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ALERT MEMORANDUM

TCL v. Ericsson: Landmark Judgment on FRAND Licensing

January 9, 2018

On December 21, 2017, the District Court for the Central District of California issued *TCL v. Ericsson*, resolving a long-standing dispute between the parties concerning worldwide licenses to 2G, 3G, and 4G standard essential patents (SEPs) owned by Ericsson. The court determined that none of Ericsson's previous offers had satisfied its obligation to license its SEPs on terms that are fair, reasonable and non-discriminatory ("FRAND"). The court therefore went on to provide its own calculation of FRAND rates using both the so-called "top-down" approach and benchmarking against comparable licenses from other firms who are "similarly situated." With respect to the "non-discriminatory" element of FRAND, the court ruled that while offering the same rate to all potential licensees is not required, differences should be justified, and differences in sales volume alone cannot justify discriminating against smaller implementers of SEPs. Adding to existing case law both in the US and abroad, the *TCL* decision provides a reasoned legal framework to parties negotiating FRAND licenses.

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Background to the dispute

In the early 2000's, Ericsson helped to develop and promote the technology that was eventually chosen as the standard for wireless communication by the European Telecommunications Standards Institute (ETSI). As a result, Ericsson's patent portfolio now includes patents declared as essential (Standard Essential Patents, or "SEPs") for 2G, 3G, and 4G wireless technology. At the time that the relevant standards were chosen, Ericsson committed to ETSI that it would license these patents to prospective licensees on FRAND terms. In 2007, TCL obtained a license to Ericsson's 2G SEPs that expired in 2014. Around 2011, TCL and Ericsson began negotiating licenses for Ericsson's 3G patents, and expanded the discussions to include 4G patents in 2013. The parties were unable to agree on license terms, however, and between 2012 and 2014 Ericsson filed a series of lawsuits against TCL in at least six different jurisdictions alleging infringement of its 2G, 3G and 4G patents. TCL counterclaimed that Ericsson had failed to license its SEPs on FRAND terms, and filed its own suit in the United States District Court for the Central District of California.

A ten-day bench trial was held to determine whether Ericsson had met its FRAND obligation in its negotiations with TCL, and whether either of Ericsson's two final offers prior to litigation satisfied its FRAND commitments. The court concluded that although Ericsson had negotiated in good faith, neither of its final offers was on FRAND terms. The court then proceeded to determine the FRAND royalty rate that should apply to the license agreement.

The judgment addresses a series of questions commonly raised in the context of negotiations and disputes concerning the licensing of SEPs subject to FRAND commitments. Specifically:

1. What is the scope of a court's jurisdiction to adjudicate FRAND commitments?
2. Can a court adjudicate FRAND royalty rates pertaining to worldwide portfolio licenses?
3. In what circumstances can a court stay concurrent foreign proceedings concerning FRAND royalty rates?
4. Do FRAND obligations require a licensor to offer rates that are in fact FRAND, or is it sufficient simply to negotiate in good faith?
5. How can a FRAND rate be calculated in practice? Is there a hierarchy of possible methodologies?
6. What does "non-discriminatory" mean in a FRAND context?

The District Court judgment provides commercial parties with a reasoned legal framework for negotiations and commercial conduct, and therefore carries significant practical value. However, it also has important limitations. Notably, the judgment only represents the view of the Central District of California, and is not binding on other district courts, higher US courts or in other jurisdictions. The judgment relies in part on facts particular to this case, and therefore several important questions remain regarding the scope and meaning of FRAND. Lastly, Ericsson has appealed the decision, and accordingly the lower court's decision will be subject to review and possible modification.

Scope of ETSI FRAND commitments varies by jurisdiction

Consistent with prior case law, the District Court recognized the right of a potential licensee to enforce an SEP holder's FRAND commitments under contract law.[1] The court noted that TCL was entitled to invoke the French equivalent of third-party beneficiary rights to enforce the agreement that was made between Ericsson and ETSI when the patented technology was chosen as the wireless communication standard (ETSI is a French association governed by French law).

The court also held, however, that FRAND obligations are to be interpreted as an encumbrance on intellectual property rights "where applicable under the laws of the jurisdiction."[2] Thus, the opinion acknowledges that the scope of a court's

[1] *See, e.g.*, *Microsoft, Corp. v. Motorola, Inc.*, No. 14-35393 (9th Cir. 2015).

