

# The Antitrust Enforcement Risks of Defensive Patent Pools

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## Introduction

The patent rights necessary to commercialize a product are frequently controlled by multiple rights holders instead of one patentee. This fragmentation of rights can increase the costs of bringing products to market due to the transaction costs of negotiating multiple licenses and greater royalty payments. Patent pools – collective licensing arrangements – can help solve the problems created by these overlapping patent rights, i.e., patent thickets, by reducing transaction costs for licensees and licensors while preserving the financial incentives for inventors to commercialize their existing innovations and undertake new, patentable R&D.<sup>2</sup> These patent pools generally take two distinct forms – in one form competitors combine patents in a separate entity in order to promote a technology (specific purpose patent pool), in the other form a separate entity acts to collect and package patents for the benefit of its members (defensive patent pool).

Patent pools may generate significant efficiencies and procompetitive benefits, including integrating complementary technologies, reducing transaction costs, reducing the risk of holdup and royalty stacking, clearing blocking positions, increasing transparency and predictability of IP costs, and avoiding costly infringement litigation.<sup>3</sup> In addition, defensive patent pools can serve to counteract strategies that lead to the overvaluation of some patents, such as the litigation pursued by patent assertion entities.

Patent pools, like any arrangement involving groups of competitors, may also raise competitive concerns if they result in price fixing, due to the collective pricing of pooled patents, coordinated output restrictions among competitors or foreclosure of innovation. Patent pools can raise concerns where they are overbroad – such as when they include competing technology or prevent members from independently licensing intellectual property. Defensive patent pools have the additional potential concern that the pool could create unlawful monopsony (buyer) power and depress the value of intellectual property and depress innovation.

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<sup>2</sup> U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition (2007) ("IP2 Report"), available at <http://www.usdoj.gov/atgr/public/hearings/ip/222655.pdf>.

<sup>3</sup> Id.; U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property (1995) ("Antitrust-IP Guidelines"), § 5.5, available at <http://www.usdoj.gov/atr/public/guidelines/0558.pdf>.

The potential for anticompetitive effects in specific purpose patent pools trigger the need for antitrust scrutiny to ensure, first, that the pooling is not a pretext for naked price fixing or output restrictions; second, the pool does not deter innovation. If competitive concerns may exist a court or antitrust enforcement agency will consider whether the collective arrangement generates substantial efficiencies that could not be achieved absent the arrangement and that procompetitive benefits outweigh anticompetitive effects.

Although specific purpose patent pools are ostensibly designed with the intention of enhancing competition and promoting innovation, e.g., by clearing blocking patents and protecting against hold-up or hold-out in the implementation of technological standards, and thus to facilitate the introduction of new technology to the market, in some cases they may be used instead as a weapon to suppress, and/or raise the costs of, actual and potential competitors because: (1) the pool members may have an incentive to eliminate competition and (2) the pool may have the incentive and ability to exercise market power through the inclusion of non-essential and/or invalid patents.

Specific purpose patent pools received considerable scrutiny during the 1990s, with the approval of several pools critical to the development of video, computer and other products. The standards articulated in Justice Department Business Review set forth a careful, searching scrutiny of patent pools that approved them subject to several conditions to protect competition.

Defensive patent pools are much more recent in creation and therefore their antitrust risks are less developed. The competitive primary concern regarding defensive patent pools is if these pools are used in such a way to artificially depress patent or licensing prices below their fair market value, and in turn decrease innovation or the incentives to innovate. Fortunately, a case currently in litigation sheds light on what these antitrust risks may be.

We begin our discussion by defining basic terms used in discussing competition risks in patent pools. We then turn to the purpose, basic definitions, and the competitive analysis of specific purpose patent pools, drawing from guidance from DOJ-FTC guidelines, a FTC report, DOJ Business Review Letters, an FTC enforcement action and a private case concerning patent misuse in the context of a patent pool. We then briefly discuss new competition challenges found in specific purpose patent pools. Next, we turn to defensive patent pools and use the ongoing case of *Cascades v. RPX Corp.* to analyze the antitrust risks involved as well as predict how courts will likely treat this business model in the future.

## Setting the Stage: Basic Terms

Understanding the competitive analysis of patent pools requires familiarity with certain terms. To set the stage, we provide the following brief glossary:

- *Specific purpose vs. general purpose patent pools*: Specific purpose patent pools occur when two or more patent owners form a separate entity to which they assign or license specified patent rights in order to better promote the adoption of a specific technology. General purpose patent pools, in contrast, often form when a separate entity buys a large

number of patents with the intent to license and not to practice as a means of generating income. Examples include Allied Security Trust, RPX Corporation, and Intellectual Ventures. Although specific purpose and general purpose patent pools are both called patent pools, they are very different in form and function and raise very different competitive concerns.

