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*By Mail*

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High Court 2013 (ne) No. 10043 case
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***Re*** ***Case 2013 (*****ne*****) No. 10043 – FRAND damages and injunctions***

Ladies and Gentlemen:

The Intellectual Property High Court has invited public comments with respect to a pending case, 2013 (*ne*) No. 10043 (first instance: Tokyo District Court 2011 (*wa*) No. 38969). The High Court has asked

> [w]hether there is any restriction on practice of rights to seek an injunction or damages based on a patent that is essential to the standard set by a standard setting organization when so-called (F)RAND declaration (a declaration that [a patentee] will grant a license on (Fair,) Reasonable and Non-Discriminatory conditions) is made.

The High Court raises two separate questions. First, the High Court asks whether a FRAND commitment limits in any way the right of a holder of a standard-essential patent (SEP) to seek an injunction against an infringer. Second, the High Court asks whether a FRAND commitment poses any restriction on the damages that an SEP holder can obtain from an infringer of a FRAND-committed SEP. I respectfully submit my opinions with respect to these two questions raised by the High Court.

My name is J. Gregory Sidak. I am the founder and chairman of Criterion Economics, L.L.C. in Washington, D.C. I am also the Ronald Coase Professor of Law and Economics at Tilburg University in The Netherlands and a founding co-editor of the *Journal of Competition Law & Economics*, published quarterly by the Oxford University Press since 2005. For more than three decades, I have worked at the intersection of law and economics. As an expert economic consultant, I have served clients in the Americas, Europe, and Asia. I have done extensive work in the area of standard-essential patents (SEPs): I have testified as an economic expert on FRAND issues in several legal proceedings, I have published academic articles, and I have presented at international conferences on FRAND matters and related topics. I have also served as Judge Richard Posner's court-appointed neutral economic expert on patent damages in U.S. District Court for the Northern District of Illinois. I do not represent the interested parties, and I have no economic interest in the outcome of the litigation.

I attach two articles that I have recently written in English that add depth to the ideas expressed in my comments submitted herein. The first, *The Meaning of FRAND, Part I: Royalties*, discusses FRAND royalties for SEPs. The second, *Holdup, Royalty Stacking, and the Presumption of Injunctive Relief for Patent Infringement: A Reply to Lemley and Shapiro*, disputes the theory that the threat of an injunction inflates royalty payments in many cases relative to a hypothetical benchmark royalty rate.

## I. Does a FRAND Commitment Pose a Restriction on the SEP Holder's Ability to Seek an Injunction?

A FRAND commitment is a contract between the SEP holder and the standard-setting organization (SSO), to which the implementer of the standard is a third-party beneficiary. The obligations arising from a FRAND commitment must be interpreted in accordance with the provisions of the FRAND contract and the intent of the parties when stipulating the terms of that contract. Most SSOs' internal rules determine that the primary purpose of a FRAND commitment is to grant implementers access to the standard. A FRAND commitment thus contractually restricts some prerogatives of the SEP holder's statutory rights. Most important, the SEP holder has a duty to make a FRAND offer to any implementer that wishes to access the standard. By making a FRAND commitment, the SEP holder agrees to forbear from its statutory right to exclude from the use of its SEPs any implementer that is *willing* to accept the SEP holder's FRAND licensing terms.

The SEP holder's duty to make a FRAND offer does not ensure, however, that a negotiation with the implementer will result in a licensing agreement. Even if the SEP holder makes a FRAND offer and negotiates the licensing terms in good faith, the negotiation might fail. For example, the implementer may refuse to accept a FRAND offer. In such a circumstance, the SEP holder and the implementer will not reach a licensing agreement. The SEP holder should hence be able to request, and obtain, an injunction against the *unwilling* implementer, without such conduct being considered a violation of the FRAND commitment.

Some commentators have argued that allowing an SEP holder to request an injunction might result in patent holdup. In their view, the SEP holder's threat of excluding an implementer's products from the market, even if for a limited period of time, could enable the SEP holder to extract from implementers licensing fees that exceed the genuine economic value of the SEP. These commentators consequently suggest that an SEP holder that has committed to license its SEPs under FRAND terms should be precluded from obtaining an injunction. These commentators, however, ignore that a categorical ban on injunctions for FRAND- committed patents is likely to lead to opportunistic behavior by the implementer. If an injunction is not available, an implementer that is already using an SEP would have little incentive to reach a prompt agreement on FRAND terms. A categorical ban on injunctions would therefore encourage free riding on the SEP holder's invention and decrease the implementer's incentives to reach a prompt licensing agreement on FRAND terms.

