

Antitrust and Competition Issues

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This chapter offers a broad overview of the impact of US antitrust laws on intellectual property (IP) licensing and transactions. It is by no means comprehensive, and there are numerous texts that deal with these issues in far greater depth.¹ A basic understanding of antitrust law is, however, critical to the analysis of IP licensing arrangements. As I observed over many years of legal practice, to the uninitiated, anticompetitive arrangements often seem like great business ideas – activities like price fixing, market allocation, even concerted refusals to deal can be profitable and beneficial for those who engage in them. Unfortunately, they are illegal. As a result, this chapter offers a summary of the antitrust doctrines that arise frequently in IP- and technology-focused transactions. Antitrust issues also play a role in the analysis of joint ventures, which are discussed in [Section 9.4](#), and IP pools, which are discussed in [Chapter 26](#) (a preview of this topic is presented in [Section 25.5](#)).

Antitrust law can be a particularly challenging subject, as the law, and even the basic premises underlying it, have evolved over time. As you read this chapter, consider how antitrust attitudes toward IP have shifted over the last fifty years, from the suspicion evidenced by the “Nine No-Nos” to the relatively permissive posture adopted in recent cases.

¹ See, e.g., Christopher R. Leslie, *Antitrust Law and Intellectual Property Rights* (Oxford Univ. Press, 2011); Mark R. Patterson, *Antitrust Law in the Online Economy: Selected Cases and Materials* (Amazon, 2020).

SHERMAN ANTITRUST ACT OF 1890

Section 1

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal ...

Section 2

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony ...

At their most fundamental level, the antitrust laws are intended to protect free market competition from private restraint. In the United States, the principal antitrust statute is the Sherman Antitrust Act of 1890 (15 U.S.C. §§ 1–38). The Sherman Act has two main goals, described in its first two sections. Section 1 of the Sherman Act is described as prohibiting unlawful combinations – concerted action by competitors – and Section 2 is described as prohibiting monopolization – unilateral action. Though these two statutory sections are brief (often referred to as Constitutional in scope), they have spawned volumes of commentary and case law over more than a century. In addition to the Sherman Act, other US statutes address antitrust issues, including the Clayton Act of 1914 (15 U.S.C. §§ 12–27, 29 U.S.C. §§ 52–53), which deals primarily with mergers and acquisitions, and the Robinson–Patman Act (15 U.S.C. § 13), which deals with price discrimination. In addition, most states have their own competition laws, which overlap with federal laws to differing degrees.

On the other hand, IP rights, by their very nature, afford their owners exclusive rights over certain works and inventions. They are sometimes referred to as legally sanctioned monopolies. Intellectual property licenses are arrangements among multiple parties. It should thus be obvious that IP licensing intersects with, and can run afoul of, the antitrust laws in a variety of ways.



FIGURE 25.1 The Sherman Act was enacted to combat the worst abuses of sprawling business “trusts.”

ANTITRUST ENFORCEMENT IN THE UNITED STATES

Unlike most countries, the United States has not one, but two federal agencies with jurisdiction to enforce the antitrust laws: the Department of Justice (DOJ) acting through its Antitrust Division, and the Federal Trade Commission (FTC), an independent federal agency formed in 1914. These two agencies have overlapping but not entirely coextensive jurisdiction over antitrust matters.

The DOJ has sole authority to prosecute criminal violations of the antitrust laws. The DOJ also issues Business Review Letters (BRL) in response to inquiries from private parties. In BRLs the DOJ indicates whether it would likely prosecute a proposed transaction.

The FTC is chartered under the Federal Trade Commission Act (15 U.S.C. § 41 *et seq.*). Section 5 of the FTC Act bans “unfair methods of competition” and “unfair or deceptive acts or practices.” The Supreme Court has held that violations of the Sherman Act necessarily violate the FTC Act. Thus, while the FTC does not technically enforce the Sherman Act, it can prosecute the same types of conduct under the FTC Act. There is also some debate over the extent to which § 5 of the FTC Act, particularly its ban on “unfair methods of competition,” prohibits conduct beyond the bounds of the Sherman Act.

The DOJ and FTC have historically coordinated their antitrust enforcement activities, and have produced numerous joint statements regarding their views of the law. Nevertheless, the agencies do not always see eye to eye. During the Trump Administration, in particular, the DOJ and FTC have taken opposing views on antitrust issues, particularly when they involve IP. The most stark example of this divergence occurred during the FTC’s enforcement action against Qualcomm, in which the DOJ intervened several times in support of the defendant.

In addition to the FTC and DOJ, private parties can also bring suits to enforce the Sherman Act, though their remedies are limited to monetary and injunctive relief – criminal penalties being available only to the DOJ. Only the FTC may enforce the FTC Act.

In considering statements and opinions issued by the US antitrust enforcement agencies, it is important to remember that these agencies *enforce* the antitrust laws, they do not *make* the antitrust laws. As in other areas of federal law, Congress enacts the laws, which are then interpreted by the courts. Just as the FBI, another unit of the DOJ, investigates violations of and enforces federal criminal laws, the DOJ’s Antitrust Division investigates potential antitrust violations and, if it feels that a violation has occurred, it may bring an action in court. But the DOJ’s determination that a violation of antitrust law has occurred does not make it so, any more than the FBI’s seizure of an alleged felon’s assets automatically passes muster under the Fourth Amendment.



FIGURE 25.2 Unlike most countries, the United States has two antitrust enforcement agencies with overlapping jurisdiction and sometimes conflicting policies.

25.1 *PER SE* ILLEGALITY VERSUS THE RULE OF REASON

From the early twentieth century through the 1970s, US antitrust authorities and courts had a relatively dim view of IP. As one DOJ official explained, “The prevailing view in the 1970s was that antitrust law and IP law shared no common purpose. One created monopolies and the other sought to prevent them, so the two regimes were seen as not only in tension, but in conflict.”² As a result, during the first three-quarters of the twentieth century, many arrangements involving IP were found to violate the antitrust laws.³ Various licensing practices that were condemned were summed up in 1970 by a DOJ official in a list that came to be known as the “Nine No-Nos.”⁴ The Nine No-Nos are summarized as follows:

1. royalties not reasonably related to sales of the patented products;
2. restraints on licensees’ commerce outside the scope of the patent (tie-outs);
3. requiring the licensee to purchase unpatented materials from the licensor (tie-ins);
4. mandatory package licensing;
5. requiring the licensee to assign to the patentee patents that may be issued to the licensee after the licensing arrangement is executed (exclusive grantbacks);
6. licensee veto power over grants of further licenses;
7. restraints on sales of unpatented products made with a patented process;
8. post-sale restraints on resale; and
9. setting minimum prices on resale of the patent products.

Committing any of the Nine No-Nos was viewed as a *per se* violation of the antitrust laws. That is, if a party was found to engage in one of these practices, antitrust liability was effectively automatic. Views of the role and scope of US antitrust law began to change in the late 1970s,

² Makan Delrahim, “*The times they are a’changin’*”: *The Nine No-No’s in 2019*, Remarks as Prepared for the Licensing Executives Society (LES) 2019 Annual Meeting, October 21, 2019 at 2.

³ For a summary of several of these early cases, see Jorge L. Contreras, *A Brief History of FRAND: Analyzing Current Debates in Standard-Setting and Antitrust through a Historical Lens*, 80 *Antitrust L.J.* 39 (2015).

⁴ See Richard Gilbert & Carl Shapiro, *Antitrust Issues in the Licensing of Intellectual Property: The Nine No-No’s Meet the Nineties*, *Brookings Papers on Economic Activity: Microeconomics* 283, 285 (1997).

influenced by the rise of the “Chicago School” of law and economics and by the publication of Robert Bork’s deeply flawed but highly influential book *The Antitrust Paradox* (1978). Thus, by the early 1980s the DOJ began to reconsider the validity of the Nine No-Nos. In 1988, the DOJ issued a policy statement that shifted its analysis of most IP licensing practices from *per se* illegality to a “rule of reason” approach in which the potential anticompetitive effects of an arrangement are balanced against its procompetitive effects.⁵ Under the rule of reason, an arrangement will be condemned only if the anticompetitive effects outweigh the procompetitive effects.

In 1995, the DOJ and FTC jointly released a set of Antitrust Guidelines for the Licensing of Intellectual Property. As explained by Richard Gilbert and Carl Shapiro, the DOJ–FTC Guidelines embody three core principles regarding IP licensing:

- an explicit recognition of the generally procompetitive nature of licensing arrangements;
- a clear rejection of any presumption that IP necessarily creates market power in the antitrust context; and
- an endorsement of the validity of applying the same general antitrust approach to the analysis of conduct involving IP that the agencies apply to conduct involving other forms of tangible or intangible property.⁶

These core principles and the other elements of the 1995 DOJ–FTC Guidelines proved remarkably influential and long-lasting. They were only updated once, in 2017, and have largely retained their original intent and scope. We will see elements from the DOJ–FTC Guidelines throughout this chapter.

While the current approach to antitrust liability largely relies on the “rule of reason” analysis, there are still some areas of *per se* liability.

25.2 PRICE FIXING

Chief among the areas of *per se* liability today is price fixing and the related activity of bid rigging. Both are forms of impermissible collusion that violate Section 1 of the Sherman Act. Because liability is *per se*, “where such a collusive scheme has been established, it cannot be justified under the law by arguments or evidence that, for example, the agreed-upon prices were reasonable, the agreement was necessary to prevent or eliminate price cutting or ruinous competition, or the conspirators were merely trying to make sure that each got a fair share of the market.”⁷

The DOJ defines price fixing as follows:

Price fixing is an agreement among competitors to raise, fix, or otherwise maintain the price at which their goods or services are sold. It is not necessary that the competitors agree to charge exactly the same price, or that every competitor in a given industry join the conspiracy. Price fixing can take many forms, and any agreement that restricts price competition violates the law. Other examples of price-fixing agreements include those to:

- Establish or adhere to price discounts.
- Hold prices firm.

⁵ See Gilbert & Shapiro, *supra* note 4, at 286.

⁶ *Id.* at 287.

⁷ US Dept. Justice (DOJ), Price Fixing, Bid Rigging, and Market Allocation Schemes: What They Are and What to Look For, www.justice.gov/atr/price-fixing-bid-rigging-and-market-allocation-schemes (June 25, 2015).

- Eliminate or reduce discounts.
- Adopt a standard formula for computing prices.
- Maintain certain price differentials between different types, sizes, or quantities of products.
- Adhere to a minimum fee or price schedule.
- Fix credit terms.
- Not advertise prices.

In many cases, participants in a price-fixing conspiracy also establish some type of policing mechanism to make sure that everyone adheres to the agreement.⁸

Three Executives Indicted for Their Roles in the DRAM Price-Fixing & Bid-Rigging Conspiracy

US Department of Justice, October 18, 2006

WASHINGTON – A federal grand jury in San Francisco today returned an indictment against two executives from Samsung Electronics Ltd. (Samsung) and one executive from Hynix Semiconductor America Inc. (Hynix America) for their participation in a global conspiracy to fix DRAM prices, the Department of Justice announced.

Including today's charge, four companies and 16 individuals have been charged and fines totaling more than \$731 million have resulted from the Department's ongoing anti-trust investigation into the DRAM industry. The \$731 million in criminal fines is the second highest total obtained by the Department of Justice in a criminal antitrust investigation into a specific industry.

