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# INNOVATION AND MONOPOLIZATION: WILL THE NEW CHINESE ANTIMONOPOLY LAW FOLLOW US AND EU PRECEDENTS?

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## I. INTRODUCTION

In both the US and the EU there is an extensive body of legal precedent addressing the tension between (a) encouraging innovation by dominant firms which benefits consumers; and (b) discouraging efforts to maintain or enhance market power through product changes of dubious value aimed at disadvantaging smaller rivals and ultimately harming consumers. Litigation now pending under existing Chinese laws could provide a glimpse into how this issue will be dealt with under the Anti-Monopoly Law when it comes into force.

Tsum Technology Co Ltd., a leading Chinese battery manufacturer, has sued Sony Corporation alleging the latter adopted technology that precluded the use of Tsum's batteries in Sony's digital cameras. The purpose of this article is to briefly summarize the applicable US and EU precedents as they might be applied to the Tsum/Sony litigation and the language of the Anti-Monopoly Law, insofar as these sources may shed light on how Chinese antitrust law will develop in this important area.

## II. TSUM'S ALLEGATIONS AND SONY'S DEFENSE

In a case pending before the Shanghai No. 1 Intermediate People's Court, Tsum (Shanghai) Technology Co Ltd. ("Tsum") has accused Sony Corporation of using a digital key that automatically rejects batteries made by other companies. Tsum alleges that there was no legitimate purpose underlying this technological obstacle to the use of its batteries. Tsum also claimed it was required to spend more than 1 million yuan (approximately $129,000) to decipher the technology and modify its own batteries so that they would work with Sony's cameras and that this resulted in higher prices for consumers.

Sony has denied that it was seeking to lock out its battery competitors. It has defended by alleging that the technology is being used in response to reports of smoke, explosion and burning resulting in damage to individuals and property caused by the use of non-Sony batteries in the company's digital cameras and camcorders. Sony also relies upon the existence of patent protection for the digital key, asserting that it has a right to use its intellectual property in its products without fear of antitrust liability.[1]

## III. APPLICABLE US PRECEDENTS

While we most often think of competition taking place in the form of lower prices, innovation competition can be at least as valuable in bringing consumers new or more efficient products. Accordingly, US antitrust law is very sensitive to protecting innovation competition. US antitrust enforcement agencies place considerable emphasis on the preservation of innovation competition in the merger review process, often digging deeply into the research and development pipelines of the merging firms to make sure the merger will not cause a diminution of important innovation competition by eliminating competition between two of very few firms seeking to develop a potentially important new product.[2] Similarly, in addressing single firm conduct, the US precedents have been quick to recognize that the Sherman Act[3] should be interpreted to "safeguard the incentive to innovate"[4] and are accordingly sensitive to "the extent to which antitrust liability might undermine the encouragement of innovation."[5]

Accordingly, it is generally the rule that monopolists may introduce new products that improve performance or lower cost without facing antitrust liability, even if formerly interchangeable component parts produced by rival firms are rendered incompatible with the new product. Moreover, even where it is debatable whether a new product whose introduction harms smaller rivals through incompatibility represents an improvement, US courts have been loathe to substitute their judgment for that reached by the innovating firm.[7] "Antitrust scholars have long recognized the undesirability of having courts oversee product design, and any dampening of technological innovation would be at cross-purposes with antitrust law."[8]

However, this is not to say "anything goes." Liability has been found where the evidence clearly shows that a new product is not much of an improvement and there is also evidence that the purpose of the change was to monopolize a complementary product. The

