



kaleidescape®

November 1, 2007

Members of the Content Protection Advisory Council
DVD Copy Control Association
c/o John J. Hoy, President and Secretary
DVD Copy Control Association
225 B Cochrane Circle
Morgan Hill, CA 95037

Re: Two Proposed “Unknown Specification Amendments” To Be Discussed At The November 7, 2007 Meeting Of The Content Protection Advisory Council of the DVD Copy Control Association

Dear Member of the Content Protection Advisory Council:

I write to you regarding two proposed amendments to the license agreement governing the encryption system used to encrypt the contents of DVD movie discs. These two amendments are currently pending before you as members of the Content Protection Advisory Council (“CPAC”) of the DVD Copy Control Association, Inc. (“DVD CCA”), the association of movie studios, consumer electronics companies, and computer companies that licenses the encryption system. These proposed amendments will be considered by CPAC at its November 7, 2007 meeting. These proposed amendments, if enacted, will have a significant adverse impact on competition in the marketplace, will harm consumers by denying to them products designed to enhance their DVD experience, will block innovation and development of new products, and will deny to consumers fair use of their DVDs under copyright law.

Kaleidescape, Inc. is a fellow member of the DVD CCA and a licensee of the DVD CCA’s Content Scramble System (“CSS”) used to encrypt the contents of DVD discs. Kaleidescape is an innovative and creative developer and manufacturer of home entertainment systems, as well as a retailer of DVD movie discs for use with its home entertainment system. At the end of March 2007, the Santa Clara County Superior Court expressly found that Kaleidescape’s products comply with its license with the DVD CCA and pose no harm to the DVD CCA or the industries that it represents.

I. Features And Benefits Of The Kaleidescape System

Kaleidescape's signature product, the Kaleidescape System, has won every major consumer electronics award in its category. Much like Apple's iPod, the Kaleidescape System permits the consumer to make a secure private copy on hard disk of every DVD and CD that the consumer owns and to play back the stored content in any room within the consumer's home.

The Kaleidescape System helps the consumer by indexing and organizing the content stored on it. Moreover, Kaleidescape has created for its customers an extensive database of information about the movies they own, including the cover art, reviews, and other detailed information about each movie. The Kaleidescape System also has an advanced user interface that allows customers to search the movies they own by many different criteria, including by actor, director, MPAA rating, year released, or running time. In addition, the Kaleidescape System allows parents to control or restrict the movies viewed by their children. By these features, the Kaleidescape System enhances the customer's experience of the movies he or she owns and actually encourages many owners to expand their DVD collections now that they have an intelligent, scalable system to manage their media collections.

It should be noted that the Kaleidescape System protects video content much more securely than does the CSS encryption system used on the DVD discs themselves:

- The Kaleidescape System stores video content on a hard disk drive in its original CSS-encrypted form, decrypting it only at the time of playback like any other DVD player. Moreover, the Kaleidescape System wraps the CSS encryption "keys" found on the DVD disc in an extra layer of military-strength encryption.
- It is impossible to use the Kaleidescape System to upload or transfer movies to the Internet. The Kaleidescape System is a completely closed system.
- It is impossible to "burn" copies of DVDs with the Kaleidescape System. It cannot be used to create pirate or counterfeit DVDs.

More information about the Kaleidescape System is available at kaleidescape.com.

II. The DVD CCA's Failed Lawsuit Against Kaleidescape

Kaleidescape worked very hard at designing the Kaleidescape System to ensure that it is fully compliant with the CSS License Agreement and that it respects the intellectual property rights of others. Since the introduction of the Kaleidescape

System four years ago, however, the DVD CCA and certain of its members have campaigned to injure Kaleidescape's business and harm its sales of the Kaleidescape System. Most notably, the DVD CCA filed a lawsuit against Kaleidescape in December 2004 alleging that the Kaleidescape System breached the CSS License Agreement. We at Kaleidescape vigorously contested the DVD CCA's lawsuit, knowing that the DVD CCA's allegations were meritless, false, and, we believe, put forward in bad faith.

