

The Impact of Kodak on Antitrust Litigation

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On June 8, 1992, the Supreme Court handed down its opinion in *Eastman Kodak Co v Image Technical Services, Inc.*, 112 S.Ct. 2072 (1992), heralding a new perspective in antitrust tying and monopoly suits involving high technology. The Supreme Court essentially re-defined former perceptions of relevant market and market power. The Court held that a single product brand could constitute a relevant product market and that a manufacturer could have market power in this submarket without power in the primary market. By focusing attention on attention on submarkets, the Supreme Court created an avenue for companies to obtain judicial relief in an area at one time overlooked by antitrust law

BACKGROUND FOR KODAK

The *Kodak* decision addressed a growing problem in the service industry for high-tech equipment. At the inception of the computer age, product manufactures initially focused their business resources on selling. Each new advance in technology seemed to guarantee large profits as businesses rushed to purchase the latest upgrade. However, when these sales became less profitable because of increased competition, many of these companies turned their attention to exploiting the parts and service markets for their own complex machines (“the aftermarket”). Since service often required parts only within the possession or control of the manufacturer, it became easy for manufacturers to secure greater market share of the service market by refusing to sell these parts to competing service companies and tying the sale of parts to the purchase of service. the customer was then left essentially with only two choices: Buy service from the manufacturer or buy a new machine.

SETTING THE STAGE FOR KODAK

Procedural History

This scenario resembles what occurred in the high speed photocopier market. In *Eastman Kodak Co v Image Technical Services, Inc.*, 112 S.Ct. 2072 (1992), independent service organizations (ISOs) had been in the business of repairing and maintaining Kodak photocopiers and micrographics equipment since the early 1980s. When Kodak adopted a policy in 1985 and 1986 forbidding the sale of Kodak replacement parts to competitors in the service market, these ISOs soon found themselves foreclosed from servicing Kodak equipment. In 1987, these organizations brought suit against Kodak for violations of §§ 1 and 2 of the Sherman Antitrust Act claiming tying and monopolization. The federal district court limited discovery, allowing the ISOs to file only one set of interrogatories and requests for production of documents and to depose only six witnesses.

After this abbreviated discovery, Kodak moved for summary judgment. The district court granted the motion on the basis that the plaintiffs lacked evidence of any tying arrangement between the equipment market and the market for services and parts. Moreover, with respect to the monopoly claim, the district court ruled that a unilateral refusal to sell parts to ISOs did not violate § 2 of the Sherman Act.

The Court of Appeals for the Ninth Circuit reversed the district court's ruling, finding genuine issues of material fact regarding both the tying and monopoly claims.

The Supreme Court upheld the Court of Appeals' ruling. However, the Court went far beyond simply focusing on the standards for summary judgment. Its decision dramatically altered the direction of antitrust jurisprudence in tying and monopoly cases. With Justice Blackmun writing the majority opinion, the Court surprised many court observers by recognizing two concepts:

- C A manufacturer may have market power in an aftermarket even if it does not in the equipment market, and
- C A single product brand may constitute a relevant market.

These ideas run contrary to the so-called Chicago School theory of market power ostensibly adopted by the Supreme Court in *Continental TV v GTE Sylvania, Inc.*, 433 U.S. 35 (1977)

The Chicago School Theory of Market Power

The Chicago School theory of market power essentially holds that where competition exists in the equipment or primary market, product manufacturers cannot have power in submarkets or aftermarkets created in the wake of the primary market. If manufacturers abuse their position in the aftermarket, customers will simply switch equipment. A manufacturer cannot thus raise the price of the aftermarket goods or services without decreasing demand for its equipment. This cross-elasticity of demand will act to limit any market power held by the manufacturer in any submarkets. Hence, there can be no tying or monopolization in the aftermarket if competition exists in the primary market.

This approach to market power, however, rests upon two assumptions:

The first is that information costs will be insignificant and that information is broadly available. Information costs are the costs of obtaining knowledge about the total price of a product. For example, when consumers compare the purchase price of various automobiles, they may wish to know how often a car breaks down, the cost of repairs, and the cost of parts. The expense of learning this information is information costs. If information costs are not

negligible, buyers will fail to see increases in after-purchase costs before purchasing the goods. These costs will be hidden.

The second assumption required by this theory also refers to costs. Even accepting the first assumption that information costs are negligible, one must determine if the costs of “switching” to another brand in the primary market will be insubstantial. Switching costs are those expenses a user will incur when a switch is made from one brand to a competitor’s brand. One often sees high switching costs in the computer software market where consumers have spent many hours training themselves how to use a particular program, and, as a consequence, have difficulty changing to competitive programs. If these costs are not negligible, consumers will likely be “locked in” to their purchases.

