# The misuse of effective rates in FRAND determinations

14 Aug 2019

[Competition Dynamics, Inc](#) - IP valuations

Co-published

Innovators holding patents that are or may become SEPs promise standard development organisations (SDOs) that they will license their SEPs on FRAND terms and conditions. Because SDOs generally do not define FRAND terms and conditions, the terms and conditions of any individual contract must be evaluated with reference to other benchmarks, which includes other contracts. Although these contracts are highly negotiated and generally possess multiple terms and conditions, economic analysts and courts frequently compare them by reducing their multiple terms to a single 'effective rate', which is generally defined as the total royalties owed under the contract, divided by the total licensed revenues (or licensed units). In other words, an effective rate is an average royalty per unit. A licensor's compliance with its FRAND promise is then evaluated with respect to that average.
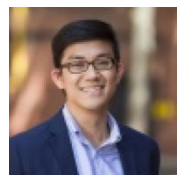
Hieu Luu

This article highlights the errors introduced when comparing effective rates, an approach that is both "simple" and wrong (MA Lemley and C Shapiro, "A Simple Approach to Setting Reasonable Royalties for Standard-Essential Patents", *Berkeley Tech L J* 28: 1135-66 (2013)). These errors arise because an effective rate:

- misstates the patent holder's promise;
- is not a term or condition found in any actual contract; or
- misrepresents a contract's multiple, interdependent terms and conditions, which must be considered as a whole.

Two simple examples

Two simple examples illustrate the failure of effective rates to capture actual contract terms.

First, an SEP holder licenses Generation 1 of the standard for $1 per unit and Generation 2 for $2 per unit. Licensee A sells 100 units of Generation 1 and 50 units of Generation 2, paying total royalties of $200, or an effective rate of $200/150 = $1.33 per unit. Licensee B sells 50 units of Generation 1 and

100 units of Generation 2, paying total royalties of $250, or an effective rate of $250/150 = $1.67 per unit.

Second, an SEP holder licenses units at $250 for the first 50 units, plus $1 per unit thereafter. Licensee A sells 100 units, paying total royalties of $300, or $300/100 = $3 per unit. Licensee B sells 200 units, paying total royalties of $400, or $400/200 = $2 per unit.

While the actual rates in the contract are the same for each licensee, the effective rates differ both from the contract and between the licensees. In both cases, the differences in the effective rate are due to differences in the actions or circumstances of the licensee and not as a result of differential treatment by the licensor. A single effective rate does not and cannot capture the two price terms actually found in the contract.

SEP holder's promise

Given these examples, it is clear that SEP holders promise to be prepared to license on FRAND terms and conditions – not a FRAND rate (eg, Annex 6 of the European Telecommunications Standards Institute Rules of Procedure). As these simple examples illustrate, even a licensor that executes identical terms and conditions, themselves FRAND, with every licensee, cannot promise identical effective rates. To require that they do so is to misstate their promise, whenever the contract contains two or more terms or conditions.

Effective rates and contractual rates

Consider the second example. Licensee A, which pays an average of $3 per unit, may argue that it is entitled to the same effective rate as licensee B ($2). Yet neither of these rates is actually found in either contract. Thus, A is demanding the same extra-contractual inference drawn from B's contract, elevating the inference above the contract itself.

Fixed-payment agreements exacerbate the error. Suppose that licensee C agrees to pay a fixed $500 fee for unlimited sales (forecast to be 500 units), thus bearing the risk of those sales. Then C's expected effective rate is $1 per unit. Critically, this licence has no contractual rate. To suggest that it does, or that A and B should receive the same rate, misstates the contract's terms.

Whole contracts and individual terms

Most-favoured licensee (MFL) cases illustrate the comparison of contracts (even though a FRAND commitment is not an MFL commitment). A favoured licensee may replace the terms of its agreement with the terms of a later contract, but only if the licensee accepts all of the terms and conditions of the later contract:

> *Whether a later license is more favorable thus depends upon the total package of consideration flowing both ways, not upon any single rate or term in isolation … where the license containing the [MFL] clause and later licenses differ significantly in terms or conditions, the most favored licensee cannot pick and choose among them, but must accept the good terms and conditions with the bad. If terms besides the royalty rate are changed, the favored licensee cannot receive the more favorable rate without also accepting any less favorable terms.* (Jay Dratler, Jr, "Licensing of Intellectual Property", Ch 9, *Most Favored Licensees*, §9.02[5,6] (2005) (citations omitted).

In the example, the licensee who demands the same rate found in an ostensibly better contract erroneously omits a condition of that contract, such as its volume commitment or payment structure.

If a licensee cannot demand one term isolated from another's contract, then it also cannot demand a term inferred from, but not present in, that contract – for example, an effective rate.

Licences for SEPs typically reflect many more than two variables; a single effective rate further misrepresents the interaction among these variables. In addition to sales volume and payment structure, other determinants include:

- the contract's length;
- the price of the licensed product;
- price caps or floors;
- prepayment of the royalty;
- the geographic region of the sale;
- the composition of the patent portfolio over time (eg, through expirations, acquisitions or divestitures); and
- the terms of release for past unlicensed sales.

In short, for both economic and legal reasons, effective rates do not and cannot enable reliable comparisons across contracts.

For further information contact:

Hieu Luu
Competition Dynamics, Inc
View website
Email: hieu.luu@competitiondynamics.com
Tel: +1 617 394 1940

Jonathan Putnam
Competition Dynamics, Inc
View website
Email: jon.putnam@competitiondynamics.com
Tel: +1 617 394 1940

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