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VIA FAX

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Dear Mr. Beeney:

This letter is in response to your request on behalf of Koninklijke Philips Electronics, N.V. ("Philips"), Sony Corporation of Japan ("Sony") and Pioneer Electronic Corporation of Japan ("Pioneer") 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 Philips will assemble and offer a package license under the patents of Philips, Sony and Pioneer (collectively, the "Licensors") that are "essential," as defined below, to manufacturing Digital Versatile Discs (DVDs) and players in compliance with the DVD-ROM and DVD-Video formats, and will distribute royalty income among the 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. You have attached the Standard Specifications as Exhibit A to your letter. DVD-Video, which is described in Part 3 of the

either format, the DVD offers storage capacity more than seven times that 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

The proposed arrangement is embodied in two pairs of licenses: two separate but substantially identical licenses to Philips from Sony and Pioneer (the "DVD-Video and DVD-ROM Agreement");[4] and a pair of standard licenses from Philips to DVD makers (the "Disc

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Standard Specifications, appears to be a subunit of the DVD-ROM format. The DVD-Video specifications indicate 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]Each of the Licensors is a leading manufacturer of consumer electronics equipment and software, including both DVD-Video discs and DVD players, and a producer of content, such as feature-length motion pictures, that can be incorporated in DVDs. Upon the completion of the pending sale of its PolyGram N.V. subsidiary to The Seagram Co., Ltd., however, Philips will no longer have a substantial presence in any market for recorded music, film, or other entertainment software, or the production of content for such software.

[3]In addition to the Licensors, the publishers of the DVD-ROM Specifications are: Hitachi, Ltd.; Matsushita Electric Industrial Co., Ltd.; Mitsubishi Electric Corporation; Thomson Multimedia; Time Warner Inc.; Toshiba Corp.; and Victor Company of Japan, Ltd. 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]The DVD-Video and DVD-ROM Agreements have been modified twice: (1) in letters from Philips to the other Licensors dated January 9, 1998 and accepted by them subsequently; and (2) in a document designated "Amendment No. 1 to the DVD-Video and DVD ROM Agreement" ("Amendment No. 1"). Like the agreements they modify, the Sony and Pioneer versions of the January 9 letter and Amendment No. 1 are substantially the same. You have

License") and player manufacturers (the "Player License").[5] Through these two sets of licenses, Philips aggregates the Licensors' patents and will disseminate them to users of the DVD-ROM and DVD-Video formats.

A. The patents to be licensed

Under the proposed arrangement, Philips is licensing from the other Licensors those patents that: (i) they owned or controlled as of specific dates in 1997;[6] (ii) are entitled to a priority date before December 31, 1996;[7] and (iii) are "essential," which is defined as "necessary (as a practical matter) for compliance with the DVD[-Video or DVD-ROM] Standard Specifications."[8] In turn, Philips will sublicense those patents, along with its own patents that meet the same criteria, in the Portfolio Licenses for use in making discs or players, respectively, that comply with either of those formats.[9]

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attached the two DVD-Video and DVD-ROM Agreements and their corresponding modifications as Exhibit D to your letter.

[5]You have attached the Player License as Exhibit B to your letter, and the Disc License as Exhibit C. I will refer to the Disc and Player Licenses collectively as the "Portfolio Licenses."

[6]The licenses to Philips convey only those patents that were in the Licensors' portfolios as of the date of the license -- in Pioneer's case, October 1, 1997, in Sony's, November 24, 1997. DVD-Video and DVD-ROM Agreement, Arts. 1.06-1.07.

[7]DVD-Video and DVD-ROM Agreement, Arts. 1.06-1.07. You have confirmed that the term "priority date" means, for any given patent in the Portfolio License, the first date on which the application for that patent, or for a patent on the same invention in an another country, was filed. *See* 35 U.S.C. § 119.

