Contemporary Issues in International Arbitration and Mediation

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CHAPTER 5

FRAND Royalty Disputes: A New Challenge for International Arbitration?

James H. Carter

As a new technology develops, industry participants often seek to standardize a version of it so that devices exploiting the technology may communicate with one another or be used interchangeably. Creation of and agreement on an industry standard typically allows a greater number of participants to develop the technology and offers consumer benefits by bringing the technology to market rapidly, assuming always that the process occurs in a manner consistent with antitrust or competition laws, without improper collusion.

Standard setting of course requires that experts agree on technical issues. But the process also must reconcile conflicting business interests of those involved. Many firms wishing to develop a new technology have patents that could cover an industry standard for products and become “standard essential.” Each patent owner would prefer to see a standard selected that is consistent with the claims of its own patents, which exploiters would be required to license, and none would care to see a standard selected that is covered by another firm’s patents that could dominate the standard and require licensing and payment of royalties. Patent holders wish to maximize royalties, but non-owners of standard essential patents would like to assure that patents covering an adopted standard are available for licensing at reasonable royalty rates.

These problems are addressed through the activities of Standard Setting Organizations or “SSOs,” typically international bodies such as the European Telecommunications Standards Institute (“ETSI”), the Institute of Electrical and Electronics Engineers (“IEEE”) and the International Telecommunication Union (“ITU”). Operating through the standard setting committees and processes of an SSO permits members of an industry, including fierce competitors, to confer and negotiate useful industry standards under antitrust safeguards. In this process participants volunteer the information they consider relevant to a potential standard and, as a condition of taking part, agree that they will disclose the existence of any patents they own that would be needed if a particular standard were adopted. The patent owners also must agree that, if a standard using a patent so disclosed is adopted, they will be willing to license any such standard essential patent to anyone on “fair, reasonable and non-discriminatory” or “FRAND” royalty terms.
So far, so good, at least in principle. But if parties are unable to agree on “FRAND” terms for a proposed license to a standard essential patent, how is the matter to be resolved? If the parties have no agreement providing a method for dispute resolution, such as arbitration, then a national court in one or more countries will be the default venue. Often the issue is presented when a patent holder requests royalty rates that a potential licensee considers excessive and declines to agree to pay. The patent owner may sue the other company as an alleged infringer, seeking an injunction and damages. In addition to asserting defenses such as patent invalidity and non-infringement, the accused infringer may counterclaim for violation by the patent holder of a FRAND licensing obligation, presenting a court with a series of issues to resolve. Is the patent valid and infringed? Is it properly standard essential, and if so what is a FRAND royalty rate? Has the alleged infringer shown itself to be willing or unwilling to negotiate on what the court determines to be a FRAND basis, and if unwilling should it be enjoined from selling its products?

Those issues become exponentially more complex when, as often is the case, the dispute involves not just a single patent but a portfolio of many U.S. patents all having been declared essential to a technology, together with their foreign counterparts in various jurisdictions worldwide. Further complications arise when a number of potential licensees are negotiating or disputing royalty terms with the same patent holder on terms that may include cross-licenses on different patents held by the prospective licensees.

U.S. courts have begun to wrestle with these issues, most recently in a series of cases involving major companies in technology industries,¹ and so has the U.S. Federal Trade Commission. The FTC is empowered by Section 5 of the Federal Trade Commission Act² to prevent unfair methods of competition, including unfair acts or practices relating to the licensing of standard essential patents.

The FTC’s FRAND Initiatives

Complaints were made to the FTC concerning alleged abuse of the FRAND system by certain standard essential patent holders, some of whom were accused of demanding very high royalty rates from a competitor and prospective licensee with an expectation and implied threat that, if the competitor

refused to agree, the patent holder would then sue for an injunction. Faced with the risk of even a short-term court-ordered interruption of its sales in a fast-moving technology product cycle, which could seriously disrupt its business, a competitor may be pressed to agree to an above-market royalty.

