Legal Backgrounder

Vol. 30 No. 18 August 21, 2015

Washington Legal Foundation
Advocate for Freedom and Justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
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Third Circuit Should Reverse Ruling that Threatens Technology Industry's Customer-Support Model

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A troubling decision from a New Jersey federal court, currently on appeal to the Third Circuit, limits companies' freedom in the delivery of aftermarket maintenance and support by greatly expanding antitrust liability for certain commonly used arrangements. The case, *Avaya Inc. v. Telecom Labs, Inc.*,[1] has been described by the New Jersey court as one of the most complicated in the district. Following a lengthy trial, the jury concluded that Avaya attempted to monopolize the maintenance aftermarket for one product while also unlawfully tying the sale of software patches and updates to the sale of another product.

Except in limited circumstances, competition in the "primary market" for equipment will constrain competition in any purported "aftermarkets." Moreover, a company should generally be able to decide without fear of antitrust liability who will service its products, and how. If left intact, the *Avaya* decision would impose antitrust liability in three problematic situations:

1) For certain conduct in an "aftermarket" for repairs, even where the associated primary market is competitive;
2) For requiring that buyers purchase software support in order to obtain other support services—a common practice—despite customers' having knowledge of such practices at the time of sale; and
3) For restricting access to the maintenance, updates, and patches of software—another common practice.

The Third Circuit should clarify the *Avaya* court's positions by narrowly defining both the duty to deal with competitors and the potential for aftermarket liability, in line with legal precedent and agency guidance. This Legal Backgrounder discusses those requirements which should inform the Third Circuit's thinking and reviews the legitimate, procompetitive reasons for the practices at issue.

Background. In *Avaya,* two products were at issue: (i) Private Branch Exchange (PBX) systems (computers with unique hardware and software used to create internal telephone networks), and (ii) Predictive Dialing Systems (PDS) (automated telephone dialing systems consisting of both hardware and software).[2] Avaya offers a variety of service options for these products, including post-warranty maintenance and software support. Avaya contracts and authorizes certain partners to provide post-warranty maintenance and software support, but otherwise prohibits system maintenance access by third parties. To obtain software patches and upgrades, PBX and PDS system owners must enter into a one-year software-support contract when purchasing Avaya equipment, a standard industry practice.

[1] *Avaya Inc. v. Telecom Labs, Inc.*, Dkt. Nos. 14-4174, 14-4277 (3d Cir. Oct. 20, 2014).
[2] *Avaya Inc. v. Telecom Labs, Inc.*, 1:06-cv-02490-JEI-KMW, 2009 WL 2928929, at *1 (D.N.J. Sept. 9, 2009).

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Telecom Labs, Inc. and Continuant Inc. (TL&C) was an authorized partner that Avaya terminated for breach of contract after it attempted to solicit existing Avaya maintenance customers. Following its termination, TL&C continued taking over the servicing of existing Avaya maintenance customers. Avaya ultimately sued TL&C alleging breach of contract. In response, TL&C argued that Avaya's maintenance program was anticompetitive.

The district court rejected Avaya's claims even though it found that TL&C tried to "hack and crack into customers' phones to obtain maintenance passwords."[3] The district court did not consider TL&C's conduct actionable because its purpose was to compete with Avaya.

The trial on TL&C's antitrust claims dragged on for seven months. Although the district court previously ruled that Avaya faced "strong competition" in the PBX market,[4] the jury found Avaya attempted to monopolize the maintenance aftermarket for its PBX systems. The jury also found that Avaya unlawfully tied software patch access to maintenance contracts for PDS systems.[5]

The district court misapplied relevant Third Circuit precedent and fundamentally misconstrued Avaya's business model. As a result, *Avaya v. Telecom Labs* can be read to require the mandatory licensing of intellectual property to third-party competitors. Such an outcome has the potential to stifle innovation and drastically increase customer-support costs.

Problem 1: Single-Brand Aftermarkets Are Rare. The Supreme Court in *Eastman Kodak Co. v. Image Technical Servs., Inc.*[6] recognized that a company could exercise market power in an aftermarket despite the existence of a competitive primary market. Since *Kodak*, however, lower courts have repeatedly declined to impose liability for aftermarket tying activities against challenges from independent service organizations.[7] When faced with similar facts, other courts have interpreted *Kodak* narrowly to allow commonplace business practices—like those employed by Avaya—where the primary market is competitive and customers can accurately evaluate lifecycle pricing at the time of purchase.[8]

The Third Circuit itself acknowledged in *Harrison Aire, Inc. v. Aerostar Int'l, Inc.*[9] that "[i]f the primary market is competitive, a firm exploiting its aftermarket customers ordinarily is engaged in a short-run game—for when buyers evaluate the 'lifecycle' cost of the product, the cost of the product over its full service life, they will shop elsewhere."[10] Relying on *Kodak*, the Third Circuit in *Harrison Aire* found that assessing lifecycle pricing was possible where consumers could ascertain the "expected cost, quality and availability" of aftermarket services at the time of purchasing equipment.[11] Other circuits have reinforced this point as well, finding that customers will balk if aftermarket costs are supracompetitive.[12]