The indictment, filed today in the U.S. District Court in San Francisco, charged that Il Ung Kim, Young Bae Rha, and Gary Swanson participated with co-conspirators in the conspiracy from on or about April 1, 2001, until on or about June 15, 2002. At the time of the conspiracy, Kim was vice president of marketing for the memory division at Samsung. Rha was vice president of sales and marketing for the memory division at Samsung. Both Kim and Rha are citizens and residents of Korea. At the time of the conspiracy, Swanson was senior vice president of memory sales and marketing for Hynix America, the U.S.-based subsidiary of Hynix Semiconductor Inc. (Hynix), which is headquartered in Korea. Swanson is a resident and citizen of the United States.

DRAM is the most commonly used semiconductor memory product, providing high-speed storage and retrieval of electronic information for a wide variety of computer, telecommunication and consumer electronic products. DRAM is used in personal computers, laptops, workstations, servers, printers, hard disk drives, personal digital assistants (PDAs), modems, mobile phones, telecommunication hubs and routers, digital cameras, video recorders and TVs, digital set-top boxes, game consoles and digital music players. There were approximately \$7.7 billion in DRAM sales in the United States alone in 2004.

⁸ DOJ, Price Fixing, *supra* note 7.

The indictment charges that Kim, Rha, Swanson, and their co-conspirators carried out the conspiracy in a variety of ways, including:

- Attending meetings and participating in telephone conversations in the U.S. and elsewhere to discuss the prices of DRAM to be sold to certain original equipment manufacturers (OEMs);
- Agreeing during those meetings and telephone conversations to charge prices of DRAM at certain levels to be sold to certain OEMs;
- Exchanging information on sales of DRAM to certain OEM customers, for the purpose of monitoring and enforcing adherence to the agreed-upon prices;
- Agreeing during those meetings and telephone conversations to raise and maintain prices of DRAM to be sold to certain OEMs;
- Agreeing during those meetings and telephone discussions to rig the online auction, sponsored by Compaq Computer Corporation on Nov. 29, 2001, by not submitting a bid in the auction, or by submitting intentionally high prices on the bids in the auction ...

The Samsung employees agreed to serve prison terms ranging from seven to eight months and to each pay a \$250,000 fine. In total, four companies have been charged with price-fixing in the DRAM investigation. Samsung pleaded guilty to the price fixing conspiracy and was sentenced to pay a \$300 million criminal fine in November 2005. Hynix, the world's second largest DRAM manufacturer, pleaded guilty and was sentenced to pay a \$185 million criminal fine in May 2005. Japanese manufacturer Elpida Memory pleaded guilty and was sentenced to pay an \$84 million fine in March 2006. German manufacturer Infineon pleaded guilty and was sentenced to pay a \$160 million criminal fine in October 2004.

Notes and Questions

1. *The continuing DRAM saga.* In July 2006, shortly before the DOJ press release excerpted above, thirty-three states, including California, Massachusetts, Florida, New York and Pennsylvania, filed a class action lawsuit against DRAM makers alleging that their price-fixing scheme injured consumers, state agencies, universities and other groups. Two of the defendants reached a settlement for \$113 million in 2007, and the remainder of the class action settled in 2010 for \$173 million. Then, in 2018, another class action lawsuit was filed against DRAM manufacturers, this time for price fixing activity from 2016 to 2017. Why do you think the antitrust enforcement authorities are so intent on prosecuting price fixing? Are criminal penalties, including jail time, warranted by the offense?
2. *Output restrictions.* The classic price-fixing scenario is the one described in the DRAM case: executives of competing companies secretly collude to set prices for their products. But there are other avenues for price fixing. One of these is restricting output. As explained by the FTC:

An agreement to restrict production, sales, or output is just as illegal as direct price fixing, because reducing the supply of a product or service drives up its price. For example, the FTC challenged an agreement among competing oil importers to restrict the supply of lubricants by refusing to import or sell those products in Puerto Rico. The competitors were seeking to pressure the legislature to repeal an environmental deposit fee on lubricants, and warned of lubricant shortages and higher prices. The FTC alleged that the conspiracy was an unlawful

⁹ Fed. Trade Comm'n (FTC), Price Fixing, www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/dealings-competitors/price-fixing.

horizontal agreement to restrict output that was inherently likely to harm competition and that had no countervailing efficiencies that would benefit consumers.⁹

Are output restrictions just as harmful as explicit price fixing? Should they be subject to *per se* antitrust liability?

3. *Uncoordinated price movements.* Everyone has probably noticed that in many industries – air travel, higher education, retail gasoline – competing vendors offer prices that are surprisingly similar, and such prices often rise and fall in unison. Such coordinated price changes do not always indicate that illegal price fixing has occurred. As the FTC explains:

Not all price similarities, or price changes that occur at the same time, are the result of price fixing. On the contrary, they often result from normal market conditions. For example, prices of commodities such as wheat are often identical because the products are virtually identical, and the prices that farmers charge all rise and fall together without any agreement among them. If a drought causes the supply of wheat to decline, the price to all affected farmers will increase. An increase in consumer demand can also cause uniformly high prices for a product in limited supply.

...

Q: Our company monitors competitors' ads, and we sometimes offer to match special discounts or sales incentives for consumers. Is this a problem?

A: No. Matching competitors' pricing may be good business, and occurs often in highly competitive markets. Each company is free to set its own prices, and it may charge the same price as its competitors as long as the decision was not based on any agreement or coordination with a competitor.¹⁰

Where should the law draw the line between collusive price fixing and natural price convergence in competitive industries?

4. *Buyer-side cartels.* Just as a group of sellers who conspire to fix prices is a *per se* violation of Section 1 of the Sherman Act, so is a conspiracy among buyers to pressure suppliers to lower their prices, to refrain from selling to their competitors or to otherwise distort the market. Such buyer cartels, sometimes referred to as oligopsonies, typically arise with respect to tangible goods, but have also been alleged with respect to intangibles such as employee wages. By the same token, buyer cartels can, in theory, occur with respect to IP licenses. Consider a patent holder, for example, as the supplier of non-exclusive licenses, and potential licensees as its customers. Were the customers to collude improperly to pressure the patent holder to lower its license rates, a *per se* violation could be found.

The specter of such buyer-side arrangements has been raised in the context of industry standard-setting (see [Chapter 20](#)). For example, potential manufacturers of a standardized product could, in theory, pressure a patent holder to lower its royalty rate for a patent covering a standard (eventually approaching zero) on the threat that the manufacturers will otherwise cause the relevant standards-development organization (SDO) to “work around” the patent and exclude it from the standard.¹¹ Both the DOJ and the FTC, however, have indicated that coordination and information sharing among the members of an SDO can have significant procompetitive benefits, including preventing patent holders from charging excessive licensing fees. Accordingly, the agencies have indicated that a rule of reason analysis should be utilized in such cases. Which approach – *per se* liability or the rule of reason – do you find more persuasive in this context?

¹⁰ FTC, Price Fixing, *supra* note 9.

¹¹ See J. Gregory Sidak, *Patent Holdup and Oligopsonistic Collusion in Standard-Setting Organizations*, 5 J. Comp. L. & Econ. 123 (2009).

25.3 MARKET ALLOCATION

As explained by the FTC, “Plain agreements among competitors to divide sales territories or assign customers are almost always illegal. These arrangements are essentially agreements not to compete: ‘I won’t sell in your market if you don’t sell in mine.’”¹² For example, the FTC has prosecuted an arrangement in which two chemical companies agreed that one would not sell in North America if the other would not sell in Japan. In addition to dividing sales territories on a geographic basis, illegal market allocation may involve assigning a specific percentage of available business to each producer or assigning certain customers to each seller. The case that follows examines an allocation scheme that arose in the context of “store brand” groceries.

United States v. Topco Associates, Inc.

405 U.S. 596 (1972)

MARSHALL, JUSTICE

The United States brought this action for injunctive relief against alleged violation by Topco Associates, Inc. (Topco), of § 1 of the Sherman Act. Following a trial on the merits, the United States District Court for the Northern District of Illinois entered judgment for Topco, and we now reverse the judgment of the District Court.

I

Topco is a cooperative association of approximately 25 small and medium-sized regional supermarket chains that operate stores in some 33 States. Each of the member chains operates independently; there is no pooling of earnings, profits, capital, management, or advertising resources. No grocery business is conducted under the Topco name. Its basic function is to serve as a purchasing agent for its members.¹³ In this capacity, it procures and distributes to the members more than 1,000 different food and related nonfood items, most of which are distributed under brand names owned by Topco. The association does not itself own any manufacturing, processing, or warehousing facilities, and the items that it procures for members are usually shipped directly from the packer or manufacturer to the members. Payment is made either to Topco or directly to the manufacturer at a cost that is virtually the same for the members as for Topco itself.

All of the stock in Topco is owned by the members, with the common stock, the only stock having voting rights, being equally distributed. The board of directors, which controls the operation of the association, is drawn from the members and is normally composed of high-ranking executive officers of member chains. It is the board that elects the association’s officers and appoints committee members, and it is from the board that the principal executive officers of Topco must be drawn. Restrictions on the alienation of stock and the procedure for selecting all important officials of the association from within the ranks of

¹² FTC, Market Division or Customer Allocation, www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/dealings-competitors/market-division-or.

¹³ [n.2] In addition to purchasing various items for its members, Topco performs other related functions: e.g., it insures that there is adequate quality control on the products that it purchases; it assists members in developing specifications on certain types of products (e.g., equipment and supplies); and it also aids the members in purchasing goods through other sources.

its members give the members complete and unfettered control over the operations of the association.

Topco was founded in the 1940's by a group of small, local grocery chains, independently owned and operated, that desired to cooperate to obtain high quality merchandise under private labels in order to compete more effectively with larger national and regional chains.⁴ With a line of canned, dairy, and other products, the association began. It added frozen foods in 1950, fresh produce in 1958, more general merchandise equipment and supplies in 1960, and a branded bacon and carcass beef selection program in 1966. By 1964, Topco's members had combined retail sales of more than \$2 billion; by 1967, their sales totaled more than \$2.3 billion, a figure exceeded by only three national grocery chains.

Members of the association vary in the degree of market share that they possess in their respective areas. The range is from 1.5% to 16%, with the average being approximately 6%. While it is difficult to compare these figures with the market shares of larger regional and national chains because of the absence in the record of accurate statistics for these chains, there is much evidence in the record that Topco members are frequently in as strong a competitive position in their respective areas as any other chain. The strength of this competitive position is due, in some measure, to the success of Topco-brand products. Although only 10% of the total goods sold by Topco members bear the association's brand names, the profit on these goods is substantial and their very existence has improved the competitive potential of Topco members with respect to other large and powerful chains.

It is apparent that from meager beginnings approximately a quarter of a century ago, Topco has developed into a purchasing association wholly owned and operated by member chains, which possess much economic muscle, individually as well as cooperatively.

II

The United States charged that, beginning at least as early as 1960 and continuing up to the time that the complaint was filed, Topco had combined and conspired with its members to violate [§ 1 of the Sherman Act] in two respects. First, the Government alleged that there existed:

a continuing agreement, understanding and concert of action among the co-conspirator member firms acting through Topco, the substantial terms of which have been and are that each co-conspirator or member firm will sell Topco-controlled brands only within the marketing territory allocated to it, and will refrain from selling Topco-controlled brands outside such marketing territory.