[8]Amendment No. 1, ¶ 7. We understand this definition to encompass patents which are technically essential -- *i.e.*, inevitably infringed by compliance with the specifications -- and those for which existing alternatives are economically unfeasible. As discussed below, a less concrete definition of the term "as a practical matter" could give rise to difficult competitive issues. Neither Sony's and Pioneer's licenses to Philips nor the Portfolio Licenses convey rights to patents that are "essential" by virtue of the DVD formats' incorporation of MPEG-2 video compression technology. DVD-Video and DVD-ROM Agreement, Arts. 1.06-1.07; Disc and Patent Licenses, App. 1, Art. 1.07.

[9]Amendment No. 1, ¶ 2.

Initially, each Licensor has designated its "essential" patents for inclusion in the Portfolio Licenses; there are 115 patents in all for the manufacture of DVD players,[10] and 95 for the manufacture of the discs themselves.[11] However, the Licensors have retained a patent expert to review the designated United States patents and make an independent determination as to their "essentiality."[12] His determination, reflecting his "best independent judgment,"[13] is to be based on information he obtains from the Licensors, others in the industry, and the advice of technical experts he may retain.[14] The review, which is already underway, will not entail an examination of validity.[15] Should the expert determine that a patent initially designated as "essential" is not, Philips will exclude it from the Portfolio Licenses.[16] However, licensees that have already taken the Disc or Player License shall have the option to retain their licenses to the newly excluded patent.[17]

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[10]Player License, Ex. I.

[11]Disc License, Ex. I.

[12]You have indicated to us that the Licensors also will retain an expert, under substantially the same conditions, to make the same determinations as to Japanese patents. Unless otherwise noted, any reference in this letter to the U.S. patent expert shall include by implication the Japanese patent expert as well.

[13]Amendment No. 1, ¶ 7.

[14]The expert will be under no obligation to share with the Licensors the information he receives from experts he retains to assist him. Letter to Expert, ¶ 5.

[15]Indeed, the licenses from Sony and Pioneer to Philips disavow any "warranty or representation . . . as to the validity or the scope of any patent." DVD Video and DVD-ROM Agreement, Art. 9.07.

[16]Amendment No. 1, ¶ 7. In addition, a letter that the Licensors will each send individually to the expert confirms that the Licensors have agreed that "[o]nce the licensing program commences . . . the Licenses shall include those and only those patents which you have determined to be 'Essential.'" Letter to Expert, ¶ 1. Sony and Pioneer will reflect any exclusions the expert requires in the next biennial update of the lists of patents that accompany their licenses to Philips. DVD-Video and DVD-ROM Agreement, Article 1.06; Amendment No. 1, ¶ 1.

[17]Disc and Player Licenses, App. 1, Art. 2.07.

While one of the license documents indicates that the patent expert is to be "appointed" by Philips,[18] the letters that the Licensors will send to the expert state that all of them are retaining him.[19] Further, the letters state that the expert's conclusions will have no bearing on either his compensation or any Licensor's future retention of him or his law firm.[20]

As noted above, the DVD-Video and DVD-ROM Agreements ensure only that the Licensors' "essential" patents with filing dates before December 31, 1996, and which were owned or controlled by the Licensors as of November 24, 1997 (or, in Pioneer's case, October 1, 1997) will be part of the Portfolio Licenses. You have stated to us that, as of December 1, 1998, no Licensor has indicated that it owns or controls an "essential" patent that falls outside these bounds. Should such a patent emerge, however, the DVD-Video and DVD-ROM Agreements commit the Licensors to licensing it, "at fair and reasonable conditions," to any licensee under the Portfolio Licenses, either through Philips or individually.[21]

B. The joint licensing arrangement

1. The licenses from Sony and Pioneer to Philips

Sony and Pioneer have granted Philips nonexclusive, sublicensable licenses on their "essential" patents to enable Philips to grant licenses "to all interested parties . . . to manufacture, have made, have manufactured components of, use and sell or otherwise dispose of" discs and players that conform to the Standard Specifications.[22] The licenses obligate Philips to grant licenses on the "essential" patents for use in conformity with the specifications

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[18] *Id.*

[19] Letter to Expert, introductory paragraph.

[20] *Id.*, ¶ 2.

[21] DVD-Video and DVD-ROM Agreement, Art. 6; Amendment No. 1, ¶ 1.

