DEPARTMENT OF JUSTICE
Antitrust Division

JOEL I. KLEIN
Assistant Attorney General

Main Justice Building
950 Pennsylvania Avenue, N.W.
Washington, D.C. 20530-0001
(202) 514-2401 / (202) 616-2645 (f)

antitrust@justice.usdoj.gov (internet)
http://www.usdoj.gov (World Wide Web)

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VIA FAX

Carey R. Ramos, Esq.
Paul, Weiss, Rifkind, Wharton & Garrison
1285 Avenue of the Americas
New York, New York 10019-6064

Dear Mr. Ramos:

This letter is in response to your request on behalf of Hitachi, Ltd., Matsushita Electric Industrial Co., Ltd., Mitsubishi Electric Corporation, Time Warner Inc., Toshiba Corporation, and Victor Company of Japan, Ltd. (collectively, the "Licensors"), for the issuance of a business review letter pursuant to the Department of Justice's Business Review Procedure, 28 C.F.R. § 50.6. You have requested a statement of the Department of Justice's antitrust enforcement intentions with respect to a proposed arrangement pursuant to which Toshiba will assemble and offer a package license under the Licensors' patents that are "essential," as defined below, to manufacturing products in compliance with the DVD-ROM and DVD-Video formats and will distribute royalty income to the other Licensors.

I. The DVD-ROM and DVD-Video Formats

The Standard Specifications for the DVD-ROM and DVD-Video formats describe the physical and technical parameters for DVDs for read-only-memory and video applications, respectively, and "rules, conditions and mechanisms" for player units for the two formats.[1] In

[1]DVD Specifications for Read-Only Disc (the "Standard Specifications"), Part 3: Video Specifications, Version 1.1 (December 1997), § 3.3.1. DVD-Video, which is described in Part 3

either format, the DVD has more than seven times the storage capacity of a compact disc; a single-layer, single-sided DVD, for example, can store 4.7 billion bytes (4.38 GB) of information including audio, video, text, and data. Employing compression technology, a DVD-Video disc can hold a 135-minute feature film on a single side.

The Licensors, along with a number of other producers of consumer electronics hardware, software, or both,[2] established the Standard Specifications.[3] These Standard Specifications appear to implicate the intellectual property rights of numerous firms.

II. The Proposed Arrangement

A memorandum of understanding among the Licensors (the "MOU," attached as Exhibit 1 to your letter) sets forth the central terms of the proposed arrangement, pursuant to which Toshiba will aggregate the Licensors' "essential" patents and disseminate rights under them to makers of Digital Versatile Discs (DVDs), DVD players, and DVD decoders[4] ("DVD Products"), and distribute royalty income to the other Licensors. The arrangement will be carried out through a group of other agreements, including: (1) a license that Toshiba will receive from each other Licensor to enable Toshiba to license users of the Standard

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of the Standard Specifications, appears to be a subunit of the DVD-ROM format. The DVD-Video specifications state that DVD-Video discs shall comply with Parts 1 and 2 of the Standard Specifications, which describe the disc's physical and file-system characteristics, respectively. *Id.*, § 1.1.

[2]Other than Time Warner, each of the Licensors is a leading manufacturer of consumer electronics equipment, such as DVD players. Several Licensors produce DVD discs and content for such discs.

[3]In addition to the Licensors, the publishers of the DVD-ROM Specifications are Philips Electronics, N.V., Pioneer Electronic Corp., Sony Corp., and Thomson Multimedia. While your letter includes information concerning the process by which these formats were established, you have not requested, and this letter does not offer, an opinion on any competitive issues presented by the development of these formats or any other DVD-related format.

[4]A DVD decoder, implemented in computer hardware or software, receives and decodes transmissions from a DVD-ROM player over a computer system bus. DVD Patent License, Art. 1.7.