⁴ [n.3] The founding members of Topco were having difficulty competing with larger chains. This difficulty was attributable in some degree to the fact that the larger chains were capable of developing their own private-label programs. Private-label products differ from other brand-name products in that they are sold at a limited number of easily ascertainable stores. A&P, for example, was a pioneer in developing a series of products that were sold under an A&P label and that were only available in A&P stores. It is obvious that by using private-label products, a chain can achieve significant cost economies in purchasing, transportation, warehousing, promotion, and advertising. These economies may afford the chain opportunities for offering private-label products at lower prices than other brand-name products. This, in turn, provides many advantages of which some of the more important are: a store can offer national-brand products at the same price as other stores, while simultaneously offering a desirable, lower priced alternative; or, if the profit margin is sufficiently high on private-brand goods, national-brand products may be sold at reduced price. Other advantages include: enabling a chain to bargain more favorably with national-brand manufacturers by creating a broader supply base of manufacturers, thereby decreasing dependence on a few, large national-brand manufacturers; enabling a chain to create a "price-mix" whereby prices on special items can be lowered to attract customers while profits are maintained on other items; and creation of general goodwill by offering lower priced, higher quality goods.

The division of marketing territories to which the complaint refers consists of a number of practices by the association. Article IX, § 2, of the Topco bylaws establishes three categories of territorial licenses that members may secure from the association:

- (a) “Exclusive—An exclusive territory is one in which the member is licensed to sell all products bearing specified trademarks of the Association, to the exclusion of all other persons.
- (b) “Non-exclusive—A non-exclusive territory is one in which a member is licensed to sell all products bearing specified trademarks of the Association, but not to the exclusion of others who may also be licensed to sell products bearing the same trademarks of the Association in the same territory.
- (c) “Coextensive—A coextensive territory is one in which two (2) or more members are licensed to sell all products bearing specified trademarks of the Association to the exclusion of all other persons ...”

When applying for membership, a chain must designate the type of license that it desires. Membership must first be approved by the board of directors, and thereafter by an affirmative vote of 75% of the association’s members. If, however, the member whose operations are closest to those of the applicant, or any member whose operations are located within 100 miles of the applicant, votes against approval, an affirmative vote of 85% of the members is required for approval. Because, as indicated by the record, members cooperate in accommodating each other’s wishes, the procedure for approval provides, in essence, that members have a veto of sorts over actual or potential competition in the territorial areas in which they are concerned.

Following approval, each new member signs an agreement with Topco designating the territory in which that member may sell Topco-brand products. No member may sell these products outside the territory in which it is licensed. Most licenses are exclusive, and even those denominated “coextensive” or “non-exclusive” prove to be de facto exclusive.



FIGURE 25.3 Some of the brands developed by Topco.

Exclusive territorial areas are often allocated to members who do no actual business in those areas on the theory that they may wish to expand at some indefinite future time and that expansion would likely be in the direction of the allocated territory. When combined with each member's veto power over new members, provisions for exclusivity work effectively to insulate members from competition in Topco-brand goods. Should a member violate its license agreement and sell in areas other than those in which it is licensed, its membership can be terminated under the bylaws. Once a territory is classified as exclusive, either formally or de facto, it is extremely unlikely that the classification will ever be changed.

The Government maintains that this scheme of dividing markets violates the Sherman Act because it operates to prohibit competition in Topco-brand products among grocery chains engaged in retail operations. The Government also makes a subsidiary challenge to Topco's practices regarding licensing members to sell at wholesale. Under the bylaws, members are not permitted to sell any products supplied by the association at wholesale, whether trademarked or not, without first applying for and receiving special permission from the association to do so. Before permission is granted, other licensees (usually retailers), whose interests may potentially be affected by wholesale operations, are consulted as to their wishes in the matter. If permission is obtained, the member must agree to restrict the sale of Topco products to a specific geographic area and to sell under any conditions imposed by the association. Permission to wholesale has often been sought by members, only to be denied by the association. The Government contends that this amounts not only to a territorial restriction violative of the Sherman Act, but also to a restriction on customers that in itself is violative of the Act.

Topco's answer to the complaint is illustrative of its posture in the District Court and before this Court:

Private label merchandising is a way of economic life in the food retailing industry, and exclusivity is the essence of a private label program; without exclusivity, a private label would not be private. Each national and large regional chain has its own exclusive private label products in addition to the nationally advertised brands which all chains sell. Each such chain relies upon the exclusivity of its own private label line to differentiate its private label products from those of its competitors and to attract and retain the repeat business and loyalty of consumers. Smaller retail grocery stores and chains are unable to compete effectively with the national and large regional chains without also offering their own exclusive private label products.

The only feasible method by which Topco can procure private label products and assure the exclusivity thereof is through trademark licenses specifying the territory in which each member may sell such trademarked products.

Topco essentially maintains that it needs territorial divisions to compete with larger chains; that the association could not exist if the territorial divisions were anything but exclusive; and that by restricting competition in the sale of Topco-brand goods, the association actually increases competition by enabling its members to compete successfully with larger regional and national chains.

III

On its face, § 1 of the Sherman Act appears to bar any combination of entrepreneurs so long as it is "in restraint of trade." Theoretically, all manufacturers, distributors, merchants, sellers, and buyers could be considered as potential competitors of each other. Were § 1 to

be read in the narrowest possible way, any commercial contract could be deemed to violate it. The history underlying the formulation of the antitrust laws led this Court to conclude, however, that Congress did not intend to prohibit all contracts, nor even all contracts that might in some insignificant degree or attenuated sense restrain trade or competition. In lieu of the narrowest possible reading of § 1, the Court adopted a “rule of reason” analysis for determining whether most business combinations or contracts violate the prohibitions of the Sherman Act. An analysis of the reasonableness of particular restraints includes consideration of the facts peculiar to the business in which the restraint is applied, the nature of the restraint and its effects, and the history of the restraint and the reasons for its adoption.

While the Court has utilized the “rule of reason” in evaluating the legality of most restraints alleged to be violative of the Sherman Act, it has also developed the doctrine that certain business relationships are *per se* violations of the Act without regard to a consideration of their reasonableness. In *Northern Pacific R. Co. v. United States*, 356 U.S. 1, 5 (1958), Mr. Justice Black explained the appropriateness of, and the need for, *per se* rules:

[T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This principle of *per se* unreasonableness not only makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned, but it also avoids the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved, as well as related industries, in an effort to determine at large whether a particular restraint has been unreasonable—an inquiry so often wholly fruitless when undertaken.

It is only after considerable experience with certain business relationships that courts classify them as *per se* violations of the Sherman Act. One of the classic examples of a *per se* violation of § 1 is an agreement between competitors at the same level of the market structure to allocate territories in order to minimize competition. Such concerted action is usually termed a “horizontal” restraint, in contradistinction to combinations of persons at different levels of the market structure, e.g., manufacturers and distributors, which are termed “vertical” restraints. This Court has reiterated time and time again that “(h)orizontal territorial limitations ... are naked restraints of trade with no purpose except stifling of competition.”

We think that it is clear that the restraint in this case is a horizontal one, and, therefore, a *per se* violation of § 1. The District Court failed to make any determination as to whether there were *per se* horizontal territorial restraints in this case and simply applied a rule of reason in reaching its conclusions that the restraints were not illegal. In so doing, the District Court erred.

United States v. Sealy, Inc., is, in fact, on all fours with this case. Sealy licensed manufacturers of mattresses and bedding to make and sell products using the Sealy trademark. Like Topco, Sealy was a corporation owned almost entirely by its licensees, who elected the Board of Directors and controlled the business. Just as in this case, Sealy agreed with the licensees not to license other manufacturers or sellers to sell Sealy-brand products in a designated territory in exchange for the promise of the licensee who sold in that territory not to expand its sales beyond the area demarcated by Sealy. The Court held that this was a horizontal territorial restraint, which was *per se* violative of the Sherman Act.

Whether or not we would decide this case the same way under the rule of reason used by the District Court is irrelevant to the issue before us. The fact is that courts are of limited utility in examining difficult economic problems. Our inability to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another sector is one important reason we have formulated *per se* rules.

In applying these rigid rules, the Court has consistently rejected the notion that naked restraints of trade are to be tolerated because they are well intended or because they are allegedly developed to increase competition.

Antitrust laws in general, and the Sherman Act in particular, are the Magna Carta of free enterprise. They are as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms. And the freedom guaranteed each and every business, no matter how small, is the freedom to compete—to assert with vigor, imagination, devotion, and ingenuity whatever economic muscle it can muster. Implicit in such freedom is the notion that it cannot be foreclosed with respect to one sector of the economy because certain private citizens or groups believe that such foreclosure might promote greater competition in a more important sector of the economy.

The District Court determined that by limiting the freedom of its individual members to compete with each other, Topco was doing a greater good by fostering competition between members and other large supermarket chains. But, the fallacy in this is that Topco has no authority under the Sherman Act to determine the respective values of competition in various sectors of the economy. On the contrary, the Sherman Act gives to each Topco member and to each prospective member the right to ascertain for itself whether or not competition with other supermarket chains is more desirable than competition in the sale of Topco-brand products. Without territorial restrictions, Topco members may indeed “(cut) each other’s throats.” But we have never found this possibility sufficient to warrant condoning horizontal restraints of trade.

The Court has previously noted with respect to price fixing, another *per se* violation of the Sherman Act, that:

The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow. Once established, it may be maintained unchanged because of the absence of competition secured by the agreement for a price reasonable when fixed.

A similar observation can be made with regard to territorial limitations.

There have been tremendous departures from the notion of a free-enterprise system as it was originally conceived in this country. These departures have been the product of congressional action and the will of the people. If a decision is to be made to sacrifice competition in one portion of the economy for greater competition in another portion this too is a decision that must be made by Congress and not by private forces or by the courts. Private forces are too keenly aware of their own interests in making such decisions and courts are ill-equipped and ill-situated for such decisionmaking. To analyze, interpret, and evaluate the myriad of competing interests and the endless data that would surely be brought to bear on such decisions, and to make the delicate judgment on the relative values to society of competitive areas of the economy, the judgment of the elected representatives of the people is required.

Just as the territorial restrictions on retailing Topco-brand products must fall, so must the territorial restrictions on wholesaling. The considerations are the same, and the Sherman Act requires identical results.

We also strike down Topco's other restrictions on the right of its members to wholesale goods. These restrictions amount to regulation of the customers to whom members of Topco may sell Topco-brand goods. Like territorial restrictions, limitations on customers are intended to limit intra-brand competition and to promote inter-brand competition. For the reasons previously discussed, the arena in which Topco members compete must be left to their unfettered choice absent a contrary congressional determination.

We reverse the judgment of the District Court and remand the case for entry of an appropriate decree.

Notes and Questions

1. *Good intentions?* The Court in *Topco* states that it "has consistently rejected the notion that naked restraints of trade are to be tolerated because they are well intended or because they are allegedly developed to increase competition." Why shouldn't intent matter when analyzing restraints such as those imposed in *Topco*?
2. *Bad intentions.* Just as a party's good or innocent intentions don't affect antitrust analysis, its intent to compete ruthlessly in the market doesn't either. As Judge Easterbrook of the Seventh Circuit wrote in *A.A. Poultry v. Rose Acre*, 881 F.2d 1396 (7th Cir. 1989):

Firms intend to ... crush their rivals if they can. Intent to harm without more offers too vague a standard ... Rivalry is harsh, and consumers gain the most when firms slash costs to the bone and pare price down to cost, all in pursuit of more business ... If courts use the vigorous, nasty pursuit of sales as evidence of a forbidden intent, they run the risk of penalizing the motive forces of competition.