- *Offensive vs. defensive patent pools*: Offensive and defensive is often used to describe the litigation strategy employed by a patent pool. Offensive patent pools actively seek out potential infringers and litigate as necessary to collect royalties. Defensive patent pool is a description often given to a general purpose patent pool that does not actively seek out infringers; instead the patent pool focuses on strategies for defending members against nuisance suits and helping them in negotiations for patent licenses with third parties. **Because the term “defensive patent pool” is most often associated with general purpose patent pools described above, the paper will simply use the term “defensive patent pool” and not “general purpose defensive patent pool” to describe such an entity.**
- *Complementary patents* are patents covering separate aspects of a given technology that do not compete with each other. They are “patents covering technologies that perform different functions but are used collectively to produce the license product.”<sup>4</sup> According to the IP2 Report [define previously], a pool containing complementary patents “may have the pro-competitive effect of lowering the total royalty rate to licensees, thereby lowering the final product cost to consumers.”<sup>5</sup>
- *Substitutable patents* are patents covering technologies that compete with each other and that licensee producers would choose between – e.g., the patents supporting either the H.264 or the VP8 coding technologies. A pool including substitutable patents would be likelier than a pool containing only or primarily complementary patents to have the anticompetitive effect of increasing the total royalty rate to licensees by foreclosing or preempting competing alternative technology.
- A *blocking patent* prohibits the practice of another patent but does not necessarily cover all design alternatives. For instance, where a patent covers a certain technology and a second inventor gets a patent that is an improvement on the first invention, the second inventor is blocked from using his technology unless he can obtain a license from the first inventor.
- *Essential patents*: “Essentiality” has been variously defined by different patent pools. Standards are critical to high technology products and often certain patents are “essential” to practice the standard. Essential patents are commonly understood to mean either or both of the following: (1) patents ‘necessarily essential’ to the standard, i.e., inevitably infringed by compliance with the standard, and (2) essential to the standard ‘as a practical matter’ because there are no economically viable substitutes for the patents (i.e., not reading on the standard itself but nonetheless required to manufacture a competitive product compliant with the standard, due to production or design costs, consumer preferences or other reasons). In other terms, an essential patent is a blocking patent that is so broad that it covers the technology necessary to enter the entire market: it prohibits

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<sup>4</sup> U.S. Dep’t of Justice & Fed. Trade Comm’n, Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition (2007) (“IP2 Report”), available at <http://www.usdoj.gov/atgr/public/hearings/ip/222655.pdf>, at 77.

<sup>5</sup> *Id.*

the practice of another in the same field because the patent covers all commercially feasible design alternatives.

- *Grantback*: An agreement by which a licensee extends to the licensor the “right to use the licensee’s improvements to the licensed technology.”<sup>6</sup> Licensors may define a grantback’s scope more broadly to cover inventions which relate in any way to the subject of the licensed patent.
- *Royalty stacking*: This is a situation in which a single product infringes on patents held by multiple owners, each of which imposes a separate royalty burden – sometimes referred to as double marginalization. Royalty stacking may and often does result in higher fees than if a single owner licensed all of the patents. Royalty stacking and the related phenomenon of patent thickets are the principal problems that patent pools can resolve.
- A *patent thicket* is a “dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology,”<sup>7</sup> requiring innovators to reach licensing deals from multiple sources for multiple patents.
- *Hold-out and hold-up*: Hold-up occurs when a patent holder asserts its intellectual property rights only after another firm has made investments related to that patent (for example, after that firm has brought to market an infringing product). If that happens the patent holder can bargain for higher rents. Hold-out occurs when a potential licensee refuses to negotiate in good faith in order to depress the value of the intellectual property.

## Purpose, Definitions and Competitive Analysis of Specific Purpose Patent Pools

When two or more patent owners form a separate entity to which they assign or license specified patent rights, the resulting arrangement is referred to as a patent pool. This pool then exploits the collective rights by licensing, manufacturing or both.<sup>8</sup> Patent pools are often formed when multiple patent technologies are needed to produce a standardized product and therefore are formed as a corollary to or following the selection of a standard by a standard setting organization, such as the IEEE<sup>9</sup> or ETSI<sup>10</sup> in the wireless technology domain. By these fundamental steps, patent pools and their members typically achieve their principal goal – to facilitate the introduction of new technology into the market.

These specific purpose patent pools can solve the problems resulting from the fragmentation of overlapping intellectual property rights pertaining to the same aggregate technology by clearing blocking patents, without any one of which the product cannot be made,

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<sup>6</sup> IP Guidelines § 5.6

<sup>7</sup> Carl Shapiro, “Navigating the Patent Thicket, Cross Licenses, Patent Pools and Standard Setting,” in Adam Jaffe et al., *Innovation Policy and the Economy*, Cambridge: MIT Press (2001), at 119-150.

<sup>8</sup> Hovenkamp, Janis and Lemley, *IP and Antitrust*, § 34.2 at 34-5 (2004 Supplement); R. Merges, “Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations,” 84 *Cal. L. Rev.* 1293, 1340 (1996).

<sup>9</sup> Institute of Electrical and Electronic Engineers.

<sup>10</sup> European Telecommunications Standards Institute.

and patent thickets. In this sense, patent pools are intended to be and typically are welfare-enhancing and procompetitive.

