

Competition and IP Rights in Brazil: The Exercise of Design Patents in the Auto Parts Aftermarket

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I. Introduction

The Brazilian Competition Authority (known as "CADE" - *Conselho Administrativo de Defesa Econômica*) is currently analyzing a landmark case regarding the interface between competition law and intellectual property (IP). The case is known as "Anfape" (acronym for *Associação Nacional dos Fabricantes de Autopeças*) and it analyzes whether the exercise of intellectual property (IP) rights over the design of spare parts in the automobile aftermarket infringes Brazilian Competition Law.

The case was brought in April 2007 by a formal complaint made by Anfape, a national association of autoparts manufacturers, against three major automobile manufacturers: Ford, Fiat, and Volkswagen (the defendants).^[fn]CADE, Administrative Proceeding No. 08012.002673/2007-51.^[fn] The complaint argued that the defendants were exercising their IP rights over the design of spare parts in an abusive and anticompetitive manner against independent spare parts manufacturers.

The conduct is the adoption of a new business strategy, since 2003, to impose design patents of spare parts in the automobile aftermarket against independent parts manufacturers. The conduct involved both judicial and private actions against the manufacturers in order to stop them from producing spare parts that reproduced the original design.

After several years of investigations, CADE's General Superintendence, the main investigation body, issued its opinion in June 2016. It found that the defendants' conducts violated Brazilian Competition Law and, therefore, recommended the conviction of the defendants.

Next, the case was sent to CADE's Attorney General's Office (ProCADE) and to the Federal Public Prosecutor's Office (MPF, its acronym in Portuguese) for their opinions. Both agreed with the General Superintendence and recommended the conviction of the defendants.^[fn]It is worth noting, however, that in the judgement hearing the current CADE's Attorney General disagreed with the formal opinion issued by his predecessor and expressed his verbal opinion in favor of the defendants.^[fn]

The judgment of the case started on November 2017, when the Reporting Commissioner Paulo Burnier da Silveira rendered his opinion to convict the defendants and to impose a fine in the minimum amount permitted. Nonetheless, the judgment was suspended due to a request by one of the Commissioner's to further examine the case, which is expected to reach a final decision in early 2018.

In this post, the authors share the key parts of the opinion that they gave in this case, which still awaits a final ruling from the Brazilian Competition Authority.

II. The Issue

Two main questions shall be answered in this case.

The first one is whether the conduct of the defendants infringes Brazilian Competition Law. In other words, whether the conduct generates anticompetitive effects without efficiencies that can compensate those negative effects.

The second is whether the conduct, in despite of its possible anticompetitive effects without proper justifications, is protected by the Brazilian Industrial Property Law. That is to say, whether the conduct of the defendants constitute a regular exercise of a right or and abuse of right.

In order to answer those two questions, we shall first analyze the applicable rules under Brazilian Law.

Addressing the first question, we shall examine the Brazilian Competition Law. In article 36, the Law considers a competition infringement any act, regardless of fault, that aims at producing or can produce the following effects, even if not reached: (i) limiting or harming competition and free trade; (ii) dominating a relevant market of goods or services; (iii) unreasonably raising profits; and (iv) exercising an abuse of dominant position.^[fn]Law nº 12.529/11. Art. 36.^[fn]

Moreover, the Brazilian Competition Law also establishes that the exercise of intellectual property rights in an abusive manner constitutes an antitrust infringement, when it fulfils the requirements presented in the paragraph above.^[fn]Law nº 12.529/11. Art. 36, § 3º, XIX.^[fn]

Regarding the second question, we shall analyze the Brazilian Constitution and the Industrial Property Law. The Constitution establishes that the "law will grant to the authors of industrial inventions a temporary privilege in its use, aiming at the social interest and at the technological and economic development of the Country".^[fn]Brazilian Constitution of 1988. Art. 5º, XXIX.^[fn]

The Industrial Property Law establishes that the holder of a design patent has the right to prevent others from producing, without its consent, the product object of the design patent.^[fn]Law nº 9279/96. Art. 109 combined with art. 42.^[fn] It also establishes that the protection of intellectual property rights shall consider its social interest and the technological and economic development of the Country.^[fn]Law nº 9279/96. Art. 2.^[fn]

Still regarding the second question, the Brazilian Civil Code defines an abuse of right. The Code establishes that the holder of a right who, when exercising it, exceeds the limits imposed by its social and economic purpose or imposed by good faith perpetrates an abuse of right.^[fn]Brazilian Civil Code (Law nº 10.406/02). Art. 187.^[fn] Those rules will be relevant to the analysis of the case undertaken in the next section.