Specifications under that Licensor's "essential" patents (the "Authorization Agreement," attached as Exhibit 3); (2) Toshiba's sublicense to makers of DVD Products under the Licensors' patents (the "DVD Patent License," attached as Exhibit 2); (3) an agreement among the Licensors concerning the retention and authority of experts to select and evaluate the patents to be licensed (the "Expert Agreement," attached as Exhibit 4); and (4) the "Ground Rules for Royalty Allocation" (attached as Exhibit 7), which set forth the formula that will determine how Toshiba will distribute royalties among the Licensors.[5]

A. The patents to be licensed

In the MOU, the Licensors commit to license each other and third parties to make, use and sell DVD Products under their present and future patents that are "essential" to doing so.[6] The Licensors agree to two separate means of carrying out this obligation. First, they agree to grant Toshiba the right to sublicense third parties under their present and future "essential" patents for these purposes, and Toshiba agrees in turn to sublicense those patents, along with its own such patents, in the DVD Patent Licenses.[7] Second, each Licensor agrees to "offer to license its essential DVD patents on a non-exclusive basis to interested third-party licensees pursuant to separate negotiations on fair, reasonable and non-discriminatory terms, whether or not said third-party licensees intend to make, use and sell DVD products that are in conformity with the Specifications."[8]

A Licensor's patent is "essential," and thus subject to the commitments in the MOU, if it is "necessarily infringed," or "there is no realistic alternative" to it, "in implementing the DVD Standard Specifications."[9] Initially, each Licensor will identify its own "essential" patents in an

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[5]You have designated all the documents attached to your letter, except the DVD Patent License, as confidential.

[6]MOU, ¶ 2; Authorization Agreement, §§ 1.3, 1.8.

[7]MOU, ¶ 3.

[8]*Id.*

[9]MOU, ¶ 4. These commitments do not, however, apply to patents "related to" the Content Scramble System or "MPEG-2 data compression patents that may be applicable to DVD Products." *Id.* We understand "MPEG-2 data compression patents" to refer to patents that are essential to compliance with the MPEG-2 standard.

attachment to its Authorization Agreement with Toshiba.[10] Toshiba will then incorporate those patents in a list attached to the DVD Patent License.[11] Shortly, however, an expert individual or panel, with "full and sufficient knowledge and skill in the relevant technology,"[12] will complete a review the patents each Licensor has designated as "essential" in order to determine whether they satisfy the MOU criteria.[13] At that time, any patent initially designated by a Licensor for inclusion in the DVD Patent License that the expert determines is not "essential" will be excluded from subsequent DVD Patent Licenses, although current licensees will have the option to retain it in their existing licenses.[14]

The expert will repeat this comprehensive review of all the patents in the DVD Patent License portfolio every four years.[15] In between the quadrennial reviews, the proposed program also provides a mechanism by which the expert may review individual patents whose essentiality comes into question. If a Licensor comes to a good faith conclusion that a licensed patent is not "essential," and provides a reasonable basis for that belief, the expert will re-examine the

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[10]MOU, ¶ 8.

[11]*Id.*

[12]Expert Agreement, § 2.3.

[13]MOU, ¶ 8. The expert's final review of the Licensors' patents is due to be completed by June 30, 1999. Although the MOU suggests that the expert will not only "determine which patents are essential" but also "evaluate the patents for the purpose of determining a fair and equitable allocation of royalties," *id.*, the allocation will be based on a mechanical application of an agreed formula set forth in the Ground Rules for Royalty Allocation, discussed below, rather than on a subjective evaluation by the expert. The Licensors have already retained experts with regard to U.S. and Japanese patents. These experts will also review patents granted in countries other than the U.S. and Japan and will designate as "essential" those that contain a claim "substantially the same as, or broader than, that of an essential U.S. or Japanese patent." Ground Rules for Royalty Allocation, ¶ 5. Because the experts will be performing the same function, I will refer to them in the singular.

[14]MOU, ¶ 4. Although the MOU does not state explicitly that the expert's determination of essentiality is binding on the Licensors, the Expert Agreement does. Expert Agreement, § 2.3.