Beginning in 2012, the FTC responded to such complaints by entering into negotiated consent orders with specific standard essential patent holders that limit their ability to seek an injunctive remedy against prospective (but reluctant) licensees. As that process has evolved, arbitration has emerged as a potential centerpiece of the FTC-approved solution to the FRAND royalty dispute issues.

In November of 2012, as part of its investigation of an acquisition of SPX Services Corporation by Robert Bosch GmbH (“Bosch”), the FTC issued for public comment a complaint and order against Bosch that discussed Bosch’s FRAND licensing obligations for certain SPX patents.³ The proposed order, which became final in April 2013,⁴ directs Bosch to offer the same license of certain standard essential patents to all marketplace participants on FRAND terms through a “Letter of Assurance.” The order restrains Bosch from seeking an injunction against any prospective licensee of those patents unless that party states in writing that it will not license one or more of the patents or refuses to accept a license on terms that “have been determined to comply with the Letter of Assurance through a process agreed upon by both parties or through a court.”⁵

While the Bosch order used the term “process agreed upon by both parties” rather than “arbitration,” it appeared to open the door to exploration of FRAND patent arbitrations.

The Motorola Order

Following publication of the draft Bosch consent order, the FTC took that process of exploration a significant step further when it announced and opened for public comment a proposed consent order involving important consumer electronics patents. Motorola Mobility LLC (“Motorola”) owns what have been identified as standard essential patents relating to cellular, video codec and wireless LAN standards for consumer electronics. Motorola was accused of

⁵ Id. at para. IV.E.2.
unfair practices in the licensing of those patents; and in June 2012 Google Inc. ("Google") acquired Motorola and its 24,000 patents or patent applications for $12.5 billion and allegedly continued Motorola’s anticompetitive behavior.

The Motorola consent order proposed on January 3, 2013\(^6\) focused on restricting abuse of the judicial injunction remedy by Google. It required that, before seeking an injunction based on any of its “FRAND-encumbered” Motorola standard essential patents, Google must (1) provide a potential licensee with a written offer containing all of the material license terms necessary to license the patents and (2) provide the potential licensee with an offer of binding arbitration to determine any terms of the proposed license on which the potential licensee refuses to agree. The potential licensee then has the option of either arbitrating the disputed license terms (including but not limited to the royalty rate) or having them resolved by a court.

The proposed order outlined two variations on a process by which a Google license offer could be reduced to a binding licensee agreement. As a first alternative,\(^7\) Google may advise the potential licensee of, and that party may then elect, a process beginning with voluntary negotiation for six months. If no license agreement is reached by negotiation, Google is required to propose (or the prospective licensee may ask Google to offer) a draft binding written agreement containing all of the material terms and limitations that Google considers necessary for a license. The potential licensee then may either accept those terms or inform Google of the terms that it accepts and those that it believes to be inconsistent with Google’s FRAND commitments and propose an alternative for each such contested term. The potential licensee may elect to have either a court or arbitrators resolve the disputed terms; but the proposed order included a provision that, if a court is selected, the opposing party nevertheless would be free to argue that the court should order the parties to arbitrate the issues instead if the court decides that it “cannot or should not hear the action on jurisdictional or justiciability grounds or because an alternative forum would be more appropriate.”

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\(^7\) Motorola Draft Order at section III.
Alternatively, Google may proceed to litigation but cannot seek injunctive relief until it first offers a license agreement and potential arbitration.\(^8\) The proposed order required that Google, before seeking an injunction, offer the same type of proposed license (including, if Google wishes, a requirement that the potential licensee in turn offer Google a license on its FRAND-encumbered patents) and an option to enter into binding arbitration over disputed terms. If the prospective licensee rejects arbitration and elects instead to have the disputed terms decided by a court, and if the would-be licensee agrees to abide by whatever royalty terms the court directs, Google again would be prohibited from seeking injunctive relief.

