FEBRUARY 2022

DEVOTED TO LEADERS IN THE INTELLECTUAL PROPERTY AND ENTERTAINMENT COMMUNITY

VOLUME 42 • NUMBER 2

THE Licensing Journal®

Edited by Gregory J. Battersby and Charles W. Grimes

Wolters Kluwer

Ketian v. Hitachi: *China's First Compulsory Licence?*

Pat Treacy and Iva Gobac

Pat Treacy is a Senior Counsel with Bristows LLP in London. She has specialized in competition law for over 30 years and works with clients on transactions and complex agreements (including settlement, R&D, licensing, and joint venture agreements) in all sectors, with a focus on high tech and pharma/life sciences.

Iva Gobac is a trainee solicitor with Bristows LLP in London, currently working in the Competition & EU team.

On 23 April 2021, the Ningbo Intermediate People's Court handed down a judgment which found that Hitachi Metals Co. (Hitachi) violated China's Anti-monopoly Law (AML) by refusing to license its patents related to the production of rare earth magnets. In doing so, it applied the "essential facilities" doctrine.

Background

Neodynmium-iron-boron (NdFeB) magnets are commonly used in high-tech industries and high-end consumer electronics, such as wind power generation, electric vehicles, and mobile phones. China is the world's top producer of rare earths and NdFeB magnets specifically. Japan-based Hitachi owns over 600 patents worldwide related to the production of sintered NdFeB magnets (i.e., magnets created through a powder metallurgical process, where no additional material is mixed with the NdFeB). The Court found that it had announced the licensing of its patents to more than 10 companies worldwide, all before 2013. In 2014, Ningbo Ketian Magnet Co. (Ketian) formed an alliance with six other Chinese companies seeking a licence from Hitachi for its sintered NdFeB magnet patents. Hitachi entered into preliminary negotiations with the alliance, but following an initial meeting and further requests for information, negotiations broke down between the parties. A few months later, Ketian filed an application against Hitachi alleging that it had abused its dominant position by refusing to license its patents and by bundling its essential patents with non-essential patents. Following two hearings in 2015 and 2017, respectively, and an exchange of evidence and expert reports, the Ningbo court delivered its long-awaited decision in favour of Ketian.

The Court's Findings

The court held that Ketian did not have standing to sue Hitachi for bundling essential and non-essential patents. It considered the "refusal to deal" ground only.

Market dominance

The court held that Hitachi was dominant. It defined the relevant markets as a downstream product market of sintered NdFeB products and an upstream "technology market" of Hitachi's Class I and Class II patents, which the Court considered to be difficult to bypass technically, although not formally standard-essential patents (SEPs). The court began its analysis by considering the downstream market affected by Hitachi's conduct. Following a substitutability test, it concluded that there was limited demand and supply substitutability between categories of NdFeB magnets, so the downstream market was for sintered NdFeB magnet products. This conclusion was based in large part on the particular physical characteristics of those magnets. When considering the upstream market, the Court considered that some of Hitachi's patents formed the relevant technology market on the basis that:

- Those patents were technically essential to the existing production process for sintered NdFeB;
- Hitachi had repeatedly advertised that its patents were essential and impossible to bypass commercially;
- Evidence suggested that customers believed that Hitachi's patents were essential to the production of sintered NdFeB.

The court accepted expert testimony put forward by Ketian that identified two categories of patents as essential: Class I patents (those which could not be avoided without raising costs to such an extent that market exit was inevitable) and Class II patents (those which could not be avoided without significantly increasing costs, described as unavoidable patents). The Court held specifically that while these were not SEPs, since there was no relevant standard, they were nevertheless "essential patents" because they were difficult to bypass technically.

The geographic scope of both the upstream and downstream market was held to be worldwide. The Court also, somewhat unusually, considered the temporal scope of the market. It noted that Hitachi had previously licensed its patents but found that it had not done so since 2013. The Court, therefore, defined the temporal market as covering the period from 2013 until the end of the first instance hearing.