[2] *TCL Comm. Technology Holdings Ltd. v. Telefonaktiebolaget LM Ericsson, et al.*, No. 8:14-cv-341 (C.D. Cal. 2014) Opinion at 11.

jurisdiction regarding FRAND may vary among the courts of different countries.

Jurisdiction to adjudicate FRAND royalty rates for worldwide portfolio licenses can be based on agreement of the parties, and is enforceable by injunction

Having established TCL's right to enforce Ericsson's FRAND commitments, the court considered TCL's request for an injunction to enjoin litigation in other countries regarding the same SEPs.

The court granted the injunction, noting that the parties had agreed to seek a binding court adjudication of FRAND terms for a worldwide portfolio license following their failed negotiations, and that TCL had agreed to be bound by the court's FRAND determination of such a license and a release payment for past infringement, thereby "effectively moot[ing]" Ericsson's other pending infringement suits against TCL.[3] Separately, the court noted that "a stay of the foreign litigation would allow the parties to concentrate on the overriding FRAND issues,"[4] though this does not appear to have been the driving factor in the decision. Thus, it is unclear on the basis of this decision whether such injunctive relief would be available where the parties have not agreed to binding court adjudication of a worldwide license.

FRAND Negotiating Obligations

On the merits, the court declined to assess whether the failure to arrive at an agreed FRAND rate meant that Ericsson had violated its FRAND obligation. Instead, in light of the declaratory relief sought by the parties, the court focused solely on whether FRAND rates had been offered. In so doing, the court left open the question whether an owner of SEPs will be found to have violated its FRAND commitment if the terms it has offered in negotiations are ultimately found not to be compliant with FRAND requirements.

Ericsson's two proposed FRAND offers filed with the court consisted of a combination of percentage running royalty rates and, in the case of the second offer, price floors and caps, that varied depending on the technology and product licensed. When unpacked by the court, the offers comprised the following effective royalty rates:

	2G	3G	4G
Offer 1	1.008%	1.054%	1.074%
Offer 2	0.870%	1.200%	1.988%

The court found that neither of these offers satisfied FRAND requirements, but nevertheless found that Ericsson had negotiated in good faith and had not breached its FRAND commitments by virtue of its conduct in negotiations alone. The court proceeded to use the evidence submitted by the parties to determine the applicable FRAND rate, and issued an injunction requiring the parties to complete a fully integrated license agreement within 30 days.

Methodology for setting FRAND royalty

To determine the applicable FRAND royalty, the court conducted a top-down analysis of the proportional value of Ericsson's SEPs,[5] which was then cross-checked using a comparison of similar licenses adjusted to compensate for differences in terms and cross-licensing. (This is the reverse of what Birss J. did in Unwired Planet, where the top-down method was used as a cross-check.) The court emphasized that starting the calculation with an aggregate value is preferable because it avoids the possibility that licensee will be forced to pay an unreasonable amount in total. The court explicitly rejected Ericsson's "ex standard" approach, which was essentially a bottom-up calculation purporting to value the SEPs independent of any benefit arising from being incorporated into a standard. The court did not address the possibility of applying the FRAND rate to the smallest saleable patent-practicing unit (SSPPU); instead, the validity of a royalty based on end-products (*i.e.*, phone sets) was assumed throughout.

3 *Id.* at 7.
4 *Id.*

5 The discussion of the 3G and 4G patent owners' press releases prior to the adoption of the standard suggests that the *ex ante* incremental value should be considered, though all of the examples of comparable licenses later cited by the court were entered *ex post*.

Top-down approach

The court described the top-down approach as consisting of two steps: first, assessing the value of a standard by reference to the aggregate royalty a licensee would need to pay to implement the relevant standard and, second, calculating the share of value attributable to Ericsson's SEPs.

