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A New Meaning For FRAND In Korea's Qualcomm Sanctions

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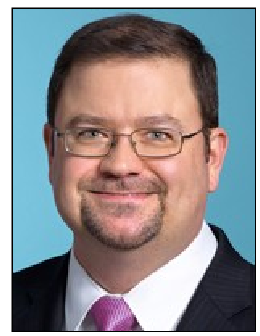
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Law360, New York (January 24, 2017, 1:14 PM EST) -- On Dec. 28, 2016, the Korean Fair Trade Commission issued a steep fine against Qualcomm for antitrust violations in patent licensing and modem chip sales — a record penalty that the U.S. company will challenge in court. Finding that Qualcomm leverages its standard-essential patent (SEP) portfolio to further its chipset business in contravention of Qualcomm's fair, reasonable and nondiscriminatory obligations and Korean antitrust law, the agency levied a penalty of over $850 million dollars and directed Qualcomm to alter its business model.

The KFTC ruling is just one of the latest challenges to Qualcomm's licensing strategy. These charges arrive not long after Qualcomm's fine by China on similar counts and its subsequent resolution, after which Qualcomm licensed the bulk of smartphone makers in that country. On Jan. 17, 2017, the Federal Trade Commission filed an antitrust complaint against Qualcomm, alleging violation of, among other things, Qualcomm's FRAND obligations. Other jurisdictions, including the E.U. and Taiwan, continue to investigate antitrust concerns raised by Qualcomm's licensing practices.

Central to each of these antitrust inquiries is the investigating jurisdiction's viewpoint on what constitutes a FRAND obligation, the encumbrance on most standard-essential patents that requires the patent holder to offer those implementing the applicable standard licensing terms that are "fair, reasonable and nondiscriminatory." But while a FRAND encumbrance arises as a result of the contract or membership agreement between the patent holder and the standard-setting organization incorporating the patent holder's IP into a standard, the metes and bounds of the encumbrance have never been contractually defined. The public policy of encouraging the adoption of standards has led governmental actors to add their own gloss to the term. The KFTC ruling is a recent example, articulating the Korean view of factors that should be considered in determining whether FRAND obligations are met.

Qualcomm's Business Model

Qualcomm derives significant revenue from, among other things, selling modem and baseband chipsets and from licensing its portfolio of 2G, 3G, and 4G patents. Roughly 20 percent of Qualcomm's total revenue comes from Korean companies, including Samsung and LG.

<Status of Qualcomm's Global Revenues (USD million)>

	Yr 2013	Yr 2014	Yr 2015
Patent Royalty (QTL)	7,554	7,569	7,947
Modem Chipset Sales (QCT)	16,715	18,665	17,154
Total	24,269	26,234	25,101

* Based on Qualcomm's 10-K for Year 2015

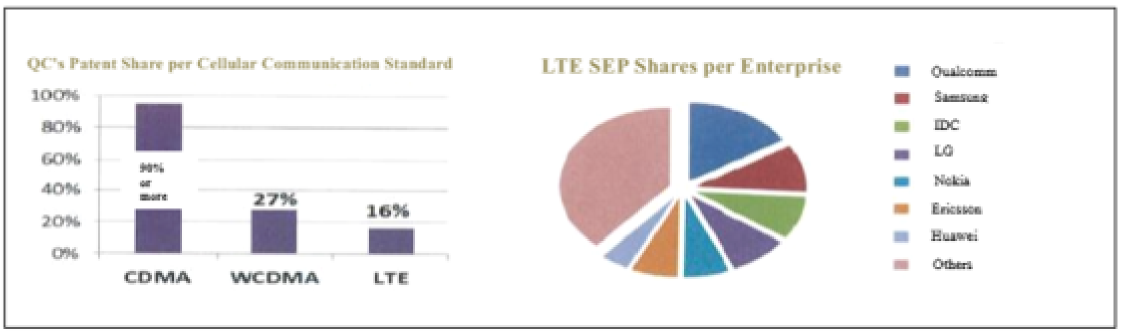
<Qualcomm's Market Share Trend in Modem Chipset Market per Standard (Based on Revenues)>

	Yr 2008	Yr 2009	Yr 2010	Yr 2011	Yr 2012	Yr 2013	Yr 2014	Yr 2015
LTE	-	-	34.2%	58.8%	94.5%	96.0%	84.8%	69.4%
CDMA	98.4%	97.6%	96.4%	94.3%	92.4%	93.1%	91.6%	83.1%
WCDMA	38.8%	47.4%	45.7%	55.0%	50.4%	53.9%	48.8%	32.3%

* Source: Strategy Analytics

Source: 2016 KFTC Ruling

Qualcomm's patent portfolio also includes significant shares of all the declared 2G, 3G, and 4G standard-essential patents, as shown below.



