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JFTC Issued Microsoft Ruling on its NAP Clause Practice

December 2008

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On September 16, 2008, Japan Fair Trade Commission (the "JFTC") issued a ruling against Microsoft Corporation ("MS") regarding its use of a so-called "NAP" clause in its software licenses. The MS NAP clause prevented licensees from asserting certain intellectual property rights against MS and its customers.

The ruling was issued after almost four years of hearings. In the ruling, the JFTC found that the NAP provision in MS's licenses for its Windows operating systems ("OS") for personal computers ("Windows OS") violated the prohibition against dealing on restrictive terms, one of the unfair trade practices under the Anti Monopoly Act (the 'AMA'). As a result, the JFTC issued a cease and desist order against MS.

The JFTC's more than 140-page ruling is voluminous and covers a wide range of topics. The full implications of this wide ranging ruling likely will only become clear over time. Set forth below is the summary of the JFTC ruling (the "JFTC Ruling").

Background

MS is a U.S. company that develops and licenses its Windows OS to original equipment manufacturers ("OEMs") on the condition that the licensee OEMs will not assert any of their patents against Microsoft even if the patented inventions were included in the licensed software (i.e., Windows OS or its replacement or successor products). This license provision is known as a non-assertion of patent or "NAP" clause. The NAP clauses in MS's agreements with OEMs (the "MS NAP Clauses") were to be effective for a certain period of time even after the termination of the underlying license agreements (survival of the MS NAP Clauses).

Beginning around 1998, on the other hand, MS started licensing its new OS, Windows 98, which contained an audio-visual ("AV") application called Windows Media Player. Since that time, MS has gradually expanded the AV capability of its OS (i.e., Windows Media Technologies including Windows Media Video, Windows Media Audio, Windows Media DRM, etc.). While some OEMs, particularly those holding patents related to AV technologies, complained that the MS NAP Clauses should be deleted from their license agreements, MS did not agree to delete the provision at that time.

The MS NAP Clauses were deleted from agreements executed on or after August 1, 2004, and there has been no NAP clause in the license agreement with MS since then. However, the MS NAP Clauses in agreements executed prior to July 31, 2004 still remain in effect, and will remain in effect beyond the expiration of the agreement term because of survival provisions contained in the agreements.

In its proposed order called "recommendation (*kankoku*)" issued July 13, 2004,^[1] the JFTC found that the MS NAP Clauses violated the prohibition against dealing on restrictive terms, one of the unfair trade practices, stating that OEMs that licensed the Windows OS could not file patent

infringement suits against MS or against other OEMs to which the Windows OS was licensed. In response, MS deleted the NAP provision from its license agreements. Having done so, however, MS nevertheless challenged the validity of the proposed order.^[2] Accordingly, a hearing called a “*shimpan*” was commenced. On September 16, 2008, the JFTC issued its decision in the case, including a cease and desist order called a “*shimpan shinketsu*.”

Summary of the JFTC Ruling

While the JFTC identifies a number of issues of dispute in the September 16, 2008 ruling (i.e., the JFTC Ruling), among the important points is whether MS NAP Clauses likely discouraged OEMs from conducting R&D activities relating to PC AV technology. While the JFTC’s fact finding and analysis are fairly detailed and complicated, the following provides a summary of its findings.

The MS NAP Clauses provided MS and its licensees with protection from patent infringement lawsuits not only when using the Windows OS, but also its replacement or successor products. The JFTC also found that the NAP remained in effect beyond the expiration of the agreement term because of the survival provision in the agreements (“future effects”). In addition, the JFTC found that the scope of coverage of the MS NAP Clauses would expand more broadly in the course of expansion of the Windows OS. Furthermore, once Windows OS incorporated technologies patented by OEMs, other OEMs and almost all PC users and developers of PC software could use the OEMs’ technologies for free for almost an unlimited period.

Before July 31, 2004, OEMs repeatedly expressed their concern about actual and potential use of their patented technologies in future versions of the Windows OS, particularly as MS expanded its AV functionalities. OEMs also complained about MS’s failure to disclose sufficient information about the Windows OS so that OEMs could review what scope of their technologies would be captured by Windows OS. The JFTC concluded that this behavior undermined the incentives of OEMs to conduct PC AV technology research and development on or before July 31, 2004.