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[3] *Id*. at *18.
[4] *Id.* at *1 n.2.
[5] *Avaya Inc. v. Telecom Labs, Inc.*, 1:06-cv-02490-JEI-KMW, 2014 WL 2940455, at *1–2 (D.N.J. June 30, 2014).
[6] *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992).
[7] *See, e.g.*, *Alcatel USA, Inc. v. DGI Techs., Inc.*, 166 F.3d 772, 777 (5th Cir. 1999); *SMS Sys. Maint. Servs., Inc. v. Digital Equip. Corp.*, 188 F.3d 11, 13 (1st Cir. 1999); *PSI Repair Servs., Inc. v. Honeywell, Inc.*, 104 F.3d 811, 814 (6th Cir. 1997).
[8] *See Harrison Aire, Inc. v. Aerostar Int'l, Inc.*, 423 F.3d 374 (3d Cir. 2005); *DSM Desotech Inc. v. 3D Systems Corp.*, 749 F.3d 1332 (Fed. Cir. 2014); *SMS Sys. Maint. Servs., Inc.*, *supra* note 7; *Smugglers' Notch Homeowners' Ass'n, Inc. v. Smugglers' Notch Mgmt. Co., Ltd.,* 414 F. App'x 372 (2d Cir. 2011); *Digital Equip. Corp. v. Uniq Digital Techs., Inc.*, 73 F.3d 756 (7th Cir. 1996).
[9] *Harrison Aire, Inc.*, 423 F.3d at 382.
[10] *Ibid* (citing *Parts & Elec. Motors, Inc. v. Sterling Elec., Inc.*, 886 F.2d 228, 236 (7th Cir. 1998) (Posner, J., dissenting); *SMS Sys. Maint. Servs., Inc.*, 188 F.3d at 16).
[11] *Ibid*.
[12] *DSM Desotech Inc.*, 749 F.3d at 1345 ("[D]efections from the manufacturer's installed base, coupled with losses in the foremarket, . . . will sabotage any effort to exploit the aftermarket.") (quoting *SMS Sys. Maint. Servs., Inc.*, 188 F.3d at 21); *see, e.g.*, *Smugglers' Notch Homeowners' Ass'n, Inc.*, 414 F. App'x at 377 ("[W]here policies were fully disclosed long before entering into an agreement, a plaintiff has no lock-in costs . . . .") (internal quotation marks omitted); *Digital Equip. Corp.*, 73 F.3d at 763.

Mirroring these circuits,[13] the Third Circuit also noted in *Harrison Aire* that a change in policies targeting locked-in customers is "an important consideration" when determining liability for anticompetitive acts in an aftermarket.[14] Upholding summary judgment for the defendant, the Third Circuit found that the plaintiff was aware of aftermarket restrictions at the time of purchase, and there had been no unilateral change in policy from the manufacturer.

In *Avaya*, the markets for PBX and PDS systems were competitive: Avaya faced significant competitors such as Siemens, NEC, and Cisco in the PBX market and a broad range of players in the PDS market. Robust competition in these primary markets informs Avaya's conduct in any aftermarket. Avaya also has a strong incentive to provide higher-quality servicing for its products to remain competitive: a slip in service quality would have a knock-on effect on its brand overall. Finally, Avaya works with "knowledgeable and sophisticated buyers"[15]—*i.e.*, the type of customers who are capable of evaluating the entire lifecycle cost. If its offerings are not competitive, its customers will choose another vendor.

Problem 2: The District Court Misconstrued Avaya's Business Model. The jury found Avaya unlawfully tied software patches to maintenance contracts for PDS systems. Tying occurs where a customer purchasing one item (the "tying" product) is forced to buy a second item (the "tied" product) regardless of the customer's desire to buy the second item.[16] Tying violates antitrust laws when the "seller has appreciable economic power in the tying product market and [] the arrangement affects a substantial volume of commerce in the tied market."[17]

As a threshold matter, the district court's finding that software maintenance and software patches constitute separate markets is questionable. Further, Avaya's practice of bundling the two is commonplace, with sound and procompetitive reasons for doing so. Tying is recognized as providing "significant efficiencies and procompetitive benefits"[18] in many circumstances. "Offering products together as part of a package can benefit consumers who like the convenience of buying several items at the same time" and "can also reduce the manufacturers' costs for . . . promoting the products."[19]

Here, providing patches and maintenance separately leads to inefficiencies, requiring a maintenance provider to first determine what causes a performance issue, and then to go through the process of purchasing the necessary patch. In addition, if a problem with one customer raises issues with other customers' systems, the provider can design and deliver a patch to all supported customers. Distributing patches to affected and non-affected customers alike increases efficiency by reducing potential downtime. Finally, software must be secure and reliable to be successful; it is therefore critical that system providers maintain control over their systems.