1 At this writing, court papers are not available and the case is under advisement after an oral hearing earlier this year. The positions of the parties as described above are taken from media reports. *Competition Law 360* (January 18, 2007); Cao Li, *Sony in Court for Battery Design*, China Daily, January 18, 2007, available at http://www.chinadaily.com.cn/china/2007-01/18/content_786232.htm. 陈芳 陆文军， 德先诉索尼电池涉嫌不正当竞争案在沪开庭 [*T-sum VS. Sony for Allegation of Unfair Competition Heard by a Court in Shanghai*]， 新华网，January 18, 2007, *available at* http://news.xinhuanet.com/tech/2007-01/18/content_5619644.htm. 商思林，反垄断法：化解知识产权国际压力的中国利器？ [*Anti-Monopoly Law: a Useful Tool to Eliminate International Pressure on IPR in China?*]，南方周末，July 06, 2006, *available at* http://www.nanfangdaily.com.cn/zm/20060706/jj/qs/200607060038.asp. 张波， 德先诉索尼案及其启示—知识产权滥用反垄断规制之实证分析 [*Thoughts on Monopoly Litigation T-sum VS. Sony*]，知识产权2006第4期，*available at* http://www.cta315.com/infor_vewe.asp?infor_id=12710&class1_id=15&class2_id=53. 王琦玲，德先科技能告倒索尼吗？[*Will T-sum Trump Over Sony?*]， IT时代周刊，February 21, 2006, *available at* http://www.ittime.com.cn/content.asp?id=2253. 严登峰 李琳，索尼中国回应涉嫌垄断职责 称为保护消费者权益 [*Sony (China) Responses to the Allegation of Monopoly and Claims to Protect Consumers' Interest*]，每日经济新闻，February 18, 2005, *available at* http://finance.sina.com.cn/g/20050118/02001300466.shtml. 王云辉，德先诉索尼背后 电池市场暗战行业标准 [*Behind-the-Scense of T-sum VS. Sony: Secret War in Battery Industry Standard*], 21世纪经济报道，February 05, 2005, *available at* http://www.nanfangdaily.com.cn/jj/20050207/it/200502050091.asp. 李秀中， 索尼否认存在垄断 [*Sony Denys Existence of Monopoly*]， 第一财经日报，January 18, 2005, *available at* http://finance.sina.com.cn/chanjing/b/20050118/02211300487.shtml. 李秀中， 索尼中国涉嫌垄断 电池设置智能识别技术壁垒 [*Alleged Monopoly of Sony China: Smart Identification Technology Set on Battery as Technical Barrier*]，第一财经日报，January 17, 2005, *available at* http://finance.sina.com.cn/chanjing/b/20050117/03091297928.shtml.

2 *See, e.g., In the matter of Sanofi-Synthelabo and Aventis*, FTC Dkt. No. C-4112 (2004); *In the matter of Boston Scientific Corporation and Guidant Corporation*, FTC Dkt. No. C-4164 (2006).

3 Section 2 of the Sherman Act prohibits monopolization or attempts to monopolize. 15 U.S.C. § 2.

4 *Verizon Communs. v. Law offices of Curtis V. Trinko*, 540 U.S. 398, 407 (2004).

5 *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 282-83 (2d Cir. 1979).

6 See, e.g., *Transamerica Computer Co. v IBM Corp.*, 698 F.2d 1377.182-83 (9th Cir. 1983); *Medtronic MiniMed, Inc. v. Smiths Med. MD, Inc.*, 371 F. Supp. 2d 578, 587 (D. Del. 2005).

7 E.g., *ILC Peripherals Leasing Corp. v. IBM Corp.*, 458 F. Supp. 423, 439-41 (N.D. Cal. 1978) ("…courts should not get involved in second guessing engineers.")

8 *United States v. Microsoft Corp.*,147 F.3d 935, 948 (D.C. Cir. 1998).

leading precedent of this type is *C.R. Bard, Inc. v. M3 Systems.*[9] Bard was the producer of a biopsy "gun" that injected a biopsy needle assembly into body tissue for sampling purposes. Unlike the prior version of Bard's biopsy gun, the new version was not compatible with biopsy replacement needles provided by other firms. The court required the plaintiff "to prove that Bard made a change…for predatory reasons, i.e., for the purpose of injuring competitors in the replacement needle market rather than for improving the operation of the gun."[10] There was significant evidence that the modifications did not improve performance and that no safety issue arose when the replacement needles of rival firms were used with Bard's gun. In addition, there was evidence that "the real reason for modifying the gun were to raise the cost of entry to potential makers of replacement needles."[11] On those facts, a jury verdict of monopolization was upheld.

