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INEQUITABLE CONDUCT:
A FLAWED DOCTRINE WORTH SAVING

Lisa A. Dolak1

A growing chorus of voices is calling for reform or even elimination of the doctrine of inequitable conduct. Critics argue that innocent or even irrelevant prosecution mistakes can be met with the ultimate penalty: unenforceability of the entire patent.

There is no question the doctrine is in need of repair. Patent owners are subject to different materiality standards in both the U.S. Patent and Trademark Office and in the courts. Inequitable conduct charges can be based on information completely immaterial to patentability. Findings of deceptive intent are increasingly based on inference and not evidence. And the one-size-fits-all remedy of total unenforceability deprives the courts of the ability to tailor the "punishment" to the offense.

This paper argues that retaining the defense is essential for maintaining the integrity of, and continuing public confidence in, the U.S. patent system. It sets forth specific recommendations for much-needed modifications designed to better serve the doctrine's essential purposes, and to ameliorate the key problems with its current application. Although these changes can be implemented by the courts, legislative action would be more appropriate, because the recommended modifications affect virtually every aspect of the doctrine, and it is unlikely that a given case or series of cases will present appropriate facts for judicial resolution in the near future.

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I. INTRODUCTION

II. RECENT DEVELOPMENTS: DOCTRINAL EXPANSIONS, PRACTICAL DILEMMAS

III. THE INEQUITABLE CONDUCT DEFENSE SHOULD BE RETAINED
   A. There is a crisis of confidence in the U.S. patent system.
   B. Inequitable conduct happens!
   C. Other proposed enforcement mechanisms are unsatisfactory.
   D. Applicants would not voluntarily elaborate on references.

IV. RECOMMENDATIONS FOR REFORM
   A. Prosecution conduct should be judged in the courts by the standards which govern applicants and practitioners inside the USPTO.
   B. Only conduct which undermines the integrity of the prosecution process should qualify for judicial sanction.
   C. The evidentiary standards governing intent findings should be revised.
   D. Courts should abandon the materiality-intent balancing inquiry.
   E. Trial judges should be permitted to tailor the remedy to the circumstances.
   F. Patentees who prevail on the issue of inequitable conduct could be awarded attorney fees.

V. CONCLUSION
I. INTRODUCTION

A growing chorus of voices is calling for reform or even elimination of the doctrine of inequitable conduct. Critics cite the high costs and unpredictability associated with litigating the issue, and argue that innocent or even irrelevant prosecution mistakes can be met with the ultimate penalty: unenforceability of the entire patent.


It is not surprising that reform-minded critics have turned their attention to the inequitable conduct doctrine. None of the various comprehensive congressional patent reform proposals introduced over the last several years has yet garnered sufficient support in both houses to reach the desk of the President. However, it is clear that there is still significant appetite for wide-ranging reforms, and therefore a real opportunity for proponents of legislative alteration of the inequitable conduct defense.

Further, the remarkable level of Supreme Court attention to the patent system in recent years has no doubt encouraged patent litigants that the legal doctrines of inequitable conduct and unenforceability may unfairly punish them with draconian penalties for innocently omitting information.


7 The Supreme Court has decided eight patent cases during the last four terms. See Quanta Computer, Inc. v. LG Elec., Inc., 128 S. Ct. 2109, 2122 (2008) (holding that “[t]he authorized sale of an article that substantially embodies a patent exhausts the patent holder’s rights and prevents the patent holder from invoking patent law to control postsale use of the article.”); Microsoft Corp. v. AT&T Corp., 550 U.S. 437, 441-45 (2007) (addressing the extraterritorial reach of U.S. patent law); KSR Int’l Co. v. Teleflex, Inc., 550 U.S. 398, 403 (2007) (revising the standard for establishing
to file certiorari petitions\textsuperscript{8} and has raised hopes that the Court might accept an inequitable conduct case for review. In addition, the fact that the Supreme Court has reversed or vacated eight decisions of the U.S. Court of Appeals for the Federal Circuit in the last five years\textsuperscript{9} might have been perceived, at least, as potentially increasing the likelihood that the Federal Circuit would grant en banc review in an attempt to preempt Supreme Court review with respect to increasingly controversial patent law doctrines.\textsuperscript{10} Thus, parties who have lost on an issue at the Federal Circuit have had reason to hope that the courts will be receptive to certiorari or rehearing petitions and an expectation that they may be able to enlist or enjoy the support of interested amici.


\textsuperscript{9} See infra note 67.

\textsuperscript{10} The Federal Circuit’s recent \textit{sua sponte} decision to rehear an appeal relating to statutory subject matter is one possible example. See \textit{In re Bilski}, 264 Fed. App’x 896, 897 (Fed. Cir. 2008).
In fact, on April 26, 2010, the Federal Circuit agreed to rehear en banc the appeal in Therasense, Inc. v. Becton, Dickinson and Co. The court asked the parties to brief six categories of questions, and invited the participation of amici curiae. Specifically, the court requested input as follows:

1. Should the materiality-intent balancing framework for inequitable conduct be modified or replaced?


3. What is the proper standard for materiality? What role should the United States Patent and Trademark Office’s rules play in defining materiality? Should a finding of materiality require that but for the alleged misconduct, one or more claims would not have issued?


5. Should the balancing inquiry (balancing materiality and intent) be abandoned?

6. Whether the standards for materiality and intent in other federal agency contexts or at common law shed light on the appropriate standards to be applied in the patent context.

The questions suggest that the Court is willing to revisit most of the key tenets of the inequitable conduct doctrine. The Court has
set oral argument for November 9, 2010.\footnote{Therasense, Inc. v. Becton, Dickinson & Co., No. 08-1511, U.S. App. LEXIS 11373, at *4 (Fed. Cir., June 3, 2010) (en banc scheduling order).} Thus, as of this writing, the extent and shape of potential judicial reform is uncertain.

But abrogation of the defense would be a mistake, particularly as concerns about patent quality echo in the U.S. Patent and Trademark Office (USPTO), the Congress, the courts, the practitioner’s office, and the media.

This essay argues that retaining the defense will help maintain the integrity of, and continuing public confidence in, the U.S. patent system. It sets forth specific recommendations for much-needed modifications designed to better serve the doctrine’s essential purposes, and to ameliorate the key problems with its current application. Although these changes can be implemented by the courts, legislative action would be more appropriate because the recommended modifications affect virtually every aspect of the doctrine, and because it is unlikely that a given case or series of cases will present appropriate facts for judicial treatment of all of these aspects of the doctrine in the near future.

Consideration of the reforms proposed herein, as well as of the proposals of others to reform or eliminate the doctrine of inequitable conduct,\footnote{Robert A. Armitage, Inequitable Conduct and Post-Grant Review: Why the Imperative to Eliminate the “Inequitable Conduct” Defense? What Relates Eliminating the Defense to Expanding Post-Grant Review?, 2009 Mid-Winter Institute Speaker Papers, AMERICAN INTELL. PROP. LAW ASS’N 18 (Jan. 29, 2009),} should be undertaken, however, with an understanding of
how the doctrine has changed and expanded in recent years. These changes have created or contributed to dissatisfaction with the current regime and to calls for reform. When considering proposed reforms, therefore, it is important to first review “how we got here.”

http://www.aipla.org/html/mw/2009/papers/Armitage-paper.pdf (“Like any ‘plague,’ there are a number of countermeasures that may have merit. Clearly, patent applicants are today undertaking many practices designed to immunize them from later allegations of inequitable conduct in patent enforcement . . . . [T]he immunization protocol—the defensive patent procurement practices of ‘over-disclosure’ and ‘under-explanation’—have cost the patent system dearly. Outright eradication would obviate the need for this type of immunization and its pernicious side effects.”); Melissa Feeney Wasserman, Limiting the Inequitable Conduct Defense, 13 VA. J.L. & TECH. 7, 16 (2008) (“I propose limiting the current inequitable conduct jurisprudence and providing a second tier of remedies for less offensive behavior. Inequitable conduct would be limited to cover only common law fraud. The defendant must have (i) failed to disclose or misrepresented material information with an intent to deceive and (ii) known of the materiality of the information not disclosed or misrepresented. My proposed heightened standard for inequitable conduct requires the defendant to have culpability not only with the intent to deceive but also with respect to the materiality of the omission or misrepresentation. This standard differs from the current inequitable conduct jurisprudence, as it abandons the Federal Circuit’s weighing of intent and materiality—a defendant must meet each bar, and the materiality of the omission or misrepresentation has no effect on whether the defendant has the requisite intent. Also, in contrast to the current jurisprudence, this heightened standard allows the subjective good faith of the accused to avert a finding of inequitable conduct.”); Katherine Nolan-Stevaux, Inequitable Conduct Claims in the 21st Century: Combating the Plague, 20 BERKELEY TECH. L.J. 147, 164 (2005) (“Reforms should be implemented to strengthen the inequitable conduct doctrine based on policy rationales, while lessening the doctrine’s effect on patentees who are unjustly forced to defend against it. Specifically, such proposals should decrease the number of unsubstantiated inequitable conduct charges and should encourage applicants to submit all relevant prior art references.”).

17 Aventis Pharma S.A. v. Amphastar Pharm., Inc., 525 F.3d 1334, 1350 (Fed. Cir. 2008) (Rader, J., dissenting) (“[R]ecently . . . the judicial process has too often emphasized materiality almost to the exclusion of any analysis of the lofty intent requirement for inequitable conduct. Merging intent and materiality at levels far below the Kingsdown rule has revived the inequitable conduct tactic.”); Ferring B.V. v. Barr Labs., Inc., 437 F.3d 1181, 1203 (Fed. Cir. 2006) (Newman, J., dissenting) (“The panel majority’s holding that deceptive intent is established as a matter of law if the applicant ‘should have known’ that information might be material to patentability, further revives the ‘plague’ of the past, with burdens that far outweigh any conceivable benefits.”); James E. Hanft & Stacey S. Kerns, The Return of the Inequitable Conduct Plague: When “I Did Not Know” Unexpectedly Becomes “You Should Have Known”, 19 NO. 2 INTELL. PROP. & TECH. L.J. 1, 1 (2007) (“The court is lowering the bar for when an inventor or attorney ‘should have known’ of the materiality of a fact or omission of fact, resulting in more findings of inequitable conduct ostensibly without the requisite scienter. If this trend continues . . . inventors and patent attorneys will need to be more diligent than ever to escape accusations of inequitable conduct or be punished years later for information that
II. RECENT DEVELOPMENTS: DOCTRINAL EXPANSIONS, PRACTICAL DILEMMAS

Recent Federal Circuit cases clearly manifest three significant, distinct lines of expansion in the substantive law of inequitable conduct. Each, independent of the others, tends to make unenforceability challenges easier and more likely to succeed. Combined, these developments pose an even greater threat to patent enforcement efforts and significantly increase prosecution-related information disclosure risks and burdens. It’s no wonder that owners, practitioners, and commentators are calling for change!

First, the Federal Circuit affirmed the viability of the older “reasonable examiner” standard for evaluating whether undisclosed or misrepresented information is material for inequitable conduct purposes. In so doing, the court acknowledged that the “new” Rule 56 standard is at least “arguably narrower” than the “reasonable examiner” standard. Accordingly, conduct that does not violate the current USPTO Rule 56 standard may well violate the “reasonable examiner” standard and be material for purposes of inequitable conduct.

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18 See Digital Control, Inc. v. Charles Mach. Works, 437 F.3d 1309, 1315 (Fed. Cir. 2006) (noting that “there is no reason . . . to be bound by any single standard” (quoting Am. Hoist & Derrick Co. v. Sowa & Sons, Inc., 725 F.2d 1350, 1363 (Fed. Cir. 1984)) (alteration in the original)). Under the “reasonable examiner” standard, “information is material where there is a substantial likelihood that a reasonable examiner would consider it important in deciding whether to allow the application to issue as a patent.” (interpreting 37 C.F.R. § 1.56(a) (1991)).

19 See Digital Control, 437 F.3d at 1315.
Therefore, a challenger need only satisfy the “reasonable examiner” standard to prevail on the issue of materiality.\textsuperscript{21}

Second, recent Federal Circuit decisions have expanded the categories of potentially material information. Information that is completely immaterial to substantive patentability, such as false statements in petitions to make special and misrepresentations relating to entitlement to small entity status, has been held material for purposes of inequitable conduct.\textsuperscript{22} Co-pending applications and the information they contain are other new categories of potentially material information.\textsuperscript{23} The Federal Circuit’s materiality and inequitable conduct rulings relating to co-pending applications, in particular, have prompted the adoption of detailed internal practice

\textsuperscript{20} 37 C.F.R. § 1.56 (2010). This rule defines “information . . . material to patentability” as follows:

[I]nformation is material to patentability when it is not cumulative to information already of record or being made of record in the application, and (1) It establishes, by itself or in combination with other information, a prima facie case of unpatentability of a claim; or (2) It refutes, or is inconsistent with, a position the applicant takes in: (i) Opposing an argument of unpatentability relied on by the Office, or (ii) Asserting an argument of patentability.

\textsuperscript{21} Id.

\textsuperscript{22} See, e.g., Scanner Techs. Corp. v. ICOS Vision Sys. Corp. N.V., 528 F.3d 1365, 1375 (Fed. Cir. 2008) (reaffirming that any false statement in a petition to make special that expedites an application is material for assessing inequitable conduct as a matter of law); Nilssen v. Osram Sylvania, Inc., 528 F.3d 1352, 1356 (Fed. Cir. 2008) (affirming the district court’s decision which held that Nilssen engaged in inequitable conduct by misclaiming small entity status and improperly paying small entity maintenance fees); Ulead Systems., Inc. v. Lex Computer & Mgmt. Corp., 351 F.3d 1139, 1146 (Fed. Cir. 2003) (holding that an unjustifiable claim of entitlement to small entity status and accompanying payment of insufficient maintenance fees was material as a matter of law); General Electro Music Corp. v. Samick Music Corp., 19 F.3d 1405, 1407 (Fed. Cir. 1994) (noting that the jury found this statement to be material and intentionally false based on evidence that the applicant’s “search” involved its attorney “ask[ing] numerous individuals in the piano design industry whether they knew of pertinent prior art designs and . . . search[ing] his own files for prior art.”).

\textsuperscript{23} See Lisa A. Dolak, The Inequitable Conduct Gyre Widens, 50 IDEA: J.L. & TECH. 215, 221-30 (2010) (describing the evolution of the co-pending applications disclosure requirement). In upholding a determination of inequitable conduct based on an applicant’s failure to disclose rejections and other information from co-pending applications, the Federal Circuit rejected the patentee’s argument that the disclosure of information in co-pending applications is a new requirement. See McKesson Info. Solutions, Inc. v. Bridge Med., Inc., 487 F.3d 897, 922-23 (Fed. Cir. 2007) (stating that “[T]he MPEP to which [the prosecuting attorney] would have referred while the . . . application was pending leaves no doubt that material rejections in co-pending applications fall squarely within the duty of candor.”).
procedures designed to facilitate the cross-citing of potentially material co-pending applications, office actions and other potentially material information, as practitioners and applicants strive to steer clear of misconduct allegations.  

Third, a number of the Court’s recent opinions evidence the application of a less rigorous deceptive intent analysis—less rigorous than some believe appropriate, at least. There are indications that at least some Federal Circuit judges are concerned about this development, and those concerns may lead or contribute, ultimately, to changes in the standard for establishing deceptive intent for inequitable conduct purposes. But this development has contributed to calls for reform.

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25 Benjamin Brown, Inequitable Conduct: A Standard in Motion, 19 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 593, 605-8 (2009) (“While Kingsdown has not been explicitly overruled, the post-2003 cases relaxing the intent standard indicate—especially when viewed alongside the Federal Circuit’s decision to maintain the “reasonable examiner” test—the Federal Circuit’s attempt to expand the scope of the inequitable conduct doctrine. Such expansion lies in sharp contrast to the limiting reform called for by the Patent Office and Legislature.”); Mitchell G. Stockwell, Zealous Advocacy Collides with Duties to the Tribunal and the Opponent, 949 PLI/PAT 593, 605 (2008) (“Two recent Federal Circuit cases, McKesson Information Solutions, Inc. v. Bridge Medical, Inc., and Aventis Pharma S.A. v. Amphastar Pharm., Inc., appear to relax the standard for showing intent sufficient to support finding inequitable conduct. In each case a strongly dissenting judge complained that the majority reverted to a lesser intent standard that may encourage opportunistic and unwarranted allegations of inequitable conduct.”).

26 See Lisa A. Dolak, Beware the Inequitable Conduct Charge! (Why Practitioners Submit What They Submit), 91 J. PAT. & TRADEMARK OFF. SOC’Y 558, 570 (Oct./Nov./Dec. 2009).

27 Chris Henry, Inequitable Conduct Inequitably Inferred: When Do Patent Applicants’ Actions Intend to Deceive?, 65 WASH. & LEE L. REV. 1159, 1162-63 (2008) (“[T]he Federal Circuit must adopt a heightened standard of objective recklessness for inferring intent to deceive... To establish intent to deceive in an inequitable conduct claim, in the absence of direct evidence of a subjective intent to
As discussed below, each of these aspects of the inequitable conduct doctrine should be modified. Other inequitable conduct-related reforms are also warranted. However, the inequitable conduct doctrine, appropriately tailored, is a valuable adjunct to the statutory and other boundaries supporting the critical innovation-competition policy compromise our patent system is intended to serve.

III. THE INEQUITABLE CONDUCT DEFENSE SHOULD BE RETAINED

Several fundamental realities militate against abrogating the doctrine of inequitable conduct. As discussed below, patent quality is widely perceived as lacking. Some applicants or their representatives do engage in egregious misconduct, and other existing and proposed enforcement mechanisms are deficient or problematic.

A. There is a crisis of confidence in the U.S. patent system.

If the recent press coverage of the patent system is an accurate reflection, patent quality is the most significant problem faced by the U.S. patent system. In fact, the importance of improving patent quality may be the only patent reform-related issue on which there is

deceive, an accused infringer should have to prove, by clear and convincing evidence, that a patentee acted objectively reckless.”); AIPLA, Patent Reform Bills Await Action as Congress Recesses, AIPLA REPORTS 4 (Aug. 7, 2007) available at http://www.aipla.org/Content/ContentGroups/About_AIPLA1/AIPLA_Reports/20074/070807AIPLAREports.pdf (“The state of mind element for both [patent reform] bills should be ‘knowing and willful deception’ rather than simply ‘intentional deception.’”).

28 See infra Part IV A-B.
29 See infra Part IV C-D.
30 Bernard Chao, Rethinking Enablement in the Predictable Arts: Fully Scoping the New Rule, 2009 STAN. TECH. L. REV. 3, 4 (2009) (“The primary goal of the patent system is to promote innovation without stifling competition.”); Stacie L. Greskowiak, Joint Infringement After BMC: The Demise of Process Patents, 41 LOY. U. CHI. L.J. 351, 357 (2010) (“[T]he patent system was carefully crafted to balance the interest in fostering innovation with the interest in avoiding monopolies that stifle competition.”).
inequitable conduct. Concerns about patent quality emanate from scholars, members of Congress, policy groups, practitioners, etc.


34 See, e.g., George S. Ford, Thomas M. Koutsky & Lawrence J. Spiwak, Quantifying the Cost of Substandard Patents: Some Preliminary Evidence 1 (Phx. Ctr. for Advanced Legal & Econ. Pub. Studies Paper Number 30, 2007), available at
consumer and industry groups, and government agencies—including the USPTO. Even the major party candidates in the last presidential election cited patent quality as a problem, particularly as it adversely

http://www.phoenix-center.org/pcpp/PCPP30Final.pdf (“Under plausible assumptions, we find that the economic losses resulting from the grant of substandard patents can reach $21 billion per year by deterring valid research with additional deadweight loss from litigation and administrative cost of $4.5 billion annually . . . .”); 21ST CENTURY REPORT, supra note 3, at 51 (“There are several reasons to suspect that more issued patents are deviating from previous or at least desirable standards of utility, novelty, and especially non-obviousness and that this problem is more pronounced in fast-moving areas of technology newly subject to patenting than in established, less rapidly changing fields.”).


affects innovation. But perhaps the most important and reliable indicator of the significance of the problem is the dissatisfaction of those who are most heavily invested in our patent system: the owners. In a 2005 survey of corporate members of the Intellectual Property Owners Association (IPO), 51.3% of responding members “rated the quality of patents issued in the U.S. today as less than satisfactory or poor . . . .”

And even if concerns about patent quality are overstated, it is clear, at a minimum, that quality is widely perceived as a problem. Abrogation of the inequitable conduct doctrine would only exacerbate this perception and, in some cases, result in illegitimate patent grants.

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40 Some worry that the proposed reforms are unnecessary and potentially harmful. See, e.g., Douglas E. Schoen, Editorial, Protecting U.S. Patents Should be Top Priority, BALTIMORE SUN, Feb. 21, 2008 at 17A (“[R]ather than overhaul the system that has fostered more than 200 years of technological breakthroughs, lawmakers ought to devote their energies to strengthening U.S. patents against the threats posed by foreign counterfeiters.”); Press Release, Biotech. Indus. Org., Study Finds Lack of Evidence to Support Draconian Efforts to Weaken Patent Rights (Jan. 31, 2008), http://www.bio.org/news/pressreleases/newsitem.asp?id=2008_0131_02 (citing study conclusions that “contrary to the assertions of the industry proponents of the pending patent reform legislation, the evidence contained in [the three reports most often relied upon] actually demonstrates that the current patent system is working well to promote innovation.”); Chief Intellectual Property and Licensing Officer for InterDigital Communications Bernstein Testifies on Patent Reform Before Senate Judiciary Committee, U.S. FED. NEWS, June 6, 2007, available at 2007 WLNR 20182540 (“In InterDigital’s view, claims [of a broken patent system with poor quality patents] are grossly exaggerated and dangerous in their potential impact on our patent system.”).

41 See Christopher Cotropia, Modernizing Patent Law’s Inequitable Conduct Doctrine, 24 BERKELEY TECH. L.J. 723, 753-62 (2009) (articulating how and why the inequitable conduct doctrine affects patent quality). In particular, Professor
There is no question that inequitable conduct allegations drain resources and inject uncertainty into litigation. And, no doubt, the defense is over-pled. But it is also undeniable that serious breaches of the duty of candor occur.

Furthermore, the reported determinations of inequitable conduct likely represent only a small fraction of the cases that involve credible evidence of inequitable conduct. A reasonable patent owner confronted with such evidence would presumably prefer to avoid a judgment of unenforceability and the expenses likely to be incurred in a futile enforcement attempt.
Thus, many, if not most, cases in which patent challengers adduce credible proof that the patent at issue was procured via misconduct settle before trial. And to the extent that the enforceability of other patents owned by the patentee could be jeopardized or called into question, the patentee may be even more motivated to settle. Accordingly, the inequitable conduct doctrine, like other defenses to patent infringement, curtails litigation in some cases, and presumably tends to function most efficiently where the evidence is the most compelling and the allegations the most meritorious. Eliminating the defense would lead to an increase in the instances of successful enforcement of patents procured through deception, and to a likely increase in attempts to mislead the USPTO.

C. Other proposed enforcement mechanisms are unsatisfactory.

It is not clear how some of those who advocate abrogation of the defense propose to deal with these consequences. Others suggest

46 Under certain circumstances, the Federal Circuit has held the connection between related patents to be sufficient to justify extending the reach of an unenforceability determination from one to another. See, e.g., Consol. Aluminum Corp. v. Foseco Int'l Ltd., 910 F.2d 804, 809-12 (Fed. Cir. 1990) (upholding a district court determination that unenforceability resulting from inequitable conduct committed during the prosecution of one patent extended to a patent claiming related subject matter and its two continuation patents); Fox Indus. v. Structural Preservation Pres. Sys., 922 F.2d 801, 803-04 (Fed. Cir. 1990) (determining that the duty of candor continues throughout a patent’s prosecution history and a breach of that duty can render unenforceable all claims from the same or related applications).

47 Because the doctrine seeks to affect the subjective decisions of practitioners, inventors, and application owners, it is not possible to measure the doctrine’s deterrent value. But it is illogical to assert or believe that there is no such effect.

48 See, e.g., John F. Lynch, “An Argument for Eliminating the Defense of Patent Unenforceability Based on Inequitable Conduct,” 16 AIPLA Q.J. 7, 10-12 (1988) (arguing that the doctrine should be eliminated because, among other articulated reasons, it is “subjective” and the concepts of materiality and intent are “vague”).

49 For example, it has been argued that the doctrine “has ceased to serve a useful purpose in our patent system” because “patent applications are no longer secret.” See, e.g., Hearings on H.R. 1908, supra note 4, at 43. However, some patent applications are still held in secrecy. 35 U.S.C. § 122(b)(2)(B)(i) (2006) (allowing patent applicants to “opt out” of the automatic pre-grant publication after eighteen months); William C. Rooklidge, Reform of the Patent Laws: Forging Legislation Reflecting Disparate Interests, 88 J. PAT. & TRADEMARK OFF. SOC’Y 9, 12 (2006) (stating that approximately 10% of patent applications are withheld from pre-grant publication). Beyond that, patent application publication does not guarantee that misconduct will come to light. For one thing, opportunities for interested parties to challenge bad patents in the USPTO remain limited. Shelby M. Knowles, Thomas E. Vanderbloemen, & Charles E. Peeler, Inter Parties Patent Reexamination in the United States, 86 J. PAT. & TRADEMARK OFF. SOC’Y 611, 612 (2004) (noting that inter partes reexamination invokes strict litigation estoppel rules, and an
that alternative existing enforcement mechanisms and doctrines would suffice to deter misconduct and protect the integrity of the prosecution system. But each of the alternatives has significant limitations. For one thing, not all misconduct which would undermine the integrity of the patent prosecution system would qualify the affected claims for invalidation.

For example, suppose that an applicant attends a conference and learns, during another’s presentation, of experimental results that undermine a patentability argument that has recently been made to the USPTO in his application. Assume further that the results are not themselves in a form which qualifies as prior art under 35 U.S.C. § 102; for example, assume the results were orally presented, but not included in any written materials published as of, or at, the conference. The presenter’s data are valid and credible, and interested party who loses an inter partes reexamination cannot later claim the patent is invalid if the asserted argument was raised or could have raised in the reexamination; Anna Mayergoyz, Lessons from Europe on How to Tame U.S. Patent Trolls, 42 CORNELL INT’L L.J. 241, 262-63 (2009) (observing that while reexamination proceedings concern only issues of novelty and obviousness, the USPTO does not have opposition proceedings similar to those in Europe which allow a broader contestable scope of issues, including patentable subject matter, enablement, and disclosure); Haitao Sun, Post-Grant Patent Invalidation in China and the United States, Europe, and Japan: A Comparative Study, 15 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 273, 310 (2004) (noting that issues available for consideration during reexamination are limited to those which raise a substantial new question of patentability and have not been seen by the examiner during prosecution). For another, even full-blown federal court litigation may not succeed in exposing prosecution misconduct. However, the threat of potential unenforceability may deter such activity.

See, e.g., 21ST CENTURY REPORT, supra note 3, at 122–23 (“If invalidity, disciplinary action, and reputational concerns are not sufficient deterrent to misconduct, other civil and even criminal remedies exist—antitrust, unfair competition, common law fraud, and tortuous interference. Moreover, since the creation of the inequitable conduct doctrine by the courts, other safeguards have been adopted by Congress and the USPTO to support the integrity of the patent system. These include third-party- and USPTO-initiated reexamination on withheld prior art, publication of pending applications, and third-party access to pending prosecution papers and the ability to submit material information.”).

This hypothetical is adapted from the facts of Monsanto Co. v. Bayer Bioscience N.V., 514 F.3d 1229 (Fed. Cir. 2008).

By specifying that, “[a] person shall be entitled to a patent unless” certain disclosures or events have occurred before the applicant’s invention or filing date, Section 102 delineates the information (i.e., publications and events) which qualifies as prior art for purposes of the novelty requirement. 35 U.S.C. § 102; see also Leanne M. Fecteau, The Ayahuasca Patent Revocation: Raising Questions about Current U.S. Patent Policy, 21 B.C. THIRD WORLD L.J. 69, 97 (2001) (noting that Section 102 does not include foreign prior knowledge, use, or invention as disqualifying prior art); Shayana Kadidal, Subject-Matter Imperialism? Biodiversity,
ultimately they are included in a “printed publication,” but the publication does not issue early enough to qualify as invalidating in a subsequent action to enforce the patent.

The applicant knows that the examiner, if told of the results presented at the conference, might not accept the previously-made patentability argument, and decides therefore not to reveal what he learned there. The applicant’s previously-submitted patentability argument persuades the examiner to issue the patent, but the issuance is unjustified under the circumstances. The patent is valid under the statute, but the applicant has violated his duty of candor, and the examiner would not have withdrawn her claim rejection had she had the opportunity to consider the applicant’s argument in light of the results presented at the conference.

More significantly, however, a pure validity-based regime—at least as the U.S. system currently operates—does not adequately police patent quality. First, there is good reason to question the adequacy of examination by the USPTO. The USPTO is struggling

Foreign Prior Art and the Neem Patent Controversy, 37 IDEA 371, 380 (1997) (“Prior foreign activity anticipates a U.S. patent only when the foreign activity is fixed in a tangible, accessible form such as by a description in a printed publication, or in a document related to either the applicant's own foreign patent . . . or some other person's foreign patent. However, prior foreign knowledge, use and invention are all excluded from the prior art related to a U.S. patent application.”).
to retain experienced examiners, and to cope with an increasingly challenging workload. These are among the factors contributing to concerns about patent quality.\(^{58}\)

Second, the enforcement “deck” is “stacked” in the patent owner’s favor. U.S. patents enjoy a statutory presumption of validity.\(^{59}\) In addition, challengers must overcome an additional, significant evidentiary hurdle: invalidity must be established via clear and convincing evidence.\(^{60}\) Furthermore, the presumption of validity and the heightened evidentiary standard apply even when the prior art on which the validity challenge is based was not considered by the USPTO while the patent application was pending.\(^{61}\) Thus, the judicial playing field is not level: patent owners enjoy the benefit of a significant evidentiary “headstart” when they embark upon enforcement.\(^{62}\) That some categories of prior art, such as prior public

\(^{58}\) See supra notes 29–36 and accompanying text.


\(^{60}\) See Iovate Health Sci., Inc. v. Bio-Engineered Supplements & Nutrition, Inc., 586 F.3d 1376, 1380 (Fed. Cir. 2009) (“Patents enjoy a presumption of validity . . . and a party seeking to invalidate a patent must overcome this presumption by facts supported by clear and convincing evidence.”). In contrast, the patent owner’s burden of proof on the issue of infringement is a preponderance of the evidence. Egyptian Goddess, Inc. v. Swisa, Inc., 543 F.3d 665, 679 (Fed. Cir. 2008) (“[T]he patentee bears the ultimate burden of proof to demonstrate infringement by a preponderance of the evidence.”).


\(^{62}\) The judge-made “clear and convincing evidence” requirement for validity challenges has itself been the subject of recent criticism. Pet. for Reh’g En Banc, Lucent Tech., Inc., v. Gateway, Inc. (2009) (Nos. 2008-1485, -1487, -1495) available at http://www.patentlyo.com/lucent_20petition.pdf (arguing that the invalidity burden of proof should be a preponderance of the evidence rather than clear and convincing evidence); B.D. Daniel, Heightened Standards of Proof in
uses and invention sales and offers, are not readily searchable further exacerbates the challenger’s disadvantage in some cases.