The primary sources of contemporary guidance on evaluating patent pools are DOJ-FTC guidelines – the 1995 DOJ-FTC Antitrust Guidelines for the Licensing of Intellectual Property (“Antitrust-IP Guidelines”);<sup>11</sup> a 2007 DOJ-FTC report – Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition (“IP2 Report”);<sup>12</sup> DOJ Business Review Letters beginning in the late 1990s; and several recent cases.

In the Business Review Letters, the DOJ applies its competitive analysis to various prospective pools and states its present intention, based on the representations about the formation and terms of operation of the pool, whether or not to pursue antitrust enforcement. Since the first of the Business Review Letters in 1992 delineating the DOJ’s contemporary competitive analysis of patent pools, the DOJ has issued a handful of favorable letters – meaning that the DOJ indicated no present intention to pursue enforcement – regarding proposed pools, including the following:

- A proposal by the MPEG to pool and jointly license as a single package patents necessary to comply with the MPEG-2 digital video and audio compression standard, with the pool comprised of nine members (1997).<sup>13</sup>
- Two proposals to pool and offer package licenses for patents necessary to manufacture DVD (Digital Versatile Disc)s and DVD players in compliance with the DVD-ROM and DVD-video formats (1998 and 1999).<sup>14</sup>
- A proposal by the 3G Patent Platform Partnership to establish five licensing and patent evaluation structures – platforms – for licensing “Third Generation” (3G) wireless telecommunications technology (2002).<sup>15</sup>
- A proposal to pool and offer package licenses for patents essential to the implementation of certain ultra-high frequency radio frequency (UHFRFID) identification standards for labels and readers (2008).<sup>16</sup>

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<sup>11</sup> U.S. Dep’t of Justice & Fed. Trade Comm’n, Antitrust Guidelines for the Licensing of Intellectual Property (1995) (“Antitrust-IP Guidelines”), available at <http://www.usdoj.gov/atr/public/guidelines/0558.pdf>.

<sup>12</sup> U.S. Dep’t of Justice & Fed. Trade Comm’n, Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition (2007) (“IP2 Report”), available at <http://www.usdoj.gov/atgr/public/hearings/ip/222655.pdf>.

<sup>13</sup> Letter from Joel I. Klein, Assistant Attorney General, U.S. Department of Justice, to Garrard R. Beene, Sullivan & Cromwell (June 26, 1997) (the “MPEG-2 Business Review Letter”), available at [www.usdoj.gov/atr/public/busreview/215742.pdf](http://www.usdoj.gov/atr/public/busreview/215742.pdf).

<sup>14</sup> Letter from Joel I. Klein, Assistant Attorney General, U.S. Department of Justice, to Garrard R. Beene, Sullivan & Cromwell (Dec. 16, 1998) (the “3C DVD Business Review Letter”), available at <http://www.usdoj.gov/atr/public/busreview/2121.pdf>; Letter from Joel I. Klein, Assistant Attorney General, U.S. Department of Justice, to Carey R. Ramos, Paul, Weiss, Rifkind, Wharton & Garrison (June 10, 1999) (the “6C DVD Business Review Letter”), available at [www.usdoj.gov/atr/public/busreview/2485.pdf](http://www.usdoj.gov/atr/public/busreview/2485.pdf).

<sup>15</sup> Letter from Charles A. James, Assistant Attorney General, U.S. Department of Justice, to Ky P. Ewing (Nov. 5, 2002) (“3G Business Review Letter”), available at <http://www.justice.gov/atr/public/busreview/200455.htm>.

<sup>16</sup> Letter from Thomas O. Barnett, Assistant Attorney General, U.S. Dept. of Justice, to William F. Dolan and Geoffrey Oliver, Jones Day (Oct. 21, 2008) (“UHF RFID Business Review Letter”), available at <http://www.justice.gov/atr/public/busreview/238429.htm>.

The DOJ's favorable responses are based on some or all of the following competitive safeguards:

- Limitation of the portfolio to patents determined by an independent expert to be essential, which, by definition, are not competitive with each other;
- A method to remove patents found to be invalid, unenforceable or no longer essential;
- Retention by pool members of the right to license their patents independently as well as in a package;
- The issuance of worldwide non-exclusive licenses to all interested parties on a non-discriminatory basis;
- License liability for royalties is conditioned on actual use of the patents;
- Licensees are free to develop and use alternative technologies; and
- Licensees are required to grant back non-exclusive, non-discriminatory license to use patents (e.g., improvements) that are essential to comply with the technology.<sup>17</sup>

The Agencies summarize their competitive analysis of patent pools in the IP2 Report as follows:

- The Agencies evaluate the competitive effects of patent pools under the framework of the Antitrust IP Guidelines and typically analyze the pool and any agreements under the rule of reason.
- Combining complementary patents within a pool is generally procompetitive.
- Including substitute patents in a pool does not make the pool presumptively anticompetitive; competitive effects will be ascertained on a case-by-case basis.
- The competitive significance of a pool's licensing terms will be analyzed on a case-by-case basis considering both their procompetitive benefits and anticompetitive effects.
- The Agencies will not generally assess the reasonableness of royalties set by a pool. The focus of the Agencies' analysis is on the pool's formation and whether its structure would likely enable pool participants to impair competition.<sup>18</sup>

In particular, the Antitrust-IP Guidelines state that intellectual property pooling is procompetitive when it

1. integrates complementary technologies,
2. reduces transaction costs,
3. clears blocking positions,
4. obviates the need for costly infringement litigation, and
5. promotes the dissemination of technology.

