Second Circuit Rules that Foreign Anticompetitive Use of Royalty-Free Patent is Insufficient to Establish a Domestic Effect Giving Rise to Claim under the FTAIA[1]

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Standards essential patents can run afoul of United States antitrust law when the patent owner acts in a matter which creates anticompetitive risks that outweigh any pro-competitive benefit. For example, the Federal Trade Commission has stated that reneging on a prior licensing commitment to a standard-setting body can be violative of Section 5 of the FTC Act.[2] Similarly, the FTC has taken the view that seeking an injunction for infringement of a patent encumbered by a promise to license under reasonable and non-discriminatory terms is an unfair act.[3] Thus, U.S. antitrust law can provide a remedy when a patent owner seeks to enforce a patent in an unfair manner in the U.S.[4] What if a standards-body participant attempts such acts in a foreign jurisdiction? The Foreign Trade Antitrust Improvements Act ("FTAIA") provides a statutory basis for addressing certain foreign anticompetitive conduct under U.S. antitrust laws. Under the FTAIA, the Sherman Act applies to foreign anticompetitive conduct only if "(1) such conduct has a direct, substantial, and reasonably foreseeable effect" and "(2) such effect gives rise to a claim" under the Sherman Act.[5] The Court of Appeals for the Second Circuit recently considered whether anticompetitive use of RAND-encumbered foreign patents could be addressed under the FTAIA, and ruled in the negative under the facts at issue.

Facts of the Case

In *Lotes Co., Ltd. v. Hon Hai Precision Industry Co., Ltd., et al.*,[6] the Second Circuit considered whether the antitrust laws provided protection for similar actions when threats or assertions are made in foreign jurisdictions. Lotes Co., Ltd. ("Lotes") is a Taiwanese corporation

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[2] See Complaint, *In the Matter of Negotiated Data Solutions LLC*, FTC File No. 0510094 (Sept. 23, 2008) (available at www.ftc.gov/os/caselist/0510094/080923ndscomplaint.pdf).

[3] See, e.g., Complaint, *In the Matter of Motorola Mobility LLC and Google Inc.*, FTC File No. 121 0120 (July 24, 2013) (available at http://www.ftc.gov/sites/default/files/documents/cases/2013/07/130724googlemotorolacmpt.pdf).

[4] It is unclear whether private parties will be able to seek the same type of relief under Section 2 of the Sherman Act. See, e.g., Renata B. Hesse, Deputy Assistant Att'y Gen., Antitrust Div., *IP, Antitrust and Looking Back on the Last Four Years*, presented at Global Competition Review, 2nd Annual Antitrust Law Leaders Forum (Feb. 8, 2013) (available at http://www.justice.gov/atr/public/speeches/292573.pdf).

[5] 15 U.S.C. § 6(a).

[6] 753 F.3d 395 (2d Cir. 2014).

focused on the manufacture and design of Universal Serial Bus ("USB") connectors. Lotes manufactures USB connectors in China and sells the connectors to Original Design Manufacturers ("ODMs") also located in China. The ODMs build computer products for computer brands such as Acer, Dell, HP, and Apple. Lotes competes with Hon Hai Precision Industry Co., Ltd., Foxconn International Holdings, Ltd., Foxconn Electronics, Inc., Foxconn International, Inc., and Foxconn (Kunshan) Computer Connector Co., Ltd. (collectively, "the Foxconn Defendants")[7] in making and selling USB connectors.

The USB standards are developed by the USB Implementer's Forum, Inc. ("USB-IF").[8] Lotes and the Foxconn defendants contributed to the development of the USB 3.0 standard as participants in the USB-IF. Lotes and the Foxconn defendants were also required to sign the USB 3.0 Contributors Agreement. The Contributors Agreement requires "Contributor[s]" to provide a "non-exclusive world-wide license under any Necessary Claim of a patent or patent application...on a royalty-free basis and under otherwise reasonable and nondiscriminatory ('RAND-Zero') terms..." to any Adopter.[9] Lotes also signed the USB 3.0 Adopters Agreement, and therefore was alleged to be entitled to a RAND-Zero license.

According to Lotes, the Foxconn defendants refused to honor their obligations under the Contributors Agreement. For example, Lotes alleges that the Foxconn Defendants contacted customers and distributors of Lotes and threatened to sue them if they did not purchase all USB 3.0 connectors from Foxconn.[10] Lotes allegedly attempted to obtain a RAND-Zero license, but was unable to do so.[11] Finally, Foxconn Kunshan filed patent infringement suits against two subsidiaries of Lotes operating in China.[12] Among other relief, Foxconn Kunshan requested an injunction on the manufacture and sale of USB 3.0 connectors and an order for the destruction of all existing inventory and associated manufacturing equipment.

Lotes filed suit against the Foxconn defendants asserting that they had violated Sections 1 and 2 of the Sherman Act as well as various state-law claims, asserting those claims under the FTAIA. Lotes alleged that "curbing competition in China will have downstream effects worldwide, including in the United States," because "any price increase in USB 3.0 connectors will 'inevitably' be passed on through each stage in the production process to consumers in the United States."[13]

The District Court dismissed the First Amended Complaint for lack of subject matter jurisdiction and further ruled that Lotes had failed to sufficiently allege a "direct, substantial, and reasonably foreseeable effect" on U.S. domestic or

[7] Lotes refers to these defendants as the Foxconn defendants. To avoid confusion, the same nomenclature is adopted herein.

