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A FRANDly dud – patent smurfs defeated

A recent German Federal Court of Justice decision on the FRAND defence strikes the perfect balance between the interests of patent owners and those of parties seeking a licence to their technology

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Patent pools serve a variety of purposes. They provide a wide array of benefits to different stakeholders, such as consumers, retailers, producers and developers in the relevant line of business. Not least among these is the establishment of a transparent, level playing field for all legitimate market participants.

This is particularly important when a product depends on adherence to a certain standard – be it a recording, communication or compression standard – as is often the case for digital multimedia or mobile communications. The resulting substitutability of these products and their mass production mean that price largely determines market competition. Due to their research-intensive nature, such high-technology products incorporate a large number of innovations. Accordingly, many patents from numerous patent-owning entities protect these standards. Patent pools provide unified licensing and patent management, relieving the patent owners of the need for extensive market supervision and patent enforcement, and offering a single point of contact with comprehensive responsibility for licence seekers. As a matter of economic principle, the licence fees charged by the patent pool should provide the appropriate return on

investment for innovation leaders from companies making use of their technology.

It is in the interests of the management of a patent pool to make sure that licence fee rates stay in tune with the market situation and general economic conditions. Any licensee will be quick to voice a perceived or real unfairness. The patent pool management will try to be a fair broker between the legitimate interests of the patent owners and patent licensees, and to move forward to resolve such issues very quickly. Any actual licence fee will not be a unilateral imposition on the part of the patent owners, but rather the result of a balanced deliberation process. For fundamental economic reasons, the pursuit of a licence policy that hinges on enforcement of unreasonably high licence fees by the patent owners will be self-defeating in the long run.

In a patent pool, the licence fee rate is exactly the same for all licensees. The patent owners contributing to the patent pool and determining the licence fees are often very different organisations, including corporations with their own products on the one hand and universities and research institutions on the other. To ensure fairness and transparency among the contributors, even those companies that own some of the patents must pay the same licence fee if they want to use the patents. Thus, for a patent pool, there can be no real question of what constitutes a non-discriminatory licence, because there are usually hundreds or thousands of existing licences which are all identical.

Does this mean that all is well for patent pools? Not quite. Enter the patent smurf.

The patent smurf is not to be confused with the patent troll, which everybody has heard of by now. As with other mythical beasts, many people claim to have seen at

least one example of a patent troll, or even several dozen. These reports, while not identical, commonly mention at least some unsettling features of patent trolls. Patents troll are not productive. They seem to earn their livelihood by abusing a legal system. Their feeding strategy allegedly consists of suing legitimate companies with spurious patents covering trivial features for large amounts of money. More often than not, the patent troll is said not even to be an inventor; it rather just buys the patent from the real inventor for a pittance.

There also exists the preferred victim of the patent troll: the patent smurf. Unlike the patent troll, the patent smurf was identified only recently and is nowhere near as well known. This may be because the patent smurf is scary only to actual patent owners. The patent smurf is (or pretends to be) naïve, ignorant of what is going on around it and unconcerned with other people's IP rights. The patent smurf does not even want to know which technology is proprietary. Because of its ostensibly carefree attitude and behaviour, the patent smurf frequently piques all kinds of patent owners, not just patent trolls. Patent owners, however, do not take lightly to patent smurfs merrily infringing their intellectual property without paying licence fees.

Whereas patent trolls seem to abound in the United States, the European patent troll appears scarcer than hen's teeth. But Europe more than makes up for this by an evident profusion of patent smurfs and the mischief they create. And it is serious mischief. Perhaps the most irksome result of their roguery is the disarray on the aforementioned fair and level playing field established by patent pools. Just a few patent smurfs disregarding IP rights in a licence-heavy business can seriously tilt the tables against those playing by the rules. It's not fair when dishonesty pays.

When caught infringing, the patent smurf professes ignorance and innocence. However, ignorance does not protect from liability for damages from patent infringement in Europe. Patent smurfs also like to question the legitimacy of having a patent system in the first place. Their discontent with the existing laws is understandable from their perspective, but of little practical avail in an infringement suit.

However, patent smurfs have been particularly effective in one regard: enlisting willing mass media or general business news outlets in the court of public opinion. A sympathetic press unfamiliar with the

day-to-day reality of intellectual property buys their side of the story, in which patent smurfs fall victim to malicious patent trolls. The same press sweeps the collateral damage to law-abiding companies and to the economy as a whole under the carpet – presumably because this side of the story is not so emotive.

Patent smurfs also keep trying to come up with legal escape strategies. Several have been put to use in the past – all of them unsuccessful in the long run.

As of late, the FRAND defence looked like it could help the business interests of the patent smurfs. FRAND is an acronym for fair, reasonable and non-discriminatory. The moniker is a summary of the widely recognised principle of "equal rights for all" under a dominant position. It does not, strictly speaking, constitute a legal term, but describes the gist of the applicable competition and antitrust laws.

The laws implementing FRAND allow the defendant in infringement proceedings to file a demurrer if the suing patent owner is allegedly in a dominant position and refuses to grant a licence on terms that are fair, reasonable and non-discriminatory. Such a demurrer would, if valid, prevent the patent owner from exercising its right to seek injunctive relief against an infringer. Of course, this demurrer becomes null and void the moment a court determines that the licensing terms in question are in fact fair, reasonable and non-discriminatory.

