

## **Copyright Law and Competition Policy: International Aspects**

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A recent Federal Court Ruling in a case brought by the Australian Competition and Consumer Commission (ACCC) against a number of record companies, alleging breaches of the *Trade Practices Act 1974* (TPA), highlights a growing interconnection between international trade in copyright product, copyright law and competition policy. The breaches were symptomatic of unwillingness on the part of foreign copyright owners (acting through their respective territorial licensees) to accept intra-brand competition brought about by the *Copyright Amendment Act (No 2) 1998* that permitted the parallel importation of non-infringing copies of sound recordings. Strategies to retain copyright owner control over vertical distribution included attempts to block both parallel exports and parallel imports. The interplay between the economics and law of trade in copyright product is a complex area that has until recently attracted little attention by economists (Fels, 2001).

A range of issues highlighted in the above Federal Court Ruling is explored in this paper. The issues addressed in the paper include the international dimensions of intellectual property law, vertical restraints in the international distribution of copyright product and the implications for domestic competition policy.

### **Authorised and Unauthorised Distribution Channels**

The *Copyright Act 1968* bestows a number of exclusive rights on creators of literary, musical and artistic works, including the right to reproduce, to perform, to adapt and to translate the work. These economic rights are necessary to promote creative endeavour and to avoid imitation (free riding) and market failure. In determining the range and strength of these monopoly rights, policy makers need be mindful of the potentially anti-competitive consequences that may ensue.

Copyright is divisible by time, act and territory. Exclusive territorial licenses, contractual arrangements negotiated between copyright owners and domestic agents within specific national territories, are a form of vertical restraint that enable copyright owners to coordinate the international distribution of copyright product. The result is a series of territory based distribution channels within which a particular copyright product is exclusively distributed by the copyright owner or his/her licensee.

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In exchange for a license fee, the territorial licensee obtains exclusive rights to the distribution of the copyright product within the territory. This provides the necessary security for licensee pre-sales (marketing and promotion) and post-sales (servicing and warranty) investments. Distributors of competing copyright product likewise typically enjoy exclusive territorial rights. To the extent that this encourages investment and product variety, exclusive territorial licenses promote inter-brand rivalry and are pro-competitive. On the other hand, this exclusivity produces local monopolies for specific copyright product and is not unambiguously welfare enhancing.

Parallel imports refer to the importation of a copyright product (released in a foreign territory) by someone other than the domestic license holder. Parallel imports arise where enterprising traders exploit territorial price differentials, diverting copyright product from a low-price territory to a high-price territory (Moran, 1999). Territorial price differentials arise for a host of reasons including exchange rate movements, international price discrimination, national price regulations, vertical controls and variations in pre-sales and post-sales investments (Maskus and Lahouel, 1999).

Parallel imports provide an unauthorised distribution channel that introduces intra-brand competition, and in the view of copyright owners and licensees, is a disruptive element to an otherwise efficient distribution system. Motivations cited for copyright owner control over parallel imports include the prevention of free riding, maintenance of product quality, detection of illicit copies (piracy), price discrimination and collusion (Chard, 1989; Abbott, 1998; Gallini, 1999).

While collusion is anti-competitive and likely to lower social efficiency, the welfare consequences of international price discrimination are less clear. Under certain assumptions, international price discrimination, backed by parallel import restrictions, can increase global welfare (Malueg and Schwartz, 1994). However, for a net importer of copyright product like Australia, the introduction of competition from parallel imports can enhance national welfare. Indeed, depending on the response by copyright owners in low price territories from which parallel imports are diverted, competition from parallel imports may even increase global welfare (Papadopoulos, 2000).

The remaining motivations are pro-competitive and likely to improve private efficiency. The debate over the legality of parallel trade centres on the issue of the timing of copyright exhaustion.

### **Exhaustion of Copyright and International Intellectual Property Law**

The exhaustion of copyright lies at the heart of a contentious and unresolved issue in international intellectual property law. Copyright in most countries provides creators with a bundle of exclusive rights, including the right to make the product available on the market for the first time. This *distribution right* is referred to as the doctrine of first-sale. In the context of international trade in copyright product, the distribution right has created great uncertainty for copyright owners, licensees, importers, distributors and retailers alike. The controversy surrounds the issue of

whether the copyright owner should control distribution of a particular copy of a product beyond the first sale. The principle of international exhaustion holds that the distribution right is exhausted once a particular copy of the product is sold anywhere in the world. In other words, the right to distribute a specific copy of the copyright product (for example, a sound recording title, book title or business software program) is exhausted after the first sale and the copyright owner can no longer control distribution. The copyright owner cannot thereafter prevent the importation of that product into another territory.

The adoption of the principle of international exhaustion would allow the parallel importation of legitimate copies of a copyright product released onto the market anywhere in the world. The principle of national exhaustion holds that the distribution right is exhausted only within the country in which the product is first sold. The distribution right survives until the sale of that same copy in another country. This amounts to an *importation right* and a prohibition on parallel imports. Copyright product can only be legally imported by the copyright owners or licensees or with their expressed authorisation.