Accordingly, relying on the validity defense as insurance against unjustified enforcement of patent rights may not adequately protect accused infringers or the public. A challenger who does not succeed in overcoming the patent owner’s evidentiary advantages may well find itself subject to a money judgment or injunction under an invalid patent. And the public interest, for example, in opportunities to compete with the patent owner, or benefit from such competition by others, may also be adversely affected as a result.

Likewise, the potential for USPTO practitioner disciplinary action would deter or punish some, but not all, of the affirmative misrepresentations and willful omissions applicants might be tempted to make. In some cases, the misconduct is attributable to someone other than the patent attorney or agent, but only practitioners are subject to USPTO discipline. And other identified remedies—such

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63 See, e.g., 35 U.S.C. §§ 102(a)–(b).
64 See *Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.*, 324 U.S. 806, 816 (1945) (“A patent by its very nature is affected with a public interest . . . . [I]t is an exception to the general rule against monopolies and to the right to access to a free and open market. The far-reaching social and economic consequences of a patent, therefore, give the public a paramount interest in seeing that patent monopolies spring from backgrounds free from fraud or other inequitable conduct and that such monopolies are kept within their legitimate scope.”).
65 The conduct of inventors and other persons associated with the patent applicant can qualify as inequitable conduct. See, e.g., *Dippin’ Dots, Inc. v. Mosey*, 476 F.3d 1337, 1340, 1346 (Fed. Cir. 2007) (inventor submitted a sworn statement that initial sales of the ice cream were in March of 1988 despite selling the product starting in July 1987); *Pharmacia Corp. v. Par Pharm., Inc.*, 417 F.3d 1369, 1371, 1373 (Fed. Cir. 2005) (inventor submitted a 37 C.F.R. § 1.132 declaration that conflicted with a paper the inventor had co-authored, but failed to bring the paper to the attention of the examiner).
66 A review of precedential decisions of the Federal Circuit affirming inequitable conduct determinations during the period of January 2006 through August 2008 reveals that in six out of ten cases, the court attributed at least some of the misconduct in question to someone (e.g., an inventor) other than the patent practitioner.
67 35 U.S.C. § 32 (2006) (“The Director may, after notice and opportunity for a hearing, suspend or exclude, either generally or in any particular case, from further
as antitrust, unfair competition, common law fraud, and tortious interference claims— are affirmative claims for relief which require the proof of elements beyond those required to establish the defense of inequitable conduct.

Another proposed alternative mechanism would have transferred the authority to adjudicate most inequitable conduct charges to a new tribunal within the USPTO. However, at a time when the USPTO is under fire for how it carries out its existing responsibilities, it is not clear that creating a new enforcement bureaucracy inside the agency is advisable. Furthermore, there is no reason to believe that the USPTO is better qualified than the federal courts to apply the applicable standards for evaluating alleged applicant misconduct.

D. Applicants would not voluntarily elaborate on references.

The inequitable conduct doctrine has been criticized on the ground that it leads applicants and practitioners to disclose too much information to the USPTO during prosecution, and to refrain from

practice before the Patent and Trademark Office, any person, agent, or attorney shown to be incompetent or disreputable, or guilty of gross misconduct, or who does not comply with the regulations established under Section 2(b)(2)(D) of this title, or who shall, by word, circular, letter, or advertising, with intent to defraud in any manner, deceive, mislead, or threaten any applicant or prospective applicant, or other person having immediate or prospective business before the Office.

68 See 21ST CENTURY REPORT, supra note 3, at 122.
70 See supra notes 32–39 and accompanying text.
72 See, e.g., Steven R. Ludwig, Ted J. Ebersole & Donald J. Featherstone, U.S. Patent Reform and the Future of Nanotechnology, 20 THE LEGAL BACKGROUNDER NO. 37 (Wash. Legal Found., Wash., D.C.), Aug. 12, 2005, at 3, available at http://www.wlf.org/upload/081205LBLudwig.pdf (“The Patent Act of 2005 would transfer determinations of inequitable conduct to the USPTO. While many companies support decreasing litigation costs, many wonder whether such a transfer of jurisdiction achieves this goal. Moreover, the USPTO may not have the resources and investigatory procedures to properly develop evidence to competently rule on these issues.”).
explaining the relevance of the information submitted. The USPTO itself has decried such practices, asserting that they undermine the USPTO’s efforts to improve patent quality:

The USPTO has observed that applicants sometimes provide information in a way that hinders rather than helps timely, accurate examination. For example, some applicants send a very large number of documents to the examiner, without identifying why they have been submitted, thus tending to obscure the most relevant information. Additionally, some applicants send very long documents without pointing out what part of the document makes it relevant to the claimed invention. Sometimes applicants delay sending key information to the examiner. These practices make it extremely difficult for the patent examiner to find and properly consider the most relevant information in the limited time available for examination of an application.

Eliminating the doctrine could alleviate the “over-disclosure” problem, depending on what other information disclosure incentives and requirements would remain or be imposed.

However, abrogating the defense of inequitable conduct would not likely affect the extent to which applicants voluntarily comment on information they submit during prosecution.

Such characterizations can certainly ground inequitable conduct charges, although the Federal Circuit has, on several occasions,
turned back inequitable conduct challenges based on alleged applicant (or practitioner) mischaracterizations of prior art references.77 Nevertheless, applicants and the practitioners who speak on their behalf are understandably—and advisedly—reluctant to make such statements.78

However, aside from the risk of being accused of inequitable conduct, there are other good reasons to avoid unnecessary elaboration

information material to enablement), rev’d, 349 F.3d 1333, 1341–43 (Fed. Cir. 2003) (reversing the district court finding of inequitable conduct stating that the undisclosed subject matter had low materiality and little basis to infer intent to deceive and that their response to the obviousness rejection at most overemphasized the benefits of the invention and did not rise to the level of misrepresentation).

77 See, e.g., Life Techs., Inc. v. Clontech Labs., Inc., 224 F.3d 1320, 1325–27 (Fed. Cir. 2000) (holding that in allegedly mischaracterizing a reference, “the inventors merely advocated a particular interpretation of the teachings of the [reference] and the level of skill in the art, which the Examiner was free to accept or reject”); Gambro Lundia AB v. Baxter Healthcare Corp., 110 F.3d 1573, 1581–82 (Fed. Cir. 1997) (rejecting the defendant’s contention that the patentee’s mischaracterization of a cited prior art reference constituted inequitable conduct because the examiner had access to the reference at issue, and thus, the opportunity to “place [the applicant’s] comments in their proper context”).


Similar concerns were raised in response to the USPTO’s proposal (in its 2007 proposed rules relating to continuation applications and limits on the number of claims) to require applicants to submit “Examination Support Documents” for patent applications containing five or more independent claims, or twenty-five or more total claims. See, e.g., Letter from Michael K. Kirk, Executive Director, AIPLA, to Honorable Jon Dudas, Under Sec’y of Commerce for Intellectual Property and Director of the USPTO 14 (Apr. 24, 2006) [hereinafter AIPLA Claims Comments], available at http://www.uspto.gov/web/offices/pac/dapp/opla/comments/fpp_claims/aipla.pdf (“[T]his requirement [to submit an ESD] makes the applicant an easy target for an inequitable conduct charge in an enforcement action.”).
during prosecution.\textsuperscript{79} As a result, careful applicants and practitioners can be expected to avoid voluntarily elaborating during prosecution, including regarding information they submit to the USPTO.\textsuperscript{80}

IV. RECOMMENDATIONS FOR REFORM

For the above reasons, eliminating the inequitable conduct doctrine would be bad policy. However, that the doctrine should be revised is just as certain. But what change is appropriate? At a minimum, the following changes should be implemented.

A. Prosecution conduct should be judged in the courts by the standards which govern applicants and practitioners inside the USPTO.

Currently, patent owners are subject to different materiality standards in the USPTO and the courts. The Federal Circuit has not only declined to adopt the “new” Rule 56 materiality standard (thus denying accused practitioners and parties the comfort of its relative clarity), but has expressly reaffirmed its 1984 decree that no “single standard” will govern materiality determinations in the court’s inequitable conduct analysis.\textsuperscript{81} This decision effectively displaces the agency’s standard, except that, because of the consequences that may result from a court finding that a particular piece of withheld or omitted information was relatively more material,\textsuperscript{82} it adds complexity and expense to the litigation of inequitable conduct by encouraging accused infringers and forcing patentees to litigate the issue under both standards.

\textsuperscript{79} See, e.g., Thomas C. Fiala & Jon E. Wright, Preparing and Prosecuting a Patent That Holds Up in Litigation, 875 PLI/PAT 515 (2006) (“One of the hallmarks of a “bullet-proof” patent is a silent prosecution history. This is because arguments in favor of patentability made on the record during prosecution can come back to haunt the patentee during litigation. For example, when such arguments characterize the claims, they may later be used during litigation to advance a narrow claim construction or even to support an assertion of prosecution history estoppel. Also, when such arguments characterize the prior art, they may be attacked as misleading and thus used to support a claim of inequitable conduct.”).

\textsuperscript{80} See supra notes 73–75 and accompanying text.

\textsuperscript{81} Digital Control Inc. v. Charles Mach. Works, 437 F.3d 1309, 1315 (Fed. Cir. 2006) (citing Am. Hoist & Derrick Co. v. Sowa & Sons, Inc., 725 F.2d 1350, 1363 (Fed. Cir. 1984) (“There is no reason . . . to be bound by any single standard . . . .”)).

\textsuperscript{82} See infra Section IV D.
Congress should redefine materiality with a standard that binds both the courts and the USPTO, and that standard should be at least as specific and objectively determinative as the current Rule 56 standard.

**B. Only conduct which undermines the integrity of the prosecution process should qualify for judicial sanction.**

Under current law, inequitable conduct charges can be based on information completely immaterial to patentability. For example, in *Ulead Systems, Inc. v. Lex Computer & Management Corp.*, a split panel of the Federal Circuit held that an unjustifiable claim of entitlement to small entity status and accompanying payment of insufficient maintenance fees was material as a matter of law. And in *General Electro Music Corp. v. Samick Music Corp.*, the Federal Circuit upheld a jury finding of materiality based on a statement—found false—that a “search” had been made in a petition to make special.

Thus, *Ulead* and *General Electro* support the general proposition that inequitable conduct can be based on gaining an advantage before the PTO if the gain is based on a deceitful misrepresentation. Instead, the qualifying conduct should be limited to acts which undermine the substantive examination function of the USPTO—conduct which, objectively viewed—could reasonably have induced the USPTO to err in the application of a substantive patentability requirement, i.e., novelty, nonobviousness, utility, statutory subject matter, or compliance with the disclosure or definiteness requirements of Section 112.

**C. The evidentiary standards governing intent findings should be revised.**

The Federal Circuit’s inequitable conduct intent prong jurisprudence has, of late, been the target of increasing criticism.

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83 351 F.3d 1139 (Fed. Cir. 2003).
84 Id. at 1146.
85 19 F.3d 1405 (Fed. Cir. 1994).
86 Id. at 1411.
87 For example, maintenance of an issued patent, *Ulead*, 351 F.3d at 1139, or early issuance, *Gen. Electro*, 19 F.3d at 1405.
88 See e.g., Ferring B.V. v. Barr Lab., Inc., 437 F.3d 1181, 1202–03 (Fed. Cir. 2006) (Newman, J., dissenting) (“[T]here is a wide gulf between a rule that intent ‘may’ be inferred by a jury upon consideration of all the circumstances, in accordance with *Kingsdown [Med. Consultants, Ltd. v. Hollister, Inc.*], 863 F.2d 867 (Fed. Cir. 1988)], and a rule that intent ‘must’ be inferred as a matter of law against a
The split panel’s decision in *Ferring B.V. v. Barr Laboratories, Inc.*\(^8\) is the focal point of much of the criticism,\(^9\) and with good reason. In *Ferring*, the determination of inequitable conduct was based upon withheld information not directly bearing on substantive patentability which the majority held the applicants “knew or should have known” and which was regarded as “highly material,” thus justifying an inference of deceptive intent.\(^9\) Moreover, the majority upheld the district court’s conclusion that there was no genuine issue of fact as to any of this.\(^9\)

*Ferring* thus exemplifies the type of inequitable conduct “snowball” that can result under recent Federal Circuit interpretations. Notably, the court appears to be cognizant of the problem. In an August 2008 inequitable conduct decision, *Star Scientific, Inc. v. R.J. Reynolds Tobacco Co.*,\(^9\) the panel emphasized that a “district court may infer facts supporting an intent to deceive from indirect evidence. But no inference can be drawn if there is no evidence, direct or indirect, that can support the inference.”\(^9\)

Admittedly, whenever subjective intent is at issue, the lines that separate reasonable inferences from conjecture are not always easy to
draw. For this reason, a renewed and invigorated emphasis should be placed on carefully evaluating evidence of good faith proffered by the patentee.

In this regard, the most important directive in *Star Scientific* is this:

[I]nferences drawn from [less-than-clear-and-convincing] evidence cannot satisfy the deceptive intent requirement . . . . Further, the inference must not only be based on sufficient evidence and be reasonable in light of that evidence, but it must also be the single most reasonable inference able to be drawn from the evidence to meet the clear and convincing standard.  

A firm resolve on the part of the courts to carefully observe this dictate should go a long way toward limiting erroneous deceptive intent findings and affirmances.

However, because so much is at stake, and the risk of error associated with discerning subjective intentions so great, the Federal Circuit (or Congress) should go further and adopt what is in effect a presumption of good faith on the part of the practitioner or inventor in question. In particular, where the patentee offers a plausible alternative explanation for the allegedly deceptive conduct, a finding of deceptive intent should be precluded. For one thing, this would significantly limit the situations where inequitable conduct could be established based upon the actions of an inventor or other non-practitioner who credibly asserts that he or she did not know the applicable law.

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95 Id. at 1366–67 (emphasis added) (citing Scanner Techs. Corp. v. ICOS Vision Sys. Corp., 528 F.3d 1365, 1376 (Fed. Cir. 2008) (“Whenever evidence proffered to show either materiality or intent is susceptible of multiple reasonable inferences, a district court clearly errs in overlooking one inference in favor of another equally reasonable inference.”)).

96 On several occasions, the Federal Circuit has upheld inequitable conduct determinations even where the misrepresentation or omission has assertedly resulted from an inventor’s (or other non-practitioner’s) unfamiliarity with relevant law and the practitioner’s unfamiliarity with the relevant facts. See, e.g., Novo Nordisk Pharm., Inc. v. Bio-Tech. Gen. Corp., 424 F.3d 1347, 1361–62 (Fed. Cir. 2005) (“Thus, Novo asks us to hold, on the one hand, that the failure of Dr. Christensen and his co-inventors to disclose the truth about Example 1 to Novo’s attorneys absolves them of their duty to disclose this information to the PTO or the Board, because without their attorney’s consultation, they could not have known that this information was material. At the same time, Novo asks us to hold that its counsel’s failure to disclose the truth about Example 1 to the PTO or Board is excused because the inventors failed to fully inform them of the details surrounding Example 1. As we have done in similar situations in the past, we reject the ‘circular logic’ of this request.”); Brasseler, U.S.A. I, L.P. v. Stryker Sales Corp., 267 F.3d 1370, 1380,
Importantly, however, successful implementation of a more rigorous intent standard, whether imposed by or on the Federal Circuit, would depend on the commitment of the Federal Circuit to speak with one voice. Panels must strictly observe the “Rule of Newell” and resist the temptation to articulate new and different formulations of the governing standards. Non-panel members must aid their colleagues by carefully scrutinizing precedential opinions before they issue, and take steps to prevent the issuance of opinions that relax or undermine what should be a very exacting standard.

D. Courts should abandon the materiality-intent balancing inquiry.

It is black-letter law, recently reinvigorated by the Federal Circuit, that district courts must undertake an equitable balancing of the evidence of materiality and intent in a given case “to determine whether a finding that inequitable conduct occurred is warranted.” On many occasions, the court has explained how that balancing can affect the ultimate conclusion on the issue of inequitable conduct, namely, that where the materiality of the omission or misrepresentation is high, a lesser showing of intent is required.

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1385 (Fed. Cir. 2001) (rejecting as “circular logic” the patentee’s argument that it could not have known—without its attorneys’ assistance—that a pre-critical date sale was material, and that its failure to fully apprise its attorneys of the facts surrounding the sale absolves them, emphasizing that “inventors represented by counsel are presumed to know the law.”).

97 I.e., by Congress.

98 Newell Cos., Inc. v. Kenney Mfg. Co., 864 F.2d 757, 765 (Fed. Cir. 1988) (“This court has adopted the rule that prior decisions of a panel of the court are binding precedent on subsequent panels unless and until overturned en banc.”).

99 Novo Nordisk Pharm., 424 F.3d at 1359; see also Purdue Pharma L.P. v. Boehringer Ingelheim GmbH, 237 F.3d 1359, 1366 (Fed. Cir. 2001) (describing the two steps of the inequitable conduct analysis as “first, a determination of whether the withheld reference meets a threshold level of materiality and intent to mislead, and second, a weighing of the materiality and intent in light of all the circumstances to determine whether the applicant’s conduct is so culpable that the patent should be held unenforceable”); Manville Sales Corp. v. Paramount Sys., Inc., 917 F.2d 544, 551 (Fed. Cir. 1990) (“A threshold showing of both materiality and intent to mislead or deceive must be first established, and then those fact-findings are balanced to make the determination whether ‘the scales tilt to a conclusion that inequitable conduct occurred.’” (quoting J.P. Stevens & Co. v. Lex Tex Ltd., 747 F.2d 1553, 1560 (Fed. Cir. 1984))).

100 See, e.g., Bristol-Myers Squibb Co. v. Rhone Poulenc Rorer, Inc., 326 F.3d 1226, 1234 (Fed. Cir. 2003); Baxter Int’l Inc. v. McGaw, Inc., 149 F.3d 1321, 1328 (Fed. Cir. 1998).
As a practical matter, however, because varying degrees of materiality can often be discerned but direct evidence of deceptive intent is rarely available, this “balancing” inquiry almost exclusively serves to bolster intent findings and affirmances in certain cases. Thus, it exacerbates the problem of lax application of the intent standard.

Furthermore, balancing materiality and intent is not a necessary facet of a regime committed to drawing only the most reasonable inferences and fully crediting plausible good faith explanations. Materiality and intent should be entirely separate threshold inquiries, and remain independent of one another throughout the analysis.

Finally, de-coupling the materiality and intent prongs would not undermine the essential equitable nature of the inequitable conduct doctrine. Trial courts should continue to be authorized to use their discretion to evaluate the quality and quantity of the evidence of each to determine, on particular facts, whether a determination that inequitable conduct has occurred is warranted. Even under current law, such a determination does not necessarily follow from findings that material information was withheld or misrepresented with deceptive intent.101 But in appropriate circumstances, where materiality and intent are independently established by clear and convincing evidence, the inherent equitable authority of the federal courts to deny relief to those who enter the court with unclean hands should be preserved and respected.

E. Trial judges should be permitted to tailor the remedy to the circumstances.

The one-size-fits-all remedy of total unenforceability deprives the courts of the ability to tailor the “punishment” to the offense. Recent reform proposals would expand the possible remedies for inequitable conduct. For example, a recent legislative initiative would have authorized courts to impose “[one] or more of” several potential

101 See, e.g., Kemin Foods, L.C. v. Pigmentos Vegetales Del Centro S.A., 464 F.3d 1339, 1347 (Fed. Cir. 2006). In Kemin Foods, the jury, acting in an advisory capacity, had found that the president of the owner of one of the patents-in-suit had withheld a reference with intent to deceive the USPTO. The Federal Circuit, though, affirmed the district court’s determination that the patent was not unenforceable, on the ground that the reference “was not highly material and that the showing of deceptive intent was not compelling.” According to the court, “[e]ven when a court finds that the patentee failed to disclose material information to the [USPTO] and acted with deceptive intent, the court retains discretion to decide whether the patentee’s conduct is sufficiently culpable to render the patent unenforceable.”
remedies, including “[h]old[ing] the patent unenforceable,” “hold[ing] [one] or more claims of the patent unenforceable,” and “order[ing] that the patentee is not entitled to equitable relief and that the sole and exclusive remedy for infringement of the patent shall be a reasonable royalty.” Such flexibility would appropriately reflect the reality that some misconduct is more egregious and deleterious than other misconduct. And giving the courts the power to sanction misbehaving patentees without necessarily wiping out all of the claims of the patent at issue, would lessen the incentives for frivolous assertions of inequitable conduct, or at least undermine the leverage of those accused infringers who seek to take advantage of the distorting effects of inequitable conduct allegations in litigation.

Authorizing courts to select from a menu of potential sanctions would, of course, add its own complexity and expense to the litigation of inequitable conduct allegations. But if such flexibility were adopted in combination with other reforms, such as those discussed above, the result should be a reduction, overall, in the frequency and burdens of litigating the issue.

F. Patentees who prevail on the issue of inequitable conduct could be awarded attorney fees.

Finally, as a further deterrent to frivolous or nuisance prosecution misconduct allegations, it may make sense to implement a fee-shifting provision in favor of patentees who prevail on the issue, for example, an automatic award of inequitable conduct-related attorney fees to a plaintiff who prevails on inequitable conduct, regardless of whether the patentee wins on infringement and validity.

V. CONCLUSION

To the extent that calls to eliminate the inequitable conduct doctrine or strip the courts of the authority to adjudicate such allegations stem from dissatisfaction with aspects of the Federal Circuit’s jurisprudence, the appropriate solution is to hone the doctrine, by congressional dictate if necessary. Abrogation would be appropriate, on the other hand, if there were a consensus that the doctrine serves no purpose. Given that the primary impetus behind calls for elimination of the doctrine is the former, the patent system is best served by efforts aimed at achieving a well-designed, well-implemented inequitable conduct doctrine.

102 S. 1145, 110th Cong. (1st Sess. 2007).
# THE ROLE OF MARKET INCENTIVES IN KSR’S OBVIOUSNESS INQUIRY

Timothy J. Le Duc

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I. INTRODUCTION

KSR\(^2\) was a game changer in the realm of patent law. The decision heightened the standard for patentability by introducing several "common sense"-based obviousness rationales. Under KSR’s flexible approach, invalidating patents based upon the concepts of “obvious to try,”\(^3\) “predictable variation,”\(^4\) and just plain common sense\(^5\) have received the bulk of the limelight. However, developing in the background is the jurisprudence espousing KSR’s “design trends or market pressure” rationale.

Of course, the underlying premise of the patent bargain is to reward invention. Patent protection provides the financial carrot to research and develop new products.\(^6\) Stated differently, patents are by definition "a market-driven incentive to invest in innovation, by allowing the inventor to appropriate the full economic rewards of her invention."\(^7\) Therefore, the KSR Court's emphasis on "design incentives," "market forces," and demands "present in the marketplace" within the obviousness inquiry is arguably contradictory with the rationale behind the patent bargain.\(^8\)

The Court may have intended for the role of market incentives to be rather limited, such as confined to instances in which the patent-in-suit can fairly be characterized as a straightforward combination patent. However, since KSR, litigants have expanded the influence of marketplace demands via various successful obviousness arguments.

This paper analyzes decisions ruling claims obvious based upon KSR’s design trends or market pressure, and the interplay between market incentives and secondary considerations. As discussed in detail below, there has been a wide spectrum of factual scenarios in which claims have been invalidated as obvious using market incentives. Persuasive market-incentive arguments to date have been premised on, \textit{inter alia}:

- Predicting business trends;

\(^3\) \textit{In re} Kubin, 561 F.3d 1351 (Fed. Cir. 2009).
\(^4\) Boston Scientific v. Cordis, 554 F.3d 982, 991 (Fed. Cir. 2009).
\(^5\) Perfect Web Techs., Inc. v. InfoUSA, Inc., 587 F.3d 1324 (Fed. Cir. 2009).
\(^7\) \textit{Id}.
\(^8\) KSR, 550 U.S. 398.
• Identifying gaps in the marketplace;
• Market demand;
• Internet-related market pressure;
• Satisfying industry desires;
• Complying with environmental regulations; and
• Meeting customer specifications.

On the bottom of the spectrum, perhaps not all that surprising due to the perceived lack of true innovation, patents directed toward merely complying with new regulations or meeting design specifications have been invalidated. In the middle of the spectrum are decisions that primarily focus on gradual market changes, without any specific triggering event, such as government marketplace intervention. On the top of the spectrum are the more interesting decisions finding obviousness based upon the identification of market needs and prediction of business trends. The wisdom of these latter decisions may be questionable as arguably being counter intuitive in view of the purposes of the patent bargain.

The post-KSR decisions discussed herein further reveal that during litigation, patentees should now be mindful that secondary indicia of non-obviousness may also support a market-incentive obviousness theory. Specifically, courts have discounted evidence of actual commercial success—or even turned the tables on the patentee, using commercial success as an implicit admission that the claimed invention is an obvious solution to a consumer demand. Similarly, evidence indicating that the claimed subject matter remedies a long-felt need or received praise by the industry has been readily dismissed.

II. **KSR**'s FLEXIBLE AND EXPANSIVE APPROACH

For nearly fifty years, an evaluation of obviousness has required an inquiry into the four *Graham* factors: (1) the scope of the prior art; (2) the differences between the prior art and the alleged invention; (3) the level of ordinary skill in the art; and (4) any relevant secondary considerations. Originally, three factors were regarded as potential secondary considerations: commercial success, long-felt but unsolved needs, and the failure of others. Since *Graham*, additional factors

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have been considered, including copying, praise of the invention, unexpected results, general skepticism, and simultaneous development.\textsuperscript{11}

In 2007, the Supreme Court revisited the obviousness standard in the well-known \textit{KSR} decision.\textsuperscript{12} \textit{KSR} gives guidance that the inquiry should be expansive.\textsuperscript{13} The Court noted that helpful insights to a proper obviousness analysis do not necessarily require a rigid test.\textsuperscript{14} Rather, the distinctions between the need for human invention and the availability of current technology should caution against confining the obviousness analysis to a mandatory formula.\textsuperscript{15}

More importantly for the purposes of this analysis, \textit{KSR} laid the framework for a market-incentive type of obviousness theory. \textit{KSR} explains that in many fields, market demand may often drive design trends.\textsuperscript{16} A design available in one field can be prompted by “design incentives and other market forces” to adapt for use in another field.\textsuperscript{17} According to the \textit{KSR} Court, if there is a design need or market pressure to solve a problem to which there are a finite number of identified, predictable solutions, one of ordinary skill has reason to pursue the known options within his or her technical grasp.\textsuperscript{18} If patent protection is granted to minor adjustments in a design that would occur naturally without any true innovation, it can have the two-fold effect of frustrating true design progress and limiting the inherent value in prior inventions.\textsuperscript{19}

In \textit{KSR}, a claimed pedal was deemed obvious in view of the market incentive to convert from mechanical pedals to electronic ones.\textsuperscript{20} The \textit{KSR} Court stated that the Federal Circuit had considered the issue of motivation to combine too narrowly.\textsuperscript{21} Instead, a proper inquiry would have been to determine if a pedal designer of ordinary skill “facing the wide range of needs created by developments in the field” would have perceived an advantage in upgrading a mechanical pedal with an electrical sensor.\textsuperscript{22}

\begin{itemize}
  \item \textsuperscript{11} \textit{Id.} at 1039.
  \item \textsuperscript{12} \textit{KSR}, 550 U.S. 398.
  \item \textsuperscript{13} \textit{Id.} at 419.
  \item \textsuperscript{14} \textit{Id.}
  \item \textsuperscript{15} \textit{Id.}
  \item \textsuperscript{16} \textit{Id.}
  \item \textsuperscript{17} \textit{Id.} at 417.
  \item \textsuperscript{18} \textit{Id.}
  \item \textsuperscript{19} \textit{Id.} at 419.
  \item \textsuperscript{20} \textit{Id.} at 424.
  \item \textsuperscript{21} \textit{Id.}
  \item \textsuperscript{22} \textit{Id.}
\end{itemize}
In brief, KSR developed additional factors that a court may consider relevant to an obviousness inquiry. Although one litigant has argued that KSR requires a detailed analysis of twenty-one separate factors, a proper analysis should remain flexible and focus on the considerations pertinent to one’s situation.23 The flexible approach leaves litigants with freedom in crafting obviousness theories. Specific KSR-based arguments have characterized the claimed subject matter as nothing more than “common sense” or “obvious to try.”24 While not as prevalent, another off-shoot of KSR has been the substantial reliance on KSR’s market-incentive rationale in certain cases, either on the part of the accused infringer or the judicial body finding the claim(s) at issue obvious.

III. MARKET FORCES AS THE MOTIVATION TO COMBINE

Traditionally, the test for obviousness has included an analysis of the motivation to combine multiple prior art references—often with an eye toward an express teaching in the invalidating references themselves. KSR has given accused infringers permission to take a broader view of motivation to combine, expressly detailing that to determine whether there was an apparent reason to combine known elements in the way that the patent claims, it will often be necessary to look to at how the demands of the design field or those found in the market affect the need to adapt a design.25

Extensive technological development in a hot field may qualify as a market force indicating obviousness. For instance, patents covering internet-related subject matter have been ruled obvious based upon KSR’s market-incentive rationale.26 It is not hard to envision the same rationale being applied in the future to nanotechnology, green technology, or clean technology-related inventions. Additionally, at least one court already has found statements made by the patentee in

24 Id. at 1080.
25 KSR, 550 U.S. at 418.
the patent itself as a consumer demand type of admission indicating obviousness under KSR.27

_Dow Jones_ is an exemplary decision in which design need and market pressure supplied the motivation necessary to alter the prior art and render the claims obvious.28 There, the prior art used Hyper Text Markup Language (HTML) tags to affect the presentation of content, while the claimed subject matter used HTML tags to affect the location of content.29 Not surprisingly, it was undisputed that HTML tag functionality was well known.30 At the end of the day, modifying the internet-related prior art to include location-changing HTML tags was found to be obvious in view of market incentives.31

In making that determination, the _Dow Jones_ court substantially relied upon the evidence proffered by the patentee’s own expert, who noted that in the mid-1990s many companies worked with web developers in order to establish themselves on the internet.32 Both parties acknowledged that personalized formatting already existed in non-web programs.33 Finally, the patentee did not dispute that, prior to the patent, there was a widespread effort to “bring the established features of various computer programs to the web platform.”34 Design need and market pressure proved to be the main catalysts in the addition of location-changing HTML tags to the prior art—rendering the claims obvious.35

IV. MARKET-INCENTIVE OBVIOUSNESS THEORIES

In addition to _Dow Jones_, a number of other market-incentive obviousness theories have been successful since _KSR_. Detailed below, prevailing theories have reduced claimed inventions to the successful prediction of a business trend, identification of a gap in the marketplace, or design of a pre-established engineering specification.

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27 _Perfect Web_, 587 F.3d at 1329.
29 _Id._ at 35.
30 _Id._
31 _Id._
32 _Id._
33 _Id._
34 _Id._
35 _Id._; see also Alloc, Inc. v. Pergo, Inc., No. 02-C-736, 2008 WL 1968301, at *10 (E.D. Wis. May 1, 2008) (explaining that market changes and design trends provided the motivation to combine old elements to reach the claimed subject matter).
A. Predicting Business Trends

Friskit v. RealNetworks Inc., like Dow Jones, is another internet-related decision in which market forces provided the motivation to alter the prior art in order to achieve the claimed invention. In Friskit, the dispute focused around a streaming system, which allowed users to search and play online media content. Although the components of the claimed invention pre-dated the patents at issue, their application was restricted to streaming media.