As Hitachi was the only owner of the Class I and Class II patents identified by the experts and considering no other business operators had licensed patents for sintered NdFeB technology for many years, the Court held that the licensing market for sintered NdFeB technology was essentially controlled by Hitachi. The Court noted that ownership of IP rights does not necessarily give rise to dominance but commented that the exercise of IP rights could demonstrate or give rise to dominance where the IP owner was able to control downstream pricing and eliminate or restrict competition. The court concluded that, on the facts, Hitachi could control prices, quantities, and other conditions in the relevant upstream market owing to its ownership of essential IP, as well as exerting a strong influence on the downstream market through its licensing agreements with manufacturers. On this basis, the court concluded that Hitachi held a dominant position.

Abuse of dominance

The court relied on Article 17 of the AML, which prohibits a "refusal to deal" by a firm with a dominant market position, especially where such refusal has the effect of eliminating or restricting competition. According to the judgment, this can include a refusal to license by an IP right holder. The court explained that in its view IP rights generally yield the most positive and efficient outcomes for production processes and consumer welfare when shared or traded collaboratively. The sentiment conveyed by the court is that cooperation is good for competition, and this appears to have provided a basis for its position that a refusal to license may be harmful for innovation, technological development and, in turn, the public interest. Against this context, the court relied on Article 7 of the amended Rules on Prohibition of IPR Abuse, which prohibits a refusal to license an IP right without a reasonable justification where that IP right constitutes an "essential facility". The court set out the test for establishing an essential facility as follows:

- The facility is indispensable for other firms to participate in competition;
- The monopolist has control over the essential facility;
- The essential facility cannot be duplicated through reasonable efforts;
- The monopolist unreasonably denies the use of the facility by others;
- It is feasible for the monopolist to provide the essential facility.

Relying on the expert opinions referred to above and general market perception that Hitachi's patents were commercially essential in order to manufacture NdFeB magnets, the court held that the patents constituted essential facilities. The court accepted that Hitachi's patents were not SEPs but found that they were technically very difficult to bypass. The court again acknowledged that IP rights, by their exclusive nature, may unavoidably give rise to a bottleneck effect in the market and noted that the essential facilities principle should therefore be applied carefully to IP licensing, given the importance of IP rights in incentivising innovation and improving public welfare. Nevertheless, the court found that Hitachi's refusal to license its NdFeB patents was anti-competitive on the following bases:

- Request for a licence: Ketian had expressed its willingness to license Hitachi's patents, which the court considered to be "fairly sincere and urgent". Hitachi had not responded within a reasonable period of time and had not put forward any specific offer to Ketian.
- Negotiation tactics: Hitachi requested technical details in response to 144 questions for the purpose of licence review. The court deemed this to be an improper use of Hitachi's dominance with an intention to acquire the technology and commercial secrets of its competitors.
- "No questioning condition": Ketian had previously filed for patent invalidation against Hitachi, which Hitachi took to indicate Ketian's lack of sincerity in entering into negotiations in the first place. The court deemed this to be akin to a no questioning condition, or "no-challenge" clause which it considered a form of "intimidation" that

would reduce the number of patent challenges in the system, in turn restricting competition and harming consumer and public interests.
- No justification for refusal: Hitachi had not provided reasonable justification for refusing the transaction, nor did it substantiate that its refusal to license had a positive impact on innovation and efficiency.

