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Parallel Imports, The Intraband/Interbrand Competition Paradigm, and the Hidden Gap Between Intellectual Property Law and Antitrust

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Abstract

The exhaustion doctrine, in intellectual property law, restrains firms from restraining competition among different sellers of the same product. Thus, it restrains firms from restraining intraband competition. In U.S. antitrust law, firms have no duty to create or tolerate competition in their own product, and if they impose territorial restraints in the course of distributing their product, those restraints are presumed to be efficient for the firm and efficient or at least neutral for competition and consumers. This Essay argues that there is a gap between the intellectual property law and the antitrust law of vertical (intraband) restraints.

RESPONSE

PARALLEL IMPORTS, THE INTRABRAND/ INTERBRAND COMPETITION PARADIGM, AND THE HIDDEN GAP BETWEEN INTELLECTUAL PROPERTY LAW AND ANTITRUST

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The exhaustion doctrine, in intellectual property law, restrains firms from restraining competition among different sellers of the same product. Thus, it restrains firms from restraining intrabrand competition. In U.S. antitrust law, firms have no duty to create or tolerate competition in their own product, and if they impose territorial restraints in the course of distributing their product, those restraints are presumed to be efficient for the firm and efficient or at least neutral for competition and consumers. This Essay argues that there is a gap between the intellectual property law and the antitrust law of vertical (intra-brand) restraints.

There is growing recognition in the world that rivalry between and among competing producers (“interbrand competition”) is the essence of competition. It is that interplay that tends to keep prices relatively close to costs, to provide choices for consumers, and to allocate resources to their best use in view of consumer demand.¹ Intrabrand competition—a producer’s product competing against itself—cannot do this job. If a producer has market power it will use this power on its first sale. It may use intrabrand competition to keep its distributors from making extra profits or operating laxly, rather than increasing sales. The producer has the incentive to “squeeze” its distributors rather than to give them the power to inflate the costs of

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1. *See* *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717 (1988).

distribution.² In this sense, it is said that the producer's interest in vertical restraints aligns with the consumer's interest.

Vertical restraints may be used to dampen competition among competitors where the market structure and conditions are susceptible to cartel behavior. Thus it is observed that vertical minimum resale price maintenance ("RPM") can be used to facilitate cartels and that this danger may justify a per se rule against RPM, at least in oligopolistic markets.³ But in all other cases (i.e., purely vertical in purpose and effect), government restraints on the freedom of firms to use vertical restraints cannot create or preserve competition in any meaningful economic sense, and it can handicap firms from realizing efficiencies.

In the 1960s, the United States had strong and rigid legal rules against vertical restraints. These were intended to preserve the freedom and autonomy of distributors, on the assumption that distributors were likely to be "the little guys," people without power in relation to producers. The background rule was called "the free trader doctrine."⁴ However, as world competition became robust and the quest for efficiency and competitiveness took center stage, U.S. law and policy changed. The free trader doctrine was overruled by the U.S. Supreme Court in *Continental T.V. v. GTE Sylvania*.⁵ The Court observed then and several times since that when a single producer (i.e., not in collaboration with competitors nor with an eye to enlisting their complicity) chooses to impose a vertical restraint, the restraint is nearly always efficient, output increasing, and good for consumers, and that government restraints (antitrust rules) against the freedom of firms to choose how to distribute their own product are nearly always inefficient, output decreasing, and harmful to consumers.⁶

2. Alternatively, a producer may decide to prevent its distributors from competing against one another in order to guard against free riding and to focus on "real" (inter-brand) competitors. See *Bus. Elecs. Corp.*, 485 U.S. at 724-25; see also Commission of the European Communities, Green Paper on Vertical Restraints in EC Competition Policy, COM (96) 721 Final (Jan. 1997).

3. See *Bus. Elecs. Corp.*, 485 U.S. at 725-26.

4. See *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), overruled by *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977); see also Eleanor Fox, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140 (1981).

5. See *Cont'l T.V.*, 433 U.S. at 58-59.

6. See *Bus. Elecs. Corp.*, 485 U.S. at 725; see also *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128 (1998).

What the Court has not said is that vertical restraints by firms with market power can help the powerful firm exploit buyers even while increasing output and increasing aggregate consumer surplus. Why does it not make this point? Perhaps because the current Supreme Court majorities do not care; or perhaps they believe that U.S. antitrust is and should be only about allocative efficiency or aggregate consumer welfare (i.e., no distributional concerns); or perhaps they are concerned that antitrust is a poor tool to regulate or squeeze out some of the pricing power of firms. This non-interventionist perspective corresponds with the stance of U.S. antitrust law on excessive pricing. Unlike the competition laws of most other nations, American anti-trust law does not prohibit excessive pricing by dominant firms. U.S. policy-makers and jurists have made a decision that pricing and its excesses should be left to the market; that excessive pricing usually attracts entry and substitutes; that if it does not, perhaps the market should be regulated, but, in the absence of regulation, freedom of pricing works better for the public than antitrust intervention, which is likely to reduce incentives to create and compete, upsetting the balance of risk and reward.⁷

If this philosophy underlies vertical restraints in general, then it would seem to apply *a fortiori* to vertical restraints chosen by owners of intellectual property ("IP"), because the rules of IP are about innovation itself, and restraints on the freedom to exercise one's IP right to exclusive exploitation decrease the rewards of innovation.⁸ Yet curiously, if the above view of vertical restraints is accepted, and if the jurisdiction has an IP rule of international exhaustion, a dominant firm without IP protection is in a better position than a firm with IP protection, because the former has the right to contract to keep out transshippers, and the latter does not.