The proposed order contained rather sketchy arrangements for a potential arbitration that might be elected under these procedures. Although the parties would be free to agree on other arrangements, including ad hoc arbitration, the order provided that in the absence of agreement the potential licensee may elect to arbitrate under the rules of a “Qualified Arbitration Organization.”\(^9\) The order defined these default administering institutions as either the American Arbitration Association (“AAA”), applying its Commercial Arbitration Rules or (through its ICDR division) its International Arbitration Rules, or JAMS, applying its Comprehensive Arbitration Rules and Procedures or its International Arbitration Rules. The proposed order added, in view of the possibility that some other regime might be selected by agreement, that if applicable rules did not specify a selection method, there would be three arbitrators, with each party selecting one and those arbitrators selecting the third arbitrator.\(^10\)

The scope of the arbitrator(s)’ authority, set forth in relation to the second of the two alternatives of the process available to Google but presumably applicable generally unless parties agree otherwise, is to “set the terms of the final License Agreement.”\(^11\) In doing so,

The arbitrator shall determine whether the terms contested by the Potential Licensee are consistent with the FRAND Commitments of Respondents, and if applicable, the Potential Licensee. The arbitrator shall revise any terms that it finds are not consistent with the relevant FRAND Commitments.\(^12\)

\(^8\) Id. at section IV.
\(^9\) Id. at paras. I.D.1, I.T.
\(^10\) Id. at para. I.D.2.
\(^11\) Id. at para. IV.B.2.(f).
\(^12\) Id. at para. IV.B.2.(e).
The proposed order did not state that the arbitrators’ determination would take the form of an award; and it provided that, within 30 days after the arbitrators “set the terms” of a final license agreement, “the parties shall enter into and execute a License Agreement.” There were no provisions referring to possible judicial review or appeal, limited or otherwise, of a “determination” to a U.S. or other court.

Under the terms of the proposed order, the parties are entitled to condition participation in an arbitration on consent that the arbitrators will be authorized to require reasonable security, including an escrow of funds if necessary, and that the field of use for patents licensed through arbitration will be limited to uses covered by the applicable FRAND commitments of the patent holder.

In addition, the proposed order allowed Motorola to seek injunctive relief against any potential licensee located outside the jurisdiction of United States District Courts and any who has “stated in writing or in sworn testimony that it will not license the FRAND Patent on any terms” or refuses to enter into a license agreement in accordance with terms set in a binding arbitration or court ruling.

Arbitration Issues

The FTC’s proposed order thus introduced the possibility of new uses of international arbitration for FRAND royalty disputes, but it was remarkably opaque about how such an arbitration process might operate. Of course, default to AAA or JAMS arbitration rules would provide answers to many procedural questions such as how arbitrators would be selected, where arbitrations would be held and what the general shape of proceedings might look like. But the FTC proposal called for arbitration of an unusual kind, involving competing forms of agreements governing patent rights, possible cross-licensing on complex business terms and a series of separate but potentially closely related proceedings involving Google on one hand but differing potential licensees on the other. The order said nothing about those issues and in fact suggests that some of them may have been overlooked.

The proposal called for a system under which arbitrators would be required, in effect, to write a contract for the parties by deciding critical business terms on which they failed to agree and revising their respective proposed terms as

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13 *Id.* at para. IV.B.(g).
14 *Id.* at para. I.D.4.
15 *Id.* at para. I.I.E.
the arbitrators consider appropriate. Google is to deliver a fully formed draft license agreement, and the potential licensee is to specify which terms within it are to be arbitrated (or resolved by a court). The paradigm license term in dispute naturally would be a royalty rate or rates, on the setting of which large amounts of money could turn; but there might be dozens of other disputed terms, many with complicated (but not readily apparent) financial implications. Patent license agreements can be complex documents.