* Based on 2015 public data on ETSI website

Source: 2016 KFTC Ruling

South Korea's Sanction

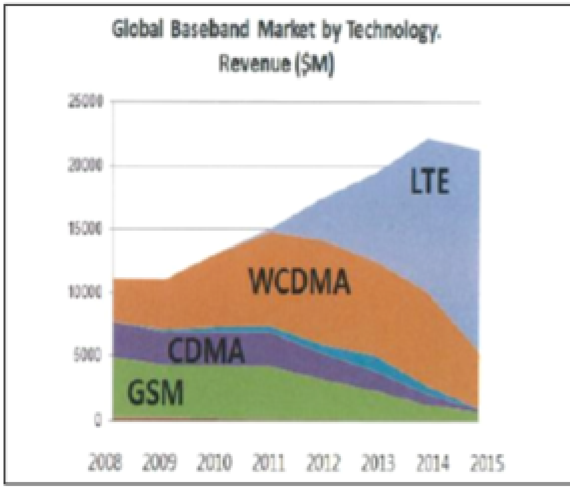
The KFTC first began investigating Qualcomm's suspected anti-competitive behavior in August 2014. By November 13 of the following year, the agency sent Qualcomm an examiner's report finding that the company was acting in an anticompetitive fashion. In response, a series of seven full commission hearings was initiated in July 2016, during which evidence was solicited and accepted from Samsung, LG, Apple, Intel, NVIDIA, MediaTek, Huawei and Ericsson.

On Dec. 21, 2016, the KFTC issued a statement declaring that Qualcomm "is a vertically integrated monopolistic enterprise" that has behaved in contradiction to its FRAND commitments with regards to its CDMA, WCDMA and LTE portfolios. Specifically, the ruling finds that "despite requests by competing modem chipset companies, Qualcomm has refused to license, or imposed restrictions on the license for, the cellular SEPs that are necessary for the manufacture and sale of chipsets[.]" Among the prejudiced companies, the ruling noted, were Samsung, Intel and Via. It further accuses Qualcomm of coercing the execution and performance of unfair license agreements by leveraging its chipset supply, thereby circumventing its FRAND commitment, all by creating a direct connection between the chipset supply and patent license agreements. It also expresses strong concerns over a lack of transparency in Qualcomm's process for establishing royalties:

Qualcomm has provided handset companies with only comprehensive portfolio licenses and coerced unilaterally determined royalty terms without conducting a procedure to calculate fair compensation, while coercing unfair agreements, e.g., demanding handset companies to license their patents for free. (KTFC 2016 ruling)

Qualcomm's actions have had a number of anti-competitive implications, the KFTC ruled. The KFTC accused Qualcomm of mandating royalty-free cross-grants to 200 of the handset companies it licenses, when those companies ought to be exempted from having to pay royalties to around 200 other patent holders — a practice which Qualcomm itself has publicized as a means of saving "IP costs." This practice of denying licensing to rival chipset manufacturers "has limited the competitors' customers and has created a structure in which Qualcomm can intervene in the transactions between the competitors and their respective customers." It can do so, for instance, by "conducting a strict royalty audit on the handset company" while winning over potential customers by offering conditional rebates to handset companies that buy its chipsets.

As evidence that these practices are producing a negative effect on the international chipset marketplace, the KFTC found that while the market for baseband processors has more than doubled in size since 2008, nine out the eleven major global chipset companies have exited that market, and no significant new competitor has been able to replace them.



Modem Chipset Maker	Exit (Imminent) Time
NXP	August 2008
TI	October 2008
Freescale	October 2008
ST Micro	February 2012
NEC	February 2014
Broadcom	June 2014
Ericsson	September 2014
Nvidia	May 2015
Marvell	September 2015

Source: 2016 KFTC Ruling

A significant reason for this, according to the KFTC, is Qualcomm's refusal to license and its unfair business practices.

All factors considered, the KFTC found Qualcomm liable under three prongs of Korean antitrust law: Article 3-2(1) of the Monopoly Regulation and Fair Trade Act; Article 5(3) of the enforcement decree of the MRFTA (abuse of market dominance: Unfair interference with another's business activities); and Article 23(1)(4) of the MRFTA, Article 36(1) of the enforcement decree (unfair trade practice: abuse of superior trading position).

