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What Does Reasonable and Non-Discriminatory Mean, Anyway?

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Legal Update

Industry standards can lower costs and increase interoperability between related technologies. These standards are developed by standard setting organizations (SSOs), which are voluntary membership groups that often include leaders in the particular field. Given the individual development efforts that precede the establishment of an industry standard, individual SSO members often have patents covering one or more aspects of the standard. If an SSO member has a patent covering an essential aspect of an industry standard, the SSO will require either licensing assurance or a disclaimer that the claims of the so-called standard essential patent (SEP) will not be enforced. Such a licensing assurance must be on terms that are described as "reasonable and non-discriminatory," or RAND. The equally non-enlightening term "fair" is often added to this description, making the acronym FRAND. The purpose of the RAND guarantee is to encourage widespread adoption of the standard because once a standard is adopted, patents covering the standard can have greatly increased market power.

Both Microsoft and Motorola were part of an SSO that developed the 802.11 wireless networking and H.264 video encoding standards. Motorola, in particular, has a number of SEPs that they agreed to license under RAND terms. When Motorola offered to license its portfolio to Microsoft for 2.25% of the price of the consumer product, Microsoft initiated a breach of contract action against Motorola for violating its obligation to provide RAND licensing terms. Microsoft contended that Motorola's proposed royalty rate was too high given that over 2,400 patents are considered essential to the H.264 standard and probably thousands of patents are essential to the 802.11 standard.

In considering Microsoft's allegations, the U.S. District Court for the Western District of Washington had an interesting challenge because no court has defined what RAND actually means. Further, initial offer terms do not necessarily need to be reasonable and non-discriminatory, as the requirement applies to any license that eventually issues. Initial offers, however, do need to be made in good faith. Faced with this challenge, Judge Robart set forth a detailed methodology for determining a RAND royalty rate.

Judge Robart began with the conventional *Georgia-Pacific* factors for determining reasonable royalties based on a hypothetical negotiation between two parties. He then examined each of the 16 Motorola H.264 patents, the 24 Motorola 802.11 patents, the Microsoft products, and the technical contribution of the Motorola patents to the overall functionality of the products. This analysis is provided in a 207 page opinion where Judge Robart notes the "central principle of the RAND commitment—widespread adoption of the standard." Some of the notable features in the opinion are:

- RAND royalties cannot be computed in a vacuum. The threat of royalty stacking must be considered since there will almost certainly be multiple patents and licenses needed before the standard can be implemented. Judge Robart points out that if each of the at least 92 entities having SEPs to the 802.11 standard requested the same percentage royalty rate as Motorola, the aggregate royalty would exceed the total product price.
- The time of the hypothetical negotiation is prior to establishment of the standard. Thus, the negotiations should not reflect any increased value resulting from the standard being chosen such that the patent covers an essential component thereof.
- The patent should be valued based on its incremental value added as compared to the next-best alternative that

could have been implemented. The Court noted, for example, that Google, Motorola's parent company, does not support interlacing video (the technology covered by the Motorola patent).
- Prior licenses that are made under the threat of litigation are not a reliable indicator of a RAND royalty rate, nor are licenses negotiated outside of the RAND obligation or where the total amount of products to be sold is substantially different.
- The fact that a fear of royalty stacking has not, to date, impeded widespread adoption of the standards is irrelevant to whether Motorola has met its RAND obligation.
- Royalty stacking "does not stand up to the central principle of the RAND commitment—widespread adoption of the standard." The royalty rate must be set with this commitment in mind.

Judge Robart determined that patent pool license agreements, which were negotiated under the RAND obligation, were highly relevant. The court noted that patent pools can have lower royalty rates than rates for patents that are independently negotiated. However, since the Motorola portfolio constituted only "a sliver of the overall technology incorporated in the H.264 standard," Judge Robart concluded that the royalty rate for Motorola's H.264 SEP portfolio should be the rate received by the H.264 patent pool, or 0.555 cents per unit. Three different indicators, including a pool, an individual license, and a valuation model were used for the 802.11 standard, to obtain an average royalty rate of 3.471 cents per unit. Comparatively, this works out to a royalty rate of just 0.01% per unit on, e.g., an Xbox having a sale price of $300. Judge Robart also determined a range of royalty rates for both technologies since "more than one rate could conceivably be RAND."

As noted above, this decision is from the Western District of Washington, so most courts will not be obligated to follow it. However, it is one of the few usable roadmaps for determining whether a RAND obligation was followed, so it is likely to be closely reviewed and addressed in future decisions involving RAND licensing. In particular, it provides a clear discussion on which of the Georgia Pacific factors are more relevant when there is a RAND obligation and clear reasoning for determining royalty rates—particularly in areas where patent pools exist. The decision also provides guideposts for determining the types of evidence relevant in evaluating RAND royalty rates.

More broadly, the decision may also be useful for a company deciding whether to become involved in an SSO because it provides more clarity on potential RAND obligations. Further, consideration of this decision may also be relevant when considering whether to join a patent pool, since the rates set by these pools can be relevant for an SEP, regardless of whether the patent owner is part of the pool or not.

This advisory was prepared by Nutter's Intellectual Property practice. For more information, please contact your Nutter attorney at 617.439.2000.

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