[15]MOU, ¶ 8; Expert Agreement, § 2.4.

patent.[16] If the expert concludes that the patent is not "essential," the patent will be excluded from the DVD Patent License.[17]

The agreement provides that the expert's determinations are "conclusive and non-appealable," although the expert must submit a report explaining any decision that a patent was not "essential."[18] Compensation will be at the expert's "standard hourly rates."[19] Each Licensor will bear the cost of the expert's review of its patents; the Licensors will share costs attributable to all of them, such as time spent reviewing the DVD Standard Specifications.[20] The expert, although retained by the Licensors and selected by a majority vote among them, will not have an economic affiliation with any individual Licensor.[21] A majority of the Licensors may remove the expert for failure or inability to perform the duties set forth in the Expert Agreement "in a professional, competent, reliable or timely manner."[22]

Although the proposed licensing program currently includes the patents of only the Licensors, it is open to any owner of an "essential" patent willing to license on the program's terms and conditions.[23]

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[16]Expert Agreement, § 2.5, as will be adopted as set forth in your letter to Christopher J. Kelly dated June 4, 1999, 2.

[17]MOU, ¶ 4.1, as will be adopted as set forth in your letter of June 4, 1999, 3.

[18]Expert Agreement, § 2.3.

[19]Expert Agreement, § 3.1.

[20]*Id.* Similarly, when a Licensor challenges the essentiality of a patent in the DVD Patent License, it will bear the cost of the expert's review of the patent unless the expert upholds the challenge, in which case the patentee Licensor will bear the cost. Expert Agreement, § 3.1, as will be amended as set forth in your letter of June 4, 1999, 2.

[21]MOU, ¶ 8.

[22]Expert Agreement, § 1.4, as will be amended as set forth in your letter of June 4, 1999, 2.

[23]MOU, ¶¶ 2, 6.

B. The joint licensing arrangement

In the Authorization Agreement, each Licensor grants Toshiba the non-exclusive right to grant: (1) sublicenses, "substantially on the terms contained in the form of the DVD Patent License," on its "essential" patents to third parties to "make, have made, use, sell or otherwise dispose of DVD Products";[24] and (2) releases to the same third parties from liability for pre-license infringement of the licensed patents.[25] Toshiba assumes the obligation to grant such sublicenses and releases "to all interested third party licensees,"[26] to collect royalties from licensees, and to distribute royalty income to other Licensors.[27]

Consistent with the MOU, the Authorization Agreement preserves the Licensors' right to license their "essential" patents independently for any application.[28] While the Licensors agree to provide each other with notification of "infringement [of the portfolio patents] or other misuse or unauthorized use" and to cooperate "in taking such steps as may be reasonably necessary to prevent any such unauthorized uses,"[29] each Licensor remains "solely responsible" for enforcing its own patent rights against infringement.[30]

The Authorization Agreement requires Toshiba to charge royalties of $.075 per DVD Disc and 4% of the net sales price of DVD players and DVD decoders, with a minimum royalty

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[24]Authorization Agreement, § 2.1.

[25]*Id.*

[26]Authorization Agreement, § 3.1.

[27]Authorization Agreement, § 4.1. In compensation for acting as the licensing administrator, Toshiba will collect a fee of three percent of the annual royalties it collects up to $100 million, and two percent of any royalties above that amount. Authorization Agreement, § 5.1. It will share these fees with Hitachi, Ltd., which will be Toshiba's licensing agent in Asia (except for Japan), Australia, and the Middle East, and Matsushita, which will be its licensing agent in the Western Hemisphere. 3-Party MOU, attached as Exhibit 6, Arts. 3.1, 7.1.

[28]Authorization Agreement, § 2.3.

[29]Authorization Agreement, § 3.2.

[30]Authorization Agreement, § 3.3.

of $4.00 per player or decoder.[31] It provides that these royalty levels will remain unchanged by the addition of any new members to the pool, unless a failure to raise royalties "would cause a significant problem in maintaining or expanding the licensing program."[32]