III. Analysis

The analysis of the issue will be twofold. First we shall examine whether the conduct of the defendants creates anticompetitive effects not justified by efficiencies and, therefore, if it infringes Brazilian Competition Law (sub item "A").

Secondly, we analyze whether the conduct constitutes a regular exercise of the right conferred by the Brazilian Industrial Property Law or if, in contrast, it constitutes an abuse of that right, in the terms of the Civil Code (sub item "B").

III.A. Unjustified Anticompetitive Effects

III.A.1. Monopolization and Lock-in Effect

Regarding the first question, the main anticompetitive effect is the monopolization of the aftermarket. Each spare part from each vehicle is a distinct relevant market, since there is no demand substitutability between different parts. A consumer cannot replace a part of his vehicle from a spare part from another vehicle model.

Furthermore, it is not possible to compete in the aftermarket without reproducing the original design. The Anfape case deals with visible spare parts, which are considered "must-match". In other words, only the original design will meet the needs of the consumers, which is to restore the original appearance of the damaged vehicle. That is why many of the must-match parts are also considered "crash parts".

In this context, if the car manufacturers have the power to stop any part manufacturer from producing spare parts of their cars, they will potentially be monopolists in the aftermarket.

It is important to refute the false premise that every patent or intellectual property right creates a monopoly. In the great majority of cases, a design patent will not result in a monopoly of a relevant market. That is because the object whose design is protected normally does not constitutes a separate relevant market. In other words, in most markets it is possible to compete with a different design. For instance, if a company files a design patent of a refrigerator, it will not be a monopolist in the market for refrigerators. If a car company has the design patent of a car, this car still suffers competitive pressure from other cars with different designs.

In this sense, the Anfape case is a very specific case in which the object of the design patent constitutes a separate relevant market and, as a result, the exercise of the IP right creates a monopoly.

This monopoly results in the lock-in effect, which is detrimental to consumers. It occurs when the owner of a product needs to replace a part of it and only has the seller of the product as an available supplier of the spare part. The consumer, after the purchase of the primary product, is locked-in to a monopoly for spare parts.

The lock-in doctrine refers to the case *Eastman Kodak Co. v. Image Technical Services Inc.*, decided by the United States Supreme Court in 1992.^[fn]*Eastman Kodak Co. v. Image Technical Services, Inc.* United States Supreme Court. 504 U.S. 451 (1992).^[fn] In this case, the Court decided that, even when the manufacturer of a complex product lacks market power in the primary market, it may have market power in the aftermarket for its parts, due to factors that restrict competition in the aftermarket.

In the Anfape case, however, the lock-in effect is aggravated due to the high switching cost of the primary good. In the Kodak case, the Court was dealing with printers and the supply of ink cartridges. If the costs of cartridges are extremely high in the aftermarket, it is feasible to purchase a new printer. In contrast, if a consumer has to replace the headlight of his car, it would not be feasible to change the whole car if the price of the headlight is high.

In addition, we do not accept the defendant's argument that the fierce competition in the foremarket (the automobile market) would hinder the defendants from exercising market power in the aftermarket, even if they were the sole supplier.

This argument shall not succeed for two reasons. First, there is an important information asymmetry in the market. Most consumers are only well informed about the costs of periodical inspections and repairs, which normally do not include parts protected by design patents, such as crash parts.