The inventor proposed applying the search-and-playback capabilities to a streaming format. According to the patentee, the new feature of the invention was remote network control of a media player, such as via executable code transferred to the media player from a remote server.

However, conventional browsing with media players demonstrates the difference between remote operation and local user control. With programming tools such as Java, JavaScript, and many others in widespread use, the benefits of remote network control of applications being performed locally, and the methods for implementing such control, were well known at the time of the invention.

The secondary considerations presented were not persuasive. The patentee sought to show a long-felt need for, and that the prior art taught away from, the claimed invention. In particular, the patentee claimed that economic concerns discouraged software developers from creating on-demand media services. Developers of streaming media applications faced challenges such as (1) the risk of copyright infringement with the downloaded material, (2) the diminished sound quality of streaming media over dial-up services, and (3) a market centered on fostering consumer demand through increased compatibility. But none of the evidence suggested that anything

37 Id. at 1421.
38 Id.
39 Id.
40 Id. at 1422.
41 Id.
42 Id. (“Real touted the expanded functionality of its media player . . . [Real] noted that media content providers interested in offering “music on demand” over the Internet would be able to “plug their own interface” into the media player, [and] “embed instructions” into the data stream . . . .”)
43 Id. at 1423.
44 Id.
45 Id.
more than ordinary skill in the art was required for the patentee’s approach once the market forces shifted and created demand for streaming media applications.46

Rather, streaming media became a practical alternative soon after copyright owners recognized the substantial consumer demand for digital media content, and slow dial-up modem connections (along with their bandwidth limitations) gave way to high-speed internet connections.47 These market forces rendered the claims obvious. According to the Friskit court, the patentee’s ability to predict a business trend that had potential profitability was not sufficient to overcome the strong showing of obviousness present in the case.48

B. Filling Identified Market Gaps

In Rothman v. Target, an apparent gap in market offerings motivated the inventor to develop a nursing garment identified by the inventor.49 Following the birth of her first child, the inventor desired a nursing garment that would offer easy nursing access, conceal her stomach, and provide support.50 After determining that those requirements would not be met by any of the typical nursing bras on the market, the inventor embarked on designing her own garment.51

The inventive process lasted a couple of weeks,52 after which the inventor stitched together a prototype.53 The starting materials included an off-the-shelf tank top and nursing bra.54 The inventor combined these off-the-shelf products with additional fabric to arrive at a prototype.55

In the Court of Appeals’ view, the evidence demonstrated that one of ordinary skill in the nursing garment industry would have been motivated to combine a tank top with a nursing bra.56 During the late 1990’s, pregnant and nursing mothers had transitioned from relatively

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46 Id.; see Section V herein, for a discussion of other decisions in which market forces also trumped evidence indicative of a long-felt need under the rationale of KSR.
47 Id.
48 Id.
49 Rothman v. Target Corp., 556 F.3d 1310, 1315 (Fed. Cir. 2009).
50 Id.
51 Id.
52 Id.
53 Id.
54 Id.
55 Id.
56 Id. at 1319-20.
sedentary lifestyles and a preference for loose-fitting clothing to a more active lifestyle.\textsuperscript{57} Pregnant women were now exercising more frequently, exercising when they were nursing, and importantly, they were much more likely to want to show off that they were exercising.\textsuperscript{58} As a result, the market demanded apparel like the claimed invention.\textsuperscript{59}

Testimony was proffered to the effect that an ordinary nursing garment artisan would routinely look at design trends.\textsuperscript{60} An ordinary artisan would strive to provide his or her customers with products similar to those already on the market, but that also included any adaptations specifically made for nursing.\textsuperscript{61} In sum, the Rothman court found that the evidence of design trends and market demand provided the motivation to combine necessary to sustain the jury’s obviousness verdict.\textsuperscript{62}

\section*{C. Meeting Design Specifications}

In addition to Friskit’s predicting business trends and Rothman’s identifying market gaps rationales, successful market-incentive obviousness theories have been premised on achieving pre-determined design specifications. After \textit{KSR}, decisions have found an implicit motivation\textsuperscript{63} or outside impetus\textsuperscript{64} to alter the prior art to achieve the claimed invention. The courts in the cases mentioned below found claims obvious in view of market incentives associated with (a) amendments to industrial codes, (b) new environmental regulations, and (c) customer requested design changes.

\subsection*{i. Industrial Codes}

In \textit{Atlantic Works}, the Supreme Court enunciated the various policy concerns underlying the patent laws. The Court stated that the patent laws are designed to incentivize innovation, which moves technology forward. However, the Court also noted that the patent system is not intended to extend monopoly power to inventions that do

\begin{thebibliography}{99}
\bibitem{57} \textit{Id.} at 1320.
\bibitem{58} \textit{Id.}
\bibitem{59} \textit{Id.}
\bibitem{60} \textit{Id.}
\bibitem{61} \textit{Id.}
\bibitem{62} \textit{Id.}
\bibitem{63} Oatey Co. v. IPS Corp., 665 F. Supp. 2d 830, 871 (N.D. Ohio 2009).
\end{thebibliography}
not advance the useful arts or those that would be obvious to someone skilled in that art. Such a broad extension of monopolies would hinder the progress of technology rather than enhance it, as innovators would be hesitant to move forward lest they become encumbered in “concealed liens” and “unknown liabilities to lawsuits.”65 The flexible analysis of *KSR* hearkens back to the fundamental principles of *Atlantic Works*.66

In *Oatey*, the claimed subject matter related to washing machine outlet boxes—which typically include faucets and drains.67 The *Oatey* court found that the “obvious to try” doctrine was not inappropriate in this situation68 because the inventor was not randomly combining prior art possibilities.69 The court reasoned that the inventor’s rearrangement of faucet and drain ports in a washing machine would not require that he “vary all parameters” or try numerous combinations without any guidance from the prior art.70

Instead, the rearrangement of faucets and drains was intended to solve the problem posed by amendments to the plumbing codes, which required the use of elements of prior art and recognized norms.71 The court stated that while regulations establishing industry standards did not automatically make certain methods of compliance obvious,72 those methods might be obvious if the regulation inevitably led to them.73

The above reasoning of *Oatey* relied heavily upon the Federal Circuit’s *Erico* decision.74 In *Erico*, a substantial question of obviousness existed based on the combination of the prior art and the relevant industry standards.75 The claimed invention related to a hook for hanging telecommunications cables, and the Electronics Industries Alliance (EIA) had established certain spacing standards for such

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66 Id.
67 Id. at 865.
68 Id. at 871 (citing *In re Kubin*, 561 F.3d 1351, 1358-60 (Fed. Cir. 2009)).
69 Id. (“[R]e-arranging the pertinent elements in the [washing machine outlet box] was not an exploratory exercise in a ‘promising field of experimentation.’”(quoting *In re Kubin*, 561 F.3d at 1359)).
70 Id. (citing *In re Kubin*, 561 at 1359).
71 Id. (citing *KSR Int’l Co. v. Teleflex Inc.*, 550 U.S. 398 (2007)).
72 Id. (citing *Abbott Labs. v. Sandoz, Inc.*, 544 F.3d 1341, 1352 (Fed. Cir. 2008)).
73 Id. (citing *Erico Intern. Corp. v. Vutec Corp.*, 516 F.3d 1350, 1356 (Fed. Cir. 2008)).
74 *Erico*, 516 F.3d 1350.
75 Id. at 1356.
hooks. The *Erico* court found that the industry standards supported obviousness because they would implicitly guide someone of ordinary skill in the art to achieve the claimed subject matter.

Similarly, in *Oatey*, the pertinent plumbing standards required independent drain ports. As a result, the *Oatey* court likened the situation to that of *Erico*, finding that the amendments to the plumbing codes would provide the implicit motivation to identify the efficiency of combining the waste water that flowed through each drain port and to use a funnel method already developed to address that need.

ii. Environmental Regulations

In *Baldwin Graphic*, the claimed subject matter involved reduced air content cleaning fabric. All of the elements of the asserted claims were available in the prior art. In addressing whether it was obvious to combine them in the manner asserted, both parties agreed to an assertion of the adverse affects of highly volatile solvents on air quality. Prior to the patent-in-suit, in response to environmental regulations limiting the release of highly volatile solvents, companies had begun experimenting with low volatile organic compound (VOC) solvents on existing systems for cleaning printing presses. The patentee asserted that the experiments had little success because of the long evaporation time of the solvents. This reduced the quality of the printing because the excess moisture caused fogging and dripping in the press.

Discounting this theory, the *Baldwin Graphic* court held that the stricter environmental regulations supplied the motivation necessary to find the claimed invention obvious. The introduction of strict regulations was an outside impetus for those in the field to begin using the claimed solvents to clean printing presses. An identified

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76 Id.
77 Id.
78 *Oatey*, 665 F. Supp. 2d at 871.
79 Id.
81 Id. at *6.
82 Id.
83 Id.
84 Id.
85 Id.
86 Id.
87 Id.
problem needed a solution, and every part of the solution that was ultimately embraced was already known.88

Therefore, the Baldwin Graphic court found that it was simply a matter of time until each of the pieces was combined in the manner claimed.89 It should be noted that the “only a matter of time” rationale relied upon by the Baldwin Graphic court is reminiscent of KSR itself. For instance, the In re Omeprazole court characterized KSR as involving a design that was simply a natural solution to a problem that would have been discovered eventually because of the need and the limited number of solutions.90

iii. Engineering Design Changes

In Sparton, enhanced manufacturing efficiencies contributed to the market forces91 deemed necessary to provide the motivation to modify a prior art Navy sonobuoy.92 There, the only design step required to reach the claimed invention was to re-position various components, such as a weakened hinge line and parachute anchor slots.93 According to the Sparton court, the necessary specifications of the release plates for the Navy sonobuoys and the examples provided by the prior art made placement of these components an easier task.94 The patentee was so confident that its design change would be successful, it submitted an aggressive seven and a half month schedule to the Navy in which to both test the design at sea, and then manufacture hundreds of units.95

In an effort to maintain reduced component complexity, and facilitate simpler production, the Sparton court concluded that it would

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88 Id.
89 Id. at *7.
91 See also First Years, Inc. v. Munchkin, Inc., 575 F. Supp. 2d 1002 (W.D. Wis. 2008) (noting that altering a product to reduce manufacturing costs was obvious). At issue was whether creating a drinking container covered by the patent-in-suit to weigh less than a certain amount was patentable. Expert opinion was provided to the effect that it would have been obvious “to make the container weigh as little as possible in order to conserve material and reduce manufacturing costs.” Id. at 1026. Although this view could have been further developed, the Munchkin court found that it did identify market forces that would drive a common-sense design approach. Id.
93 Id. at 236.
94 Id.
95 Id.
have been obvious to use a sonobuoy with a weakened hinge line.\footnote{Id. at 237.} The overriding driving force of the claimed invention was the Navy’s interest in obtaining a sonobuoy that could detect deeper submarines.\footnote{Id. at 241.} Thus, the design demands of developing sonobuoys for the Navy substantially reinforced the case of obviousness presented.\footnote{Id. at 238.}

With respect to secondary considerations, any failure by the patentee’s competitors was not a failure nearly as much as the patentee asserted.\footnote{Id. at 240.} In addition to the patentee, the Navy also awarded Engineering Change Proposals (ECPs) to two other companies.\footnote{Id.} While the design of each competitor was never approved for full-scale production, the \textit{Sparton} court found that it was hardly accurate to say that neither competitor had actually failed to develop a design.\footnote{Id.} The patentee was wrong to suggest that the Navy’s rejection of a design was the same as its competitors’ failure to develop one in the first place.\footnote{Id.}

V. SECONDARY CONSIDERATIONS

Depending upon one’s perspective, facts that have historically favored non-obviousness may now also potentially be part of a market-incentive obviousness theory. Since \textit{KSR}, evidence of commercial success, long-felt need, and industry reaction have been discounted in certain circumstances. The decisions discussed herein suggest that \textit{KSR} may have severely diminished the impact of any secondary indicia during an obviousness inquiry, at least in the so-called predictable mechanical and electrical arts.\footnote{Cf. \textit{In re Kubin}, 561 F.3d 1351, 1360 (Fed. Cir. 2009) (indicating that the obviousness standard must be the same for all of the arts, and that there should be no differentiation between so-called predictable and non-predicatable arts—“This court also declines to cabin \textit{KSR} to the ‘predictable arts’ (as opposed to the ‘unpredictable art’ of biotechnology) . . . this court cannot deem irrelevant the ease and predictability of cloning the gene that codes for that protein. This court cannot, in the face of \textit{KSR}, cling to formalistic rules for obviousness, customize its legal tests for specific scientific fields in ways that deem entire classes of prior art teachings irrelevant, or discount the significant abilities of artisans of ordinary skill in an advanced area of art.”).}
A. Market Demand Versus Commercial Success

Over the years, commercial success has been viewed as the primary indicator of non-obviousness. The rationale being, at least in part, that a truly novel and worthwhile invention will contribute substantially to the arts, and presumably be met with an appropriate level of commercial success in the marketplace, as implicitly recognized long ago in Atlantic Works.104 Recently, some courts have downplayed the significance of commercial success, or even suggested that such evidence is indicative of obviousness under KSR, rather than non-obviousness under Graham.

Two of the recent decisions previously mentioned are illustrative. In Oatey, the patentee, while arguing commercial success, submitted evidence demonstrating that soon after it began marketing its product covered by the patent, customers of a competitor started demanding a similar design.105 This garnered the exact opposite reaction than that intended by the patentee. The Oatey court stated that although such a reaction by customers shows the effect of market demand on design trends, objective proof indicating these trends would not have evolved in the ordinary course of business was lacking, and thereby did not overcome obviousness in view of KSR’s rationale.106

In Baldwin Graphic, the commercial success of the patented product was undisputed.107 Evidence was also proffered indicating industry skepticism once the product was introduced.108 Further, it was the success of the patentee’s product itself that prompted the accused infringer to enter the market in the first place.109 Still, in light of the new environmental regulations, there was a market need for the claimed invention.110 Thus, the Baldwin Graphic court found that the market need was not a longstanding one. It was a need created by the new regulations, making its subsequent fulfillment obvious.111

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106 Id.
108 Id.
109 Id.
110 Id.
111 Id.
Whether the KSR Court intended for the lower courts to go this far during an obviousness inquiry is a question that the Federal Circuit may desire to address in the not too distant future—perhaps not only to provide for more consistency during patent litigation, but to also ensure that commercially successful ideas that are patented receive their just rewards. It should be noted that since KSR, the number of patent applications being filed in the U.S. has substantially decreased due to a variety of reasons, including the KSR decision itself, as well as the economic downturn.

B. Market Changes Versus Long-Felt Need

Similar to commercial success, evidence of long-felt need can play two differing roles. First, long-felt need may be evidence of non-obviousness. Second, if the other factors support obviousness, the presence of “market pressure to solve a problem” may indicate obviousness where there are a fixed number of possible solutions. The decisions discussed directly below illustrate the interplay between KSR’s market pressure and the secondary consideration of long-felt need. In both decisions, arguments that the claimed inventions provided enhanced efficiency, among other things, were unavailing.

i. Industry Development

In Perfect Web, the patent claimed a method of managing bulk e-mail distribution to groups of targeted consumers. There, the Federal Circuit found the patent-in-suit itself to include several implicit admissions related to industry development which contributed to the market-incentive obviousness finding.

In particular, the patent application was filed in early 2000, when the Internet was experiencing rapid development. The patent

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112 In KSR, the Court noted that the district court had discounted the commercial success of the patented pedal. KSR Int’l Co., v. Teleflex Inc., 550 U.S. 398, 413 (2007).
113 See, e.g., LizardTech v. Earth Res. Mapping, 433 F.3d 1373, 1381 (Fed. Cir. 2006) (noting that various dissents from the denial of rehearing en banc lamented the inconsistencies between certain Federal Circuit decisions related to the written description requirement, leaving district courts in the difficult position of attempting to reconcile the inconsistencies).
114 Shuffle Master, Inc. v. MP Games LLC, 553 F. Supp. 2d 1202, 1225 (D. Nev. 2008).
115 Id. (citing KSR, 550 U.S. at 421).
117 Id. at 1326.
further recognized that e-mail is a frequently used element of the Internet. The patent described “opt-in, bulk e-mailing” as a service where distributors access lists of customers who indicated a preference for specific types of commercial e-mail.

The claimed invention compared the number of successful e-mail message deliveries in a single delivery to a particular desired quantity. If the number of e-mails delivered did not reach the desired quantity, the invention repeatedly selected and e-mailed a group of customers until the desired number of successful deliveries was achieved.

When addressing secondary considerations of non-obviousness, the patentee argued that the invention solved a long-felt need and identified unique problems with conventional systems. Marketers were hit with unreimbursed expenses from sending additional e-mail messages to recipients and customers often opted out of e-mails because of these unnecessary messages. Of course, the repeated sending of e-mails was inefficient, costly, and counter-productive.

The Perfect Web Federal Circuit found that the patentee had failed to show that these problems were sufficiently long-felt or unmet to satisfy non-obviousness. Specifically, the patentee had failed to provide evidence regarding the issues of when the problem initially arose and how long the need had been felt. The evidence also failed to show that the patent met any such long-felt need. Instead, the patentee had merely asserted the patent’s efficiency over and above the previous systems. No data was proffered supporting the assertion that the patent reduced the superfluous costs and customer attrition that the patentee identified as both long-felt and unmet.

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118 Id.
119 Id.
120 Id.
121 Id.
122 Id. at 1332.
123 Id.
124 See id.
125 Id.
126 Id. (citing Tex. Instruments v. Int'l Trade Comm'n, 988 F.2d 1165, 1178 (Fed. Cir. 1993)).
127 Id.; see also Agrizap Inc. v. Woodstream Corp., 520 F.3d 1337 (Fed. Cir. 2008) (stating that despite a long-felt need for electrical rat traps, solving the problem was obvious under KSR).
128 Perfect Web Tech., 587 F.3d at 1333.
129 Id.
ii. Industry Desire

In *Hitachi Koki Co., Ltd. v. Doll*, a patent was issued covering a tiltable saw that performed certain kinds of cuts, including miter, bevel, and compound cuts. Two years later, the patentee surrendered the patent and filed a related re-issue application, which was finally rejected as being obvious—first by the Patent Office examiner, and then by the Board of Patent Appeals and Interferences. The patentee sought review by the D.C. District Court.

The patent described a desire to improve upon the low efficiency of the admitted prior art by redesigning the saw to prevent the motor from hitting the base while tilting the saw. However, the accused infringer provided testimony indicating that there had been an industry desire for a desktop saw that could make bevel cuts and pivot 45 degrees in either direction. The holder of the patent for a prior art reference voiced similar concerns about the conventional single-bevel design. Given these two instances of testimony indicating the inadequacy of the current art, one of ordinary skill would have likewise perceived a design need to alter a pre-existing saw assembly to reach the claimed invention.

The patentee asserted that its design solved a longstanding industry need for a dual-bevel desktop miter saw. In response, the *Hitachi* court noted that a market demand or need for an invention, by itself, does not indicate non-obviousness. To the contrary, market demand and need can lead to obvious improvements on current technology under *KSR*.

Further, non-obviousness cannot be met solely because time has passed without the invention.” The correct standard is whether the need is both long-felt and unsolved. If a need is long recognized, it permits the inference that artisans over time attempted to solve the

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131 *Id.* at 8-9.
132 *Id.* at 6-7.
133 *Id.* at 28.
134 *Id.*
135 *Id.*
136 *Id.*
137 *Id.* at 29.
138 *Id.* at 30.
139 *Id.*
140 *Id.* (quoting *In re Kahn*, 441 F.3d 977, 990-91 (Fed. Cir. 2006)).
141 *Id.* (citing *Monarch Knitting Mach. Corp. v. Sulzer Morat GmbH*, 139 F.3d 877, 884 (Fed. Cir. 1998)).
problem, but were ultimately unsuccessful. If there is actual documentation of these artisans’ failed attempts, such documentation would strongly support the inference that the patent shows “ingenuity beyond the compass of the routineer.” Thus, one attempting to prove non-obviousness must look beyond the mere existence of a need, and instead focus on how long the need has presented itself without any resolution to the problem.

The Hitachi court found that the patentee did indeed establish a six or seven year gap between the commercial introduction of single-bevel saws and the design of dual-bevel saws. Nonetheless, the patentee had failed to convincingly show that the power tool design industry had a long-felt but unsolved need for a dual-bevel saw. The testimony indicated that the power tool design industry failed to see “any articulated need” for a dual-bevel saw at Emerson Electric, one of the world’s largest manufacturers of power tools. During Emerson’s monthly product planning meetings, there was never any discussion of a project or a proposal for the development of a double bevel saw.

As a result, the Hitachi court found that the patentee’s evidence did not meaningfully rebut the testimony proffered by the accused infringer that an “industry desire” for a dual-bevel saw existed prior to the patent. Any perceived long-felt need for the dual-bevel saw was seriously undermined because the patentee’s single-bevel design was still commercially available.

In fact, the evidence demonstrated that the single-bevel saw was still commercially viable and not necessarily made obsolete by a dual-

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142 Id. (citing Dickey-john Corp. v. Int'l Tapetronics Corp., 710 F.2d 329, 346 (7th Cir. 1983)).
143 Id. (quoting Kirsch Mfg. Co. v. Gould Mersereau Co., 6 F.2d 793, 794 (2d Cir. 1925)).
144 Id.
145 Id. at 31; see also Oatey Co. v. IPS Corp., 665 F.Supp.2d 830, 872 (N.D. Ohio 2009) (noting that evidence indicated that the problem had lingered for a decade between the first amendment to the plumbing codes and patent issuance. However, plumbing supply distributors are loyal to a single manufacturer due to economic incentives at play—this, in turn, slows industry response time to problems that arise.).
147 Id. at 31 (citing Orthopedic Equipment Co., Inc. v. All Orthopedic Appliances, Inc., 707 F.2d 1376, 1382 (Fed. Cir. 1983)).
148 Id. at 31.
149 Id. at 31.
150 Id. at 31.
151 Id. at 31-32.
bevel design. Tool reviewers had a hard time picking a “winner” from among the saws tested. All of the saws worked well, and which particular model a customer selected depended entirely upon the customer’s individual budget and cutting requirements.

In sum, a mere “industry desire” under KSR was viewed as not rising to the level of a long-felt need traditionally recognized by patent law jurisprudence as indicative of non-obviousness. The Hitachi court apparently viewed the lack of discussion of the claimed subject matter at production meetings with the lack of a long-felt need for the claimed subject matter—the absence of a long-felt need not negating the obviousness case presented.

On the other hand, the Alloc court equated a discussion of the subject matter during various production meetings as an industry “movement” toward the claimed invention, indicating obviousness. There, evidence of a long-felt need morphed into the market-incentive rationale of KSR. Viewed together, it appears that a patentee would be wise to think twice before rushing into presenting any alleged long-felt need evidence, for any such evidence may be viewed as indicative of a seven-year industry desire for (Hitachi), or a movement towards (Alloc), the claimed invention.

C. Market Pressure Versus Industry Reaction

In Ex parte Jellá, the Board of Patent Interferences and Appeals downplayed evidence of favorable industry reaction to the patented invention. The claimed subject matter related to garage doors, and at issue was a claim reciting a layer of sheet metal with a twenty-eight inch finished height. The Board found that the claimed door section height was simply the substitution of one element commonly known in the field for another. The Board reasoned that there was suitable market pressure in the garage door industry to initiate design updates for the purpose of increasing sales. Numerous declarations submitted by the applicant acknowledged that the appearance of a garage door is a matter of great concern to customers and design professionals alike who wanted garage doors with appearances that

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152 Id. at 32.
153 Id.
156 Id. at 1010.
157 Id. at 1014.
158 Id.
differed from conventional doors. The inventor himself acknowledged that there was a market pressure for a new garage door.

Based on these unintended admissions, changing a conventional garage door from a four-panel section door to a three-panel section door was simply a predictable modification fueled by design incentives, with the expectation that the new appearance would increase sales. Of import, the Board held this to be an explicit demonstration of a design trend driven by market demand, relying expressly upon KSR's warning against granting patent protection to minor advances that would occur in the natural progression of things.

With respect to secondary considerations, declarations were submitted that the response to the new door had been “enthusiastic”, and provided comments touting “how uniquely different” it looked from other garage doors. The applicant further declared that the twenty-eight inch panel sections achieved the unexpected and desired results of improved aesthetics, easier and lower cost installation, and increased moisture resistance. The Jellá Board responded that evidence of non-obviousness for a utility patent cannot be shown by industry reaction to the aesthetic appearance of the claimed invention. 

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159 Id.  
160 Id. The inventor testified that the “garage door is a highly visible feature of a home. In many cases, the garage door comprises more than 60% of the homes [sic] front elevation. As such, its appearance is a matter of great concern for architects, developers, home designers, city planners, builders, and ultimately, the end user, for the entire life of the garage door. As steel overhead doors have flooded the industry, the need has arisen for a deviation from existing garage door designs. In other words, a garage door that looks different from the traditional raised panel steel garage doors that are currently inundating the market.” Id.

161 Id.  
162 Id.  
163 Id. at 1015 (indicating that members of the garage door industry “attested that they were skeptical that a steel garage door product with a twenty-eight inch section height would work satisfactorily because the size of the sections would be too big to move smoothly on the door tracks, and that they were surprised at how smoothly the door moved . . . .” However, the evidence of skepticism was held to have no connection to the claim language and was discounted).

164 Id. at 1016.  
165 Id.  
166 Id. The ornamental appearance of a product is the purview of design patent law. To allow secondary considerations to be based on industry reaction to the ornamental appearance of the claimed invention would be blurring the distinction between design and utility patent protection. For a utility application, objective evidence of secondary considerations should be tied to the functional aspects of the
VI. CONCLUSION

Under KSR, it has arguably become easier to invalidate patents, especially in the predictable mechanical and electrical arts. Of note, a number of litigants have successfully argued market-incentive obviousness theories. As discussed herein, claims have been found obvious in view of a wide spectrum of market-incentive based theories, including:

- *Dow Jones*’ internet-related design needs;
- *Friskit*’s business trend prediction;
- *Rothman*’s market gap identification;
- *Oatey*’s industry standards;
- *Baldwin Graphic*’s environmental regulations;
- *Sparton*’s customer specifications;
- *Perfect Web*’s industry developments;
- *Alloc*’s market changes;
- *Hitachi*’s industry desire; and
- *Jellá*’s market demand.

Certain holdings may be characterized as being less controversial under KSR. For instance, judicial bodies have viewed inventions that reduce operational costs or solve manufacturing waste as being the result of KSR’s strong financial incentives at work, not flash of genius. We have seen courts readily dismiss arguments that the claimed invention provided enhanced operational efficiency in both *Perfect Web* and *Hitachi*. Likewise, arguments of enhanced manufacturing and installation efficiency have been discarded, such as in *Munchkin* and *Jellá*.

More problematic from a policy standpoint may the Federal Circuit decisions in which claims have been ruled obvious as being a business trend prediction (*Friskit*) or a market gap identification (*Rothman*). Given that patents are a market-based incentive to develop new products, in the author's view, those visionaries that saw a market need and delivered a solution should be rewarded for their efforts with the limited monopoly that a patent brings, not denied patent protection.

Also difficult to reconcile with traditional patent law underpinnings are the decisions in which actual commercial success has been deemed indicative of KSR’s design trends or market claimed invention. See Cable Elec. Prod., Inc. v. Genmark, Inc., 770 F.2d 1015, 1027 (Fed. Cir. 1985).
pressure, such as in *Oatey* and *Baldwin Graphic*. More recently, now-Chief Judge Rader wrote a strong dissent in *Media Tech Licensing*, opining that “significant objective indicia of non-obviousness” was ignored because the subject matter of the patent—celebrity trading cards—was non-technical.\(^{167}\) Further, in *Hitachi*, evidence of a seven-year gap in the upgrade of commercial saws was coined a mere industry desire indicating obviousness, not a long-felt need.

In sum, *KSR*’s market-incentive rationale has been expanded to foreclose patent protection to those who identify future needs (*Friskit*) and exploit untapped niche markets (*Rothman*). Moreover, evidence of secondary considerations of non-obviousness has been either completely ignored (*Media Tech*) or transformed into indicia of obviousness (*Oatey, Baldwin Graphic, Hitachi*). If the goal is truly a strong U.S. patent system that promotes economical development and protects financially successful innovation, as the Court recognized in *Atlantic Works*, then perhaps in the near future, either the Court or the Federal Circuit will attempt to resolve some of the inherent inconsistencies of the expansive application of *KSR*’s market-incentive rationale with traditional notions of both patentability and secondary considerations.

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IT IS TIME FOR THE FEDERAL TRADE COMMISSION TO REQUIRE FINANCIAL PERFORMANCE REPRESENTATIONS TO PROSPECTIVE FRANCHISEES

Marvin E. Rooks

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I. INTRODUCTION

As our country moves beyond the recent years of financial and investment abuses fueled by greed and corruption—such as the Enron accounting scandal, Bernie Madoff and other Ponzi schemes, and the subprime mortgage housing crisis—the need for greater regulation and effective enforcement, as well as transparency in the financial community, have become vital issues. Burned by huge financial losses, the public clamors for reforms that will eliminate or at least mitigate similar calamities in the future. Although the country and Congress have their eyes glued on the banking industry and the investment sector, another popular and very pervasive business system begs reexamination in terms of appropriate governmental regulation. This is the ever-growing arena of franchising.

The most comprehensive recent estimate of the total economic impact of franchised businesses on the United States economy comes from the 2005 PricewaterhouseCoopers prepared study, The Economic Impact of Franchised Businesses. According to PricewaterhouseCoopers, in 2005 there were 909,253 establishments in franchise systems that provided 11 million jobs, which translates into 8.1% of all private-sector jobs. Thus, franchised businesses accounted for more jobs than were found in durable goods, manufacturing, financial activities, or construction, and had an economic output worth $880.9 billion, equaling 4.4% of all private-sector output. Combining this with the additional jobs and larger payrolls that result from franchise businesses and employees, which purchase products and services from other enterprises on both a professional and a personal level, the numbers swell to 21 million jobs (15.3% of all private-sector jobs) with an economic output worth $2.31 trillion (11.4% of all private-sector output).

Notwithstanding the significance this business system has on the U.S. economy and on the lives of U.S. citizens, there continue to be serious gaps in the regulation of the sale of franchises to prospective franchisees by the Federal Trade Commission (“FTC”), the governing body at the Federal level. These gaps have created opportunities for
serious financial abuse, have helped perpetuate ongoing fraudulent schemes, bad investments and hidden agendas, and have fostered serious misrepresentations about the viability of new franchised businesses, thereby causing significant injury to investors purchasing start-up franchises.

Although the FTC’s Franchise Rule requires pre-sale disclosure by franchisors to prospective franchisees of certain material information to assist the prospect in making an informed investment decision, surprisingly, the FTC fails to require the person selling the franchise (“franchisor”) to answer the most pertinent question that any prospective buyer of the franchise (“franchisee”) should ask, that is: “How much money can I reasonably expect to make operating the franchise, based on the experiences of the existing franchisees?” Although such a disclosure is of paramount interest to a prospective franchisee, the FTC, through Item 19 of the Franchise Disclosure Document (“FDD”), does not mandate such disclosure but rather merely makes disclosure of this information optional.7

For the improved health of the franchise industry—by rewarding profitable franchise concepts and weeding out the unprofitable ones—as well as the financial well-being of franchisees, it is imperative that the FTC correct this problem by making Financial Performance Representations (“FPRs”) a mandatory pre-sale disclosure requirement.