After deducting its licensing-administrator fee, Toshiba will distribute the remaining royalties among the Licensors pursuant to an agreed allocation formula set forth in the Ground Rules for Royalty Allocation.[33] This formula takes into account how often a Licensor's "essential" patents are infringed by either manufacture or sale of licensees' products, the age of the patents, and, in the case of patents "essential" to disc standards, whether the Licensor's patents relate to optional or mandatory features of the standard.[34] Pursuant to the expert's quadrennial review of the portfolio, the formula also takes into account the elimination of patents from the portfolio, whether due to expiration, the departure of a Licensor from the joint licensing program, or the expert's determination that a patent is no longer "essential," and the addition of new "essential" patents.[35] Until the first allocation pursuant to the formula is calculated, Toshiba will distribute royalties equally among the Licensors;[36] thereafter, Toshiba will distribute royalties in accordance with the formula, adjusting distributions so as retroactively to make the total distributions during the initial two-year period conform to the formula.[37] Each Licensor may retain an independent accountant to audit Toshiba's licensing activities up to twice a year.[38]

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[31]Authorization Agreement, § 5.1.

[32]*Id.*

[33]Authorization Agreement, § 4.2. Thus, although the MOU suggests that the expert will have a dual role, not only to "determine which patents are essential," but also to "evaluate the patents for the purpose of determining a fair and equitable allocation of royalties," the allocation will be based on a mechanical application of the Ground Rules for Royalty Allocation rather than on a subjective evaluation by the expert.

[34]Ground Rules for Royalty Allocation.

[35]MOU, ¶ 8; Authorization Agreement, § 4.2.3.

[36]Authorization Agreement, § 4.3.

[37]Authorization Agreement, § 4.4.

[38]Authorization Agreement, § 4.9.

Toshiba will sublicense the Licensors' patents through a single DVD Patent License, which will convey to licensees a non-exclusive, non-transferable license under the licensed patents to "make, have made, use, sell, and otherwise dispose of DVD Products" in exchange for the aforementioned royalties.[39] As contemplated in the Authorization Agreement, the DVD Patent License will also release licensees from liability for any infringement of the licensed patents prior to the effective date of the license.[40] The license will inform the licensee of the specific patents being licensed,[41] and will state that the licensee may choose instead to license the patents separately from the individual Licensors on "fair, reasonable and non-discriminatory terms, whether or not Licensee intends to manufacture and/or sell DVD Products in conformity with the DVD Standard Specifications."[42] A most-favored-nations clause will entitle the licensee to opt for any more favorable royalties that Toshiba agrees to with any other licensee, if the licensee is willing to agree to "any additional benefits to Licensor that may be included among the terms and conditions corresponding to such royalty rates."[43]

The licensee's only grantback obligation covers any "essential" patents it may own or control during the term of the license. Each licensee agrees to grant non-exclusive licenses on such patents, on "fair, reasonable and non-discriminatory terms," to the Licensors, their affiliates, and all other licensees of the pool.[44] Disputes between the licensee and any Licensor over what constitutes "fair and reasonable terms and conditions" for the license are subject to arbitration by an expert "jointly appointed and paid" by the parties to the dispute.[45] The failure to grant such a license to a Licensor, followed by an infringement suit against the Licensor under

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[39]DVD Patent License, Art. 2.1.

[40]DVD Patent License, Art. 2.2. This release is not gratuitous; it is in exchange for a payment based on the royalty rates. DVD Patent License, Exhibit 3, Art. 2.1.

[41]DVD Patent License, Exhibit 2.

[42]DVD Patent License, Art. 2.3.

[43]DVD Patent License, Art. 6.1. The most-favored-nations clause does not apply to terms arising from dispute settlements, court orders, and individual Licensors' independent licenses to third parties. *Id.*

[44]DVD Patent License, Art. 3.1.

[45]*Id.* The license does not indicate who will determine whether or not the patent in question is in fact "essential" within the meaning of the DVD Patent License.

that "essential" patent, subjects the licensee to termination of the DVD Patent License with respect to that Licensor's "essential" patents.[46]

The DVD Patent License will run until December 31, 2007, and renew automatically for 5-year terms thereafter unless the licensee provides 60 days' notice of its intent not to renew.[47] Notwithstanding that, the license will terminate on the expiration of the last of the licensed patents to expire.[48] Toshiba may terminate the license in the event of the licensee's bankruptcy,[49] and either party may terminate the license on 30 days' notice for a breach that is not remedied within 30 days after notice of the breach.[50]