For instance, suppose several leading manufacturers of a consumer electronic product hold patents covering alternative circuit designs for the product. The manufacturers assign to a separate entity only their relevant patents which are blocking – that is, those patents without a

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<sup>17</sup> For a discussion of these safeguards and the potential competitive effects of pools, see David A. Balto and Andrew Wolman, *Intellectual Property and Antitrust*, 43 *IDEA* 395, 445-51 (2003).

<sup>18</sup> IP2 at 9.

license to which no potential manufacturer can practice any other patent needed to make the product; stated another way, none of the patents assigned to the entity can be used without infringing a patent owned by another firm contributing its IP to the pool. That pooling entity then licenses the right to use the circuit designs to other consumer product manufacturers and establishes the license royalties.<sup>19</sup>

## **A Brief Discussion of Modern Competitive Concerns Found in Specific Purpose Pools<sup>20</sup>**

As noted by other commentators,<sup>21</sup> the DOJ's Business Review Letters of 1997 - 2008, in which the DOJ stated its present intention not to pursue antitrust enforcement with respect to the proposed pools, have turned substantially on two commitments, among others – that the pools would contain only complementary (i.e., essential) patents and that this determination of essentiality would be made by an independent, unbiased expert. Indeed, the MPEG-2 Business Review Letter mentions the independent expert no less than 16 times. Given the paramount importance of the essentiality of patents to ensuring that a pool is not likely on balance to be anticompetitive, the question arises how any expert, even one assumed to be independent, can make a thorough and accurate evaluation of, say, 1,700+ patents in a pool to ensure that they are all Complementary to each other – and this especially because many patents defy such black-and-white characterization, having claims that may be substitutes for claims in other patents. The answer inevitably is that complete accuracy may be out of reach – which is not to condemn the effort or say it should not be undertaken, for of course it should and at present there is no better alternative that has been proposed. But this fact calls for frank acknowledgement that the competitive landscape of patent pools has changed. No less is true of the difficulty of an independent expert to evaluate the validity and enforceability of such large numbers of patents in a pool.

In these circumstances, the savings on transaction costs to a potential licensee in having the pool's expert evaluate its patents for infringement or essentiality may be illusory: as astutely noted,

[F]ew, if any potential licensees have the resources at their disposal to procure non-infringement opinions – or an independent expert determination of essentiality – for a pool containing *thousands* of patents. Indeed, it is far cheaper for a potential licensee to simply take a license to the pool, whether or not the patents in the pool are truly essential, because the alternatives – spending considerable time and money to conduct an independent assessment or not do so and run the risk of infringement liability – are prohibitively expensive.<sup>22</sup>

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<sup>19</sup> Example adapted from Example 10 of the Antitrust-IP Guidelines.

<sup>20</sup> For a more in depth discussion, see David A. Balto, Barriers to Competition on the Innovation Superhighway: How the Lack of Antitrust Scrutiny of Patent Pools Deters Competition (2013), *available at* <http://www.dcantitrustlaw.com/patent%20pools%20-5%209%20pdf.pdf>.

<sup>21</sup> S. Sher, J. Lutinski and B. Tennis, “The Role of Antitrust in Evaluating the Competitive Impact of Patent Pooling Arrangements,” 13 Sedona Conf. J. 111, 129 (2012).

<sup>22</sup> Sher et al, *supra*, at 130 (emphasis in original).

These issues need to be ‘called out’ so that the agencies and private parties can more effectively help stem the inevitable tide of patent pools encompassing more and more substitute patents by virtue of their sheer size alone, if not also as a result of any corollary deliberate effort to suppress competing technology.

Of course, if in a given instance the independence of an expert evaluator is compromised, the potential for anticompetitive effects from the pool looms larger. This assessment must be case by case, but given that it is the pool itself, or its administrator, which hires the expert evaluator, the “independence” of the expert should be approached with a certain healthy skepticism – to ensure that the expert is not somehow abetting a process of capture of potentially competing technology by the pool, as suggested perhaps by MPEG LA’s conduct with respect to the open-source VP8 video encoding alternative to the H.264 standard and technology.<sup>23</sup>

The growth in size of recent pools is a structural change. Of a more dynamic nature, recent acquisitions of large patent portfolios by groups of firms that compete among themselves – in effect, building large agglomerations, or pools, of patents – also challenge certain assumptions about the ostensible procompetitive character of patent pools: whereas pools are intended to bring new technology to the market for commercialization, these latest acquisitions – again, somewhat like MPEG LA’s alleged conduct vis-à-vis the VP8 technology – arguably seem more directed at creating blocking positions to protect already commercialized products and inhibit the development of alternative technologies.