II. A REAL-WORLD SCENARIO BETWEEN ATTORNEY AND CLIENT

To illustrate on a practical level how this lack of information could affect an attorney and his or her client, let’s hypothetically step into the shoes of a successful commercial and business attorney. Because several of his commercial clients have been talking about expanding their business through franchising and a number of his individual clients are considering purchasing a franchise, he has become increasingly curious about the legal end of franchising, but has not yet delved into it.

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The attorney receives a phone call early Monday morning from Fred, one of his clients who attended a franchise sales show over the weekend. Fred relates that he is interested in a hobby shop franchise and has been given a lengthy document called a Franchise Disclosure Document by the franchisor’s salesperson. Fred said that he quickly perused the document and noticed, in Item 19 of the FDD, several paragraphs regarding financial performance representations. Fred asked the salesperson if this Item 19 tells him how the existing franchise outlets have performed financially over the past few years, thereby giving him an idea of what he may earn in the future. To Fred’s utter dismay, the salesperson said: “No, the purpose of Item 19 is to inform you that the franchisor does not make any FPRs, and that the FTC does not require us to make such claims or representations.” Fred asks his attorney the same question he posed to the salesperson: “How can I possibly consider buying a franchise when a franchisor does not, and cannot, provide me with the most important information I need to make a decision as to whether to purchase the franchise?” The attorney tells Fred that he cannot believe that this is the state of the law since it makes no sense, and intends to make some calls to determine how the sale of franchises is regulated.

III. CURRENT REGULATION OF FRANCHISES

The attorney discovers, as do all other attorneys who enter the world of franchising, that the sale of a franchise is highly regulated by the FTC and by a number of states. These regulatory bodies in essence require the franchisor to give a franchisee an FDD before the franchisor can sell the franchise to the franchisee.8 There are twenty-three categories of information about the franchisor and the franchise offering that must be included in the FDD.9 The guidelines as to what each of these items in the FDD must contain and disclose are contained in the 2008 NASAA Franchise Registration and Disclosure Guidelines (also referred to as the 2008 UFOC Guidelines or Amended and Restated UFOC Guidelines).10 Each item in the FDD contains representations by the franchisor that must be disclosed to a prospective franchisee, with the exception of what is, in the opinion of this author, the most important item—Item 19 pertaining to FPRs.11

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8 See generally id.
9 Id. at 15,545-46.
11 See Disclosure Requirements, supra note 7, at 15,546.
As the attorney investigates further, he learns that the term FPR, which replaced the term “earnings claim” in 2007, means “any representation, including any oral, written, or visual representation to a prospective franchisee, including a representation in the general media that states expressly or by implication a specific level or range of factual or potential sales, income, gross profits, or net profits.”\textsuperscript{12} To his dismay, however, the attorney discovers that his client’s concerns were correct. Under the present law, providing FPRs in Item 19 is merely an optional disclosure obligation. Franchisors are not required to provide potential franchisees with information pertaining to the financial performance of the franchise concept.\textsuperscript{13} Because of the optional nature of Item 19, only twenty-five to thirty percent of franchisors make an FPR in their FDDs.\textsuperscript{14} A recent publication of the American Bar Association Forum on Franchising stated that approximately seventy-five percent do not include FPRs.\textsuperscript{15}

IV. THE NATURE OF A FRANCHISE – COMPARISON TO RENTING A BUSINESS

While this would be a concern in any form of investment, the very nature of a franchise exaggerates the magnitude of Item 19’s permissiveness. If a person desires to start a business, such as a restaurant, he or she can go through the steps of starting a business from scratch or that person can “rent” an existing business or restaurant that has been developed by others. This idea of renting a business is the essence of a franchise. What does the franchisee actually rent or lease? He gets to use the name of the business. If it is a restaurant called McDonald’s, the franchise essentially gives him a license to use that name while the franchise is in effect. He also rents an existing business system, which is usually set forth in a training manual that describes operating procedures. For example, in the case


\textsuperscript{13} See Legal Symposium, supra note 12.


\textsuperscript{15} RUPERT BARKOFF ET AL., \textit{FINANCIAL PERFORMANCE REPRESENTATIONS: THE NEW AND UPDATED EARNINGS CLAIMS} xx1 (Stuart Hershman & Joyce Mazero eds., 2008).
of a restaurant, the manual would explain how to purchase food products and discuss the franchisor’s basic experience in running the business. In addition to licensing the use of the trade name or trademark, part of the rental or franchise package includes the franchisor’s agreement to provide training and assistance during the term of the franchise. In order to acquire this package, called a franchise, the franchisee pays an initial franchise fee to the franchisor and usually pays periodic royalties based upon a percentage of either gross or net income. It is not uncommon for the duration of a franchise to be twenty or thirty years.

The franchisee, upon entering into the franchise agreement, does not own the name of the business, nor does he generally own what is known as good will of the business. He is merely renting the business. At the termination of the franchise agreement, either through default or expiration of term, the franchisee must cease using the business name and essentially turn the business back over to the franchisor. In addition, the franchisee generally agrees not to compete with franchisor in the same type of business for a period of time.

Given the nature of a franchise, which includes elements of rental or lease arrangements, it is imperative that the prospective franchisee be provided with as many FPRs in Item 19 as possible; to make such FPRs optional, as does the present law, does not serve the best legal interest of either the franchisor or the franchisee.

V. PURCHASING A FRANCHISE WITHOUT AN FPR

Let’s focus in on the problem even closer. Fred sits down with a salesperson while at the franchise show. The franchisor usually hires such salesperson on a commission basis. One of the first questions that enters Fred’s mind is how well these hobby shops have done in the past, and what he can expect to make in the future if he works hard at the business. The salesperson has several options at this point. He can say: “Well, the sale of this hobby shop franchise is controlled by the rules of the FTC, and I would love to tell you about their financial performance, but the FTC just will not let me do it. Accordingly, we state in Item 19 of our FDD, which you have before you, that we do not make any FPRs.” Note that the salesperson intentionally misleads Fred by not telling him that the franchisor had the option of making an FPR, but has chosen not to do so. The salesperson may also choose to pull out the proverbial cocktail napkin or other piece of paper and start writing figures with his ballpoint pen, all the while telling Fred: “Now
I am not supposed to be giving you these figures, but you look like a
straight guy, and you need to know the facts, and here they are.” Or
an FPR may take a less explicit form, such as the salesperson pointing
to an expensive car outside and saying to Fred that: “You’ll be driving
that in no time.” Fred looks briefly at some numbers, which may or
may not be accurate, whereupon the salesperson retrieves the paper
from Fred’s hands and tosses it in the trash. Fred believes that he has
received certain FPRs, but there is no documentation or proof. Fred
leaves without the essential and reliable information that he needs in
order to make an intelligent investment decision as to whether to
purchase the franchise.

VI. A BRIEF SUMMARY OF THE HISTORY OF FEDERAL
AND STATE REGULATION AS THEY PERTAIN TO
EARNINGS CLAIMS AND FPRs

It is beyond the scope of this article to chronicle the history of
federal and state regulation of franchises. A recent publication of the
ABA Forum on Franchising offers a detailed history of federal and
state regulation of franchises, particularly as those regulations pertain
to earnings claims (now FPRs).16

Until 1970, there were no specific laws regulating the sales of
franchises. It was certain states and not the Federal Government that
first began regulating the sale of franchises. The ABA publication
describes the first franchise law adopted by the state of California in
1970, which is still in effect.17 The California law mentions earnings
claims and provides a procedure for their disclosure.18

In 1974, the Midwest Securities Commissioners Association
(“MSCA”) developed a set of guidelines entitled “The Requirements
for Preparation of a Uniform Franchise Offering Circular and Related
Documents” (the “UFOC Guidelines”) that were adopted September 2,
1975.19 This was in response to a number of states, primarily in the
Midwest, enacting franchise registration and disclosure laws.
Earnings claims were addressed in Item 19, which permitted

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16 Id. at 1.
17 Id. at 2 & n.4 (citing CAL. CORP. CODE §§31000-31516 (1977 & Supp. 2002)).
18 Id. at 2-3, n.7 (“The 1975 version of Item XIX stated in part: ‘If franchises
have not been in operation long enough to indicate what sales, profit or earnings may
result, then use of actual, average, projected or forecasted sales, profits or earnings is
prohibited.’”).
19 Id. at 3.
disclosure of actual or projected earnings claims based only on data from franchise units.20 “[T]he underlying data must have been prepared in accordance with generally accepted accounting principles (GAAP).”21

In 1977, the MSCA changed Item 19 by adding Item 19a, which became known as Alternative Item 19.22 Item 19a authorized franchisors to use company-owned or -operated outlets as the source of information upon which earnings claims could be based.23 Item 19a still did not enable start-up franchisors without company-owned units to provide earnings claims because the earnings claim still had to be based on the specific system's experience.24 At this point in time, very few franchisors were making earnings claims in their UFOCs, notwithstanding Alternative Item 19a.

The next significant regulatory action was the 1978 Franchise Rule promulgated by the FTC, which did not mandate, but merely permitted the disclosure of earnings claims.25 The disclosure requirements proved onerous, and the data supporting those earnings claims had to have been prepared with generally accepted accounting principles (GAAP).26 Franchisors found these requirements draconian and closed their eyes while cocktail napkins were being written upon with ballpoint pens.

There were other attempts to address earnings claims requirements, well-chronicled in the ABA publication, which led to the North American Securities Administrators Association (NASAA) adopting new Item 19 on November 21, 1986.27 The effect of new Item 19 required that an earnings claim have a “reasonable basis” and eliminated the requirement “that earnings claims be based on actual operating results of franchise or company-owned units.”28

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20 Id. at 3.
21 Id.
22 Id. at 4.
23 Id.
24 Id.
25 Id. at 11.
26 Id. at 3.
27 Id. at 3.
28 Id. at 7.
VII. FTC STAFF REPORT AND THE REVISED FTC FRANCHISE RULE

On August 25, 2004, the FTC released its “Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule.” The Staff Report stated that FPRs should remain voluntary, even though the report also stated that Item 19 was perhaps the most important anti-fraud disclosure. The Staff Report pointed out three main arguments against mandating Item 19, which are as follows:

1. The cost involved in requiring franchise systems to employ new accounting data collection procedures and review costs;

2. The difficulty and cost of standardizing a format for Item 19 and the complexity of gathering and comparing data; and

3. Liability issues that could be incurred by existing franchisees subject to potential liability for indemnification where inaccurate financial performance data is furnished to the franchisor.

The FTC stated that keeping Item 19 voluntary is a “free market” approach. As such, prospective franchisees, in theory, can find franchise systems that voluntarily disclose such information. “If prospective franchisees were to seek out such franchise systems, or demand the disclosure of such information from franchisors, ordinary market forces may compel an increasing number of franchisors to disclose earnings information voluntarily, without Federal government intervention.” History has shown that this has not happened.

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30 STAFF REPORT, supra note 29, at 158.
31 Id. at 162.
32 Id.
33 Id. at 159-60.
34 Id. at 160.
VIII. THE 2007 FRANCHISE RULE

After considering the 2004 Staff Report and other input, on January 22, 2007, the FTC approved the 2007 Franchise Rule with an effective date of July 1, 2007, and a mandatory compliance deadline of July 1, 2008. As will be noted below, the net effect of the 2007 Franchise Rule permits, but does not mandate, a franchisor to make FPRs. The FTC appeared to be moving in the direction of making it easier for a franchisor to make FPRs, but unfortunately, stopped short of mandating FPRs. Although the FTC did not diverge from its previous position on earnings claims, the ensuing 2007 Franchise Rule, which adopted the Staff Report, did make the following changes relating to earnings claims:

A. Changed the term “Earnings Claims” to “Financial Performance Representations;”

B. Reversed the FTC staff’s position that financial performance data be prepared according to GAAP. The FTC staff concluded that GAAP was only one way of presenting accurate historical performance information, and historical performance representations should merely be “reasonable;”

C. Recommended removal of cost and expense information from Item 19, and

D. Recommended the adoption of two preambles to Item 19. One preamble would be for franchisors making earnings claims, and the other would be required only if the franchisor did not make an FPR.

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35 See Disclosure Requirements, supra note 7, at 15,444.
36 Id. at 15,473.
37 Id. at 15,497.
38 Id. at 15,456.
39 Id. at 15,500 n.584 (“The first preamble reads: ‘The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.’”).
40 Id. at 15,500 n.585 (“The second preamble reads: ‘We do not make any representations about a franchisee’s future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either
The 2007 Franchise Rule defines an FPR as:

[A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.\(^{41}\)

The net effect of the 2007 Franchise Rule, as it relates to FPRs, is the advancement of the same thirty-year-old regulation, although dressed in new language and set in a different context. As of the date of this article, FPRs are permitted, but not mandated.

**IX. FPRs AS ADDRESSED BY THE FTC AND THE SEC**

The need for mandatory FPRs continues to grow and some experts have begun to speak out. In the fall of 2007, to celebrate the thirtieth anniversary of the ABA Forum on Franchising, the *Franchise Law Journal* invited all former chairs of the ABA Forum on Franchising to express their views on franchising.\(^{42}\) One of the questions asked of the panel was, “What is the biggest surprise in franchising in the past twenty years, was it positive or negative, and why?”\(^{43}\)

Shelley Spandorf, chairman of the ABA Forum on Franchising, from 1995-1997, answered the question as follows:

I was surprised when the FTC took up the idea of mandating that franchisors disclose earnings information and dismayed when it ultimately decided against it. In representing franchisors for almost thirty years, I have found UFOC Item 19 disclosure rules sufficiently flexible to allow franchisors to fashion a

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\(^{42}\) Shelley Spandorf et al., *Thirty Years of Franchising*, 27 FRANCHISE L.J. 85 (Fall 2007).

\(^{43}\) Id. at 99.
basic earnings claim so that they can capitalize on the disclosures marketing advantages. For some time even before the FTC began rule making on the amended Rule, I thought franchisee advocates made a sound case that earnings information is not only critical to an informed investment decision but also the single most important piece of information that prospective franchisees need to make a truly informed purchasing decision . . . . It has never seemed a good enough reason to deny prospective franchisees the critical information they seek because franchisors fear that revealing earnings information may subject franchisors to liabilities if franchisees fail to achieve the level of disclosed earnings or profits. Federal securities laws require issuers to make forward-looking statements in their prospectuses, which has not brought about a torrent of litigation from every disappointed stockholder. . . . When the benefits of mandatory earnings disclosures to franchisees are weighed against the cost of franchisors, I expected the FTC’s scale to tip in favor of changing the current voluntary system.44

Ms. Spandorf suggested a compelling case for mandatory FPRs by comparing FTC regulation of franchises to the SEC’s regulation of the sale of securities.45 When corporate stock is sold to an investor, prodigious requirements regarding financial representations are placed upon the company selling its stock. The SEC’s initial public offering (“IPO”) process for even a small company (less than $20 million in revenue) takes six to nine months and costs at least $100,000 in fees for legal, accounting, audit, printing, filing fees, and underwriter commissions.46 The SEC requires a company selling shares of its stock to virtually jump through hoops regarding disclosing financial representations relative to the company’s history.

This is a far cry from the permissive FTC disclosure requirements of FPRs by a franchisor to a prospective franchisee, despite the fact that franchisees may take significantly more risk in purchasing franchises than investors do in purchasing stock. A franchisee, upon the purchase of a franchise, generally pays an up-front fee, in many cases nonrefundable, which can be anywhere from $5,000 to $75,000,

44 Id. at 100.
45 Id.
or more. The franchisee will also be required to expend many thousands of dollars to acquire leases on property to conduct the business, make capital improvements, and hire employees, all of which must be disclosed in Item 7 of the FDD. If a franchisee signs a lease for the business premises and/or borrows money from a bank to finance the purchase of the assets to be used in the franchised business, in all likelihood, the franchisee must personally guarantee these obligations, thereby creating hundreds of thousands of dollars of personal liability. On top of the initial outlay of capital by the franchisee, he or she is also entering into a contract to establish the franchise with the franchisor, which can last twenty or thirty years.

X. THE MARYLAND EXPERIENCE REGARDING FPRS AS VIEWED BY A REGULATOR

From May 17-19, 2009, the International Franchise Association (IFA) held a legal symposium that included a session and written materials on “Advanced Financial Performance Representations: Preparing and Using Financial Performance Representations.”47 One of the authors of the paper was Peggy Shanks, a Senior Franchise Examiner with the Office of Attorney General - Division of Securities, Baltimore, Maryland. Ms. Shanks offered valuable insight in the paper included as “Regulator’s Notes.” Ms. Shanks included a disclaimer that the opinions and observations “are her own and do not necessarily represent the views of the Attorney General of Maryland or the Securities Division of the Maryland Attorney General’s office.”48 Ms. Shanks stated that:

[T]here is a trend toward including financial performance representations in FDDs . . . . [t]he amended rule is less restrictive. It is estimated that only 10% of franchisors included a financial performance representation (then known as earnings claims) in 1975. By 2002, the percentage had only risen to 20%. In 2007 and 2008, over 40% of franchisors that sought registration in Maryland provided a financial performance representation.49

47 Legal Symposium, supra note 12.
48 Id. at 1.
49 Id. at 2.
It is thus apparent from the Maryland experience that there has been an increase in the number of franchisors making FPRs. One can only conclude from this trend that those franchisors believe they are deriving benefits from making Item 19 disclosures.

XI. FITTING FINANCIAL INSTITUTIONS INTO THE FPR DILEMMA

One of the ironies regarding FPRs is that even those franchisors that do not make FPR claims in their FDD must often create and distribute those exact same numbers to the financial institutions of prospective franchisees seeking financing to purchase the franchise. Unless a franchisee has sufficient personal capital for the franchise fee and the total initial investment to purchase, construct, and open the franchise, he may seek a loan from a bank (usually to be guaranteed by the Small Business Administration) to fully fund the franchisee's investment. In the process of a bank performing its due diligence, it will not make a loan to the prospective franchisee without first getting an FPR of the franchisor. If the franchisor wants to sell a franchise, it will furnish the FPR directly to the lending institution. Neither the franchisor nor the lender, however, is required to forward such numbers to the prospective franchisee without exposing the franchisor to a claim of making an illegal FPR to the prospective franchisee. Ultimately, the franchisee may find out how solid these numbers are based on the bank's reaction to granting the loan, but chances are good that the franchisee will never directly see the numbers. Given the number of SBA loans involving franchises, it is clear that many franchisors have FPR data, but are unwilling to share it with prospective franchisees through an Item 19 FPR.

While industry-wide failure rates on franchisees are not available, this author was able to get a clear snapshot of such failure rates from those franchisees who obtained SBA guaranteed loans. The SBA released failure rate information of franchises in which at least ten franchisees have outstanding SBA loans. The failure rate reported was based on defaulted loan failure rates by franchise brand from October 1, 2000 until September 31, 2008, which totaled 399 franchisors. Additionally, FRANdata, a franchise information and document retrieval firm in Arlington, Virginia, was gracious enough to provide

further information on those 399 franchisors concerning whether they had made an Item 19 FPR.

The data showed that those franchisees that were not provided an Item 19 FPR were more likely to default on their SBA loan.51 A “risky franchise opportunity” is defined as a franchise program with over a 35% default rate of its franchisees.52 Only 23% of these “risky” franchisors had made an Item 19 FPR.53 In contrast, of the “safest” franchise programs, defined as a franchise program with a 10% or less default rate, 67% of these franchisors had made an Item 19 FPR.54 Thus, there is an interesting and direct correlation between those franchisors that made an Item 19 FPR, and the safety of the franchise opportunities they represent. It can be fairly surmised that those SBA loan recipients who purchased a franchise benefitted from an Item 19 FPR.

process in order to derive the increased franchisee SBA loan failure rate of those whose franchisor did not make an Item 19 claim versus those whose franchisor did make such a claim (all computation data sheets are on file with author). The three-step process is as follows:

1. The SBA released the failure rate of all the loans given to franchisees of individual franchises (minimum ten distinct loans). The franchise industry website BlueMaumau is a source for such a list. (http://www.bluemaumau.org/6812/2008s_sba_loan_failure_rates_franchise_brand)

2. The franchise analytic company, FRANdata (www.frandata.com), then was able to provide the information of whether or not each of the distinct franchisors listed in the SBA default list did or did not provide an Item 19 claim in their FDD. This was done pro-bono as the information is to be used for educational/research purposes only.

FRANdata's business is turning vast amounts of data into information that helps businesses make better decisions. FRANdata is the franchise industry's source for objective information and analysis. With the world's largest repository of franchise information, an experienced staff of franchise specialists, and a genuine commitment to objective research and analysis, FRANdata stands alone as the franchise world's information source.

3. By cross-referencing the SBA default data with franchisor's Item 19 claims, I was able to statistically compute how the Item 19 claims factored into the failure rate of franchisees. In short, the overall SBA failure rate of those franchisees of franchisors which did make an Item 19 claim was 11.07%, versus a failure rate of 17.28% for those franchisees of franchisors who did NOT make an Item 19 claim.

Therefore, a franchisee is 56.11% more likely to default on a SBA loan when the franchisee is working with a franchisor who did not make an Item 19 claim versus a franchisor that did make such a claim.

51 Id.
52 See id.
53 See id.
54 See id.
Another metric to show how much riskier an investment is for a franchise opportunity where no Item 19 FPR is made is based on the overall default rate of such opportunities. The SBA default rate for those franchise opportunities that did not make an Item 19 FPR is 17.28%, while the default rate for franchise opportunities that did make an Item 19 FPR was 11.07%. Therefore, based on SBA guaranteed loans, a franchisee was 56.11% more likely to default in his or her loan when purchasing a franchise from a franchisor that did not make an Item 19 FPR, compared to franchisee purchasing a franchise from a franchisor that did make an Item 19 FPR. This higher default rate is significant, and supports the theory that franchise opportunities that do not make an Item 19 FPR are riskier, while strengthening the argument in favor of an Item 19 FPR becoming mandatory for transparency.

XII. COMMON OBJECTIONS BY FRANCHISORS TO MANDATORY FPRS

It is necessary to examine the objections asserted by franchisors to mandatory disclosure of FPRs, which are well-chronicled in many franchise publications, such as the Franchise Law Journal. The remainder of this article will be devoted to addressing and refuting these “red herring” objections.

A. Increased Costs

One of the principal objections against mandatory FPRs cited by the FTC and others is the increased cost to the franchisor to assemble the data. Ignored by the argument are the costs prospective franchisees incur in developing their own data without the benefit of the actual information in the possession of the franchisor. However, in 2007 and 2008, over forty percent of franchisors that sought registration in Maryland provided an FPR, according to Ms. Shanks. While it is true that there would be additional costs to a franchisor in making an Item 19 FPR, cost is only relevant when compared to the benefits. Even though making an FPR may be more costly and time-consuming to the franchisor, the extra time and expense are worth the

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55 See id.
57 Legal Symposium, supra note 12, at 12.
58 Id. at 15.
effort, with benefits to both the franchisor and the prospective franchisee. There are some obvious benefits to a franchisor for making a financial representation.

First, the prospective franchisee is going to gather information pertinent to whether he or she can make money with the franchise. In a 2007 decision, the FTC voiced that it is aware of investors’ natural inclinations to educate themselves before any investment and points to a myriad of resources an investor can utilize to gather an investment projection on earnings. Without an Item 19 FPR, however, an investor is forced to become a detective in order to gather relevant investment data and inspect not only the 100-plus pages of information the FTC does mandate in the FDD, but also the other outside sources, including the initial investment costs and certain other ongoing costs. For each prospective individual franchise investment, an investor will need to look at information such as: the number of years the franchisor has been in business, any pending litigation (of franchise company or its owners), and/or direct interviews with existing and former franchisees. Additionally, the investor can hire outside agencies that specialize in FDD analysis or pay an accountant to prepare a business plan including a financial forecast. The most reliable information, however, should come from an Item 19 FPR that serves as a foundation upon which all further analysis is based.

An analogy can be made to new automobiles. Imagine if automobile manufacturers no longer listed mileage per gallon on the windows due to their complaints about the costs and liability associated with formulating that number. Without such transparency, it would put the responsibility on the prospective buyer to guess the MPG based on size, engine, etc., or would force a buyer to interview other car owners to get their estimates. Such a system would create extra, inadvertent upfront costs and time that each buyer would have to invest in order to educate themselves before such a large purchase.

Second, the franchisor would benefit in making an Item 19 FPR by marshalling the information in one place: Item 19. This would give the franchisor more control over financial information disseminated about its business, as opposed to forcing a prospective franchisee to gather the information piecemeal from other sources.

A third benefit to the franchisor that would justify the cost of an Item 19 FPR is its use as a sales tool. From the seller’s perspective, it is easier for a salesperson to close the deal if allowed to answer that

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initial question as to potential earnings, particularly if there is good news to tell.60 “We don’t have anything to hide, and here it is in black and white.”

B. Potential Liability of Franchisors for Incorrect Information

Another common objection to mandatory FPRs is the potential liability that could be incurred by franchisors if the information provided does not meet the standard of reasonableness required by the 2007 Franchise Rule, or is simply incorrect. This fear, however, has proven to be unfounded. While there are reported cases involving earnings claims and FPRs, primarily in the sale of business opportunities, these cases relate to instances where (1) the disclosure document stated that no earnings claim was being made, but a claim was made orally or in another writing, and (2) in cases where an unsubstantiated and grossly exaggerated earnings claim was made. At the time of publication, no case could be found where liability was imposed on a franchisor that followed the rules in making an earnings claim or FPR, even if the franchisee’s experience was different than what was disclosed by the franchisor.

An example of where a franchisor was protected from a class action suit brought by franchisees involved a claim that defendant/franchisor Quiznos fraudulently induced the franchisees to enter into the franchise agreement by making various misrepresentations concerning the profitability of the franchises.61 Defendant Quiznos made an Item 19 earnings claim, giving sales figures for various individual franchisees; however, the following disclaimers were contained in the Quiznos UFOC:

YOUR ACTUAL FINANCIAL RESULTS ARE LIKELY TO DIFFER FROM THE FIGURES PRESENTED. THE AVERAGE GROSS SALES FIGURES PRESENTED ABOVE REPRESENT SALES BEFORE DEDUCTIONS FOR CONTINUING ADVERTISING AND ROYALTY FEES PAYABLE TO THE FRANCHISER [sic] AND ALL OTHER OPERATING EXPENSES. SEE ITEMS 6 AND 7 OF THIS OFFERING CIRCULAR FOR A PARTIAL LIST OF EXPENSES YOU WILL INCUR.

60 Legal Symposium, supra note 12, at 12.
THE SALES FIGURES ABOVE ARE AVERAGES OF HISTORICAL DATA OF SPECIFIC FRANCHISES. THEY SHOULD NOT BE CONSIDERED AS POTENTIAL SALES THAT MAY BE REALIZED BY YOU. WE DO NOT REPRESENT THAT YOU CAN EXPECT TO ACHIEVE THESE SALES LEVELS. ACTUAL RESULTS VARY FROM RESTAURANT TO RESTAURANT, AND WE CANNOT ESTIMATE THE RESULTS OF ANY PARTICULAR FRANCHISE.

OTHER THAN THE ABOVE INFORMATION, WE DO NOT FURNISH OR AUTHORIZE OUR SALESPERSONS TO FURNISH ANY ORAL OR WRITTEN INFORMATION CONCERNING THE ACTUAL OR POTENTIAL SALES, INCOME OR PROFITS OF A QUIZNO’S [sic] RESTAURANT.62

The Court held that the franchisees could not reasonably rely on any claims of profitability allegedly made outside of the UFOC and the franchise agreement, in view of the explicit disclaimers stated above. In rendering its opinion, the Illinois court relied on what it described as “an almost identical case.”63 The court in that case pointed out that Quiznos moved to dismiss a similar complaint filed by franchisees on the grounds that the explicit disclosures given to franchisees “gutted” plaintiff’s claims.64 Judge Griesbach, in the Wisconsin case, found Quiznos’ argument persuasive:

In the face of these clear and unambiguous disclaimers and non-reliance clauses, plaintiffs cannot plausibly claim that they relied on oral statements concerning likely profits and expenses in deciding whether to invest in a Quiznos franchise. [I]t is simply unreasonable to continue to rely on representations after stating in writing that you are not so relying.65

The Illinois court adopted the same reasoning and Quiznos was “let off the hook” for any alleged earnings claims made outside of the

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62 Id. at *5-6.
63 Id. at *11, citing Westerfield v. Quizno’s [sic] Franchise, LLC, 527 F. Supp. 2d 840 (E.D. Wis. 2007).
64 Westerfield, 527 F. Supp. 2d at 844.
65 Id. at 849.
Item 19 disclosure for the reasons stated above. Implicit in the court’s analysis is the idea that if the franchisees believed they had been given improper earnings claims regarding the profitability of the Quiznos franchise, they should have raised those objections or concerns before they signed the franchise agreement, which specifically disclaimed that any claims regarding earnings claims or FPRs had been made to them.

It is submitted that one of the reasons why there is not a great body of litigation striking down an Item 19 FPR is due to the reasoning used by the court in the above-cited cases relative to disclaimer language. How could a prospective franchisee claim that he had been given false earnings claims and then subsequently sign a franchise agreement specifically disclaiming that any such earnings claims outside of the franchise agreement had been made?

From the point of view of Ms. Shanks, a regulator in Maryland,

It’s harder to prove an unlawful earnings claim if the franchisor’s Item 19 contains a financial performance representation. For example, it would not be unreasonable for the franchisor to raise the issue that if a prospective franchisee received a financial performance representation that substantially deviated from the Item 19 disclosure, they would have questioned it at the time the representation was made, and not after the purchase of the franchise.66

Over the years, franchise lawyers with whom I have spoken have shied away from making Item 19 earnings claims or FPRs because of a supposed exposure to liability on the part of their clients. These fears, which were in fact shared by this author for many years, have simply not been well-founded. There is not any significant amount of litigation in which Item 19 earnings claims have been successfully challenged.

In the interest of fairness, a provocative case against mandatory earnings claims relating to the issue of potential liability to the franchisors was presented by David J. Kaufmann in an article entitled "The Case Against Mandatory Earnings Claims Disclosure."67 When Mr. Kaufmann wrote the article, both FTC and NASAA were considering mandatory disclosure of earnings claims, which would

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66 Legal Symposium, supra note 12, at 23.
67 Kaufmann, supra note 56.
require franchisors to disclose average gross sales, average net profits, and average annual “break-even” levels of gross sales of all units in their chain. 68 Mr. Kaufmann states that those three types of mandatory earnings claims being considered by the FTC and NASAA would give rise to massive liabilities for franchisors compelled to make them, 69 and concluded that such mandatory claims would be relatively meaningless to franchisees. 70 Rather than being a mandatory earnings claims-bashing, as the title would initially suggest, Mr. Kaufmann’s article actually offered an interesting compromise, which he states “more closely adheres to the norms customarily observed when businesses are sold in the United States, and one that would impart far more useful information to prospective franchisees.”71

Mr. Kaufmann went on to state:

If one is offering to sell an existing unit to a “new” franchisee (one who has not previously been a franchisee in the chain), then disclosure of that unit’s actual operating results for the immediately preceding three years should be required. Nothing could better assist a prospective franchisee considering the purchase of an operating unit than the actual numbers achieved by that unit. Under this scenario, the problems associated with any average unit numbers are done away with.72

While Mr. Kaufmann does not go as far as this author would go regarding mandatory claims, he certainly proposed a reasonable compromise back in 1995,73 which has not yet been accepted by either NASAA or the FTC.

