

**TIPPING THE BALANCE AT THE PATENTS/ANTITRUST INTERFACE: CSU
v. XEROX**

Dale L. Carlson & Nathaniel J. Zylstra

Wiggin & Dana, LLP
New Haven, Connecticut

"This narrow isthmus 'twixt two boundless seas,
The past, the future, ---two eternities!"
Thomas Moore [1780-1852]

Two classic American ideals, innovation and competition, have provided the foundation for two important areas of law, namely intellectual property and antitrust, respectively. These two areas, while purporting to foster the same worthy goal of maximum economic efficiency, often collide by virtue of their differing approaches toward promoting this goal. The Federal Circuit recently explored that collision, and decided in favor of intellectual property having the better of the battle. In this article, we examine the Federal Circuit's decision and examine its impact upon an arcane area of intellectual property law relating to repair versus reconstruction of patented products.

I. *CSU V. XEROX*¹: SCORECARD: PATENTS - WON; ANTITRUST - NONE

A. Introduction to the Case

Xerox Corporation (hereinafter "Xerox") owns patents on the high volume copiers it manufactures, sells, and services, and also owns separate patents on many component parts for its copiers. In 1987, Xerox established a policy not to sell any of the component parts to independent service organizations (hereinafter "ISOs"), such as CSU, L.L.C. (hereinafter "CSU"), unless those ISOs were end users of the copiers. In 1989, Xerox instituted an "on-site end-user verification" program for the purpose of ensuring that any parts purchased by ISOs were actually used for their own use, not for repair of third-parties' copiers. This policy forced ISOs like CSU to cannibalize used parts from used Xerox equipment or find alternative sources for new Xerox parts. Obviously, CSU and its fellow ISOs could not operate under this system forever. In 1994, Xerox settled an antitrust lawsuit brought by a class of ISOs, agreeing to suspend its restrictive parts policy for six and one-half years (a time period which now has expired). CSU opted out of that settlement and sued Xerox alleging, *inter alia*, that Xerox had violated the Sherman Act by setting the prices of its patented parts for ISOs at a level much higher than for end-users in a move to drive the ISOs out of business.

Xerox counterclaimed for patent and copyright infringement. It also asserted that CSU's alleged injuries occurred solely as a result of Xerox's lawful refusal to sell or

¹ In re Independent Service Organizations Antitrust Litigation, 203 F.3d 1322, 53 U.S.P.Q.2d 1852 (Fed. Cir. 2000), *cert. Denied* 121 S.Ct. 1077 (Feb. 20, 2001).

license patented parts and copyrighted software. The district court granted summary judgment to Xerox, holding that if a patent or copyright is lawfully acquired, the patent or copyright holder's unilateral refusal to sell or license its patented invention or copyrighted expression is not unlawful exclusionary conduct under the antitrust laws, even if the impact extended to more than one market.

B. The Federal Circuit's Decision

The Federal Circuit first needed to decide which jurisdiction's law governed the various questions in the case. It determined that its own law would govern the patent claims, holding that the antitrust laws as applied to patents is a question of Federal Circuit law. As to the copyright claims, 10th Circuit law would apply in light of the fact that the case originated in the District of Kansas. This distinction was significant since, by deciding that it alone had jurisdiction to determine how the patent laws affect antitrust liability, the Federal Circuit freed itself from any restrictions imposed by a related Ninth Circuit decision, and affirmed the Federal Circuit's position as the definitive national authority on this issue.

The court went on to hold that a patent owner has broad rights to exclude others from use of its inventions, even in the face of possible anti-competitive practices by the patentee. In general, the antitrust laws do not trump a patent holder's rights. Nonetheless, the Federal Circuit did postulate specific hypothetical circumstances under which a patentee could run afoul of the antitrust laws. More specifically, the court recognized three possible ways that such a violation could occur, namely: (1) the patent owner sues for infringement and the defendant proves that the owner obtained the patent through "knowing and willful fraud within the meaning of *Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.*;"² (2) the defendant may prove that the infringement suit was "a mere sham to cover what is actually no more than an attempt to interfere directly with the business relationships of a competitor;"³ or (3) the patent owner was engaged in illegal tying in an attempt to gain a monopoly in another market.

