# *Princo v. ITC* and the FTC's Radical Analytical Framework

By David F. Ryan[1]

The FTC's brief in *Princo v. ITC* proposes a radical analytical framework for patent rights clearance agreements negotiated subsequent to the joint development of industry standards. The FTC's proposal is unjustified under patent-antitrust precedents and would subvert incentives to invest by participants in both research joint venturers ("RJVs") and industry standard setting organizations ("SSOs").

## A. <u>Introduction</u>

*Princo v. ITC*[2] is an important patent misuse case which has been pending since 2002, and which already has resulted in the seminal *Philips I* decision of the Federal Circuit in 2005.[3] In its most recent iteration, oral argument before the Court sitting *en banc* is currently scheduled for March 3, 2010. The issues for determination concern the terms upon which patent rights that threaten freedom to operate under a proposed or issued industry standard can be negotiated by research joint ventures ("RJVs") and standard setting organizations ("SSOs"), either *ex ante* or *ex post* the creation of such industry standard.

On February 17, 2010, more than two months after the deadline under the *En Banc* Order and appellate rules and only two weeks before the scheduled *en banc* oral argument, the Federal Trade Commission ("FTC") filed a motion seeking leave from the Court to file an admittedly "out-of-time" brief amicus curiae in support of neither party.[4] The FTC's motion

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[2] *Princo Corp. v. Int'l Trade Comm'n*, 563 F.3d 1301 (Fed. Cir. 2009), *vacated and en banc reh'g granted*, 583 F.3d 1380 (Fed. Cir. 2009) (*en banc, per curiam*) ("*En Banc* Order") ("*Princo v. ITC*"). References herein to the panel majority opinion ("Op.") and Judge Bryson's dissent ("DOp.") are to the slip versions of those opinions which are readily available online.

[3] *U.S. Philips Corp. v. Int'l Trade Comm'n*, 424 F3d 1179 (Fed. Cir. 2005) ("*Philips I*").

[4] In its order granting *en banc* review dated October 13, 2009, the Federal Circuit had specified that amicus briefs could be filed without leave of the Court so long as they complied with the rules. Pursuant to that order, amicus briefs timely under the rules were filed in support of

was granted on February 22, 2010 in an order which does not provide for the filing of responsive briefs by either the parties or the other amici curiae.[5]

This article is intended to assist those who wish to audit Wednesday's oral argument, either in person or via the Federal Circuit's online transcription, by providing an overview of the issues for determination before the *en banc* Court and a discussion of how the FTC's arguments might affect determination of those issues. Those issues and arguments are outlined in Section B, and the technical and procedural background facts are then set forth briefly in Sections C and D, respectively. Section E then discusses in summary fashion the pertinent research market in which the RJV operated, the two pertinent product markets and the two vertical licensing markets within which the effects of the challenged patent rights clearance agreements must be assessed.

Point F sets forth a necessarily abbreviated analysis of why the FTC's "efficiency justification" argument should be viewed as overly narrow and Point G discusses why the FTC's "inherently suspect" argument should be rejected for the type of patent rights clearance agreement that Princo challenges here. Both of these analyses are preliminary and the FTC's arguments and putative precedents are not dissected and rebutted with the level of detail that would be appropriate in a responsive brief. To the extent the positions of the parties and other amici curiae are pertinent to the FTC's arguments, however, they are discussed briefly within Points F and G.

## B. <u>The Issues For Determination & The FTC's Arguments</u>

On this appeal, Princo asserts the alleged unenforceability for patent misuse of the six Philips patents it has been found to infringe. These assertions are predicated upon the alleged or postulated terms of the arrangements under which Sony authorized its co-venturer Philips to include the Lagadec patent[6] as part of the package of patents under which manufacturers of recordable ("CD-R") and re-writable ("CD-RW") data storage discs compliant with the Orange Book industry standards jointly developed by Philips and Sony were granted freedom from suit on reasonable and nondiscriminatory terms.[7]

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neither party by the AIPLA (on December 4, 2009), in support of the patentee ("Philips") by the NYIPLA (on December 7, 2009) and by the IPO (on December 9, 2009), and in support of appellant ("Princo") by the American Antitrust Institute (on January 22, 2010).