C. The “One Size Does Not Fit All” Argument

The next major objection to mandatory earnings claims is what is described as the proverbial “one size does not fit all” argument. An
excellent discourse of this argument is set forth in an article by Andrew C. Selden.74 Mr. Selden states:

This argument asserts that no single financial datum or set of financial information is both available and relevant across the broad spectrum of franchising. This is a concern because with two to three thousand companies offering franchises in several dozen different lines of business, it is difficult to imagine a single set of financial information that could be compiled by and be relevant to all of them.75

Mr. Selden goes on to say that in 1995, NASAA was grappling with three different draft proposals of a mandate: “disclosure of ‘top-line’ gross sales information; disclosure of an abbreviated statement of profit and loss showing only certain major categories of expense;” and disclosure of “a generalized mandate directing each franchisor to choose something that is relevant to its business and disclose that.”76 And Mr. Selden pointed out that each of these approaches, although not without challenges, did not appear to be insurmountable.77 The one-size-fits-all argument, as aptly noted by Mr. Selden, was not persuasive in 1995, and certainly is not persuasive under the 2007 Franchise Rule where the new guidelines state that any franchisor making an FPR must have a “reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 (§ 436.5(s)) of the franchisor’s disclosure document.”78

The one-size-fits-all disclosure format has been identified as the principal argument against FPRs.79 As was pointed out in the IFA Legal Symposium, neither the amended rule nor the UFOC Guidelines clearly state what constitutes a reasonable basis, yet the franchisor bears the burden of showing it had a reasonable basis for the FPR when such representation was made.80 The symposium authors went on to say that the concept of reasonable basis “is subjective, and as a result every franchisor must analyze the information offered in the context of what is reasonable for its business and its industry.”81

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75 Id. at 4.
76 Id.
77 Id.
78 16 C.F.R. § 436.9 (2007).
80 Legal Symposium, supra note 12, at 6.
81 Id.
Thus, it would appear that the one-size-fits-all standard has been answered by the reasonable basis standard. The article does point out, by quoting from the compliance guide, that there are several factors that a franchisor should consider in determining whether it has a reasonable basis, but those guidelines do not box in the franchisor in the manner that was being considered in 1995 by the IFA and NASAA.

D. New Franchisors Will Be Handicapped

Another interesting objection cited by Mr. Selden in his article pertains to a supposed handicap for new franchisors in having a mandatory disclosure requirement. Mr. Selden argues that new franchisors and new programs are always at a competitive disadvantage relative to established programs in some respects, but they have competitive advantages in others. He states “[l]ack of a track record, or lack of a track record with any particular magnitude, is intrinsic to the circumstances; it is not a function of a disclosure mandate.”82 There, of course, could be time periods available to a new franchisor to enable it to obtain the required data.

E. FPRs and the Unsuccessful Franchisee

If the logic of this paper is persuasive, it should probably be asked: “What successful franchisor would not want to make an Item 19 FPR?” Ms. Shanks, in her regulator’s note quoted above, opines: “A system that is not doing well, whether based on revenue loss due to competition, decline in system size, or even marketing of a product/service that is no longer in demand, probably would not elect to include a financial performance representation.”83 The fact that this category of franchisors described by Ms. Shanks is able to sell franchises at all to an unsuspecting pool of prospective franchisees is perhaps the most cogent argument in favor of mandatory Item 19 FPRs.

This author, along with most other franchise attorneys, has refused to accept as clients potential franchisors that are not doing well as a business. Such franchisors may see the initiation of a franchise program as a last ditch effort to generate revenue, either by obtaining franchise fees or other means. Most of the professional services—

82 Selden, supra note 69, at 5.
83 Legal Symposium, supra note 12, at 13.
such as attorneys, consultants, and brokers—needed to sell a franchise are compensated on a purely transactional basis, which is usually commission-driven. This instant gratification allows these service providers to profit on a franchise sale for a business that has not developed the necessary qualifications to become franchised. The franchise industry should learn from the lessons of the current “Great Recession” sparked by the bursting of the housing bubble in which realtors, brokers, and banks all were compensated on a transactional basis, without having “skin in the game” in the long-term solvency of their deals. While they profited, countless others were seriously hurt.

A mandatory Item 19 FPR would weed out these weaker players and prevent them from showing up at franchise shows and eluding the appropriate question of a prospective franchisee by saying, “Well, we would love to tell you what our financial history is, but we are prevented from doing so because we don’t make Item 19 representations in our FDD.” Weeding out these piranhas from franchise sales is an appropriate measure of federal regulation in the franchise sales process but can only be accomplished by requiring Item 19 FPRs.

**F. Maintaining the Free Market Approach**

One final objection advanced by the FTC, noted earlier, is that keeping Item 19 optional promotes a free market approach by encouraging prospective franchisees to search out franchise systems that disclose financial information voluntarily. According to this theory, if enough potential franchisees were vigilant in pursuing franchise opportunities that included Item 19 disclosures, ordinary market forces would force franchisors to voluntarily make FPRs, and government intervention would be unnecessary.

However, the opinion of this author is that a true “free market” can only be achieved when pertinent financial information is transparent to the investment community. Many prospective franchisee investors will typically go through the entire franchise procurement process without engaging with a third party, such as an attorney, CPA, or industry association. These franchisees are often unaware of the flexibility of the Item 19 rule and the more transparent disclosures that other franchisors might make. Mandating Item 19 disclosures would provide the financial transparency needed to better educate the investor in their decision making.
XIII. CONCLUSION

Not only is a franchisee investor damaged by a bad franchise investment, but also, in the long term, investors purchasing flawed franchises hurt every person involved in the franchise industry. By not mandating an Item 19 FPR, the FTC is undermining the main source of capital—the new franchisee investor—used to grow the franchise industry. The franchise industry, just like our nation's GDP, is not a finite pie; instead, it is constantly seeking to expand. However, some prospective franchisees that comprise these pieces of the pie are crushed by an unsound business concept. Without a mandatory Item 19 FPR, the FTC is not allowing these poisoned pieces of the pie to become visible to investors before they take a bite. Once these investors are poisoned and lose their investment, they rarely try to bite off another piece. They also communicate their bad franchise experience to their network of friends, family, and business relations. These negative experiences may serve to be the worst type of public relations for the franchise industry, and the entire franchise industry may be damaged. In contrast, the primary parties that may be damaged by requiring an Item 19 FPR are those underperforming franchisors that will be exposed to the investment community. Any increased costs to legitimate franchise concepts will be balanced by better investor confidence in franchise investment that will increase the size of the franchise pie.

In examining the various arguments against mandatory FPRs, none of them outweigh the advantages, nor are any of them convincing enough to justify the grave injustice being done to potential franchisees. Denying potential franchisees the advantage of examining the FPRs of the franchisor in order to weigh the financial pros and cons subjects them to unnecessary hardship. It is evident that FPRs provide valuable information needed by the prospective franchisee to make a decision as to whether to invest in the franchise.

Requiring an Item 19 FPR is not only a good idea, it is also a necessary addition to the franchise process and imperative to growing a healthy franchise system. With franchising now making such a significant contribution to the U.S. business community, a strong system of viable franchise concepts will benefit all Americans and the U.S. economy as a whole. It is time for the FTC to regulate, rather than placate, the franchise industry. The SEC is doing its job in regulating the sales of securities, and the FTC needs to follow suit in mandating an Item 19 FPR. The time has come for Item 19 Financial Performance Representations to be mandatory.
Executive Compensation: The Law and Incentives

Stas Getmanenko¹

Excessive executive compensation frequently breeds resentment, undermines consumer faith in the financial system, and overly stigmatizes otherwise common business failures. Frequently, the opponents of lavish pay packages compare executive compensation to the compensation of rank-and-file workers. Such criticism reflects perfectly appropriate societal concerns over pay equity and distribution of wealth within a society. An entirely separate source of friction is the shareholders’ right to benefit from the corporation’s wealth. Shareholders’ dividends are directly reduced by the company’s expenses, one of which is executive compensation. For most of today’s public companies, the executive compensation expense is often negligible when considered in light of mammoth balance sheets. However, these amounts are still large and lucrative for their individual recipients. More than once, the incentives of executives have conflicted with the long-term interests of shareholders. In the most unfortunate scenario, executives’ personal interests can tumble a corporation and send ripples of pain elsewhere. To prevent such a result, independent compensation committees have been charged with creating appropriate incentives for executives. And recently, when these committees have proved to be imperfect, additional legislative efforts have been introduced. As it unfolds, this paper attempts to answer the following three questions.

First, how meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

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Second, how consistent is Business Roundtable’s guiding principle for executive compensation—that executive compensation should be closely aligned with long-term shareholder interests—with the reality of executive compensation in today’s corporate America?

Third, what would be the scope and the efficacy of any proposed legislative check on executive compensation?

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I. INTRODUCTION

Excessive executive compensation frequently breeds resentment, undermines consumer faith in the financial system, and overly stigmatizes otherwise common business failures. Frequently, the opponents of lavish pay packages compare executive compensation to the compensation of rank-and-file workers. Such criticism reflects perfectly appropriate societal concerns over pay equity and distribution of wealth within a society. An entirely separate source of friction is the shareholders’ right to benefit from the corporation’s wealth. For example, shareholders’ dividends are directly reduced by the company’s expenses, which include executive compensation. For most of today’s public companies the executive compensation expense is often negligible when considered in light of mammoth balance sheets. However, these amounts are still large and lucrative for their individual recipients. More than once, the incentives of executives have conflicted with the long-term interests of shareholders. In the most unfortunate scenario, executives’ personal interests can tumble a corporation and send ripples of pain elsewhere. To prevent such a result, independent compensation committees have been charged with creating appropriate incentives for the executives. Recently, when these committees have proven to be imperfect, additional legislative efforts have been introduced. As it unfolds, this paper attempts to answer the following three questions:

Question 1

Against the backdrop of the recent bursting of the real estate bubble and the resulting financial crisis, the populist outcry against

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2 This paper examines executive compensation as it applies to publicly-traded companies. The analysis could differ significantly for private companies.
4 See infra text accompanying notes 35–36. Prior to AIG’s downward spiral, the average salary in Joseph Cassano’s business unit was $1 million a year for the 377 people employed there; Cassano personally received $280 million in the eight years prior to his resignation in 2008.
5 See infra text companying notes 20–24. For instance, in 2007, WaMu held assets valued at $327.9 billion, while WaMu’s chief executive, Kerry Killinger was compensated with $88 million for six years from 2001 to 2007.
6 See infra text accompanying note 31.
7 See infra text accompanying notes 20–31.
8 See infra text accompanying notes 41–47.
9 See infra Part IV.
excessive executive compensation is gaining momentum. Some argue that executive compensation—more specifically the misaligned incentives on executive pay—was one of the chief factors contributing to over-inflation and the bursting of the real estate bubble. Those who support this view often place the blame on executives and the compensation schemes at such companies as Washington Mutual (“WaMu”) and American International Group (“AIG”). They argue, inter alia, that WaMu was a primary facilitator of bad mortgage debt that “built [an] empire on shaky loans.”12 Meanwhile, AIG exacerbated the problem by insuring the repackaged mortgage debt in the secondary market. How meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

Question 2

Business Roundtable is an American policy association comprised of chief executive officers of major U.S. companies. The group’s membership controls over $5 trillion in annual revenues and more than twelve million employees. The group claims one-third of the total value of the U.S. stock market and pays more than sixty percent of all corporate income taxes. On average, the group pays $167 billion in dividends and gives away another $7 billion in charitable donations. As justification for its existence, Business Roundtable routinely issues position statements on relevant economic and societal matters. In 2007, the organization published a white paper titled “Executive Compensation: Principles and Commentary.”14 The first principle of the white paper states: “Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.” How consistent is this guiding principle with the reality of executive compensation in today’s corporate America?

12 Id.
15 Id. at 1.
Question 3

In recent months, as the bottom has dropped out of the economy and the unemployment rate has surpassed ten percent, excessive executive compensation has generated a significant public firestorm.16 “Bonus” payments at companies receiving government funds have taken center-stage on several occasions. In 2008, the Wall Street banks paid themselves some $20 billion in bonuses amidst a year of dismal returns (more accurately “a year of colossal losses”).17 President Obama called the payouts “shameful.”18 Moreover, his sentiment is likely shared by most Americans who were not amongst the bonus recipients. Whether the bonuses were “right” or “wrong,” and deserved or undeserved, they gave rise to numerous attempts to “rein in Wall Street pay.”19 Among other proposals, a legislative response appears more likely than ever. What would be the scope and the efficacy of any proposed legislative check on executive compensation?

II. Executive Pay and Misaligned Incentives

II. Executive Pay and Misaligned Incentives

How meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

A. The biggest bank failure in U.S. history

In 2007, WaMu held assets valued at $327.9 billion,20 yet in 2008, WaMu was the biggest bank failure in U.S. history.21 Over the last decade, and prior to its failure, WaMu was synonymous with easy lending, and for a time it worked for WaMu. In 1990, Kerry K. Killinger became WaMu’s chief executive. He led the bank to an incredible expansion: during Killinger’s tenure, WaMu made some thirty banking acquisitions—it became the sixth largest American bank—and its stock price and number of branches more than

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16 Executive Pay, supra note 10.
17 See id.
18 Id.
doubled.\textsuperscript{22} In 1999, WaMu made a key acquisition of Long Beach Financial, a California lender specializing in subprime mortgages.\textsuperscript{23} From that time onward, WaMu positioned its subprime lending business at the core of its offerings. Killinger was the primary engineer behind WaMu’s easy lending philosophy. According to The Corporate Library, a research firm, Killinger’s compensation from 2001 to 2007 totaled $88 million.\textsuperscript{24}

Killinger’s compensation levels were set similar to the compensation of any other chief executive officer of a company traded on the New York Stock Exchange.\textsuperscript{25} Specifically, WaMu’s corporate filings disclosed that in addition to a predetermined annual salary, Killinger’s total compensation was significantly tied to WaMu’s performance. In fact, ninety-four percent of Killinger’s total direct compensation for 2007 was considered “at risk”—meaning it was tied to specific performance measures—and seventy-one percent of Killinger’s total direct compensation was tied to \textit{long-term} performance measures.\textsuperscript{26} Consider the following language from WaMu’s independent Compensation Committee:

\begin{quote}
For 2008 we have structured our long-term equity incentive and annual incentive bonus programs for named executives to align with our objective to improve Company performance in 2008 and beyond. We continue to provide at least 50\% of total direct compensation to executives (over 70\% for the CEO) in the form of long-term equity incentive compensation which is directly linked to stock price and total shareholder return . . . . Our 2008 annual incentive bonus plan is designed to align executive bonus compensation with the achievement of four objective performance measures that are core to the success of our business: (i) net operating profit, (ii) noninterest expense, (iii) depositor and other retail banking fees, and (iv) customer loyalty.\textsuperscript{27}
\end{quote}

In theory and on paper, this compensation scheme would likely pass the scrutiny of most vigilant shareholders who demand the

\begin{footnotesize}
\begin{enumerate}
\item[23] \textit{Id.}
\item[24] \textit{Id.}
\item[26] Annual Report, \textit{supra} note 20, at 88.
\item[27] \textit{Id.} at 84.
\end{enumerate}
\end{footnotesize}
highest dividend possible, especially in the long-term. In reality, however, WaMu did not make it through the end of 2008.

The demise of WaMu was brought on by subprime mortgages. In 2007, WaMu recorded a $67 million loss in its subprime lending unit and shut it down.\(^{28}\) In total, by 2007 WaMu had accumulated $180 billion in mortgage-related loans. Intriguingly, prior to the burst of the housing bubble, it was this enormous mortgage portfolio that inflated WaMu’s stock price and created value out of thin air (or out of empty IOUs). With the increase in stock price, the level of Killinger’s compensation also increased. Consistent with the formulas drawn out by the Compensation Committee, Killinger’s compensation was directly related to the growth in the mortgage portfolio.\(^{29}\) This growth, however, was achieved through reckless lending, and a day of reckoning was still several years away.

In 2007, when WaMu’s shareholders’ wealth was essentially wiped out entirely, the calculation of Killinger’s bonus still excluded the losses from mortgage securities, thus igniting shareholders’ rage\(^ {30}\) and rightfully positing the question: whose interests were the executives advancing after all? Despite seemingly infallible language and the intent of WaMu’s Compensation Committee, reality proved that the executives’ incentives were entirely misaligned with the long-term interests of the shareholders.\(^ {31}\)

Even worse for everyone else, WaMu’s resale of mortgage securities in the secondary market spread the pain elsewhere. Contrary to the well-known colloquialism, this is one case where spreading the manure around did not do much good.

B. “Business acumen” in AIG’s “shop”

When these “shaky” WaMu loans were resold in the secondary market, they were sliced up, bundled, and repackaged into sophisticated derivatives intended to minimize the risk of default. AIG then insured these instruments.\(^ {32}\) This novel type of insurance

\(^{28}\) Goodman & Morgenson, supra note 11.
\(^{29}\) See Annual Report, supra note 20, at 88.
\(^{30}\) Goodman & Morgenson, supra note 11.
\(^{31}\) We can hardly expect the compensation committee to have a greater foresight into the company’s core business than the company’s CEO. Nevertheless, it is the compensation committee that is charged with defining long-term incentives for the company’s executives. Herein lies one of the paradoxes.
was pioneered by one Joseph Cassano with the help from a handful of people in AIG’s London-based banking unit. While the entire unit employed only 377 of AIG’s 116,000 employees, it was the primary cause of AIG’s downward spiral, posting $25 billion in losses two quarters into 2008. These losses translated into direct and immediate cash outflows for AIG. Suddenly, a company with a trillion dollar balance sheet was lining up with an outstretched hand for the largest corporate “bailout” in history.

Prior to all the trouble, the compensation in Cassano’s unit averaged $1 million a year for the 377 people employed there; Cassano personally received $280 million in the eight years prior to his resignation in 2008. The incentives at AIG were clear: write more insurance, get more money. Unfortunately, when the dust settled, the American taxpayers were the ones who ultimately paid for the salaries of these London-based bankers.

C. Executive compensation as the cause? Likely not, but a trigger?

So, how meritorious is the claim that misaligned incentives on executive pay can trigger worldwide financial turmoil?

Killinger and Cassano hardly knew that they were operating in tandem when they were writing and insuring risky mortgages. Their expectations for the future were based on their knowledge of the past. Killinger and Cassano both had incentives to increase their corporations’ revenues, thereby increasing their own compensation; they did this by relying on “constantly rising housing prices and inflated appraisals, conditions that could not possibly last.”

Of course, it would be an overstatement to place the responsibility for a worldwide financial collapse squarely on the shoulders of these...
two men. After all, it was not Killinger and Cassano who were delinquent on their mortgage payments, nor did they erase margin requirements or make easy lending commonplace through lax monetary policies and low interest rates.\(^39\)

They have, however, proved to be far less insightful than they held themselves out to be. In 2007, a year prior to AIG’s embarrassing demise, Cassano said:

We’re sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places . . . . The question for us is, where in the capital markets can we gain the best opportunity, the best execution for the business acumen that sits in our shop?\(^40\)

The irony of the situation is blatant. Fortunately for Killinger and Cassano, they emerged largely unscathed, stripped only of their egos. The author argues that the compensation schemes at WaMu and AIG were not the least of the reasons that brought on the recent financial turmoil,\(^41\) and that the independent compensation committees at these companies were as near-sighted as Cassano and Killinger themselves.

D. Conclusion

Without a doubt, Killinger and Cassano were motivated by their paychecks. Today, with the benefit of hindsight, many accuse this duo of engineering worldwide financial turmoil. But the accusers rarely link compensation with the men’s behavior.\(^42\) The author believes this omission to be material. What people do at work is motivated by a paycheck; otherwise they would not be collecting one. If a person is given an opportunity to increase the amount of his pay, he will most likely pursue that opportunity. It must be mentioned that neither Cassano’s nor Killinger’s contract had a “clawback” provision. Therefore, both men expected to keep their money once they received it.

On paper, WaMu did everything right, and yet it failed. The compensation incentives spoke of long-term value for the shareholders, but the reality proved the opposite. Cassano and

\(^40\) Morgenson, supra note 32.
\(^41\) See discussion infra Part III.
\(^42\) See, e.g., Goodman & Morgenson, supra note 11, at 22 (compensation mentioned but not discussed as a contributing factor).
Killinger most likely did not foresee the mayhem or cause it intentionally: after all, they were considered the all-stars of their trade. If that’s the case, this underscores the difficulty of determining the company’s long-term interests and deriving meaningful incentives for executive pay therefrom.

III. The Difficulty of Allocating Incentives on Executive Compensation: The Paradoxical American Reality

How consistent with reality is Business Roundtable’s maxim on executive compensation?

A. Introduction

This section examines the structure and role of compensation committees and reviews practical constraints affecting the committees’ work. Specifically, this section considers the independence of committee members, the role of compensation consultants, and the difficulty of formulating effective long-term incentives.

B. Compensation committee on paper

For the majority of U.S. public companies, the compensation of top executives is determined by a compensation committee, and the favorite task of any compensation committee is benchmarking—that is, comparing one company’s executive pay to that of its peers. As a result, in 2007, an average S&P 500 CEO made 344 times the pay of an average American worker, 724 times the pay of a minimum-wage worker, and about $10.5 million more than 15 million unemployed Americans. These “populist” figures aside, the compensation committee is meant to ensure integrity in corporate compensation schemes. It embodies the principles of corporate law commonly known as the duties of loyalty, care, and good faith; it prevents

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46 Minimum wage assumed at $7.25 an hour; 15 million unemployed Americans is the present estimate. BUREAU OF LABOR STATISTICS (Sept. 2010), http://www.bls.gov/news.release/empsit.nr0.htm.
potential conflicts of interest and ensures the greatest possible return for the shareholders.

Organizations such as Business Roundtable, consisting exclusively of top-tier CEOs who are accustomed to frictions with shareholders over executive pay, recognize the importance of compensation committees. Because the “oversized” executive pay packages originate from these committees and not from the executives themselves, compensation committees serve as a deflection from scrutiny. A compensation committee also serves a tax purpose. The IRS requires such a committee before a company can claim the $1 million limit on salary deductibility.

Therefore, Business Roundtable wisely allots a central role for compensation committees. Business Roundtable’s principles on executive pay include the following provisions, among others: (1) long-term interests of the shareholders; (2) executive pay where a large portion of the compensation is tied to long-term performance and is represented by executives’ equity investment in the company; (3) existence and operation of an independent and well-educated compensation committee that determines the pay and the incentives; and (4) complete, accurate, understandable, and timely disclosure of compensation schemes to the shareholders.

It is difficult to argue against the soundness of these principles. But how consistent are they with reality?

C. Practical Hurdles of a Typical Compensation Committee

i. Independence of Directors

Jiang Jianqing, chairman of the world’s largest bank, made just $234,700 in 2008. The Industrial and Commercial Bank of China is one of three Chinese banks in the world’s top five, and each of Jiang’s Chinese fellow CEO colleagues made roughly the same sum last year. HSBC, England’s largest and the world's third-largest bank, paid its CEO Michael Geoghegan $2.8 million in 2008. In contrast, America’s JPMorgan Chase, the world’s fourth-largest bank, rewarded

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47 BUSINESS ROUNDTABLE, supra note 13.
48 See I.R.C. § 162(m) (2010).
49 See Executive Compensation, supra note 14, at 1.
51 Id.
52 Id.
its CEO, Jamie Dimon, with a hefty $19.6 million for the same time period.\footnote{id} As it turns out, in 2008, the Chinese bankers made less than 2 percent, and Mr. Geoghegan made less than 15 percent of Mr. Dimon’s pay.

Skeptics link this disparity to the work of U.S. compensation committees. To fully ascertain the independence of compensation committees, it is first necessary to understand the general makeup of an average board of directors. A typical board consists of past and present CEOs of major U.S. companies, which are often from within the same industry.\footnote{see \textit{robert a.g. monks, et al., corporate governance} 261 (2008).}

Independent board members are those who are not employed and those without “strong ties” to the company on whose board they sit. Several independent board members then make up a compensation committee.\footnote{see id. at 24.} Most commonly, the committee also includes a compensation consultant.

When a committee convenes, it sets compensation for the company’s top executives. In doing so, committees often use “benchmarking,” a process that includes creating peer groups of comparable companies and using those companies’ compensation figures as a standard for comparison.\footnote{see \textit{id. at} id.} Thus, in reality, although CEOs do not set their own compensation, their compensation is set by other “independent” CEOs who are comparing each others’ pay checks.\footnote{see \textit{id.}}

The author believes this setup also explains the growing “pay gap at the top,”\footnote{see the pay gap at the top, \textit{ny times}, may 25, 2007, http://www.nytimes.com/imagepages/2007/05/25/business/20070525_EXECS_GRAPHIC.html.} meaning the pay gap between the chief executives and their top subordinates. Over the last two decades the compensation of number three executives has decreased from around fifty percent to about twenty-five percent of the CEO’s pay.\footnote{see \textit{id.}} Similar trends are also in effect for other top subordinates. Could it be because the number of CEOs on corporate boards exceeds the number of CFOs? Or could it be because the CEOs have joined a covert union?\footnote{see joseph kahn, former treasury secretary joins leadership triangle at citigroup, \textit{ny times}, oct. 27, 1999, at A1.}

\footnote{id.\footnote{see \textit{robert a.g. monks, et al., corporate governance} 261 (2008).} \footnote{see \textit{robert a.g. monks, et al., corporate governance} 261 (2008).} \footnote{see id.} \footnote{see \textit{id. at} id.} \footnote{see \textit{id.}} \footnote{see the pay gap at the top, \textit{ny times}, may 25, 2007, http://www.nytimes.com/imagepages/2007/05/25/business/20070525_EXECS_GRAPHIC.html.} \footnote{see \textit{id.}} \footnote{see joseph kahn, former treasury secretary joins leadership triangle at citigroup, \textit{ny times}, oct. 27, 1999, at A1.}
Of course, the cynical view includes an entrenched committee “rubber-stamping increasingly lucrative pay programs with a wink and a nod.” Skeptics have good reason to argue that an “independent” compensation committee is nothing more than a thinly-veiled self-serving “union.” They insist that benchmarking benefits even “independent” directors: these directors can set a high standard against which their own companies can set a benchmark.

For example, WaMu used the following companies in its peer group when determining Killinger’s compensation: Bank of America, Bank of New York, Capital One Financial Corp., Citigroup, Countrywide Financial, Fifth Third Bancorp, JPMorgan Chase & Co., KeyCorp, National City Corp., PNC Financial Services Group, Suntrust Bank, U.S. Bancorp, Wachovia, and Wells Fargo & Co. In 2009, JPMorgan Chase & Co. used the following companies: American Express, Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, and Wells Fargo & Co. Note that neither bank included their Chinese or even European colleagues in the mix.

ii. A Short Aside

A very interesting, although not directly related topic, is the spread of American compensation practices overseas. For example, when an American subsidiary conducts business in another country, the American parent typically implements American executive compensation practices within the subsidiary. Such was the case for Cassano and AIG’s London-based banking unit. This practice forces additional pressure on foreign companies, who are beginning to benchmark against their American competitors, thus increasing executive compensation worldwide. With additional pressure on

62 The author must add that they insist quite convincingly. But compare id. (I tend to dismiss the cynical scenario . . . . Although there are undoubtedly exceptions, outside board members approach their jobs with diligence, intelligence, and integrity, regardless of whether they have social or business ties with the CEO. However, judgment calls tend systematically to favor the CEO. Faced with a range of market data on competitive pay levels, committees tend to err on the high side.).
63 See Annual Report, supra note 20, at 86.
65 Fortunately for the American companies, this likely makes their foreign counterparts less competitive. For further discussion, see Goodman & Morgenson, supra note 11.
executive pay after the recent financial turmoil, the future undoubtedly holds intriguing developments in this area.

iii. Independence of Compensation Consultants

In 2008, ninety-two of the top-100 U.S. companies disclosed the retention of a compensation consultant.\(^{66}\) The compensation consultant also participates in determination of executive pay. The present disclosure rules require the company to disclose the role played by the compensation consultant in determining or recommending executive pay.\(^{67}\) However, presently, disclosure of the consultant’s independence is not required, nor is the employment of an independent consultant.

An issue with the independence of compensation consultants arises when the consultant, in addition to providing compensation consulting, also provides other consulting services to the company.\(^{68}\) Compensation consulting usually represents only a small fraction of the total consulting bill. Therefore, non-compensation consulting, which is contractually secured by the management, represents the consultant’s livelihood. The consultant thus has few incentives to be the shareholders’ watchdog on the compensation committee.

For the 2009 proxy season, fifty-four of the top-100 U.S. companies voluntarily disclosed that their compensation consultant was independent and twenty-nine acknowledged that their compensation consultant provided other services to the company.\(^{69}\) In light of the growing concern over independence of compensation consultants, additional disclosure rules have been proposed. They are discussed infra.

iv. The Difficulty of Formulating Meaningful Long-Term Incentives

The premise that corporations exist to create shareholder wealth is rarely questioned, and the creation of this wealth typically results from payment of dividends and appreciation of the company’s stock. Theoretically, there could be nothing easier than to tie these objectives


\(^{67}\) See id.

\(^{68}\) See id.

\(^{69}\) See id.
to executive compensation. In practice, however, determination of meaningful long-term incentives requires profound knowledge of the company’s core business.

For instance, in the previously discussed WaMu example, WaMu’s compensation committee connected the following objectives to the level of executive pay: “(i) net operating profit, (ii) noninterest expense, (iii) depositor and other retail banking fees, and (iv) customer loyalty.”\(^70\) These objectives stated nothing about “upside potential” or “downside risk,” the two maxims at the center of the Business Roundtable’s principles. In fact, within just a few months, WaMu crashed into the downside territory under the risk which its management flagrantly ignored. On the other hand, risky lending indisputably increased WaMu’s net operating profit, banking fees, and customer loyalty—at least in the short run. Killinger himself, assumingly the best CEO WaMu could find and afford at the time, did not foresee this risk. The only people who foresaw the imminent burst of the bubble were marginalized economists that now stand in line for the Nobel Prize.\(^71\) Unfortunately for WaMu, none of them were sitting on WaMu’s compensation committee.

Herein lies the extreme difficulty of determining meaningful long-term incentives. The task is particularly complicated in the financial world, where banking and finance companies engage, \textit{inter alia}, in highly sophisticated derivative trading. Consider, for example, the sheer size of the components of the derivative trading industry: credit default swaps now account for $45 trillion; interest rate derivatives stack up at $500 trillion.\(^72\) Faulty and near-sighted incentives laid out by inadequate compensation committees can be the first causal “trigger” of the next meltdown.\(^73\) Therefore, if shareholders are serious about creating long-term value, they must insist that executives’ incentives are thoroughly analyzed and determined by highly competent and truly independent compensation committees.

\(^{70}\) Annual Report, \textit{supra} note 20, at 84


D. Conclusion

So, how consistent with reality are the Business Roundtable’s maxims on executive compensation? Again, Business Roundtable calls for executive compensation that is “closely aligned with the long-term interests of shareholders and with corporate goals and strategies.” Executive compensation “should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.” Compensation should be determined “entirely by independent directors” who understand all of its aspects and who oversee compensation consultants to ensure their independence.