## **The Conundrum of the Defensive Patent Pool: What Can We Learn from Cascades v RPX?**

The defensive patent pool is a modern invention motivated by the rise of nuisance suits and aggressive patent enforcement tactics often by patent assertion entities that seek to maximize the value of intellectual property. These defensive patent pools can be very different from traditional patent pools in formation, purpose, and operation. In fact, most defensive patent pools aren’t actually patent pools, in the sense that they are not formed by two or more operating entities to promote a technology. Rather, defensive patent pools generally arise independently by those seeing a business opportunity in the desire of operating entities to be protected from the threat of patent litigation. Defensive patent pools are perhaps more similar to insurance companies than specific purpose patent pools because their primary goal is to lessen the risk of a potential negative outcome rather than to facilitate the adoption of technology.

RPX Corporation (“RPX”), perhaps the prototypical defensive patent pool, describes its services thusly:

Any company that uses technology in its products or services today faces a steadily increasing threat of patent litigation. That threat is already costing

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<sup>23</sup> See, e.g., *Nero AG v. MPEG LA*, 2010 WL 4366448, \*2 (C.D. Cal. 2010) (noting plaintiff-licensor’s allegations of expert evaluator’s lack of independence from MPEG LA and dismissing on other grounds plaintiff’s Sherman Act Section 2 claim).

operating companies approximately \$13 billion per year in legal costs and even more in lost productivity.

RPX is changing this equation. Our market-based solution dramatically reduces patent-related costs for client companies by sharing risk across our network. We aggregate capital from annual subscription fees to acquire dangerous patents and patent rights, with each RPX client receiving a license to every asset we own. We acquire those patents for defensive purposes, and we have committed to never assert these patents. As the network continues to grow and our service offerings expand, we are removing progressively more high-threat patents – and more high-cost risk – from the operating ecosystem.

The result: strong, broad-based defense against wasteful patent litigation and dramatically lower operating costs and financial risk for our clients.<sup>24</sup>

Defensive patent pools are a novel solution to what is widely seen as a failure in the marketplace. While novel solutions can be great for filing patent applications, they are not good for assessing risk when it comes to antitrust enforcement – especially in a field as complicated as the intersection of patent law and competition law. The DOJ provides a good example of this dilemma. While the DOJ’s Business Review Letters of specific purpose patent pools provided invaluable guidance on how to minimize enforcement risk, the DOJ recently declined to give guidance on whether Intellectual Property Exchange International’s business model would be subject to enforcement, stating “[w]e simply do not know enough to conclude that IPXI’s activities, once operational, will not raise competitive concerns.”<sup>25</sup> Among the DOJ’s concerns were “(1) the pooling of patents from multiple patent holders, (2) the listing of competing URLs, and (3) the sharing of competitively sensitive information.”<sup>26</sup> Perhaps it was this uncertainty that led to RPX to include the possibility in its S.E.C. Registration Statement that their conduct might be interpreted by the courts as violating antitrust laws. Indeed, RPX was sued for violating antitrust laws and the case, which is still in litigation, represents the best indication of antitrust enforcement risks for defensive patent pools.

On December 13, 2013, judge Yvonne Gonzales Rogers, in the Northern District of California, denied RPX and manufacturing defendants’ motions to dismiss.<sup>27</sup> “The thrust of Cascades’ First Amended Complaint . . . is that Defendants’ alleged conduct constitutes a conspiracy to monopsonize the market to buy Cascades’ patent licenses, in violation of Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2, and California unfair competition laws.” The court concluded that Cascades alleged “specific facts raising a reasonable inference that the Manufacturing Defendants and RPX engaged in a so-called ‘hub-and-spoke’ conspiracy to force sub-competitive pricing for Cascades’ patent licenses by monopsonizing the market therefor.”<sup>28</sup>

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<sup>24</sup> RPX CORPORATION, <http://www.rpxcorp.com/> (last visited Sept. 27, 2014).

<sup>25</sup> Letter from William J. Baer, Assistant Attorney General, U.S. Department of Justice, to Garrard R. Beene, Sullivan & Cromwell (Mar. 26, 2013), available at <http://www.justice.gov/atr/public/busreview/295151.pdf>.

<sup>26</sup> *Id.*

<sup>27</sup> *Cascades Computer Innovation LLC v. RPX Corp., et al*, No. 12-CV-1143 YGR (N.D. Cal. Dec. 2, 2013) (order denying motions to dismiss first amended complaint)

<sup>28</sup> *Id.*

A “hub-and-spoke” conspiracy is a special kind of antitrust conspiracy that is a hybrid of both vertical (ex. manufacturer and distributor) and horizontal (i.e. among competitors) elements.<sup>29</sup> Under this theory of a hub-and-spoke conspiracy, RPX served as the hub, which coordinated the conspiracy among the manufacturing defendants, who served as the spokes. A key fact in any hub-and-spoke claim is whether there was a horizontal agreement among the spokes, who are direct competitors. This horizontal agreement, called a rim, will determine whether the conspiracy can be found a *per se* violation. “There is no special exception for applying *per se* status just because there is a hub and spoke conspiracy; the complaint still must show some horizontal relationship.”<sup>30</sup> If there is no rim holding everything together, then the challenged conduct must be analyzed under the rule of reason.