Do you agree with Judge Easterbrook's reasoning? Is a firm's ruthlessness irrelevant to antitrust analysis? Should it be?

3. *Per se liability.* Market allocation is one of the few remaining areas of *per se* antitrust liability. Do you think that the harm arising from arrangements such as that described in *Topco* warrants *per se* liability? How comparable is market allocation to price fixing? Are the potential injuries to competition similar?
4. *The Magna Carta of free enterprise.* Why does Justice Marshall refer to the Sherman Act as "the Magna Carta of free enterprise"? Do you agree with his characterization? Are there other laws that are equally as important to the free enterprise system? What would happen to the market economy if there were no antitrust laws?
5. *The reformed Topco program.* On remand, the district court entered the following order, which was summarily affirmed by the Supreme Court (414 U.S. 801 (1975)):

Defendant is ordered and directed ... to amend its bylaws, Membership and Licensing Agreements, resolutions, rules and regulations to eliminate therefrom any provision which in any way limits or restricts the territories within which or the persons to whom any member firm may sell Topco brand products.

...

Notwithstanding the foregoing provisions, nothing in this Final Judgment shall prevent defendant from creating or eliminating areas or territories of prime responsibility of member firms; from designating the location of the place or places of business for which a trademark

license is issued; from determining warehouse locations to which it will ship products; from terminating the membership of any organization which does not adequately promote the sale of Topco brand products; from formulating and implementing passovers or other procedures for reasonable compensation for good will developed for defendant's trademarks in geographic areas in which another member firm begins to sell trademarked products; or from engaging in any activity rendered lawful by subsequent legislation enacted by the Congress of the United States.

How are the activities that Topco and its members are permitted to engage in under this order different than those that were challenged by the DOJ? How will Topco's new restrictions promote competition?

6. *The IP licensing "safety zone."* Recognizing the inherent procompetitive features of IP licensing arrangements, the DOJ and FTC established in § 4.3 of their 2017 *Antitrust Guidelines for the Licensing of Intellectual Property* an antitrust "safety zone" for licensing arrangements.¹⁵ There, the agencies indicate that they "will not challenge a restraint in an intellectual property licensing arrangement" (other than a restraint that is "facially anti-competitive") if "the licensor and its licensees collectively account for no more than twenty percent of each relevant market significantly affected by the restraint," or "four or more independently controlled entities in addition to the parties to the licensing arrangement possess the required specialized assets or characteristics and the incentive to engage in research and development that is a close substitute of the research and development activities of the parties to the licensing agreement." In effect, these guidelines recognize that below a certain level of market dominance, even otherwise anticompetitive arrangements have limited potential to harm competition in the market. The exception, of course, is "facially anticompetitive" activity, which is generally understood to mean any conduct that would be *per se* illegal. Do you agree with the idea of thresholds below which antitrust enforcement will not be pursued? Why doesn't this logic apply to *per se* illegal conduct? Should it?

ANTITRUST REMEDIES

Violation of the Sherman Act is a felony punishable by a fine of up to \$100 million for corporations, and a fine of up to \$1 million and up to ten years imprisonment (or both) for individuals. Under some circumstances, the maximum fine may be increased to twice the gain or loss involved, and restitution to victims may be ordered. Only the Department of Justice has the authority to prosecute criminal actions under the Sherman Act, but rarely does so with respect to anticompetitive conduct involving IP.

The FTC may impose fines on parties that have violated an existing order prohibiting certain conduct. In July 2019, the FTC imposed a fine of \$5 billion on Google for allegedly violating a 2012 FTC order relating to consumer privacy.

In addition to criminal sanctions and fines, private parties injured "by reason of anything forbidden in the antitrust laws" may bring suit and "shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee" (15 U.S.C. § 15(a)).

¹⁵ US DOJ & FTC, *Antitrust Guidelines for the Licensing of Intellectual Property* (1995). The 1995 Guidelines were updated in 2017 with only minor changes. US DOJ & FTC, *Antitrust Guidelines for the Licensing of Intellectual Property* (2017) [hereinafter DOJ-FTC 2017 Licensing Guidelines].

Both government enforcement agencies and private plaintiffs may seek preliminary and permanent injunctive relief to prevent the continuation of anticompetitive conduct. Injunctive relief may consist of relatively common “cease and desist” orders (behavioral remedies), as well as “structural” remedies that require a firm to divest portions of its business. Structural remedies are the most common in merger cases, but have also been imposed in large monopolization cases. The most famous of these is the 1984 break-up of AT&T, which split the massive enterprise into a long-distance carrier, seven regional service operators (the “Baby Bells”) and an equipment supplier (Western Electric). In the *Microsoft* case (see [Section 25.6](#)), the district court ordered Microsoft to divest its internet browser operations, though that order was eventually overturned on appeal.

Many remedial measures in antitrust cases are imposed not through judicial decisions, but through orders by the enforcement agency. If the government and the defendant agree to settle litigation brought by the agency, they may stipulate the terms of settlement in a mutually agreed “consent decree,” which is submitted to the court for entry into the record. Though not fully adjudicated, a consent decree has the force of judicial decision, enforceable on penalty of contempt. If, on the other hand, the defendant denies the allegations brought by the government or otherwise rejects the terms of a proposed order, the parties may litigate and the court may fashion a remedial decree based on its assessment of the case and the parties’ respective arguments. Such a decree is termed a “contested decree.”

The compulsory licensing of patents and other IP rights is sometimes required under antitrust remedial orders. From the 1940s through the 1970s, federal courts in antitrust cases approved more than 100 remedial patent licensing decrees, often requiring that patents be licensed to potential users on “fair, reasonable and nondiscriminatory” terms in order to remedy anticompetitive arrangements involving those patents.¹⁶

25.4 VERTICAL RESTRAINTS: RESALE PRICE MAINTENANCE

The antitrust violations discussed above have related largely to conspiracies among competitors – so-called “horizontal” arrangements. Anticompetitive arrangements can also exist, however, between suppliers and resellers or manufacturers and customers in what are called “vertical” relationships. For example, a manufacturer may assign different geographical markets to different distributors of its products. Unlike the horizontal territorial restraints discussed in *Topco*, this type of vertical territorial restraint is generally viewed as permissible under the rule of reason. See *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977).

Resale price maintenance is an arrangement whereby an “upstream” supplier or licensor requires that its “downstream” distributors, resellers or licensees sell products at certain minimum prices. That is, the supplier establishes a floor on prices of downstream products. Traditionally, this practice looked a lot like price fixing, which is *per se* illegal under Section 1 of the Sherman Act. However, in the following case the Supreme Court establishes that such vertical restraints should be evaluated under the “rule of reason.”

¹⁶ See Contreras, *FRAND History*, *supra* note 3 (cataloging and discussing these historical consent decrees).

Leegin Creative Leather Products, Inc. v. PSKS, Inc., dba Kay's Kloset
551 U.S. 877 (2007)

KENNEDY, JUSTICE

In *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U. S. 373 (1911), the Court established the rule that it is per se illegal under §1 of the Sherman Act, 15 U. S. C. §1, for a manufacturer to agree with its distributor to set the minimum price the distributor can charge for the manufacturer's goods. The question presented by the instant case is whether the Court should overrule the per se rule and allow resale price maintenance agreements to be judged by the rule of reason, the usual standard applied to determine if there is a violation of §1. The Court has abandoned the rule of per se illegality for other vertical restraints a manufacturer imposes on its distributors. Respected economic analysts, furthermore, conclude that vertical price restraints can have procompetitive effects. We now hold that *Dr. Miles* should be overruled and that vertical price restraints are to be judged by the rule of reason.

I

Petitioner, Leegin Creative Leather Products, Inc. (Leegin), designs, manufactures, and distributes leather goods and accessories. In 1991, Leegin began to sell belts under the brand name "Brighton." The Brighton brand has now expanded into a variety of women's fashion accessories. It is sold across the United States in over 5,000 retail establishments, for the most part independent, small boutiques and specialty stores. Leegin's president, Jerry Kohl, also has an interest in about 70 stores that sell Brighton products. Leegin asserts that, at least for its products, small retailers treat customers better, provide customers more services, and make their shopping experience more satisfactory than do larger, often impersonal retailers. Kohl explained: "[W]e want the consumers to get a different experience than they get in Sam's Club or in Wal-Mart. And you can't get that kind of experience or support or customer service from a store like Wal-Mart."

Respondent, PSKS, Inc. (PSKS), operates Kay's Kloset, a women's apparel store in Lewisville, Texas. Kay's Kloset buys from about 75 different manufacturers and at one time sold the Brighton brand. It first started purchasing Brighton goods from Leegin in 1995. Once it began selling the brand, the store promoted Brighton. For example, it ran Brighton advertisements and had Brighton days in the store. Kay's Kloset became the destination



FIGURE 25.4 Brighton handbag and belt by Leegin.

retailer in the area to buy Brighton products. Brighton was the store's most important brand and once accounted for 40 to 50 percent of its profits.

In 1997, Leegin instituted the "Brighton Retail Pricing and Promotion Policy." Following the policy, Leegin refused to sell to retailers that discounted Brighton goods below suggested prices. The policy contained an exception for products not selling well that the retailer did not plan on reordering. In the letter to retailers establishing the policy, Leegin stated:

"In this age of mega stores like Macy's, Bloomingdales, May Co. and others, consumers are perplexed by promises of product quality and support of product which we believe is lacking in these large stores. Consumers are further confused by the ever popular sale, sale, sale, etc.

"We, at Leegin, choose to break away from the pack by selling [at] specialty stores; specialty stores that can offer the customer great quality merchandise, superb service, and support the Brighton product 365 days a year on a consistent basis.

"We realize that half the equation is Leegin producing great Brighton product and the other half is you, our retailer, creating great looking stores selling our products in a quality manner."

Leegin adopted the policy to give its retailers sufficient margins to provide customers the service central to its distribution strategy. It also expressed concern that discounting harmed Brighton's brand image and reputation.

A year after instituting the pricing policy Leegin introduced a marketing strategy known as the "Heart Store Program." It offered retailers incentives to become Heart Stores, and, in exchange, retailers pledged, among other things, to sell at Leegin's suggested prices. Kay's Kloset became a Heart Store soon after Leegin created the program. After a Leegin employee visited the store and found it unattractive, the parties appear to have agreed that Kay's Kloset would not be a Heart Store beyond 1998. Despite losing this status, Kay's Kloset continued to increase its Brighton sales.

In December 2002, Leegin discovered Kay's Kloset had been marking down Brighton's entire line by 20 percent. Kay's Kloset contended it placed Brighton products on sale to compete with nearby retailers who also were undercutting Leegin's suggested prices. Leegin, nonetheless, requested that Kay's Kloset cease discounting. Its request refused, Leegin stopped selling to the store. The loss of the Brighton brand had a considerable negative impact on the store's revenue from sales.

