THE SCIENCE OF CHINA'S FRAND RATE-SETTING

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I. BACKGROUND

China's courts and antitrust authorities have increasingly played active roles in setting fair, reasonable and non-discriminatory ("FRAND") royalty rates for the wireless communication industry. The Shenzhen court applied a very low rate in *Huawei v. InterDigital* back in 2014, which was vacated as a result of a settlement. The Beijing Intellectual Property Court and the higher people's court affirmed the rate for China's own WiFi standard in favor of a China-based technology company (IWNCOMM), in 2017. In September 2019, Nanjing Intellectual Property Court issued the China FRAND rates for Conversant's 3G/4G patent portfolio. Of course, the most influential decision is the anti-monopoly enforcement authority's decision in 2016 against Qualcomm, where a 65 percent discount was imposed in China sales.

China's courts have also announced their intention to adjudicate on global FRAND rates. In May 2018, the appellate court in China's Guangdong Province, where some of largest Chinese mobile handset manufacturers are based, issued special judicial guidelines on dealing with standard-essential patent ("SEP") cases. One of the most interesting provisions suggested that at least the Guangdong court was willing to adjudicate global FRAND rates at the request of litigants.

While we have not seen any such global rates being set by any of the Chinese courts, it seems to many of us that Chinese judges, whether in Shenzhen, Beijing, Nanjing or in the Intellectual Property Court in the Supreme Court, might sooner or later take up opportunities to make such rulings.

This article proposes that certain "framework aspects" and "foundational factors" should be the focus of discussions if China is genuinely interested in setting FRAND rates (either for China only or globally), with credibility and support. China aspires to have global accountability, and its courts must be prepared to issue decisions that have global impact. Whether or not the courts are the ideal place for handling such disputes, judges must be ready.

The framework aspects and the foundational considerations that we propose here are largely based on rule of law considerations for FRAND rate determination. The framework aspects we set out include the boundary of the royalty stack, the good faith of implementers, the readiness to use arbitration, and the larger context of trade policies and the global industry ecosystem. The foundational factors to be built include China's jurisdiction (ultimately the comity issue), protection of confidentiality, use of expert witnesses, *amicus* briefs, and due process requirements for antitrust investigations.

One of the specific questions we raise relates to foreign policy, as trade tensions have long formed a significant part of the backdrop to IP issues. The most worrisome policy part of current dialogue concerning the U.S.-China trade relationship relates to so-called "delinking," i.e. excluding China from U.S.-centered technologies and supply chains. If China-based implementers see no hope of being part of the global supply chain, implementers will exhibit much more resistance, and the potential for collaboration between licensors and licensees will come up against more barriers. These barriers could all become part of a blockade to future developments in many important technological fields such as 5G and the internet of things ("IoT").

Our aim is to provide some pathways for policymakers and stakeholders (both inside and outside China) to develop a system to address the conflicts between patent owners and implementers. Finding a solution would unlock tremendous efficiencies and significant opportunities for innovation and the global supply chain.

II. FRAMEWORK ASPECTS

By "framework aspects" we refer to broader contextual issues China needs to consider when its courts have opportunities to take on FRAND rate setting cases.

These issues concern the views or perceptions among licensors, China-based implementers, and Chinese regulators, judges and regulators. The points of view listed below may or not already be familiar. Providing opportunities for stakeholders to address these points is key. These issues include:

- Whether China-based implementers will be forced to carry an unfair burden of royalty rates?
- Whether China-based implementers will be treated fairly or discriminated against outside China, specifically in foreign courts or foreign arbitration tribunals?
- Should not China-based implementers be accountable for any hold-out behavior?
- Will hold-out even hurt China-based innovators one day? Can patent owners ever be paid for their innovation efforts?
- Will China try to choke off or unfairly squeeze resources for innovations made outside China?
- Where does royalty money come from? Are we still in the same economic ecosystem? Will we truly be business partners, rivals or even enemies in the future, given the way the world (and specifically U.S.-China trade relations) is developing?
- Does the patent system still make a key difference to innovation?

The following is the set of framework aspects to work from.

A. Boundary of the Royalty Stack

One of the biggest concerns among Chinese regulators and judges is royalty stacking. Industrial policy decision-makers are often haunted by stories that Chinese implementers end up having no profits at all after paying royalties, whether or not they have been paid in reality.

It is suspected that, as a defense mechanism, Chinese implementers, antitrust enforcers and judges are looking to the excessive pricing provision under China's anti-monopoly law ("AML") to threaten actions against patent owners. It is unsurprising that the implementers' recourse to AML litigation is often considered to be a form of hold-out by patent owners.