During the term of the license, Toshiba will have the right to have an independent auditor review the licensee's books "with respect to sales, other transfers and royalties."[51] Pursuant to the MOU, Toshiba will erect internal firewalls to protect competitively sensitive information, such as sales volume and selling prices of particular DVD Product models, that it receives from licensees.[52] Toshiba's internal procedures for protecting the confidentiality of this information will prohibit Toshiba licensing and accounting personnel who receive confidential licensee information from disclosing that information to any unauthorized person, whether or not that person is a Toshiba employee.[53] Toshiba will implement these procedures in part through confidentiality agreements it will enter into with its licensing and accounting employees who are

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[46]DVD Patent License, Art. 3.2.

[47]DVD Patent License, Art. 5.1.

[48]DVD Patent License, Art. 5.2.

[49]DVD Patent License, Art. 5.4.

[50]DVD Patent License, Art. 5.3.

[51]DVD Patent License, Exhibit 3, Art. 2.8.

[52]MOU, ¶ 13. The MOU provides further that the Licensors may have access to information "as to the names of licensees, categories and model numbers of licensed products, total quantities of sales of such products and total royalties." *Id.*

[53]Procedures for Protecting the Confidentiality of Information Provided by DVD Patent Licensing Program Licensees, attached as Exhibit 8, ¶ 4.

authorized to receive confidential licensee information.[54]

III. Analysis

As with any aggregation of patent rights for the purpose of joint package licensing, commonly known as a patent pool, an antitrust analysis of this proposed licensing program must examine both the pool's expected competitive benefits and its potential restraints on competition. The potential benefit of a patent pool is that it "may provide competitive benefits by integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation."[55] At the same time, "some patent pools can restrict competition, whether among intellectual property rights within the pool or downstream products incorporating the pooled patents or in innovation among parties to the pool."[56] Accordingly, the following analysis addresses (1) whether the proposed licensing program here at issue is likely to integrate complementary patent rights and (2), if so, whether the resulting competitive benefits are likely to be outweighed by competitive harm posed by other aspects of the program.

A fundamental premise of the following analysis is that the patents to be licensed are valid. While this is a legitimate presumption with any patent,[57] "[a] licensing scheme premised on invalid or expired intellectual property rights will not withstand antitrust scrutiny."[58] Unaccompanied by legitimate intellectual property rights, restrictions on licensors or licensees are highly likely to be anticompetitive. None of the information that you have provided us, however, warrants abandonment of the presumption of validity as to any of the patents to be

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[54]DVD Licensing Program: Authorized Employee Confidentiality Agreement, attached as Exhibit 9.

[55]Department of Justice-Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property* ("*IP Guidelines*"), § 5.5.

[56]Letter from Joel I. Klein to Gerrard [*sic*] R. Beeney, Esq., June 26, 1997 ("MPEG-2 Business Review Letter"), 9 (citing *IP Guidelines*, § 5.5).

[57]*See* 35 U.S.C. § 282 (in an action for infringement, "[a] patent shall be presumed valid"); *Genentech, Inc. v. Novo Nordisk, A/S*, 108 F.3d 1361, 1364 n.2 (Fed. Cir. 1997).

[58]MPEG-2 Business Review Letter, 9 (citing *United States v. Pilkington plc*, 1994 Trade Cas. (CCH) ¶ 70,842 (D. Ariz. 1994)).

licensed. In particular, although Article 4.1 of the DVD Patent License explicitly disavows any warranty of validity,[59] a final determination of a licensed patent's invalidity by a competent court will lead to the patent's exclusion from the DVD Patent License.[60] This provision should ensure that this pool is unlikely to foist invalid patents upon users of the Standard Specifications. However, should the Department subsequently receive information that undercuts this conclusion, its enforcement intentions as to the proposed arrangement might be very different from those expressed below.