To determine the aggregate royalty, the court examined public statements made by Ericsson and other SEP owners before each standard was adopted. (In *Unwired Planet*, Birss J. rejected the relevance of these statements on the ground that they resulted in rates that were lower than the rates agreed in license agreements that Birss J used as comparators.) In advocating for the adoption of their technologies as the ETSI standard, the companies had stated that they expected the cumulative royalty rate to remain in the single digits, around 5% for 2G and 3G, and between 6-8% (or at least not higher than 10%) for 4G.[6] [7] The court rejected Ericsson's argument that a royalty floor should be applied, on the basis that the decline in smartphone prices in the years after these statements were made meant that a 5% royalty rate would translate into a lower absolute dollar amount. The court concluded that Ericsson would have reasonably anticipated this decline in prices, which had occurred with previous technologies, and observed that the overall volume of smartphone sales increased dramatically along with the fall in prices, thus offsetting any potential loss on a per-unit basis and leading to higher overall royalty revenues even without the imposition of a royalty floor. The court also rejected Ericsson's argument that *ex ante* statements by SEP owners do not account for subsequent releases of the relevant standard that include additional valuable features on the basis that Ericsson was not able to advance any supporting evidence (the court accepted in principle that a higher total aggregate royalty could be appropriate if valuable subsequent additions were indeed made).

To determine the share of value attributable to Ericsson's SEPs as a percentage of the total universe of patents applicable to the standards at issue, the court adopted a simple patent counting system that treats every "essential"[8] patent as having equal value. In doing so, the court relied in part on public statements made by Ericsson and others prior to the adoption of 2G technology advocating for a licensing system based on the proportional number of SEPs owned by each company. In assessing Ericsson's SEPs, the court found that, of the 235 patent families Ericsson contended were essential to the 2G, 3G and 4G standards, only 148 patents at most were truly essential. While conducting its analysis, the court adjusted the number of Ericsson SEPs down to take account of expired and expiring patents, but rejected TCL's proposed adjustments to the calculation of the proportional share of value attributable to Ericsson's SEPs to account for the relative importance of Ericsson's patents to the overall technology, which TCL argued was low.

As a result of the court's calculations, Ericsson's share of the total royalty stack was found to be 3.28% for 2G technology, 2-2.6% for 3G technology, and 4.7-7.5% for 4G technology.

Comparable Licenses

To confirm that the royalty rate determined using the top-down approach is non-discriminatory, the court identified six firms it deemed comparably situated to TCL[9] that had entered SEP licenses with Ericsson and derived for comparison a one-way running royalty rate by making adjustments for

6 The court discounted the calculations derived from *ex ante* industry surveys, noting that there was no evidence that licenses had in fact been entered into at those rates and that the incentives of the companies announcing the proposed rates would have been to propose rates that were artificially high because they would be a ceiling for any future negotiations.

7 While the court did not address the issue directly, it left open the possibility that an SEP holder that had not joined the press release advocating a particular royalty rate might have expected higher royalties and therefore might not be bound. *C.f.* Opinion at 21 ("While outside groups not a part of this press release may have expected higher rates, Ericsson advocated and expected a rate close to 5%."). However, the *ex ante* expectations of future royalties is just one of many factors considered by the court in determining the aggregate rate, and thus presumably would not be determinative.

8 Neither side used the PA Consulting Reports of Patent Essentiality, instead doing their own work. The court adopted most of TCL's analysis of essentiality with a few minor adjustments.

9 The firms considered comparable by the court were: Apple, Samsung, Huawei, LG, HTC, Huawei, and ZTE.

cross-licenses, lump sum payments and other terms affecting the effective royalty rate such as royalty caps and floors. Because the resulting benchmark royalty rates were comparable to the figures produced by the top-down analysis, the court concluded that the rates it had calculated were fair.

In determining which firms are similarly situated to TCL, the court considered that the geographic scope of the licensee's business was "the most important factor" in the case at hand.[10] The court explicitly rejected Ericsson's argument that TCL should be treated similarly to smaller regional players, finding that "[s]ales volume alone does not justify giving lower rates to otherwise similar firms" and the global nature of the license sought by TCL required comparison to other global players.[11]

The court held that "similarly situated firms" include large firms making the same product.[12] The court reasoned that the greater negotiating power of companies such as Apple and Samsung is no excuse for discriminating against smaller firms such as TCL.