Based on these findings, the KFTC fined Qualcomm 1.03 trillion won ($853 million dollars) and directed it to alter its business practices with regard to Korean companies. Henceforth, Qualcomm must offer, upon request, licenses to its cellular SEP portfolios untethered to any other Qualcomm patents or any other Qualcomm business. All such offers, the KFTC ruled, must make clear the methodology used to arrive at the requested royalty rate. This methodology must account for, among other things, the value of any patent rights granted to Qualcomm as part of such a licensing proposal and the current composition of the Qualcomm SEP portfolio relative to the universe of patents essential to the standards in question.

Qualcomm's Violation of FRAND

The KFTC, in the course of finding Qualcomm in violation of its FRAND obligations, announced four previously-unarticulated aspects to FRAND compliance under Korean law.

First, a FRAND encumbrance greatly limits the availability of exclusionary relief. Qualcomm's

FRAND obligations precluded even de factor exclusionary relief, the KFTC ruled. The possibility of Qualcomm refusing to supply chipsets to a given handset original equipment manufacturer threatens such a disruption to a prospective licensee's supply chain that it is tantamount to the threat of exclusionary relief. Qualcomm links its supply agreements to its patent licenses, meaning that Qualcomm essentially threatens an injunction against any handset company that refuses to take a patent license:

> Qualcomm established and strictly implemented a business policy where Qualcomm does not supply modem chipsets to handset companies that are not licensed by Qualcomm [...] Incorporating the business policy into its modem chipset supply agreement, Qualcomm prescribed that Qualcomm can, at any time, refuse/stop the supply of chipsets when a handset company does not execute or perform a license agreement. (KTFC 2016 ruling)

Injunctions for infringement of SEPs are disfavored worldwide and should, in any event, be imposed by a neutral adjudicatory body and not at Qualcomm's discretion. Thus, Qualcomm leverages the threat of de facto injunction in the process of license negotiations with handset companies.

Second, a licensor must make available, if requested, a license simply to the subset of its portfolio that is standard-essential. Qualcomm's refusal to offer anything short of portfolio-wide patent licenses, including non-SEPs, amounts to "patent holdup" — the specter that a prospective licensee could be excluded from practicing a standard was an unfair inducement to license nonessential patents in the Qualcomm portfolio.

Third, whether the royalty rate in a given cross-license is FRAND must be adjudged with reference to the value of patents licensed back. By requiring a royalty-free cross-license, Qualcomm fails to account for the value of licensees' patents in its royalty demands. In fact, this license-back requirement ensures not only that competitors are not fairly compensated for their innovation, but also that Qualcomm unfairly benefits from competitors' innovation. Each such cross-license increases the value of the licensing "umbrella" Qualcomm can offer customers of its chipsets.

Finally, a FRAND royalty rate should reflect the number of declared standard-essential patents owned by the licensor in proportion to those declared essential writ large, adjusted over time as SEPs expire and are divested and as additional patents are declared essential. Qualcomm's royalty demands are too high to comply with FRAND, insofar as they fail to account for the size of Qualcomm's essential portfolio relative to the universe of essential patents: "Despite that Qualcomm SEPs' level of contribution has declined as the standards developed from 2G [to] 3G [to] 4G, Qualcomm has kept the same royalty rate by coercing comprehensive portfolio licenses during the long-term or perpetual agreement period." KFTC Ruling.

Qualcomm's Response

In a public statement last month, Qualcomm affirmed that it "strongly disagrees with the KFTC's announced decision" and expects to appeal the ruling. After a long history of working with Korean companies, Qualcomm believes it has been denied basic due process rights, and that the allegations are ignorant of the realities of the marketplace and "misapply fundamental tenets of competition law" according to the company's general counsel. Most of all, counsel asserts that "this decision does not take issue with the value of Qualcomm's patent portfolio," which the company says has facilitated "explosive" technological and economic growth in Korea and across the globe. Qualcomm undermines the ruling for its lack of evidence of harm to competition, "denial of procedural safeguards guaranteed to American companies under [the Korea-U.S. Free Trade Agreement]," and a desire to "disrupt established licensing practices that have been accepted by the wireless industry" for decades, "including Korean companies and government institutions like ETRI, Samsung, and LG."

In recent years Qualcomm has been involved in a number of international antitrust conflicts, with new investigations promising more allegations in the near future. In 2009, the KFTC fined Qualcomm 273.1 billion won ($225.6 million dollars) for inducing customers with conditional rebates on licensing fees, thus discouraging them from buying chips from competitors. The company appealed the ruling, which is now pending before the Korea Supreme Court. In 2015, Qualcomm struck a deal with the Chinese government after allegedly violating the country's anti-monopoly law. The settlement involved a $975 million fine and established markedly lower license fees compared to what Qualcomm charges companies elsewhere.