There is a real need for regulators or judges who take into account industrial policy factors (whether or not they should do so) to have reliable knowledge about the current consensus, if any, or other views about the total size of the royalty stack in wireless communication. One of the common worries about judges or regulators is that they might not be sufficiently knowledgeable about industry or business practices.

If FRAND cases indeed reach the courts or antitrust regulators, our best hope is that these judges or regulators will catch up quickly and gain real business insight. It would also be valuable for them to be aware of current trends in other jurisdictions, e.g. the pending FTC case against Qualcomm, the DOJ's investigation into standard-setting organizations, etc. All of these developments could reshape current thinking. When stakeholders have more insight, they might find it sobering to look at the real state of the royalty stack.

B. Arbitration

Are courts really the ideal forums for FRAND rate determination? In China and other jurisdictions, there are committed judges who are fully capable of adjudicating such disputes. There is no doubt about these judges' capabilities. But even those judges in China who have in fact rendered such decisions in the past privately admit that they are reluctant to handle the task, given the complexity and the amount of time that must be allocated to FRAND cases. Judges are increasingly overloaded with complex cases and other judicial responsibilities. This is particularly true in China.

Going to courts for FRAND rate setting is probably not what was intended when patent owners made FRAND commitments during the standard setting process in the first place. FRAND rates are by their nature business decisions to be made by the parties to transactions. Arbitration by a team of experts in this area is supposed to offer efficiency when disputes arise. This is probably why China's MOFCOM seemingly accepted the use of arbitration as a condition to determining the willingness of licensees in its conditional approval of Microsoft's acquisition of Nokia's cellphone business.[2]

Why are China-based implementers showing little willingness to take the arbitration route? What are the lessons, valid or invalid, that they have drawn from the past experiences? Reportedly, leading Chinese companies have suffered significant disappointment from their arbitration experiences. What caused this, aside from the result itself? Some implementers think arbitration decisions are not binding precedents, as licensors could always assert patents elsewhere against other implementers if the licensors are not pleased with certain results.

If location is a key issue, might arbitration in Hong Kong or Singapore be a better choice? Mainland China and the Hong Kong SAR recently reached a new agreement that allows China's courts to enforce injunctions issued in Hong Kong. But anecdotally, the Hong Kong International Arbitration Center ("CIETAC") does not have a sufficient supply of competent arbitrators that are considered to be FRAND experts.

What would it take for more arbitration organizations to be ready to truly realize this form of alternative dispute resolution? Are there arbitration panels that are irresistible to both implementers and patent owners? If not, what would it take to build them? And how long would it take?

C. Asymmetry in the World of FRAND

FRAND was never intended to be a rigorous set of legal tests, but FRAND commitments make it possible for standardized technologies to be implemented at scale. China places high priority on the good faith principle ("cheng shi xin yong") in its civil code (Art. 7) and in its intellectual property system. This is arguably consistent with the values behind FRAND.

China's legal scholars seem to agree that a FRAND commitment is a unilateral legal act that delivers legal effect under its civil code and contract law. It would be interesting to clarify whether implementers should be held accountable to the good faith principle in China.

The China Supreme People's Court's position on SEP injunction issues suggests that it looks at the "fault" (i.e. "culpability)" of both licensors and implementers. The guidance issued by the Beijing Higher People's Court even went one step further by comparing the "fault" on both sides. All this implied that implementers bear some obligation to act in good faith. China has long recognized the principles of "fault in contract making" (Art. 42 in the Contract Law). Should this principle be applied more rigorously to stop "hold-out" behaviors and prevent "efficient infringements"?

D. International Trade Relationships

One of the most worrying conversations surrounding the U.S.-China trading relationship concerns "delinking" or the so-called "new cold war."[3] The idea is that the U.S. should abandon economic cooperation with China concerning science, technology, investments, industry, education and shared talent pools. Whether or not this will become a reality is beyond the scope of this discussion, but it inevitably affects policymaking and even judges' thought processes when discussing FRAND royalties.

Irrespective of the territoriality of patent laws around the world, all jurisdictions share one common underlying value – providing stimulus for innovation. No one has convincingly argued that innovation incentives should be limited to local innovation in a particular country. Given the nature of the global economy and innovation ecosystem, the way patent licensing has been working undoubtedly benefits global innovation. This is not a secret, despite the doctrine of territoriality of intellectual property laws.

Empirical experience shows that much less hold-out has been experienced by companies in Japan and Korea, particularly in the past. Moreover, hold-out was rarely mentioned back in the DVD licensing era by China-based implementers. Even today, the Chinese firms that take on most licenses are often those with more sales outside China. All this probably proves that a real commitment to become a bigger player in the global market makes it more likely for implementers to pay royalties.