The challenged conduct in the Cascades case involves services that RPX sometimes performs where it acts “as a purchasing or negotiating agent for a subset of its members in what it calls, variously, structured or syndicated acquisitions.”<sup>31</sup> “By exercising group purchasing power and causing potential licensees to negotiate solely through RPX, RPX can obtain for its members reduced royalty rates, which RPX commonly refers to as ‘wholesale’ prices.”<sup>32</sup> In these types of arrangements, the pertinent members provide the financing for the specific patent rights.<sup>33</sup> RPX allegedly initiated licensing negotiations with Cascades and when those negotiations broke down Cascades “made each of the Manufacturing Defendants an identical licensing offer which included a sizable rebate to the first company to accept.”<sup>34</sup> When none of the manufacturing defendants responded to the offer, Cascades initiated an antitrust lawsuit alleging that “RPX and the Manufacturing Defendants had agreed for the Manufacturing Defendants to refrain from negotiating with Cascades individually and instead to negotiate any license only through RPX.”<sup>35</sup> RPX and manufacturing defendants made many sound arguments that their challenged conduct did not violate the antitrust laws, but the court ultimately rejected these arguments at the pleading stage.

## RPX’s Alleged Conspiracy

To survive a motion to dismiss on an alleged hub-and-spoke conspiracy, Cascades “must allege both a horizontal agreement between the Manufacturing Defendants (that is, a connecting “rim”) and vertical agreements (or “spokes”) between RPX and each individual Manufacturing Defendant.”<sup>36</sup> The defendants posed three challenges to these allegations by Cascades:

- (1) Defendants’ alleged conduct is more plausibly explained by Cascades’ overvaluation of the Elbrus Patents than by any collusive activity;
- (2) Cascades alleges mere parallel conduct and organizational membership in RPX and thus falls short of pleading a rim, i.e., horizontal agreement between Manufacturing Defendants; and

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<sup>29</sup> *E.g.*, Total Benefits Planning Agency v. Anthem Blue Cross and Blue Shield, 552 F. 3d 430, 435 (6th Cir. 2008).

<sup>30</sup> *Id.*

<sup>31</sup> Cascades, *supra* note 27, at 4.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 4-5.

<sup>35</sup> *Id.* at 5.

<sup>36</sup> *Id.* at 10.

(3) Cascades fails to plead the spokes, i.e., a vertical conspiracy, because the subscription agreements between RPX and its members are not themselves actionable.<sup>37</sup>

The court addressed each challenge in turn.

In regards to the first challenge, the court found this explanation to be plausible.<sup>38</sup> However, at the pleading stage “Plaintiff’s complaint may be dismissed only when defendant’s plausible alternative explanation is so convincing that plaintiff’s explanation is *implausible*.”<sup>39</sup> The court was especially concerned with the rejection of the first taker incentive by all manufacturing defendants. This incentive offer “could have required the first taker to pay \$2.5 million—a figure roughly in line with the amount each Manufacturing Defendant would have had to pay under the original” offer made by RPX.<sup>40</sup> The court ultimately determined that it was up to discovery to reveal which explanation is true.<sup>41</sup>

The defendants’ second argument is that Cascades alleged no more than parallel conduct and organizational membership, and that Cascades failed to allege that “RPX served as the Manufacturing Defendants’ go-between.”<sup>42</sup> This latter allegation is necessary to establish the rim in a hub-and-spoke conspiracy claim. In rejecting this argument, the court relied on three alleged facts regarding the negotiations with RPX: (1) that at least one manufacturing defendant “expressed a desire to conduct business only through RPX;” (2) that after RPX reached an agreement on price, an RPX representative told Cascades that RPX members had raised the necessary money – suggesting “RPX members’ awareness that RPX was negotiating with Cascades;” and (3) that an RPX representative informed Cascades that it had to withdraw its offer because at least one RPX member refused to pay that amount – suggesting that the members had to agree on a price. More concerning, however, was that the court also found persuasive RPX’s alleged public statements that RPX could get members “wholesale” prices substantially lower than if they were acting individually. The court reasoned that implicit in this claim is that other manufacturers have to agree to negotiate through RPX to achieve these lower prices which could be interpreted as an invitation to common action.

The defendant’s final argument hinges on the ability, included in the membership agreement, of each RPX member to act independently in their own self-interest.<sup>43</sup> This challenge was defeated, in the courts opinion, by Cascades allegation that “each Manufacturing Defendant understood that it should refrain from exercising its right to negotiate individually with Cascades and instead deal with Cascades either through RPX or not at all.”<sup>44</sup>

## RPX’s Alleged Unreasonable Restraint of Trade

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<sup>37</sup> *Id.* at 10-11.