<Comparison of Measures by Chinese NDRC and Measures by KFTC>

	Measures by Chinese NDRC	**Measures by KFTC**
Remedial Measures for Modem Chipset Companies	(N/A)	▷ Upon competing modem chipset companies' request, [QC] shall engage in good-faith negotiations to execute a license agreement and will refrain from demanding unfair restrictive conditions
Remedial Measures for Handset Companies	▷ Calculate royalties based on 65% of the handset price ▷ Provide list of patents when executing a license agreement and refrain from imposing royalties on expired patents ▷ Refrain from demanding free cross-licenses ▷ Refrain from tie-in sale of cellular-SEPs and other patents	▷ Refrain from linking modem chipset purchase and patent license agreement ▷ Upon handset companies' request, amend or remove provision that links licensing to supply of modem chipset from the modem chipset supply agreement ▷ Refrain from coercing patent license terms that were unilaterally decided - Comprehensive port-folio license - Free Cross-grant - Coercion of unilateral license terms without the procedure of calculating fair compensation ▷ Upon handset companies' request, engage in renegotiation of existing license agreement

Source: 2016 KFTC Ruling

The latest allegations over Qualcomm's business practices in Korea have sparked international concern. On Jan. 17, 2017, the Federal Trade Commission filed an antitrust complaint against Qualcomm, on grounds that, inter alia, its licensing practices ran afoul of its FRAND obligations. Taiwan recently initiated its own year-long investigation, with a spokesman for Taiwan's Fair Trade Commission noting "Korea's decision will serve as an important reference point for us." Japan is also paying close attention to the ruling, as the Japanese Fair Trade Commission previously sanctioned Qualcomm for demanding free cross-licenses in September 2009 (a formal objection procedure is pending), and the European Union is examining Qualcomm's practice of conditional rebates on license fees which led to the conflict with Korea in 2009.

Implication and Conclusions

The KFTC's ruling represents a significant action against the business model of Qualcomm, a leading U.S. firm, and provides insight into how Korea views a FRAND encumbrance.

The outcome of the KFTC's decision will likely significantly affect Qualcomm's business. As previously mentioned, Qualcomm resolved its antitrust dispute with China in 2015 and has since licensed all the top Chinese handset OEMs. It is likely that Qualcomm with strike a similar deal with Korea, whereby a standard negotiation process — including, perhaps, a methodology for determining a FRAND rate, is agreed-upon. Korean companies will then likely negotiate or renegotiate patent licenses with Qualcomm for subsets of the overall Qualcomm portfolio. These licenses may include cross-licenses, but the license fees will likely account for the value of the patents to be cross-licensed. Qualcomm's patent licensing business will most likely continue slightly diminished, as additional jurisdictions, including the U.S., file antitrust actions of their own or weigh actions similar to Korea's.

Equally important is the fact that the KFTC ruling represents a new data point for the worldwide understanding of the meaning of a FRAND encumbrance. Korea's perspective on FRAND is rooted in policy, not contract. The KFTC ruling is uninterested with the origins of the FRAND encumbrance — the governing documents of the relevant standard setting organizations — and concerned instead with the policy questions implicated generally when one licenses SEPs. As a practical matter, this viewpoint could have significant import to the enforceability of SEPs. A policy-based view of FRAND could essentially place the burden on the party seeking to enforce SEPs to assuage the policy concerns. In contrast, a jurisdiction that approaches FRAND as an entirely contractual obligation would most likely place on the accused infringer of SEPs the onus of establishing its affirmative FRAND defense, i.e., the existence of a contractual obligation, the metes and bounds of that obligation and the SEP holder's failure to meet that obligation.

The KFTC ruling also suggests the FRAND rate may reflect the number of declared SEPs dedicated to a given standard in a given portfolio, versus the total number of declared SEPs for that standard, and that the FRAND rate may change over time as the above proportion changes. Various studies have determined that only a subset of patents declared essential to a given standard are actually essential. For instance, a 2010 Fairfield Resources International study of WCDMA patents found that only 33 percent of U.S. patents declared essential to the standard were, upon further scrutiny, actually essential.

In addition, the ruling presents a nonexhaustive list of practices Korea will require of those seeking to license SEPs, including the following:

- SEP holders must, at least upon request, make license offers for their SEP portfolios and not tie-in nonessential IP.
- SEP holders may not require cross-licenses unless their offers reflect the value of the portfolios to be cross-licensed.
- FRAND offers should make clear the methodology employed to derive the requested rates.
- No exclusionary relief available for infringement except under extraordinary circumstances.

In conclusion, the KFTC ruling is meaningful because of the identity of the sanctioned party, the alleged behavior leading to the sanction and the delineated approach to FRAND.

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