There are precedents for arbitrations in which parties agree that arbitrators can fill in a missing term\(^\text{16}\) of an otherwise negotiated agreement, sometimes using business judgment rather than strictly legal criteria. But it seems unlikely that anything as ambitious as this sort of proposed arbitration has been attempted. Questions immediately arose. Was the FTC asking arbitrators to act as a court would in a patent infringement case, with all of the same defenses and burdens of proof available? Would infringement perhaps be presumed if the accused products adhered to a standard covered by a patent? Was the intent that arbitrators should move more or less directly to a determination of a FRAND royalty rate, with the usual defenses to a patent suit demoted to some secondary status? Did the proposal perhaps implicitly suggest that the paradigm term, the royalty rate, was what the arbitration was to be mainly about?

The proposed order’s language was not helpful in considering these matters. It directed that Google extend a form of license agreement but provided no guidance on how such a potentially complex document, likely to be opposed by an equally complex alternative drafted by a licensee, would be addressed by arbitrators or a court. If issues other than simply a royalty rate were raised, would arbitrators conduct a full patent trial? Could the patent holder swamp the process by offering only a combination of many different patents, some of which a licensee might not need or want? Would there be some required sampling of the contested claims, for purposes of adjudication?

The proposal included a provision stating that, whether a prospective licensee elected either arbitration or a court determination, neither party would be precluded from presenting evidence or making arguments in the resulting proceeding regarding validity, essentiality, infringement or the value of the patents included in the agreement.\(^\text{17}\) But the right to make these

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16 Common examples, although they by no means exhaust the possibilities, include contract terms authorizing arbitrators to deal with changed circumstances, hardships or changes in equilibrium of the contract. See generally Nigel Blackaby, et al., REDFERN AND HUNTER ON INTERNATIONAL ARBITRATION 536–540 (5th ed. 2009).

17 Motorola Draft Order at para. III.D.
arguments was subjected, confusingly, to a limitation that it existed "except to the extent inconsistent with the preceding sentence" in the proposed order. That preceding sentence stated: "It is intended that the Request for a FRAND Determination or Binding Arbitration shall establish the Contested Terms, and that these terms, together with the Accepted Terms, shall constitute a binding Relevant License Agreement, which if executed will form a binding license agreement."

How arguments about validity, essentiality, patent exhaustion or non-infringement might be injected into a proceeding defined by an exchange of proposed and counter-proposed license terms and intended to "establish" those terms remained ambiguous. If arbitrators were limited to dealing with alternative language or royalty rate numbers that would comprise license terms, as suggested by the limiting sentence of the paragraph, when would these logically preceding patent law issues be presented? Would the prospective licensee be expected to counter-propose a term for the preferred license saying, "None of the above shall apply, and this agreement shall be of no legal effect, because the patents are invalid, nonessential and not infringed"?

This was not the only aspect of the proposed order that raised arbitration questions. Although a FRAND dispute is extremely likely to involve multiple parties, the subject of access by one prospective licensee to the outcome of a FRAND arbitration involving Google and a different prospective licensee was not addressed. A FRAND royalty by definition must be not only fair and reasonable, but also non-discriminatory. How are potential licensees to have access to information about other determinations, or about Google's other licenses or other companies' licenses that might be relevant to a determination in a later case? Arbitration ordinarily is treated as at least in some respects confidential under relevant laws and rules, so that potential licensees might encounter difficulty in obtaining access to other awards or licenses without the consent of the companies that are parties to those other arbitrations or agreements.

Further, there could be FRAND license disputes involving different but related sets of declared standard essential patents. One set might cover some aspects of the standards used by a new type of device, while others could cover different functions. Determining a fair and reasonable royalty for a license to patents that relate only to some functions of the device would seem to require consideration of the royalties payable by the licensor on other patents covering other aspects of the same device. The total royalty "stack" would have to be reasonable. The proposed order did not address this issue.

