

H031631

**IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
SIXTH APPELLATE DISTRICT**

**DVD COPY CONTROL ASSOCIATION, INC., a Delaware
corporation,**

Plaintiff and Appellant,

v.

KALEIDESCAPE, INC., a Delaware corporation,

Defendant and Appellee.

APPEAL FROM THE SUPERIOR COURT FOR THE COUNTY OF SANTA CLARA
HON. LESLIE C. NICHOLS, JUDGE
CASE No. 1:04 CV 031829

APPELLANT'S OPENING BRIEF

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CERTIFICATE OF INTERESTED ENTITIES OR PARTIES

[Cal. Rules of Court, rule 8.208]

Appellant knows of no entity or person that must be listed under subsections (1) or (2) of Rule 8.208. (Cal. Rules of Court, rule 8.208 (d)(3).)

APPELLANT'S OPENING BRIEF

INTRODUCTION

The trial court ruling in this case, if left undisturbed, threatens to destroy the uniform licensing scheme underlying one of the most successful entertainment innovations of all time – the DVD.

To protect against unlawful copying, the content contained on DVDs is protected by a patented encryption/decryption technology known as the Content Scramble System (CSS). Every company that seeks to manufacture a device authorized to play back DVD content must license CSS from the DVD Copy Control Association (the DVDCCA), a non-profit licensing entity made up of representatives from the entertainment, consumer electronics, and information technology industries. The standardized license agreement, which reflects a delicate balance among industries with significantly divergent interests, requires licensees like defendant-appellee Kaleidescape to follow certain “Technical Specifications” that are delivered upon completion of the license agreement and payment of an administrative fee.

The main question in this case is whether a document entitled “CSS General Specifications,” which was delivered to Kaleidescape after it entered into the license agreement (the Agreement) and paid its fee, is a component of the Technical Specifications with which Kaleidescape must comply. The General Specifications contain crucial protections against unauthorized copying of DVD content, including, as relevant here, the requirement that when a machine plays back DVD content for viewing, the physical DVD itself must be present in the device.

The court ruled that the General Specifications are *not* a subset of the Technical Specifications. But this interpretation, which is subject to de

novo review, is clearly wrong. Overwhelming evidence, including the language of the license agreement and a wealth of undisputed extrinsic evidence, shows that the parties mutually understood the General Specifications to be a subset of the Technical Specifications.

Kaleidescape's own witnesses testified that this was their understanding, and during the course of this litigation – at the summary judgment stage and right up to the moment of trial – Kaleidescape affirmatively took the position that the General Specifications were Technical Specifications. The trial court could reach a contrary reading of the Agreement only by erroneously deeming dispositive extrinsic evidence to be irrelevant. In so doing, the court reached the absurd result of reading out of the license agreement provisions that are essential to the agreement's central purpose – to prevent the unauthorized copying of copyrighted DVD content.

The court also ruled in the alternative that, regardless of whether Kaleidescape had to comply with the General Specifications, the DVDCCA was not entitled to the injunctive remedies it sought. The court ruled out specific performance on the grounds the General Specifications were purportedly too uncertain. The court also refused to enforce a contract provision stipulating to irreparable harm in the case of breach by a licensee and then ruled out injunctive relief against Kaleidescape out of concern the company might suffer if compelled to follow the Agreement's requirements. With respect to all its remedies-related rulings, the court misapprehended the governing law and disregarded the unequivocal intent of the parties that, to preserve uniformity among companies licensing CSS, injunctive remedies should be available for breaches of the Agreement.

For more than a decade, consumers and businesses alike have shared the enormous benefits that come from widely distributing content through a secure digital medium. The CSS licensing regime – by which all licensees have access to the essential encryption/decryption technology on the exact

same terms – has played no small role in this success. With no sound justification, the trial court has dramatically upset this carefully-wrought system. Its ruling should be reversed.