But as understood by the patent smurfs, the FRAND defence is a convenient tool to defer the finding of patent infringement and the issue of injunctive relief by trying to force courts to determine what constitutes a fair, reasonable and non-discriminatory licence. Conveniently, patent smurfs thought to invoke the FRAND defence by the plain assertion that the terms offered by the patent owner are not fair, reasonable and non-discriminatory. Such a determination by the courts would, of course, take a very long time, as for any question that should properly be answered in the marketplace and not in the courtroom.

In this way, the FRAND defence afforded a potential replacement for previous legal defences, which were all thrown out by EU jurisprudence, by creating sufficient delay against patent litigation. Patent smurfs banked on raising the FRAND defence based on the most far-fetched of arguments. They could then continue using the patented invention without paying a licence or being otherwise inconvenienced by actual or threatened injunctive relief. By the time a

court had determined what constituted a fair, reasonable and non-discriminatory licence, the patent smurf would have made good its escape. Just by ostensibly seeking a fair licence, the patent smurf could have its cake and eat it, too.

Thus, the FRAND defence appeared to allow a company to use the patented invention and dramatically undercut the prices of the licence-paying competition. In the particular case of a standard covered by a patent pool, because of the sheer number of essential patents, licence fees usually make up a significant proportion of costs. Thus, companies using patents relevant for a standard without paying a licence fee could reap significant profits in short amounts of time and swiftly control a share of the market. By the time due legal process finally resulted in a payment order, enough time would have passed to move the profits out of the company and let the company fold. Deliberately having run out of funds, such a company would end up paying only a fraction of the awarded damages or licence fees under insolvency and thus effectively circumvent the patents covering the standard.

However, the recent *Orange Book* decision of the German Federal Court of Justice in mutual consent with the lower courts has now provided a solution to this problem and put a spoke in the patent smurfs' wheel.

In its decision, the Federal Court of Justice affirmed the fundamental right of a party seeking a licence to file a demurrer based on FRAND. The judges determined that this exception to the enforcement of an IP right conforms to the TRIPs Agreement, at least in principle. TRIPs specifies strict conditions under which signatories may curtail the enforcement of IP rights in their legislation. A demurrer based on FRAND is considered to represent such a restriction and thus the validity of this demurrer under TRIPs needs to be examined.

According to the Federal Court of Justice, the legitimacy of such a demurrer hinges on an essential condition, which Article 31 of TRIPs also unequivocally espouses: if the licence seeker is already using the patent, it must immediately begin fulfilling the obligations arising from the offered licensing agreement.

In particular, this means paying an appropriate licence fee for both ongoing and past use of the invention. This licence fee will be based on revenue or sales units. The obligations also include providing records of sales as well as the relevant accounting information.

If no agreement on the licence rate or actual infringement has been reached, the licence seeker need not pay the patent owner directly. Instead, the licence seeker may make a deposit to an escrow account. This deposit must be sufficient to cover the yet-to-be-determined licence fee.

If a court later determines that the licence seeker is not infringing, or that the licence fee needs to be adjusted on competition grounds, this will be considered in the final tally. But this does not detract from the need to deposit upfront a sufficient amount to cover the eventual licence fee. Without actual payment – to the patent owner or to the escrow account – the court will simply dismiss the FRAND defence.

Once (escrow) payment has been made, the next question becomes what constitutes a FRAND licence rate. Prudently, the judges have steered clear of any determination of the criteria that a FRAND licence fee must fulfil in terms of specific numbers and percentages. As with other prices, this should be determined by the market, not a judge. But the Federal Court of Justice also made it very clear that in the case of existing licence programmes, such as patent pool licence programmes, an established uniform licence rate is, quite obviously, non-discriminatory. The bottom line is that the licence seeker must pay what everyone else is paying and the obligation to make immediate payment is all but inevitable.

Obviously, this decision cuts the lifeline of any patent smurf seeking to exploit the window of opportunity between starting a pure marketing business – the typical patent smurf does not actually produce itself – and being tackled by injunctive relief.

The theory underlying this decision is that anyone that is already enjoying the rights arising from a licence agreement in accordance with FRAND must also fulfil the duties arising from the same. Most importantly, since that party is acting as though it had already obtained a licence through its continued use of the patent, it must also immediately begin paying the appropriate licence fee. The *Orange Book* decision thus leaves no room for patent smurfs to enjoy a free ride.

This closing of this loophole has important ramifications, especially in high-technology industry sectors characterised by rapid development, tight standardisation and high licence fees.

Clearly, this decision is good news for – almost – all parties dealing with a patent pool. It strengthens the patent owners' right



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to receive the licence fee in a timely manner. It prevents paying licensees from being disadvantaged where other patent users have not yet entered into a licence agreement. And it continues to protect licence seekers from being pressured into entering into a licence agreement with an unfairly high fee. All in all, it affirms the fundamental economic rationale behind patent pools.

Patent smurfs, on the other hand, are getting short shrift. Their new defensive weapon has turned out to be ineffective. The FRAND defence remains useful only for those for which it was originally intended: companies that are seeking a licence in earnest, but are unable to reach an agreement about the terms. It remains to be seen what the patent smurfs will come up with next; but it is unlikely that their next move will be any more successful.

The Federal Court of Justice struck just the right balance between the legitimate interests of patent proprietors and licence seekers. The decision upholds both the right to protection against discriminatory licence agreements and the right to enforce licence payments. In doing so, this solution appeals to both legal philosophy and common sense, and will hopefully serve as a prime example. ■

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