PSKS sued Leegin in the United States District Court for the Eastern District of Texas. It alleged, among other claims, that Leegin had violated the antitrust laws by "enter[ing] into agreements with retailers to charge only those prices fixed by Leegin." Leegin planned to introduce expert testimony describing the procompetitive effects of its pricing policy. The District Court excluded the testimony, relying on the *per se* rule established by *Dr. Miles*. At trial PSKS argued that the Heart Store program, among other things, demonstrated Leegin and its retailers had agreed to fix prices. Leegin responded that it had established a unilateral pricing policy lawful under §1, which applies only to concerted action. The jury agreed with PSKS and awarded it \$1.2 million. Pursuant to 15 U. S. C. §15(a), the District Court trebled the damages and reimbursed PSKS for its attorney's fees and costs. It entered judgment against Leegin in the amount of \$3,975,000.80.

The Court of Appeals for the Fifth Circuit affirmed. On appeal Leegin did not dispute that it had entered into vertical price-fixing agreements with its retailers. Rather, it

contended that the rule of reason should have applied to those agreements. The Court of Appeals rejected this argument. We granted certiorari to determine whether vertical minimum resale price maintenance agreements should continue to be treated as *per se* unlawful.

II

The rule of reason is the accepted standard for testing whether a practice restrains trade in violation of §1. In its design and function the rule distinguishes between restraints with anticompetitive effect that are harmful to the consumer and restraints stimulating competition that are in the consumer's best interest.

The rule of reason does not govern all restraints. Some types "are deemed unlawful *per se*." The *per se* rule, treating categories of restraints as necessarily illegal, eliminates the need to study the reasonableness of an individual restraint in light of the real market forces at work; and, it must be acknowledged, the *per se* rule can give clear guidance for certain conduct. Restraints that are *per se* unlawful include horizontal agreements among competitors to fix prices or to divide markets.

Resort to *per se* rules is confined to restraints, like those mentioned, "that would always or almost always tend to restrict competition and decrease output." To justify a *per se* prohibition a restraint must have "manifestly anticompetitive" effects and "lack of any redeeming virtue."

As a consequence, the *per se* rule is appropriate only after courts have had considerable experience with the type of restraint at issue, and only if courts can predict with confidence that it would be invalidated in all or almost all instances under the rule of reason. It should come as no surprise, then, that "we have expressed reluctance to adopt *per se* rules with regard to restraints imposed in the context of business relationships where the economic impact of certain practices is not immediately obvious." And, as we have stated, a "departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than ... upon formalistic line drawing."

III

The Court has interpreted *Dr. Miles* as establishing a *per se* rule against a vertical agreement between a manufacturer and its distributor to set minimum resale prices. In *Dr. Miles* the plaintiff, a manufacturer of medicines, sold its products only to distributors who agreed to resell them at set prices. The Court found the manufacturer's control of resale prices to be unlawful. It relied on the common-law rule that "a general restraint upon alienation is ordinarily invalid." The Court then explained that the agreements would advantage the distributors, not the manufacturer, and were analogous to a combination among competing distributors, which the law treated as void.

The reasoning of the Court's more recent jurisprudence has rejected the rationales on which *Dr. Miles* was based. By relying on the common-law rule against restraints on alienation, the Court justified its decision based on "formalistic" legal doctrine rather than "demonstrable economic effect". Yet the Sherman Act's use of "restraint of trade" "invokes the common law itself, and not merely the static content that the common law had assigned to the term in 1890." The general restraint on alienation, especially in the age when then-Justice Hughes used the term, tended to evoke policy concerns extraneous to the question that controls here. Usually associated with land, not chattels, the rule arose from restrictions removing real property from the stream of commerce for generations.

The Court should be cautious about putting dispositive weight on doctrines from antiquity but of slight relevance.

Dr. Miles, furthermore, treated vertical agreements a manufacturer makes with its distributors as analogous to a horizontal combination among competing distributors. In later cases, however, the Court rejected the approach of reliance on rules governing horizontal restraints when defining rules applicable to vertical ones. Our recent cases formulate anti-trust principles in accordance with the appreciated differences in economic effect between vertical and horizontal agreements, differences the *Dr. Miles* Court failed to consider.

The reasons upon which *Dr. Miles* relied do not justify a *per se* rule. As a consequence, it is necessary to examine, in the first instance, the economic effects of vertical agreements to fix minimum resale prices, and to determine whether the *per se* rule is nonetheless appropriate.

A

Though each side of the debate can find sources to support its position, it suffices to say here that economics literature is replete with procompetitive justifications for a manufacturer's use of resale price maintenance. The few recent studies documenting the competitive effects of resale price maintenance also cast doubt on the conclusion that the practice meets the criteria for a *per se* rule.

The justifications for vertical price restraints are similar to those for other vertical restraints. Minimum resale price maintenance can stimulate interbrand competition—the competition among manufacturers selling different brands of the same type of product—by reducing intrabrand competition—the competition among retailers selling the same brand. The promotion of interbrand competition is important because “the primary purpose of the antitrust laws is to protect [this type of] competition.” A single manufacturer's use of vertical price restraints tends to eliminate intrabrand price competition; this in turn encourages retailers to invest in tangible or intangible services or promotional efforts that aid the manufacturer's position as against rival manufacturers. Resale price maintenance also has the potential to give consumers more options so that they can choose among low-price, low-service brands; high-price, high-service brands; and brands that fall in between.

Absent vertical price restraints, the retail services that enhance interbrand competition might be underprovided. This is because discounting retailers can free ride on retailers who furnish services and then capture some of the increased demand those services generate. Consumers might learn, for example, about the benefits of a manufacturer's product from a retailer that invests in fine showrooms, offers product demonstrations, or hires and trains knowledgeable employees. Or consumers might decide to buy the product because they see it in a retail establishment that has a reputation for selling high-quality merchandise. If the consumer can then buy the product from a retailer that discounts because it has not spent capital providing services or developing a quality reputation, the high-service retailer will lose sales to the discounter, forcing it to cut back its services to a level lower than consumers would otherwise prefer. Minimum resale price maintenance alleviates the problem because it prevents the discounter from undercutting the service provider. With price competition decreased, the manufacturer's retailers compete among themselves over services.

Resale price maintenance, in addition, can increase interbrand competition by facilitating market entry for new firms and brands. “[N]ew manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive

retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer.” New products and new brands are essential to a dynamic economy, and if markets can be penetrated by using resale price maintenance there is a procompetitive effect.

Resale price maintenance can also increase interbrand competition by encouraging retailer services that would not be provided even absent free riding. It may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying the different services the retailer must perform. Offering the retailer a guaranteed margin and threatening termination if it does not live up to expectations may be the most efficient way to expand the manufacturer’s market share by inducing the retailer’s performance and allowing it to use its own initiative and experience in providing valuable services.

B

While vertical agreements setting minimum resale prices can have procompetitive justifications, they may have anticompetitive effects in other cases; and unlawful price fixing, designed solely to obtain monopoly profits, is an ever present temptation. Resale price maintenance may, for example, facilitate a manufacturer cartel. An unlawful cartel will seek to discover if some manufacturers are undercutting the cartel’s fixed prices. Resale price maintenance could assist the cartel in identifying price-cutting manufacturers who benefit from the lower prices they offer. Resale price maintenance, furthermore, could discourage a manufacturer from cutting prices to retailers with the concomitant benefit of cheaper prices to consumers.

Vertical price restraints also “might be used to organize cartels at the retailer level.” A group of retailers might collude to fix prices to consumers and then compel a manufacturer to aid the unlawful arrangement with resale price maintenance. In that instance the manufacturer does not establish the practice to stimulate services or to promote its brand but to give inefficient retailers higher profits. Retailers with better distribution systems and lower cost structures would be prevented from charging lower prices by the agreement.

A horizontal cartel among competing manufacturers or competing retailers that decreases output or reduces competition in order to increase price is, and ought to be, *per se* unlawful. To the extent a vertical agreement setting minimum resale prices is entered upon to facilitate either type of cartel, it, too, would need to be held unlawful under the rule of reason. This type of agreement may also be useful evidence for a plaintiff attempting to prove the existence of a horizontal cartel.

Resale price maintenance, furthermore, can be abused by a powerful manufacturer or retailer. A dominant retailer, for example, might request resale price maintenance to forestall innovation in distribution that decreases costs. A manufacturer might consider it has little choice but to accommodate the retailer’s demands for vertical price restraints if the manufacturer believes it needs access to the retailer’s distribution network. A manufacturer with market power, by comparison, might use resale price maintenance to give retailers an incentive not to sell the products of smaller rivals or new entrants. As should be evident, the potential anticompetitive consequences of vertical price restraints must not be ignored or underestimated.

C

Notwithstanding the risks of unlawful conduct, it cannot be stated with any degree of confidence that resale price maintenance “always or almost always tend[s] to restrict competition

and decrease output.” Vertical agreements establishing minimum resale prices can have either procompetitive or anticompetitive effects, depending upon the circumstances in which they are formed. And although the empirical evidence on the topic is limited, it does not suggest efficient uses of the agreements are infrequent or hypothetical. As the rule would proscribe a significant amount of procompetitive conduct, these agreements appear ill suited for per se condemnation.

Respondent contends, nonetheless, that vertical price restraints should be per se unlawful because of the administrative convenience of per se rules. That argument suggests per se illegality is the rule rather than the exception. This misinterprets our antitrust law. Per se rules may decrease administrative costs, but that is only part of the equation. Those rules can be counterproductive. They can increase the total cost of the antitrust system by prohibiting procompetitive conduct the antitrust laws should encourage. They also may increase litigation costs by promoting frivolous suits against legitimate practices. The Court has thus explained that administrative “advantages are not sufficient in themselves to justify the creation of per se rules,” and has relegated their use to restraints that are “manifestly anticompetitive”. Were the Court now to conclude that vertical price restraints should be per se illegal based on administrative costs, we would undermine, if not overrule, the traditional “demanding standards” for adopting per se rules. Any possible reduction in administrative costs cannot alone justify the *Dr. Miles* rule.

Respondent also argues the per se rule is justified because a vertical price restraint can lead to higher prices for the manufacturer’s goods. Respondent is mistaken in relying on pricing effects absent a further showing of anticompetitive conduct. For, as has been indicated already, the antitrust laws are designed primarily to protect interbrand competition, from which lower prices can later result. The Court, moreover, has evaluated other vertical restraints under the rule of reason even though prices can be increased in the course of promoting procompetitive effects. And resale price maintenance may reduce prices if manufacturers have resorted to costlier alternatives of controlling resale prices that are not per se unlawful.

Respondent’s argument, furthermore, overlooks that, in general, the interests of manufacturers and consumers are aligned with respect to retailer profit margins. The difference between the price a manufacturer charges retailers and the price retailers charge consumers represents part of the manufacturer’s cost of distribution, which, like any other cost, the manufacturer usually desires to minimize. A manufacturer has no incentive to overcompensate retailers with unjustified margins. The retailers, not the manufacturer, gain from higher retail prices. The manufacturer often loses; interbrand competition reduces its competitiveness and market share because consumers will “substitute a different brand of the same product.” As a general matter, therefore, a single manufacturer will desire to set minimum resale prices only if the “increase in demand resulting from enhanced service . . . will more than offset a negative impact on demand of a higher retail price.”

