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A MONOPOLIST'S "DUTY TO DEAL": THE BRIAR PATCH REVISITED

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I. INTRODUCTION

Recently, two antitrust appellate decisions[1] dealt with the extent to which an owner of intellectual property has some kind of "duty to deal" with another firm (either by licensing the patent/copyright or by selling the product containing the intellectual property), when that firm needs the intellectual property to compete in some downstream market. The two decisions were not in agreement and the Supreme Court declined to hear either case,[2] so the situation remains unclear. The cases have generated animated commentary;[3] the only consensus that has emerged is that these are decisions with important implications for antitrust law and policy.

While antitrust law has for some time recognized that there are circumstances in which a monopolist may have a duty to deal, the claim is frequently made that some fundamental new issues arise when the monopoly is based on intellectual property. It is further claimed that the tension between the goals of intellectual property policy and the goals of competition policy makes the law that has so far developed with respect to the duty to deal not necessarily appropriate in the intellectual property context.

In all the discussion of these recent duty to deal cases, one very important element has been generally neglected or at least downplayed - viz., the price that the intellectual property owner should be able to charge, assuming that there is some kind of duty to deal. When this element is brought to the fore, my claim is that the tension between the intellectual property cases and the general duty to deal cases is largely eliminated. That is the good news. The bad news is that focus on the price of access demonstrates that there are important unresolved problems even in the general duty to deal cases and that there is no obvious or easy solution to these problems. This may require some rethinking about the place of the monopolist's "duty to deal" in modern antitrust policy.

II. AN OVERVIEW OF THE RECENT CASES

The two cases, *Kodak* and *Xerox*, were remarkably similar. Each company manufactured and sold photocopiers. Indeed, in the market for new equipment, Kodak and Xerox were competitors. Each also sold spare parts for the equipment they sold. The spare parts manufactured by each were not interchangeable; i.e., a particular spare part for a Kodak

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1 *Image Technical Servs., Inc. v. Eastman Kodak Co.*, 125 F.3d 1195 (9th Cir. 1997) and *Independent Services Organizations Antitrust Litigation*, 203 F.3d 1322 (Fed. Cir. 2000).

2 The Court had issued an earlier decision in the *Kodak* case 504 U.S. 451 (1992), but it was only on remand that the intellectual property issue became significant.

3 See, e.g., "Challenges of the New Economy: Issues at the Intersection of Antitrust Law and Intellectual Property," remarks of FTC Chairman Robert Pitofsky at the American Antitrust Institute Conference: An Agenda for Antitrust in the 21st Century, Washington, D.C., June 15, 2000.

machine would not work in the corresponding Xerox machine and *vice versa*.[4] Finally, each producer offered to provide service for the machines that it manufactured, although there were other firms (called "independent service organizations" ("ISOs")) that also competed to provide service for Kodak and Xerox machines. (Some ISOs would service the machines of both manufacturers.)

To provide service, ISOs normally required spare parts. For many of the parts, the only primary source was the manufacturer of the original equipment. At some point, both Kodak and Xerox effectively refused to sell spare parts to the ISOs for their respective machines (and made it difficult for the ISOs to obtain spare parts from other sources). ISOs sued each manufacturer claiming that each had monopoly power in the spare parts for its respective machines and that the refusal to make parts available was an attempt to misuse that monopoly power in order to prevent the ISOs from competing effectively in the service business. The issue in both cases was whether the manufacturer, because of its alleged monopoly power in the spare parts, was under a duty to deal with its would-be competitors in the service business. Each manufacturer raised as a defense the claim that its alleged monopoly in spare parts was based on intellectual property rights and that this was a business justification which gave the manufacturer the right to refuse to sell or licence the patented or copyrighted products. Each case reached the Court of Appeals on this issue, with *Kodak* going to the 9th Circuit and *Xerox* going to the Federal Circuit.

Neither court was prepared to offer an owner of intellectual property blanket immunity from the antitrust laws. The *Kodak* court noted specifically (quoting from a portion of the earlier Supreme Court decision in the same case) that market power gained through a patent or copyright can give rise to antitrust liability if "a seller exploits his dominant position in one market to expand his empire into the next." (504 U.S. at 480 n.29) The *Xerox* court noted "[I]ntellectual property rights do not confer a privilege to violate the antitrust laws," but gave as examples only situations where the original patent was obtained through fraud[5] or where an infringement suit was "a mere sham to cover what is actually no more than an attempt to interfere directly with the business relationship of a competitor."[6]