A. Integration of Complementary Patent Rights

If the Licensors owned patent rights that could be licensed and used in competition with each other, they might have an economic incentive to utilize a patent pool to eliminate competition among them. A pool that served that purpose "would raise serious competitive concerns."[61] In combining such substitute patents, the pool could serve as a price-fixing mechanism, ultimately raising the price of products and services that utilize the pooled patents. If, on the other hand, the pool were to bring together complementary patent rights, it could be "an efficient and procompetitive method of disseminating those rights to would-be users."[62] By reducing what would otherwise be six licensing transactions to one, the pool would reduce transactions costs for Licensors and licensees alike. By ensuring that each Licensor's patents will not be blocked by those of the other five, the pool would enhance the value of all six Licensors' patents.

One way to ensure that the proposed pool will integrate only complementary patent rights is to limit the pool to patents that are essential to compliance with the Standard Specifications. Essential patents by definition have no substitutes; one needs licenses to each of them in order to comply with the standard. At the same time, they are complementary to each other; a license to one essential patent is more valuable if the licensee also has licenses to use other essential patents.

An inclusion criterion broader than "essentiality" carries with it two anticompetitive

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[59]DVD Patent License, Art. 4.1.

[60]MOU, ¶ 4.1, as will be amended as set forth in your letter of June 4, 1999, 3.

[61]MPEG-2 Business Review Letter, 9.

[62]*Id.*

risks, both arising from the possibility that the pool might include patents that are substitutes for one another and not just complements. Consider, for example, a situation in which there are several patented methods for placing DVD-ROMs into packaging -- each a useful complement to DVD-ROM manufacturing technology, but not essential to the standard. A DVD-ROM maker would need to license only one of them; they would be substitutes for each other. Inclusion in the pool of two or more such patents would risk turning the pool into a price-fixing mechanism. Inclusion in the pool of only one of the competing non-essential patents, which the pool would convey along with the essential patents, could in certain cases unreasonably foreclose the non-included competing patents from use by manufacturers; because the manufacturers would obtain a license to the one patent with the pool, they might choose not to license any of the competing patents, even if they otherwise would regard the competitive patents as superior. Limiting a pool to essential patents ensures that neither of these concerns will arise; rivalry is foreclosed neither among patents within the pool nor between patents in the pool and patents outside it.

From the information you have provided us, it appears reasonably likely that the pool will combine only complementary patents for which there are no substitutes for the purpose of compliance with the Standard Specifications. To be sure, the definition of "essential" contained in the MOU and the Authorization Agreement introduces some uncertainty. By asking the expert to identify not only those patents that are literally essential to compliance with the DVD-ROM and DVD-Video standards, but also those for which there is no "realistic" alternative, the definition introduces a degree of subjectivity into the selection process. Based on your representations, however, it appears that the expert will interpret "realistic" to mean economically feasible. So long as the patent expert applies this criterion scrupulously and independently, it is reasonable to expect that the Portfolio will combine only complementary patent rights, and not limit competition between them and other patent rights for purposes of the licensed applications.[63] If, however, the expert over time interprets "realistic" more broadly, so as to include patents for which economically feasible alternatives exist, there would be serious questions as to whether the pool might injure competition by including such substitutes.[64]

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[63]Whether any of the licensed patents might be substitutes for each other in connection with some other application is not an issue here because the license here will neither authorize nor impede the use of the licensed patents for any other application.

[64]This is not to say that the Department would challenge such an arrangement without taking into account the possibility that it creates significant efficiencies. *IP Guidelines*, § 5.3. Moreover, the availability of licenses on the Licensors' "essential" patents independently of the pool might ameliorate some of the potential competitive harm.

The retention of the expert by the Licensors creates some initial concern about the expert's ability to apply the essentiality criterion entirely independent of the Licensors. While the Licensors have agreed that the expert must be free from any substantial business relationship with any individual Licensor, the Licensors as a group, to which the expert answers, have an economic incentive to do the opposite of what they have retained the expert to do -- to combine in the pool their competing DVD-related patents and to foreclose others' competing patents. Without more, there would be justifiable skepticism that the expert can be counted on to undertake a disinterested review of the "essentiality" of the patent rights put forward.