In addition, would a "determination" resulting in a final license agreement constitute an arbitral award? If not, what if any judicial review would be possible of an arbitral decision in a FRAND arbitration? Would the standard
be that of the Federal Arbitration Act,\footnote{9 U.S.C. §§1 et seq.} or perhaps some more expansive review for errors of fact or law?

The FTC solicited views of the public on the proposal and received a total of 25 written comments.\footnote{Public comments, available at http://www.ftc.gov/os/comments/motorolagoogle/index.shtm.} Commentators appear to have assumed generally that the type of relief that the FTC was proposing would not necessarily be limited to Google but could become a model for dealing with licensing of FRAND patents. Many of the commentators challenged the authority and/or wisdom of the basic premise that the FTC could and should place limits on parties’ access to the courts for injunctive relief. Only a few addressed issues relating to the proposed arbitration mechanisms.\footnote{See, e.g., Statements of American Arbitration Association (Feb. 21, 2013) and Apple Inc. (Feb. 22, 2013), available at http://www.ftc.gov/os/comments/motorolagoogle/index.shtm.}

On July 24, 2013 the FTC issued its final order in the \textit{Motorola} case.\footnote{\textit{In the Matter of Motorola Mobility LLC and Google, Inc.}, FTC File No. 1210120, Docket No. C-4410 (July 24, 2013), available at http://ftc.gov/os/caselist_1210120/index (“Motorola Final Order”). In addition, the European Commission on May 6, 2013 issued a Statement of Objections to Motorola on potential misuses of mobile phone standard-essential patents, described at http://europa.eu/rapid/press-release_IP-13-406_en.htm.} Most of the structure of the proposed order emerged intact, but the FTC did make some revisions in the arbitration terms. The final order addressed, at least to some extent, the question of how arguments about validity, essentiality or non-infringement might be considered. The order requires Google to provide potential licensees with an offer to arbitrate in the form of an exhibit to the order,\footnote{Motorola Final Order at Exh. D.} to ensure consistent forms of offers. The required form includes express language that Google will use, stating that arbitrators’ role in determining contested terms in competing forms of proposed licenses “does not restrict either party from making arguments in Binding Arbitration regarding the validity, Essentiality, Infringement or value of the patents at issue in such proceeding, or the ability of the arbitrator to consider these arguments, or to follow existing legal standards and burdens of proof.” In its published letter responding to the written comments on the draft order, the FTC stated:

\begin{quote}
It is important to highlight that the Order, including the arbitration provision, does not negate or alter traditional burdens of proof, or deprive implementers of their rights to seek judicial review, challenge
infringement, or raise defenses such as validity, exhaustion, and essentiality. Moreover, the Order does not presume infringement by the implementer, and leaves Google with the same burdens of proof it would have in any court proceeding. The arbitration provisions allow the arbitrator to establish an appropriate procedure for resolving the dispute at hand based on the circumstances presented and the nature of that dispute.23

It therefore seems clear that important elements of a judicial patent litigation can be made part of a Google FRAND royalty arbitration and that some form of judicial review is contemplated. But many practical questions remain.

Some Remaining Questions

The first set of questions concern detailed rules and procedures. Since these are not contained in the FTC’s order, they remain to be promulgated by arbitration institutions or created by arbitral decisions in any initial arbitrations.

The sequence in which contested matters are to be determined will be important. In a U.S. patent case, claim construction normally is an issue for early determination. Summary judgment motions may dispose of particular claims or defenses. Court rules normally require the parties to select and focus on only a limited number of claims in the patent or patents in suit, for manageability purposes.24 The results of a trial or other disposition are part of a public record, so that parties in subsequent cases can use prior outcomes as a basis for arguments, including as precedents for specific royalty rates. Is a FRAND arbitration intended or permitted to mimic all of these features of litigation?