The author’s research and analysis reveals that for the most part the trends in executive compensation are consistent with the Business Roundtable principles. At the same time, the principles themselves reflect an imperfect system: independence and competence of directors and consultants can be reasonably questioned. Can the proposed legislative efforts provide a fix?

IV. Legislative Proposals on Executive Compensation

What would be the scope and the efficacy of any proposed legislative check on executive compensation?

A. Introduction

Since the passage of the Troubled Assets Relief Program (“TARP”), there have been several legislative proposals that could significantly impact U.S. compensation practices. The reality of a legislative intervention is more likely than ever. Of course, few management teams will welcome the new rules, which will abridge the management’s authority and potentially limit or reduce executive paychecks.

Moving in the same direction, but using a different mechanism, are the proposals of shareholders. Within the recent year alone, there was a total of seventy-seven compensation-related shareholder proposals at

74 Executive Compensation, supra note 14.
75 Id.
76 Id.
77 For background on the compensation regulations under the TARP, see Linda E. Rappaport et al., Treasury Releases Executive Compensation Regulations for TARP Recipients, SHEARMAN & STERLING LLP (June 22, 2009), http://www.shearman.com/treasury-releases-executive-compensation-regulations-for-tarp-recipients.
the top-100 U.S. companies. This section examines the convergence of two fundamentally different influences on corporate law: the external governmental intercession and the internal shareholder pressure.

B. Shareholder Initiatives

Shareholders’ authority is derived from their ownership of the corporation. It is only natural that shareholders would desire to do everything within their power to ensure efficient operation of the enterprise. This subsection reviews the following shareholder initiatives as they relate to executive pay: say-on-pay provisions, clawback provisions, and risk assessment.

i. Say-on-Pay Provisions

Say-on-pay provisions allow shareholders to influence remuneration of executives. In a typical say-on-pay scenario, shareholders do not directly determine executive pay; rather, they have an opportunity to vote on the numbers prepared by the compensation committee. The vote is usually advisory—that is, non-binding—or, less frequently, shareholders may insist on a binding vote. Those companies that have adopted say-on-pay proposals most commonly give the shareholders a non-binding vote. The vote serves a purpose similar to the compensation disclosure rules. In essence, the shareholders are timely informed on the issue of executive pay and, at a minimum, are able to voice their support or opposition to the compensation figures.

Although say-on-pay votes are most often advisory, they can, nevertheless, serve an important purpose. Compensation committees become more aware of the scrutiny given by the shareholders to the committees’ proposals. Timely disclosure and the feedback process also allow for greater accountability. Caution, on the other hand, should be taken with binding shareholder votes. In certain scenarios, disagreements and standoffs are possible between shareholders and management. The current administration is a big proponent of say-on-


80 See id.
pay provisions. The governmental efforts in this area are discussed *infra*.

ii. Clawback Provisions

Clawback provisions are after-the-fact confiscatory measures. Clawback provisions are not particularly novel. For example, the Sarbanes-Oxley Act of 2002 provides for recoupment of certain executive compensation in the event of material noncompliance with financial reporting.81 Similarly, shareholders may include clawback provisions that are triggered by certain threshold performance figures. Arguably, such provisions have some merit for a company with a very predictable business model where meaningful incentives can be set with certainty. However, clawback provisions will do very little to help compensation committees set incentives within sophisticated industries, such as the financial industry. In short, clawback provisions do not offer a remedy for a lack of foresight; instead, they merely offer token assurance that “bad-boy” executives will not collect a windfall at the expense of shareholders.

iii. Risk Assessment

Risk assessment attempts to tackle head-on one of the recurring themes of this paper: the difficulty of setting meaningful long-term incentives for executives. Risk is the new “buzzword” in the executive pay discussion.82 Relevant shareholder proposals call for thorough evaluation of all potentially detrimental risks and for their disclosure. Compensation incentives should then thoroughly discourage unnecessary risk taking. The author is skeptical of any potential effectiveness of broad language that discourages unnecessary risk-taking. At large, risk assessment analysis is nothing more than a reincarnation of the age-old duty of loyalty: the management is not expected to take on excessive risks for personal benefit and at the detriment of the shareholders. Because risk assessment will most likely become the task of a company’s compensation committee, the entire issue is again reduced to the competence of the committee’s members and their knowledge of the company’s core business. As long as broad admonitions are not replaced with company-specific and truly beneficial long-term incentives, the new “buzzword” will be as ineffective as any previous broadly-worded measures.

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82 2009 Trends in Corporate Governance, supra note 65, at 4.
C. Governmental Efforts

Unlike the shareholders, who derive their authority to influence corporate decisions from their ownership of the corporation, the government contends that it vicariously represents the host of other legitimately interested parties such as employees, labor unions, citizens, and consumers. The government is particularly watchful of companies receiving federal aid. Following the recent bailout and in response to populist outrage, the Obama administration took several steps to limit executive compensation at these companies.

To a large extent, the current administration’s efforts have paralleled those of the shareholders. Specifically, President Obama and his advisors have issued strong backing for say-on-pay provisions, risk assessment and disclosure, and clawback provisions. The Securities and Exchange Commission (“SEC”) is preparing a series of rules aimed at introducing these principles. At this time, the rules extend only to companies receiving government aid, but the administration has not been apologetic about the possibility of these rules applying to a broader mix of companies. Predictably, such propositions are likely to cause near-hysteria in certain corporate circles.

In addition to the present TARP and SEC rules, Congress is working on the Corporate and Financial Institution Compensation Fairness Act of 2009. This Act would codify non-binding say-on-pay shareholder votes, require the SEC to develop an additional set of executive pay regulations, and introduce “sound risk management” within executive pay.

In the interim, the administration has appointed a well-known Washington lawyer, Kenneth Feinberg, to the position frequently dubbed as “pay czar.” This development is entirely unique and unprecedented. Feinberg wields wide discretion, and he has not been

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86 See id.
88 Id.
afraid to use it. As of October 2009, he had cut total compensation by about fifty percent for the top twenty-five earners at seven companies that receive “exceptional help.”\(^\text{90}\) Most recently, he left Kenneth Lewis of Bank of America without a salary or bonus for 2009.\(^\text{91}\)

Unfortunately, Feinberg’s efforts are likely to be as effective as clawback provisions: they provide a measure of consolation but do not reverse the past or create shareholder value for the future. Arguably, Feinberg’s efforts may even have an opposite effect—that of discouraging top executives from working at already struggling “bailed out” companies.\(^\text{92}\) Moreover, if Feinberg alone determines future incentives for executives at a broad range of industries and does so without appropriate knowledge or expertise, he may repeat the mistakes of WaMu’s and AIG’s compensation committees.

\section*{D. Conclusion}

So, what is the scope and efficacy of any proposed legislative check on executive compensation? The proposed scope of governmental action is largely parallel to already existing internal initiatives of the shareholders, and legislation will only make mandatory what many companies have adopted voluntarily. Of course, if any legislation codifies or extends the position of the “pay czar,” it may not be long before American executives are “benchmarking” against their Chinese counterparts. As to the efficacy of the proposed rules, it will be marginal at best. Voluntary compliance has stolen much of legislators’ “thunder,” and none of the proposals are revolutionary or particularly innovative. The legislation does, however, send an important signal to the corporate world: the government is not afraid to challenge the existing \textit{status quo} in executive pay and beyond. If the present administration continues until 2016, the country will undoubtedly face additional changes.

\section*{V. Afterword}

This paper has presented a short legal survey of today’s state of executive compensation. Presently, this field is evolving at a rapid pace, and many of the overarching issues within this debate are truly interdisciplinary and of significant societal importance. The author

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believes the scrutiny awarded to this subject by the general public, the press, and the academic community is fully justified. Our joint discussion elicits recurrent, critical, and indispensable themes of just societal construction. Many of the questions presented by this dialogue—wealth, its generation and distribution within a society, incentives and their effect on human behavior, efficiency and the formative power of law—are all long-stranding and recurring human concerns. Hopefully, our efforts will foster a realization that maximum overlap of seemingly diverging interests is possible. However, that is the subject of a different intellectual journey.
COMMENT: DVD COPY PROTECTION RULES VIOLATE THE SHERMAN ACT

Matthew W. Turetzky

The majority of DVDs sold in the United States are protected by the Content Scramble System (CSS). Any firm wishing to use it, either to encrypt their content or to decrypt encrypted content, must first obtain a license from the DVD Copy Control Association (DVD-CCA). Because of CSS’s prevalence, the DVD-CCA has an extraordinary amount of market power.

Copyright based challenges to the DVD-CCA’s practices have been largely unsuccessful despite CSS’s well known ineffectiveness at stopping individuals with little technical sophistication from ripping CSS-encrypted DVDs. Indeed, programs that can circumvent CSS, like DeCSS, are widely available on the internet. With its impotence shrouded in the color of law, CSS remains the prevailing form of encryption of DVD content.

These practices should be challenged under the Sherman Act, the cornerstone of federal antitrust law. Such challenges, like the recent one made in RealNetworks, Inc. v. DVD Copy Control Association, have been unsuccessful. Given the prevalence of DVDs, it is surprising that the association’s CSS license agreement has escaped a full-scale rule of reason review. This is especially concerning in light of the agreement’s effect on the market for devices like video servers, digital video recorders, and backup programs like RealDVD. This comment concludes that the DVD-CCA’s implementation of CSS, the prevailing method of DVD copy protection in the United States, is an anticompetitive restraint of trade in violation of section 1 of the Sherman Act.

1 J.D. Candidate, Duke University School of Law, 2011; Editor-in-Chief, Duke Law & Technology Review; B.S., University of Florida, 2008. I am profoundly grateful to Professor Barak Richman and Shelly R. Turetzky for their comments, wisdom, and guidance throughout this entire process. I would also like to thank Dirk Lasater for his extraordinary assistance with this comment. Any mistakes or omissions are mine alone.
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I. INTRODUCTION

Imagine a world where technology allows you to access all of your
movies, music, and games on any device in your home. In this utopian
fantasy, you could take your music and movies anywhere with a cell
phone signal. Forgot to upload your newest playlist? No problem.
Want to view an old movie you have not seen in decades? Just log on.
Have a song stuck in your head? Hit play.

This, of course, is not a fantasy. Technology has caught up with
utopia. Unfortunately, copyright law has not. Many scholars have
condemned the Digital Millennium Copyright Act (DMCA) as being
responsible for this disparity. Emerging in the commentary is the role
of antitrust law in policing excesses spawned by the DMCA.

This is due to the erosion of the doctrinal contours of copyright law. A more
thorough analysis of the subject is beyond the scope of this comment. For an
insightful discussion of copyright law’s recent setbacks, see JAMES BOYLE, THE

The chief criticism of the DMCA is that it has not been subject to the
traditional limitations of copyright law. E.g., Timothy K. Armstrong, Fair
Circumvention, 74 BROOK. L. REV. 1, 2–3 (2008) (contending that judges should
develop a fair circumvention doctrine to respond to the DMCA’s hostility towards
fair use); Dan L. Burk, Anticircumvention Misuse, 50 UCLA L. REV. 1095, 1132
(2003) (criticizing the DMCA for giving copyright owners rights that would
This comment attempts to further define that role. Rather than broadly focusing on the DMCA’s impact on innovation, I have taken aim at a very narrow issue: the effect of Hollywood’s licensing practices of its DVD encryption technology on the market for video servers and other devices that require the copying of Digital Versatile Discs (DVD). Based on the recent RealNetworks decision, it appears that content owners are shrouding their cartel-like anticompetitive conduct beneath the veil of what would otherwise be legitimate copy protection technology. In order to pierce the veil, this comment applies a complete rule of reason analysis to the DVD-CCA’s influence on the market for video servers, personal video recorders, and software like RealDVD.

A. DVDs and the Digital Revolution

In the market for digital video, DVDs today represent the standard medium of distribution to consumers. The discs allow consumers to instantly jump to any scene in a movie while retaining near perfect digital quality. This format allows users to take advantage of new high-definition TVs and digital surround sound systems while making the rewind and fast-forward buttons a thing of the past.
The problem with DVDs is that unlike their Compact Disc (CD) cousins, they cannot be copied, archived, or converted into other formats without violating federal copyright law. As a result, no American firm has manufactured a true DVD replication device that can take encrypted DVD content and move it to another device (like an iPod) or another DVD for backup. This is because DVDs are encrypted; and notwithstanding the exceptions, the DMCA prohibits the very act of circumventing CSS, which is the predominant form of DVD encryption. The very act of circumventing was made illegal by the DMCA to respond to the ease with which digital media can be duplicated. While analog VHS tapes had to be physically


11 Compare Universal City Studios, Inc. v. Reimerdes, 111 F. Supp. 2d 294, 324 (S.D.N.Y. 2000) (ripping DVDs violates no fair use defense under the DMCA in DVD copy case), aff’d sub nom. Universal City Studios, Inc. v. Corley, 273 F.3d 429 (2d Cir. 2001), with RIAA v. Diamond Multimedia Sys., Inc., 180 F. 3d 1072, 1079 (9th Cir. 1999) (ripping CDs into MP3 format for use on a portable MP3 player is fair use).


13 But see Kaleidescape – Legal Update, KALEIDESCAPE.COM, http://www.kaleidescape.com/news/pr/legal-update.php (last visited Mar. 27, 2010). Even in light of an adverse ruling in a state appellate court, Kaleidescape still maintains that its product is “100% licensed and legal.” Id. I believe that Kaleidescape has erred. When the trial court examines the CSS license agreement on remand, it will likely reach the same conclusion that was reached in RealNetworks, 641 F. Supp. 2d at 913.

14 But cf. Rick Broda, Battle of the Premium DVD Rippers, CNET (Jan. 22, 2010, 5:00 AM), http://reviews.cnet.com/8301-19512_7-10438934-233.html (reviewing WinX DVD Ripper Platinum and Wondershare DVD Ripper Platinum; both products are capable of ripping a non-CSS-encoded DVD into MPEG-4 format, which allows the end user to “space shift” her movies onto an iPod or an iPhone). Because most commercially sold DVDs are encoded with CSS, the DVD rippers evaluated by Broda are useless for most consumer applications. See id.


16 H.R. REP. NO. 105-551, pt. 2, at 25 (1998) (“In contrast to the analog experience, digital technology enables pirates to reproduce and distribute perfect copies of works—at virtually no cost at all to the pirate. As technology advances, so must our laws.”).
copied from one tape to the next—a process which is considered time-consuming and laborious by today’s standards—digital media can be duplicated in a matter of minutes by simply copying and pasting the file on a computer. Additionally, widespread broadband internet access has made it possible to take these otherwise colossal files and transmit them over vast distances in short periods of time.\textsuperscript{17}

It should be no surprise then that content piracy continues to be the scapegoat for a decade of abysmal movie sales in Hollywood.\textsuperscript{18} Sony laid off several hundred employees last year because “DVD sales, which gave the movie industry an unprecedented boost over the past decade, are suffering double-digit declines.”\textsuperscript{19} In an e-mail to employees, CEO Michael Lynton and Co-Chairman Amy Pascal blamed “the growth of online piracy . . . the social media effect on the performance of films . . . [and] the way people have changed how they watch television and acquire DVDs.”\textsuperscript{20}

This e-mail is surprising, because Sony and other industry giants had gone to great lengths to prepare for widespread piracy long before the layoffs. In the mid-1990s, content producers established the DVD-CCA to create a uniform encryption system that would be licensed to hardware manufacturers and movie studios for the purpose of making it very difficult—and after the DMCA was passed, illegal—to copy DVD content.\textsuperscript{21} The encryption system they settled on was CSS.\textsuperscript{22}

But CSS was not the only technological protection measure employed by content providers.\textsuperscript{23} Some content providers have used RipGuard or ARccOS.\textsuperscript{24} The advantage of these systems is that they are not exclusive; they can be used in addition to CSS.\textsuperscript{25} RipGuard

\textsuperscript{18} See id.
\textsuperscript{19} Julia Boorstin, Sony to Layoff 450 Workers as DVD Sales Fall, CNBC (Feb. 1, 2010, 7:30 PM), http://www.cnbc.com/id/35189365.
\textsuperscript{20} Id.
\textsuperscript{21} See RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913, 918–19 (N.D. Cal. 2009).
\textsuperscript{22} Id. at 919.
\textsuperscript{23} Id. at 927–29.
\textsuperscript{24} Id. at 927–28.
\textsuperscript{25} Id. at 927. Although ARccOS and RipGuard have restricted the media server market much in the same way CSS has, they have done it without using concerted industry action. As a practical matter, there are plenty of public policy arguments that can be made against utilizing encryption mechanisms on DVDs without reaching the concerted action issue. However, these arguments sound mostly in copyright, not antitrust law. I have chosen to save these issues for another day because the focus of this comment is narrowly tailored to the anticompetitive harms
protection targets CSS ripping procedures themselves, “making it impractical for all but the most determined” to copy CSS-encrypted content. It is used by Disney “to protect nearly all of its DVD titles distributed throughout the United States.” ARccOS, on the other hand, is a “passive control technology” that uses a different encryption code for each disc. The studios have spent millions of dollars to deploy both of these technologies in their DVDs.

The significance of these measures was highlighted by the District Court in *RealNetworks*:

> Of the top 300 DVD titles commercially released in 2005-2007, thirty were protected by RipGuard, and an additional twenty five by ARccOS. . . . The Studios have paid tens of millions of dollars over the last four years to protect their content using these systems.

The proliferation of encryption mechanisms combined with a broad reading of the DMCA in DVD copying cases has made it difficult for even the most successful innovators to innovate. Apple’s dilemma in its design of Apple TV illustrates this point. Apple TV did not include a DVD player, perhaps because Apple realized that including one might cannibalize its sales of digital content on iTunes. Phillip Schiller, an Apple senior vice president, has nevertheless maintained that Apple TV is a “new DVD player for the Internet age.” But the truth is that Apple TV was never designed as an all-in-one replacement for traditional set-top boxes. Without the ability to playback DVDs, consumers never saw a need for Apple TV;

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27 *RealNetworks*, 641 F. Supp. 2d at 928.
28 ARccOS, http://www.arccos.com/opencms/opencms/sites/am/Digital_Services/ArccOS.html (last visited Mar. 25, 2010). This is more sophisticated than CSS, which relies on a single algorithm. *Id.*
29 *RealNetworks*, 641 F. Supp. 2d at 928.
30 *Id.*
the device—despite its innovative potential—struggled to gain traction in the market.\textsuperscript{34}

TiVo has faced similar issues. Rather than relying on a centralized media hub like iTunes for the vast majority of its content, TiVo relies on a consumer’s cable provider.\textsuperscript{35} The problem here is that most cable providers have their own DVRs, and have purposefully designed their systems to be incompatible with the device. When TiVo is compatible, thus justifying its purchase, TiVo users can use their internet connection to download rented movies from Netflix.\textsuperscript{36} These digital downloads, like the ones distributed over iTunes, have no doubt cannibalized the market for DVDs.\textsuperscript{37}

The problems with these innovations are obvious. Technology has surpassed the business practices of content providers in Hollywood. This was realized by Rob Glaser, former CEO of RealNetworks, who “fell in love with a DVD-copying device from Kaleidescape while [his wife] was pregnant and confined to a bed several years ago.”\textsuperscript{38} Glaser assumed that if Kaleidescape could build a device that copied DVDs while maintaining membership with the DVD-CCA then RealNetworks could too.\textsuperscript{39} The inspiration for RealDVD and its hardware cousin Facet was born.

\begin{itemize}
\item[34] First Year Apple TV Sales Fall Below Expectations, APPLE INSIDER (Dec. 7, 2007, 4:00 PM), http://www.appleinsider.com/articles/07/12/10/first_year_apple_tv_sales_fall_below_expectations.html.
\item[35] Cable providers have fought vigorously to make TiVo technology incompatible with digital cable. Nate Anderson, TiVo: Cable is Strangling our Business with SDV, ARS TECHNICA (Feb. 21, 2010), http://arstechnica.com/tech-policy/news/2010/02/tivo-cable-is-strangling-our-business.ars. These practices raise anticompetitive concerns of their own. Although outside the scope of this comment, the overuse of licensing and the erosion of the \textit{Sony} rule—that copying for personal use is presumptively fair—has encouraged cable and satellite providers to shut TiVo and other innovators out of the market. If you are among the millions of consumers who pay more than one hundred dollars per month for a sophisticated HD-DVR cable package and wonder why the cable box itself is so slow and suffers from such laggard performance, you now know why.
\item[37] Cf. Carlo Longino, Film Studios can ‘Cannibalize’ Their DVD Sales, or Lose them Completely, TECHDIRT (May 27, 2009), http://www.techdirt.com/articles/20090526/0908025013.shtml (studios have considered pulling their movies from Netflix in light of declining sales).
\item[39] Id.
\end{itemize}
Glaser “viewed RealDVD as a way to enter the digital video market.”40 In addition to traditional DVD playback, RealDVD could retrieve information about the film, provide links to related websites, and store “an image of the copy-protected DVD to a computer hard drive” for archival and playback without the in-drive presence of a DVD.41

RealNetworks also developed Facet. Facet was a hardware platform that relied on the RealDVD software for playback, organization, and storage of DVD content by means of “an intuitive user interface.”42 Unlike AppleTV or TiVo, which have the capacity to cannibalize DVD sales, RealDVD and Facet could add value to DVD’s by allowing consumers to make new uses of the discs themselves.43

Glaser’s belief that the legal hurdles were insignificant was confirmed by a state trial court in Kaleidescape.44 RealNetworks responded to the Kaleidescape decision by moving forward with the production of RealDVD. From this point on, every facet of the story fell apart.45

B. The RealDVD/Facet Dispute

Under the DMCA,46 manufacturers may not make devices that assist consumers in circumventing CSS encryption because the DMCA

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40 RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913, 924 (N.D. Cal. 2009).
41 Id.
42 Id. at 925–26.
43 See Julie Jacobson, Copy Protection Group Sues Kaleidescape, CEPRO (Jan. 1, 2005), http://www.cepro.com/article/copy_protection_group_sues_kaleidescape/D1 (explaining how the demand for DVDs goes up as Kaleidescape’s market share expands).
46 Many believe that the United States was obligated to pass the DMCA after signing the World Intellectual Property Organization Copyright Treaty (“WIPO Treaty”). Burk, supra note 4, at 558. But Burk contends that 1998 U.S. copyright law was largely compliant with these requirements and that “lobbying by content industries resulted in the enactment of . . . [the DMCA] containing anti-circumvention provisions that far exceed anything contemplated by the treaty.” Id.
makes trafficking in such devices, regardless of their use, illegal.\footnote{17 U.S.C. § 1201(a)(2) (2006) (anti-trafficking provision).} In other words, while consumers possess the fair use right to backup their DVDs to other hard drives or devices,\footnote{\textit{Cf.} RIAA v. Diamond Multimedia Sys. Inc., 180 F.3d 1072, 1079 (9th Cir. 1999) (ripping CDs into MP3 format for use on a portable MP3 player is fair use).} they do not possess the right to \textit{circumvent} the encryption protecting them in order to make fair use backup copies of copyrighted works.\footnote{Universal City Studios, Inc. v. Corley, 273 F.3d 429, 440 (2d Cir. 2001) (holding that a computer programmer violates the anti-trafficking provision of the DMCA when he designs and posts software (DeCSS) on the internet that allows users to circumvent CSS to access copyrighted works on DVDs). For a superb and concise discussion of \textit{Corley}, see ROGER E. SCHECTER & JOHN R. THOMAS, \textsc{Intellectual Property: The Law of Copyrights, Patents and Trademarks} § 7.7, at 144–46 (2003).} The result of this paradigm is that consumers paradoxically need to obtain permission to circumvent CSS from the DVD Copy Control Association in order to convert their DVDs into a format that can be used on a laptop or iPod.\footnote{This result is absurd because consumers cannot call the DVD-CCA even if they wanted to. The DVD-CCA, according to its chief litigator is “not a regular company” because “[y]ou can’t call them up and ask questions.” Julie Jacobson, \textit{Industry Insider: DVD CCA is an Innovation-Stifling Cartel}, CE PRO (Jan. 1, 2005), http://www.cepro.com/article/industry_insider_dvd_cca_is_an_innovation_stifling_cartel/.}

This interpretation of the DMCA, that manufacturers cannot sell devices that backup lawfully purchased DVDs for space-shifting purposes, was not shared by RealNetworks.\footnote{RealNetworks was convinced that they could raise a \textit{Sony} styled “substantial non-infringing” fair use argument despite post-DMCA DVD copying cases that have held the contrary. \textit{Compare} Reporter’s Transcript of Proceedings at 78–85, RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913 (N.D. Cal. 2009) (No. 3:08-CV-04548), ECF No. 44 [hereinafter TRO Hearing], and \textit{Sony} Corp. of Am. v. Universal City Studios, Inc., 464 U.S. 417, 442 (1984) (fair use defense covers devices with substantial non-infringing uses), \textit{with} Universal City Studios, Inc. v. Reimerdes, 111 F. Supp. 2d 294, 324 n.170 (S.D.N.Y. 2000) (the DMCA does not incorporate \textit{Sony}), \textit{aff’d sub nom.} Universal City Studios, Inc. v. Corley, 273 F.3d 429 (2d Cir. 2001).} Despite their optimism, RealNetworks realized that this fair use argument has not gained much traction in the courts.\footnote{Indeed, it has gained an especially deaf ear in Judge Patel’s courtroom in the Northern District of California. Before adjudicating the RealDVD dispute, Judge Patel gained notoriety as the jurist who shut down Napster. A&M Records, Inc. v. Napster, Inc., 114 F. Supp. 2d 896, 913–14 (N.D. Cal. 2000) (rejecting Napster’s \textit{Sony} argument because users “can keep the music they download”), \textit{aff’d in part, rev’d in part}, 239 F.3d 1004 (9th Cir. 2001).} Accordingly, RealNetworks pursued licensing negotiations with Paramount and Fox directly. The negotiations did not go well, and at one point a Paramount representative flatly told RealNetworks that they would “require blood money to break the
Rather than capitulating, RealNetworks proceeded with the development of RealDVD.

On September 30, 2008, the date RealDVD was scheduled to be released, RealNetworks filed a complaint in the United States District Court for the Northern District of California seeking a declaratory judgment that “the CSS License Agreement permits the manufacture, distribution, and sale of the RealDVD product” and that RealNetworks did “not violate the DMCA.” The DVD-CCA and the movie studios responded by filing counterclaims alleging breach of the CSS license agreement and DMCA violations. On October 9, 2008, citing RealDVD’s noncompliance with the DMCA and Real’s probable breach of the CSS license agreement, the District Court entered a temporary restraining order against RealNetworks to prevent the continued distribution of RealDVD and its hardware cousin Facet. Both parties litigated the matter vigorously over the next several months. On May 13, 2009, RealNetworks filed antitrust counterclaims against the DVD-CCA and the studios.

In the final chapter of the litigation, RealNetworks received a beat down; everything that could have gone wrong for them did. The breach of contract and DMCA claims went to final judgment on August 11, 2009 in favor of the DVD-CCA. Adding insult to injury, the Kaleidescape ruling was reversed a day later. On January 8, 2010, the District Court granted the studios’ motion to dismiss the antitrust counterclaims. On March 3, 2010, Real settled with the six major Hollywood studios and the DVD-CCA for $4.5 million, agreed to withdraw its appeal, and stopped selling its RealDVD software and affiliated products.

53 Transcript of Proceedings at 36, RealNetworks, 641 F. Supp. 2d 913 (No. C 08-04548 MHP) [hereinafter Antitrust Transcript].
55 TRO Hearing, supra note 51 at 103.
57 Plaintiffs and Counterclaim Defendants RealNetworks, Inc. and RealNetworks Home Entertainment, Inc.’s Answer and Counterclaims to the Counterclaims of the DVD Copy Control Association, RealNetworks, 641 F. Supp. 2d 913 (No. C 08-04548), ECF No. 323 [hereinafter Antitrust Counterclaims].
58 RealNetworks, 641 F. Supp. 2d at 954.
60 Antitrust Order, supra note 5, at 2-3.
61 Press Release, RealNetworks, Inc., RealNetworks Settles RealDVD Dispute
II. CONTEXTUALIZING THE ANTITRUST ISSUES

RealNetworks claimed that the CSS license agreement was the mechanism by which the studios effectuated their concerted refusal to deal. In order to evaluate that claim fairly, inquiry into the DVD-CCA and the CSS license agreement must be made.

A. The DVD-CCA

Matsushita and Toshiba, the original developers of CSS, granted the DVD-CCA a “royalty-free license in CSS technology and the DVD-CCA became the sole licensor and administrator of CSS technology under the CSS License Agreement.” As the sole licensor of CSS, the DVD-CCA requires that every licensee comply “with the uniform set of rules set forth in the CSS license” whose purpose is to prevent copying of CSS-protected content. Licensees must also pay a $15,000 fee to the DVD-CCA.

Approximately 300 companies in various industries have licensed CSS from the DVD-CCA. Licensees include content producers, creators of software and hardware decoders, and manufacturers of DVD players. “CSS has been implemented in millions of DVD players and computers worldwide and is used to protect the content on hundreds of millions of DVDs.”

The DVD-CCA is governed by a twelve member Board of Directors: five from the major motion picture studios, three from the consumer electronics industry, three from the computer manufacturing industry, and one at-large director. Strangely, the DVD-CCA does not openly publicize the members of the board on their website. However, in one correspondence between Kaleidescape and the


63 Id. at 921.
64 Id. (“To become a CSS licensee, an interested party must . . . pay the requisite fee.”); Jacobson, supra note 50 (CSS licenses cost $15,000).
66 RealNetworks, 641 F. Supp. 2d at 921.
67 Id.
68 Id. at 918.
70 Kaleidescape is a product similar to RealNetworks’ Facet. See John Y. Kim, The Great Kaleidescape: New Hope in the Digital Rights Debate, 27 TEMP. J. SCI.
DVD-CCA, six of the board members are identified. 71 One glance at their names makes the multi-industry cartel-like appearance of the DVD-CCA too hard to ignore: Chris Cookson, of Warner Brothers; Benn Carr, of Disney; Jeff Lawrence, of Intel; Gabe Beged-Dov, of Hewlett-Packard; David Harshman, of Toshiba; and Andy Parsons, of Pioneer. 72 These are some of the largest players in the content and electronics industries. 73 Moreover, it is impossible to reach the DVD-CCA’s board members by simply picking up the phone and calling them because there is no “them” to talk to. 74

B. The CSS License Agreement

The dispute in RealNetworks focused on the interpretation of the CSS license agreement. The CSS license agreement prohibited Real from “making available the means for . . . unauthorized copying of copyrighted content intended to be protected using CSS.” 75 Real argued that it could win at trial regardless of the construction given to the word “unauthorized.” 76

One interpretation of the agreement, informed by the Kaleidescape case, is that the word unauthorized must mean that some forms of copying must be authorized. 77 Otherwise, the term unauthorized, as

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72 Id.
73 See generally id. (arguing the potential influence DVD-CCA members have on the market and to the viability of Kaleidescape as a business).
74 Jacobson, supra note 43.
75 RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913, 921 (N.D. Cal. 2009) (internal quotations omitted) (emphasis added).
76 See id. at 946 (“According to Real, the Agreement does not ban all copying of DVDs, but rather, only requires copy protection to the extent that the technical specifications mandate certain functions be preserved in compliant DVD products.”).
77 Antitrust Counterclaims, supra note 57, at 20 (“If the Studios and the DVD CCA are wrong in their interpretation of the CSS License, then their attempt to use the License to impose post-hoc terms that were not included in the License amounts to an illegal group boycott.”).
used in the CSS license agreement, is meaningless (i.e., the agreement’s drafters could have omitted the word unauthorized and achieved the same result). Because the inclusion of the word unauthorized implies that certain forms of copying were authorized, the studios must have still been able to license their copyrighted content stored on DVD to Real, including the right to reproduce that content. The only way that the studios could not make such a license is if the DVD-CCA could paradoxically sue the movie studios for licensing its own content simply because that content is stored on DVD. To protect the interests of the DVD-CCA, Real could, under this interpretation, create a product like Facet that locks up content with enhanced security measures to prevent infringement, and then raise a *Sony*-styled “substantial non-infringing” fair use argument in subsequent infringement suit by non-consenting studios. The court rejected these arguments.

