Antitrust, Intellectual Property Rights, and the Online Music Industry: An Antitrust Analysis of Apple’s Combination of Services and Products

Article By:

Rui Li

I. INTRODUCTION

For many music consumers, the ideal medium for music is digital. It offers many advantages over CDs, including easier distribution, decreased physical size, greater choice in the medium of sound reproduction, and the ability to include digital data such as artistic information and graphic artwork. Online music stores offer more variety than consumers would get in a brick-and-mortar store, including reviews, recommendations, and other interactive features which increase the choices for consumers. The advantages of digital music, coupled with the efficiency of online purchasing, have helped online music stores such as Apple’s iTunes Store become the most prevalent form of commercial music distribution. However, online music piracy has been harming the music industry via lost CD sales even before commercial distribution of music over the Internet became prevalent. As online music firms attempt to tackle online music piracy, both antitrust enforcement agencies and private plaintiffs have raised concerns. Some of the solutions implemented by online music firms appear to promote competition by protecting intellectual property rights. However, others require closer scrutiny because some actions taken to protect these intellectual property rights have been, at times, abusive.

The tactics used by Apple to combat digital piracy have drawn legal scrutiny from a number of sources in recent years. In June 2006, the antitrust enforcement agencies of Norway, Sweden and Denmark filed a complaint against Apple regarding the restrictions it placed on iTunes audio downloads, an action that was later joined by Germany and France. On December 31, 2007, a group of plaintiffs brought an antitrust lawsuit against Apple in the United States District Court for the Northern District Court of California, charging Apple with maintaining an illegal monopoly on the digital music market. On December 28, 2008, the court granted plaintiffs’ motion for class certification against Apple. On May 25, 2010, the New York Times reported that the United States Department of Justice was examining Apple’s tactics in the market for digital music. In light of this scrutiny, in 2009 Apple stopped selling music downloads with its proprietary digital rights management (“DRM”) restrictions, a technology that prevented audio downloads purchased through the iTunes Store from playing on portable media players other than Apple’s iPod. Given the dominant position of iTunes in online music distribution, the effect of Apple’s decision to remove DRM restrictions on the online music industry and the fight against online music piracy remains to be seen.

Apple’s digital music business has important ramifications for antitrust law that this Note explores. Part II of this Note examines Apple’s digital music business practices with particular
emphasis on the manner in which Apple combines products and services. Part III engages in an antitrust analysis of four possible causes of action against Apple’s business conduct with an eye toward the market structure of the digital music industry. The Note concludes that Apple’s combination of products and services is procompetitive, and, in addition, offers a promising solution to digital music piracy.

II. IPOD, ITUNES AND ITUNES STORE

In 2001, Apple introduced the iTunes music software application to help music consumers organize, browse, and play digital media. In 2003, Apple launched the iTunes Store which, in April 2008, became the number one music vendor in the United States. On February 24, 2010, the Store had its 10 billionth song download and a music catalog of over 12 million songs. iTunes Store now accounts for seventy percent of the worldwide digital music download retail market.

Until January 2009, Apple restricted iTunes Store and iTunes Software to work only with its own portable media player, the iPod, a product that currently claims 70 percent of the portable media player market. Apple restricted the iPod so it could only play files embedded with Apple’s own DRM downloads called “FairPlay”, and no one else’s. Likewise, files downloaded from the iTunes Store could only be played on an iPod. Apple maintained this closed system through regular updates and the threat of legal action. Most notably, in 2005, Apple forced RealNetworks to abandon its “Harmony” technology through software updates and the threat of patent infringement lawsuit. Harmony allowed music downloads purchased through RealNetworks direct playback on iPod.

III. ANTITRUST ANALYSIS WITH AN EYE TOWARD THE MARKET STRUCTURE OF THE MUSIC INDUSTRY

As a precursor to an analysis of Apple’s conduct from an antitrust perspective, an inquiry must be made into the market structure of the music industry.