[5] The Brief Of Amicus Curiae Federal Trade Commission On Rehearing *En Banc* Supporting Neither Party ("FTC Br.") is available on the FTC's website ≪http://www.ftc.gov/os/2010/02/100219amicusbrief.pdf≫.

[6] United States Patent No. 4,942,565 which expired on September 28, 2008.

[7] The actual terms of the arrangements between Sony and Philips regarding the Lagadec patent cannot be discerned from the public record. *See* Op. 33-38. For all practical purposes, however, the terms of those arrangements as posited by Princo can be accepted as accurate – since those terms do not violate the antitrust laws as a matter of law.

The panel majority concluded that the action must be remanded to the International Trade Commission ("ITC") for three separate determinations in respect of Princo's defense of "patent misuse by horizontal price fixing": (a) whether the record supports the existence of some horizontal agreement between Sony and Philips "to prevent Lagadec from being licensed as a competing technology" (Op. 22, 33-36), (b) where on the "continuum" of potential commercial viability the standard for the putative misuse of suppression of alternative technology should be placed (Op. 32), and (c) whether the record establishes that this standard was met with respect to those claims of Lagadec other than claim 6 which presumably do not apply to Orange Book compliant discs (Op. 32).

Although the panel majority purports to ground its analysis upon the rule of reason (Op. 23, n.11), it never defines the product market within which the alleged horizontal restraint is said to operate, suggests that the nature of the alleged restraint is such that anticompetitive effects within that undefined market may be presumed (Op. 26), and concludes that "[s]uch agreements are not within the rights granted to a patent holder" (Op. 27). Judge Bryson dissented for the reason that, in his view:

> the Commission's findings of fact and legal conclusions provide a sufficient ground for upholding the Commission's ruling that Princo has failed to satisfy its burden of showing patent misuse through a horizontal price-fixing agreement.

(DOp. 4).

The FTC has now belatedly injected two new legal arguments for consideration by the *en banc* Court by asserting:

1. That the alleged agreement not to license the Lagadec patent except for uses complying with the Orange Book standard could be justified only if *ex ante* and only if reasonably necessary to further the procompetitive technical collaboration between Philips and Sony under their RJV (the "efficiency justification" argument set forth in Point II of the FTC's brief); and

2. That, unless so justified, the alleged agreement not to license Lagadec more broadly could be proscribed as "inherently suspect" with the result that Princo would be relieved of its burden under *Windsurfing* of establishing that "the overall effect of the license tends to restrain competition unlawfully in an appropriately defined relevant market" (the "inherently suspect" argument set forth in Point III of the FTC's brief).[8]

As developed in Points F and G below, both of these arguments should be squarely rejected. Indeed, acceptance of the FTC's position might significantly reduce the amount of capital

[8] *Windsurfing Int'l, Inc. v. AMF, Inc.*, 782 F.2d 995, 1001-02 (Fed. Cir. 1986) ("*Windsurfing*").

available to RJVs and SSOs for the funding of R&D directed to innovation and increased productivity. Section H sets forth a brief summary conclusion.

## C. Technical Background Facts

### 1. The Orange Book Standards And The Philips Licenses

*Princo v. ITC* involves the two very successful licensing programs of Philips under the "Orange Book" industry standards for recordable (CD-R) and re-writeable (CD-RW) compact discs. The technology for those standards was developed jointly by Philips and Sony as part of a decades-long collaborative research effort directed to the establishment of industry standards for digital storage technology.[9] The Orange Book standards were authored by Philips to reflect the product of the research joint venture to which both Sony and Philips made important technological contributions.