A court's decision on whether to grant an injunction against an infringer of a FRAND-committed patent must therefore account for possible strategic behavior, both by the SEP holder *and* by the implementer. To create correct incentives, a court must ensure that an SEP holder that acts in good faith will be able to obtain an injunction against any implementer that is unwilling to accept a FRAND offer. If an SEP holder makes an initial licensing offer that is in the FRAND range, then the SEP holder has complied with its FRAND commitment. Any further negotiation of the licensing terms is solely at the discretion of the SEP holder. The implementer cannot refuse an offer that is in the FRAND range and hope to avoid the injunction because it wants a better deal. Thus, there is no reason to deny a permanent injunction against an implementer that declines a FRAND offer.

During the negotiation process, there might nevertheless be a genuine disagreement between the SEP holder and the implementer as to whether the licensing offer is indeed within the FRAND range. The relevant question is whether, in such circumstances, the implementer might be able to avoid a preliminary injunction until the disagreement regarding the FRAND royalty is resolved. In such a case, economic theory suggests that the court might decide to limit the availability of a preliminary injunction. However, it is important for the court to ensure that only an implementer that, first, has engaged in the process of negotiating a FRAND license and, second, is negotiating in good faith, is able to avoid a preliminary injunction. Otherwise, the court risks encouraging bad-faith negotiation by the implementer.

To evaluate whether the implementer is negotiating in good faith, the court should examine several variables. First, the court should evaluate whether the implementer has made a counteroffer and whether *prima facie* evidence indicates that such a counteroffer is within the FRAND range. An implementer that makes a counteroffer outside the FRAND range does not negotiate in good faith and should not be protected against a preliminary injunction. Second, the court should analyze whether the implementer has shown willingness to reduce the difference between the licensing offer and counteroffer (that is, the bid-ask spread), and reach a voluntary licensing agreement on FRAND terms. In this respect, the court can evaluate several variables, including the implementer's reaction to the information obtained during the negotiation process, and the promptness of the implementer's negotiation moves. Finally, the SSO's internal rules may provide for an alternative dispute resolution mechanism to resolve disagreements over FRAND rates. For example, the VITA Standards Organization provides that disputes over FRAND terms should be solved through an internal arbitration procedure. The court should consider the implementer's refusal to use this mechanism as evidence of bad-faith negotiation and thus unwillingness to reach a FRAND agreement.

By applying the economic framework that I have presented above, courts will ensure that they disfavor the party that acts opportunistically, which properly balances both the interests of the SEP holder and the implementer. In the long run, the implementation of this framework will discourage opportunistic practices and stimulate voluntary licensing agreements on FRAND terms.

Finally, some commentators have suggested that an SEP holder's request for an injunction constitutes anticompetitive behavior. However, there is no economic basis to support the assumption that an SEP holder's request for an injunction will automatically have anticompetitive effects on the market. The court would have to evaluate several elements before finding that a request for an injunction is anticompetitive. First, the court must determine whether the SEP holder has significant market power, such that its conduct has the ability to harm competition in the market. Second, the court needs to evaluate whether the request for an injunction is illegitimate. If the SEP holder's request is legitimate—for example, because the licensee has refused even to discuss with the SEP holder the terms of a license—there is no reason to consider such a request anticompetitive. Finally, even if the court finds that the SEP holder's request for an injunction was illegitimate, it needs to evaluate whether such a request imposes the type of harm that competition law aims to prevent. An unfair, illegitimate act should not be considered anticompetitive simply because it was undertaken by a company with market power. Therefore, there is no valid justification to presume that an SEP holder's request for an injunction would be *a priori* anticompetitive.

## II. Does a FRAND Commitment Pose a Restriction on Damages for Patent Infringement?

In the case of an infringement of an SEP, the SEP holder is entitled to obtain damages from the infringer of the SEPs. The High Court asks whether the damages calculated for a FRAND-committed SEP should differ in any way from damages calculated for standard-*in*essential patents.