The other possible interpretation, advanced by the DVD-CCA, is that the CSS license agreement does not allow any copying of CSS protected content whatsoever. Under this construction, the CSS license agreement does not permit individual studios from licensing their CSS-protected DVD content to a manufacturer like Real even though the studios have the exclusive right to license such content under the copyright laws. This is because—the DVD-CCA would argue—such a license would effectively destroy the protection that the DVD-CCA afforded to other content producers. In other words, the

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79 *RealNetworks Inc.*, 641 F. Supp. 2d at 941–43.

80 Antitrust Counterclaims, *supra* note 57, at 19.

81 Antitrust Transcript, *supra* note 53, at 27–28, 30. The studios also argued that the CSS license agreement does not prohibit the licensing of digital content directly (in other words, digital content not on DVD). *Id.* at 16–17. This argument makes sense only in the complicated haze of copyright law, in which “courts do not rely on a description of the work, but rather look to the fixed format of the work itself . . . for determining the scope of protection.” Dan L. Burk & Mark A. Lemley, *Fence Posts or Sign Posts? Rethinking Patent Claim Construction*, 157 U. PA. L. REV. 1743, 1774 (2008) (emphasis added). But in reality, *digital video* is the fixed format, not DVD. See generally Antitrust Transcript, *supra* note 53, at 31. And though copyright law does not say much about reality, antitrust law does. My argument is a simple one: that, under the guise of their DMCA-endorsed *faux* distinction between DVDs and digital download, the studios are forcing innovators like RealNetworks to sign the CSS license agreement just to negotiate licensing terms with member studios.

82 For example, if Paramount sold RealNetworks a license to let its customers
only way the movie studios can protect their content is by surrendering their ability to license CSS protected content to the DVD-CCA, which could not license individual studio content without consent from all of the member studios; or, in metaphorical terms, the studios locked up their movies and then threw away the key. In sum, the DVD-CCA read the agreement to mean that under no circumstances was copying of CSS-protected content permitted. And this reading was adopted by the District Court in *RealNetworks*.

The problem with this reading of the CSS license agreement is that the DVD-CCA’s amendment process functionally stops Real from negotiating with the DVD-CCA directly. This is a classic section 1 antitrust concern known as a horizontal refusal to deal, or a horizontal group boycott.

This horizontal refusal was effectuated in many ways. First, “[p]rospective licensees are not permitted to negotiate any aspect of the CSS License or Procedural Specifications.” Thus, Real had to agree to the CSS license’s terms first, and then try to amend them later. Next, once it obtained the CSS license—which of course bound Real to the unamended terms—Real would then have to convince all three hundred DVD-CCA members (movie studios, consumer electronics firms, and members of the computer industry) to agree to permit copying of CSS-protected content. This is far from likely. Recognizing that the agreement retards innovation in the market for video servers, personal video recorders, and software like RealDVD, consumer electronics manufacturers have invested their limited resources elsewhere. If they now agree to an amendment that permits copying, they will (upon agreement) be lagging in a market where innovation and first-mover advantage is critical. Movie studios also have no interest in amending the agreement because of their belief that revenues from the digital download market would consequently decline. This is the classic motive and effect of a horizontal refusal to deal.

make backup copies of *Iron Man* using RealDVD, then RealDVD could also copy content produced by other studios who have refused to negotiate with RealNetworks. In this case, nothing is stopping nonparties to this hypothetical agreement to pursue a cause of action for copyright infringement. Assume for instance that Paramount sold Real a license to let consumers make backup copies of its content. Also, assume that Real refused to pay for a license on similar terms with the other studios. On these facts, there is no reason why the other studios—who were not parties to the license—could not pursue a copyright infringement action against RealNetworks.

83 *RealNetworks*, 641 F. Supp. 2d at 923.
84 *Id.* at 922.
86 Jacobson, *supra* note 50.
Realizing that it was locked into a virtually unamendable agreement, Real met with Fox and Paramount in the hopes of obtaining an exclusive license that would allow RealDVD to copy Fox and Paramount DVDs onto consumer hard drives. Discussions broke down, and Paramount—along with the remaining six major movie studios—refused to license their DVD content to Real. Relying on the CSS license agreement, the movie studios claim that they were contractually bound not to sell such a license.

This interpretation of the CSS license agreement—that the agreement itself prevents movie studios from licensing their DVD content—presents a colorable concerted refusal to deal claim under section 1 of the Sherman Act.

C. The Digital Millennium Copyright Act

Dealing with the DVD-CCA is a nightmare for innovators. It is no surprise then that RealNetworks tried to avoid negotiating with them entirely. Instead, they thought, why not simply reverse engineer CSS and design software like RealDVD or hardware like Facet without obtaining a CSS license? The answer is that the DMCA makes this activity illegal, even though the DMCA does not grant a new copyright per se. Instead, it merely creates new bases of liability. Since no new property rights are created, organizations like the DVD-CCA can run afoul of the Sherman Act when they use encryption mechanisms to block the licensing of copyrighted content by tying the

87 Antitrust Order, supra note 5, at 2–3.
88 Antitrust Counterclaims, supra note 57, at 12.
89 Id.
90 The intersection of antitrust law and copyright law is an obvious by-product of the DMCA. Had the DMCA not been in force when RealNetworks was decided (i.e., copyright law prior to 1998), then there would be no antitrust issue: one could simply reverse engineer the CSS encryption and distribute products that make decryption possible. The only limitation would be copyright infringement, which is subject to traditional defenses like fair use, as opposed to the DMCA’s regime of anticircumvention violations, which is not.
92 Chamberlain Grp., Inc. v. Skylink Techs., Inc., 381 F.3d 1178, 1192 (Fed. Cir. 2004) (“The essence of the DMCA’s anticircumvention provisions is that §§ 1201(a),(b) establish causes of action for liability. They do not establish a new property right. The DMCA’s text indicates that circumvention is not infringement . . . . This distinction between property and liability is critical.”) (emphasis added).
93 Id. at 1192–93 (“Whereas copyrights, like patents, are property, liability protection from unauthorized circumvention merely creates a new cause of action under which a defendant may be liable.”).
content to a horizontal agreement, which requires the licensee to refrain from entering the market for personal video servers and similar devices.

That is not to say that Hollywood’s copyright concerns are entirely illegitimate. The owner of a federally protected copyright has “the exclusive right” to reproduce the copyrighted work, to prepare derivative works, to distribute copies, to perform the work, and to display the work. The copyright owner may also license or sell these rights to a third-party. Possession of a copyright satisfies the functional definition of monopoly because a copyright owner is able to decide how and at what price to extract value from the copyrighted content.

In addition to infringement under the 1976 Copyright Act, plaintiffs in DVD copying cases often raise the anti-trafficking provisions of the DMCA as an additional cause of action. The anti-trafficking provisions target “not those who break into another’s domain, but instead those who facilitate the process.” There are two types of anti-trafficking provisions: the access-control provision and the copy-control provision. The District Court found that RealNetworks violated both of these provisions by developing and distributing RealDVD.

One problem with the DMCA is that it is not subject to traditional defenses to copyright infringement like fair use. Fair use is the “guarantee of breathing space” at the heart of copyright. Although anti-trafficking violations are not necessarily copyright infringement cases, most defendants in DMCA actions will nevertheless raise fair use as a defense. Before the DMCA, fair use—as codified in

96 BLACK’S LAW DICTIONARY 1028 (8th ed. 2004) (defining monopoly as “[t]he market condition existing when only one economic entity . . . provides a particular service.”).
98 3 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 12A.03[D][1] (2007).
99 Id. § 1201(b)(1).
100 RealNetworks, 641 F. Supp. 2d at 932–36.
102 E.g., RealNetworks, 641 F. Supp. 2d at 940–44; Universal City Studios, Inc.
section 107 of the Copyright Act—was understood by the Supreme Court to include “substantial noninfringing uses.” This included using a VCR to record TV shows that you otherwise would not be at home to watch.

Applying the fair use doctrine to the DMCA has been problematic, because it is an affirmative defense to copyright infringement, not circumvention or trafficking. Like most DMCA cases, RealNetworks was not an infringement suit. Therefore, fair use’s application to DMCA cases remains suspect at best.

With fair use out of the picture, current copyright law has pitted the legitimate expectations of consumers (to have access to new and innovative technology that naturally results from a competitive marketplace) against this notion that copyright law permits content owners to restrain the development of that technology in the name of protecting their copyrighted works.

Fair use’s absence, however, presents a false choice with respect to liability under the Sherman Act. Simply put, nothing in the DMCA provides content owners with the right to control the use of their content to restrain trade in the market for other technologies in violation of section 1 of the Sherman Act.


104 17 U.S.C. § 107. Although fair use is codified in § 107, legislative history makes it clear that statutory recognition of fair use was meant to simply “restate the present judicial doctrine of fair use, not to change, narrow, or enlarge it in any way.” WILLIAM F. PATRY, THE FAIR USE PRIVILEGE IN COPYRIGHT LAW, 413 (2d ed. 1995) (quoting H.R. REP. NO. 94-1476 (1976)).


106 Id.

107 PATRY, supra note 105, at 413 (“Fair use is an affirmative defense. As such, it is relevant only after there has been a prima facie showing of infringement, i.e., copying and substantial similarity.”) (citations omitted); see 17 U.S.C. §§ 107, 1201(c)(1).

108 For the same reason, the applicability of the doctrine of copyright misuse also remains suspect. Burk, supra note 3, at 1132. I have not considered copyright misuse in this comment because misuse is traditionally invoked as an affirmative defense to copyright infringement. See Kathryn Judge, Rethinking Copyright Misuse, 57 STAN. L. REV. 901, 902–03 (2004). Despite its similarities with section 1 Sherman Act claims, copyright misuse is not an affirmative cause of action that if proven entitles the claimant to relief.

III. APPLYING ANTITRUST ANALYSIS TO THE DVD-CCA

Section 1 of the Sherman Act bans “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations.”\textsuperscript{110} However, section 1 “cannot mean what it says”\textsuperscript{111} because “[e]very agreement concerning trade . . . restrains. To bind, to restrain, is of their very essence.”\textsuperscript{112}

There are, however, “certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.”\textsuperscript{113} Courts considering the use of this per se rule must determine “whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output.”\textsuperscript{114} “The ‘concerted’ refusal to deal, or agreement of two or more persons not to deal with a third, has traditionally been characterized as per se illegal under the antitrust laws.”\textsuperscript{115} The concerted aspect of the refusal explains its “pernicious effect on competition,”\textsuperscript{116} not the refusal itself.\textsuperscript{117}

Not all concerted refusals, however, will receive per se scrutiny.\textsuperscript{118} Hovenkamp notes that “[t]he per se rule is reserved for so-called naked boycotts—that is, concerted refusals of competitors to deal with another competitor, customer or supplier when no case can be made that the refusal is ancillary to any legitimate joint activity.”\textsuperscript{119}

\begin{itemize}
\item \textsuperscript{110} 15 U.S.C. § 1.
\item \textsuperscript{111} Nat’l Soc’y of Prof’l Eng’rs v. United States, 435 U.S. 679, 687 (1978).
\item \textsuperscript{112} Bd. of Trade of Chi. v. United States, 246 U.S. 231, 238 (1918).
\item \textsuperscript{113} N. Pac. Ry. Co. v. United States, 356 U.S. 1, 5 (1958) (describing the types of agreements traditionally condemned as per se illegal).
\item \textsuperscript{116} N. Pac. Ry. Co., 356 U.S. at 5.
\item \textsuperscript{117} See E. States, 234 U.S. at 611–12 (explaining while a single firm may voluntarily refuse to deal with another, competitors who agree to a refusal may not).
\item \textsuperscript{119} HOVENKAMP, supra note 115, § 5.4a, at 221.
\end{itemize}
the “competitive effect can only be evaluated by analyzing the facts peculiar to the business, the history of the restraint, and the reasons why it was imposed,” the court should employ the rule of reason.\(^{120}\) Under the rule of reason, “the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition.”\(^{121}\)

The DVD-CCA’s practices are not of the type for which “no case can be made” that the total ban on copying of CSS-protected content is ancillary to “legitimate joint activity.”\(^{122}\) Certainly the CSS license agreement is a mechanism by which content owners can protect their copyrights.\(^{123}\) Moreover, the agreement fosters competition in the market for DVD players and other compliant devices. Because the agreement can foster competition in that market, it is not entirely anticompetitive. Analysis must therefore proceed under the rule-of-reason.

The framework for analyzing a practice under the rule-of-reason was best articulated by Justice Breyer, who wrote separately in *California Dental Association v. Federal Trade Commission*.\(^{124}\) *California Dental* involved dentists who were members of an association (the CDA) that required its members to abide by a code of ethics.\(^{125}\) The code provided that dentists could not make false or misleading advertisements.\(^{126}\) This included the advertising of “fees for specific types of services without fully and specifically disclosing all variables and other relevant factors.”\(^{127}\)

Disapproving of the practice, the FTC filed an enforcement action against the CDA. The agency alleged that the “CDA had unreasonably restricted two types of advertising: price advertising, particularly discounted fees, and advertising relating to the quality of dental services.”\(^{128}\)

The Court held that the Court of Appeals erred in applying a so-called “quick-look analysis.”\(^{129}\) The Court believed that because the


\(^{122}\) HOVENKAMP, supra note 115, § 5.4a, at 221.

\(^{123}\) Albeit, much like a nuclear bomb can be used as a fly swatter.

\(^{124}\) 526 U.S. 756 (1999).

\(^{125}\) Id. at 759–60.

\(^{126}\) Id. at 760.

\(^{127}\) Id. at 760 n.1.

\(^{128}\) Id. at 762.

\(^{129}\) Id. at 769. Quick-look is less categorical than the per se rule, but less thorough than the rule of reason.
anticompetitive effects were “far from intuitively obvious . . . a more thorough enquiry into the consequences of those restraints [should have been] performed.”  

Justice Breyer, concurring in judgment, found this distinction to be ridiculous. Recognizing that antitrust analysis was more of a continuum rather than one constricted by bright line categorical rules, Justice Breyer wrote that

I would not simply ask whether the restraints at issue are anticompetitive overall. Rather, like the Court of Appeals (and the Commission), I would break that question down into four classical, subsidiary antitrust questions: (1) What is the specific restraint at issue? (2) What are its likely anticompetitive effects? (3) Are there offsetting procompetitive justifications? (4) Do the parties have sufficient market power to make a difference? 

This mode of analysis is eminently sound. For that reason, it should be no surprise that this organizational structure is in accord with the views of noted antitrust scholar Phillip Areeda.  

The following analysis of the DVD-CCA and the CSS license agreement is correspondingly broken down to that structure.

A. Identifying the Specific Restraint: The Studios’ Collective Refusal to License

The specific restraint at issue is the studios’ collective refusal to grant a license to RealNetworks to “make and sell a device that copies their DVD content onto a hard drive.”  

Id. at 759.

Id. at 782 (Breyer, J., dissenting).

See id. at 784 (citing 7 P. AREEDA, ANTITRUST LAW ¶ 1503a, at 372–77 (1986)); id. at 786–87 (citing 7 P. AREEDA, ANTITRUST LAW ¶ 1504, at 377–83 (1986)); id. at 788 (citing 7 P. AREEDA, ANTITRUST LAW ¶ 1503, at 376–77 (1986)).

RealNetworks, Inc. & RealNetworks Home Entertainment, Inc.’s Opposition to Studios’ Motion to Dismiss Antitrust Claims at 1, 4–5 RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913 (N.D. Cal. 2009) (No. 3:08-CV-04548-MHP), ECF No. 476 [hereinafter Opposition to Dismissal]. The argument that there was no explicit agreement is of no import and requires little discussion in light of numerous Supreme Court decisions, like Interstate Circuit, Inc. v. United States, 306 U.S. 208 (1939), which hold that an illegal conspiracy can be inferred “without direct proof of an agreement.” Barak D. Richman, The Antitrust of Reputation Mechanisms: Institutional Economics and Concerted Refusals to Deal, 95 VA. L. REV. 325, 343 (2009).
careful in his *California Dental* opinion to distinguish between the agreement, which the defendants blame for their anticompetitive behavior, and the behavior itself.\(^{134}\) This distinction is important, because if the restraint was simply the CSS license agreement itself, then it would be difficult for courts to evaluate the “substantive economic effect” of the DVD-CCA’s conduct.\(^{135}\)

Nevertheless, I refer to the restraint as “the studios’ collective refusal” and the “CSS license agreement” interchangeably. This is because the CSS license agreement memorializes the studios concerted refusal to license.

**B. What are the CSS-License Agreement’s likely anticompetitive effects?**

The second part of the analysis asks whether the restraint has “the potential for genuine adverse effects on competition.”\(^{136}\) There are two main anticompetitive effects of the studios’ refusal to deal: (1) the damage to the market for video servers, aftermarket DVRs, and software like RealDVD, and (2) the agreement’s potential to prevent individual studios from licensing their copyrighted CSS-protected DVD content.

i. Damage to the Market for Video Servers, Aftermarket DVRs, and Software like RealDVD

The studios’ refusal to license their CSS-protected DVD content has retarded innovation in the consumer electronics market. Without a license from the studios’ or the DVD-CCA, RealNetworks cannot legally build a device that can compete with a DVR like TiVo or a standalone media server like Apple TV. Unlike both of these

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\(^{134}\) *Cal. Dental*, 526 U.S. at 782 (Breyer, J., dissenting) (“The most important question is the first: What are the specific restraints at issue? Those restraints do not include merely the agreement to which the California Dental Association’s . . . ethical rule literally refers, namely, a promise to refrain from advertising that is ‘false or misleading in any material respect.’ Instead, the Commission found a set of restraints arising out of the way the Dental Association implemented this innocentsounding ethical rule in practice, through advisory opinions, guidelines, enforcement policies, and review of membership applications.”) (second emphasis added) (internal citations omitted).


\(^{136}\) *Cal. Dental*, 526 U.S. at 784 (Breyer, J., dissenting) (internal citations omitted).
products, Facet has the advantage of not being linked to a downstream subscription (from either a cable provider or iTunes, respectively). If released, it would pave the way for the next generation of media servers that could truly claim the title “God’s Machine.”

The studios argued that the CSS license agreement, not their concerted conduct, was the basis of their refusal. This argument should have carried little weight because the studios framed the CSS license agreement. In fact, the trial transcripts make clear that “the motion picture studios got together as a group to determine the terms of the CSS license.”

Nevertheless, the studios might point out that all of the relevant players in the consumer electronics industry (including RealNetworks) are members of the DVD-CCA. This argument has two prongs to it. First, as a horizontal agreement with vertical overtones, the studios would contend that the CSS license agreement should be provided more deference than what antitrust law provides for ordinary horizontal arrangements. Second, to the extent that the agreement restrains trade, the companies who are restrained have voluntarily agreed to the restraint. Both of these arguments must be rejected.

137 This was the FCC Chairman’s description of TiVo. See TiVo Sales Remain Tepid Despite Fanatic Fans, FORBES.COM (Sept. 11, 2003, 6:00 AM), http://www.forbes.com/2003/09/11/0911tivopinnacor.html. However, technology today allows for so much more. For example, it is entirely possible to build a device that would have two terabytes of storage space (that is equal to 2,000 gigabytes, or about 750 hours of HD programming), with 802.11n wireless networking (so it could access Netflix and other online services in addition to movies, music, and videos stored on your other computers quickly), a DVD-burner (like Facet), a TV tuner (like TiVo), a built-in VPN protocol (so you can access all of your media anywhere in the world from your phone or laptop), an AM/FM tuner, and a port for connecting Sirius/XM radios. What’s the point of any of this technology though, if you cannot use it to archive, organize, and view your DVD movie collection? See Longino, supra note 37 (studios have considered pulling their movies from Netflix in light of declining sales). As long as consumers agree with this sentiment, electronics firms will invest their research dollars elsewhere. Accordingly, innovation and consumers will suffer.


139 Second Amended Complaint, supra note 138, at 13.

140 Unlike horizontal competition, which “takes place between firms at the same stage,” vertical competition refers to “competition between firms at successive stages.” Robert L. Steiner, Vertical Competition, Horizontal Competition, and Market Power, 53 ANTITRUST BULL. 251, 251 (2008).
The vertical aspect argument is fundamentally flawed. In pointing to antitrust law’s recent tradition of not scrutinizing vertical agreements under the per se rule, the argument fails to account for circumstances—like this one—wherein the vertical players have an economic interest in restraining innovation in the relevant market. In the case of DVDs, consumer electronics manufacturers have invested their limited resources towards endeavors other than DVD archivers or video servers. If the consumer electronics firms now agree to a proposed amendment that permits copying, they will (upon agreement) be among the second movers; lagging in a market where being first to market is key.

The second part of the argument—that RealNetworks has agreed to the restraint—is a sheer misstatement of the facts. Agreement implies mutual assent to the terms. As mentioned supra, however, the CSS license agreement is offered on a take-it or leave-it basis. As the District Court pointed out,

> prospective licensees are not permitted to negotiate any aspect of the CSS License or Procedural Specifications. Nor does DVD CCA offer prospective licensees any legal advice about the License Agreement or the Procedural Specifications at any time—whether the advice concerns specific terms, membership categories, or more general questions about compliance.

In other words, not only was RealNetworks required to accept the terms as they were offered, or in the alternative, refuse the license and have no ability to develop innovative devices that utilize DVD content, but it was also forced to accept these terms without an understanding of the DVD-CCA’s interpretation of them. Regardless of whether such a contract of adhesion is enforceable as a matter of state contract law, it certainly should not provide a basis for estopping a federal antitrust claim under the Sherman Act.

The consequence of this type of activity is clear. Before an innovator develops new devices or technologies that utilize DVD content, they must first accept the take-it-or-leave-it CSS license agreement. By digitally restricting all forms of copying, including

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142 Jacobson, supra note 43.

143 See supra note 70 and accompanying text.

144 RealNetworks, 641 F. Supp. 2d at 922.
those permitted by copyright law, the CSS license agreement provides a virtual guarantee that innovation will be restricted, if not eliminated, in the market for video servers and other related devices.

ii. The Agreement Eliminates the Ability of Movie Studios to License their Copyrighted CSS-Protected DVD Content

The second anticompetitive effect of the restraint is that it prohibits the studios from licensing their copyrighted CSS-protected DVD content. The point here is exposed by the Court of Appeals for the Second Circuit: “while owners of copyrights may individually refuse to deal with a party seeking a license, such owners may not collectively refuse to deal to prevent competition.”\textsuperscript{145} This is exactly what the movie studios did in RealNetworks.\textsuperscript{146}

Arguing that such an agreement was necessary without more is no defense. Rather, the DVD-CCA must provide a basis for a court to conclude that the restraint—the refusal to license RealNetworks the ability to manufacture RealDVD and Facet—was “no greater than was [reasonably] necessary” to achieve the studios goal of protecting their copyrights.\textsuperscript{147}

The studios’ refusal to license, as memorialized in the CSS license agreement, appears to fail this test on two grounds. First, the studios made no attempt to consider whether the development of RealDVD and Facet actually posed a threat to the copyrighted works owned by the studios. Although copyright law does not require such a consideration, antitrust law does. Second, the studios’ decision to construct and bind the entire industry to a virtually unamendable CSS license agreement made an individual consideration of RealDVD and Facet impossible.\textsuperscript{148} Although the antitrust laws impose no duty for a


\textsuperscript{146} Antitrust Counterclaims, supra note 57, at 11–12.

\textsuperscript{147} Clarence E. Eldridge, \textit{A New Interpretation of the Sherman Act}, 13 MICH. L. REV. 1, 10 (1914) (“[T]he restraint imposed must be no greater than was necessary to a full consummation of the indispensable main, lawful purpose.”); see also Gabriel A. Feldman, \textit{The Misuse of the Less Restrictive Alternative Inquiry in Rule of Reason Analysis}, 58 AM. U. L. REV. 561, 567 (2009) (“Taft explained that a restraint was reasonably necessary if it was ‘reasonably adapted and limited to the necessary protection of a party in carrying out [the underlying agreement.]’” (quoting United States v. Addyston Pipe & Steel Co., 85 F. 271, 281 (1898), \textit{modified and aff’d sub nom. Addyston Pipe & Steel Co. v. United States}, 175 U.S. 211 (1899))).

\textsuperscript{148} See Second Amended Complaint, supra note 138, at 13.
firm to deal with its rivals, they certainly provide no refuge for the competitor who—rather than competing on the merits—bands together with his rivals for the sole purpose of eliminating competition.

Had the studios conducted even a perfunctory investigation, they would have discovered that RealDVD and Facet posed little objective threat to the value of the studios’ copyrighted DVDs. In fact, RealNetworks went to great lengths to design a product that protected the ripped DVD content in an encryption format that was far superior to the debilitated CSS—a quintillion \(^{149}\) times more secure to be exact.\(^{150}\) When Facet rips a DVD to its hard drive, it locks the AES encrypted version of the video content onto its hard drive so only Facet can play the saved copy.\(^{151}\) Of particular irony, RealDVD does not even allow a user to transfer playable DVD content onto a device like an iPod or to a backup DVD disc.\(^{152}\) On these facts, it is hard to understand how RealDVD or Facet even posed a threat to the studios’ copyrights.\(^{153}\) Refusing to grant a license to RealNetworks under these circumstances is not “[reasonably] necessary”\(^ {154}\) to protect the studios’ copyrights.

Even if an agreement was necessary in order to protect their copyrights, it is not clear why the agreement had to bind its members to unanimous approval of potential amendments. The argument that it was necessary to promulgate CSS as a secure standard makes little sense once CSS has been hacked.\(^ {155}\) It makes even less sense when alternative security mechanisms like ARccOS and RipGuard are available and do not damage DVD’s compatibility as a format.\(^ {156}\)

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\(^{149}\) One quintillion is equal to \(10^{18}\). *Quintillion Definition*, DICTIONARY.COM, http://dictionary.reference.com/browse/quintillion+ (last visited Sept. 3, 2010).

\(^{150}\) See Second Amended Complaint, supra note 138, at 18. This is the same “encryption system used by the U.S. Government for classified information.” Id.

\(^{151}\) Id. at 18–19.

\(^{152}\) Id. at 18. In other words, RealDVD does not even create the utopia that I described at the beginning of this comment: a world where everyone can access all of their content regardless of where they are or when they want it. This makes the studios’ anticompetitive bent all the more obvious.

\(^{153}\) It is not clear why RealNetworks developed software and hardware that lacked many desirable features. It is probable that Glaser and his team anticipated the RealNetworks litigation. Perhaps they wanted to design a product that would survive the perfect test case. Regardless of their motives, the bottom line is that RealDVD and Facet did not pose a threat to the studios; if anything, RealDVD and Facet’s success could have been a wake-up call to the them. Only then would the studios have realized that their paranoia of DVD copying was hurting their bottom line.

\(^{154}\) Eldridge, supra note 147; Feldman, supra note 147.

\(^{155}\) See infra note 180 and accompanying text.

\(^{156}\) See supra text accompanying notes 23–29.
argument fails for those reasons.

C. Are there offsetting procompetitive justifications?

In light of the aforementioned anticompetitive effects of the studios’ refusal to deal, the studios must proffer some offsetting procompetitive justifications to justify their refusal. In simple terms, the procompetitive justifications must outweigh the anticompetitive effects of the restraint.

There are four offsetting procompetitive justifications that the DVD-CCA could raise in the CSS license agreement’s defense: (1) the protection of copyrighted works, (2) the DVD-CCA is a standard setting organization, (3) the DVD-CCA is a joint venture among competitors, and (4) that RealNetworks was free to license content from the studios directly. These justifications are examined seriatim.

i. The Protection of Copyrighted Works

The first justification, the protection of copyrighted works, is by far the strongest and yet the most misunderstood. Its premise is that copyright law gives the studios the exclusive right to make copies of their works and distribute those copies. The studios, therefore, should be allowed to take any necessary steps to ensure that their works are not being copied. To support this argument, the studios would point to the DMCA, which provides content owners with a cause of action against those who circumvent an encryption mechanism (like CSS) that protects a copyrighted work (like a DVD).157

However impenetrable the bulwark of copyright may be, one is hard pressed to find the specific section of Title 17 that “confer[s] a privilege to violate the antitrust laws.”158 The argument that copyrighted works should be treated differently in the antitrust context is a “ruinous competition” argument that, as the following analysis will show, has consistently been rejected by the Court as invalid.159

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The seminal decision on this issue was handed down more than half-a-century ago in *United States v. Paramount Pictures*.[160] In *Paramount*, the five major motion picture studios,[161] and others, were engaged in a series of practices that violated sections 1 and 2 of the Sherman Act.[162] One of these condemned practices was block-booking, which is the “licensing, or offering for license, one feature [film] or group of feature [films] on condition that the exhibitor will also license another feature or group of features released by the distributors during a given period.”[163] As in *RealNetworks*, the defendants in *Paramount Pictures* argued that their practices should be treated differently because their horizontal agreement dealt with copyrighted works. Affirming the district court’s decision to enjoin this practice, the Court held that

[t]he copyright law, like the patent statutes, makes reward to the owner a secondary consideration. In *Fox Film Corp. v. Doyal*, 286 U.S. 123 (1932), Chief Justice Hughes spoke as follows respecting the copyright monopoly granted by Congress: “The sole interest of the United States and the primary object in conferring the monopoly lie in the general benefits derived by the public from the labors of authors.” It is said that reward to the author or artist serves to induce release to the public of the products of his creative genius. But the reward does not serve its public purpose if it is not related to the quality of the copyright. Where a high quality film greatly desired is licensed only if an inferior one is taken, the latter borrows quality from the former and strengthens its monopoly by drawing on the other. The practice tends to equalize rather than differentiate the reward for the individual copyrights. Even where all the films included in the package are of equal quality, the requirements that all be taken if one is desired increases the market for some. Each stands not on its own footing but in whole or in part on the appeal which another film may have. As the District Court said, *the result is to add to the monopoly of the copyright in*

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[160] *Id.*

[161] In 1948, this included Paramount Pictures, Inc., Warner Bros. Pictures, Inc., Twentieth Century-Fox Film Corp., Columbia Pictures Corp., and Universal Corp. *Id.* at 140.

[162] *Id.* at 141–61 (unlawful practices included price fixing, clearances, pooling agreements, master agreements, block-booking, and discrimination).