<sup>38</sup> *Id.* at 12.

<sup>39</sup> *Starr v. Baca*, 652 F.3d 1202, 1216-17 (9th Cir. 2011) cert. denied, 132 S. Ct. 2101 (2012)

<sup>40</sup> *Cascades*, *supra* note 27, at 13.

<sup>41</sup> *Id.* at 15.

<sup>42</sup> *Id.* at 16.

<sup>43</sup> *Id.* at 18.

<sup>44</sup> *Id.* at 19.

In order for Cascades to prevail, it must also adequately plead that defendants' alleged conduct was an unreasonable restraint of trade. Defendants challenged each of these elements – (1) that the alleged conduct was a restraint of trade and (2) that if it was a restraint of trade, it was an unreasonable restraint of trade.<sup>45</sup> The court also addressed these arguments.

The first argument flows from the same logic as the arguments above – that RPX members were permitted to negotiate independently and in their own best interest. The court stated that “it is reasonable to infer the existence of a restraint on trade in the form of a secondary, “off-the-books” agreement or understanding to deal only through RPX, despite being contractually permitted to do otherwise.”<sup>46</sup>

As to the second argument, at the pleading stage “a plaintiff must plead that the challenged agreement, by virtue of the defendants' market power, was unreasonably restrictive of competition in a relevant market and that the plaintiff suffered antitrust injury” in order to adequately make out a plea under the rule of reason.<sup>47</sup> The court found that Cascades had successfully pled under the rule of reason, and therefore did not need to address the adequacy of the plea under the stricter *per se* standard. In making this ruling, the court accepted a relevant market defined as the market for “purchase, acquisition or licensing of technology covered by all the Elbrus Patents, with the market for licenses under the ‘750 Patent along allegedly constituting a relevant submarket.”<sup>48</sup>

RPX countered in its motion to dismiss that this market definition failed because the complaint contained no allegations about reasonable interchangeability, cross-elasticity of demand, or other factors that define the limits of a relevant market. The court explained however that Cascades' market definition is sufficient because it “alleges a monopsony in the market to buy Cascades' patents, not a monopoly to sell them.”<sup>49</sup> And Cascades alleged the defendants comprise 75 to 90 percent of the underlying market for at least the submarket for the '750 patent, rendering, according to the court, a plausible market to survive a motion to dismiss.<sup>50</sup>

## RPX's Alleged Monopsonization

Cascades brought its monopsonization claim against all defendants and an additional claim for monopsonizing the market against RPX individually. In order to prevail on its monopsony claims Cascades must allege monopsony power in the relevant market, that was willfully acquired and in-fact caused antitrust injury. And pleading monopsony power requires a showing by Cascades that RPX possesses a dominant share of the market, generally at least 65 percent.

The court found that Cascade met that burden at least at the pleading stage. By virtue of its role as a purchasing agent for the manufacturing defendants, “who collectively

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<sup>45</sup> *Id.* at 20.

<sup>46</sup> *Id.* at 21.

<sup>47</sup> *Nat'l Soc. of Prof'l Engineers v. United States*, 435 U.S. 679, 690 (1978).

<sup>48</sup> *Cascades*, *supra* note 27, at 23.

<sup>49</sup> *Id.*

<sup>50</sup> RPX argued that Cascade overstates the market share of defendant, but the court indicated this is a factual dispute rather than a pleading deficiency relevant at the pleading stage.

control more than 90% of the mobile phone business using the Android operating system and 75% of the combined mobile and phone tablet business[.]” RPX allegedly wields monopsony power in the market for Cascades’ patents and specifically for the ‘750 patent, according to Cascades.<sup>51</sup> RPX argued that Cascade was looking at the issue from the wrong lens and that there could not be monopsony power since there were other alternatives for the patents. The proper market was not the “downstream” product market for Android mobile devices, but the “buyer share in the upstream input market for the ‘750 patent.”<sup>52</sup> The court rejected that argument finding Cascades’ allegations of market power in purchase of Cascades’ patents sufficient.

## Case Status and Predictions

The Cascades case is currently stayed pending resolution of the merits of the patent litigation underway in the Northern District of Illinois. Many questions concerning the antitrust risk of defensive patent pools remain unanswered until the case proceeds further in litigation.

Perhaps one of the most uncomfortable aspects of antitrust litigation against defensive patent pools is that they attack the potential exercise of monopsony power. The typical concerns over the exercise of monopsony power is that by depressing compensation providers of the good Of course it is critical in such a claim for the defensive patent pool to have substantial power – as noted in RPX’s motion to dismiss over a 65% market share. If there are significant other alternative buyers of the intellectual property it seems difficult for a plaintiff to prevail. Moreover, in order to prevail the plaintiffs will have to demonstrate the lack of other potential buyers for the technology.