It was always contemplated that any patents generated by Philips or Sony in connection with their respective technological contributions to the research joint venturers would be licensed on reasonable and non-discriminatory ("RAND") terms to those CD manufacturers who elected to take an Orange Book license. Prosecution of those patents, however, was left entirely to the party who had developed the respective technology, and ownership of such patents remained with the originating party.[10] Eventually, patent rights were contributed via license for use under the Orange Book licensing program by Philips, Sony and two other firms.[11]

A CD-R compact disc is a recordable compact disc upon which information can be written once in a CD-R recorder or computer drive, and read or played back on a CD-RA audio player or CD-ROM computer drive.[12] CD-R compact discs can be used for both audio and data recording. All blank CD-R compact discs conform to Orange Book Part II (CD-R) specifications and are compatible with all recorders and computer drives manufactured under the Orange Book CD-R or CD-RW standards.

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[9] Indeed, the RJV for the development of the Orange Book standards was modeled upon the previous successful collaborations between Philips and Sony for the joint development of CD-RA audio technology under the "Red Book" industry standard and CD-ROM technology under the "Yellow Book" industry standard.

[10] For that reason, it would be technically incorrect to refer to the Orange Book licensing program as a "patent pool", since there was no "pooling" of the underlying patents under the ownership of a single licensing entity.

[11] Separate clearance agreements were negotiated with Ricoh and Taiyo Yuden to facilitate the grant of rights by Philips to the Orange Book licensees under the potentially blocking patents of those firms as well.

[12] Thus, one engineering criterion for the CD-R Orange Book discs was that they should be backwards compatible for playback purposes with the installed capacity of CD-RA audio players and CD-ROM computer drives.

A CD-RW compact disc is a recordable compact disc upon which information may be written, erased, overwritten and read. CD-RW compact discs can be used for both audio and data recording. A CD-RW compact disc, once recorded, must be read or played back on either a CD-RW drive or a CD-RA player or CD-ROM drive designed to read lower reflectivity compact discs.

All blank CD-RW compact discs conform to Orange Book Part III (CD-RW) specifications and should be compatible with all recorders and computer drives manufactured under the Orange Book CD-RW standard.

The six Philips patents at issue in this action are broadly licensed to the industry by Philips on a nonexclusive basis for the manufacture and sale of such CD-R and CD-RW compact discs as comply with the Recordable CD-R and Rewritable CD-RW Orange Book standards.

### 2. Analog ATIP And The Raaymakers And Lagadec Patents

Two of the six Philips patents at issue in *Princo v. ITC*, the Raaymakers patents,[13] relate to an analog method by which a CD-R or CD-RW recorder or computer drive can determine where its laser is positioned along the spiral pre-groove track of the compact disc. The Philips analog method, known as the "Absolute Time In Pre-groove" or "ATIP" method, built upon the preexisting wobble signal technology already used to supply velocity control.[14]

The Lagadec patent claimed a digital method for accomplishing the same objective. As the panel decision states, "there is no dispute that a disc made using one technological approach would not work in a CD recorder designed to read position data using the other" (Op. 8). As the Court also found, however, claim 6 of Lagadec was sufficiently broad to read upon the CD-R and CD-RW compact discs using the Raaymakers technology which complied with the CD-R and CD-RW standards (Op. 17-20).

It is worth noting that the Lagadec approach does not represent an "improvement" on the Raaymakers technology, but rather a contemporaneously developed alternative approach that was rejected by the two joint venturers on technological grounds. Indeed, the Lagadec patent expired before either of the two Raaymakers patents.

### 3. Interchangeability And Installed Capacity Considerations

[13] United States Patent No. 4,999,825 (the "Raaymakers '825 patent") expired on November 1, 2008. United States Patent No. 5,023,856 (the "Raaymakers '856 patent") expired on June 11, 2008.

[14] *See* Op. 7-8.

Once Philips and Sony agreed to employ the Raaymakers approach rather than that of Lagadec for the two Orange Book standards, every recorder or computer drive unit that was manufactured and sold under those standards could be considered a part of an installed base that would not be available as part of the potential market for compact discs manufactured and sold under some hypothetical competing compact disc standard that would employ digital Lagadec rather than analog Raaymakers technology.