STATEMENT OF THE CASE

A. The Formation and Purpose of the DVDCCA.

Today, hundreds of millions of people throughout the world take for granted the DVD technology that allows them to watch movies and television programs at their convenience. But this stunningly successful technological breakthrough – virtually unimaginable a generation ago – did not develop spontaneously. It is the product of a delicate set of compromises achieved through painstaking negotiation among the companies that produce the content for DVDs and the consumer electronics and information technology companies that make the devices consumers use to play back the DVDs and enjoy their content. (4RT294:17-304:7.)¹

All three industries recognized a common interest – shared with consumers – to achieve a single format (the DVD) for delivering digital content to the public. (2RT92:6-13; 4RT295:24-296:4.) To obtain this uniformity, however, the content providers needed strong assurance that the content delivery system would render it very difficult for the typical consumer to make unauthorized copies of their copyrighted materials. (2RT92:14-22; 4RT299:26-27.) The consumer electronics and information technology companies, for their part, needed a content protection system that would not add unduly to the price of their products. (2RT92:15-22; 4RT299:27-300:4.)

¹ References to the Reporter’s Transcript are cited as “[volume]RT[page:line]” and references to the Appellant’s Appendix are cited as “[volume]AA[page].”

Enormous effort across industries with widely differing perspectives produced a solution to the problem of protecting copyrighted works at a manageable cost – the DVD-Video Content Scramble System (CSS). (4RT303:21-304:7.) Under this patented system (which was designed by Matsushita Electric Industrial Co, Ltd. and Toshiba Corporation in 1996), the video data on every DVD is encrypted – that is, the data on the disc is scrambled so that it cannot be copied or played coherently without first being decrypted through a process employing a set of decryption “keys.” (2AA273-277; 1AA78-79.) Anyone wanting to manufacture a product (hardware, software or other related technology) used for playing back DVD content would be able to license these decryption keys and the authorized methods and processes for decryption. (*Id.*; 1AA130.) In exchange for this permission to use CSS, licensees would simply have to pay an administrative fee and agree to observe detailed specifications for the decryption process in order to achieve CSS’s underlying goal of preventing casual users from creating unauthorized copies. (*Id.*; 1AA136.)² Licensees, who pay no royalty whatsoever for using the CSS license, are all subject to the exact same rules for the license’s use.

The DVDFCA is the not-for-profit entity that acts as the licensing agency for CSS. (2RT91:25-92:13; 1AA200.) Its membership consists of all the companies that take a CSS license and want to participate in the organization. (2RT92:6-93:10; 5RT434:9-14.) Its governing Board of Directors consists of six members elected by content providers, three members elected by companies from the consumer electronics industry, and three members elected by companies from the information technologies

² See *Universal City Studios, Inc. v. Corley* (2d Cir. 2001) 273 F.3d 429, 436-437, and *Universal City Studios v. Reimerdes* (S.D.N.Y. 2000) 111 F.Supp.2d 294, 310, for a discussion of the development of CSS.

sector.³ (2RT93:11-16; 3RT151:9-28.) Its functions include administering the CSS license, considering amendments to the license, and enforcing the license to safeguard the widespread availability of DVD content through a secure medium. (2RT92:6-13, 94:25-95:15; 1AA217-255.)

B. The CSS License Agreement.

To preserve the delicate balance of interests that CSS serves, the CSS License Agreement (the Agreement) is uniform in nature. Rights to the CSS system are made available to licensees – more than 350 since 1997 – on equal terms through an easy to use administration process.

(5RT429:28-430:5, 432:6-14.) This process begins with a prospective licensee filling out and signing the Agreement (available on the DVDCCA website) and paying an administration fee. (5RT410:27-412:3; *see generally* 1AA127, 2AA322.) In connection with signing the Agreement, the prospective licensee chooses to participate in one or more of 14 “membership categories.” (5RT413:9-21; 1AA136, 178.) Through this category selection, the prospective licensee identifies the type (or types) of technology – e.g., DVD Player, DVD Drive, descrambler, authenticator – for which the license is sought. (*Id.*)

The Agreement begins by reciting the core underlying purpose of CSS: “to provide protection for” the content placed on DVDs “against unauthorized consumer copying.” (1AA127.) To effectuate this goal, the Agreement requires the licensee “to comply with the CSS Specifications,” which contain the requirements that a licensee must meet in using CSS to preserve the integrity of the content protection scheme. (1AA136.)