Problem 3: *Avaya* Requires Mandatory Licensing of Proprietary Knowledge to Competitors. Avaya's practice of limiting access to maintenance software by requiring that customers purchase maintenance from Avaya or an authorized partner is a common practice among software providers. There are legitimate, procompetitive reasons for this: a slip in service quality would assuredly affect the quality of Avaya's brand overall. For that reason alone Avaya may wish to limit the possibility of customer dissatisfaction or reputational harm by regulating who

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[13] *See id.*; *see, e.g.*, *Hack v. President and Fellows of Yale College*, 237 F.3d 81, 87 (2d Cir. 2000) (finding that plaintiffs were not locked-in where aftermarket policies were "fully disclosed long before" purchase), *abrogated on other grounds by Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002); *Alcatel USA, Inc.*, *supra* note 7 at 783; *Lee v. Life Ins. Co. of North America*, 23 F.3d 14, 19 (1st Cir. 1994).

[14] *Harrison Aire, Inc.*, 423 F.3d at 384.

[15] *United Asset Coverage, Inc. v. Avaya Inc.*, 409 F. Supp. 2d 1008, 1014 (N.D. Ill. 2006).

[16] *Eastman Kodak Co.*, *supra* note 6 at 461.

[17] *Id.* at 462 (internal quotation marks and citations omitted).

[18] Dep't of Justice and the Fed. Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property 26 (Apr. 5, 1995), *available at* http://www.justice.gov/atr/antitrust-guidelines-licensing-intellectual-property.

[19] *Tying the Sale of Two Products*, Federal Trade Commission, https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/single-firm-conduct/tying-sale-two-products (last visited June 3, 2015).

ISBN 1056 3059

services its products. Avaya may also want to limit access to its proprietary maintenance programs to protect its intellectual property or the security of its software.

As it stands, the *Avaya* decision ignores these reasons, requiring instead that software providers make products available to any independent third-party service provider that is considered a "competitor." Such "mandatory licensing" could deter manufacturers from offering aftermarket support in the first place. Mandated licensing would also increase customer-support costs for existing systems by dissuading technology manufacturers from investing in support-focused research and development. This would foist expensive costs on independent third-party service providers, who then must develop their own patches for existing software systems—a duplication of efforts bound to increase support costs and confusion among customers.

Additionally, the Supreme Court established in *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP* that a business may refuse to deal with a competitor except in the rare situation where (1) the refusal to deal reversed a prior course of conduct and (2) the defendant sacrificed short-term profits in return for long-term anticompetitive gain.[20] Yet the district court in *Avaya* makes no reference to whether this *Trinko* standard applies to the relevant technology services market; the Third Circuit therefore may wish to consider whether *Trinko* is pertinent.

The Federal Trade Commission and the Department of Justice also agree that intellectual property rights "promote innovation by allowing intellectual property owners to prevent others from appropriating much of the value derived from their inventions or original expressions."[21] Regulators and courts therefore must tread carefully in this space to avoid chilling innovation.

Solution. The Third Circuit can unambiguously state the law regarding aftermarket competition and antitrust liability. A ruling that follows its own decision in *Harrison Aire*—along with the approach advanced by regulators—would establish a standard whereby a manufacturer is not liable for anticompetitive conduct in an aftermarket where the primary market is competitive unless:

1) Customers are "locked in" to purchasing maintenance by an excessively high switching cost;
2) The customer is unable to assess the lifecycle cost of products and maintenance together at the time of purchase; or
3) There was a unilateral policy change by the manufacturer after the time of purchase.

This approach would allow equipment and software manufacturers to continue competing and innovating in the primary technology systems market while providing cutting-edge patches and upgrades in the services aftermarket.

Conclusion. Mandatory licensing of aftermarket support flouts the Supreme Court's holding in *Trinko*, chills innovation, and is likely to increase support costs. The Third Circuit should reiterate that businesses may refuse to deal with competitors as long as short-term profits are not sacrificed in exchange for long-term anticompetitive gains.

Antitrust laws are designed to protect competition, not competitors. By overturning the district court's decision in *Avaya*, following the Supreme Court's *Trinko* framework, and employing the three-pronged approach to aftermarket liability outlined above, the Third Circuit can do just that.

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[20] *See Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 409 (2004).

[21] U.S. Dep't of Justice and the Fed. Trade Comm'n, Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition 1 (Apr. 2007), *available at* https://www.ftc.gov/sites/default/files/documents/reports/antitrust-enforcement-and-intellectual-property-rights-promoting-innovation-and-competition-report.s.department-justice-and-federal-trade-commission/p040101-promoting-innovation-and-competition-rpt-07-04.pdf.

ISBN 1056 3059