[163] *Id.* at 156.
violation of the principle of the patent cases involving tying clauses. 164

The Court went on to mention in a footnote that the Copyright Act “includes no such privilege” to add to the monopoly of copyright by tying the license of one feature to another.165 It is irrelevant that “enforcement of the restriction as to block-booking will be very disadvantageous to [the studios] and will greatly impair [their] ability to operate profitably.”166 This argument, known as the “ruinous competition argument,” is rejected by the Court because “the policy of the antitrust laws is not qualified or conditioned by the convenience of those whose conduct is regulated.”167

This principle applies just as strongly even when the goods in question are not protected by intellectual property law. In Fashion Originators, a guild refused to sell their garments to department stores that sold garments from competing manufacturers, which in the guild’s view, were pirating the guild’s designs.168 The attire designed by the guild was “neither copyrighted nor patented,” and in fact, “existing legislation affords [the guild] no protection against copyists.”169 The guild argued that the combination did not violate the Sherman Act because they did not fix or regulate prices, parcel out or limit production, nor did the practice cause a deterioration in quality.170 Nevertheless, the Court struck down the guild’s acts under the Sherman and Clayton Acts because the guild “exercised sufficient control and power in the women’s garments and textile businesses ‘to exclude from the industry those manufacturers and distributors who do not conform to the rules and regulations of [the guild], and thus tend to create in themselves a monopoly in the said industries.’”171 In other words, the guild had market power.

164 Id. at 158 (emphasis added). The one obvious way to distinguish Paramount Pictures from RealNetworks is that the antitrust harm in RealNetworks is not based on tying; it is based on a group refusal. This difference is meaningless: both tying and group refusals are restraints of trade in violation of section 1 of the Sherman Act. The leveraging concern remains the same regardless of what you label the cause of action. See United States v. Microsoft Corp., 253 F.3d 34, 84 (D.C. Cir. 2001).
165 Paramount Pictures, 334 U.S. at n.12. See also Chamberlain Grp., Inc. v. Skylink Techs., Inc., 381 F.3d 1178, 1201 (Fed. Cir. 2004).
166 Paramount Pictures, 334 U.S. at 159.
167 Id.
168 Fashion Originators’ Guild of Am., Inc. v. FTC, 312 U.S. 457, 461 (1941).
169 Id.
170 Id. at 466.
171 Id. at 466–67.
The guild also argued that “their boycott and restraint of interstate trade” was not prohibited by the Sherman and Clayton Acts because the restraint was “reasonable and necessary to protect the manufacturer, laborer, retailer and consumer against the devastating evils growing from the pirating of original designs and had in fact benefitted all four.”

Like in Paramount Pictures, the Court again rejected this ruinous competition argument because “the aim of [the guild’s] combination was the intentional destruction of one type of manufacture and sale which competed with guild members.” The Court went on to note that “[t]he purpose and object of this combination, its potential power, its tendency to monopoly, the coercion it could and did practice upon a rival method of competition, all brought it within the policy of the prohibition declared by the Sherman and Clayton Acts.”

Fashion Originators cannot be distinguished from Paramount Pictures on the ground that the guild did not have any statutory or common law intellectual property right in its garment designs. “Indeed, even if such rights existed the defendants would not have been permitted to pursue them by means of a boycott but would have had to assert them in a court that could determine both the validity of the claimed rights and the factual issue of infringement.” The relevance of this point is clear: concerted refusals are not a valid method for enforcing intellectual property rights.

From these cases, some principles emerge. Paramount Pictures teaches that fierce competition does not justify leveraging the copyrights over successful movies to the licensing of less popular ones. Fashion Originators takes the proposition one step further to say that Sherman Act liability cannot be avoided by shrouding anticompetitive conduct in an adverse actor’s alleged “piracy.”

The studios’ argument in RealNetworks, that the DMCA vests the studios with a special exemption from the antitrust laws, is the same.
ruinous competition argument that was rejected by the Court over sixty years ago in Paramount Pictures. Simply clothing the devil in a digital dress is not enough to avoid the argument’s circularity. Congress, not the studios, defines the outer boundaries of intellectual property rights.\textsuperscript{178} This is true even when those not conforming to the anticompetitive restraint can be objectively described as pirates, like in Fashion Originators.\textsuperscript{179}

From a pragmatic standpoint, arguing that a horizontal refusal to license DVD content—or CSS itself—is the only reasonable way for the studios to prevent unauthorized copying of their copyrighted content ignores the reality of CSS’s ineffectiveness. Copies of CSS decryption software (like DeCSS) are widely available on the internet.\textsuperscript{180} But more importantly, arguing that a digital fence is necessary to protect content is much different than arguing that all of the competitors in an industry needed to collude to develop the product, lock, and key to that fence; and that access to what lied beyond the fence would be limited only to those who accepted a take-it-or-leave-it license agreement. Copyright law provides the remedies for copyright infringement. All other actions taken by private individuals must be subject to the scrutiny of the Sherman Act. This is the lesson of Fashion Originators: Content producers seeking to protect their intellectual property rights must obtain their remedy from the courts, not themselves.\textsuperscript{181}

Perhaps the DVD-CCA will point to a literal reading of the DMCA. They will contend that any circumvention of CSS on CSS-protected DVDs is now per se illegal under the DMCA unless the DVD-CCA provided Real with explicit authorization to circumvent CSS. However, this argument has already been made and disposed of by the Federal Circuit in Skylink.\textsuperscript{182} The Skylink court held that “[t]he essence of the DMCA’s anticircumvention provisions is that §§ 1201(a)-(b) establish causes of action for liability. They do not

\textsuperscript{178} See Fashion Originators, 312 U.S. at 468 (guild cannot refuse to deal with certain retailers even if the conduct of the “pirates” was tortious or unlawful).

\textsuperscript{179} Id. at 461.

\textsuperscript{180} Faultline, RealNetworks Claims CSS License Lets it Copy DVDs. Sues Studios, THE REGISTER (May 21, 2009, 8:10 GMT), http://www.theregister.co.uk/2009/05/21/realnetworks_sues_hollywood_in_dmca_dispute/ (“CSS algorithms have been known for at least a decade, and are not hard to crack at all.”).

\textsuperscript{181} See Fashion Originators, 312 U.S. at 468.

\textsuperscript{182} Chamberlain Grp., Inc. v. Skylink Techs., Inc., 381 F.3d 1178, 1195 (Fed. Cir. 2004).
establish a new *property right*. The DMCA’s text indicates that *circumvention is not infringement* . . . . “183

The *Skylink* court rejected a literal interpretation of the DMCA.184 It held that such an interpretation “is only plausible if the anticircumvention provisions established a new property right capable of conflicting with the copyright owner’s other legal responsibilities— which as we have already explained, they do not.”185 The court went on to hold that the DMCA did not change “the legal landscape governing the reasonable expectations of consumers or competitors . . . the ways that courts analyze industry practices . . . [nor did it] render the pre-DMCA history of the . . . industry irrelevant.”186 Rather, the “[s]tatutory structure and legislative history both make it clear that § 1201 applies only to circumventions *reasonably related* to protected rights.”187 The court concluded that intellectual property rights of content owners to exclude others from copyrighted content *must be balanced with the policies and limitations imposed by the Sherman Act*.188

Thus, there is nothing peculiar about copyright or the DMCA that *requires* a uniform encryption mechanism to be tied to an agreement that prohibits the licensing of encrypted content.

ii. The DVD-CCA as a Standard Setting Organization and
CSS as the Standard

If *RealNetworks* went to trial on the merits, the studios would have argued that CSS and its accompanying license agreement promotes rather than restrains competition. Because of the “potential for procompetitive benefits [inherent in standard setting associations] . . . most lower courts [have] appl[ied] rule-of-reason analysis to product standard-setting by private associations.”189 As a corollary to the argument that the DVD-CCA is a standard setting organization, the studios have argued that the CSS license agreement is “enormously output-enhancing and pro-competitive.”190

183 *Id.* at 1192 (emphasis added).
184 *Id.* at 1202.
185 *Id.* at 1193.
186 *Id.* at 1194 (alteration in original).
187 *Id.* at 1195 (emphasis added).
188 *Id.* at 1201–03 (emphasis added).
189 Allied Tube & Conduit Corp. v. Indian Head, Inc., 486 U.S. 492, 501 (1988); see also Richman, supra note 133, at 348.
190 E.g., Motion Picture Studio Parties’ Notice of Motion and Motion to Dismiss Real’s Antitrust Claims; Memorandum of Points and Authorities at 17, RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913 (N.D. Cal.
Certainly the agreement is output-enhancing for the studios insofar as it provides an additional layer of protection against the public goods problem inherent in every type of intellectual property. But this is irrelevant for the purpose of determining the practice’s validity under antitrust law. The factfinder must weigh the restraint imposed on the market against the procompetitive benefits derived from the standard. In other words, does the agreement foster more competition in the market for copyrighted movies than it restraints in the market for personal video servers and digital video archivers?

Whether CSS is a procompetitive standard depends on (1) preliminary inquiry of whether the DVD-CCA actually promulgates a standard, (2) whether strong network effects currently exist for the standard, and (3) if internal procedures existed within the DVD-CCA for Real to take advantage of to preserve the output enhancing features of the standard.

The term “standard” must be defined before determining whether the DVD-CCA promulgates one. Professor Lemley defines standards as “any set of technical specifications that either provides or is intended to provide a common design for a product or process.” Even under Lemley’s broad definition, it does not appear that the DVD-CCA is a true standard setting organization. Any argument to the contrary is undercut by the DVD-CCA’s, who in its Answer asserted that “nothing requires a Studio to distribute its content on CSS-protected DVDs.” On the other hand, the DVD format itself is a standard because all major industry players have to distribute their content on DVD because it is the standard means of distribution of movies.

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191 See Mark A. Lemley, Intellectual Property Rights and Standard-Setting Organizations, 90 CALIF. L. REV. 1889, 1892 (2002) (“Intellectual creations are public goods that are much easier and cheaper to copy than they are to produce in the first place. Absent some form of exclusive right over inventions, no one (or not enough people) will bother to innovate. IP rights are thus a ‘solution’ to the public-goods problem because they privatize the public good, giving potential inventors an incentive to engage in research and development.”).

192 See Allied Tube, 486 U.S. at 501.

193 Lemley, supra note 191, at 1896.

194 Studios’ Motion to Dismiss, supra note 190, at 16 (emphasis added).

195 See Kirk, supra note 10. Some may suggest that my argument ignores the growing popularity of internet based distribution of digital video. While internet-based digital video’s popularity is exploding, it is not in the same market as DVDs. DVDs allow a user to take a movie with him in the car, to a friend’s house, or on another device. Digital download doesn’t offer this type of tangibility. Some forms
The second step in the analysis of CSS’s status as a standard turns on the existence of strong network effects for a single encryption format.\textsuperscript{196} When a product has strong network effects, the value for the product increases as more people use it.\textsuperscript{197} For example, the telephone, fax machine, Facebook, Google Chat, and the QWERTY keyboard all have strong network effects. In the late 1990s, this factor would swing strongly in the DVD-CCA’s favor because CSS was the mechanism for protecting DVDs. It was assumed that a standard encryption mechanism, like the DVD format itself, would need to be agreed upon by the entire industry. In other words, it was thought that the lock and key must both be designed by the same locksmith.

However, CSS was eventually cracked. Once broken, developers and content producers scrambled to develop secondary encryption mechanisms without abandoning the DVD format. What they came up with was ARccOS and RipGuard.\textsuperscript{198} Both of these encryption mechanisms, unlike CSS, do not require a horizontal agreement to take effect. Or, to extend the locksmith metaphor, the lock and key were now being manufactured by different locksmiths. Thus, prevalence of CSS amongst studio-produced DVDs ten years ago is not enough to trigger a finding of strong network effects today.

In fact, rather than adding value, the recent sales figures indicate that CSS probably reduces the value for studio produced DVDs.\textsuperscript{199} Realizing that DVDs have limited uses and cannot be copied, archived, or converted into other formats, consumers have turned to rental services like Netflix in increasing numbers.\textsuperscript{200} The absence of strong network effects and the existence of alternative methods of protecting DVD content indicates that rigid adherence to the CSS license agreement is hardly the least restrictive method to protect studio content from copyright infringement.\textsuperscript{201}

The third and final prong of the standard-setting analysis examines whether RealNetworks failed to take advantage of internal DVD-CCA procedures. The DVD-CCA argues that Real has failed to propose an

\textsuperscript{196} See Lemley, supra note 191 at 1900 (“Absent network effects, economists generally presume that consumers fare best when many companies compete to offer different sorts of products. To the extent that standardization on a single product reduces consumer choice, it may be undesirable.”) (citations omitted).

\textsuperscript{197} BOYLE, supra note 2, at 69.

\textsuperscript{198} See supra text accompanying note 26.

\textsuperscript{199} See Boorstin, supra note 19.

\textsuperscript{200} See Face Value: Movies to go, ECONOMIST, July 9, 2005, at 57.

\textsuperscript{201} Feldman, supra note 147. See generally Eldridge, supra note 147.
amendment to the CSS license agreement despite having “ample opportunity” to do so. Although somewhat incriminating, this fact has less argumentative force when placed in the context of the DVD-CCA’s behavior of “stacking the private standard-setting body with decision-makers sharing their economic interest in restraining competition.” The shared interest of DVD-CCA members in restraining competition in the market for personal video servers, video archivers, and software like RealDVD, has been demonstrated both in this comment and elsewhere. In these situations, the Court has held that

[the antitrust validity of [a standard-setting process] is]

not established, without more, by [an association’s]
literal compliance with the rules of the Association, for
the hope of procompetitive benefits depends upon the
existence of safeguards sufficient to prevent the
standard-setting process from being biased by members
with economic interests in restraining competition.

The DVD-CCA, whose members all share an interest in the restraint, does not appear to have these safeguards.

In sum, the CSS license agreement is not a standard setting agreement. It is a contract of adhesion. As such, it is offered to studios and consumer electronics manufacturers on a take-it-or-leave-it basis. The apparent goal of the agreement is two-fold: (1) to establish a variety of legal consequences for non-studio actors that circumvent CSS, regardless of whether they belong to the DVD-CCA or not, and (2) to have a regime in place to make it extremely costly for one of the member studios to defect from the DVD-CCA cartel. This restraint is not ancillary to the maintenance of a standardized encryption mechanism. And the existence of ARccOS and RipGuard in the marketplace renders the need for a uniform encryption mechanism suspect at best. Therefore, the argument that the CSS

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202 Studios’ Motion to Dismiss, supra note 190, at 6.
204 See supra notes 81–82 and accompanying text. Consumer electronics manufacturers who abide by the agreement have invested resources in markets other than the market for video servers, personal video recorders, and software like RealDVD. If they agree to the proposed license, they will be behind in a market where being the first mover is critical. See Jacobson, supra note 45, at 9.
205 Allied Tube, 486 U.S. at 509.
207 RealNetworks, Inc. v. DVD Copy Control Ass’n, 641 F. Supp. 2d 913, 922 (N.D. Cal. 2009).
208 See supra text accompanying notes 23–29.
license agreement is the instrument of the DVD-CCA’s function as a legitimate standard setting organization should not be given much weight.

iii. The DVD-CCA as a Joint Venture Among Competitors

Modern jurisprudence defines joint ventures as arrangements “in which persons who would otherwise be competitors pool their capital and share the risks of loss as well as the opportunities for profit. In such joint ventures, the partnership is regarded as a single firm competing with other sellers in the market.” Based on this definition, it does not appear that the DVD-CCA is a joint venture among competitors.

Rather than pooling capital and sharing the risks of loss in addition to the opportunities for profit, the DVD-CCA appears to be a for-profit organization of horizontal and vertical competitors who have contractually bound each other to produce only attenuated DVD products. The DVD-CCA is not financed by the studios. Instead, it is run by LMI, a limited liability company based out of Morgan Hill, California, which manages the DVD-CCA and several other significant copyright protection bodies. Multiplying the $15,000 license fee by the 300 members of the association indicates that LMI has taken in about $5 million through the administration of the DVD-CCA.

The DVD-CCA might nevertheless succeed at convincing a court that it is a joint venture among competitors. Such success, however, would not end the matter because even efficiency creating joint ventures have historically come under scrutiny. In 1889, a number of railroad companies organized the Terminal Railroad Association of St. Louis to combine and operate the various independent terminal companies in St. Louis as a unitary system. The combination was necessary in order to efficiently cope with the unique topography of St. Louis. The Association made no secret of its desire to “obtain

209 Arizona v. Maricopa Cnty. Med. Soc’y, 457 U.S. 332, 356 (1982); see also Texaco, Inc. v. Dagher, 547 U.S. 1, 6 (2006) (explaining that price fixing in a joint venture between two competitors who retain their brand names is no different than a single firm setting its own price) (emphasis added).
210 Jacobson, supra note 50.
211 Id.
213 Namely, the separation of St. Louis and East St. Louis by the Mississippi River.
the control of every feasible means of railroad access to St. Louis.”

The government sued the Association under the Sherman Act in 1890. Twenty-one years later, the case reached the Supreme Court. The question before the Court was whether “the unification of substantially every terminal facility by which the traffic of St. Louis is served resulted in a combination which is in restraint of trade within the meaning and purpose of the anti-trust act?”

The Court answered in the affirmative even though the companies used the Association’s bridges and terminals because it was cheaper than building their own. The Court noted that whether the combination was an efficiency enhancing joint venture or “an unreasonable restraint, forbidden by” the Sherman Act would “depend upon the intent to be inferred from the extent of the control” over the bridges and terminals that all competitors are under “compulsion to use.”

As a practical matter, the Court recognized that even if constructing individual bridges was not financially prohibitive “the city would be cut to pieces with the many lines of railroad intersecting it in every direction” if every railroad built its own terminals and bridges.

More recent rules concur with the Court’s one-hundred year old precedent. The Antitrust Guidelines for Collaboration Among Competitors, while not binding, signals that the CSS license agreement is of the type that should be subjected to heavy scrutiny by the DOJ and FTC. Under the guidelines, an agreement that is not “reasonably necessary to achieve” the procompetitive objective of agreeing to a single form of encryption is per se illegal. “An agreement may be ‘reasonably necessary’ without being essential. However, if the participants could achieve an equivalent or comparable efficiency-enhancing integration through practical, significantly less restrictive means, then the Agencies conclude that the agreement is not reasonably necessary.”

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214 Terminal R.R., 224 U.S. at 393.
215 Id. at 390–91.
216 Id. at 383.
217 Id. at 394.
218 Id. at 397.
219 Id. at 394–95.
220 Id. at 403.
222 Id. at 8 (emphasis added).
223 Id. at 9.
Of course, the CSS license agreement is not a naked restraint of trade. There are plenty of procompetitive justifications for having an organization that grants licenses to decrypt CSS. When properly organized, the organization could provide the necessary balance between the desires of consumer electronics manufacturers to innovate and the wishes of content owners to protect their copyrighted works. But the present organization of the DVD-CCA, with its take-it-or-leave-it CSS license agreement, leaves no room for procompetitive considerations.

The Court faced this issue in *Terminal Railroad*, and concluded that “the combination which has occurred would not be an illegal restraint under the terms of the statute [sic] if it were what is claimed for it, a proper terminal association acting as the impartial agent of every line which is under compulsion to use its instrumentalities.”

Perhaps the same can be said of the DVD-CCA. If it was what it claimed to be, an organization that has “enabled the owners of movie content to provide consumers access to high quality DVD movies for home viewing,” then it would probably be negotiating specific licenses with companies like RealNetworks to enable new and exciting uses of DVD products. It could also require RealNetworks to take measured steps to prevent unauthorized duplication of home movies (or, at the very least, open its eyes to the fact that RealNetworks was taking such steps *sua sponte*). Such action would likely survive Sherman Act scrutiny.

But the DVD-CCA is *not what it claims to be*. It is, like the standard setting organization in *Allied Tube*, systematically “stack[ed] . . . with decisionmakers sharing their economic interest in restraining competition.”

Under the reasoning of *Terminal Railroad*, a court could order the DVD-CCA to negotiate a new CSS license agreement in good faith, or restructure the organization to provide an amendment process that allows for legitimate bargaining by both sides.

In sum, the situation in *RealNetworks* was quite similar to *Terminal Railroad*. The DVD-CCA was not a *legitimate* joint venture. There was no shared investment. There was no shared risk of loss. It was, and still is, a mere shell association that promulgates a non-negotiable standard for the use of DVDs. True joint ventures involve risks borne mutually by all its members. The DVD-CCA, on the other hand, eliminates risk for its members by restraining competition in markets that pose a threat to the sales of traditional DVD players.

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these facts, the District Court in *RealNetworks* should have done something similar to what the Court did in *Terminal Railroad*, and order the association to reorganize in a form that resembles what it was supposed to be: “an impartial agent of every line which is under compulsion to use its instrumentalities.”

iv. Real was Free to License Content from the Studios

The studios’ final hypothetical procompetitive justification, that Real was free to license content from the movie studios, is akin to an estoppel argument. They would contend that neither the studios nor the DVD-CCA ever prevented Real from licensing content from the studios. They would further argue that Real was free to license digital content at all times. This is a strawman argument.

The dispositive concern here is not whether the studios refused to license content in *another medium*, it is whether the studios collectively refused to license *CSS-protected DVD content* to RealNetworks. The studios’ argument is no different than contending that there is no refusal to deal in *Terminal Railroad* because other, smaller, non-member railroads, were free to build their own bridge to cross the Mississippi. The operative question in *Terminal Railroad*, as it is here, is not whether or not the plaintiffs were free to go another route, it is whether the most logical and reasonable route is being cut off by a concerted effort among competitors whose object is to restrain trade, charge higher prices, and stifle innovation. This is by all appearances the object of the DVD-CCA.

The studios would respond by pointing to *Broadcast Music, Inc. v. Columbia Broadcasting System*. In *BMI*, the Court held that blanket licenses of copyrighted music should be judged under the rule of reason, because the monitoring and enforcement of music copyrights would be impossible for individual artists to effectively carry out on their own. However, *BMI* is fundamentally different from *RealNetworks* because the musicians in *BMI* were still able to license

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227 See id. (stating that the “topographical condition peculiar to” St. Louis renders a unified system of bridges and rail terminals a restraint on commerce despite the fact that competitors would “remain the right and power to construct their own terminals.”).

228 See id. at 405–09 (examining the different practices of the association for anticompetitive effects and procompetitive justifications).


230 Id. at 24.
COMMENT: DVD COPY PROTECTION
RULES VIOLATE THE SHERMAN ACT

their music on an individual basis. Conversely, in RealNetworks, the movie studios could not individually license DVD content to Real without violating the CSS license agreement.

BMI would have been a completely different case if the blanket license agreements excluded the ability of musicians to contract licenses for their content on an individual basis. That completely different case is, in essence, RealNetworks. Ironically, this means that BMI is an argument against, rather than support for the studios’ position.

D. Do the parties have sufficient market power to control access to instrumentalities critical for competition?

It appears that the studios and the DVD-CCA possess significant market power because they control access to intellectual property critical for competition. The facts spelled out in RealNetworks make this point eminently clear: The studios met as a group to discuss the terms of the CSS license agreement. They all agreed that the license would prohibit copies of CSS protected content unless the studios unanimously agreed at a later date to modify the agreement. The association that would act as licensor—the DVD-CCA—would be composed of the largest and most prominent firms in the content, consumer electronics, and computer industries because of the network effects associated with the DVD format itself. Consequently, CSS

231 Id. at 24–25.
232 Compare id. at 11, with Antitrust Transcript, supra note 53, at 41. Despite these differences, the studios still argued the strawman; that content was never denied to Real, because they were free to license content on other mediums. Antitrust Transcript, supra note 53, at 16.
233 Richman refers to the arguments made in this section as the “Associated Press doctrine.” Richman, supra note 133, at 351 (“The Associated Press doctrine . . . permits [trade associations] to exclude members only if exclusion is pursuant to a procompetitive justification that is essential to promote the purpose of the venture.”). The claim is similar to an “essential facilities” argument. See infra note 240.
235 Second Amended Complaint, supra note 138, at 5–6 (internal citations omitted).
236 Id. (internal citations omitted).
237 See supra text accompanying notes 182–201; RealNetworks, 641 F. Supp. 2d
has been implemented on millions of DVDs, and remains the prevalent form of encryption.

Moreover, market power can be established by looking to the control that the association wields over the instrumentalities of the marketplace. To borrow language from the Court’s opinion in *Terminal Railroad*, consumer electronics manufacturers were instantly “under compulsion” to create devices that can playback DVD movies once the movie studios agreed on DVD as the standard format for the distribution of digital media. At precisely the moment when the movie studios agreed to encode their DVD movies with CSS, consumer electronics manufacturers who wished to compete in the DVD products market were under further compulsion to decrypt CSS. If decryption of CSS is illegal under the DMCA, then the manufacturers are also under compulsion to obtain a CSS license agreement from the appropriate licensing association: the DVD-CCA. If that license agreement prohibits manufacturers from creating software or hardware that can copy a DVD for lawful and reasonable purposes, then the market for video servers, personal video recorders, and software like RealDVD is necessarily restrained.

Although separated by 100 years of technology, *Terminal Railroad* and *RealNetworks* present the same economic problem. Both antitrust-plaintiffs are “compelled” to use the instrumentalities of a stronger defendant that is restraining competition. In *Terminal Railroad* it was a railway bridge. In *RealNetworks*, it is the CSS license agreement. Compulsion is essentially market power; and as explicated above, the DVD-CCA has it in spades.

In sum, the CSS license agreement is no defense to Sherman Act liability. The requirement that no product have the capability to copy CSS-protected DVDs is not ancillary to the lawful purpose of establishing a collectively agreed upon encryption mechanism by the major movie studios to protect copyrighted content. The agreement is

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238 See *RealNetworks*, 641 F. Supp. 2d at 921.
239 See id.
240 United States v. Terminal R.R. Ass’n, 224 U.S. 383, 394–95 (1912). This “under compulsion” argument can be analogized to an essential facilities claim. However, I avoid using the phrase “essential facilities” to describe the issue for four reasons: (1) because the Court has never recognized the essential facilities doctrine, (2) it is not used in the Court’s *Terminal Railroad* opinion, (3) the use of the phrase is unnecessary to advance my argument, and (4) the “essential facilities” doctrine applies to section 2, not section 1 of the Sherman Act. *Hovenkamp, supra* note 115, §7.7, at 309–10.
a restraint in the market for video servers (like Facet) and archival software (like RealDVD). The result of this restraint is that consumer electronics firms will not innovate in this field. Until a court stops these practices, consumers will be unable to legally archive their DVD movie collections, put their movies on their iPods, or make backup copies of their DVDs.

IV. CONCLUSION

Copyright is supposed to be a solution to the public goods problem inherent in works of original authorship. In copyright’s absence, piracy would be widespread, innovation would be limited, and creative works like music, movies, and books would never hit the stores. It is simply cheaper to duplicate a DVD than it is to produce a one-hundred million dollar blockbuster like Iron Man.

But more intellectual property rights do not necessarily mean more innovation.\textsuperscript{241} The practices of the DVD-CCA reveal this to be the case. The DMCA gave the movie studios broad powers to stop piracy, punish infringers, and protect their creative works. Despite these dramatic changes in American copyright law, the movie studios have suffered more in the last decade than in all of history.

In RealNetworks, the District Court conveniently avoided analyzing the DVD-CCA’s practices and its take-it-or-leave-it CSS license agreement by basing its dismissal of RealNetworks’ antitrust counterclaims on procedural doctrines like Noerr-Pennington and the requirement that an antitrust plaintiff state an antitrust injury.\textsuperscript{242} This dismissal implicitly accepts as true some notion that the antitrust laws can conflict with the DMCA even in cases involving highly creative works like DVDs, as opposed to garage door openers in \textit{Skylink}. The dismissal also suggests that when they conflict, the DMCA’s prohibitions must prevail. This assumption is baseless, because “[i]ntellectual property rights do not confer a privilege to violate the antitrust laws.”\textsuperscript{243} Intellectual property rights and the prohibitions of the Sherman Act have always been coexistive.

\textsuperscript{241} See BOYLE, supra note 2, at 48–49 (arguing that too much intellectual property protection will stifle innovation just as severely as not protecting intellectual property at all).

\textsuperscript{242} Antitrust Order, \textit{supra} note 5, at 7.

\textsuperscript{243} \textit{In re} Indep. Serv. Orgs. Antitrust Litig., 203 F.3d 1322, 1325 (Fed. Cir. 2000).
While it is clear that the court avoided discussing antitrust law with any substance, it is not clear why. Certainly the DVD-CQA would not pose much of a problem to anybody, except maybe pirates, "if it were what is claimed for it." For this reason, courts have broad discretion to fashion specific remedies to Sherman Act violations. In order to bring the DVD-CQA’s practices into conformance with the Sherman Act, a court should—in a hypothetical case—strike the modification clause of the CSS license agreement that requires unanimous approval from the DVD-CQA. The court in this hypothetical should also subordinate the CSS license agreement to any future licenses of CSS-protected DVD content by copyright owners. In other words, the CSS-license agreement should not be a weapon by which the DVD-CQA can limit the exclusive rights vested to copyright

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244 To the extent that the District Court addressed the procedural aspects of the antitrust issues in RealNetworks, its analysis was not without error:

First, the court assumed that the relevant license was for movie content generally, not for a license over the material support for that content (in this case, CSS-protected DVD content). See Antitrust Order, supra note 5, at 9 ("There is no allegation that Real is not at full liberty to negotiate individual agreements with motion picture studios to license their content in the form of non-CSS encrypted digital copies."). This is false. Antitrust law requires the court to narrowly define the relevant market, which in this case would be DVD content, not digital video generally.

Second, the District Court invoked the Noerr-Pennington doctrine as a basis of immunity of the DVD-CQA’s group conduct prior to litigation. Id. at 7. This argument has two flaws: (1) Noerr-Pennington has nothing to do with this case because this case is not about petitioning the government. Petitioning a court for redress should not immunize antitrust violations in every case or else the Sherman Act would be swallowed up by the Noerr-Pennington doctrine. (2) Even if the doctrine applied because of some concern about the enforceability of studios’ copyright, then that argument would necessarily fail for being based on a false assumption: that someone’s copyright was being infringed, which was not alleged.

Third, the District Court assumes that Real has to allege that the Studios entered into an explicit agreement. Id. at 10–11. The Supreme Court has made it clear, however, that an agreement can be inferred when a rational actor would not have committed an act absent agreement. Theatre Enterprises, Inc. v. Paramount Film Distributing Corp., 346 U.S. 537, 541 (1954) ("‘Conscious parallelism’ has not yet read conspiracy out of the Sherman Act entirely."); see also Richman, supra note 133, at 343.

245 I am referring to pirates of the digital, not seafaring variety.

246 Terminal R.R., 224 U.S. at 410.

247 E.g., Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 598 n.23 (1985) (approving of district court injunction requiring the parties to offer joint lift tickets); Associated Press v. United States, 326 U.S. 1, 21 (1945) (approving of a vague injunction which prohibited the defendants from “observing [the old bylaws], or agreeing to observe any new or amended By-Law having a like purpose or effect.”); United States v. Terminal R.R. Ass’n, 224 U.S. 383, 411–13 (1912).
owners absent an actual—and in antitrust terms, legitimate—license from the copyright owner to the DVD-CCA.

Policing the use of copyrighted works through technological protection measures is a serious threat to innovation. I recognize and am willing to concede that sifting through competing claims of DMCA liability and Sherman Act antitrust violations involves an intellectually burdensome journey into uncharted jurisprudential waters. However, if the courts and Congress continue to ignore the Sherman Act’s role as a limit on complicated copyright laws like the DMCA, then the very purpose of American intellectual property law—incentivizing innovation and creation—will be obstructed by newer and more restrictive license agreements that will make the CSS agreement look edentulous by comparison.