A. The Equilibrium Between Major Labels, Online Music Vendors, and Customers

The music market is highly concentrated, dominated by a small number of large firms (hereinafter “Major Labels”: Sony Music Entertainment, Universal Music Group, Warner Music Group, and EMI Music Group). Major Labels’ collective catalogs comprise about 85 percent of the distribution rights in the music industry. Each of these firms has exclusive control of a large and fungible catalog of intellectual property. In the past, Major Labels have taken advantage of their dominant position to extend market power into downstream distribution channels. These practices have at times drawn the attention of antitrust enforcement agencies. In 2000, the Major Labels settled the Federal Trade Commission’s charge of restraining competition in the music market.

The significant economies of scale achieved through the grouping of thousands of authors’ and composers’ copyrighted music products operate as a barrier for other firms to enter the music licensing market. This concentrated market structure lays the groundwork for a tacitly collusive environment in which Major Labels can achieve collusive results in the online music market through the non-collusive exercise of their power in the licensing market. Under this tacitly collusive structure, they may be able to reach a consensus about how to develop the online music market without explicitly agreeing with each other. If one of the Major Labels sets a high and relatively profitable licensing price, the rest of the Major Labels may follow the practice of the price-setting firm even though they do not formally communicate with each other.

The appearance of online music vendors poses a threat to this shared dominant market position. Scholars estimate that Major Labels would lose thirty to forty percent of their profit margins if online music vendors could freely compete with Major Labels. To protect their advantage, it is in the Major Labels’ best interest to either deny market entry to online music vendors or bring them into the fold in an advantageous manner. Fortunately for the Major Labels, this is not much of a challenge
because the barriers to entry are high and the products are fungible. In addition, copyright laws have given Major Labels influence over online music vendors. Major Labels can potentially use licensing practices to create prohibitive barriers to entry or to contractually bind online music vendors to the pricing structure of the CD market. Because of this market structure, online music vendors stand little chance of success competing with the traditional distribution networks established by the Major Labels over the decades.

A major, common priority of Major Labels is to gain control of the digital music distribution market. To achieve this goal, in descending order of preference, Major Labels have the potential strategies of: 1) attempting to terminate online music piracy through vigorous infringement suits or other form of antipiracy enforcement measures, 2) extracting shared monopoly profits from online sales at a rate higher than or equal to that from CD sales, or 3) expanding volume of online sales at lower profit levels by licensing online music at reasonable rates. An examination of the economic theories explaining the behaviors of oligopolies lends support to the prediction of strategies laid out above. The part that follows will compare the actual practices of Major labels to the behaviors predicted above.

Strategy No.1: Terminating online music piracy through vigorous infringement suits or other form of antipiracy enforcement measures. In 2003, the Recording Industry Association of America (RIAA), the representative of Major Labels, began attacking online music piracy by filing mass infringement suits. However, this approach, besides being expensive and time consuming, backfired. It not only failed to win public sympathy for the music industry but also demonized the plaintiffs, the Recording Industry Association of America and the copyright holders they represented. In light of this, the RIAA announced in December 2008 that it was ending its mass infringement suits and attempting to cooperate with Internet Service Providers whereby Internet Service Providers will suspend or terminate Internet users’ service after repeated RIAA notices of alleged piracy.

Strategy No.2: Extracting shared monopoly profits from online sales at a rate higher than or equal to that from CD sales. In 2001, Major Labels pooled their catalogs into two non-overlapping online music vendors, MusicNet and Pressplay. They refused to license music for less than two dollars per song, and, in some cases, as much as three and a half dollars. In addition, the music downloads are not transferable to CDs. In 2002, the Major Labels licensed Listen.com for a price of 99 cents per song, roughly the equivalent to the price of a CD. Still, most of that music could not be burned to a CD. In March 2001, U.S. Department of Justice opened an investigation into alleged collusion in the online market. However, the DOJ later dropped the investigation in 2003 because “major labels licensed their music to a broader array of third-party music services that compete on price and features” and that unrelated firm Roxio’s acquisition of Pressplay diminished the possibility of collusion.