Royalty Rate Calculation Methodologies

Case law and economic literature has identified several possible methodologies for calculating FRAND rates:

Top-down approach/apportioning aggregate royalty burden. The top-down approach requires the court or agency to calculate the aggregate royalty burden (numerator) of all SEPs for the standard (denominator). This produces a "per-SEP" royalty. A variation of this process is to adjust the per-SEP royalty to take account of differences in the value of SEPs. The US court in *In Re Innovatio* preferred this approach.[13]

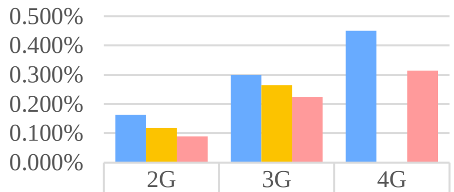
Use of comparables. Similar patent licenses and/or similar patent transactions (*i.e.*, similar portfolio sales) may be used as evidence of the "market valuation" of the technology in question. Many courts hearing FRAND disputes have considered the availability and content of "comparables," including the Washington District Court in *Microsoft v. Motorola*,[14] the Federal Circuit Court in *Ericsson v. D-Link*,[15] and the Court for the Northern District of California in *Realtek v. LSI*.[16]

Incremental value/bottom-up approach. The bottom-up approach attempts to calculate the *ex ante* incremental value to the standard of the SEPs in question (as compared with the *ex post* value, which could allow for a "hold-up" premium). Under this approach the court or agency reviews evidence on the alternative technologies available at the time the standard was chosen and assess whether those alternative technologies were more "costly," for example, because they would have adversely affected performance of increased manufacturing or development costs. This method was considered in conjunction with the comparables approach in *Microsoft v. Motorola*[17] and *Ericsson v. D-Link*.[18]

10 *Id.* at 59.
11 *Id.* at 61.
12 *Id.* at 55-60.
13 *See In re. Innovatio IP Ventures*, 2013 WL 5593609 (N.D. Ill. Oct. 3, 2013).
14 *Microsoft Corp. v. Motorola Inc.*, 2013 WL 2111217 (W.D. Wash. April 25, 2013).
15 *Ericsson, Inc. v. D-Link Sys. Inc.*, 773 F.3d 1201 (Fed. Cir. 2014).
16 *Realtek Semiconductor Corp. v. LSI CORP.*, 946 F. Supp. 2d 998 (N.D. Cal. 2013).
17 *Microsoft Corp. v. Motorola Inc.*, 2013 WL 2111217 (W.D. Wash. April 25, 2013).
18 *Ericsson, Inc. v. D-Link Sys. Inc.*, 773 F.3d 1201 (Fed. Cir. 2014).

Level of FRAND royalty

As a result of applying the methodology outlined above, the *TCL* court concluded that the following benchmark royalty rates were FRAND:



	2G	3G	4G
Court's U.S. Rate	0.164%	0.300%	0.450%
Court's Europe Rate	0.118%	0.264%	
Court's RoW Rate	0.090%	0.224%	0.314%

The court ordered a single rate for past and projected future sales, differentiated based on three categories of jurisdiction: the U.S., Europe and Rest of World. The rate supplied by the court is substantially lower than that proposed by Ericsson (and below what Birss J found in *Unwired Planet*), but is higher than that proposed by TCL.

To resolve Ericsson's claims for past infringement, the court ordered TCL to pay a release payment of approximately $16.5 million, which was calculated by applying the FRAND rate to the net-selling-price of the infringing products.

Non-discrimination (ND) obligation within FRAND

The court noted that the non-discrimination obligation did not require the terms offered to TCL to be the same as the lowest offered to others in the market place. The court held that ETSI had explicitly rejected the "most favored licensee" requirement, and that accordingly the FRAND rates could differ depending on "the economics of the specific license."[19] In so holding, the court relied on a French law expert who suggested at trial that FRAND rates may differ based on the changing value of an SEP portfolio over time as the result of patent expirations, new patent acquisitions or grants, market forces or uncertainty concerning the essentiality, validity or likelihood of infringement of the patents contained in the SEP portfolio.[20]

The court further held that a potential licensee need not prove distortion of competition in the market to demonstrate that a rate is discriminatory, and noted that "harm to the competitor firm offered discriminatory rates is sufficient."[21] (This is an important difference with the judgment of Birss J. in *Unwired Planet*, who did require a competitive disadvantage, although that issue is subject to appeal.)

The court also declined to impose a minimum dollar-per-unit royalty, as had been requested by Ericsson, deeming it to be discriminatory in this case. The court relied on testimony that several of Ericsson's licenses to other smartphone manufactures had been percentage-based royalties. Indeed, the court observed that one of Ericsson's own fact witnesses testified that there was no technical justification for the use of price floors and caps, and that this was just a negotiating tool.