[8] See www.usb.org.

[9] USB 3.0 Contributors Agreement ¶ 3.4.

[10] 753 F.3d at 401.

[11] Id. at 401-402.

[12] Id. at 402.

[13] Id. at 402-403.

import commerce under the FTAIA.[14] Lotes appealed.

Second Circuit Analysis

The Second Circuit's decision addressed three issues related to the application of the FTAIA.

First, the Second Circuit overruled its previous decision in *Filetech S.A. v. France Telecom S.A.*[15] and held that the FTAIA's limitations on antitrust claims involving foreign commerce are not jurisdictional.[16] In this regard, the Second Circuit agreed with Lotes' argument that the *Filetech* decision was undermined by the Supreme Court's decision in *Arbaugh v. Y&H Corp,*[17] and accordingly, that such requirements can be waived by contract.[18] Therefore, standards bodies can require application of the Sherman Act to foreign anticompetitive conduct in contributors' agreements, committee by-laws, and other contractual arrangements with participants.

Second, the Second Circuit ruled that the district court had used an incorrect test to determine whether the Foxconn defendants' anticompetitive conduct has a "direct, substantial, and reasonably foreseeable effect" on U.S. domestic or import commerce as required under the FTAIA. The district court relied on the Ninth Circuit's decision in *United States v. LSL Biotechnologies*, which held that an effect is direct "if it follows as an immediate consequence of the defendant's activity."[19] Instead, the Second Circuit agreed with the Seventh Circuit[20] that the effect need not follow as an immediate consequence of the defendant's conduct, so long as there is a reasonably proximate causal nexus between the conduct and the effect.[21]

The Second Circuit acknowledged that the determination of whether the conduct in question has a "direct, substantial, and reasonably foreseeable effect" on U.S. domestic or import commerce is a difficult one.[22] However, the Second Circuit agreed with amici that any domestic effect caused by the Foxconn defendants' foreign conduct did not "give[] rise to" Lotes claims, and therefore ruled they need not decide that issue:

> To review the statutory framework, the FTAIA generally excludes wholly foreign conduct from the reach of the Sherman Act, but brings such conduct back within the statute's scope when two requirements are met: (1) the foreign conduct has a 'direct, substantial, and reasonably foreseeable effect' on U.S. domestic, import, or

[14] See *Lotes Co., Ltd. v. Hon Hai Precision Industry Col, Ltd.*, 2013 WL 2099227 (S.D.N.Y. May 14, 2013).

[15] 157 F.3d 922 (2d Cir. 1998).

[16] 753 F.3d at 408.

[17] 546 U.S. 500 (2006).

[18] 753 F.3d at 398.

[19] 379 F.3d 672, 680 (9th Cir. 2004).

[20] The United States and the Federal Trade Commission also advocated this interpretation in *amicus* briefs.

[21] See *Minn-Chem, Inc. v. Agrium, Inc.*, 683 F.3d 845, 856-58 (7th Cir. 2012)(en banc).

[22] 753 F.3d at 413.

> certain export commerce[]; and (2) that effect "gives rise to a claim under' the Sherman Act[]. In *Empagran*, the Supreme Court held that the statutory phrase 'gives rise to a claim' means 'gives rise to *the plaintiff's* claim.' [citations omitted]...The FTAIA thus includes two distinct causation inquiries, one asking whether the defendants' foreign conduct caused a cognizable domestic effect, and the other asking whether the effect caused the plaintiff's injury.[23]

Here, Lotes' injury is being excluded from the Chinese market, and Lotes alleges that the Foxconn defendants' foreign conduct had the effect of driving up prices for U.S. consumers. "But those higher prices did not cause Lotes's injury of being excluded from the market for USB 3.0 connectors - that injury flowed directly from the defendant's exclusionary foreign conduct."[24]The Second Circuit instead ruled that exclusion from the Chinese market is the type of "independently caused foreign injury" that the Supreme Court held falls outside of Congress' intent[25]:

> Indeed, to the extent there is any causal connection between Lotes's injury and an effect on U.S. commerce, the of causation runs the wrong way. Lotes alleges that the defendants' patent hold-up has excluded Lotes from the market, which reduces competition and raises prices, which are then passed on to U.S. consumers. Lotes's injury thus *precedes* any domestic effect in the causal chain. And '[a]n effect never precedes its cause.' [citations omitted].

Lotes also alleged that the Foxconn defendants' failure to license their U.S. patents had the effect of foreclosing competition in the United States. However, given that Lotes does not manufacture products in or import products to the United States, and appeared to have an irrevocable right to a license, the Second Circuit deemed this alternative domestic effect "illusory."[26]

Conclusion

The Second Circuit's decision highlights the limitations of U.S. antitrust laws on overseas conduct, and the need to carefully review contractually agreed-to provisions in the standards setting area. The by-laws, other relevant corporate governance documents of standards setting bodies and any agreements signed by participants in the standards-setting process should be considered to determine the applicability of U.S. antitrust law.[27]

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[23] Id. at 413-414.

[24] Id. F.3d at 414.

[25] See *F. Hoffman-La Roche Ltd.v. Empagran S.A.*, 542 U.S. 155, 173 (2004).

[26] 753 F.3d at 415.

[27] Lotes also included state-law claims for breach of contract, promissory estoppel, tortious interference with contracts and prospective business relations, a declaration of waiver, and a declaration of a license for all necessary patent claims in its complaint, so other remedies may be available for adopters.