³ In keeping with the delicate balance of interests that created the DVDCCA, its By-Laws allocate voting powers equally across the founding industries so that no single industry group controls how CSS is administered. (1AA187-263.)

The CSS Specifications are defined in the Agreement as having two parts: the “Procedural Specifications” and the “Technical Specifications.” (1AA130.) Every membership category is subject to the publicly available documentation entitled “Procedural Specifications.” (2AA277.) In addition, some membership categories (including the two selected by Kaleidescape) are governed by confidential Technical Specifications, which include trade secrets of how CSS works. (*Id.*; 5RT419:5-14.)

As DVDFCA President John Hoy explained at trial, once a licensee selects one or more of these membership categories, the DVDFCA delivers to the licensee the appropriate confidential Technical Specifications documentation. (5RT413:9-414:1, 414:11-18, 417:10-19.) This documentation comes in two forms. First, there is a set of “General Specifications,” which, according to Hoy’s uncontroverted testimony, are overarching Technical Specifications that apply to every membership category for which Technical Specifications exist. (5RT420:8-17, 421:11-14; 1AA74-99.) Second, there are category-specific Technical Specifications that are exclusive to the specific membership category selected. (5RT413:9-414:1, 417:10-420:20; 1AA1-73.)

The Agreement itself outlines this process, linking the definition of the CSS Specifications with which a licensee must comply to the documentation delivered by the DVDFCA to the licensee. As described in Section 4.1,

Upon Licensee’s selection of one or more Membership Categories . . . and the payment of the appropriate Administration Fee(s), Licensor shall distribute to Licensee the portions of . . . CSS Specifications appropriate to its Membership Category or Categories[.]”⁴

⁴ Along the same lines, the Agreement defines the “CSS Specifications” as “the documentation relating to CSS entitled ‘CSS

(1AA136.) Thus, under the DVDCCA practice that Hoy described, a licensee (like Kaleidescape) that selects the “Descrambler Manufacturer” and “Authenticator Module for CSS Decryption Module” membership categories would receive and have to comply with three sets of Technical Specifications – the General Specifications, and two sets of category-specific Technical Specifications, which are labeled to reflect the category at issue (e.g., “DVD-Video Descrambler”). (See 1AA1-73.)

The Agreement reflects the extraordinary importance of strictly observing the CSS Specifications. It explicitly recognizes that a breach of its specifications will cause lasting and ultimately irreparable harms, “including making available the means for widespread unauthorized copying of copyrighted content[.]” (1AA150.) Accordingly, the Agreement provides that “money damages alone will not adequately compensate an injured party” for the damages caused by their breach, and “injury to such party will be irreparable.” (*Id.*) The Agreement further states that an injured party, “upon showing to the relevant court’s satisfaction that applicable factors other than [irreparable harm and inadequate monetary remedy] have been fulfilled,” will be entitled to equitable relief, including specific performance or injunctive relief. (*Id.*)

C. Kaleidescape and Its Product.

Kaleidescape was founded in 2001 by Michael Malcolm, Daniel Collens, and Cheena Srinivasan with no particular product in mind. (5RT475:8-23.) Over time, they decided to use their computer and engineering expertise to create a high-end video content storage and playback system designed mainly to exploit the content on DVDs. (5RT476:13-479:25.) From the outset, the founders understood that their

Specifications’ (including the Procedural Specifications and the Technical Specifications) [that] Licensor makes available to Licensee.” (1AA130.)

product would have to accommodate the intense concern of content providers about the proliferation of unauthorized copies of their copyrighted content. (5RT483:22-484:13, 487:10-20.) To this end, Kaleidescape started examining the Procedural Specifications and other materials available on the DVDCCA website. (5RT493:9-22, 494:25-495:13; 6RT619:13-26.)