Strategy No.3: Expanding volume of online sales at lower profit levels by licensing online music at reasonable rates. By the end of 2002, the Major Labels had licensed their catalogs to all major online music vendors which charged a nine to ten dollars per month subscription fee, plus 99 cents per burnable download. During this period Apple launched iTunes Store with a market model combining iTunes Store, iTunes Software, and iPod. The combination proved to be a huge success. Apple was thus able to dispense with subscription fees. In 2008, Apple became the number one music vendor. The entrance of a radically efficient product model, the iTunes-iPod combination, coupled with the shared interest of Apple and Major Labels in eliminating online music piracy, promoted competition, lowered costs, improved services, and increased overall economic efficiency in the music industry.

The evolution of the online music market showed that even though Major Labels' preference of options may partially be explained as legitimate attempts to eliminate online music piracy, they still had every incentive to thwart the development of the online music market despite the fact that customers preferred music downloads. Major Labels thought the rising of the online music market and the new business models for delivering music would deprive them of their control over the market. But when they realized they were not able to stop the development of online music distribution, they attempted to control the pace and the manner of development of online music.

Apple’s business model combines pricing, ease of use, and technical prohibition in a way that
significantly decreases the incentives for customers to choose pirated music. However, it remains to be seen whether the appearance of powerful market participant such as Apple will eventually create a more competitive environment, bring down the costs of online music, and terminate online music piracy. Therefore, the courts and the antitrust enforcement agencies should understand the equilibrium between the music industry’s interest in controlling mechanisms of distribution, the threat of online music piracy, online music vendors’ interest in lowering licensing costs, and the consumers’ interest in innovative and effective access to music. The courts could consider refraining from imposing direct legal action against online music vendors such as Apple. History has shown that time and market forces often provide equilibrium in balancing interests, whether the new technology is a player piano, a copier, a tape recorder, a video recorder, a personal computer, or a MP3 player.

B. The Alleged “Tying Arrangement” of iPod, iTunes Music Store, And iTunes Software

“Tying” occurs when a seller insists that the buyer take a second, or “tied”, product as a condition of obtaining the seller’s initial “tying” product. Tying arrangements can be condemned either as contracts in restraint of trade under section 1 of the Sherman Act, or else under the more explicit provisions of section 3 of the Clayton Act.

Prior to January 2009, Apple had created something that resembles a tying arrangement by using its FairPlay technology to require owners of iPods to purchase digital music from the iTunes Store (users could still use music ripped from CDs or downloaded from unauthorized websites).

Tying is illegal per se when the defendant ties two separate products and has market power in the tying product. The “leverage” theory articulated by Justice Brandeis in Caprice was the only theory articulated by the Supreme Court supporting the per se approach. The theory understood tying arrangements as inherently anticompetitive because it permitted a monopoly firm to “leverage” its market power to a product market in which it lacked market power, increasing its monopoly profits. The leverage theory has largely been discredited by economists who argue that when the second product is imposed as a cost of using the first monopoly product, the monopolists are not necessarily better off because the elevated price of the tied product reduces the consumers’ willingness to pay for the tying product. It is now widely accepted most tying arrangements are procompetitive and efficient.

While the “leverage” theory of tying has been largely debunked, the market foreclosure theory continues to have relevance. It is now understood that tying arrangements are anticompetitive only in the rare cases that tying denies rivals access to markets. However, economists have argued that this “access denial” or “entry barrier” theory is only marginally more plausible than the “leverage” theory.

Courts have followed the lead of economists and become skeptical of antitrust claims based on tying theories. In the Microsoft case, the D.C. Circuit Court held that integration in the software industry involving computer operating systems promised significant efficiencies and that even relatively low-tech ties typically produce significant efficiencies by enabling firms to control the quality of collateral products. The D.C. Circuit Court further concluded that the rule of reason should be applied to the Windows and Internet Explorer tie because a per se rule could act as an irrational restraint on efficiency and innovation, which often consists in combining features or functions that previously were separate. The court recognized the difficulty in distinguishing anticompetitive forced package sales from those that are efficient and effective. This is exactly the reason why a “rule of reason” analysis should be applied to all tying arrangements, the court explained.