There is experience with arbitration of patent disputes, of course. A license agreement may contain an arbitration clause subjecting all disputes arising out of or relating to the contract to arbitration, and parties to it might contest validity and infringement of the licensed patents, as well as other disputes about license terms, in an arbitration involving patent laws and concepts. One arbitration organization, the AAA, has promulgated Patent Arbitration Rules


24 On July 22, 2013 the Federal Circuit Advisory Council issued a model order that calls for limits on the number of patent claims and prior art references that be asserted in U.S. litigation. Two days later, the U.S. Court of Appeals for the Federal Circuit removed the model order from its web site, and it is not presently available.
that are made applicable to any AAA arbitration in which patent law issues are presented.\textsuperscript{25} Most others have not.

That leads to the second set of questions: where will these cases be heard, and by whom? In addition to the AAA and JAMS, which were designated by the FTC in the proposed order as administering bodies, the final order adds a third institution to the default category of administrators of FRAND arbitrations. In recognition of the fact that disputes involving FRAND issues are likely to be global, the FTC added the World Intellectual Property Organization ("WIPO") as a third "Qualified Arbitration Organization" that a potential licensee from Google may elect.\textsuperscript{26}

Somewhat surprisingly, the final order adds a proviso that "if the procedures for Binding Arbitration as set forth in this Order conflict with the mandatory arbitration rules of an SSO to which both Respondent [\textit{i.e.}, Google] and a Potential Licensee are subject, then either Respondent or the Potential Licensee may require that the relevant provisions of the License Agreement be determined pursuant to the mandatory arbitration rules of such SSO."\textsuperscript{27} This is surprising because, at the date of this writing, none of the three SSOs mentioned in the order (ETSI, IEEE and ITU) has published any such arbitration rules or listed any experience with administering FRAND or other arbitrations.\textsuperscript{28} The order provides no guidance concerning who would determine whether any such SSO mandatory arbitration rules, if and when they are created, would "conflict with" arbitration provisions of the order.

It seems likely that additional sets of rules or guidelines for FRAND arbitrations will be promulgated by both arbitral institutions and SSOs, perhaps working together, to address the new potential caseload. In addition, parties may elect other arbitral alternatives by agreement.

Arbitrators with specialized skill in patent dispute resolution are likely to be in great demand. The AAA maintains a roster of arbitrators specialized in patent disputes (which is not available to the public), but other administering authorities generally do not. This also is likely to change if FRAND arbitrations become relatively frequent.

\begin{itemize}
\item \textsuperscript{25} AAA Supplementary Rules for the Resolution of Patent Disputes (2006), \textit{available at} \url{http://adr.org}.
\item \textsuperscript{26} Motorola Final Order at para. I.T.; see WIPO Arbitration Rules, \textit{available at} \url{http://www.wipo.int/amc/en/arbitration/rules}.
\item \textsuperscript{27} Motorola Final Order \textit{at para.} IV.B.2.
\item \textsuperscript{28} Web sites for these organizations are: \url{http://www.etsi.org}; \url{http://www.ieee.org}; \url{http://www.itu.int/en}.
\end{itemize}
Third, the confidentiality issue will require further thought. Parties naturally wish to maintain the privacy of their royalty arrangements to the greatest extent possible; but it will be difficult for arbitrators to make rulings on what is non-discriminatory without some access to information about related decisions and licenses. Much of this information may be available through discovery of the parties in a particular arbitration, but that may not be a complete answer.

There are precedents for publication of arbitral dockets, including awards, in situations where a set of cases may be related or potentially related but are not consolidated. For example, the AAA publishes on its web site the docket and awards of class action arbitrations brought under its rules.\textsuperscript{29} Arbitral awards filed with courts sometimes redact key commercial data from the publicly filed versions, so that only the court sees the full text. Arbitration organizations may develop rules and procedures that seek such a solution for FRAND arbitrations.

It remains to be seen whether FRAND arbitrations will be attempted and what procedures will be devised to bring order to them. This is likely to be a significant challenge for the international arbitration system in coming years.