In the case of standard-*in*essential patents, the calculation of a reasonable royalty in U.S. patent law is based on a model of bilateral bargaining—the royalty that would have arisen from the hypothetical negotiation between a willing licensor and a willing licensee at the time of the first infringement. The upper bound of the bargaining range is the defendant's maximum willingness to pay. It represents the difference in the value that the use of the patent creates for the infringer and the value created by the next-best noninfringing substitute. This difference necessarily includes the infringer's cost of acquiring the lawful right to use the next-best alternative (if it is not in the public domain). The lower bound of the bargaining range is the patent holder's minimum willingness to accept for granting a license to the patent, a value that is derived from the patent holder's opportunity cost of licensing to the infringer. It reflects the value that the patent holder could have gained from using the patent besides licensing it. The damages for patent infringement should be determined within that bargaining range.

When determining the damages for the infringement of a FRAND- committed SEP, the court needs to consider the parties' *individual rationality constraint,* under which both the SEP holder and the implementer are better off with the FRAND license than without it. The individual rationality constraint provides a bargaining range for the calculation of a FRAND royalty. The lower bound is determined by the SEP holder's minimum willingness to accept a payment for its SEPs, which equals the SEP holder's opportunity cost of choosing to monetize its inventions through the standard. Participating in the setting of a standard and licensing its SEPs to any implementer on FRAND terms imposes substantial constraints on the SEP holder's licensing policy. The SEP holder will decide to submit a patent to an SSO only if the SEP holder expects to earn more profits by contributing its technology to the standard than by making an exclusive use of the technology or licensing the technology outside the standard. Conversely, the upper bound of the bargaining range is determined by the licensee's maximum willingness to pay for the SEPs. The implementer will produce standard-compliant devices only if it believes that it will be better off by implementing the standard and paying the FRAND royalty than by producing devices that do not comply with the standard. FRAND damages must therefore (1) ensure the SEP holder's continued contribution to the standard-setting process and (2) not deny the implementer access to the standard.

As of March 2014, U.S. courts have not developed yet an intellectually rigorous methodology for calculating FRAND damages. In *The Meaning of FRAND, Part I: Royalties*, I examined the various methodologies courts can apply—such as the reliance on data from patent pools and the "Proportional Contribution" and "Top-Down" approaches. Each of these approaches has disadvantages, such that none of them provides an optimal method for calculating a FRAND royalty.

Several commentators have erroneously suggested that a FRAND royalty should reflect the "*ex ante* incremental value" of the technology—that is, the incremental value of the SEP above the value of substitute patents, which competed with the patent in suit for adoption into the standard. However, the *ex ante* incremental value approach fails to compensate patent holders for the additional risk that SEP holders face as a result of their participation in the standardization process. For example, an SEP holder incurs additional risk when it releases information related to its IPRs. By joining an SSO, an SEP holder also forgoes the profit it could derive from the exclusionary use of the patented technology. The disregard for such risks makes the *ex ante* incremental value approach inconsistent with the need to encourage participation in the standard. Moreover, as expressed by its leading academic proponents and as described by one U.S. district court, the *ex ante* incremental value approach erroneously assumes that alternatives to a given SEP are available at no cost. Because switching to an alternative patent would entail the cost of acquiring it, the actual value of the SEP is not merely the incremental value. Instead, the actual value of the SEP should include the sum of the value of the next-best alternative *and* the incremental value that the SEP offers over the next-best alternative. Finally, the *ex ante* incremental value theory is inapplicable in the real world. Using this approach to determine a FRAND royalty would require a fact-intensive, time-consuming analysis that is often difficult—if not impossible—for the courts to perform. I am not aware of any court that has actually applied (as opposed to having merely described) the *ex ante* incremental value approach when calculating FRAND damages.

If available, the royalties stipulated in the parties' existing bilateral licenses generally provide the most probative data for determining FRAND damages. A voluntarily agreed-upon royalty is typically the best measure of a reasonable royalty, because it removes the need for the court to guess the terms the parties would have hypothetically agreed upon. The voluntarily agreed-upon royalty implies that both parties expected to be better off as a result of the license than in its absence. Otherwise, the parties would have not concluded the license. Claims that past licenses reflect a holdup value are wrong. It is highly unlikely that sophisticated parties would systematically agree to exploitative licensing terms. Besides, in case of a disagreement over license terms, the licensee can ask a court, including in response to a claim for infringement and request for injunction by the licensor, to evaluate whether the offered licensing terms comply with the SEP holder's FRAND commitment. Therefore, when available, data from comparable past licenses provide the best evidence for calculating FRAND damages.

Sincerely,

J. Gregory Sidak

J. Gregory Sidak
Chairman

Attachment
Translation