The JFTC also found that the incentives of OEMs to innovate in AV functions were undermined after July 2004. In addition, the JFTC concluded that OEMs already had a large concern that their patents may have been infringed by Windows OS as of July 31, 2004, and such patented technologies were “core” technologies of PC AV technologies. The JFTC determined that the OEMs’ incentives and ability to expand upon these technologies such as audio and video compression and decompression technologies were substantially diminished.

Under these circumstances, particularly given the vague scope of functionalities and future MS products covered by the NAP clause in the pre-July 31, 2004 agreements, incentives of OEMs to invest in PC AV technology research and development were undermined due to the future effect of the MS NAP Clauses.

Implications of the Ruling

While the JFTC Ruling made clear certain unresolved issues concerning unfair trade practices in the technology and intellectual property contexts, there are many open issues. The JFTC found that the “remarkably overbroad nature” of the MS NAP Clauses made them anticompetitive. The JFTC is silent, however, on what type of NAP clauses are permissible.

1. Unfair trade practices is an antitrust violation unique to Japan that the JFTC designates as tending to impede fair competition. The JFTC currently designates sixteen such types of acts under “General Designations,” including “dealing on restrictive terms,” which the JFTC found MS violated. While unfair trade practices do not necessarily require possession of market power, the JFTC apparently considers it to be one of the important factors that MS had a market power in the worldwide PC OS segment.
2. The JFTC found that the MS NAP Clauses violate the AMA even though they no longer exist in agreements executed on and after the August 1, 2004 agreement, mainly because those in the pre-July 31, 2004 agreements have future effect. While the JFTC did not say a NAP clause only covering the patents that existed at the time of execution of the agreement is permissible and a NAP clause also covering the patents to be obtained after execution of the agreement is problematic, a NAP clause that will cover the technologies to be developed after the agreement may be subject to scrutiny similar to that of the JFTC Ruling. Moreover, a NAP clause that covers only the technologies to be developed during the term of agreement, for instance, nevertheless may be an AMA violation particularly in the case

where the agreement term is long, or there is an automatic renewal.

3. In addition, the JFTC found the MS NAP Clauses to be anticompetitive, because of their overbroad scope. Namely, the JFTC Ruling mentions that (a) under the MS NAP Clauses, once Windows OS incorporates technologies patented by OEMs, *other OEMs and almost all PC users* can use their technologies for free (for an almost unlimited period), and (b) the vague scope of functionalities and future MS products covered by the MS NAP Clauses do not provide OEMs with proper predictability of their scope. The JFTC Ruling, however, does not provide a bright line test on what is the permissible scope of the coverage. Therefore, although it is common for a NAP clause to cover other licensees of the licensor in addition to the licensor itself, it still does not appear to be automatically permissible even if the scope of a NAP clause is clearly defined.
4. In weighing the procompetitive effect and anticompetitive effects of the NAP provision, the JFTC does look at the procompetitive justifications for the provision. This is consistent with the position that the JFTC recently announced in its IP Guidelines.^[3] In fact, the JFTC recognizes the advantage of utilizing a NAP clause stabilizing a platform that is broadly used in society. The JFTC in the end found, however, that such procompetitive effects would not outweigh the anticompetitive impacts on PC AV technology markets. Therefore, while the JFTC would consider the procompetitive justification in reviewing the legality of a restriction, simple theoretical justifications may not be sufficiently persuasive.

Conclusion

In essence, the JFTC ruled that the MS NAP Clauses were a violation of the prohibition against dealing on restrictive terms because of their existing and potentially overbroad coverage in terms of time frame, technologies, and parties. Firms engaged in technology-related businesses should carefully design their NAP clauses in light of the JFTC Ruling, which does not provide a bright line test.

Footnotes

[1] Recommendation of JFTC, July 13, 2004.

[2] If MS voluntarily accepted the proposed order, the JFTC would have issued the formal order whose contents are the same as the recommendation ("*kankoku shinketsu*"). This system to conduct a hearing before the formal order (in case of a refusal by the recipient of the proposed order to voluntarily accept the order) was abolished in the 2005 amendments to the AMA, and *shimpan* hearing is conducted only after the formal order as review process (see our Legal Update of April 21, 2005 "[Amendments to Japanese Anti Monopoly Act: Japan Significantly Strengthens Its Antitrust Laws](#)").

[3] Please see our Legal Update of November 2007 "[JFTC Publishes Final Guidelines Concerning Use of Intellectual Property](#)".