However, on the specific issue raised in the parallel cases, the courts went in opposite directions. The *Kodak* court acknowledged that Kodak's contention that its refusal to sell its parts to ISOs was based on its reluctance to sell its patented or copyrighted parts was a presumptively legitimate business justification, based on a desire to profit from its intellectual property rights. However, the court indicated that the presumption was rebuttable and, in particular, was rebuttable by a showing that this was a pretext. The court went on further to indicate that the jury was entitled to find that Kodak's "reason" was in fact a pretext (based in part on the fact that only a small portion of the parts were in fact patented, yet the refusal to deal applied to all spare parts).[7]

In contrast, the *Xerox* court specifically declined to follow the *Kodak* court's finding that a patentee's subjective motivation for refusing to sell its patented products was

4 It was on this issue that the *Kodak* case went to the Supreme Court in an appeal that predated the 9th Circuit opinion discussed below. Kodak claimed that, even if it had a "monopoly" in spare parts for its own machines, it could not have any market power because sophisticated customers would see an increase in the price of parts as equivalent to an increase in the price of the original machine. Since any customer contemplating the purchase of a new machine would be able to turn to an alternative manufacturer, Kodak would lose so many sales in the market for new machines that a strategy of increasing parts prices to those customers that already owned a Kodak machine would not be profitable. The Court determined that this need not be the case as a matter of economic theory and remanded to the lower court for a determination on the facts. The lower court found that, in this case, competition in the market for new equipment did not prevent Kodak from exercising market power in parts.

5 Citing *Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.*, 382 U.S. 172, 177 (1965).

6 Citing *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 144 (1961).

7 Of course, this suggests that the court could have ducked the entire issue by focusing only on the parts that were not covered by intellectual property rights.

potentially relevant in seeking to rebut the defendant's claim of a legitimate business justification. The court indicated that "[i]n the absence of any indication of illegal tying, fraud in the Patent and Trademark Office, or sham litigation, the patent holder may enforce the statutory right to exclude others from making, using, or selling the claimed invention free from liability under the antitrust laws."[8] The court went on to conclude that in the absence of any evidence that "the copyrights were obtained by unlawful means or were used to gain monopoly power beyond the statutory copyright granted by Congress," Xerox's refusal to sell or licence its copyrighted works "was squarely within the rights granted by Congress to the copyright holder and did not constitute a violation of the antitrust laws."[9]

Because of its special role in patent and copyright cases, the Federal Circuit's decision in *Xerox* is likely to be influential, if not controlling, in other circuits. This has led to concern on the part of some pro-enforcement antitrust commentators. Robert Pitofsky, for example, the immediate past Chairman of the Federal Trade Commission, expressed concern that its sweeping language "exalts patent and copyright rights over other considerations and throws into doubt the validity of previous lines of authority that attempted to strike a balance between intellectual property and antitrust."[10] Along similar lines, Linda Cohen and Roger Noll have commented that "[i]f this precedent stands, the Microsoft verdict will fall, and one probably never again will see a successful monopolistic leveraging complaint against an IP monopolist."[11]

While I will not seek to underestimate the potential significance of the *Xerox* opinion, I do want to argue that much of the discussion surrounding the opinion (both pro and con) is handicapped by a failure to focus on a critical question: assuming, hypothetically, that there are conditions under which an owner of intellectual property does have a duty to deal, who or what determines the price at which such dealings will take place?[12] I contend that, when this issue is examined, the apparent difference in the treatment of intellectual property monopolists and other monopolists may substantially diminish if not disappear altogether. However, the price of this harmonization is that a previously ignored problem with the general duty to deal doctrine comes to the surface and what may be a fatal flaw in the doctrine is exposed.

III. ANALYSIS OF THE DUTY TO DEAL IN INTELLECTUAL PROPERTY CASES

Simplify the facts of *Kodak* and *Xerox* only slightly. Assume that there is only a single manufacturer of the original equipment. (This disposes of the issue that the Supreme Court grappled with in *Kodak*. The assumption is unnecessary if we assume that there is consumer ignorance or myopia so that competition in new equipment does not eliminate market power in the unique spare parts for each producer's equipment.) Assume that there is a single part which is required for most service calls (e.g., a diagnostic tool which, to make the arithmetic simple, is completely used up in the process of providing service so that a new part is required for each service call). The part is patented and the patent is held by the producer of the original equipment, and that producer seeks to compete with ISOs in the downstream service market. Assume further that the service branch of the upstream

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8 A showing of tying, which normally involves an agreement with another party (i.e., the customer), would, in the court's analytical framework, take the matter out of the category of a <u>unilateral</u> refusal to deal.

