formation of the pool but never implemented, may serve as an indicator of the RAND royalty rate, careful consideration should be given to the implications of patent pool activities on a participant's ability to seek higher royalties in subsequent bilateral negotiations for patents subject to a RAND commitment. On the other hand, to the extent Judge Robart's decision is read to limit the ability of a patentee to obtain substantially higher royalties, the patentee may have little incentive to remain outside an available patent pool. It thus remains to be seen what effect Judge Robart's decision may have on the formation of patent pools for standard-essential patents.

Moreover, to the extent that it can be read to limit the royalty available for a standard-essential patent subject to a RAND commitment to approximately the value set by a relevant patent pool, Judge Robart's decision may well affect the valuation of such patents in the secondary market. Parties considering the purchase or sale of standard-essential patents subject to a RAND commitment should carefully consider Judge Robart's decision in evaluating the likely return on their investment.

Finally, Judge Robart's opinion indicates that, before engaging a consulting firm to conduct a patent valuation analysis, careful consideration should be given to the implications, as well as the discoverability, of that analysis should the patents later become the subject of litigation.

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ENDNOTES

[1] No. C10-1823JLR (W.D. Wash. Apr. 25, 2013).

[2] In *Apple Inc*. v. *Motorola Mobility, Inc.*, No. 11-cv-178 (W.D. Wis.), another breach of contract action based on a Motorola Mobility RAND commitment, Judge Crabb cancelled a trial to determine a RAND royalty for certain Motorola standard-essential patents, and dismissed the action with prejudice, after Apple took the position that it would only agree to be bound by the court's determination if the royalty did not exceed $1 per iPhone.

[3] *Id.*, slip op. ¶¶ 33, 44.

[4] *Microsoft* v. *Motorola*, slip op. ¶¶ 70-74.

[5] Judge Robart rejected the competing methodology offered by Microsoft as unworkable. Microsoft suggested that the RAND rate should be calculated as the incremental value of the patented technology compared to the alternatives that could have been written into the standard, at a time before the standard was adopted and implemented.

[6] 318 F. Supp. 1116 (S.D.N.Y. 1970).

[7] *Id.* ¶ 100.

[8] *Id.* ¶¶ 518-519.

[9] In fact, the court noted, Motorola had originally approved the royalty rate for the pool as appropriate, although it ultimately declined to participate in the pool as a licensor.

[10] In other words, the RAND royalty was (0.185 cents)[the express royalty] + 2*(0.185 cents)[the value of pool membership], for a total of 0.555 cents per unit. In a long footnote, the court attempted to add some mathematical rigor to its determination. *See* slip op*.* at p. 171 n.23.

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