Unless a new type of recordable or re-writeable compact disc is backwards compatible with recorder and computer drive units already installed in the marketplace, it would not be expected to compete effectively for incremental market share unless the new generation of recorders and computer drives represents a generational paradigm shift – such as the change from vinyl to the CD-RA standard of the Red Book.[15]

## D. Procedural Background Facts

This is the second time that this seven-year-old Section 337 action has been before the Federal Circuit on an appeal from a final determination of the ITC. In the first ITC decision of March 25, 2004 ("the 2004 ITC Decision"), the ITC affirmed the Initial Decision ("ID") of the Administrative Law Judge ("ALJ") and found 29 claims of the six asserted Philips patents infringed by Princo and not invalid.[16] Relief was nevertheless withheld by the ITC on the theory that the six "essential" Philips patents asserted against Princo were unenforceable for misuse because they had been packaged in the licenses issued by Philips along with four allegedly "nonessential" patents.[17]

On the first appeal to the Federal Circuit, Princo and the ITC argued that the ITC's ruling should be affirmed and that the Philips package licenses (1) should be deemed *per se* unlawful by analogy with (a) the product tying cases,[18] and (b) the block-booking cases,[19] and (2) were also unlawful under the rule of reason. Those arguments were squarely

[15] The more common setting for such an improved second generation standard is typified by the Blu-Ray DVD players which are capable of playing first generation DVDs in addition to the new high definition Blu-Ray discs.

[16] A redacted public version of the 2004 ITC Decision was issued on August 27, 2004. Copies of both that decision and a redacted version of the ID are available as part of Pub. No. 3686 on the ITC website (www.usitc.gov).

[17] The ALJ had determined that a total of twelve patents – including the Lagadec patent – licensed under one or more of the Orange Book agreements between Philips and the Orange Book compliant CD manufacturers were "nonessential", but the 2004 Commission Decision considered only four of those twelve patents.

[18] *International Salt Co. v. United States*, 332 U,S. 392 (1947); *Morton Salt Co. v. G.S. Suppiger Co.*, 314 U.S. 499 (1942); *IBM Corp. v. United States*, 298 U.S. 131 (1936).

[19] *United States v. Loew's, Inc.*, 371 U.S. 38 (1962); *United States v. Paramount Pictures, Inc.*, 334 U.S. 131 (1946).

rejected in the unanimous *Philips I* ruling which the first Federal Circuit panel issued on September 21, 2005.[20]

In rejecting the tying theories the ITC had applied to the claim that the Orange Book licenses contained unlawful package licensing provisions, the *Philips I* opinion of Judge Bryson announced two important principles:

1. That because a "nonexclusive patent license is simply a promise not to sue for infringement", the "conveyance of such a license does not obligate the licensee to do anything; it simply provides the licensee with a guarantee that it will not be sued for engaging in conduct that would infringe the patent in question" (424 F.3d at 1189) (citations omitted); and

2. That "[t]he effect of a nonexclusive license was different before the Supreme Court" in *Lear, Inc. v. Adkins*, 395 U.S. 653 (1969), "abolished the doctrine of licensee estoppel", since

> Before *Lear*, a nonexclusive license had a legal effect that made it more than a mere covenant by the licensee not to sue. Acceptance of the license barred the licensee from challenging the validity of the patent. Some of the early decisions regarding patent-to-patent tying arrangements appear to have been based, at least in part, on that feature of pre-Lear patent licenses . . . In the post-*Lear* era, the "acceptance" of a license has no such restrictive effect on the licensee's freedom.

(Id. at 1190) (citations omitted).

The action was remanded for such further proceedings by the ITC as might be necessary to resolve any additional outstanding alleged misuse defenses.[21] On remand, Princo focused its arguments upon putative misuse defenses allegedly arising from inclusion of the Lagadec patent in the Orange Book licenses and the ITC squarely rejected those arguments in the 2007 ITC Ruling, 2007 WL 1256290 (Feb. 5, 2007).