In March 2007, the DVD CCA's unfounded claims came to trial in the Superior Court of California. The Court heard witnesses and received evidence for over a week. In fact, a number of members of the DVD CCA board of directors testified at the trial. After hearing all of the evidence, the Superior Court of California found that the Kaleidescape System was fully compliant with the CSS License Agreement and that sales of the Kaleidescape System had caused no harm to the DVD CCA or its members.

I invite you to read the Court's decision for yourself at <http://kaleidescape.com/company/pr/PR-20070329-DVDCCA.html>. While the DVD CCA has filed an appeal, I believe that you will find from reading the decision that the judge carefully supported his analysis with substantial evidence.

III. The Failed June 2007 Amendment To The CSS License Agreement

In June of this year, in the wake of Kaleidescape's vindication by the Superior Court of California, some of the DVD CCA's members put forward a proposed amendment to the CSS License Agreement. This amendment, sponsored by proponents from the movie studios, the consumer electronics industry, and the computer industry, was clearly aimed at putting Kaleidescape out of business and was intended to exclude the Kaleidescape System from the DVD playback devices authorized by the CSS License Agreement.

The proposed June 2007 amendment read as follows:

“DVD Products, alone or in combination with other DVD Products, shall not be designed to descramble scrambled CSS Data when the DVD Disc containing such CSS Data and associated CSS Keys is not physically present in the DVD Player or DVD Drive (as applicable), and a DVD Product shall not be designed to make or direct the making of a persistent copy of CSS Data that has been descrambled from such DVD Disc by such DVD Product.”

We wrote to CPAC before the June meeting at which this amendment was to be considered. In our letter, we vigorously objected to the amendment. We explained how the unjustified change in the standards set by a standard-setting

organization to put one of its members out of business ran afoul of the antitrust laws, and how the proposed amendment exposed the DVD CCA and its members to legal liability. At the June CPAC meeting, the proponents apparently withdrew the amendment without a vote in the face of our letter.

IV. The Proposed November 2007 Amendments Retain The Essence And The Defects Of The Failed June 2007 Amendment

The new proposed November 2007 amendments divide the failed June 2007 amendment into two parts. The first clause of the failed June 2007 amendment has become in the proposed November 2007 amendments the so-called “DVD Playback Amendment” to section 6.4 of the CSS Procedural Specifications:

“DVD Products, alone or in combination with other DVD Products, shall not be designed to descramble scrambled CSS Data when the DVD Disc containing such CSS Data and associated CSS Keys is not physically present in the DVD Player or DVD Drive (as applicable).”

The second clause of the failed June 2007 amendment has become in the proposed November 2007 amendments the last subsection of the so-called “Managed Copy Amendment” to section 6.2.9.3 of the CSS Procedural Specifications:

“... Other than as set forth in this Section 6.2.9.3, DVD Products shall not be designed to make or direct the making of a playable, persistent copy of CSS Data.”

The “Managed Copy Amendment” also contains provisions regarding the “managed copying” of the content stored on DVD discs. The movie studios have twice previously proposed “Managed Copy” amendments, most recently in December 2006; both of these proposals failed.

Unlike the failed June 2007 amendment, the November 2007 amendments are sponsored only by three movie studio representatives: Chris Cookson of Warner Brothers, Benn Carr of Walt Disney Studios, and Jane Sunderland of Fox.

The current “managed copy” proposal by the studios is fundamentally different in two respects from the studios’ previous December 2006 proposal. First, the previous versions did not contain the prohibition on the making of persistent copies quoted above. This prohibition, like the failed June 2007 amendment from which it is drawn, is clearly aimed at putting Kaleidescape out of business. Second, the December 2006 proposal required the studios to make all of their movies available for managed copying if the amendment were adopted and managed copying technologies were approved and developed. The current “Managed Copy Amendment” contains no requirement that any studio make even

a single movie available for managed copying. Thus, even if managed copying technologies are approved and computer or consumer electronics companies build products incorporating managed copying, there is no requirement that the studios make any movies at all available for managed copying. The only mandatory feature of the current “Managed Copy Amendment” is the final provision quoted above, the prohibition on the making of persistent copies that is aimed at driving Kaleidescape out of business. All the rest is illusory and is nothing more than another shameless attempt by certain members of the DVD CCA to put Kaleidescape out of business.