Given the court's lengthy discussion of the specific facts pertaining to the royalty rates in this case, and the court's reliance on Ericsson's own prior statements advocating a percentage-based royalty prior to the adoption of the standard, it seems unlikely that the court's ruling in this case implies an overall prohibition of dollar-per-unit royalties in all FRAND cases. Rather, the availability of such royalties will depend on the individual circumstances of the SEPs and the owner of the SEPs.

Putting the decision in context

The Central District of California is just one of several jurisdictions to address these important issues related to the scope and meaning of FRAND.

Particularly worthy of comparison is the English High Court's recent judgment in *Unwired Planet v. Huawei*,[22] handed down in April 2017, in which Birss J considered a number of similar issues to

[19] *TCL Comm. Technology Holdings Ltd. v. Telefonaktiebolaget LM Ericsson, et al.*, No. 8:14-cv-341 (C.D. Cal. 2014), Opinion at 30.

[20] *Id.* at 30 (*citing Declaration of Bertam Huber* (Dkt. 1329) ¶¶ 36-42); *see also* Huber Decl. ¶¶ 51-53.

[21] *Id.* at 91.

[22] *Unwired Planet International Limited v. Huawei Technologies Co. Ltd. and others* [2017] EWHC 711 (Pat).

those arising in *TCL v. Ericsson* (and which is currently also under appeal).

First, Birss J similarly held that Unwired Planet's commitment to ETSI was enforceable as a contract by Huawei as a third party beneficiary under French law.[23] Like the court in *TCL v. Ericsson*, Birss J also considered it possible for the court to determine a single FRAND rate[24] and that an SEP owner's making of higher offers did not necessarily amount to a breach of the FRAND commitment in and of itself.[25]

Birss J also relied on a combination of the top-down approach to patent valuation and use of comparable licenses in setting the FRAND rate. However, he chose to focus his analysis on comparable licenses, using the top-down analysis as a cross-check only, due to the difficulty he perceived in establishing the aggregate royalty for purposes of the top-down approach – unlike the court in *TCL v. Ericsson*, Birss J did not consider *ex ante* statements of SEP owners themselves to be a reliable indicator of either the full royalty stack or the proportion of the stack owned by any particular SEP owner.[26]

Another difference in approach between the two decisions relates to the interpretation of the "non-discriminatory" element of FRAND. In *Unwired Planet v. Huawei*, Birss J held that FRAND does not introduce a "hard-edged" non-discrimination obligation unless there is distortion of competition.[27] The court in *TCL v. Ericsson* took the better approach by not conflating the concept of discrimination for purposes of the FRAND obligation – which is concerned with striking a fair balance between licensor and licensee while patent hold-up and hold-out – with the concept of discriminatory pricing under antitrust laws, which serves a different purpose.

Conclusion

The District Court for the Central District of California has re-confirmed that potential licensees have the authority to enforce FRAND obligations against SEP holders, and clarified the scope of the court's review.

The decision makes clear that public statements of patent owners play an important role in defining the rights and obligations in the FRAND context. Here, the District Court enjoined concurrent litigation of other countries pending the determination of a FRAND rate for a worldwide license – based in part on the parties' agreement to be bound by such a determination.

Furthermore, the court relied heavily on *ex ante* public statements by the patent holder regarding the anticipated future royalty rates for the technologies, and used these statements to inform the FRAND obligation.

The court expressed a clear preference for a top-down approach to calculating FRAND royalties, combined with an examination of comparable licenses, and declined to adopt a "bottom-up" approach to valuation. In choosing this approach, the court confirmed that the royalty should reflect the incremental value of the technology, not the value added by the standard or the patent holder's attempts to capture the value added by the standard.

The court also clarified that "non-discriminatory" in the FRAND context did not require a "most favoured licensee" approach but did not require a licensee to prove distortion of competition in the market to demonstrate that a rate is discriminatory.

Although the court provided a detailed analysis of its calculations, much of its analysis was fact-intensive and it remains to be seen to what extent the choices made by this court will become standard in future FRAND determinations.

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23 *Id.*, ⁋146.
24 *Id.*, ⁋165.
25 *Id.*, ⁋159.
26 *Id.*, ⁋269-270. Birss J appears to have engaged in circular reasoning here.
27 *Id.*, ⁋501-503.