## E. A Brief Analysis Of Relevant Markets

[20] The unanimous opinion of the panel in *Philips I* was authored by Judge Bryson – who dissented from the portion of the panel majority opinion now at issue *en banc*.

[21] "Because the Commission did not address all of the issues presented by the administrative law judge's decision under both the *per se* and rule of reason analysis, further proceedings before the Commission may be necessary with respect to whether Philips's patents are enforceable and, if so, whether Philips is entitled to any relief from the Commission" (424 F.3d at 1198).

1. The Pertinent Research Market

The only competition between Philips and Sony foreclosed by the RJV – what the FTC terms "the productive collaboration on CD-R and CD-RW technologies and standards" (FTC Br. 3) – was the potential for research competition on data storage technologies. At all pertinent times, moreover, the parties to the RJV understood that any patent rights issued to the two parties would be cleared through Philips for licensing to the Orange Book CD-R and CD-RW manufacturing licensees.

2. The Two Product Markets

The sole "product" of the RJV between Philips and Sony was represented by the Orange Book standards themselves. The downstream product markets for the CD-R and CD-RW compact discs manufactured by the Orange Book licensees were enormously competitive from the standpoint of both increasing production and price reductions.

3. The Two Licensing Markets

The upstream licensing market involved vertical clearance agreements between Philips as licensing agent for the Orange Book standards and the three other owners of patents under which licenses were deemed necessary to provide freedom to operate to the disc manufacturers. As discussed below, those vertical clearance agreements presumably contained field of use restrictions, provisions for royalty sharing and, at least in the case of the 1993 agreement regarding Lagadec, a covenant not to engage in contributory infringement by sublicensing beyond the scope of the limited grant.[22]

The downstream licenses to the manufacturers of Orange Book compliant compact discs were issued on non-exclusive, RAND terms.

## F. The "Efficiency Justification" Argument Is Unacceptably Narrow

The "efficiency justification" argument is unacceptably narrow to the extent the FTC argues that any ancillary terms of a patent rights clearance agreement can only be justified *ex ante* the development of a standard and solely to the extent "reasonably necessary to achieve an efficient collaboration" (FTC Br. 4). This tunnel vision approach erroneously ignores two central facts: (1) that patent clearance agreements negotiated *ex post* can be just as important to the success of an industry standard as those negotiated *ex ante*; and (2) that obviating potential patent disputes under patent rights clearance agreements is favored by public policy to at least the same extent as settlement agreements terminating patent litigations.

[22] The importance of such covenants is highlighted by the recent Supreme Court decision in *Quanta Computer, Inc. v. LG Electronics, Inc.*. ___ U.S. ___, 128 S.Ct. 2109 (2008).

The panel majority framed the issue as whether "Philips allegedly agreed with Sony not to license the Lagadec patent as competing technology to the Orange Book" (Op. 2). Whether such an agreement can or should be proscribed represents an extremely important question, since that determination necessarily must be made in every case where an industry standard setting organization attempts to convey freedom from suit under patent rights held by more than one inventive entity.

The terms of the arrangement between Sony and Philips regarding Lagadec as postulated by Princo are presumptively lawful. It is vertical and pro-competitive rather than a horizontal naked restraint. Moreover, the three specific ancillary restraints at issue – the division of royalties, the field of use limitation, and the agreement not to engage in contributory infringement – are each sanctioned under persuasive case authority.

1. <u>The Agreement Regarding Lagadec Is Vertical</u>

Because Sony owned the Lagadec patent which it had prosecuted, it was necessary to negotiate an arrangement under which Philips would be empowered to offer rights under Lagadec as part of the nonexclusive Orange Book licenses. The panel majority incorrectly believed that such an arrangement could be characterized as horizontal – apparently because the RJV contemplated collaborative research and development in an area where Philips and Sony were at least potential research competitors. Since the parties prosecuted patents on their respective developments separately, however, the relationship between Sony and Philips in respect of the Lagadec patent was vertical rather than horizontal.