In a “rule of reason” analysis, an antitrust enforcer proceeds by asking first whether the tying arrangement unreasonably excludes rivals. If the products are widely available separately, then there is no market foreclosure because widespread availability of alternatives indicates that no rival is foreclosed by the tie. Applying this analysis to the subject of this Note, Apple’s online music business, it is clear that alternatives to iTunes Music Store and iPod are widely available. Alternatives to iTunes Music Store include: RealNetworks, Wal-Mart, Amazon, Napster and Yahoo. In the portable media player market, alternatives to the iPod include: Microsoft, Sony, Creative, and SanDisk. Therefore, no rival is foreclosed by the tying from a properly defined market.

Courts should not substitute their own product designs for those generated by the market. Nevertheless, courts are often asked to determine whether a tying bundle is unreasonably anticompetitive. iTunes Music Store, the dominant online music vendor, needs to combat online
music piracy and perform additional functions besides distributing music in order to develop the online music market. iTunes Music Store now offers customer support, a platform for customer reviews, Podcasts subscriptions, music and audio book previews, and iTunes U online service at no extra cost. A price-cutting online music vendor or online music piracy service might take advantage of the fact that Apple cannot charge separately for these services. The other vendors might charge a lower markup and refuse to provide essential services such as combating online music piracy and developing the online music market, knowing that the consumer will keep enjoying the free services provided by iTunes Store. Undoubtedly, iTunes Store cannot survive by only supplying uncompensated services that benefit other dealers. One strategy Apple can employ to minimize free riding is to tie iTunes and iPod to ensure a healthy supply of consumers who have subscribed to either iPod or iTunes.

While all these practices are readily defended as procompetitive, the defense is unnecessary in the first place when there is no injury to competition. The purchasers of iPod and iTunes bundle simply want a smaller product than the one that Apple is offering. But that desire does not harm competition. Apple’s bundle is simply the equivalent of the land developer who refuses to subdivide before selling. It is not the purpose of antitrust law to regulate the size of the products that Apple chooses to sell.

C. Refusal To License FairPlay Patent

Apple used its FairPlay digital rights management system to require owners of iPods to purchase digital music from iTunes Store. Apple refused to license its patented FairPlay technology to other portable media player manufacturers such as Microsoft and declined to support alternative digital rights management systems such as RealNetworks’ Harmony technology that circumvented Apple’s FairPlay system. Generally, the owner of an intellectual property right does not have a duty to deal with a competitor, even if the owner refusing to deal is a monopolist, as long as there are valid business reasons for refusing to deal. In CUS, L.L.C. v. Xerox Corp., the Federal Circuit held that a “patent holder may enforce the statutory right to exclude others free from liability under the antitrust laws” in the “absence of an indication of illegal tying, fraud in the Patent and Trademark Office, or sham litigation.” In addition, the patent statute contains no compulsory licensing provisions and even stipulates that there is no patent “misuse” when a patentee refuses to license its patent to competitors. The provisions of 35 U.S.C. § 271 provide that “No patent owner shall be denied relief or deemed guilty of misuse or illegal extension of the patent right by reason of his having refused to license or use any rights to the patent.” Although in Image Technical Services, Inc. v. Eastman Kodak Co., the Ninth Circuit Court of Appeals affirmed a finding of antitrust violation where Kodak refused to sell patented products to competitors, it is now widely accepted that the Ninth Circuit Court of Appeals made a significant error. In that case, Kodak refused to license its patented parts to firms that wanted to compete with Kodak in the repair of Kodak photocopiers. The court determined that Kodak was unlawfully creating a second monopoly in service by refusing to sell the patented parts. The court based its decision on the theory that under the patent laws, a patent may legally create a monopoly in only one market. Kodak reflects an erroneous understanding of the nature and functions of a patent. Rather than market rights, patent claims create exclusive rights in technologies. A compulsory licensing of intellectual property rights is only justified where a monopolist’s refusal to license is profitable only because it tends to extend or preserve a monopoly. Apple’s refusal to license its FairPlay technology to any other online music vendor and MP3 manufacturer would easily pass this test because licensing FairPlay to a rival such as Microsoft or RealNetworks would deprive Apple of both online music and iPod sales and that is always an adequate business justification. A compulsory licensing of Apple’s FairPlay technology to competitors would effectively turn Apple into a public utility and places the court in the undesirable position of price regulator.