An importation right, therefore, provides copyright owners with a statutory monopoly over the importation and distribution of copyright product. In this way, the right is a form of vertical restraint that enables copyright owners to control the international distribution of copyright product. It has been argued that this statutory monopoly provides copyright owners the wherewithal to partition the global market into national segments and implement a strategy of price discrimination reflecting varying incomes and elasticity of demand (Malueg and Schwartz, 1994; Papadopoulos, 2000).

An importation right provides copyright owners with greater market power and control and consequently, enhances the economic value of the copyright. Not surprisingly then, national governments in countries that are net exporters of copyright product advocate stronger economic rights, including a prohibition on parallel imports. Intellectual property owners in these countries have urged government to advocate the adoption of the principle of national exhaustion in forums such as the WTO.

Distribution is a key right identified in the World Copyright Treaty (WCT) and World Phonograms and Performers Treaty (WPPT) and bestows on producers the exclusive right of making copies of their product available to the public. Interestingly, article 6 of the WCT explicitly avoids determination with respect to the timing of the exhaustion of this right.

Nothing in this Treaty shall effect the freedom of the Contracting Parties to determine the conditions, if any, under which the exhaustion of the right in paragraph (1) applies after the first sale or other transfer of ownership of the original or a copy of the literary and artistic works with the authorisation of the producer of the literary and artistic works.

In other words, members of these copyright conventions are free to determine the timing of the exhaustion of the right of distribution and adopt the principle of national or international exhaustion as they see fit.

Negotiations within the World Trade Organisation (WTO), as evidenced in the text of the Trade Related Intellectual Property Rights Agreement (TRIPS), have also left the controversial issue of the importation right up to individual national regulators. Article 6 of TRIPS (WTO, 1995) deals with the issue of exhaustion in the following way:

For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 and 4, nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights.

There was considerable disagreement on this issue at the time of its drafting. Ultimately, trade negotiators agreed to disagree and this question was left to individual member states to determine their respective policy positions. In short, there is nothing in international trade and intellectual property rights (IPR) law that mandates the provision of an importation right. As a statutory impediment to the free flow of copyright product, an importation right would seem to conflict with the underlying objective of the WTO: to promote free trade via the removal of tariff and non-tariff barriers to trade.

### **Trade Related Copyright Law Reform in Australia**

Australian copyright law reform, and the liberalisation of trade in copyright product, has progressed in a step-wise fashion for individual product classes. A review of the book market in 1992, by the then Prices Surveillance Authority (PSA), resulted in a partial removal of the importation right. Parallel importation is now permissible, for example, if a book is not published in Australia within 30 days of its first publication overseas.

A review of the market for sound recordings (PSA, 1990; Senate Legal and Constitutional Legislation Committee, 1998) culminated in the *Copyright Amendment Bill (No.2) 1998*, permitting the parallel importation of non-infringing copies of a sound recording.<sup>1</sup> More recently, a review of all remaining copyright related products saw the drafting of the *Copyright Amendment Bill (2001)*.

The Copyright Amendment Bill proposes to remove restrictions on the parallel importation of all copyright products, including books but exempting motion pictures. The House of Representatives passed the Bill in June 2000 but it lapsed with the November 2001 election. The (slightly amended) Bill was reintroduced in March 2002. Its passage through the Senate is uncertain since both the Labor opposition and Democrats have expressed their opposition to the

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<sup>1</sup> A 'non-infringing' copy is defined as one that does not breach copyright law in the country of manufacture and is released into that market with the owners consent.

Bill. For the moment, at least, it remains illegal to import business software, video games, periodicals and similar products without the permission of the copyright owner or their domestic licensee.

The Australian government has adopted a rule of reason approach to copyright law reform and parallel imports. It has undertaken a sequential review and economic cost-benefit analysis of each category of copyright product and amending copyright law accordingly.

For example, the proposed exemption of motion pictures relates to the unique characteristics of that product and the prevailing market dynamics. Release timing is a critical dimension of competition and distribution in this market. The primary income earning activity is the public performance. A new motion picture is first released in movie theatres, and then to video rental stores before ultimately being released on DVD and videocassette. Release timing varies between territories and is a function of, among other things, seasonal factors. The removal of parallel imports could see the importation of DVD and videocassette copies of films prior to their scheduled release in the domestic market with obvious financial costs to both copyright owners and the movie theatre industry. It makes sense, therefore, to adopt the principle of national exhaustion with respect to this product class.

Not surprisingly, given the economic significance of copyright dependent industries and the income redistributive effects of changes to the nature and extent of exclusive commercial rights, copyright law reform has been very controversial. The response to the adoption of international exhaustion with respect to sound recordings by the dominant multinational (MNE) record companies provides an excellent case study of the complexities surrounding the relationship between copyright law, international trade and competition policy.