2. <u>The Agreement Regarding Lagadec Is Pro-Competitive</u>

The panel unanimously and correctly found that claim 6 of Lagadec was "essential" or "blocking" in respect of the analog ATIP system incorporated into the Orange Book standard (Op. 14-20). As the unanimous panel also found, inclusion of the nonexclusive license under Lagadec in the Philips Orange Book licenses was necessary in order to foreclose potential patent disputes before Lagadec expired on September 28, 2007.

As the Federal Circuit recently reaffirmed in a different context,[23] long-standing public policy considerations favor settlements of patent litigation. A necessary corollary of that policy is that mechanisms designed to obviate patent disputes entirely before they arise likewise should be favored. RJVs, SSOs and patent pools which license broadly and non-exclusively on reasonable and non-discriminatory terms represent important examples of such mechanisms.[24]

[23] *In re Ciprofloxacin Hydrate Antitrust Litigation*, 544 F.3d 1323 (Fed. Cir. 2008) ("*Cipro*").

[24] At this critical economic juncture, when the potential for the economic reward constitutionally guaranteed to the patentee under Article I, Section 8 of the Constitution is under attack on many fronts, the pitfalls of the misuse defense should not be expanded to further reduce the incentives for the disclosures which the framers determined would "promote the progress of science and useful arts".

The arrangements between Sony and Philips regarding Lagadec have as their central purpose the avoidance of patent controversy. For that reason, the panel majority was wrong to treat the ancillary provisions of those arrangements as naked restraints.

3. The Three Ancillary Restraints In The Agreement Regarding Lagadec Are Each Presumptively Lawful

(a) The Division Of Royalties

In its unsuccessful *en banc* challenge to the tying aspects of the panel's opinion, Princo attempted to rely upon the Supreme Court's *Gasoline Cracking*[25] case. Rather than supporting Princo's challenge to that aspect of the panel deciaion, however, the primary thrust of the *Gasoline Cracking* decision actually supports the challenge of Philips to that portion of the panel majority opinion to be argued on Wednesday. Thus, the portion of *Gasoline Cracking* cited by Princo squarely holds that

> An interchange of patent rights and a division of royalties according to the value attributed by the parties to their respective patent claims is frequently necessary if technical advancement is not to be blocked by threatened litigation.

Moreover, footnote 5 of *Gasoline Cracking* which Princo also cites clearly implies that the justification for pooling and cross-licensing arrangements can extend well beyond "essential" patents because "frequently, the cost of litigation to a patentee is greater than the value of a patent for a **minor improvement**" (emphasis supplied).

The only limitation which the case law appears to impose upon royalty sharing arrangements is that the royalties may not be fixed at levels which are tantamount ro price. The leading case is *Yarn Processing*,[26] a case cited by all parties on the *Princo v. ITC* appeal, and whose continuing vitality is reflected by its citation to the Supreme Court by the Solicitor General in *McFarling*. There a number of former use licensees brought suit against a textile machinery manufacturer who held a number of patents containing process claims directed to the use of its machinery.

In *Yarn Processing*, there had been a factual showing that the use royalties were set at levels which over time could amount to 2 to 6 times the selling price of the machinery (*Id*. at 1134). On that basis the Fifth Circuit found that "Leesona guaranteed income to the manufacturers and effectively fixed the price of the machinery" (*Id*. at 1136). The only limitation placed on the horizontal agreements at issue before the Fifth Circuit in *Yarn Processing* was that the royalties charged to the throwsters could not be fixed at levels

[25] *Standard Oil Co. (Ind.) v. U.S.*, 283 U.S. 163 (1931) ("*Gasoline Cracking*").

[26] *In re Yarn Processing Patent Validity Litig*., 541 F.2d 1127 (5th Cir. 1977) ("*Yarn Processing*").

tantamount to the selling price of the machines upon which the licensed processes were carried out. Princo cannot make any comparable assertion here.