Despite making the cosmetic change of dividing the June 2007 amendment in two, the November 2007 amendments retain the fatal defects of the June 2007 amendment. First, there is no valid business justification for the DVD Playback Amendment or for the prohibition on the making of persistent copies contained in the Managed Copy Amendment. After hearing all the evidence at trial, the Superior Court of California expressly found in its decision that the DVD CCA and its members have suffered no harm from the Kaleidescape System. To the contrary, the first thing many Kaleidescape owners do is to purchase hundreds of additional DVDs. In fact, over a million dollars of Kaleidescape’s revenue during the past 12 months was from DVD sales to its customers.

Instead, these proposed amendments are an attempt to put Kaleidescape out of business by excluding the Kaleidescape System from the DVD playback devices authorized by the CSS License Agreement. You should be aware before you vote on the proposed amendments that you expose yourself, your employer, and the DVD CCA to serious and substantial antitrust liability if you vote for either amendment. Both federal and state antitrust laws outlaw anticompetitive conduct by businesses joining together to put a competitor out of business.

The purpose of the antitrust laws is to promote competition and innovation, and thereby benefit consumers with products and services that are better or cheaper than the ones previously offered. The innovations of the Kaleidescape System are an example of the consumer benefits that fair and vigorous competition provides.

The United States Supreme Court has made clear that those who use a standards-setting organization to engage in anticompetitive activity and harm competitors can be held liable under the antitrust laws. Because of the potential for abuse, “private standard-setting associations have traditionally been objects of antitrust scrutiny.” *Allied Tube & Conduit Corp. v. Indian Head, Inc.*, 486 U.S. 492, 500 (1988). “There is no doubt that the members of such associations often have economic incentives to restrain competition and that the product standards set by such associations have a serious potential for anticompetitive harm. Agreement on a product standard is, after all, implicitly an agreement not to manufacture, distribute, or purchase certain types of products.” 486 U.S. at 500.

When a member or group of members of a standards-setting organization like the DVD CCA set standards for the purpose of excluding a competitor from a market, they commit an antitrust violation. *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556 (1982). As the United States Supreme Court said in *Hydrolevel*, “a standard-setting organization like ASME [the American Society of Mechanical Engineers] can be rife with opportunities for anticompetitive activity. Many of ASME’s officials are associated with members of the industries regulated by ASME’s codes. Although, undoubtedly, most serve ASME without concern for the interests of their corporate employers, some may well view their positions with ASME, at least in part, as an opportunity to benefit their employers. When the great influence of ASME’s reputation is placed at their disposal, the less altruistic of ASME’s agents have an opportunity to harm their employers’ competitors through manipulation of ASME’s codes.” 456 U.S. at 571.

The members of CPAC and of the DVD CCA board of directors are in a unique position to collude to promote an anti-innovation agenda on behalf of their corporate employers and to restrain competition and innovation within the consumer electronics and computer industries. That is exactly what the proposed amendments are intended to accomplish by putting Kaleidescape out of business and deterring other innovative companies from entering the market. The proposed amendment will harm consumers by denying them access to new and innovative products like the Kaleidescape System and by obstructing their ability to make fair use of the DVD movie discs that they own.

The proposed amendments also raise significant issues of copyright misuse. The doctrine of copyright misuse prohibits copyright holders from using the economic leverage provided by ownership of copyrights to impair or distort competition in other markets, or to otherwise extend the copyrights beyond their lawful limits. For example, in *United States v. Paramount Pictures*, 334 U.S. 131 (1948), movie studios unlawfully used the leverage of their movie copyrights to suppress competition for theater patrons among theater owners, a separate market from the market for licensing motion pictures to theater owners for exhibition. Misuse exists when “the copyright is being used in a manner violative of the public policy embodied in the grant of a copyright.” *Lasercomb America, Inc. v. Reynolds*, 911 F.2d 970, 978 (4th Cir. 1990).