9 Of course, plaintiffs were claiming that the purpose and effect of Xerox's conduct was to extend its monopoly into the service market. Nevertheless the court indicated that Xerox's refusal did not exceed the scope of the patent grant without explaining the principles by which it determined the scope of the grant.

10 Pitofsky, p. 12.

11 Linda R. Cohen and Roger G. Noll, *Intellectual Property, Antitrust and the New Economy*, 62 U. Pitt. L. Rev. 453 (2001) at 471.

12 The issue was present in both cases but it was not discussed and its significance was not appreciated. In *Kodak*, after a jury had found Kodak liable for monopolization and awarded plaintiffs substantial damages, the district court crafted a 10 year injunction requiring Kodak to sell all parts to ISOs on "reasonable and nondiscriminatory terms and prices." In *Xerox*, the actual claim was not that Xerox had absolutely refused to sell parts but that Xerox had set the prices for parts so high that ISOs would be effectively eliminated as competitors in the relevant service markets.

manufacturer is not separately incorporated so that there are no "sales" of parts from the upstream manufacturer to its service affiliate. Rather, the sales branch simply uses parts as it needs them to provide service, and the revenues from sales of new equipment, external sales of parts (if any), and service are consolidated. (This assumption is not necessary to the results but avoids the need to discuss a transfer pricing issue early in the analysis. We can relax the assumption later.) Finally, I will assume that, if the monopolist sells parts to the ISOs, it will sell to all ISOs at the same price. Hence there is no issue of discrimination among competing ISOs.

Under these assumptions, the problem, simply put, is this. Assuming for the sake of argument that there are circumstances in which the antitrust laws want to assert that the upstream firm (the parts monopolist) has a duty to deal with the ISOs that seek to compete with it in the downstream service market, what is the price at which such sales may (or must) take place? In other words, what price can the upstream monopolist charge without violating its "duty to deal?"

There are two polar alternatives. First, the upstream monopolist can charge whatever it wants or, perhaps slightly less sweeping (but with the same consequence), it can charge whatever price is consistent with maximizing its overall profits. Second, the monopolist must charge a competitive or (what may be the same thing) a "reasonable" price. (Note that, under the assumptions I have made in the preceding paragraph, a requirement that the parts monopolist sell at nondiscriminatory prices is superfluous and equivalent to allowing the monopolist to sell at whatever price it chooses.[13])

Consider the first alternative. (The monopolist has a duty to deal but can sell at the profit maximizing price.) Three things follow. First, as a general matter, the upstream monopolist ought to be more or less indifferent between complete freedom to deal or not deal as it chooses and the requirement that it must deal but can choose the price which maximizes its overall profits.[14] Absent some pathological animosity toward ISOs, the monopolist would not be expected to refuse to deal if there is a "real" price (real in the sense that some transactions actually occur) that will generate more profits than a complete refusal.[15]

Second, if we allow the monopolist to set its profit-maximizing price for parts, in many circumstances the price will in fact allow for the appearance of competition in the downstream markets. In particular, unless the ISOs are less efficient than the manufacturer's own service branch, the ISO's should be able to buy at the monopoly price for the parts and still be able to compete against the manufacturer in the service business. (Indeed, if the ISOs are more efficient, the manufacturer ought to be happy to let the ISOs take all of the service business as long as there are enough ISOs to make for effective competition among them.) The ISO's will not get rich, but they should be viable. (This is not to say they won't complain.)

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13 The assumption that there are no intra-corporate "sales" means that any requirement that the monopolist not discriminate between ISOs and its own service branch is impossible to enforce and hence meaningless.

14 One might argue that there are some savings in not having to defend a particular price as one that maximizes profits but these are not likely to be significant.

15 This proposition is a first cousin of the so-called "single-monopoly-profit" theorem, which in context, would say that, by setting the right price for parts and being willing to sell parts to ISOs at that price, the parts monopolist can capture all the profits that it could have captured by getting a monopoly in service as well as in parts. Hence, as long as the monopolist is free to set the price, there is no reason for it to refuse to deal. While there are some highly technical exceptions to this theorem (see, for example, Keith K. Wollenberg, *An Economic Analysis of Tie-In Sales: Re-examining the Leverage Theory*, 39 Stan. L. Rev. 737 (1987)), it is hard to see important issues of antitrust liability being decided on the basis of such details. There is also one substantive exception. Suppose that making substantial sales to ISOs would in fact maximize current profits but that the upstream monopolist is afraid that eventually the ISOs will use their experience to integrate backwards and break the monopoly in spare parts or new equipment. Then it becomes in the monopolist's long run best interest to refuse to deal (or to set a price so high that no transactions take place). The question, then, is whether this would qualify, under the first standard, as setting the "profit-maximizing price." It is not clear that courts are well-equipped to distinguish between short-run and long-run profit maximization, but an alternative route would be that followed by the DOJ (and endorsed by the Court of Appeals) in the *Microsoft* case: condemn the conduct as illegally maintaining a monopoly in the original equipment. [In *Microsoft*, the Court of Appeals upheld the DOJ's claim that Microsoft had suppressed Netscape in an attempt to prevent the possibility that a competitive browser would eventually be used as "middleware" which could serve as a platform for applications software that could run on Windows and on other operating systems as well. Then consumers would no longer be forced to use Windows in order to get the most popular applications. *United States of America v. Microsoft Corporation*, 253 F3d. 234 (2001).]