(b) The Field Of Use Limitation

The field of use limitation to the Orange Book applications in the agreement regarding Lagadec was also entirely appropriate. A patentee can unilaterally determine whether, to whom and upon what terms he wishes to license, and can refuse to license entirely.[27] As *Paper Bag* and *Special Equipment*[28] teach, moreover, the right to unilaterally suppress can be exercised for any economically pertinent reason.

Indeed, in assessing the legality of a joint venture under Section 1 of the Sherman Act and Section 7 of the Clayton Act, the Supreme Court presumes that the parties will elect not to compete with the joint venture they have established. *U.S. v. Penn-Olin Chem. Co.*, 378 U.S. 158. 168 (1964) ("*Penn-Olin*") ("Realistically, the parents would not compete with their progeny"); *see also Texaco Inc. v. Dagher*, 547 U.S. 1, 5-6 (2000) ("*Dagher*") (Oil companies' operations in a market limited to joint participation "through their investments" in a joint venture").

Indeed, the amicus brief filed jointly by the FTC and the Department of Justice ("DOJ") in *Dagher* argued that any agreement "reasonably related" to a pro-competitive joint venture must be evaluated under the rule of reason rather than a per se rule – irrespective of the fact that such agreement postdated the formation of the joint venture.[29] The FTC's present "ex ante" argument seems flatly inconsistent with the argument it presented to the Supreme Court in 2006

(c) Agreement Not To Engage In Contributory Infringement

Finally, even if the terms of the arrangement with Sony obligate Philips not to license Lagadec for non-Orange Book applications, Section 1 of the Sherman Act would not be violated – even if the license from Sony to Philips were exclusive for the Orange Book-compliant field of use as Princo suggests, and even if the promise of Philips not to license outside this field of use were phrased affirmatively rather than inferred from a field of use limitation on the grant of the license under Lagadec.

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[27] *See In re Independent Service Orgs. Antitrust Liyig.*, 203 F.3d 1322, 1327 (Fed. Cir. 2000) ("*Xerox/ISO*").

[28] *Cont'l Paper Bag Co. v. E. Paper Bag Co*, 210 U.S. 405 (1908) ("*Paper Bag*"); *Special Equipment Co. v. Coe*, 324 U.S. 370 (1945) ("*Special Equipment*").

[29] "Brief Of The United States As Amicus Curiae Supporting Petitioners" 7-8 (September 2006) ("*Dagher Br.").*

The leading case is again *Yarn Processing* where, in the wake of *Lear v. Adkins*, former use licensees sued a textile machinery manufacturer who had granted licenses to competing manufacturers in which each agreed not to sell machinery to any customer who refused to execute the royalty-bearing use license. Under the pre-*Lear* estoppel paradigm, this meant that any customer who was forced to take the use license to purchase the machinery would be estopped from contesting the underlying patents.

When the former licensees challenged the prohibition on sales to non-licensees, however, the Fifth Circuit upheld that provision:

> We fail to see how this is an illegal extension of the patent monopoly . . . . Absent the restriction on sales to unlicensed throwsters, manufacturers who knowingly sold sold machinery to unlicensed throwsters would be liable for contributory infringement,

541 F.2d at 1135.

## G. <u>The "Inherently Suspect" Argument Lacks Foundation</u>

The FTC directs Point III of its brief amicus curiae to the proposition that patent clearance agreements are "inherently suspect". None of the cases discussed in Point III, however, even remotely suggest that a quick look approach should be employed to evaluate the antitrust legality of the agreement under which Philips received sublicensing rights to the Lagadec patent from Sony.

As the FTC argued to the Supreme Court in *Dagher*, moreover, "[p]er se condemnation is reserved for conduct that" can be characterized as "manifestly anticompetitive". *Dagher* Br. 7, *citing Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49-50 (1977) ("*GTE Sylvania*").

The FTC's Supreme Court brief in *California Dental*[30] is also quite instructive regarding the conditions precedent which must be satisfied before application of the "quick look" analysis can be justified.[31] Before the FTC can characterize an alleged restraint as "inherently suspect", it must be examined "in the detail necessary to understand its competitive effect" and that examination must be based upon "extensive experience with the effect of" that restriction and "considerable expertise".[32]

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[30] *California Dental Ass'n v. FTC*, 526 U.S. 756 (1999) ("*California Dental*").