*Bard* was a 2-1 decision. The dissenting judge was loathe to second-guess Bard's conclusion that its modification of the gun made it easier to use and concluded that finding antitrust liability in such circumstances would have the "pernicious" effect of penalizing innovators for making improvements to their products.[12] The majority disagreed, noting the existence of evidence on which the jury could properly find that Bard's real reasons for modifying the gun were to raise the cost of entry to potential makers of replacement needles, to make doctors apprehensive about using non-Bard needles, and to preclude the use of "copycat" needles. The majority opinion cited in this regard an internal Bard document purportedly acknowledging that the gun modifications had no effect on gun or needle performance and another internal document showing that the use of non-Bard needles in the gun "could not possibly result in injury to either the patient or the physician." In the majority's view, this was evidence upon which a jury could reasonably conclude that Bard's modifications to its guns constituted "restrictive or exclusionary conduct" in a market over which it had monopoly power.[13]

Whatever the merits of the *Bard* case most US courts would agree that antitrust claims of the type there asserted "must always be treated circumspectly by the courts because the issues will always be highly technical and because undue interference will chill innovation."[14]

## IV. APPLICABLE EU PRECEDENTS

Like the US, the EU takes the view that innovation constitutes an essential and dynamic component of an open and competitive market economy.[15] However, if a manufacturer who holds a dominant position for one product in a given market (say, digital cameras) re-designs that product for the sole purpose of eliminating competition in some neighboring markets (for, say, batteries), the Commission's general sympathy for innovation as an inherently pro-competitive activity will be of little or no avail to that manufacturer.

In the EU, there is no antitrust precedent similar to Bard. However, there are a couple of tying cases that shed light on how the Commission might assess such a design practice. It is also hard to overlook the relevance of the Microsoft case in which the Court of First Instance ("CFI") recently upheld the Commission's decision to

9 157 F.3d 1340 (Fed. Cir. 1998).

10 157 F.3d at 1382.

11 157 F.3d at 1382.

12 157 F.3d at 1370-71.

13 157 F.3d at 1382.

14 3A PHILIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION at ¶776a (2006 ed.) The authors state:

(1) all U.S. courts "recognize that product improvement is protected and beyond antitrust challenge";

(2) in the U.S., antitrust liability is unlikely except in the extraordinarily rare case where the defendant's "position in the dominant product is so substantial that the market for the older technology is eliminated" and the purported innovation is "clearly not superior to the older technology"; and

(3) since innovation is always motivated in part by a desire to gain competitive advantage, the innovator's intent "should be admitted [into evidence] only insofar as it shows that (a) the defendant believed that the new product was not superior to the older technology, and (b) the only purpose of the innovation was to deny market access to rivals in the complementary market."

15 *Cf., e.g.* Commission Guidelines on technology transfer agreements, O.J. C 101/2 of 27 April 2004, § 7 according to which intellectual property right laws ("IPR") and competition law pursue the same objective, namely to promote dynamic competition, in the sense that IPRs reward companies who develop new or improved products while competition law puts them under the pressure to do so.

impose a heavy fine on Microsoft for having abused its dominant position in the client PC operating systems market by seeking to extend that position to two adjacent markets, i.e. the market for work group server operating systems and the market for media players.[16] We will first review the older tying cases and then present the CFI's judgment in a nutshell.

In Hilti[17], a dominant manufacturer of nail guns had refused to sell its guns to customers unless they would also purchase its cartridge strips and nails for use in these guns. Hilti had strengthened the tie between the guns and the cartridge strips by indulging in a number of other practices, including the refusal to honor the guarantees on its guns when non-Hilti cartridge strips and nails were used and the imposition of an excessive royalty for the patent license to manufacture its cartridge strips. In addition, Hilti had informed would-be licensees that, in any event, it also held a copyright over these strips so that the patent license would be of little value.

According to the Commission, all these practices were part of a policy solely aimed at preventing independent producers of Hilti-compatible cartridge strips and nails from entering the market.

Hilti claimed that its policy had been "motivated purely by safety considerations". However, the Commission found that Hilti had actually never voiced any safety concerns with customers, independent manufacturers or public authorities). Moreover, in some contemporaneous internal documents, Hilti had itself acknowledged that the safety argument was a poor justification for the tying practice. Furthermore, another internal document showed that Hilti's patent licensing practice had no other aim than to prevent or delay market entry.