However, several factors suggest that the expert should be able to identify "essential" patents independently of the Licensors. First, the Licensors' Expert Agreement explicitly sets forth the rules governing the expert's review and provides that the expert's determination of essentiality is "conclusive and non-appealable."[65] Second, the bases for which the Licensors may dismiss the expert -- malfeasance and nonfeasance -- should insulate the expert's work from undue pressure. Third, since the expert's compensation will be based directly on time spent evaluating patents, regardless whether a given patent is designated as "essential," the expert's compensation will not be affected by his or her determinations as to essentiality. Finally, the basis on which Toshiba will allocate royalties gives the Licensors an incentive to ensure that the expert does its job. The formula that will determine the royalty allocation is based on how many of each Licensor's "essential" patents are infringed. Thus, although the formula weights the patent count with other factors, each Licensor will benefit monetarily from the exclusion of other Licensors' non-"essential" patents and accordingly has a strong incentive to encourage the expert to review other Licensors' patents critically, and to bring to the expert's attention any patents that have ceased to be "essential."

These factors suggest that it is reasonably likely that the expert will function independently and, consequently, that the portfolio will contain only complementary patents without foreclosing competition. In that case, the proposed arrangement would serve the procompetitive purpose of combining complementary technologies into a package that will be likely to lower costs to makers of DVD-Video and DVD-ROM discs, players and decoders. If, however, these factors prove to be insufficient either to ensure the expert's ability to function independently and objectively or to ensure that the pool will contain only "essential" patents, the Department's conclusions as to the proposed arrangement might be very different.

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[65]Expert Agreement, § 2.3.

B. Foreclosure of Competition in Related Markets

As mentioned above, the Licensors are competitors in markets vertically related to the licensed technology -- not only in "downstream" markets such as the manufacture of DVD discs and players, but also in the creation of content that is incorporated in DVD discs. Consequently, the question arises whether the pool is likely to impede competition in any of those markets, not only between any Licensor and licensees or other third parties, but also among the Licensors themselves.

Based on what you have told us, the proposed licensing program does not appear to have any such anticompetitive potential in the markets in which the licensed technology will be used. First, the agreed royalty is sufficiently small relative to the total costs of manufacture that it is unlikely to enable collusion among sellers of DVD discs, decoders or players. Second, the proposed program should enhance rather than limit access to the Licensors' "essential" patents. Because Toshiba, the joint licensor, must license on a non-discriminatory basis to all interested parties, it cannot impose disadvantageous terms on competitors, let alone refuse to license to them altogether.[66] Third, the extent of Toshiba's access to proprietary licensee information, either through information provided directly to its licensing employees or through audits conducted by independent accountants, is unlikely to afford it anticompetitive access to competitively sensitive proprietary information, such as cost data. The other Licensors' similarly limited right to an annual audit of Toshiba's conduct as joint licensor should not increase the likelihood of collusion. Nor does there seem to be any facet of the proposed program that would facilitate collusion or dampen competition among the Licensors in the creation of content for software.

C. Effect on Innovation

The proposed licensing program would require Licensors and licensees alike to agree to license to each other not only their present "essential" patents, but also any ones they obtain in the future.[67] The procompetitive benefits of such a requirement are clear. It ensures that no party to the pool will be able to benefit from the pool while blocking other parties from utilizing

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[66]Although the meaning of "reasonable" is open to various interpretations, each Licensor's commitment to license its "essential" patents independently of the pool on reasonable, non-discriminatory terms may further ensure that the proposed program facilitates, rather than forecloses, access.

[67]MOU, Article 1.3; DVD Patent License, Art. 3.1.

the Standard Specifications. Further, by bringing other "essential" patents into the portfolio, the requirement lowers licensees' costs in assembling the patent rights they need to comply with the Standard Specifications. And while it is unclear whether any future "essential" patent will emerge absent an amendment of the Standard Specifications, the requirement as to future patents reduces the possibility that a future patent will block licensees from practicing a technology in which they may already have invested in heavily. Reducing this uncertainty may be a significant benefit to licensees.

The question arises, nevertheless, whether these procompetitive benefits are likely to be outweighed by significant discouragement of research and development relating to the Standard Specifications.[68] Licensors and licensees might have greater incentives to invest in research and development in the field were they free to refuse to license other users of the Standard Specifications under any patent that resulted.