[22] DVD-Video and DVD-ROM Agreement, Arts. 2.01, 1.03-1.05. In addition, the licenses authorize Philips to grant non-assertion commitments to makers of integrated circuits and other components specifically designed for inclusion in licensed DVD players. *Id.*, Art. 2.01. This article grants Philips its rights as to "DVD-Products," which in turn are DVD-ROM and DVD-Video discs and players that conform with the formats' Standard Specifications. *Id.*, Arts. 1.03-1.05.

nondiscriminatorally to all interested third-parties.[23] All three Licensors, however, remain free to license their "essential" patents independently of the Portfolio Licenses, including for uses outside the DVD-ROM and DVD-Video formats.[24]

The licenses from Sony and Pioneer also establish the Portfolio Licenses' royalty rates. The Player License per-unit royalty is to be 3.5% of the net selling price for each player sold, subject to a minimum fee of $7 per unit, which drops to $5 as of January 1, 2000.[25] The Disc License royalty is to be $.05 per disc sold.[26] In addition, each Portfolio License requires a $10,000 initial payment, half of which is creditable against the per-unit royalties.[27] Philips' licenses from Sony and Pioneer separately set the latter two firms' share of these royalties, again on a per-unit basis. The allocation of royalties among the Licensors is not a function of the number of patents contributed to the pool.[28] To ensure the receipt of their agreed royalties, Sony's and Pioneer's independent auditors may audit Philips' books and records up to once a year.[29]

While each of the Licensors retains sole discretion to pursue infringers, the licenses from Sony and Pioneer require each Licensor to notify the others before initiating any enforcement action[30] and provide for sharing of joint infringement litigation expenses.[31]

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[23]Amendment No. 1, ¶ 5.

[24]*Id.*, Art. 2.03; Amendment No. 1, ¶ 3.

[25]DVD-Video and DVD-ROM Agreement, Art. 5.02, as amended by letter agreements dated January 9, 1998.

[26]*Id.*, Art. 5.03.

[27]Disc and Player Licenses, Art. 4.01.

[28]You have designated the exact allocation of the royalties among the Licensors as confidential.

[29]DVD-Video and DVD-ROM Agreement, Art. 7.02.

[30]DVD-Video and DVD-ROM Agreement, Art. 4.04.

[31]*Id.*, Art. 4.03. You have explained to us that this provision is meant to facilitate joint funding by plaintiffs; it does not, for example, provide that any Licensor will subsidize another's litigation.

2. The Portfolio Licenses

As authorized by its licenses from Sony and Pioneer, Philips' licenses to disc and player manufacturers will be for use in conformity with the Standard Specifications.[32] However, the Portfolio Licenses will notify potential licensees that all the Licensors are "willing to license their respective patent rights for optical disc manufacturing, whether within or outside of the DVD-Video and DVD-ROM Standard Specifications . . . on reasonable terms and conditions."[33] They will warn potential licensees that licenses from other intellectual property owners may be necessary for compliance with the formats.[34] A "Most Favourable Conditions" clause will entitle the licensee to the benefit of any lower royalty rate Philips grants to another licensee under "otherwise similar and substantially the same conditions."[35]

Each Portfolio License will have a term of ten years from the license's effective date,[36] subject to termination for a limited number of reasons.[37] To verify royalties owed and paid, Philips may appoint an independent accountant to audit its licensees' books and records up to once a year[38] and may require licensees to provide the accountant with additional information for

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[32]For example, the "Licensed Product" whose manufacture the Disc License authorizes is the "DVD-Video Disc/DVD-ROM Disc," Disc License, App. 1, Art. 1.06, which in turn "conforms to the DVD-Video and DVD-ROM Standard Specifications," *Id.*, Art. 1.02. The Player License adopts the Specifications correspondingly. Player License, App. 1, Arts. 1.05, 1.06.

[33]Player License and Disc License, Preamble, ¶ 6.

[34]*Id.*, App. 1, Art. 6.

[35]*Id.*, App. 1, Art. 5.

[36]*Id.*, App. 1, Art. 10.01.