Furthermore, even if consumers were well informed about the costs, they would not give due consideration to the information when acquiring a vehicle. This is due to overoptimism about the risks of being involved in a car accident, according to studies of behavioral economics.^[fn]See Posner, Richard A. "Rational Choice, Behavioral Economics, and the Law." *Stanford Law Review*, vol. 50, no. 5, 1998, pp. 1551-1575; and Van Den Steen, Eric. "Rational Overoptimism (and Other Biases)". *American Economic Review*, 94, September 2004, 1141- 1151.^[fn]

In this sense, the competition in the primary market is not able to preclude firms from exercising monopoly power in the aftermarket. Therefore, the exercise of design rights over spare parts in the automobile aftermarket has the potential to monopolize the market, creating harmful lock-in effect to consumers.

III.A.2. Incentives to Innovation

One of the main arguments of the defendants is that the anticompetitive effect is justified and compensated by dynamic efficiencies, in special by incentives to innovation. They argue that the two purposes that underpin IP policy are (1) to create adequate incentives to research and development investments, which lead to product differentiation and innovation; and (2) to reduce transaction costs with regards to the

avoidance of free-rider and opportunistic behavior.

This argument shall not succeed due to a simple reason: it is not possible to innovate in the design of a must-match spare part. Therefore, what is impossible cannot be incentivized.

The purpose of the design patent of a spare part is to stop a car manufacturer from copying the design of its competitor's car and, as a consequence, to force it to innovate and create its own design. This results in more innovation and options for the consumers.

In the spare parts market, the exercise of the design patent against independent parts manufacturers will not lead to more innovation, to the creation of new options of design. There is only one possible design for the auto part in the aftermarket - the original design. No other design, even if considered more attractive, will satisfy the consumer necessity to properly replace a damaged part and restore the original visual identity of the car.

The investment in design targets essentially the foremarket and not the aftermarket. That is so because the design only influences the consumer in the foremarket. Only when the consumer is choosing between different cars, the design is relevant for his choice. When the consumer has to replace a damaged part, the design will not influence his choice. In fact, there is no choice. Only the original design will meet the consumer's need.

Therefore, it is a false premise the argument that the protection of design patents in the aftermarket creates incentives to innovation. Thus, alleged dynamic efficiencies created by innovation are not able to compensate the harmful monopolization effect.

III.B. Abuse in the Exercise of the Intellectual Property Right

The second issue of the case is whether the defendants were regularly exercising a right granted by law or if, in contrast, they were exercising this right in an abusive way. In order to address this issue, we shall analyze if the exercise of the right by the defendants "exceeds the limits imposed by its social and economic purpose or imposed by good faith", in accordance with the Brazilian Civil Code.

The doctrine of abuse of right (*abus de droit*) is mostly present in civil law jurisdictions.^[fn]Byers, Michael. "Abuse of rights: an old principle, a new age." McGill LJ 47 (2001): 389.^[fn]The Brazilian Law, following other civil law countries, establishes that a right shall be exercised in accordance with the purpose to which the right was granted. In the words of the Civil Code, the exercise of a right shall not exceed the limits imposed by its social and economic purpose.

To determine if the exercise of the IP right by the defendants in the Anfape case exceeded the limits imposed by its social and economic purpose, we shall first determine the "social and economic purpose" of the industrial property right over design.

Both the Brazilian Constitution and the Industrial Property Law expressly mention that the purpose of IP rights is "the social interest and the technological and economic development of the Country". Those goals are addressed by IP protection by the creation of incentives to innovation. It is almost a consensus that the main purpose of IP rights is to foster innovation, leading to technological and economic development and enhancing general welfare.

Therefore, according to Brazilian Law, if the exercise of design patents by the defendants is not in accordance with the goal of creating incentives to innovation, it shall be deemed an abuse of right.

*In the Anfape case, it was demonstrated that there is no incentive to innovate on auto parts design in the aftermarket. In other words, the exercise of design patents against spare parts manufacturers does not lead to innovation, simply because is not possible to innovate in this market. The reproduction of the original design is a *conditio sine qua non* to compete in the market.*

Hence, the exercise of the design patent in the aftermarket is not consistent with the purpose of the right - the reason why the right was granted. Thus, the conduct of the defendants does not constitute a regular exercise of its IP right. Rather, it is an abuse of right under Brazilian law.

In conclusion, considering that the conduct is not protected by the Industrial Property Law, it can be punished by CADE as an antitrust infringement since it produces harmful anticompetitive effects not compensated by economic efficiencies.