The CFI upheld the Commission's decision—not really a surprise in light of the evidence stemming from Hilti's own documents. However, the CFI used some sweeping language suggesting that Hilti would even have had a hard time justifying its conduct in the absence of such evidence. It observed that it was "clearly not the task of an undertaking in a dominant position to take steps on its own initiative to eliminate products which, rightly or wrongly, it regards as dangerous or at least as inferior in quality to its own products" (italics added).[18]

In Tetra Pak II[19], the manufacturer had tied the sale of its aseptic packaging machines to that of its cartons for use in these machines. It had also systematically requested and obtained patent protection for slight modifications to the machines and cartons. As in Hilti, the manufacturer had invoked safety reasons to justify its practices and this time, there were no unhelpful internal documents. The Commission nevertheless rejected the safety justification on the ground that Tetra Pak could have reverted to a more proportionate method to address the problem, e.g. by publishing clear standards and specifications to be complied with by suppliers and users of packaging machines and cartons. This was "all the more vital" since Tetra Pak's exclusionary conduct had occurred in a market where competition had already been "extremely limited." The CFI upheld the Commission's decision, relying on its sweeping Hilti language, and it shared the Commission's view that Tetra Pak's tying practice had been disproportionately restrictive.[20]

In short, safety concerns will not easily justify a dominant company's practices that frustrate the dominant company's competitors, especially if competition is already substantially restricted in the relevant market.

In Microsoft, the CFI confirmed that Microsoft had committed two abuses. The first one consisted in a refusal to provide manufacturers of work group server operating systems certain information to improve the interoperability between their software and that of Microsoft. In view of the exceptional circumstances

16 Judgment in case T-201/04 of 17 September 2007, *Microsoft Corp. v. Commission*.

17 Commission decision of 22 December 1987, (O.J. L 65/19 of 11 March 1988).

18 Judgment of 12 December 1991 in case T-30/89, ECR II-1439, § 118.

19 Commission decision of 24 July 1991 (O.J. L 72/1 of 18 March 1992.

20 Judgment of 6 October 1994 in case T-83/91, *Tetra Pak v. Commission*, ECR II-755, § 139.

(including Windows' very high share of the client PC operating system market), the fact that the interoperability information was—at least in part—protected by patents and copyrights did not justify Microsoft's refusal. The second abuse consisted in the bundled sale of Windows and its Windows Media Player, which was treated as a tying arrangement.

On its face, the Microsoft case seems to deal with practices that raise less foreclosure concerns than those at stake in the Sony case. Microsoft's conduct did not prevent all interoperability between its products and those of its competitors. Rather, in the Commission's view, there was just not enough interoperability. And Microsoft's bundling of Windows and the media player did not prevent consumers from using a non-Microsoft media player on their PC,. While both practices were prohibited, it is hard to be certain of the implications for conduct like that at issue in the Sony case. The Commission itself seems to acknowledge that the Microsoft case is a pretty unique case due to the 95% market share of Windows in the client PC operating systems market.

## V. THE LANGUAGE OF THE ANTI-MONOPOLY LAW AND HOW IT MIGHT BE APPLIED TO THE SONY-TSUM LITIGATION

For some time, China has been considering adoption of a new antitrust statute, called the Anti-Monopoly Law ("AML"). On August 30, 2007, the Standing Committee of the National People's Congress passed the China Anti-monopoly Law, which will, as promulgated, come into effect as of August 1, 2008. The new Chinese Anti-Monopoly Law includes provisions on restrictive agreements, abuse of a dominant position, merger control, and abuse of administrative powers.

While there has been considerable input received from interested US parties during the deliberation of the draft AML,[21] the influence of the EU competition law and precedents turns out to be more significant. The formal EU-China Competition Policy Dialogue began in 2004 as a result of a Joint Statement adopted at the 2001 EU-China Summit. The primary objective of the Dialogue is to establish a permanent forum for consultation and transparency between China and the EU, and for enhancing the EU's technical and capacity-building assistance to China regarding competition law. The most recent session of the EU-China Competition Policy Dialogue took place in Brussels on June 20, 2006. An important item on the agenda was the draft AML.

Although the new AML is not yet in effect, we believe the court that is adjudicating the SONY case will consider this law in reaching its decision. In our view, Chinese courts are likely to consider EU precedents carefully in analyzing cases like this one under the new AML. Article 17 of the AML provides: "any undertaking with a dominant market position should be prohibited from engaging in the abusing conducts as follows: … (iv) compelling trading partners to trade with certain firms, or without valid business reasons, restricting trading partners to only trade with a designated firm or firms; (v) without valid reasons, tying products or imposing other unreasonable trading conditions…."