Third, even if there is the appearance of competition in the downstream market (i.e., the profit-maximizing price for parts allows ISO's enough margin to compete), the consumer will pay essentially the same price for service as he or she would pay if the parts monopolist refused to deal and took over the service business as well. (The only exception would be where the ISO's were more efficient, but in this case, as indicated, there is an incentive for the parts manufacturer to welcome ISO's into the downstream market.)[16]

Now consider the second alternative. (The monopolist must sell at a competitive or "reasonable" price.[17]) Again, several things follow. First, there is the general issue of judicial competence to determine a competitive price. We often credit (then) Circuit Judge William H. Taft as articulating the premise of the modern *per se* rule against price fixing,[18] and it was precisely the difficulty that a general purpose federal court judge would have in determining a fair or reasonable (or competitive) price.[19]

The second issue that arises under this second alternative is: what general principle will be applied in setting a competitive price where intellectual property is involved? If we allow the parts manufacturer to charge a price equal only to the marginal cost of production, the manufacturer is receiving no payment at all for the intellectual property.[20] Surely, it cannot be a premise of antitrust law that an owner of intellectual property has an obligation to give it away. But once we get into the issue of fair compensation for the manufacturer's past R&D expenditures or simply fair compensation for his creative success, we are in a hopeless situation. It is hard enough for courts to determine marginal production costs. How would a court ever assess how much a firm should be fairly rewarded for its creative efforts? (And notice that an assertion that the manufacturer should be entitled to profits from the parts, based on the intellectual property, but not on the service, does not help since, by assumption, the monopolist is making all the "monopoly" profits through parts sales.)

The third problem that arises from this second alternative stems from the fact that virtually all of the litigated duty to deal cases (whether they arise as run-of-the-mill Section 2 cases or under the special variant known as "essential facilities" cases) arise in a situation where the upstream monopolist is also attempting to compete in the downstream market. [21] There is a consensus, I would claim, that if Kodak or Xerox were selling only original equipment and parts, and made no effort to compete in the service business, they would be able to sell the parts for any price they wished (and presumably could refuse to sell at any price, although there would be no motive to do so).[22] But if that is the case, then consider the message to firms with a monopoly in an upstream product such as the spare parts: If you stick to selling the upstream product, you can charge as much as you like and make as much profit as you can; but if you make any attempt to integrate into the downstream market, you

16 While one can't rule out a pathological refusal to act consistently with this incentive, I question whether antitrust doctrine should be driven by such possibilities.

17 For now, I will treat them as equivalent although there are contexts (such as damages in cases of intentional infringement of a patent) in which courts try to set a "reasonable" price which is almost certainly not the same as a competitive price.

18 *United States v. Addyston Pipe & Steel Co.* 85 F. 271.

19 The issue does not arise where all the court is trying to do is to prevent discrimination among different downstream competitors. That is not to say that there is not the possibility of some uncertainty, but a "do not discriminate" injunction is a lot easier to understand, follow, and enforce than one which says "charge a reasonable price."

20 This can be seen more easily by changing the initial problem to one where the downstream ISOs want to license the patent and produce themselves. The approach in the text would require that the license be given away since the marginal cost of an extra license is zero.

21 A frequently cited summary of the essential facilities doctrine comes from Judge Greene in the *AT&T* case: Any company which controls an "essential facility" or a "strategic bottleneck" in the market violates the antitrust laws if it fails to make access to that facility available to its competitors on fair and reasonable terms that do not disadvantage them. *United States v. AT&T* 524 F.Supp. 1336 (D.D.C. 1981) (emphasis added). One of the classic cases, *Aspen Skiing*, is somewhat difficult to fit in this pigeonhole since there were no clearly delineated upstream and downstream markets. But the defendant was competing against the plaintiff, and was not merely a supplier to that plaintiff. *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.* 472 U.S. 585.