In recognizing only these three exceptions to a patentee's right to unilaterally refuse to deal with competitors under the aegis of its patent rights, the Federal Circuit distinguished the Supreme Court's decision in *Eastman Kodak Co. v. Image Technical Services, Inc.*⁴ In that case, the Supreme Court stated, in a footnote, that patent rights could give rise to antitrust liability if those rights were used to extend market power from one market to the next. In distinguishing this case, the Federal Circuit noted that *Kodak* was an illegal tying case, while CSU had brought no claims of tying. Thus, the Supreme Court in *Kodak* had simply made the "undisputed" statement that a patent owner cannot extend his patent rights into a market "*beyond the scope of the patent.*"⁵

The Federal Circuit went on to disagree with the Ninth Circuit's holding on remand in *Kodak*. Upon remand, the Ninth Circuit held that a patent provides a presumption that a patentee's refusal to deal has a valid business justification for any

² 382 U.S. 172, 177 (1965).

³ See *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 144 (1961).

⁴ 504 U.S. 451 (1992).

⁵ CSU, *supra* note 1, at 1327 (emphasis in original).

consumer harm, but that an opposing party could rebut that presumption.⁶ According to the Federal Circuit's reading of that case, the Ninth Circuit's rule would necessitate an inquiry by the court into the "subjective intent" of the patent owner, something the Federal Circuit considered inappropriate. Instead, the Federal Circuit adopted an "objective" rule to the effect 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. We [the Federal Circuit] therefore will not inquire into his subjective motivation for exerting his statutory rights, even though his refusal to sell or license his patented invention may have an anticompetitive effect, so long as that anticompetitive effect is not illegally extended beyond the statutory patent grant.⁷

Because Xerox clearly had the right under the patent laws to refuse, at least in the first instance, to sell or license its patented parts to CSU and other ISOs, the Federal Circuit reasoned that it did not violate the antitrust laws by doing so.

The Federal Circuit's analysis of CSU's copyright claims employed much the same line of reasoning, following the First Circuit's analysis in *Data General Corp. v. Gruman Systems Support Corp.*⁸ In that case, the First Circuit stated that Congress had established the copyright laws based upon the assumption that the right to exclude provides the proper incentive for maximizing consumer welfare, and that the court would not require copyright holders to prove that assumption whenever their exercise of their right to exclude came under attack by antitrust plaintiffs. Again, an antitrust plaintiff could rebut the presumption of valid business justification for exclusion, but only by showing that the copyright holder acquired the copyright in an unlawful manner. Although in line with the First Circuit's analysis, the Federal Circuit's reasoning disagreed with the Ninth Circuit's somewhat different standard. Under the Ninth Circuit's standard, an antitrust plaintiff would be allowed to rebut the presumption of valid business justification by showing that the copyright holder's assertion of its rights was a pretextual justification designed to mask anticompetitive conduct.

C. Impact

Several commentators have concluded that the Federal Circuit's decision in *CSU v. Xerox* tips the balance of antitrust and intellectual property strongly in favor of intellectual property, and therefore IP rights can provide a powerful defense to antitrust claims.⁹ Some believe that there is some wiggle room in the Federal Circuit's decision

⁶ *Kodak*, 125 F.3d at 1218.

⁷ *CSU*, *supra* note 1 at 1327-28.

⁸ 36 F.3d 1147.

⁹ See Teague I. Donahey, *At the Intersection of Antitrust and Intellectual Property: Lessons from Intergraph v. Intel and CSU v. Xerox*, 10 FED. CIR. B. J. 129; and Jon R. Roellke and Leiv H. Blad, Jr., *Intellectual Property and Antitrust: The Federal Circuit at the Crossroads*, IP WORLDWIDE, Dec. 2000.

for Sherman Act Section 2 claims against intellectual property holders.¹⁰ So what impact might this have on established intellectual property doctrines and their relationship with antitrust laws?