Here, the studios sponsoring these amendments are attempting to wrongfully extend their copyrights beyond what the law grants them in two directions. First, by proposing these amendments, they are attempting to use the combined leverage of their copyrights to restrict innovation and competition in the market for DVD playback devices and technologies. Because their copyrights give them no right to

control this separate market, this is an extension of their copyrights beyond their lawful limits.

Second, the studios are attempting to remove the ability of consumers to exercise their fair use rights in the DVDs that they purchase. A DVD owner has a fair use right to make a private, persistent, copy of a purchased DVD. While a copyright owner has the right to prevent unauthorized copies of copyrighted works (17 U.S.C. § 106), that right is limited by the doctrine of fair use (17 U.S.C. § 107). Fair use permits the purchaser of a copyrighted work to make copies of the work for personal, private uses. *RIAA v. Diamond Multimedia Systems*, 180 F.3d 1072 (9th Cir. 1999); *Vault Corp. v. Quaid Software Ltd.*, 847 F.2d 255, 267 (5th Cir. 1988). “Any individual may reproduce a copyrighted work for a ‘fair use’; the copyright owner does not possess the exclusive right to such a use.” *Sony Corp. of America v. Universal City Studios*, 464 U.S. 417, 435 (1984). In addition, the Copyright Act contains a specific fair use exception to permit a purchaser of software to make fair use copies of that software as an essential step in the utilization of the software in a machine and to make archival copies. 17 U.S.C. § 117.

The November 2007 amendments seek to prevent consumers from exercising their fair-use right to make a private, persistent, CSS-encrypted copy of a purchased DVD. This is a wrongful attempt by the movie studios to expand their copyright grant to encompass fair use rights that Congress has given to consumers, not to the movie studios. Copyright misuse is especially harmful when it is practiced not simply by a single copyright holder with respect to a single copyrighted work, but, as here, by a group of copyright holders who control the majority of the copyrighted works in a particular medium of expression and who are acting in concert.

We note that counsel for the DVD CCA, the law firm of Bryan Cave, wrote a letter to our counsel dated August 6, 2007, disputing the antitrust implications of the last proposed amendment. In the fall of 2004, Bryan Cave advised the DVD CCA board regarding the merits of an action against Kaleidescape. That advice was proven to be completely misguided at trial. The analysis set forth in the August 6 letter is similarly misguided. It misses the forest for the trees.

Moreover, unlike the failed June 2007 amendment which was sponsored by representatives of movie studios, computer companies, and consumer electronics companies, the November 2007 amendments are sponsored only by movie studio representatives. Whether this change truly indicates that the studios were unable to obtain any support from the consumer electronics and computer industries for the proposed November 2007 amendments, or whether having only the studios sponsor the amendments is a subterfuge intended to conceal collusion behind the scenes, remains to be seen. It is worth noting that where collusion or

anticompetitive conduct exists, formalisms designed to conceal it cannot legalize the collusion or anticompetitive conduct they conceal. Thus, contrary to what Bryan Cave suggests in its letter, mere compliance with the procedural formalities of the DVD CCA Bylaws does not immunize the DVD CCA or its members from liability for the anticompetitive consequences of their conduct.

In closing, we request that you reject the proposed amendments. Instead, we again invite you and your employers to join with us in working together to bring to consumers new and innovative products and services that enhance and expand the consumer's enjoyment of great entertainment. To the extent that members of the DVD CCA have any legitimate business concerns regarding the misuse of CSS protected content, Kaleidescape is more than willing to work with these members to address these concerns without targeting the Kaleidescape System. Entertainment servers, such as the Kaleidescape System are not a threat to any of the industries that the DVD CCA represents; instead, entertainment servers can act as the impetus to expand the overall market for DVDs and DVD-related products now that consumers have a simple and elegant way to collect, manage and store their media products.

Sincerely,

Michael Malcolm
Founder, Chairman, and Chief Executive Officer
Kaleidescape, Inc.