[37]Philips or its licensee may terminate the license on 30 days' notice for the other party's default, *id.*, Art. 10.02. Philips also may terminate for licensee bankruptcy, *id.*, Art. 10.03, failure to pay royalties, *id.*, Art. 10.04, and without notice in response to a licensee's lawsuit against any Licensor for infringement of an "essential" patent that licensee owns or controls, after the licensee has refused that Licensor's request for a license, *id.*, Art. 10.05.

[38]Player License, App. 1, Art. 4.10; Disc License, App. 1, Art. 4.09.

that purpose.[39] The Portfolio Licenses also require licensees to provide, on request, information for review by a patent expert to determine whether a particular product infringes any of the licensed patents and, thus, triggers royalty obligations.[40] The licensees' obligation to provide information to the independent accountant and patent expert extends only to the information necessary to determine the amount of royalties owed or whether they are owed at all.[41]

One of the grounds on which Philips may terminate a license relates to the licensees' grantback obligation: Portfolio licensees must grant the Licensors and fellow licensees a license, "on reasonable, non-discriminatory conditions comparable to those set forth herein," on any patents they own or control that are "essential" to either disc or player manufacture in conformity with the Standard Specifications.[42] As noted above, this obligation is reinforced by Philips' right to terminate without notice the license of any licensee that, after having refused to grant a Licensor a license on an "essential" patent it owns, sues that Licensor for infringement of that patent.[43]

III. Analysis

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[39]Player License, App. 1, Art. 4.11; Disc License, App. 1, Art. 4.10.

[40]*Id.* We understand this patent expert to be the same "independent patent expert" who undertakes the review of patents for essentiality. Disc and Player Licenses, App. 1, Art. 2.07.

[41]Player License, App. 1, Art. 4.11; Disc License, App. 1, Art. 4.10.

[42]Disc and Player Licenses, App. 1, Arts. 2.05-2.06. The Licensors also contemplate that, in exchange for an agreement not to assert claims under their "essential" patents against makers of integrated circuits ("ICs") and components for sale to licensed player makers, the IC and component makers will agree not to assert any "essential" patents of their own against the Licensors arising from the manufacture of DVD-Video and DVD-ROM players. DVD-Video and DVD-ROM Agreement, Art. 5.01. Although the language of the Licensors' agreements contemplates that the IC and component makers would effectively abandon their "essential" patent rights as against the Licensors, you have indicated to us that the covenant not to sue would not outlive the Licensors' "essential" patents.

[43]Disc and Player Licenses, App. 1, Art. 10.05. Presumably a licensee's refusal to honor its grantback obligation as to one of the Licensors or a fellow licensee would qualify as a terminable default pursuant to Art. 10.02, requiring 30 days' notice and an opportunity to remedy.

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 competitive hazards. In particular, one expects that a patent pool "may provide competitive benefits by integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation."[44] 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."[45] Accordingly, the following analysis addresses (i) whether the proposed licensing program is likely to integrate complementary patent rights and (ii), 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. This is a legitimate presumption with any patent.[46] On the other hand, persuasive evidence to the contrary would undermine virtually any licensing arrangement: "A licensing scheme premised on invalid or expired intellectual property rights will not withstand antitrust scrutiny."[47] 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 warrants abandonment of the presumption of validity as to any of the patents to be licensed.[48]

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

[45]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).

[46]*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).

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

[48]At the same time, it is worth noting that the pool does not seem well equipped internally to eliminate any patents whose validity becomes dubious. The proposed arrangement provides no internal screen for catching those patents, either at the outset of the pool or thereafter. The expert's role, for example, is to assess essentiality, not validity. Nor is there a mechanism for weeding out patents later held invalid. In contrast, the pool established for the joint licensing of patents essential to the MPEG-2 compression standard automatically excludes patents conclusively held invalid or unenforceable. *See* MPEG-2 Business Review Letter at 5. Since the

Should the Department subsequently receive information that undercuts this presumption, its enforcement intentions as to the proposed arrangement might be very different.

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."[49] 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."[50] By reducing what would otherwise be three 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 two, the pool would enhance the value of all three 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.

