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Why Patent Holdout is Not Just a Fancy Name for Plain Old Patent Infringement

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Patent holdup – where a standard essential patent (SEP) holder exploits a licensee's costs to switch away from the related standard as a means of obtaining royalties above the fair, reasonable, and non-discriminatory (FRAND) level – is a regular feature of the innovation policy debate. Indeed, one of the apparent motivations behind the Federal Trade Commission's upcoming study of Patent Assertion Entities (the 6(b) study) is concern over "excessive" litigation and patent holdup by non-practicing patent aggregators. Analogous conduct, licensee holdout – where a would-be licensee implements a standard but does not take a license to the SEPs underlying it – has gotten far less attention.

In some circles, patent holdout is dismissed as no more than a fancy name for regular patent infringement. The thinking here is that when an implementer does not take a license to SEPs, it can be sued for patent infringement just as with any other patent. Thus, patent holdout is merely old wine in a new bottle, with no need for any special treatment. In this article, I explain why this view reflects a lack of understanding of important differences between traditional patent litigation and litigation over SEPs under a FRAND obligation.

A Handful of Patents Versus Portfolio Licensing

The first fundamental difference lies with the number of patents involved. With SEP licensing, an implementer requires a license to the entire portfolio of essential patents and cannot be in compliance with the standard without such a license. This follows because SEPs are, by definition, perfect complements to one another, each essential to the practice of the standard. Even if actual essentiality has not been determined and the case involves patents disclosed as potentially essential to a standards development organization (SDO), it is the full portfolio of disclosed-essential patents that are at issue. Geography commonly plays a role as well, as most technology standards govern global product markets, where licensors hold patents in numerous jurisdictions and implementers have operations and sales around the world. As a result, in practice SEPs are licensed at the portfolio level, with FRAND defined for the portfolio as a whole, not for individual patents. Under current legal practice, however, patent holders cannot assert an entire portfolio of patents in litigation. Judicial resource restraints dictate that only a few patents can be asserted at a time.[2] This constraint is particularly binding for worldwide SEP portfolios, where litigation must proceed one country at a time (absent voluntary global settlement). As a result, even if the SEP holder prevails in a given infringement action, standard implementers can (and typically do) proclaim that they are only obligated to take a license to the specifically adjudicated patents, which have been proven to be valid and infringed.

As a result, SEP holders either receive a below-FRAND payment, obtaining damages on the fraction of their portfolio that has been successfully litigated, or they need to file sequential litigation to obtain payment for all of their infringed SEPs (e.g., the full essential portfolio). This approach is costly, time consuming, and risky as court decisions are always uncertain and some countries' courts are ill-equipped to handle SEP infringement matters.

Patent Damages Floors Versus Caps

A second fundamental difference lies in the legal rules governing SEP infringement damages as compared to traditional damages. For traditional patent infringement cases, 35 U.S.C. § 284 states that "upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer . . ." In plainer language, "reasonable royalties" define the floor or lower bound for damages set in non-FRAND assured patent infringement cases. In contrast, FRAND commitments define "reasonable royalties" as the cap or upper bound on what SEP holders may receive, not the floor. While the exact language of FRAND pledges differs across SDOs, the broad consensus among academics, policymakers, and the courts is that FRAND rates cannot exceed a reasonable level, dictated by the contribution the patented technologies make to the standard and products compliant with that standard.

In sum, litigation over the exact same patented technology as infringed by the exact same firm selling the exact same products would nevertheless likely lead to meaningfully different "reasonable royalty" damages, simply due to the FRAND commitment. If a SEP holder can achieve "reasonable royalties" only through litigation, or worse, through serial litigation for handfuls of patents at a time because of patent holdout, then SEP holders will not obtain FRAND payment for their SEP contributions; compensation is likely to fall below the FRAND level once litigation costs are accounted for.

Probabilistic Patents Versus Established Valid and Infringed Patents

As another potential difference between damages awarded in traditional infringement cases as compared to FRAND cases, consider uncertainty over patent validity. Arm's length patent license agreements are negotiated under uncertainty: if the patent has never been litigated before, neither party can be sure of its validity, and even if it has been proven valid in the past, the question of infringement for each new enforcement action still remains. Both forms of uncertainty are resolved through litigation. Damages are only owed if the court finds the asserted patents both valid and infringed, and experts therefore assume validity and infringement in calculating damages.

In traditional patent infringement cases, known validity may be used as justification for a higher royalty payment, framed as an increase relative to extant licensing payments with similarly situated licensees (i.e., comparable licenses), which were negotiated before the patent was known to be valid. That is, arm's length negotiations are likely to reflect discounted royalty payments to account for uncertainty over the patent's validity. Once that uncertainty is resolved, the discount is removed, resulting in higher royalties.

SEPs are encumbered with the same uncertainty, if not more given the added dimension of "essentiality." And just like traditional cases, in SEP infringement litigation damages are calculated assuming patent validity, essentiality, and infringement. However, I am unaware of any FRAND infringement case in which the damages expert has argued for increased damages to

reflect resolution of uncertainty. I am deeply skeptical that a court would accept such an argument even if a damages expert were to attempt one. Comparable licenses with similarly situated licensees form the cap to damages in FRAND infringement cases, as explained above, preventing any upward adjustments accounting for adjudicated validity, infringement, and essentiality. Moreover, the non-discriminatory prong of FRAND reinforces this point, so that rates set in arm's length agreements will not differ materially from those set in litigation (for similarly situated parties).

The Bottom Line

When all of the above is put into the context of expected behavior (or alternatively, an options framework), it is clear that patent holdout can be a very attractive strategy for standards' implementers. Working backwards through a simple example illustrates this point. After litigation is concluded, if an implementer is found to infringe the asserted SEPs it will have to pay FRAND damages/royalties of F. But there is some chance (call it p, where $0<p<1$) that the court will decide the litigation in the implementer's favor, in which case it will pay nothing in damages. Abstracting from litigation expenses that both the plaintiff and the defendant must pay, on the eve of litigation the implementer's expected loss is only $p \times F$, which is clearly less than F. Stepping back even earlier in time, there is some chance (call it ð, where $0<ð<1$) that the SEP holder will never file suit, say because it is focused on its downstream market or because it is worried about retaliation in other commercial dealings with the implementer. Thus, before the implementer ever makes its first investment in bringing standard-compliant products to market, it faces two options: 1) enter into a license with the SEP holder now and pay the FRAND royalty F with certainty, or 2) practice patent holdout, which has the expected payout of $ð \times p \times F$, an amount clearly lower than either $p \times F$ or F.[3] It would be entirely unsurprising for a significant number of implementers to choose option 2.

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[2] *Microsoft v. Motorola*, which did determine a FRAND rate for a portfolio of SEPs, was a bench trial over breach of contract initiated by the putative licensee Microsoft, not a jury trial for patent infringement initiated by the SEP holder Motorola. Findings of Fact and Conclusions of Law in *Microsoft Corporation, v. Motorola, Inc, et al*, Case No. C10-1823JLR.

[3] In light of recent court rulings and antitrust agency guidelines, it appears that SEP holders only have the option of seeking an injunction when they can show the infringer is an unwilling licensee. Implementers can agree to pay a court adjudicated FRAND amount to avoid being cast as an unwilling licensee. Thus, they do not face the risk of shutdown.