The implications of respondent’s position are far reaching. Many decisions a manufacturer makes and carries out through concerted action can lead to higher prices. A manufacturer might, for example, contract with different suppliers to obtain better inputs that improve product quality. Or it might hire an advertising agency to promote awareness of its goods. Yet no one would think these actions violate the Sherman Act because they lead to higher prices. The antitrust laws do not require manufacturers to produce generic goods that consumers do not know about or want. The manufacturer strives to improve its product quality or to promote its brand because it believes this conduct will lead to increased demand despite higher prices. The same can hold true for resale price maintenance.

Resale price maintenance, it is true, does have economic dangers. If the rule of reason were to apply to vertical price restraints, courts would have to be diligent in eliminating their anticompetitive uses from the market. This is a realistic objective, and certain factors are relevant to the inquiry. For example, the number of manufacturers that make use of the practice in a given industry can provide important instruction. When only a few manufacturers lacking market power adopt the practice, there is little likelihood it is facilitating a manufacturer cartel, for a cartel then can be undercut by rival manufacturers. Likewise, a retailer cartel is unlikely when only a single manufacturer in a competitive market uses resale price maintenance. Interbrand competition would divert consumers to lower priced substitutes and eliminate any gains to retailers from their price-fixing agreement over a single brand. Resale price maintenance should be subject to more careful scrutiny, by contrast, if many competing manufacturers adopt the practice.

The source of the restraint may also be an important consideration. If there is evidence retailers were the impetus for a vertical price restraint, there is a greater likelihood that the restraint facilitates a retailer cartel or supports a dominant, inefficient retailer. If, by contrast, a manufacturer adopted the policy independent of retailer pressure, the restraint is less likely to promote anticompetitive conduct. A manufacturer also has an incentive to protest inefficient retailer-induced price restraints because they can harm its competitive position.

As a final matter, that a dominant manufacturer or retailer can abuse resale price maintenance for anticompetitive purposes may not be a serious concern unless the relevant entity has market power. If a retailer lacks market power, manufacturers likely can sell their goods through rival retailers. And if a manufacturer lacks market power, there is less likelihood it can use the practice to keep competitors away from distribution outlets.

The rule of reason is designed and used to eliminate anticompetitive transactions from the market. This standard principle applies to vertical price restraints. A party alleging injury from a vertical agreement setting minimum resale prices will have, as a general matter, the information and resources available to show the existence of the agreement and its scope of operation. As courts gain experience considering the effects of these restraints by applying the rule of reason over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses. Courts can, for example, devise rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones.

For all of the foregoing reasons, we think that were the Court considering the issue as an original matter, the rule of reason, not a *per se* rule of unlawfulness, would be the appropriate standard to judge vertical price restraints.

The judgment of the Court of Appeals is reversed, and the case is remanded for proceedings consistent with this opinion.

Notes and Questions

1. **MSRP.** Many suppliers, from book publishers to automobile manufacturers, print a “manufacturer’s suggested retail price” (MSRP) on the packaging or documentation of their products. How does this common practice differ from Leegin’s “Heart Store Program”? Is there an anticompetitive threat from MSRPs?

2. *Injury*. PSKS was not part of the Heart Store Program when it brought suit against Leegin, and the vertical restraint that it alleged to be anticompetitive was between Leegin and other retailers. What injury did PSKS allege? Isn't a manufacturer entitled to sell its products to whomever it chooses? How could Leegin's discontinuation of sales to PSKS violate the antitrust laws?
3. *Resale price maintenance and price fixing*. How does the Court differentiate resale price maintenance (RPM) from horizontal price fixing? Couldn't the same procompetitive benefits that the Court identifies with respect to RPM be used to justify horizontal price fixing as well?
4. *Value-added services*. In finding procompetitive justifications for Leegin's RPM program, the Court notes that "Many decisions a manufacturer makes and carries out through concerted action can lead to higher prices. A manufacturer might, for example, contract with different suppliers to obtain better inputs that improve product quality. Or it might hire an advertising agency to promote awareness of its goods. Yet no one would think these actions violate the Sherman Act because they lead to higher prices." Leegin wanted retailers carrying its products to offer individualized customer attention and a high level of support. But was requiring retailers to charge minimum prices the best or most effective way to achieve this goal? What else might Leegin have done to ensure that retailers provided these enhanced services? Would these alternatives have been more or less likely than RPM to ensure that such enhanced services were provided?
5. *Legislative reversals*. Both federal and state legislative proposals have been made to reverse the effects of the *Leegin* decision. Some state efforts have even been successful.¹⁷ Who would have an interest in reinstating the *per se* illegality rule for RPM? Would you support such an effort in your state?
6. *Discounts and distributed retail*. In an interview about the PSKS case, one customer said that she liked the 20 percent discount that Kay Stores offered on Leegin products, but when Kay Stores stopped carrying Leegin products she found them on eBay at a 50 percent discount.¹⁸ Given the reality of massively distributed retail today, do RPM programs make business sense anymore?
7. *Maximum prices*. *Leegin* dealt with minimum prices that a manufacturer wished to impose on its retailers. What about maximum prices? Is any antitrust concern raised when a manufacturer requires its resellers to impose prices no higher than a set maximum? Isn't a maximum price inherently good for consumers? In *State Oil Co. v. Khan*, 522 U.S. 3 (1997), the Supreme Court held that a vertical restraint on the maximum resale price of a product should be examined under the rule of reason, rather than constitute a *per se* violation of the antitrust laws. What procompetitive justifications can you find for maximum price restraints?

25.5 UNILATERAL CONDUCT: TYING

So far, we have discussed anticompetitive agreements among parties in either horizontal or vertical relationships, all falling under the banner of concerted conduct under Section 1 of the Sherman Act. But unilateral conduct, the subject of Section 2 of the Sherman Act, can also give rise to antitrust liability.

¹⁷ See *Darush v. Revision LP*, No. CV 12-10296 GAF (AGRx), 2013 WL 1749539, at *6 (C.D. Cal. Apr. 10, 2013) (vertical RPM *per se* illegal under California's Cartwright Act) and Md. Code Ann., Commercial Law, § 11-204(b) ("[A] contract, combination, or conspiracy that establishes a minimum price below which a retailer, wholesaler, or distributor may not sell a commodity or service is an unreasonable restraint of trade or commerce").

¹⁸ See Maria Halkias, *Mr. Smith to Washington Goes*, Dallas Morning News, March 25, 2007.

One such form of unilateral conduct is the tying arrangement or “tie-in,” in which one party agrees to sell, lease or license one product (the “tying product,” which is usually protected by the seller’s IP) only on the condition that the buyer also purchase from the seller another product (the “tied product,” which is often not covered by the seller’s IP).¹⁹ The buyer who wishes to purchase, lease or license the tying product is thus left with no option but to purchase unwanted (or overpriced) tied products. And because the tying product is typically covered by the seller’s IP, the buyer has no choice but to obtain it from the seller.

As noted in [Section 25.1](#), tying arrangements were once considered *per se* illegal – one of the Nine No-Nos of IP licensing. In *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 12 (1984), the Supreme Court confirmed that tying arrangements remain *per se* illegal. However, the Court has also recognized a number of factors that tend to soften the application of the *per se* test in cases of tying. Thus, to establish illegal tying, the following four elements must be proved:

1. the existence of at least two distinct products or services;
2. the sale of the tying product or service is conditioned on the purchase of the tied product or service;
3. the defendant has sufficient economic or market power over the tying product to restrain competition for another product; and
4. the amount of commerce involved is not insubstantial.²⁰

In some circuits, courts have even permitted a defendant to introduce evidence that there was a legitimate business rationale for the alleged tie-in, causing many practitioners (as well as the DOJ and FTC²¹) to view tying as being subject to the “rule of reason” for all practical purposes, notwithstanding the Supreme Court’s adherence to the *per se* label.

In tying cases there must be both a tying product and a tied product. The tying product can generally be covered by any form of IP – patent, copyright or trademark. The following case focuses on an alleged anticompetitive tie involving trademarks.

Siegel v. Chicken Delight, Inc.

448 F.2d 43 (9th Cir. 1971)

MERRILL, CIRCUIT JUDGE

This antitrust suit is a class action in which certain franchisees of Chicken Delight seek treble damages for injuries allegedly resulting from illegal restraints imposed by Chicken Delight’s standard form franchise agreements. The restraints in question are Chicken Delight’s contractual requirements that franchisees purchase certain essential cooking equipment, dry-mix food items, and trademark bearing packaging exclusively from Chicken Delight as a condition of obtaining a Chicken Delight trademark license. These requirements are asserted to constitute a tying arrangement, unlawful *per se* under Sec. 1 of the Sherman Act.

¹⁹ As discussed in [Chapter 24](#), tying arrangements, exemplified by *Morton Salt v. Suppiger*, may also form the basis for a claim of IP misuse.

²⁰ *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992).

²¹ See US DOJ & FTC, Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition 114 (2007) (“as a matter of their prosecutorial discretion, the Agencies will apply the rule of reason when evaluating intellectual property tying and bundling agreements”) [hereinafter DOJ–FTC 2007 IP Report].

After five weeks of trial to a jury in the District Court, plaintiffs moved for a directed verdict, requesting the court to rule upon four propositions of law: (1) That the contractual requirements constituted a tying arrangement as a matter of law; (2) that the alleged tying products – the Chicken Delight name, symbols, and system of operation – possessed sufficient economic power to condemn the tying arrangement as a matter of law; (3) that the tying arrangement had not, as a matter of law, been justified; and (4) that, as a matter of law, plaintiffs as a class had been injured by the arrangement.

The court ruled in favor of plaintiffs on all issues except part of the justification defense, which it submitted to the jury. On the questions submitted to it, the jury rendered special verdicts in favor of plaintiffs. Chicken Delight has taken this interlocutory appeal from the trial court rulings and verdicts.

I. Factual Background

Over its eighteen years existence, Chicken Delight has licensed several hundred franchisees to operate home delivery and pick-up food stores. It charged its franchisees no franchise fees or royalties. Instead, in exchange for the license granting the franchisees the right to assume its identity and adopt its business methods and to prepare and market certain food products under its trademark, Chicken Delight required its franchisees to purchase a specified number of cookers and fryers and to purchase certain packaging supplies and mixes exclusively from Chicken Delight. The prices fixed for these purchases were higher than, and included a percentage markup which exceeded that of, comparable products sold by competing suppliers.

II. The Existence of an Unlawful Tying Arrangement

In order to establish that there exists an unlawful tying arrangement plaintiffs must demonstrate *First*, that the scheme in question involves two distinct items and provides that one (the tying product) may not be obtained unless the other (the tied product) is also purchased. *Times-Picayune Publishing Co. v. United States*, 345 U.S. 594, 613–614 (1953). *Second*, that the tying product possesses sufficient economic power appreciably to restrain competition in the tied product market. *Northern Pacific R. Co. v. United States*, 356 U.S. 1, 6 (1958). *Third*, that a “not insubstantial” amount of commerce is affected by the arrangement. *International Salt Co. v. United States*, 332 U.S. 392 (1947). Chicken Delight concedes that the third requirement has been satisfied. It disputes the existence of the first two. Further it asserts that, even if plaintiffs should prevail with respect to the first two requirements, there is a *fourth* issue: whether there exists a special justification for the particular tying arrangement in question.

A. Two Products

The District Court ruled that the license to use the Chicken Delight name, trademark, and method of operations was “a tying item in the traditional sense,” the tied items being the cookers and fryers, packaging products, and mixes.

