Commission settles allegations of abuse and clears patent pools in the CD market

Miguel Ángel PEÑA CASTELLOT, Directorate-General Competition, unit C-3

1. The complaints

Several manufacturers of pre-recorded CD discs (1) (that is CD discs that include already content – music or software – provided by content-owners) lodged complaints against Philips and Sony a number of years after both companies had agreed on a joint licensing program for different CD formats.

Three complaints were made, bringing together a total of 20 complainants (2). A common assessment was made for all three complaints.

The complaints alleged that Philips and Sony had violated Articles 81 and 82 of the Treaty by setting up a patent pool which included non-essential and expired intellectual property and fixed royalties at an unfair level.

2. The products

Philips and Sony had engaged in joint research and development (R&D) in the field of optical data storage technology since the 1970s, resulting in joint inventions protected by patents in many EEA countries as well as in other parts of the world. In the early 1980s, at a time when vinyl discs and magnetic tapes were the prevailing audio storage media on the market, both companies jointly developed the CD system standard specifications as part of an innovation program regarding digital audio recording initiated by the Electronics Industry Association of Japan. At that time, the CD system was but one among several systems presented by the participants in this program, although the CD system prevailed over time.

The first format launched by Philips and Sony was the highly successful CD-Audio. A CD-Audio is a disc comprising audio information encoded in digital form, which is optically readable by a CD-Audio player. It was launched in 1982 and quickly replaced the analogue sound reproduction owing in particular to its high audio specifications, large storage capacity and durability. At that time Philips and Sony published the System Description Compact Disc Digital Audio (‘Red Book’). In 1987 the International Electrotechnical Commission (‘IEC’) adopted the Red Book as the basis for its international standard for CD digital audio systems. In 1992, this standard was also adopted by the European Committee for Electrotechnical Standardisation.

In 1984 Philips and Sony developed the CD-ROM disc, i.e., a read-only storage medium for personal computers. CD-ROM has been widely adopted by the computer industry and has replaced the floppy disk as the magnetic storage media of choice for the publishing of large databases and distribution of software. Philips and Sony set a specification for CD-ROM discs in the System Description Compact Disc Read Only Memory (‘Yellow Book’), which was adopted by the IEC and the International Organisation for Standardisation in 1989.

The CD system specifications and the licenses offered were subsequently extended to newly developed formats, such as CD-I, CD-V and CD-Extra, but none of these additional formats was as successful as the previous two.

The CD system is also the technological basis for recordable discs (CD-R and CD-RW) and DVDs.

3. The preliminary analysis by DG Competition

3.1. Market for the licensing of the CD technology

In the horizontal guidelines (3), it is stated that ‘when rights to intellectual property are marketed separately from the products concerned to which they relate, the relevant technology market has to be defined as well. Technology markets consist of the intellectual property that is licensed and its close substitutes, i.e. other technologies which customers could use as a substitute’.

(1) That type of manufacturers are known in the industry by the generic term ‘replicators’.
(2) These 20 complainants represented close to 25% of all EEA licensees.
In the present case, it was clear that Philips and Sony licence their intellectual property rights which provide a licensing revenue, verifiable in their respective annual accounts. In addition, both organise their respective licensing activities as a separate business activity within their organisations:

- The licensing activity of Philips takes place through a dedicated website (http://www.licensing.philips.com/). Philips’ patents and copyrights concerning CD systems, DVD systems, Blue ray systems, etc are on offer on that website.
- Within the Sony Corporation, the Licensing Department is part of the Intellectual Property Division. The staff members in the Licensing Department are in charge of the licensing activity of Sony Corporation.

From this starting point, the analysis of demand and supply conditions led to the definition of a relevant market for the licensing of the CD technology. The geographic scope of such market would at least be the EEA.

3.2. Likely joint dominance by Philips and Sony

The following step was to assess whether Philips and Sony could be held to be jointly dominant in the relevant market.

A first important element was the tight structural links developed over time between Philips and Sony in the CD field. These links were later extended to many other areas. On 20 September 1979, Philips and Sony signed a first cross-licence agreement to co-operate in the design and development of optical audio disk players and their related apparatus as well as record media. That agreement was replaced, extended and/or superseded by a series of cross-licence agreements and side letters concluded subsequently. The most recent one, a patent cross licence agreement dated 1 January 1999, widens the field of co-operation between the two firms significantly beyond the CD field.