In reliance on this Chicago School theory of market power, Kodak claimed it could not have market power in submarkets where no such power existed in the fairly competitive photocopier market. Kodak relied principally upon *Continental TV, supra* for this contention. While the Supreme Court recognized the efficacy of Kodak’s theory, the Court questioned its application to the case at hand. Taking its cue from the Court of Appeals rather than the Chicago School, the Supreme Court viewed the equipment, parts and service submarkets as three potentially distinct relevant markets, rather than a single market composed of equipment, service and parts.

IMPACT UPON TYING AND MARKET POWER

With respect to the tying claim, the high court focused on the relationship between the parts and service markets and not the connection between the equipment market and the service and parts market. In order to establish an illegal tie under § 1, ISOs must show: (1) the existence of a tying arrangement, (2) the existence of an “appreciable economic power” in the tying product market, and (3) the arrangement must affect a substantial volume of commerce in the tied market. *Kodak, supra* at 2079. Because Kodak conceded the third prong of the *prima facie* case, the Supreme Court only addressed the first two issues.

Tying Arrangement

A tying arrangement consists of two distinct products that are sold together. *Kodak, supra* 2080. Two products are distinct when there is sufficient consumer demand for the products to be sold separately. *Kodak, supra* at 2080, citing *Jefferson Parish Hospital Dist. No. 2 v Hyde*, 466 U.S. 2, 21-22 (1984). With little difficulty, the Supreme Court found an issue of fact regarding whether a tying arrangement existed between the parts and service markets. Although Kodak contended that the two products were the same because the demand for one was not distinct from demand for the other, the Court noted that both in the past and present parts were often sold separately from service.

Appreciable Economic Power

The more complicated and difficult issue for the Court to resolve was whether economic power in the parts market can exist where no such power existed in the equipment market. Apparently, the ISOs had waived any argument that Kodak had significant market share in the equipment market.

Essentially, the ISOs argued that Kodak's control of parts gave it market power over replacement parts. Kodak then used this power to foreclose competition in the service market by tying the sale of necessary parts to the sale of service. Since the ISOs had difficulty obtaining these parts, they lost market share in the service market to Kodak. Kodak, in turn, argued that it had no market power in the parts market when it faced interbrand competition in the equipment market.

Although the Court recognized that interbrand competition may negate power in the intrabrand market, the Court refused to grant summary judgment on the basis of theory alone.

Legal presumptions that rest on formalistic distinctions rather than actual market realities are generally disfavored in antitrust law. This Court has preferred to resolve antitrust claims on a case-by-case basis, focusing on the particular facts disclosed by the record....In determining the existence of market power, and specifically the responsiveness of the sales of one product to price changes of the other, this court has examined closely the economic reality of the market at issue. Kodak, supra at 2082.

In doing so, the Court rejected Kodak's argument that summary judgment could be granted simply on the basis that the ISOs' understanding of the market made no "economic sense."¹

The Court then examined in detail Kodak's theory. Although the Court felt the theory was "perhaps intuitively appealing," the Court questioned if the theory modeled reality. *Kodak, supra* at 2084. The Court opined that even if a manufacturer would lose sales in the equipment market by raising prices in the parts and service markets, a manufacturer could still charge less than an optimal price and profit from its scheme. *Kodak, supra* at 15.²

Information Costs. Moreover, the Court challenged the underlying assumptions of Kodak that both information and switching costs were insignificant. When such costs are significant, these "market imperfections" may prevent customers from choosing other competitive brands in the equipment market. *Kodak, supra* at 2087.

In the context of *Kodak, supra*, the information costs were knowing the total cost of purchasing the equipment, and the cost of service and parts over the "life cycle" of the equipment. If the consumer does not or cannot determine "life cycle" pricing because of high information costs, then the manufacturer has some latitude to raise prices in the aftermarket since the purchaser will not see these price increases. Hence, a less than perfect equipment market is created.

In *Kodak*, the Court felt that information costs could be significant. These costs could make discovering the life cycle price of the equipment unaffordable to most consumers. In fact, the Court recognized that some life cycling information is difficult if not impossible to obtain. *Kodak, supra* at 2086. Furthermore, the Court doubted Kodak's contention that competitors would provide this information to consumers or even if consumers themselves would seek to obtain this information. *Kodak, supra* at 2086-2087.

Switching Costs. In addition to information costs, the Court examined the effect of switching costs upon the consumer, stating these costs could also be significant. The Court found that the ISOs presented sufficient evidence that the high cost of the equipment and support material could "lock-in" consumers to their original purchase.

Because of these "market imperfections," the Court concluded that genuine issues of material fact existed regarding whether Kodak had market power in the parts market in spite of the absence of market power in the equipment market. Accordingly, the Court denied summary judgment with respect to the tying count. In doing so, the Court recognized that market power can exist in submarkets ("aftermarkets") even in the absence of power in the primary market.