The court’s decision to regard the trademark or franchise license as a distinct tying item is not without precedent. In *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir. 1964), all three judges regarded as a tying product the trademark license to ice cream outlet franchisees, who were required to purchase ice cream, toppings and other supplies from the franchisor. Nevertheless, Chicken Delight argues that the District Court’s conclusion conflicts with the purposes behind the strict rules governing the use of tying arrangements.

The hallmark of a tie-in is that it denies competitors free access to the tied product market, not because the party imposing the arrangement has a superior product in that market, but because of the power or leverage exerted by the tying product. *Northern Pac. R. Co. v. United States, supra*. Rules governing tying arrangements are designed to strike, not at the mere coupling of physically separable objects, but rather at the use of a dominant desired product to compel the purchase of a second, distinct commodity. In effect, the forced purchase of the second, tied product is a price exacted for the purchase of the dominant, tying product. By shutting competitors out of the tied product market, tying arrangements serve hardly any purpose other than the suppression of competition.

Chicken Delight urges us to hold that its trademark and franchise licenses are not items separate and distinct from the packaging, mixes, and equipment, which it says are essential components of the franchise system. To treat the combined sale of all these items as a tie-in for antitrust purposes, Chicken Delight maintains, would be like applying the antitrust rules to the sale of a car with its tires or a left shoe with the right. Therefore, concludes Chicken Delight, the lawfulness of the arrangement should not be measured by the rules governing tie-ins. We disagree.

In determining whether an aggregation of separable items should be regarded as one or more items for tie-in purposes in the normal cases of sales of products the courts must look to the function of the aggregation. Consideration is given to such questions as whether the amalgamation of products resulted in cost savings apart from those reductions in sales expenses and the like normally attendant upon any tie-in, and whether the items are normally sold or used as a unit with fixed proportions.

Where one of the products sold as part of an aggregation is a trademark or franchise license, new questions are injected. In determining whether the license and the remaining ("tied") items in the aggregation are to be regarded as distinct items which can be traded in distinct markets consideration must be given to the function of trademarks.

The burgeoning business of franchising has made trademark licensing a widespread commercial practice and has resulted in the development of a new rationale for trademarks as representations of product quality. This is particularly true in the case of a franchise system set up not to distribute the trademarked goods of the franchisor, but, as here, to conduct a certain business under a common trademark or trade name. Under such a type of franchise, the trademark simply reflects the goodwill and quality standards of the enterprise which it identifies. As long as the system of operation of the franchisees lives up to those quality standards and remains as represented by the mark so that the public is not misled, neither the protection afforded the trademark by law nor the value of the trademark to the licensee depends upon the source of the components.

This being so, it is apparent that the goodwill of the Chicken Delight trademark does not attach to the multitude of separate articles used in the operation of the licensed system or in the production of its end product. It is not what is used, but how it is used and what results that have given the system and its end product their entitlement to trademark protection. It is to the system and the end product that the public looks with the confidence that established goodwill has created.

Thus, sale of a franchise license, with the attendant rights to operate a business in the prescribed manner and to benefit from the goodwill of the trade name, in no way requires the forced sale by the franchisor of some or all of the component articles. Just as the quality of a copyrighted creation cannot by a tie-in be appropriated by a creation to which the copyright does not relate, *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 158 (1948),

so here attempts by tie-in to extend the trademark protection to common articles (which the public does not and has no reason to connect with the trademark) simply because they are said to be essential to production of that which is the subject of the trademark, cannot escape antitrust scrutiny.

Chicken Delight's assertions that only a few essential items were involved in the arrangement does not give us cause to reach a different conclusion. The relevant question is not whether the items are essential to the franchise, but whether it is essential to the franchise that the items be purchased from Chicken Delight. This raises not the issue of whether there is a tie-in but rather the issue of whether the tie-in is justifiable, a subject to be discussed below.

We conclude that the District Court was not in error in ruling as matter of law that the arrangement involved distinct tying and tied products.

B. Economic Power

Under the *per se* theory of illegality, plaintiffs are required to establish not only the existence of a tying arrangement but also that the tying product possesses sufficient economic power to appreciably restrain free competition in the tied product markets. *Northern Pacific R. Co. v. United States, supra*.

Chicken Delight points out that while it was an early pioneer in the fast food franchising field, the record establishes that there has recently been a dramatic expansion in this area, with the advent of numerous firms, including many chicken franchising systems, all competing vigorously with each other. Under the circumstances, it contends that the existence of the requisite market dominance remained a jury question.

The District Court ruled, however, that Chicken Delight's unique registered trademark, in combination with its demonstrated power to impose a tie-in, established as matter of law the existence of sufficient market power to bring the case within the Sherman Act.

We agree.

It can hardly be denied that the Chicken Delight trademark is distinctive; that it possesses goodwill and public acceptance unique to it and not enjoyed by other fast food chains. It is now clear that sufficient economic power is to be presumed where the tying product is patented or copyrighted.

Just as the patent or copyright forecloses competitors from offering the distinctive product on the market, so the registered trademark presents a legal barrier against competition. It is not the nature of the public interest that has caused the legal barrier to be erected that is the basis for the presumption, but the fact that such a barrier does exist. Accordingly we see no reason why the presumption that exists in the case of the patent and copyright does not equally apply to the trademark.

Thus we conclude that the District Court did not err in ruling as matter of law that the tying product – the license to use the Chicken Delight trademark – possessed sufficient market power to bring the case within the Sherman Act.

C. Justification

Chicken Delight maintains that, even if its contractual arrangements are held to constitute a tying arrangement, it was not an unreasonable restraint under the Sherman Act. Three different bases for justification are urged.

First, Chicken Delight contends that the arrangement was a reasonable device for measuring and collecting revenue. There is no authority for justifying a tying arrangement on

this ground. Unquestionably, there exist feasible alternative methods of compensation for the franchise licenses, including royalties based on sales volume or fees computed per unit of time, which would neither involve tie-ins nor have undesirable anticompetitive consequences.

Second, Chicken Delight advances as justification the fact that when it first entered the fast food field in 1952 it was a new business and was then entitled to the protection afforded by *United States v. Jerrold Electronics Corp.*, *supra*, 187 F.Supp. 545. As to the period here involved – 1963 to 1970 – it contends that transition to a different arrangement would be difficult if not economically impossible.

We find no merit in this contention. Whatever claim Chicken Delight might have had to a new business defense in 1952 – a question we need not decide – the defense cannot apply to the 1963–70 period. To accept Chicken Delight’s argument would convert the new business justification into a perpetual license to operate in restraint of trade.

The third justification Chicken Delight offers is the “marketing identity” purpose, the franchisor’s preservation of the distinctiveness, uniformity and quality of its product. In the case of a trademark this purpose cannot be lightly dismissed. Not only protection of the franchisor’s goodwill is involved. The licensor owes an affirmative duty to the public to assure that in the hands of his licensee the trademark continues to represent that which it purports to represent. For a licensor, through relaxation of quality control, to permit inferior products to be presented to the public under his licensed mark might well constitute a misuse of the mark.

However, to recognize that such a duty exists is not to say that every means of meeting it is justified. Restraint of trade can be justified only in the absence of less restrictive alternatives. In cases such as this, where the alternative of specification is available, the language used in *Standard Oil Co. v. United States*, *supra*, 337 U.S. at 306, in our view states the proper test, applicable in the case of trademarks as well as in other cases:

the protection of the good will of the manufacturer of the tying device – fails in the usual situation because specification of the type and quality of the product to be used in connection with the tying device is protection enough. The only situation, indeed, in which the protection of good will may necessitate the use of tying clauses is where specifications for a substitute would be so detailed that they could not practicably be supplied.

The District Court found factual issues to exist as to whether effective quality control could be achieved by specification in the case of the cooking machinery and the dip and spice mixes. These questions were given to the jury under instructions; and the jury, in response to special interrogatories, found against Chicken Delight.

Notes and Questions

1. *Tying product.* In *Chicken Delight*, the “tying product” is the Chicken Delight trademark. Is a trademark a product? Does a trademark possess characteristics similar, for example, to a patented salt-depositing machine?
2. *Market power.* As noted by the court, “the tying product [must possess] sufficient economic power appreciably to restrain competition in the tied product market.” Clearly the owner of a trademark controls the use of that mark with respect to the relevant classes of goods and services. But is that the relevant market? Benjamin Klein and Lester Saft argue that

“Chicken Delight, although it possesses a trademark, does not possess any economic power in the relevant market in which it operates – the fast food franchising (or perhaps, more generally, the franchising) market.”²² According to Klein and Saft, Chicken Delight, a relatively small operation compared to fast-food giants such as McDonald’s and Kentucky Fried Chicken, had little market power, despite its trademark. How does this observation affect your view of the court’s conclusion that a tying arrangement existed?

3. *Consideration*. How was Chicken Delight compensated in this arrangement? Is it relevant that it charged its franchisees no franchise fees or royalties?
4. *Tied products*. Eleven years after *Chicken Delight*, in *Krehl v. Baskin Robbins Ice Cream Co.*, 664 F.2d 1348 (9th Cir. 1982), the Ninth Circuit sought to distinguish *Chicken Delight* on the basis of the type of franchise arrangement that it used.

In *Chicken Delight*, we were confronted with a situation where the franchisor conditioned the grant of a franchise on the purchase of a catalogue of miscellaneous items used in the franchised business. These products were neither manufactured by the franchisor nor were they of a special design uniquely suited to the franchised business. Rather, they were commonplace paper products and packaging goods, readily available in the competitive market place. In evaluating this arrangement, we stated that, “in determining whether the (trademark) ... and the remaining ... items ... are to be regarded as distinct items ... consideration must be given to the function of trademarks.” Because the function of the trademark in *Chicken Delight* was merely to identify a distinctive business format, we found the nexus between the trademark and the tied products to be sufficiently remote to warrant treating them as separate products.

A determination of whether a trademark may appropriately be regarded as a separate product requires an inquiry into the relationship between the trademark and the products allegedly tied to its sale. In evaluating this relationship, consideration must be given to the type of franchising system involved. In *Chicken Delight*, we distinguished between two kinds of franchising systems: 1) the business format system; and 2) the distribution system. A business format franchise system is usually created merely to conduct business under a common trade name. The franchise outlet itself is generally responsible for the production and preparation of the system’s end product. The franchisor merely provides the trademark and, in some cases, supplies used in operating the franchised outlet and producing the system’s products. Under such a system, there is generally only a remote connection between the trademark and the products the franchisees are compelled to purchase. This is true because consumers have no reason to associate with the trademark, those component goods used either in the operation of the franchised store or in the manufacture of the end product. “Under such a type of franchise, the trade-mark simply reflects the goodwill and quality standards of the enterprise it identifies. As long as ... franchisees (live) up to those quality standards ... neither the protection afforded the trade-mark by law nor the value of the trade-mark ... depends upon the source of the components.”

Where, as in *Chicken Delight*, the tied products are commonplace articles, the franchisor can easily maintain its quality standards through other means less intrusive upon competition. Accordingly, the coerced purchase of these items amounts to little more than an effort to impede competition on the merits in the market for the tied products.