One government antitrust official, Robert Pitofsky, Chairman of the FTC, has been particularly critical of the Federal Circuit's decision in *Xerox*. Just last month, Mr. Pitofsky stated that "the Federal Circuit has leaped from the undeniable premise that the intellectual property holder does not have to license anyone in the first instance to the unjustifiable conclusion that it can select among licensees to achieve an anticompetitive purpose or can condition a license...to achieve an anticompetitive effect."¹¹ Under this view, it is the Federal Circuit's new "objective" rule that lies at the heart of the apparent tipping of the balance in favor of the intellectual property holder. In other words, the Federal Circuit's test is "objective" as to the intent of the patent holder, but it is not objective as to the intent of Congress by placing the intellectual property laws above the antitrust laws. Mr. Pitofsky is particularly concerned that lower courts will give the Federal Circuit's decision broad application, as the District Court did in *Townshend v. Rockwell Int'l Corp.*¹² In that case, the District Court seemed to read the Federal Circuit's decision to allow a patent holder to place virtually any restrictions it wanted to on its licensees.¹³

However, Mr. Pitofsky's view of the *Xerox* case and the prior relationship between intellectual property and antitrust laws is not the only possibility. For instance, the United States' brief on petition for certiorari as amicus curiae in the *Xerox* case argued that the Supreme Court should not take the case, because the Federal Circuit's decision did not necessarily gut the antitrust laws.¹⁴ The United States' brief pointed out that the Federal Circuit acknowledged that the patent laws do not confer a privilege to violate the antitrust laws, and noted that, immediately after stating the three reasons under which a patentee could violate the antitrust laws, the Federal Circuit also said that the patentee's actions were valid so long as the anticompetitive effect did not extend beyond the statutory grant. Under this view, the Federal Circuit left open a potential range of inquiry into the scope of the patent grant. Furthermore, the United States' brief detailed the already extensive protection provided by the patent laws.¹⁵ Under this view, the relevant question is whether a particular restriction is allowed under the patent laws. If it is, the action presumably will not result in antitrust liability.

¹⁰ See Brief for the United States as Amicus Curiae, cert petition in *CSU v. Xerox*. See also U.S. Dept. of Justice, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY, § 2.1 (1995) (stating that the same general antitrust principles that apply to other forms of property apply to intellectual property).

¹¹ See Robert Pitofsky's prepared remarks on "Antitrust and Intellectual Property: Unresolved Issues at the Heart of the New Economy", page 5 (Berkeley Center for Law and Technology, March 2, 2001).

¹² ___ F.Supp.2d ___, 55 U.S.P.Q.2d 1011 (N.D.Cal. Mar. 28, 2000).

¹³ Id. at ___, 55 U.S.P.Q.2d at 1018.

¹⁴ Brief for the United States, *supra* note 10.

¹⁵ Id. See also *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195 (2nd Cir. 1981) ("where a patent has been lawfully acquired, subsequent conduct permissible under the patent laws cannot trigger any liability under the antitrust laws"); *United States v. Studiengesellschaft Kohle, m.b.H.*, 670 F.2d 1122, 1131 (D.C. Cir. 1981) (patentee has broad rights to exclude others without violating the antitrust laws); and *United States v. Westinghouse Elec. Corp.*, 648 F.2d 642, 649 (9th Cir. 1981) (patentee may license its patents for use only in foreign nations, and not allow competition in the United States).

In summary, it is not clear whether the Federal Circuit placed a significant new restriction on the antitrust laws, or whether it merely reiterated an already strong preference for the intellectual property laws. In either case, it becomes incumbent upon the defendant in an intellectual property litigation to allege, and provide support for, any illegal extension of the intellectual property holder's statutory exclusionary right.

II. REPAIR VS. RECONSTRUCTION: DOES AN ARCANE LINE OF DEMARCATION BECOME A DISTINCTION WITHOUT A DIFFERENCE?

It is well-established patent law doctrine that one who purchases a patented machine, or article, has the right to repair that machine, or article, in order to keep it functioning property, but that he or she may not reconstruct the machine entirely.¹⁶ The distinction between repair and reconstruction is highly fact-specific, and it is very difficult to define, in the abstract, exactly what would constitute one or the other.¹⁷ By way of illustration, let's consider a Xerox copier scenario.

Imagine that Xerox only has a patent on the copier as a whole, not on any of the individual parts. A purchaser of a Xerox copier would have the right to do such things as add paper, replace the toner, or have a service technician replace a single broken piece of the sorter. But, he or she could not, if the copier "wore out", refurbish the whole machine by replacing all the working parts with new ones.