As a consequence of the above agreements, Philips and Sony launched in 1982 a world-wide joint CD Disc Licensing Program to be managed by Philips. Sony granted Philips an exclusive, sub-licensable licence on (i) joint inventions and (ii) other patents held by Sony regarding Compact Disc Digital Audio System enabling Philips to grant licences. The licence has been extended over the years to the additional formats introduced on the market. A standard licence agreement (‘SLA’) was set up and offered to potential licensees. Many different version of the SLA have been used over the years.

In addition, as indicated above, Philips and Sony jointly set the specifications for CD-Audio and CD-ROM discs. These later became the internationally adopted standards.

The presence of a standard may give the intellectual property rights holders a dominant position on the market for the technology in question. This depends not only on the general acceptance of the standard, but also on the existence of alternative technologies for compliance with it.

In the present case, it is without doubt that the CD technology has been an immense success - at least as regards CD Audio and CD ROM applications. They have entirely or largely replaced previous storage media, such as vinyl discs, music cassettes or floppy discs.

Furthermore, no alternative set of specifications is available to comply with the relevant standards other that those covered by Philips’ and Sony’s patents.

On the basis of these elements, it was possible to arrive at the preliminary conclusion that Philips and Sony had to be considered jointly dominant in the relevant market.

3.3. Possible instances of abusive behavior under Article 82(a) of the Treaty

Before going any further a couple of preliminary considerations should be kept in mind:

- The analysis did not question the validity of Philips’ and Sony’s intellectual property rights in respect of the CD technology. However, the assessment of the essentiality of the relevant CD Audio and CD-ROM patents by an independent expert was only concluded in November 2002. By that time, all CD Audio patents had expired in the majority of countries where they were ever granted.
- Philips’ and Sony’s right to seek a royalty to recover their respective investments in the relevant technology, and to subsequently profit from them, was not questioned either.

With these provisos in mind, it should be pointed out that a number of doubtful practices in the administration of the joint licensing program were identified.

- Until 2000 patent lists attached to the SLA did not include any list of countries for which each patent was granted nor their respective expiry
dates. It was found, however, that far more detailed patent lists were internally available well before 2000 but were not attached to the SLA.

- Again, until 2000 expired or useless patents were not systematically deleted from the list of patents. As the same list was used for several years, the result was that lists of patents attached to the SLA often contained patents that had expired several years before.

- The assessment of the essentiality of patents made by an independent expert concluded that only 4 patents for CD-Audio (out of 44 included for instance in the 1996 list) were essential for the manufacture of those discs. Hence, it is evident that until June 2001 – date at which, following the expiration of the two most relevant patents for that format in the majority of countries where they were granted, Philips and Sony stopped charging royalties in respect of any remaining CD Audio patent for those same countries- the lists of patents included many non-essential or irrelevant patents, in addition to those for which the right had already expired.

- Licensees were not informed of changes introduced into later versions of the SLA. Some complainants indicated that they did not even receive a list of patents at all when they entered into their respective SLA.

- Finally, until very recently, CD ROM discs were presented as a single format; when, in fact, there are different modes of CD-ROM discs and patent protection varies per mode and across countries.

The result of the above practices was that the administration of the program lacked transparency and created confusion among licensees –most of which are very small independent firms– in ways that could amount to the imposition of unfair trading conditions in the sense of Article 82 (a) of the Treaty.

4. The solution

After discussing the preliminary analysis as presented above with Philips’ and Sony’s representatives, in view of the type of alleged abusive behaviour and the co-operative attitude of complainants, and with the agreement of Commissioner Monti, a two step solution was envisaged.

As a first stage, complainants and complainees were to be given a limited window of opportunity to agree a settlement satisfactory to both sides. During that time, the instruction of the case would be put on hold. Once a settlement was reached, the second stage would involve the removal of any remaining restrictions contained in the SLA following appropriate discussions between DG Competition’s services and Philips and Sony.

In mid-June 2003, all complainants but one informed DG Competition that they were withdrawing their complaints. At this point steps were taking to move to the second stage mentioned above.

5. The notification of the new standard license agreement

Shortly after the withdrawal of the complaints, Philips and Sony formally notified their bilateral agreements establishing the world-wide Philips/Sony joint CD Disc Licensing Program and the 2003 SLA to be offered by Philips to third parties under the remaining enforceable patents of Philips, Sony as well as those based on the companies’ joint inventions.