Several considerations suggest that the magnitude of any disincentive resulting from this requirement will not be sufficiently great to outweigh the requirement's procompetitive benefits. In the first place, the scope of the requirement is commensurate with that of the license: It covers only "essential" patents. The requirement does not prevent Licensors and licensees from capturing whatever value they create in non-"essential" technology.[69] Second, the pool's royalty-allocation formula makes each Licensor's share of the royalties a function of the number of its patents that are infringed, and newer patents are weighted more heavily than older ones; so each Licensor benefits from introducing new "essential" patents into the pool. Third, licensees can choose between licensing their own "essential" patents through the pool, pursuant to the same royalty-allocation rules, and licensing them separately, on "fair, reasonable, and non-discriminatory terms," to each Licensor and pool licensee that requests a license. Finally, licensees, and to a lesser extent, Licensors, remain free to capture whatever value such new

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[68] *See IP Guidelines*, § 5.6.

[69] DVD Patent License, Art. 3.1. Licensees' freedom to exploit their non-"essential" patents will be meaningful only to the extent that the determination whether a licensee's patent is "essential" is made independently of the Licensors and other licensees, who may earnestly wish to practice a DVD-related patent that, although attractive, is not essential to the standard. The documents you have provided do not indicate who would determine "essentiality" in this instance. If it is to be the expert, this points up again the need to ensure the expert's independence.

patents may have outside the standard.[70] On balance, on the basis of the information before us, it appears unlikely that the requirement the program will impose on Licensors and licensees concerning "essential" patents not already licensed by the pool will be anticompetitive.

In the current circumstances, the proposed term of the license to December 31, 2007, does not pose significant concerns as to innovation competition. The DVD Patent License authorizes only a limited field of use for the licensed technology -- the manufacture and sale of products that comply with the Standard Specifications -- and does not limit licensees' other options. Licensees may seek presently unknown methods of complying with these standards, or they may support altogether different product standards.

IV. Conclusion

Based on the information and assurances that you have provided us, it appears that the proposed arrangement is likely to combine complementary patent rights, thereby lowering the costs of manufacturers that need access to them in order to produce discs, players and decoders in conformity with the DVD-Video and DVD-ROM formats. Your assurances and information indicate that the proposed arrangement is not likely to impede competition, either in the licensing or development of technology for use in making DVDs, players, or decoders or for other products that conform to alternative formats, or in the markets in which DVDs, players and decoders compete.

For these reasons, the Department is not presently inclined to initiate antitrust enforcement action against the conduct you have described. This letter, however, expresses the Department's current enforcement intention. In accordance with our normal practices, the Department reserves the right to bring an enforcement action in the future if the actual operation of the proposed conduct proves to be anticompetitive in purpose or effect.

This statement is made in accordance with the Department's Business Review Procedure,

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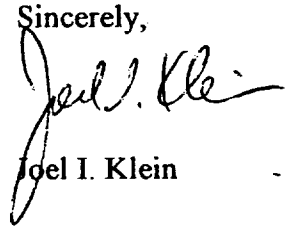
[70]The Licensors have limited their own options somewhat, having committed to making their "essential" patents available on reasonable, non-discriminatory terms independently of the pool license, even for applications that do not comply with the Standard Specifications. MOU, ¶ 3. Licensees, in contrast, remain free to decide how best to exploit their "essential" patents outside of the Standard Specifications. *See* DVD Patent License, Art. 3.1; MOU, ¶ 4.

28 C.F.R. § 50.6. Pursuant to its terms, your business review request and this letter will be made publicly available immediately, and any supporting data will be made publicly available within 30 days of the date of this letter, unless you request that part of the material be withheld in accordance with Paragraph 10(c) of the Business Review Procedure.

Sincerely,



Joel I. Klein

JIK/cjk

cc:Stuart Robinowitz, Esq.
Time Warner Inc.

Jeffrey L. Kessler, Esq.
Weil, Gotshal & Manges LLP

Carl W. Schwarz, Esq.
McDermott, Will & Emery