Commentary

The Ningbo court's application of the essential facilities doctrine as an "analytical tool" in this case is interesting for a few reasons:

- The essential facilities doctrine was originally developed in the United States and has been utilised only sparingly in other jurisdictions, traditionally in the context of access to physical infrastructure, hence the requirement in the legal test that it should be applied to require access only where it is "feasible" for a monopolist to provide an essential facility. While "feasibility" may be a real issue in cases of providing access to physical infrastructure (such as an entry point to a bridge, port or railway), it seems unlikely to be a bar to the application of the doctrine in IP licensing cases. This means that one of the key factors limiting the scope of the doctrine is removed in the context of IP licensing and is one of the reasons why the application of the doctrine to IP issues has been somewhat controversial.
- In finding that patents which were not SEPs were still considered sufficiently "essential" to engage the doctrine, the court applied a test based at least in part on the technical difficulty of designing around the patents so as to enter the market. The court's rationale for this conclusion was based both on expert evidence put forward by Ketian, which is not publicly available, as well as various subjective statements put forward by Hitachi, including in its marketing materials.
- In assessing the categorisation of Class I and Class II patents, the court seemed to link the "indispensability" of the patents to the financial cost of avoiding them. That is, the technology was considered indispensable if, absent a licence, avoiding it would be prohibitively costly. In articulating this test, the Ningbo court did not elaborate on the precise level of financial burden that would qualify as "prohibitive" for competitors. This approach can be contrasted with the approach suggested in, for example, *Oscar Bronner v Mediaprint (Case C-7/97)* (and endorsed in *Slovak Telekom (Case C-165/19 P)*) that an increase in the financial cost of accessing a market does not automatically render access indispensable.
- This judgment suggests that the potential application of the essential facilities doctrine to refusals to license IP rights may be considerably expanded in China. Taken at face value, and given the approach to market definition, it appears that the essential facilities doctrine may frequently provide a basis for compulsory licensing where a patent holder otherwise refuses to license key IP without a justifiable reason. Whilst the court acknowledged that refusing to deal is a legitimate form of exercising an IP right, the decision implies that such refusals, absent reasonable justification, will only be lawful where they do not restrict competition. The extent of restriction required is not stipulated. Without a detailed analysis by the court on this point, it is not clear in what circumstances a refusal to license a very commercially important patent could be considered legitimate, since the exclusionary effect of such a commercial decision would inevitably affect other firms' abilities to compete in the same market. The lack of clarity in the court's reasoning about how and when the expense of avoiding a patent renders that patent essential may exacerbate this concern.
- The court, rather significantly, does not address the implications of the fact that Hitachi had already licensed the patents to which Ketian sought access to eight Chinese companies on a worldwide basis (excluding Japan). As such, it is not clear how a refusal to license Ketian would have prevented follow-on innovation or the development of new products, given that eight other firms had access to Hitachi's NdFeB patents. There may be reasons why this is the case, for example, if Hitachi had obtained new patents not previously licensed to other competitors, or if there were limitations in the licences that could chill follow-on innovation, but this is not apparent from the judgment and does not appear to have formed any part of the court's reasoning. This gives rise to a concern that patent holders deemed to have a dominant position will face pressure to license all firms that request a licence, since even eight licensees in this case was not considered sufficient to deal with the competition concerns identified by the court. In such circumstances, the economic returns from licensing may be significantly reduced as the benefits of obtaining a licence for each individual licensee will be reduced to avoiding litigation

costs, rather than offering an opportunity to share in the exclusive rights of the patentee. It also reduces the patentee's rights to decide on the best means of obtaining a return on its costs of innovation and stands in stark contrast to the freedom of contract rationale that underpinned AG Francis Jacobs' consideration of the essential facilities approach in his Opinion in *Oscar Bronner*.

- In reaching its conclusion, the court explicitly referred to the incentives to innovate arguments underpinning the IP system. It then weighed these considerations against concerns that IP rights may block innovation. In this instance, as explained above, the court gave considerable weight to the view that cooperation and collaboration in the creation and use of IP rights is the preferred outcome for innovative processes, with a shared benefit for all producers and users of IP. For the Ningbo court, this consideration ultimately appears to have carried the day.

Given that the court's decision has been appealed to the Supreme People's Court, these points may yet find welcome clarification by China's highest arbiter.