Professor Korah's paper fits nicely within this context.⁹ Professor Korah notes, unsympathetically, the exhaustion doctrine within the EU, and, sympathetically, the rule of no international exhaustion when imports come from a non-member country. If

7. See *Berkey Photo Inc. v. Eastman Kodak Co.*, 603 F.2d 263 (2d Cir. 1979).

8. Legal systems may, however, overprotect IP rights, and excessive protection to one IP holder may impair incentives of competing inventors and may cause unnecessary harm to competition.

9. Valentine Korah, '*Consent*' in *Relation to Curbs of Parallel Trade in Europe*, 25 *FORDHAM INT'L L.J.* 972 (2002).

a firm unilaterally exercises IP rights granted under the law of one Member State to exclude a product that it has put on the market in another Member State (e.g., one that has suppressed price by price control), it (or technically the authorizing State) violates Article 28 of the European Community ("EC") Treaty.¹⁰ If an IP holder prohibits parallel imports by concert, it violates Article 81 of the EC Treaty.¹¹

Moreover, the IP holder is at risk even in the absence of collusion and the absence of exhaustion. Under *Micro Leader*, the unilateral exercise of an IP right in a Member State to keep out low-priced parallel imports from a non-EU country is some evidence that the price in the Member State is abusively high, therefore that the IP holder must be dominant, and therefore that the "excessive" price violates Article 82.¹²

Professor Korah applauds the Court of First Instance in *Bayer* for finding no agreement where Bayer merely allocated the supply of its product to its distributors in a unilateral effort to prevent arbitrage.¹³ She criticizes the Court of First Instance in *Micro Leader* for plotting an end run around both lack of international exhaustion and absence of concert. She criticizes the EC doctrine of internal market exhaustion, and criticizes EC law generally for failing to recognize that price discrimination and the ability of a producer to segment its own markets can be the means to increase output and sell more product, rather than to restrain trade. Indeed, without the lid on arbitrage, making it possible to price discriminate, the firm may not be able to serve

10. Treaty establishing the European Community, O.J. C 340/3 (1997), 37 I.L.M. 79 [hereinafter Consolidated EC Treaty], *incorporating changes made by* Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, Oct. 2, 1997, O.J. C 340/1 (1997). Article 28 provides that "quantitative restrictions on imports and all measures having equivalent effect shall be prohibited between Member States." *Id.* art. 28, O.J. C 340/3, at 51 (1997) (ex Article 30).

11. Article 81 prohibits agreements that restrict competition.

12. *Micro Leader Business v. Commission*, Case T-198/98, [2000] 4 C.M.L.R. 886 (holding that the Commission abused its discretion in not investigating further the complaint that Microsoft France violated EC Treaty Article 82, if not Article 81, by charging an appreciably higher price in France for French language software than was charged by Microsoft in Canada for the same software, and exercising copyright rights to exclude imports from Canada). Article 82 prohibits abuse of a dominant position.

13. *Bayer AG v. Commission*, Case T-41/96, [2001] 4 C.M.L.R. 4 (Oct. 26, 2000).

the lowest priced market.¹⁴ Both Professor Korah's praise and her criticism find support in U.S. law and policy.

One need not conclude from the above analysis that granting freedom to producers who act unilaterally is the prescription that serves the interests of the world. If one cares about distribution of resources (as opposed merely to efficient allocation), it is not. However, the above analysis might cause us to rethink whether the unilateral use of vertical restraints is the problem and whether government proscription of vertical restraints is the cure. We might enthusiastically applaud the commitment of Bristol-Myers Squibb, Merck, GlaxoSmithKline, Hoffmann-La Roche, and Boehringer Ingelheim to provide South Africa with their anti-AIDS drugs at lowest rates available anywhere in the world.¹⁵ (I do.) But if distributors in South Africa can ship those drugs to the United States, the UK, and Germany, undermining the market that pays back total costs, there will be no low-priced drugs for South Africa after the very short term.

Thus, the problem is not about freeing trade, but controlling or subsidizing price. The EC rules on internal-market exhaustion and on parallel imports are ad hoc tools, dependent upon fortuities, by which government can sometimes put a lid on price without calling the intervention price control. The EC exhaustion and competition rules would import into all of the EU the price regulation of the Member State that suppresses price the most. But, of course, one hundred percent success would mean one hundred percent failure: the market would disappear.

Price is the problem, not restraint of trade. The question is: Who should pay and how when the market does not work; especially when the market fails to provide the necessities of life?

14. See Michel Waelbroeck, *Price Discrimination and Rebate Policies Under EU Competition Law*, 1995 FORDHAM CORP. L. INST. 147 (Barry E. Hawk ed., 1996).

15. See Rachel L. Swarns, *Drug Makers Drop South Africa Suit Over AIDS Medicine*, N.Y. TIMES INT'L, Apr. 20, 2001, at 1.