IMPACT UPON MONOPOLY AND THE RELEVANT MARKET

In order to prove monopoly under § 2 of the Sherman Antitrust Act, a plaintiff must show: (1) the possession of monopoly power in the relevant market, and (2) the willful acquisition or maintenance of that power. *Kodak, supra* at 2089. Following an analysis similar to that followed under the tying claim, the *Kodak* Court held that a manufacturer could have power in the relevant market even in the absence of power in the equipment market.

Monopoly Power in the Relevant Market

By viewing the equipment, parts and service markets separately as in the tying context, the Court implicitly recognized that a single product could constitute a relevant market for purposes of a monopolization claim. Had the Court lumped equipment, parts and service markets together as Kodak suggested, Kodak could not have had market power in the relevant market. This Chicago School approach was discarded in the face of evidence brought forth by the ISOs that Kodak had power to control prices or exclude competition in service and parts markets. *Kodak, supra* at 2090.

With this perspective in hand, the Court turned to the long-established interchangeability test of *DuPont*. The Court then concluded that because equipment purchasers could not use brands of service and parts other than Kodak, Kodak's brand itself could constitute a relevant market. The dissent noted that such an analysis would give every manufacturer of a unique durable good an "inherent monopoly on its parts" and create a flood of antitrust litigation. *Kodak, supra* at 2094 (dissent). The majority responded that "to grant

per se immunity to manufacturers competing in the service market would exempt a vast and growing sector of the economy from antitrust laws. *Kodak, supra* at 21.

Willful Acquisition of Maintenance of Power

The Court then concluded that issues of fact existed regarding whether Kodak “willfully acquired or maintained” market power. The Court felt enough evidence existed to show Kodak’s policy served to exclude competition and acquire greater market share. It then looked to Kodak’s three proffered business justifications.

Legitimate Business Justifications

First, Kodak maintained that foreclosing the maintenance and repair market to intrabrand competition would promote interbrand competition. Kodak argued that by preventing the ISOs from servicing Kodak equipment, Kodak could ensure high quality maintenance and repair. Hence, customers would not confuse poor service with poor quality equipment, making Kodak more competitive in the interbrand market.

The Court expressed some doubt about this defense, noting that other ISOs provided service even superior to Kodak. Moreover, the Court noted that it seemed contradictory for Kodak to maintain that its customers were not sophisticated enough to diagnose the true problem with its machines and yet sophisticated enough to conduct life cycle pricing.

The Court further doubted Kodak’s second defense. Kodak argued that its policy allowed it to control inventory costs. The Court noted here that the inventory of parts depends upon the breakdown rate rather than who services the machines.

Finally, the Court gave short shrift to Kodak’s other business justification. Kodak argued that it could discourage free riding on Kodak’s investment in the equipment market by excluding competitors in the service market. The Court stated that in order to free ride, the ISOs must free ride on Kodak’s activities in the service market and not the equipment market.

Without sufficient business justifications for its actions, Kodak could not resist denial of its motion on the ISOs’ monopoly claims. Instead, Kodak was left to fight these issues before the jury.

CONCLUSION

In *Kodak*, the Supreme Court took a bold step in making service aftermarkets more competitive by laying the foundation for greater judicial scrutiny of anticompetitive conduct in product aftermarkets. Although many court observers view the decision simply as a confirmation of the stringent standards for summary judgment, there can be no doubt that *Kodak* facilitates litigation for plaintiff ISOs foreclosed from aftermarkets by equipment manufacturers. Read broadly, *Kodak* could signal a retreat from the Chicago School panorama

of antitrust economics. Even a narrow interpretation, however, should lead product manufacturers to reassess their business practices in the service and parts market.

Footnotes

1. The Court held that *Matsushita Electrical Industrial v Zenith Radio Corp*, 475 U.S. 574 (1986) did not create any additional burden upon plaintiffs in antitrust cases in opposing motions for summary judgment, *Kodak, supra* at 2083. “The Court did not hold that if the moving party enunciates any economic theory supporting its behavior, regardless of its accuracy in reflecting the actual market, it is entitled to summary judgment.” *Kodak, supra* at 2083.
2. As noted above, Kodak relied upon *Continental TV, supra*, for the proposition that competition in the equipment market precluded market power in the parts and service markets. In *Continental TV, supra*, the Supreme Court held that vertical restraints on dealers could actually promote competition inasmuch as these restrictions could increase the quality of service and encourage promotion. However, the Supreme Court in *Kodak, supra*, found *Continental TV, supra*, inapplicable because the manufacturer of *Continental TV, supra*, did not compete with the companies it restrained while Kodak did. *Kodak, supra* at pp. 2084-2085, fn 18. The Court concluded that it was thus possible that Kodak undertook its activities with the intention of excluding competition in the parts and service markets.