### **Anti-Competitive Conduct in the Post-Reform Period: A Case Study**

In 1999 the ACCC initiated legal action against Universal Music Australia, Warner Music Australia and Sony Music Entertainment (Australia) alleging conduct that breached Sections 45, 46 and 47 of the TPA. Prior to the commencement of the trial, the ACCC and Sony reached a settlement whereby Sony gave an undertaking to refrain from conduct designed to impede parallel imports and parallel exports.

#### *The music recording industry*

Record companies are in the business of producing and distributing sound recordings. Performing artists are signed to exclusive contracts, typically encompassing multiple albums (sound recording titles). Record companies own copyright in the sound recordings they produce, and pay royalties to the performing artist(s) and songwriter(s) for each copy of the sound recording reproduced. In this way, a record company has monopoly control over its catalogue of artist specific sound recording titles.

The Australian sound recording market is dominated by four record companies (the ‘majors’), which are subsidiaries of MNEs. Together these record companies share around 90 per cent and 80 per cent of the domestic and international markets respectively. Not surprisingly, international repertoire represents around 85 per cent of all sound recordings sold in Australia. The majors have exclusive territorial licenses for the parent company’s foreign music catalogue. Prior to 1998 music retailers had to deal exclusively with record companies to source artist specific sound recording titles over which they had monopoly distribution rights. This provided the majors with a considerable degree of market power in the wholesale distribution market. This influence over the market for sound recordings was used in an attempt to maintain monopoly control over their respective music catalogues.

### *The conduct*

The removal of the importation right provided the opportunity for the establishment of competing unauthorised distribution channels for sound recordings that divert sound recordings from relatively low-price markets into Australia. These competing distribution channels provide music retailers with alternative sources of supply and introduce intra-title competition and place downward pressure on prices.

Record companies responded by adopting strategies, both domestic and international, that would impede parallel imports. The domestic conduct included the withdrawal of trading terms to music retailers<sup>2</sup>, and in some cases the outright cessation of supply, for those deemed to be buying parallel imports from competing distributors or directly engaging in parallel imports themselves. In the view of the ACCC, this adverse treatment was a form of *signalling* to other music retailers as a deterrent to dealing with competitors.

The international dimension to the actions undertaken by the major record companies included attempts to impede parallel exports from relatively low-price markets, such as Indonesia. This was achieved by putting pressure on Indonesian distributors, via affiliate record companies and distributors in that territory, to not supply Australian retailers or independent wholesale distributors.

### *Breaches of the Trade Practices Act*

In considering the merits of the case, Justice J. Hill found that both Universal and Warner were in breach of Sections 46 and 47 of the TPA (Federal Court of Australia, 2001).

Section 46 prohibits the use of market power that has the effect of eliminating competition or impeding entry into a market. The removal of the importation right provided the opportunity for new entrants into the wholesale distribution market

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<sup>2</sup> Trading terms typically offered to retailers included bulk discounts, credit terms, sale-or-return policy and cooperative advertising.

and for local retailers to source products from distribution channels located in foreign territories. The actions undertaken by the record companies were designed to prevent parallel importation of sound recordings by competing distributors and retailers. While the record companies did not have any direct control or influence over competing distributors, the removal of trading terms and, in some cases, the closure of accounts (cessation of supply) for retailers that stocked parallel imports, discouraged retailers from buying relatively low-price substitutes from a competitor. Both companies were found to have breached section 46, having used their market power to prevent entry into the wholesale distribution market.

Section 47 (exclusive dealing) prohibits the imposition of conditions on customers that prevents them from dealing with competitors. By threatening to impose sanctions on retailers found to be directly importing or sourcing parallel imports from a domestic competitor, the record companies attempted to force retailers to deal exclusively with them. Accordingly, they were judged to have breached section 47 of the TPA. In addition, a number of senior record company executives were also judged to be guilty of accessorial liability by knowingly engaging in conduct that was in breach of Sections 46 and 47.

The ACCC also brought charges against the record companies in relation to the overseas conduct in which they attempted to impede parallel exports to Australia. Section 45 of the TPA prohibits arrangements or understandings that impede or substantially lessen competition. This action failed because, while there was documentary evidence relating to correspondence between the Australian and Indonesian affiliates, it could not be proved that the arrangement to refuse supply to Australian competitors was entered into by the Australian companies rather than their Indonesian counterparts.

## **Conclusions**

There remains considerable disagreement over the economic rationale for copyright owner control over the international distribution of copyright product and parallel imports. The music recording industry case study highlights the interplay between copyright law, international trade and competition policy.

The recent Federal Court decision demonstrates that former statutory monopoly distributors of copyright product cannot pursue anti-competitive strategies to maintain their monopoly control in an environment of international exhaustion and parallel imports. Foreign copyright owners need be aware of potential competition policy violations of actions by their domestic subsidiaries. The judgment will no doubt have a signalling effect to monopoly distributors of other copyright products should the Government's reform agenda continue, with the reintroduction of the Bill to remove parallel import restrictions on all remaining copyright products (except motion pictures).

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