Client Alert.

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Federal Circuit Narrows Patent Misuse Doctrine and Provides Guidance to Patent Pools

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In January of this year, we alerted clients to the potential implications of *Princo Corporation v. International Trade Commission*, in which the Federal Circuit, sitting *en banc*, would decide whether an agreement among patent pool participants not to license a competing technology constitutes patent misuse even in the absence of evidence of anticompetitive effects.[1] As we explained, the *en banc* decision could significantly impact the formation of patent pools in particular and the scope of the patent misuse doctrine in general. Not surprisingly, the case attracted a number of amici, including the Federal Trade Commission, the American Intellectual Property Law Association, the American Antitrust Institute, and the Intellectual Property Owners Association.

On August 30, the *en banc* court issued its decision,[2] substantially narrowing the patent misuse doctrine, providing guidance to patent pools, and continuing to stress the procompetitive aspects of standard-setting. Thus, the case has significant implications not only for patent pool participants, but for patent infringement litigants in general. Given the relationship between patent misuse and antitrust doctrine, the case also has implications for the intersection of intellectual property and antitrust.

KEY POINTS

- The Federal Circuit clarified that patent misuse applies only to conduct or agreements that "have the effect of increasing the physical or temporal scope of the patent in suit."[3] Patent misuse, therefore, may not apply even if a patent is used as part of an antitrust violation.
- Misuse claims aimed at patent pool or technology joint venture agreements must be supported by proof of actual anticompetitive effects unless the pool is a sham or the agreements are naked restraints of trade.
- Technology joint venture participants may legitimately agree not to compete against their own joint venture by using or licensing competing technology.
- Patent misuse or antitrust claims asserting that pool participants agreed to suppress a competing technology must be supported by evidence that there was a reasonable probability the technology would have matured into a competitive force if licensed.

BACKGROUND

During the 1980s and 1990s, Philips and Sony jointly developed recordable and rewritable compact discs ("CD-R" and "CD-RW"). As part of that effort, Philips and Sony established technical standards, which they collected in a publication known as the "Orange Book." Also as part of that effort, Sony and Philips each addressed the problem of encoding

[1] Cynthia Beverage, *Risks of Agreeing Not to License a Pooled Patent*¸ MoFo Client Alert (Jan. 8, 2010).
[2] No. 2007-1386, slip op. (Fed. Cir. Aug. 30, 2010).
[3] *Id.* at 2.

position information in writable discs. Philips developed an analog solution, set forth in the Raaymakers patents, while Sony generated a digital solution, set forth in the Lagadec patent. After Philips and Sony engineers agreed that Philips's approach was superior, the technology covered by the Raaymakers patents was incorporated in the Orange Book.

Philips and Sony monetized their efforts by licensing patents necessary to manufacture Orange Book-compliant CD-Rs and -RWs. Philips acted as licensing administrator to a pool of Sony's and its patents. Initially, Princo agreed to license the patent pool. When it stopped paying licensing fees, however, Philips filed a complaint with the International Trade Commission ("ITC"), alleging that Princo was importing infringing CD-Rs and -RWs. This led to a lengthy litigation, resulting in two appeals to the Federal Circuit.

In the first round of ITC proceedings, Princo alleged that the patent pool constituted patent misuse because it contained nonessential patents. The Administrative Law Judge and the ITC agreed. The ITC found that Philips had included two nonessential patents in its package license of patents related to the manufacture of Orange Book-compliant CD-Rs and -RWs.[4] In addition, the ITC found that there were four nonessential patents included in a patent pool related to the manufacture of compliant CD-RWs.[5] Philips did not license separately any of the patents in the package or in the pool. On these facts, the ITC held that these licenses constituted *per se* patent misuse, and, in the alternative, were patent misuse under the rule of reason because the licenses could foreclose alternative technologies.[6]