In the course of this study and against the backdrop of the broad public attention given to the problem of unauthorized copying, Kaleidescape's founders explicitly discussed the very problem that became the basis of this lawsuit – namely, that they were considering a device design that would allow an end-user to play back content that had been copied from a DVD without having the actual disc present in the device. (1AA101-104; 4RT354:16-359:7.) As Kaleidescape recognized, this feature would permit consumers to make and play back unauthorized, permanent digital copies of rented or borrowed DVDs and would also allow for the spread of unauthorized copies if Kaleidescape's affiliated dealers “pre-loaded” DVD content into the device's library, thus allowing playback by an end-user who never owned the DVD being played. (1AA104.)

In August 2001, David Bryant, the analyst Kaleidescape hired in part to evaluate content protection issues, summarized his findings regarding compliance with anticipated CSS restrictions and, in particular, the problem associated with a machine that would play back DVD content from a server or hard drive rather than from the disc itself. (1AA107.) Bryant was unequivocal, warning his bosses that, “Methods that don't rely on physical possession of the DVD are not going to cut it with the [DVD]CCA.” (*Id.*)

Given his appraisal of “a near 100% chance” that Kaleidescape would need a CSS license, Bryant recommended a secure vault for housing an end-user's DVDs as the best (though not guaranteed) path to potential compliance. (1AA185; see also 4RT373:7-10.) Although the device would

actually play the DVD content from a copy on a hard drive, the vault system would at least guarantee that consumers could not then give away the DVD disc itself to another user or return it for further rental.

(1AA185.) Kaleidescape also considered other product designs aimed at providing the kind of content protection they expected the DVDCCA to require. For example, Kaleidescape considered a system that would destroy the physical discs once their content had been “imported” into the Kaleidescape storage system. (1AA125; 5RT486:24-487:9.)

Kaleidescape’s founders, however, had severe doubts about the commercial attraction of these approaches and were rankled by Bryant’s analysis of what the DVDCCA would, at a minimum, require. (1AA120; 6RT592:7-25.) The reaction of Srinivasan, a Kaleidescape founder and its Chief Operating Officer, was typical. Srinivasan did not dispute Bryant’s conclusions about what the DVDCCA would require as part of its license. But he did not think the vault concept would catch on with consumers. In Srinivasan’s view, Kaleidescape had “a lot more to worry about meeting the needs of the consumer than the content owners.” (1AA121.)

Accordingly, Srinivasan urged that Kaleidescape shift its focus away from compliance with anticipated DVDCCA licensing requirements towards completion of a device that would win awards and wow consumers. (1AA121-123.)

D. Kaleidescape’s Participation in the Agreement.

In September 2002, after a year of study, Kaleidescape licensed CSS from the DVDCCA. (1AA127.) It selected two membership categories – “Descrambler Manufacturer” and “Authenticator Module for CSS Decryption Module.” (1AA178.) As called for in the Agreement, DVDCCA delivered to Kaleidescape (and Kaleidescape signed for) the Technical Specifications for these categories. (1AA184.) Specifically, the DVDCCA delivered the General Specifications (applying to both

categories) and the documentation labeled “DVD-Video Descrambler” and “Authenticator Module for CSS Decryption Module,” comprising the category-specific Technical Specifications for the two membership categories that Kaleidescape elected to join. (*Id.*; 4RT375:7-20; 1AA1-99.)

E. The Kaleidescape System.

Neither executing the license nor studying all of these Technical Specification documents deterred Kaleidescape from Srinivasan’s suggested change of focus away from compliance and towards commercial pizzazz. By early 2003, the company had produced a prototype for a high-end system for DVD copying and playback that did not require the physical disc to be in the machine during playback. (4RT372:15-20.) The product introduced into the marketplace by Kaleidescape, known as the “Kaleidescape System,” incorporated none of the safeguards (such as the vault system) that Kaleidescape considered during its earlier evaluation of potential product designs.