While we are not privy to all the facts, the outcome may well turn on Sony's ability to demonstrate that it is not dominant in the relevant market. If the market is defined as digital cameras and digital videocameras ("DC/DV") in China, and if Sony has less than 50% of that market, under EU and US Sony would not be found to have a dominant position and that would be the end of the matter. Article 19 of the new AML similarly contains a presumption of dominance where a firm has a share of 50% or more. However, Article 19 also permits a presumption of dominance based on overall market structure where the defendant firm has a share of more than 10%. Specifically, a presumption of dominance applies where two firms account for two-thirds of the market or three firms account for three-fourths of the market. This represents a significant departure from the US approach.[22] While EU law includes a concept of collective dominance, including the concept of abuse

21 Comments regarding the draft have been provided by the United States Department of Justice, the Federal Trade Commission, the American Bar Association, and various U.S. business groups.

of dominance by a collectively dominant firm acting individually, it has been rarely applied.[23] The practical implications of the new AML's presumption of dominance based upon market structure, rather than the share of the defendant, remain to be seen.

If Sony were found to have a dominant position, the legality of its action would turn on whether or not there were what the AML calls "valid reasons" for its action. Assuming that safety concerns are recognized as a potentially "valid reason" for conduct that may otherwise be prohibited under the AML, we believe Sony will bear the burden of proof to show that batteries from other sources are unsafe and that there are no other less restrictive alternatives. Under Tetra Pak, it would seem that some less restrictive alternative, such as publishing clear standards for safe batteries and then licensing the technology required for those batteries to work with Sony DC/DV equipment, might be required.

Sony has also pointed to the patent protection of its Infolithium technology as a justification for preventing interoperability. Article 55 of the new AML provides that "[w]here undertakings utilize the intellectual property rights pursuant to the stipulations in laws and administrative regulations relating to intellectual property, this Law is not applicable." But the fact that the Infolithium technology is protected by patents is unlikely to be sufficient to provide a defense if Tsum reverse engineered the Sony technology to create a battery that does not infringe the claims of Sony's patents. Sony's patents appear to cover the calculation of the consumption of battery power and time remaining available for use. If Tsum's batteries do not offer this functionality, but simply provide a digital key, there may be no infringement and thus no patent "defense" available to Sony.

Even if Tsum's batteries do infringe Sony's patents, that may not be the end of the matter. While Article 55 of the new AML provides a general patent "defense," it also nevertheless provides that "this Law is applicable to conduct by undertakings eliminating or restricting competition by the abuse of the rights stipulated by the Intellectual Property Right Laws or administrative regulations." It remains unclear where China will draw the line between "use" and "abuse" of intellectual property rights, and this lack of clarity has been the subject of significant comment.[24]

Multinationals have attached great significance to this case, not only because it involves both intellectual property and antitrust, but also because it is likely to be the first antitrust case in which the principles of the new Anti-Monopoly Law are applied. We are inclined to believe that the Court is likely to follow the legislation's approach and to give greater consideration to the EU competition law and precedents.

22 *See, e.g.*, Gerald F. Massoudi, Deputy Assistant Attorney General, Antitrust Division, US Department of Justice, Some Comments On The Abuse-Of-Dominance Provisions Of China's Draft Antimonopoly Law, Speech before the UIBE Competition Law Center Conference: Abuse of Dominance: Theory and Practice, Beijing, China (July 21, 2007), *available at* http://www.usdoj.gov/atr/public/speeches/225357.htm.

23 *See, e.g., Irish Sugar plc v. Commission*, Case T-228/97, 1999 E.C.R. II-2969, at II-3006.

24 *See, e.g.*, Gerald F. Massoudi, Deputy Assistant Attorney General, Antitrust Division, US Department of Justice, Key Issues Regarding China's Antimonopoly Legislation, Speech Before the International Seminar on Review of Antimonopoly Law, Hangzhou, China (May 29, 2006) (noting that Article 54 "has received more attention from the foreign business community than any other provision"), *available at* http://www.usdoj.gov/atr/public/speeches/217612.htm.