2 See MOFCOM merger review decision dated April 8, 2019, http://www.mofcom.gov.cn/article/b/e/201404/20140400542508.shtml.

3 See https://foreignpolicy.com/2019/09/06/the-u-s-china-cold-war-is-a-myth/.

Today, the divisiveness surrounding free trade and globalization, and more worryingly, the rising conversation around "delinking" the U.S. and Chinese economies, paints a much darker picture for implementers. At some point, governments will begin to inquire if royalty payments benefit rivals, and why?

If there is more government intervention in the near future, patent licensing will become more of a geopolitical rather than a legal issue. This is not desirable for implementers or patent owners. Even worse, if we unfortunately fall into a new cold war era, we should simply leave royalty issues to diplomats and bureaucrats.

III. FOUNDATIONAL FACTORS

While all stakeholders pay attention to the framework aspects noted above, there is no doubt that certain specific foundations should also be developed in China, if courts or antitrust regulators plan to rule on FRAND rates, be they local or global, with credibility and global influence.

The foundational factors we set out below may not be exhaustive, but developments concerning these factors will be critical. None of these proposals are out of reach. There is no reason not to try to implement any of them.

A. Loopholes in Jurisdictional Rules

Generally speaking, Chinese courts can exercise jurisdiction over FRAND cases through either (i) a special "FRAND fee dispute cause of action," or (ii) under the AML. The FRAND fee dispute cause of action originated from the *Huawei v. InterDigital* case back in 2013. The second cause of action derives from the "excessive fee" provision of the AML. Both causes of action seem to be loosely based on Chinese anti-monopoly laws. In particular, the nature of the FRAND fee dispute cause of action is somewhat perplexing.

Why should Chinese courts exercise jurisdiction under the anti-monopoly rules? In China, anti-monopoly claims are generally treated as tort claims in nature. The competent jurisdictions for tort claims include the places where the tort is committed, the places where its consequences materialize, or the domicile of the defendant. One significant loophole concerns places where the consequences of a tort materialize. A plaintiff can always allege it suffers from a tort and that its home court should have jurisdiction. If Chinese courts blindly say yes to such claims, it would essentially allow plaintiffs to choose where they want to sue.

Chinese courts might have to at least set out some clearer rules on the standard of proof to establish where the "consequences" of a tort occur in the context of anti-monopoly violations. A plaintiff should have to prove at the outset what the consequences are, and how they would happen, if at all.

Chinese courts should be fully aware of the likelihood of abusive forum shopping by implementers. This is particularly problematic when there are existing court actions between the same parties outside China. When a SEP licensor sues an implementer outside China based on SEP disputes, for infringement and/or for FRAND rate determination, a Chinese court action will make the situation much more complex. Conflicting court opinions might be exactly what the implementers are looking for, as part of a "hold out" strategy.

Another trending dialogue concerns China's anti-suit injunctions. A U.S. Court imposed an anti-suit injunction against Huawei in its battle against Samsung. Will China follow this path?[4]

B. Confidentiality

Chinese judges now widely employ a "top-down" approach to FRAND disputes, and rely on comparable licenses to determine royalty rates. In future FRAND rate cases in China, we might see that the courts will first determine which licensees were "similarly-situated," and then calculate royalty rates from a set of comparable licenses. However, disclosure of comparable licensing agreements is a very sensitive issue, even when the parties choose to do so with waivers from third parties.

If the courts in China wish to conduct proceedings with full trust from litigants around the world, the issue of confidentiality must be handled flawlessly. In China, as far back as 2012, the Supreme Court's judicial interpretation for private antitrust lawsuits already set out measures such as ordering non-public hearings, compulsory confidentiality undertakings, restrictions or bans on reproduction of documents, or allowing

4 See https://www.essentialpatentblog.com/2018/04/judge-orrick-enjoins-huawei-enforcing-injunction-infringing-seps-issued-chinas-shenzhen-court-huawei-v-samsung/.

evidence to be reviewed only by attorneys.[5] Such measures are critical when courts try to determine FRAND rates by looking at "comparable licenses" or other confidential information. Courts must instruct lawyers acting for SEP owners and implementers to sign confidentiality undertakings. In China, one sensitive issue is that in-house counsel often appear in the courtroom to particulate in the entire proceeding, and have access to all documents and evidence. Chinese courts might consider imposing restrictions on the access of in-house counsel to confidential information provided by the other side.