Basically, when a user puts a DVD into the Kaleidescape System, the content of the DVD is copied (“imported”) onto a server, which can store permanent copies of more than 1000 DVDs. (3RT215:26-216:5, 202:20-203:17; 5RT505:6-22; 2AA353 at 17:8-12, 18:1-17.) Once the content of the DVD has been copied onto the server, the user does not need to retain physical possession of the DVD. (2AA354-355 at 22:18-23:2.) Whenever the user wants to play back the DVD’s content, the system simply plays directly from the copy on the server. (3RT200:19-201:17, 232:17-233:7; 2AA354 at 22:7-17.) Accordingly, the user can return, sell, or give away the DVD because the Kaleidescape System permanently stores a perfect digital copy of the content.

The Kaleidescape System has no mechanism for verifying that a user continues to possess the DVD or for distinguishing among owned, borrowed, or rented DVDs. (6RT676:8-677:9; 2AA355 at 23:3-7, 80:20-

23; 2AA364 at 74:17-75:07) And far from discouraging unauthorized copying, the Kaleidescape System automatically removes the “FBI Warnings” from DVDs imported into the system – which means that users will not be admonished about the illegality of making unauthorized copies. (3RT191:17-26, 217:6-13.)

F. The DVDFCA’s Efforts to Curb Kaleidescape’s Violation of the Agreement.

When the DVDFCA got wind of what Kaleidescape was doing, it wrote Kaleidescape on December 22, 2003 about its serious concern that Kaleidescape was violating the CSS Specifications because the Kaleidescape system did not require the DVD to be in the machine during playback. (2AA320.) In response, a new Kaleidescape analyst (together with several of Kaleidescape’s top executives) prepared a compliance presentation designed to convince the DVDFCA that it had taken sufficient precautions to minimize unlawful copying. (6RT653:7-654:6.)

Beginning in January 2004, the parties met and subsequently went through an ombudsman process, as required by the Agreement, but failed to resolve their differences. (4RT277:28-279:14, 281:18-282:5.) From the DVDFCA’s perspective, precautions Kaleidescape claimed it had taken were insufficient: having the disc in the system at the time of playback was vital to content protection.

As designed, the Kaleidescape system itself would surely produce some unlawful copying, especially from rental DVDs.⁵ But this was just the tip of the iceberg. Over time, systems like Kaleidescape’s were nearly certain to proliferate at much lower cost – and that development, in turn, would lead to the risk of widespread unlawful copying, to the severe

⁵ By his own admission, one of Kaleidescape’s founders, Daniel Collens, engaged in just such unauthorized copying of a rented DVD when trying out the machine. (6RT604:12-606:5.)

detriment of content providers and other businesses in the distribution chain. (3RT101:20-103:8, 145:7-146:2; 4RT305:11-306:26, 333:14-334-6.)

No one understood the destructive force such a system would unleash better than the people at Kaleidescape. As early as July 2001, Kaleidescape recognized in its internal strategy meetings that a system – like the one it chose to develop – that plays back content from a permanent stored copy (rather than from the disc) would “become[] a value-loss proposition for content owners and rental businesses because there is no repeat business ever Rental business will die, and retail business will suffer because borrowing once to have a permanent copy forever seems too good to forego for the average consumer.” (1AA104.) Naturally, this would be the death knell for the delicate balance of interests – the DVD “ecosystem” as one board member called it – that gave the content providers the sense of security they needed to offer to consumers their incredibly valuable copyrighted works in an agreed-upon digital format. (3RT101:20-103:8, 145:7-146:2; 4RT305:11-306:26.)

G. The DVDCCA’s Lawsuit.

After the ombudsman process failed, the DVDCCA sued Kaleidescape on December 7, 2004, for failing to comply with the CSS Specifications as required in the Agreement. (2AA326.) In particular, the DVDCCA alleged that the Kaleidescape system failed to comport with Sections 1.5 and 2.1.2 of the General Specifications. (See 3RT184:13-19, 186:12-18, 217:18-23, 226:4-8; 2AA477-479; 3AA607-611.)

The General Specifications contain, among other things, detailed technical information specifying how components of a DVD playback system interact with one another to carry out essential functions, such as data authentication and descrambling. (1AA83-99.) It is the only set of