22 A clear statement of this doctrine (although it did not involve an intellectual property rights claim) is contained in *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, U.S. Circuit Court of Appeals, Second Circuit (1979). From footnote 12: "Nor is a lawful monopolist ordinarily precluded from charging as high a price for its product as the market will accept. True, this is a use of economic power; indeed, the differential between price and marginal cost is used as an indication of the degree of monopoly power. But high prices, far from damaging competition, invite new competitors into the monopolized market (cites omitted)."

will be subject to judicial regulation of the price you charge and will not be allowed to charge more than a "reasonable" price. The monopolist does not need to be a rocket scientist to figure out that he is better off not being vertically integrated, even where there are clear economies associated with vertical integration.

IV. NON-INTELLECTUAL PROPERTY REFUSAL CASES

From the forgoing it appears that there is a special problem applying the duty to deal in situation where the monopoly is based on intellectual property rights. It would be inconsistent with the whole point of patent or copyright protection (which is to provide an incentive to create and innovate) to require the owner of intellectual property rights to give those rights away. And thus, it is said, a tension is created between the policy underlying intellectual property law (which tolerates monopoly pricing and monopoly profits as the cost of encouraging creative activity) and the policy underlying antitrust law (which seeks to promote competition and eliminate or constrain monopoly).

But at this point, the perceptive reader, in re-examining the analysis above, might pause to say: don't some or all of these same problems exist even when the monopoly is not based on intellectual property? And of course, the reader would be right. All three problems, perhaps only slightly disguised, are present. The first and third are easy. A court is still charged with the responsibility of determining whether the price charged by the monopolist was reasonable or enforcing an injunction to charge reasonable prices in the future. There is still the same distortion with respect to the incentives for vertical integration since an unintegrated monopolist is, as far as I can tell, free to charge whatever it likes.[23] The only apparent difference is with respect to the second point: the intellectual property monopolist is forced to give away the intellectual property, whereas the nuts-and-bolts monopoly is at least allowed to charge a competitive price. But the difference is only apparent. The spare parts producer with a patent can charge the competitive price for the manufacture of the parts but gets nothing over and above that to reward it for its creative efforts. The monopolist without intellectual property protection recoups the marginal cost of manufacture but gets nothing to reward it for whatever skill, foresight, and industry allowed it to achieve and maintain a monopoly position in the first place.

Therefore, I conclude that the same fundamental problems exist whether or not the monopoly is based on intellectual property rights. Perhaps the reason that the problem has not received a lot of attention to date is that many of the original duty-to-deal or essential facilities cases fell in either of two categories: a) they dealt with discrimination towards an individual customer or set of customers and could be cured simply by requiring non-discriminatory prices (without regard to whether those prices were at supra-competitive levels)[24]; or b) they dealt with an upstream product, the price of which was subject to ongoing regulation by some permanent regulatory body and cured simply by requiring the monopolist to sell at the approved price.[25] But in a great many of the more recent essential facility cases, the problem is there, even if it is not acknowledged.[26]

23 See the quote from *Berkey Photo* in note 22 *supra*.

24 I would place *Lorain Journal* and *Terminal Railroad* in this category (*Lorain Journal v. United States* 342 U.S. 143 (1951) and *United States v. Terminal Railroad Association* 224 U.S. 383 (1912)).

25 I would put *Otter Tail* in this category (*United States v. Otter Tail Power Co.* 410 U.S. 366 (1973)).

26 On occasion, a plaintiff complains that the discrimination is between, on the one hand, the transfer price charged between the upstream monopoly and the downstream affiliate and, on the other hand, the price charged by the upstream monopoly to the unintegrated competitors in the downstream market. While there will always be some debate around the fringes, an upstream monopolist should be able to avoid such litigation by charging the same monopoly price to all customers, internal and external. It solves the discrimination problem without sacrificing monopoly profits and without really helping the consumer.

V. SOLUTIONS?

Alas, I don't think there is any easy solution. Unless we are to undo 100 years of antitrust jurisprudence and declare it unlawful for an otherwise lawful monopolist to charge a price which is above the competitive level, I think it makes no sense to impose a special duty of competitive pricing just because a firm had decided to integrate into the downstream market. Nor do I think it wise to take on what seem to be hard-rock principles of intellectual property law and policy to impose a general duty on an intellectual property monopolist to charge competitive prices. I think both would be bad from the perspective of incentives and both raise the questions of the judiciary's ability to enforce such a standard. Therefore, one should consider confining the duty to deal doctrine to one of its historic origins - regulated industries - recognizing that this would largely eliminate the doctrine from the modern antitrust lexicon.