A broader inclusion criterion than essentiality carries with it two anticompetitive risks, both arising from the possibility that there may be substitutes for patents included in the pool. Consider, for example, a situation where 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 needs to license only one of them; they are substitutes for each other. Inclusion in the pool of two or more of those patents would risk turning the pool into a price-fixing mechanism. Inclusion in the pool of one of the patents, which the pool would convey along with the essential patents, could in certain cases unreasonably

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Licensors here are not allocating royalties on a per-patent basis, no Licensor has an incentive to challenge the validity of any particular patent of another.

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

[50]*Id.*

foreclose the 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.

If our understanding of the criterion "necessary (as a practical matter)" is correct,[51] then it appears that the Licensors intend to license through the pool only complementary patents for which there are no substitutes for the purposes of compliance with the Standard Specifications. Some uncertainty arises from this definition's imprecision: Unlike the MPEG-2 pool, which required actual technical essentiality for eligibility, this pool introduces the concept of necessity "as a practical matter." On its face, this latter standard is inherently more susceptible to subjective interpretation.[52] An excessively liberal interpretation of it could lead to the inclusion of patent rights for which there were viable substitutes. In that event, the pool could injure competition by foreclosing such substitutes.[53]

Based on what you have told us, however, the definition of "necessary (as a practical matter)" that the expert will be employing is sufficiently clear and demanding that the portfolio is unlikely to contain patents for which there are economically viable substitutes.[54] Thus, so long as the patent expert applies this criterion scrupulously and independently, it is reasonable to expect that the Portfolio will combine complementary patent rights while not limiting competition between them and other patent rights for purposes of the licensed applications.[55]

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[51]*See supra*, n.8.

[52]This is true particularly as to players, which the Standard Specifications describe much less specifically than they do the discs.

[53]This is not to say that the Department would challenge such an arrangement without taking into account the possibility that it affords 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.

[54]*See supra*, n.8.

[55]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 licenses here neither authorize nor impede the use of the licensed patents for any other application.

The structure of this pool, however, creates some concern about the expert's ability to apply this criterion entirely independent of the Licensors. While you have stated that the patent expert will be "independent" and demonstrated that his independence is a term of the licenses from Sony and Pioneer to Philips, the expert is being retained directly by the Licensors, who have an incentive to combine in the pool any of their competing DVD-related patents and to foreclose others' competing patents.[56] Without more, there would be justifiable skepticism that this structure would ensure a disinterested review of the "essentiality" of the patent rights put forward.

However, in furtherance of the provision for independence in the licenses from Sony and Pioneer to Philips, each Licensor has assured the U.S. expert in writing that the expert's compensation and future retention will not be affected by his determinations as to essentiality; the same assurance will go to the Japanese patent expert as well.[57] These assurances, of course, are no guarantee. Their continuing fulfillment is necessary to the expert's independence and, consequently, to the likelihood that the portfolio will contain only complementary patents without foreclosing competition. Whether they will be sufficient as well as necessary remains to be seen.

Although the patent-expert mechanism is flawed, the Department is willing to base its present enforcement intentions on your representation that the combination of the Licensors' contractual commitment to independence and their written assurances to the expert will insulate him from their interests sufficiently to ensure that the Portfolio Licenses will contain only those patent rights of the Licensors that all DVD-Video and DVD-ROM licensees will need. 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 and players. If, nevertheless, these assurances prove insufficient either to ensure the expert's ability to function independently and objectively or to ensure that the

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[56]Because the royalty allocation is unaffected by each Licensor's share of the patents in the Portfolio License, the Licensors have no financial incentive to exclude each other's non-essential patents. In the MPEG-2 pool, in contrast, the joint licensor, which retained the expert, was an entity separate from the patent owners with no intellectual property of its own at stake. Moreover, the pool members themselves had a strong incentive to exclude non-essential patents, since their share of the royalties was a direct function of the number of essential patents they held.

[57]Of course, the same assurances to any subsequently retained expert would buttress confidence in his or her independence, as well.

pool will contain only essential patents, the Department's enforcement intentions as to the proposed arrangement might be very different.

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, such as feature-length films, that is incorporated in DVD discs. Consequently, the question arises whether this pool is likely to impede competition in any of those markets, not only between any given Licensor and licensees, but also among the Licensors themselves.