[31] Brief For The Respondent 30-34 ("*California Dental* Br.").

[32] *California Dental* Br. 33.

The FTC's brief represents its first foray into the realm of patent clearance agreements.[33] Based upon that circumstance, it is questionable whether the FTC could claim the requisite experience and expertise to justify a "quick look" analysis.

Princo totally failed to demonstrate before the ITC that the arrangements regarding the exploitation of Lagadec generated any cognizable anti-competitive effect in any properly defined relevant product market. Although the panel majority suggests that a second remand is required despite Princo's failure to discharge its burden under *Windsurfing*, this suggestion is completely undermined by the panel's failure to deal with the undisputed economic facts.

It is important for those sectors of the economy where technological progress is facilitated by collaborative research and industry standards that application of the defense of unenforceability for patent misuse should not be expanded without warrant. In *Windsurfing*, 782 F.2d at 1001-02 the Federal Circuit announced that:

> To sustain a misuse defense involving a licensing arrangement not held to have been per se anticompetitive by the Supreme Court, a factual determination must reveal that the overall effect of the license tends to restrict competition unlawfully in an appropriately defined relevant market (footnote omitted).

The *Windsurfing* rule has been followed consistently by numerous panels of this Court.[34] Just as with the *Clorox* rule of the Second Circuit recently endorsed in *Cipro*,[35] speculation, hypothesis or conjecture should never be permitted to substitute for the factual showings required under the principles of *Windsurfing*.

Before the ITC, Princo totally failed to adduce a scintilla of evidence regarding any actual anticompetitive effect proximately caused by the alleged exploitation of the Lagadec patent in "the technology market for recordable and rewritable compact discs" which it now asserts. The rule of *Windsurfing* assigned that burden to Princo, and Princo failed to discharge it. The ITC so found and Judge Bryson would have affirmed on that ground alone.

Princo could not point to a single request for a license under the digital claims of Lagadec, and made no attempt whatsoever to prove that such a license would have been useful to

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[33] This action is the first case involving both standard setting and patent rights in which the FTC has submitted an amicus brief. Its own enforcement activities on such subject matter have been limited to challenges to patent hold-ups – which subject matter is at the opposite pole from the patent clearance agreement at issue here.

[34] *E.g.*, *Monsanto Co. v. McFarling*, 363 F.3d 1336 (Fed. Cir. 2004); C.R. *Bard, Inc. v. M3 Sys., Inc.*, 157 F.3d 1340 (Fed. Cir. 1998); *Virginia Panel Corp. v. MAC Panel Co.*, 133 F.3d 860 (Fed. Cir. 1997).

[35] *Clorox Co. v. Sterling Winthrop, Inc.*, 117 F.3d 50, 56 (2d Cir. 1997.

someone who might have contemplated developing a new standard platform to compete with the Orange Book. Most importantly, Princo did not attempt to prove that Lagadec might have any technical or economic advantages over the Raaymakers technology.

It also appears from the opinion that the majority failed to appreciate the virtually insuperable economic difficulties which would militate against a potential role for digital Lagadec in any putative competitive licensing program. It is undisputed that the "digital" systems of Lagadec are "fundamentally incompatible" with the Orange Book standard as the Panel Decision found (Op. 8). Since any putative Lagadec system would not be backwards compatible with the installed Orange Book capacity, the chances for commercialization of such a system would be virtually nonexistent.

## H. <u>Conclusion</u>

The FTC's "efficiency justification" approach is overly narrow and ignores the critical role of patent rights clearance agreements in those important sectors of the economy where industry standards promote market efficiencies and technological progress. Its suggestion that ancillary restraints in those pro-competitive agreements explicitly sanctioned under authoritative case law can be analyzed as "inherently suspect" naked horizontal restraints contravenes both law and policy.

The radical analytical framework proposed by the FTC should be squarely rejected by the Federal Circuit,

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