And in litigation demonstrating harm to competition and antitrust injury may be daunting in this type of case. For example one of the rare high tech monopsony cases involved an attempt by a group of computer manufacturers to develop an operating system, in *Addamax Corp. v. Open Software Foundation*.<sup>53</sup> *Addamax* involved a monopsony price-fixing claim against the Open Software Foundation (“OSF”), a non-profit joint venture of a number of large computer manufacturers, including HP, IBM and Digital, formed to establish an operating system to compete against an AT&T/Sun Microsystems product in an alleged market for UNIX operating systems. OSF desired to have a security product within its operating system and put out a “request for technology” to Addamax and SecureWare to bid on an exclusive right to sell to OSF. SecureWare was selected, and within two years Addamax had begun to phase out its own product to concentrate on products for other markets. Addamax sued OSF, HP and Digital, alleging that the defendants engaged in horizontal price fixing by conspiring to force down the price for security software below the competitive price. The district court granted the defendants’ motion for summary judgment on the plaintiff’s per se claim, but found triable issues under the rule of reason.

The court recognized the difficulties in trying to find harm from the alleged exercise of monopsony power, so it held a mini-trial just on the issue of antitrust injury and damages. In that

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<sup>51</sup> Cascades, *supra* note 27, at 26.

<sup>52</sup> *Id.*

<sup>53</sup> *Addamax Corp. v. Open Software Foundation*, 964 F. Supp. 549 (D. Mass. 1997), *aff’d*, 152 F.3d 48 (1st Cir. 1998).

trial, the court found that the plaintiff's injuries were self-inflicted and did not constitute antitrust injury.<sup>54</sup>

Based on the ruling in RPX there are some clues as to the antitrust risks of defensive patent pools. This was by no means a clear victory for Cascades. In the hearing, Judge Rogers regularly stated that there was a plausible legitimate alternative explanation put forth by RPX and manufacturing defendants. This alternative explanation was simply not enough to render Cascades allegations implausible, therefore Cascades successfully made out its plea. However, the fact that Cascades survived a motion to dismiss at the pleading stage is significant because discovery for an antitrust case is usually expensive.

The Cascades case also provides a clue as to the legitimacy of the defensive patent pool business model under the antitrust laws. The challenged conduct only concerned a specific service provided by RPX – negotiating on behalf of multiple manufacturers – and not the business model as a whole. Even if Cascades were to prevail, there are steps that RPX can take to provide an equivalent service while minimizing their antitrust risk. For example, RPX could be careful to be more independent in obtaining patent rights for its members and to instate firewalls that prevented the sharing of potentially competitively sensitive information. RPX could also make sure that members were adequately informed that not exercising their rights to act independently in their best interest could create antitrust risk under some circumstances.

Defensive patent pools are being formed based on a real need to arm potential defendants of often-dubious litigation brought by patent assertion entities. This type of self-help, especially against dubious litigation, is likely to be seen by the courts as largely procompetitive as long as it is properly conducted. The courts likely skepticism of greater challenges to the defensive patent pool business model is exemplified by the following line of questioning by Judge Rogers directed at Cascades' counsel during oral arguments:

How could one ever determine what a market rate is when . . . it is a unique license? . . . There is no comparison . . . . What turns this into a market violation as opposed to an independent contractual dispute? . . . And how can it be free negotiation when all of these cases seem to get postured in the context . . . of a patent suit being filed? How is that free negotiation?<sup>55</sup>

Outside of the intellectual property arena antitrust monopsony claims face many litigation challenges. As then Judge Breyer once observed “the Congress that enacted the Sherman Act saw it as a way of protecting consumers against prices that were too high, not too low. [Courts] should be cautious—reluctant to condemn too speedily—an arrangement that on its face appears to bring low price benefits to the consumer.”<sup>56</sup> Courts, and consumers, generally like buyer power when it serves to balance out an existing market imbalance of power. This lowers prices and benefits consumers. And consumers, after all, are the primary focus of antitrust laws.

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<sup>54</sup> *Id.*

<sup>55</sup> *Cascades Computer Innovation LLC v. RPX Corp., et al*, No. 12-CV-1143 YGR (N.D. Cal. Dec. 2, 2013) (oral arguments).

<sup>56</sup> *Kartell v. Blue Shield*, 749 F.2d 922, 931 (1st Cir. 1984), *cert. denied*, 471 U.S. 1029 (1985).

## Conclusion

The rapidly changing usage and role of patents in competition has led to new questions in what had seemed to be settled areas of antitrust law as well as new market solutions that raise very different, but also new, questions in enforcement risk. In specific purpose patent pooling there is reasonable evidence to support the conclusion that in recent years structural, behavioral and market forces, especially in high-tech markets, are putting significant, perhaps unanticipated pressures on the competitive model of pooling and collective licensing set forth in the Agencies' guidance and in the DOJ Business Review Letters. As I have written elsewhere the DOJ and the courts need to take a fresh look at potential anticompetitive conduct by specific purpose patent pools.

Defensive patent pools can raise similar issues. But it is important to remember that antitrust enforcers and the courts are generally very solicitous about the exercise of buyer power. For plaintiffs to prevail they must not only demonstrate decreased compensation but harm to both the competitive process and consumers. That will be a daunting challenge, especially where these pools are created to battle against vexatious IP litigation.