Based upon 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 players or discs. Second, the proposed program should enhance rather than limit access to the Licensors' "essential" patents. Because Philips must license on a non-discriminatory basis to all interested parties, it cannot impose disadvantageous terms on competitors, let alone refuse to license them altogether. Should the agreed pool royalty prove economically unrealistic, each Licensor's ability to grant licenses on its own to users of the Standard Specifications provides a backstop. Third, the extent of Philips' ability to audit licensees, through independent accountants, is unlikely to afford it anticompetitive access to competitively sensitive proprietary information, such as cost data. Sony's and Pioneer's similarly limited right to an annual audit of Philips' conduct as joint licensor should not create any greater 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

Because only already-filed "essential" patents and patent applications are required for inclusion in the Portfolio, the program does not discourage the Licensors from continuing research and development that may relate to the standard.[58] Further, the Licensors are free to

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[58]At the same time, the exclusion of patents with a priority date of December 31, 1996 or later, and those acquired by a Licensor only after November 24, 1997 (October 1, 1997 for Pioneer), could create anticompetitive costs for Portfolio licensees if any Licensor did not honor its commitment to make such patents available at reasonable rates. Transaction costs to licensees

license their "essential" patents for purposes that compete with the DVD-Video and DVD-ROM standards.

Ordinarily, patent license grantback provisions might be expected to raise the question whether, by reducing licensees' incentives to innovate, they threaten competitive harm that outweighs their procompetitive effects.[59] Here, however, the proposed grantback provisions are so narrow that they are unlikely to raise significant issues. Their scope is commensurate with that of the Licenses: They cover only "essential" patents. A licensee's non-"essential" improvements remain its own and may be licensed or not, as the licensee wishes. Thus, the grantback obligation seems unlikely to apply to further innovation within the DVD-ROM and DVD-Video formats. Instead, it is far more likely to force cross-licenses, on "reasonable, non-discriminatory conditions comparable to those" of the Portfolio Licenses, from owners of already extant "essential" patents. In requiring licensees to offer the Licensors and fellow licensees access, on reasonable terms, to whatever "essential" patents they own or control, the Portfolio Licenses ensure that no licensee may take advantage of the benefits of the pool while exploiting its own market power over users of the Standard Specifications. The grantback provision is likely simply to bring other "essential" patents into the Portfolio, thereby limiting holdouts' ability to exact a supracompetitive toll from Portfolio licensees and further lowering licensees' costs in assembling the patent rights essential to their compliance with the Standard Specifications. While easing, though not altogether eliminating, the holdout problem,[60] the grantback should not create any disincentive among licensees to innovate.

In the current circumstances, the proposed ten-year term of the license does not pose significant concerns. The Portfolio Licenses authorize only a limited field of use for the licensed technology -- the manufacture and sale of products that comply with the Standard Specifications; they do not limit licensees' other options. Licensees may seek presently unknown methods of complying with these standards, or they may support altogether different product standards. The absence of any renewal clause puts potential licensees on notice that they will be facing a new

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would almost certainly be somewhat lower if these later patents were included in the pool, instead of being subject to separate negotiations. However, the fact that this pool might not enable the realization of all potential efficiencies of pooling patents in this area does not mean that the efficiencies that it does create are insubstantial or that the arrangement is anticompetitive or unlawful.

[59]*IP Guidelines*, § 5.6.

[60]Any non-manufacturing owner of an "essential" patent, in contrast, can still be a holdout, having no need for either Portfolio License.

market-based negotiation for access to the technology on the expiration of the Portfolio Licenses ten years hence. The uncertainty of market conditions at that time makes it impossible to speculate on the degree of power, if any, the Licensors will hold over any future technology licensing market.

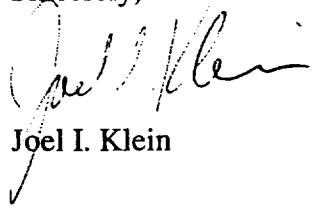
IV. Conclusion

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 and players 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 products that conform to alternative formats, or in the markets in which DVDs and players 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, 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