On appeal, the Federal Circuit reversed. The court recognized that the inclusion of patents that are "nonessential" because of the existence of rival technologies may have procompetitive benefits.[7] According to the court, the inclusion of such patents still provides "'procompetitive benefits by integrating complementary technologies.'"[8] Moreover, the inclusion of these types of patents may reduce transaction costs "by eliminating the need for multiple contracts and reducing the licensors' administrative and monitoring costs."[9] The inclusion can also "obviate any potential patent disputes between the licensor and the licensee," thereby reducing the licensee's risk in manufacturing standard compliant products.[10] And inclusion "allows the parties to price the package based on their estimate of what it is worth to practice a particular technology, which is typically much easier to calculate than determining the marginal benefit provided by a license to each individual patent."[11]

The *Philips* court also reasoned that a license is in effect nothing more than a promise not to sue, which (unlike other tying arrangements) does not force the licensee to use the patented technology.[12] The court then explained that a patent holder could bring about the same effect wrought by including a nonessential patent in a package by simply surrendering the patent or announcing an intention not to enforce the patent.[13] Such actions would not "force" a licensee to use the patented technology, would by no means be considered anticompetitive, and would have the same effect on rivals as including the nonessential patent in the package.[14] The court therefore remanded for further proceedings.

[4] *See U.S. Philips Corp. v. ITC*, 424 F.3d 1179, 1183 (Fed. Cir. 2005).
[5] *See id.* (the patent pool included two patents held by other companies).
[6] *See id.* at 1184.
[7] *See id.* at 1192-93.
[8] *See id.* at 1192 (quoting U.S. Dep't of Justice and Federal Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property § 5.5 (1995)).
[9] *Id.*
[10] *Id.* at 1192-93.
[11] *Id.* at 1193.
[12] *See id.* at 1190.
[13] *See id.*
[14] *See id.* at 1191-92.

On remand, Princo pushed the argument that including the Lagadec patent in the patent pool enabled Philips to secure Sony's adherence to Orange Book standards, thereby foreclosing competition from an alternative standard built around the Lagadec patent. The ITC rejected this argument and entered remedial orders against Princo. On appeal to the Federal Circuit, a divided panel vacated the ITC's decision, holding that an agreement to suppress the Lagadec technology by agreeing to forego separate licensing of the Lagadec patent could constitute misuse. The panel directed the ITC to further examine the record to see whether such a technology could have been viable. The Federal Circuit granted Philips's and the ITC's petitions for *en banc* review.

THE *EN BANC* DECISION

The *en banc* court held that there was no patent misuse. In doing so, the court narrowed the scope of the patent misuse doctrine, opined on patent pooling agreements, commented on the procompetitive aspects of standard-setting, and touched on the antitrust treatment of intellectual property agreements.

After recounting the development of the patent misuse doctrine, the court noted that this "case presents a completely different scenario from the cases previously identified by the Supreme Court and by this court as implicating the doctrine of patent misuse."[15] The court stressed a narrow scope of the doctrine of patent misuse, explaining that it applies only where "the patentee has impermissibly broadened the physical or temporal scope of the patent grant and has done so in a manner that has anticompetitive effects."[16] "What patent misuse is about, in short, is 'patent leverage,' i.e., the use of patent power to impose overbroad conditions on the use of the patent in suit that are 'not within the reach of the monopoly granted by the Government.'"[17] Given this limitation, the court distinguished between agreements that constitute patent misuse and agreements that may violate the antitrust laws but do not broaden the scope of the patent.[18] Under this rubric, the court regarded the claimed agreement between Philips and Sony to suppress the Lagadec patent was independent of the patent pool licensing, stating that while such an agreement might be susceptible to a challenge under the antitrust laws, it did not constitute patent misuse. In short, the court concluded that the alleged agreement "does not leverage the power of a patent to exact concessions from a licensee that are not fairly within the ambit of the patent right."[19]

Importantly for patent pool participants, using antitrust principles as a guide, the court held that even if the patent misuse doctrine applied, the alleged agreement to suppress the Lagadec technology would be subject to a rule of reason analysis, which requires proof of anticompetitive effect. In coming to this conclusion, the court reiterated the procompetitive benefits of standard-setting activity:

In particular, as we explained in *Philips I*, research joint ventures that seek to develop industry-wide standards for new technology can have decidedly procompetitive effects. The absence of standards for new technology can easily result in a "Tower of Babel" effect that increases costs, reduces utility, and frustrates consumers. As a leading treatise has noted, cooperation by competitors in standard-setting "can provide procompetitive benefits the market would not otherwise provide, by allowing a number of different firms to produce and market competing products compatible with a single standard." Those benefits include greater product interoperability, including the promotion of price competition among interoperable products; positive network effects, including an increase in the value of products as interoperable products

[15] No. 2007-1386, slip op. at 23.
[16] *Id.* at 18.
[17] *Id.* at 24 (quoting *Zenith Radio Corp v. Hazeltine Research, Inc.*, 395 U.S. 100, 136-38 (1969)).
[18] *Id.*
[19] *Id.* at 27.

become more widely used; and incentives to innovate by establishing a technical baseline for further product improvements.[20]

Given these potential procompetitive benefits, the court held that ancillary restraints to the joint venture, "such as agreements between the collaborators not to compete against the joint venture," are assessed under the rule of reason.[21] Rejecting the use of a quick-look analysis,[22] the court held that unless the joint venture was a sham or the agreements naked restraints, patent misuse (or antitrust) would require a showing of anticompetitive effects.[23]

The court went on to hold that Princo failed to prove the alleged agreement had anticompetitive effects. The court relied on the ITC's finding that "the Lagadec technology was not a viable competitor to the Raaymakers patents,"[24] the finding that the Lagadec technology did not work well according to Orange Book standards, and the lack of evidence that Sony would have developed technologies that competed with the Orange Book standard but for the Lagadec patent's inclusion in Philips's patent pool.[25] What was required, stated the court, was evidence that there was a reasonable probability the technology would have matured into a competitive force.[26]

The significance of the court's decision is demonstrated by the dissent. According to the dissent, the majority decision eviscerates the patent misuse doctrine:

Evidently the majority thinks it appropriate to emasculate the doctrine so that it will not provide a meaningful obstacle to patent enforcement. Outside of unlawful tying arrangements and agreements extending the patent term, the majority would hold that antitrust violations are not patent misuse and would leave to private and government antitrust proceedings the task of preventing abuse of patent monopolies, enforcement that is likely inadequate to the task.[27]

In particular, the dissent maintained that "Supreme Court cases establish that license agreements that suppress alternative technologies can constitute misuse of the patents for the protected technology, and the regional circuits have agreed."[28] The dissent thus maintained that patent misuse is not limited to cases of "leveraging."[29] The dissent also viewed the standard-setting context of the case to enhance, not lesson, competitive concerns:

Agreements not to compete are a matter of particular concern where, as here, the competitors collectively enjoy a monopoly position and set standards for an industry. Agreements between competitors to engage in standard setting may force an entire industry to adhere to a particular standard, effectively foreclosing competition from alternatives. Indeed, the Supreme Court has routinely condemned efforts to use standard-setting agreements to suppress competition of alternative products.[30]

The dissent would have therefore applied a quick-look analysis, in which Philips and Sony would have to justify the agreement before any evidence of anticompetitive effects would be necessary.[31] In short, the dissenting opinion

[20] *Id.* at 32.
[21] *Id.* at 33.
[22] *Id.* at 39-41.
[23] *See id.* at 40.
[24] *Id.* at 29.
[25] *Id*. at 35-37.
[26] *Id.* at 37.
[27] Slip op., Dyk dissent, at 2.
[28] *Id.* at 4.
[29] *Id.* at 17.
[30] *Id.* at 23-24.
[31] *Id.* at 25-26.

highlights the doctrinal shift the *en banc* opinion creates.

While *Princo* will have wide-ranging impact on patent litigation involving claims of misuse, the decision is particularly important to firms who participate, or are considering participating, in patent pools or technology joint ventures. Such firms can take some comfort in the court's adherence to the rule of reason. It not uncommon for joint ventures to prohibit participants from competing with the venture, and *Princo* extends that the logic permitting such agreements to cases involving the licensing of patented technology.

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