D. Patent Misuse

Patent misuse refers to improper acts committed by a patent or other intellectual property rights holder. In 1952 and again in 1988 Congress amended the Patent Act to bring the concept of misuse more closely in line with antitrust principles. Congress intended to put a stop to the expansionist applications of patent misuse doctrine to reach practices which were not anticompetitive under any definition. For example, in Bruolotte v. Thys Co., 379 U.S. 29 (1964), the Supreme Court condemned a contract under the patent misuse doctrine demanding royalty payments after the patent expired, even though there was no showing of anticompetitive practices. In response to the Court’s
application of the patent misuse doctrine to reach practices which are irrelevant to the concerns of antitrust law, Congress limited the use of the doctrine by providing that a patent owner is not guilty of patent misuse if it refuses to license, requires licensees to purchase goods that would work effectively only with the patent, or ties different products in the absence of showing of market power in the primary product. Therefore, whether Apple’s use of FairPlay technology is a patent misuse may not have independent relevance when Congress limited its scope to antitrust violations. Thus, there is no need to make an independent inquiry as to whether Apple’s use of FairPlay technology is a patent misuse.

E. Product Design: Strategic Creation of Incompatibility

Apple engaged in strategic creation of incompatibility by designing an exclusive combination or system of iPod, iTunes Software, and iTunes Store. Generally speaking, antitrust courts are not competent to second-guess decisions about product design. In most circumstances, the conduct that creates excessive incompatibility is also self-deterring. The market provides strong discipline for firms that produce innovations that customers reject. This suggests that truly anticompetitive product redesigns are uncommon. Therefore, Apple’s regular updates to iTunes Software and iPod, which add new features as well as maintain the closed system of iPod, iTunes software, and iTunes Store are presumably procompetitive. However, Microsoft showed that a product redesign is anticompetitive if the firm has very substantial market power and the redesign is sufficient to exclude complementary products from the market. Moreover, the firm must intend the injury caused by the selection of a particular technology. In addition, the injury must greatly outweigh the benefits that the redesign produces for consumers. As explained in Part B, Apple’s redesign serves the purpose of its unique product model. It provides consumers through various updates with new features such as visual music, podcasts, playback capacities, and seamless management of music. Unlike the case in Microsoft, there is integrative benefit from combining the iTunes and iPod.

IV. CONCLUSION

Apple’s business practices of combining services and products have raised antitrust concerns. This Note analyzed Apple’s practices with an eye toward the realities of the music market. For courts and antitrust enforcement agencies to continue to serve as competition and innovation facilitators, they need to fully understand what the structure and the landscape of the music market are and how the entrance of a new and aggressive business model such as Apple’s exclusive system alters the competitive landscape of the music market. The most serious impact of a court’s finding of antitrust violation is not the large damages awarded to the plaintiffs. Rather, it is the loss of healthy competition and the innovative and effective access to copyrighted materials. An antitrust analysis of the possible causes of action against Apple shows that Apple’s conduct may not have harmed competition after all. If balancing is required to determine whether certain restraint is anticompetitive or not, antitrust should stand aside, trusting that the market rather than the government will strike the right balance.

See NDP Group Press Release, supra note 2.
See Apple Press Release, supra note 3.
See NDP Group Press Release, supra note 2.
See FTC Press Release, supra note 15.
xxii Id.
xxiii  ld. at 373-74.
xxvi ld.
xxvii
Id.
xxviii  See Maul, supra note 19.
xxix \textit{Id.}
xxx ld.
Id.
ld.
See Maul, supra note 19.
See NDP Group Press Release, supra note 2.
See Maul, supra note 19.
Id.
xliii Id. at 263.
xliv Id.
xlvi  ld.
Hovenkamp, supra note 42, at 265.
Hovenkamp, supra note 42, at 265.
35 U.S.C § 271(d).
liv *ld.* at 1218-1219.
lld.
Hovenkamp, supra note 42, at 269.
 lvii ld. at 270.
lviii Id. at 272.
Hovenkamp, supra note 42, at 274.

lxiii Hovenkamp, supra note 4, at 274.
lxiv Id. at 275.
lxv Id.
lxvi See Microsoft, supra note 45.
lxvii Hovenkamp, supra note 42, at 276.
lxviii  Id.

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