However, where the seller has patents on the component parts, as Xerox does in the case at hand, a purchaser of a Xerox copier has no right to manufacture or replace any of the patented parts without authorization from Xerox, because to do so would infringe upon the patent for that part. Under these circumstances, presumably the argument that the purchaser is merely "repairing" the copier by replacing the patented part on the machine with an unauthorized part would fail. Hence, the "repair" versus "reconstruction" argument, that the purchaser would otherwise have available, becomes irrelevant with respect to patented parts in view of the Federal Circuit's decision in *Xerox*.¹⁸

The Federal Circuit's decision means that patent owners like Xerox have broad ability to restrict what purchasers can do with their patented machine, and have little

¹⁶ Lipsomb's Walker on Patents, §22.8, see also *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 365 U.S. 336 (1961).

¹⁷ See generally, Mark D. Janis, *A Tale of the Apocryphal Axe: Repair, Reconstruction, and the Implied License in Intellectual Property Law*, 58 MD. L. REV. 423 (1999) (criticizing the confusing test for determining whether an action is repair or reconstruction).

¹⁸ Furthermore, use of a patented part for what would otherwise be considered a legitimate repair, might be viewed as infringing on the system patent as well. In one case, a district court held that getting a patent over the component part basically eliminates the repair vs. reconstruction analysis for the overall system patent as well, stating that "the patent owner's common ownership of the component patent negates the presumption that his sale of the patented combination also includes a license to preserve the entire combination through the use of the infringing device as a element of the patented combination." *R2 Medical Systems, Inc. v. Katecho, Inc.*, 931 F.Supp. 1397, 1442-46 (N.D.Ill. 1996) (holding that manufacture of a patented electrode can violate not only the patent on the electrode, but also the patent on the entire cardiac care device that utilized the electrode).

concern for the antitrust implications of those actions. At a minimum, Xerox need not worry that its motivations for its restrictions will be questioned, as long as the restrictions do not exceed the authority of the patent laws. Furthermore, in consideration of the possible broader reading of the *Xerox* decision, once a patentee can demonstrate that what the licensee or purchaser did amounted to reconstruction of the invention, he or she has seemingly essentially freed himself or herself from the restrictions of the antitrust laws.

It is important to remember, though, that Xerox had patents on all the individual parts and copyrights on the diagnostic software that CSU wanted. Had those parts been unpatented, or the diagnostic software uncopyrighted, CSU would have been free to manufacture and/or purchase them for use in repair of Xerox copiers. Under these circumstances, Xerox's attempts to eliminate service competition would not have been protected from the antitrust laws. Nonetheless, in order to be successful in an antitrust suit against Xerox, CSU would still have to prove the elements of a Sherman Act claim (e.g. for a § 2 claim, market power and bad acts). So there is no guarantee that a company like CSU would prevail in an antitrust suit, but CSU would certainly have the opportunity for a stronger position in the absence of patents on the component parts of the machine.

III. CONCLUSION AND OUTLOOK

No matter whether one views the *Xerox* decision broadly or narrowly, one should be reminded by that decision that the patent laws provide significant protection against antitrust liability. By its decision in *Xerox*, the Federal Circuit may have created a "reverse per se rule"—that is, instead of activity being per se illegal or being considered under the rule of reason, if that activity is accomplished pursuant to a lawfully acquired patent, it is virtually per se lawful. This new approach will provide a powerful incentive for patent holders to attempt to get separate patents over every component of an invention, because it may allow them to safely control both the original equipment and the parts and service markets for that invention.

The arcane consideration of "repair vs. reconstruction" further enhances the potential impact of this decision. No matter which side of an issue your client is on, the repair vs. reconstruction determination has now takes on even greater significance than before. Not only does the answer to this question help to determine whether a patent has been violated, but also whether the broad scope of antitrust theories is available, or whether your client is limited to the set described in *CSU v. Xerox* (i.e., fraud on the patent office, sham patent litigation, or tying).

In the future, courts will explore the edges and limits of the *CSU v. Xerox* decision. The ambiguity of the holding will induce patent holders to try more restrictive licensing arrangements in an attempt to achieve market power that they may not have had under prior law. As it stands, the ruling does not provide crystal clear guidance as to how aggressive patent holders will be allowed to be in extending their power over their licensees. Indeed, lower courts will have to struggle with these ambiguities until the Federal Circuit or the Supreme Court provides a more definitive answer.