A related point is the possibility of limited discovery. China does not have U.S.-style discovery, but of late more courts, the latest example being Beijing, appear to be willing to grant special orders to counsel to investigate evidence from third parties, including government authorities. Such investigation orders could open up new opportunities for litigants to discover more evidence.

C. Expert Witnesses

The value of economic analysis has increasingly been recognized by Chinese judges. In some recent high-profile court cases and antitrust investigations, economic testimony has played a substantial role, even when offered by U.S.-based economists. This was unthinkable even 10 years ago.

In August 2019, the Beijing local government issued a special policy guideline encouraging the active participation of expert witnesses in evaluating intellectual property disputes. If this guideline is fully implemented, we could well see judges becoming more willing to spend court-room time on expert opinion and to allow cross-examinations and rebuttals, etc. In the past, one reason judges were less willing to grant requests for expert testimony was the risk of extended hearings. Judges probably have to realize that a lot more time will be needed for FRAND cases.

We expect that judges could well soon begin to scrutinize the qualifications of experts (although no clear criteria have been established in this regard). Rules on the scope of expert opinion, the manner of presenting expert evidence, or cross-examining experts could also emerge. After all, Chinese judges and counsel receive little training in handling experts in the courtroom. Judges in China are still suspicious about the credibility of paid expert witnesses, and tend to rule out expert opinion on even very technical subject matter, without providing sufficient reasons. This could undermine courts' abilities and credibility in dealing with complex subject matter in the long run.

D. Amicus Briefs

The utility of *amicus* briefs has started to be appreciated. The Beijing Intellectual Property Court has even experimented with publishing such *amicus* briefs in certain cases.[6] And in certain high-profile cases, Chinese courts are known to receive briefings or opinions from prominent professors or even industry associations.

The courts in China have yet to establish a formal mechanism close to the *amicus* brief. One reason is that Chinese courts do not make certain litigation documents open to the public, and it is therefore almost impossible for outsiders to submit an *amicus* brief in a timely fashion. Courts also lack experience in dealing with *amicus* briefs in actual proceedings. But Chinese judges could soon realize that being open to *amicus* submissions is very valuable in adjudicating on FRAND cases of global significance. Even before the official adoption of an *amicus* brief mechanism, industry associations, professors or companies should actively seek opportunities to submit their opinion or reports to Chinese courts where FRAND cases are being litigated.

E. Due Process in Antitrust Investigation

Whenever Chinese antitrust enforcement agencies start looking at the issue of FRAND rates, they must bear in mind fundamental due process requirements. For example, on April 5, 2019, the ICN published its Framework for Competition Agency Procedures, which provides that antitrust investigations should focus on competition-related information. In the latest U.S. China Phase One Trade Agreement concluded on January 15, 2020, Art. 1.9 specifically dealt with the protection of confidential information by China in any criminal, civil, administrative ore regulatory proceeding. The same provision suggests that China undertake to limit requests for or access to information to no more than what is necessary for

5 See Art. 11 of China Supreme Court's Judicial Interpretation on Private Antitrust Lawsuits, Fa Shi 2005 no. 5, https://www.wipo.int/edocs/lexdocs/laws/zh/cn/cn375zh.pdf.

6 See http://www.chinaiprlaw.com/index.php?id=3487 Beijing Daily "Beijing Intellectual Property Cited Legal Opinion from Third Party Body in its Judgment," January 28, 2016.

the government to perform legitimate investigative or regulatory functions.[7] All such ICN recommendations and the Phase 1 Trademark Agreement need to be fully implemented in China, so that parties involved in such procedures are not unduly burdened. Notably, the recently-issued interim SAMR rules on abuses of dominance do not set out any additional procedural safeguards beyond those in the general administrative penalty rules it issued in December 2018. The traditional approach in China emphasizes "objectivity, completeness, fairness and timeliness" in dealing with the extent to which evidence should be required by enforcement authorities. There is a strong and urgent need to address the issue of relevancy, reasonableness and proportionality. This should be a priority when FRAND rates are at issue in any antitrust investigation.

IV. CONCLUSION

This article set out certain framework aspects and foundational factors for discussion among all stakeholders in FRAND rate determination in China. It might be useful for stakeholders to confront their underlying concerns and conduct meaningful dialogue that provides a basis for real action.

After all, setting FRAND rates for patent portfolios essential to global technology standards is one of the key challenges in today's IP world. We must keep updated about global perceptions of IP, technology, innovation and trade policies. If deadlocks can be dissolved soon, it would benefit everyone.

7 See https://ustr.gov/sites/default/files/files/agreements/phase%20one%20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf.

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