DG Competition’s Services reviewed these agreements and come to the following conclusions:

- First, agreements establishing the joint CD Disc Licensing Program were covered by the block exemption regulation concerning certain categories of technology transfer agreements (TTBE). Although the agreements between the members of a patent pool are normally excluded from the Regulation, Article 5.2(2) of the TTBE brings within its scope patent pools concluded between only two parties without any territorial restrictions within the EEA.

- Second, the new 2003 SLA did not appreciably restrict competition within the meaning of Article 81(1). Only essential patents are now licensed. Licensees can opt to take the joint license or individual licenses from Philips or Sony and to use them within or outside the standard specifications. In addition, the 2003 SLA does not contain any of the restrictions referred to in Articles 2, 3 and 4 of the TTBE.

Consequently, a comfort letter was sent in late July 2003 to Philips and Sony.

The contents of the 2003 SLA can be summarised as follows:

- It explicitly recognises Philips’ and Sony’s right to license their respective patents separately and to give non-assertion undertakings with regard to jointly owned patents, whether within or outside the standard specifications of the different types of CD discs.
• It provides for options to any Licensee as to the different types of CD discs manufactured.

• It specifies the essential patents required for the manufacturing of each type of CD discs.

• The different patent lists attached to the 2003 SLA include only essential patents. An independent patent expert has confirmed the essentiality of such patents.

• Philips and Sony have one essential patent each or at least a joint essential patent for each type of CD disc in different EEA countries.

• It has to be noted that the independent expert has yet to conclude the assessment of the essentiality of two patents for the CD Extra and CD Text formats respectively. The 2003 SLA states that should the independent expert conclude that any patent is not essential, the patent will be deleted from the relevant annex. As the agreement will terminate at the date of expiration of the last essential patent in the territory for the type(s) of CD discs selected by licensee, it could be the case that the effective duration of the licence will be shortened in case any of the pending patents is finally considered not essential.

• In addition, Sony has two further pending applications, for which patents have not been granted yet, concerning the CD Extra format. Should these patents be granted and should the independent expert consider them essential, they will be included in the relevant patent annex. However, such inclusion will have no effects on the royalty, the duration of the licence or the grant back provision.

• Under the grant-back provision, licensees are obliged to license back to Philips and Sony, and to other licensees having selected the same type of CD disc, only patents essential for the type(s) of CD discs they have selected.

• Royalty payment obligations have been clarified to reflect the territorial scope and duration of the licensed patents. Furthermore, licensees will only be obliged to provide information in respect of royalty bearing CD discs produced and sold.

• Conditions for access to the existing reduced compliance royalty rate have been clarified and made more attractive. In particular:
  — all EEA licensees will be offered a one time only credit on royalty payments up to a maximum amount of 25,000 USD, for the specific costs incurred by an audit confirming compliance during the last three years, required to benefit from the reduced compliance royalty rate.
  — In addition, compliant licensees that send the above audit before 1 December 2003 can apply the reduced compliance royalty rate retroactively with effect as from 1 July 2002.
  — Finally, compliant licensees that have produced less than 5 million CD discs in the preceding year will be exempted from the obligation to present yearly audits in order to show continued compliance for that year. A statement signed by a duly authorised officer of the licensee will be enough.

• As indicated above, the 2003 SLA will terminate at the date of expiration of the last essential patent in the Territory for the type(s) of CD discs selected by Licensee. The patent lists establish definitive cut off dates per type of CD discs for each EEA country.

• The 2003 SLA can be entered into by all existing Licensees in lieu of their existing license agreements. Of course, such a switching will be free of charge for existing licensees.

Philips Licensing website (www.licensing.philips.com) provides now clear information as to the Licensing Program, the patents involved and the essential character thereof, as well as a software tool freely downloadable for Licensees, to differentiate between different types of CD-ROM discs. Philips has undertaken to keep its website constantly updated.

Finally, Philips has informed the Commission that it intends to inform each EEA licensee in writing about the contents of the 2003 SLA. As part of that letter, Philips will grant to each EEA licensee a one-time credit of 10,000 USD on royalties due.

6. Conclusion

The cases discussed in this article shows that DG Competition is open to propose and accept pragmatic solutions when the likely result will be equivalent to that obtained by conducting formal proceedings. The suitability of such an approach necessarily depends on the nature of the infringement in question; on considerations related to the efficient use of Commission resources; on the position of all companies involved on the relevant markets; and on the parties’ cooperative attitude.

Notwithstanding these conditions, the above cases certainly add to the growing corpus of cases dealt with by the European Commission in the field of patent pools.