Where a distribution type system, such as that employed by Baskin-Robbins, is involved, significantly different considerations are presented. Under the distribution type system, the franchised outlets serve merely as conduits through which the trademarked goods of the franchisor

²² Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. L. Econ. 345, 356 (1985).

flow to the ultimate consumer. These goods are generally manufactured by the franchisor or, as in the present case, by its licensees according to detailed specifications. In this context, the trademark serves a different function. Instead of identifying a business format, the trademark in a distribution franchise system serves merely as a representation of the end product marketed by the system. "It is to the system and the end product that the public looks with the confidence that the established goodwill has created." Consequently, sale of substandard products under the mark would dissipate this goodwill and reduce the value of the trademark. The desirability of the trademark is therefore utterly dependent upon the perceived quality of the product it represents. Because the prohibition of tying arrangements is designed to strike solely at the use of a dominant desired product to compel the purchase of a second undesired commodity, the tie-in doctrine can have no application where the trademark serves only to identify the alleged tied product. The desirability of the trademark and the quality of the product it represents are so inextricably interrelated in the mind of the consumer as to preclude any finding that the trademark is a separate item for tie-in purposes.

In the case at bar, the District Court found that the Baskin-Robbins trademark merely served to identify the ice cream products distributed by the franchise system. Based on our review of the record, we cannot say that this finding is clearly erroneous. Accordingly, we conclude that the District Court did not err in ruling that the Baskin-Robbins trademark lacked sufficient independent existence apart from the ice cream products allegedly tied to its sale, to justify a finding of an unlawful tying arrangement.

Affirmed.

Do you agree? Does it matter that the tied products in *Chicken Delight* included "cookers and fryers" and "dry-mix food items" in addition to "commonplace paper products and packaging goods, readily available in the competitive market place"?

5. *Block booking.* The practice of "block booking" in the motion picture industry involved the movie studio policy of licensing films to theaters and television networks only in packages that included both desirable and less desirable titles. As explained by the Supreme Court in *United States v. Loew's, Inc.*, 371 U.S. 38 (1962),

[a studio] negotiated four contracts that were found to be block booked. Station WTOP was to pay \$118,800 for the license of 99 pictures, which were divided into three groups of 33 films, based on differences in quality. To get "Treasure of the Sierra Madre," "Casablanca," "Johnny Belinda," "Sergeant York," and "The Man Who Came to Dinner," among others, WTOP also had to take such films as "Nancy Drew Troublesooter," "Tugboat Annie Sails Again," "Kid Nightingale," "Gorilla Man," and "Tear Gas Squad."

Thus, if the station wished to broadcast *Casablanca*, it also had to pay for *The Gorilla Man* and a host of other "B" movies, whether it wanted them or not. Block booking arrangements have generally been treated by the courts as tying arrangements, and have largely been condemned on that basis. Do you think that the result would be different if these arrangements had been evaluated under a "rule of reason" approach?

6. *Platform software products and the rule of reason.* In the government's massive antitrust case against Microsoft, one of the allegations was that Microsoft illegally tied its Internet Explorer web browser (IE) to its ubiquitous Windows operating system by contractually requiring computer manufacturers to license a copy of IE with every copy of Windows and prohibiting them from removing or uninstalling IE from computers using Windows. The district court, applying the Supreme Court's *per se* rule, found an illegal tie (87 F. Supp. 2d 30 (D.D.C. 2000)). On appeal, the DC Circuit (253 F.3d 34 (D.C. Cir. 2001)) questioned the *per se* rule itself, reasoning that



FIGURE 25.5 With “block booking,” in order to show classic films like *Casablanca*, television stations and movie theaters were also required to license, and pay for, “B” movies like *The Gorilla Man*.

because of the pervasively innovative character of platform software markets, tying in such markets may produce efficiencies that courts have not previously encountered and thus the Supreme Court had not factored into the per se rule as originally conceived.

Among the examples of efficiencies that could have flowed from Microsoft’s tying of IE to Windows were ease of integration with third-party applications and consumer preference for an integrated product:

These arguments all point to one conclusion: we cannot comfortably say that bundling in platform software markets has so little “redeeming virtue,” and that there would be so “very little loss to society” from its ban, that “an inquiry into its costs in the individual case [can be] considered [] unnecessary.”

Accordingly, the Circuit remanded to the district court for reconsideration of the tying claim under the rule of reason. In view of the heightened burden imposed by the rule of reason test, the DOJ dropped its tying claim on remand.²³

7. *No license, no chips?* In order to obtain a license to the valuable Chicken Delight trademark (tying product), franchisees were required, among other things, to purchase Chicken Delight’s commodity packaging (tied products). In this context, consider *FTC v. Qualcomm* (N.D. Cal. 2018). There, *Qualcomm* was accused of enforcing a “no license – no chips” policy, under which smartphone manufacturers (OEMs) who desired to purchase *Qualcomm*’s wireless communication chips were required to enter into separate royalty-bearing patent

²³ David S. Evans, *Introduction*, in *Microsoft, Antitrust and The New Economy: Selected Essays* 1, 6 (David S. Evans ed., Springer, 2002).

license agreements. In finding that Qualcomm violated Section 2 of the Sherman Act (a monopolization claim – see [Section 25.6](#)), the district court explained,

Qualcomm wields its chip monopoly power to coerce OEMs to sign patent license agreements. Specifically, Qualcomm threatens to withhold OEMs' chip supply until OEMs sign patent license agreements on Qualcomm's preferred terms. In some cases, Qualcomm has even cut off OEMs' chip supply, although the threat of cutting off chip supply has been more than sufficient to coerce OEMs into signing Qualcomm's patent license agreements and avoiding the devastating loss of chip supply.²⁴

Interestingly, the court did not explicitly characterize Qualcomm's "no license – no chips" policy as an illegal tying arrangement. Rather, it considered a range of Qualcomm's licensing practices together, concluding that they "strangled competition" in the relevant chip markets and "harmed rivals, OEMs, and end consumers in the process."²⁵ Is the district court describing a tying agreement here? If so, why not say so explicitly? Does it matter that both the presumably tying products (the chips) and the tied product (the license) are patented?

In any event, the Ninth Circuit reversed, holding that:

If Qualcomm were to refuse to license its SEPs to OEMs unless they first agreed to purchase Qualcomm's chips ("no chips, no license"), then rival chip suppliers indeed might have an antitrust claim under both §§ 1 and 2 of the Sherman Act based on exclusionary conduct. This is because OEMs cannot sell their products without obtaining Qualcomm's SEP licenses, so a "no chips, no license" policy would essentially force OEMs to either purchase Qualcomm's chips or pay for both Qualcomm's and a competitor's chips (similar to the no-win situation faced by OEMs in the *Caldera* case). But unlike a hypothetical "no chips, no license" policy, "no license, no chips" is chip neutral: it makes no difference whether an OEM buys Qualcomm's chip or a rival's chips. The policy only insists that, whatever chip source an OEM chooses, the OEM pay Qualcomm for the right to practice the patented technologies embodied in the chip, as well as in other parts of the phone or other cellular device.²⁶

What does the Ninth Circuit view as the crucial difference between "no license – no chips" and "no chips – no license"? Why might the latter be a potential violation of the Sherman Act, but not the former?

25.6 MONOPOLIZATION AND MARKET POWER

The possession of a monopoly in a given market is not itself a violation of the antitrust laws. Monopolies may be gained in a variety of legitimate ways including "growth or development as a consequence of a superior product, business acumen, or historic accident."²⁷ Rather, it is the willful acquisition or maintenance of monopoly power through anticompetitive, predatory or exclusionary conduct that violates § 2 of the Sherman Act.

In order to prove a case of monopolization, the plaintiff must first show that the defendant had "market power" in a relevant market. As explained by the DOJ and FTC, "Market power is the ability profitably to maintain prices above, or output below, competitive levels for a significant period of time."²⁸

²⁴ *FTC v. Qualcomm Inc.*, 411 F. Supp. 3d 658, 698 (N.D. Cal. 2019), *rev'd* 969 F.3d 974 (9th Cir. 2020).

²⁵ *Id.* at 812.

²⁶ *FTC v. Qualcomm Inc.*, 969 F.3d 97, 1002–03 (9th Cir. 2020).

²⁷ *United States v. Grinnell Corp.*, 384 U.S. 563, 570–71 (1966).

²⁸ DOJ-FTC, 2017 Licensing Guidelines, *supra* [note 15](#), at 4.



FIGURE 25.6 Häagen-Dazs successfully argued that inexpensive and expensive ice cream products compete in the same market.

Market power is always defined by reference to a particular *market*. In antitrust cases, two types of market are generally considered: product and geographic markets. Entire books have been written about the complex exercise of defining markets in antitrust cases.²⁹ Geographic markets are defined based on the ability of suppliers to sell beyond their immediate locations, taking into account factors such as transportation costs, buyer convenience and customer preferences. To grossly oversimplify, the principal factors that are evaluated when defining a product market include the degree to which different products can function as substitutes for one another, the degree of price elasticity among different products and the degree to which producers can easily shift from production of one product to another. Thus, in one well-known case involving an exclusive distribution arrangement among Häagen-Dazs and its distributors, potential markets could have included the market for all frozen desserts, packaged ice cream, packaged premium ice cream or packaged super-premium ice cream.³⁰

In *United States v. Microsoft*, the court established that the relevant market was “Intel-compatible PC operating systems” and that Microsoft controlled more than 95 percent of that market (253 F.3d at 51). Microsoft argued, unsuccessfully, that the market should have been defined to include non-Intel-compatible operating systems such as Mac OS, operating systems for non-PC devices such as handheld devices, and middleware products such as Netscape Navigator and Java. But the court, in applying the rule that “the relevant market must include all products reasonably interchangeable by consumers for the same purposes,” excluded these other products from the definition of Microsoft’s market (Id. at 52–54).

One particularly thorny issue in market definition is the role that IP rights play in defining a market. Some have argued that the owner of a patent, copyright or trade secret has a “monopoly” over the use of that right. But does that IP right give its owner real power over any particular market? The following case, in which an illegal tie was alleged, considers the issue.

²⁹ See, e.g., ABA Section of Antitrust Law, *Market Definition in Theory and Case Studies* (ABA, 2012).

³⁰ See *In re Super Premium Ice Cream Distribution Antitrust Litigation*, 691 F. Supp. 1262, 1268 (N.D. Cal. 1988) (finding that “all grades of ice creams compete with one another for customer preference and for space in the retailers’ freezers” and “gradations among various qualities of ice cream are not sufficient to establish separate relevant markets for the purposes of determining market power” and finally holding that “the relevant market is ice cream generally”).

Illinois Tool Works Inc. v. Independent Ink, Inc.

547 U.S. 28 (2006)

STEVENS, JUSTICE

In *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U. S. 2 (1984), we repeated the well-settled proposition that “if the Government has granted the seller a patent or similar monopoly over a product, it is fair to presume that the inability to buy the product elsewhere gives the seller market power.” This presumption of market power, applicable in the antitrust context when a seller conditions its sale of a patented product (the “tying” product) on the purchase of a second product (the “tied” product), has its foundation in the judicially created patent misuse doctrine. In 1988, Congress substantially undermined that foundation, amending the Patent Act to eliminate the market power presumption in patent misuse cases. 35 U. S. C. §271(d). The question presented to us today is whether the presumption of market power in a patented product should survive as a matter of antitrust law despite its demise in patent law. We conclude that the mere fact that a tying product is patented does not support such a presumption.

I

Petitioners, Trident, Inc., and its parent, Illinois Tool Works Inc., manufacture and market printing systems that include three relevant components: (1) a patented piezoelectric impulse ink jet printhead; (2) a patented ink container, consisting of a bottle and valved cap, which attaches to the printhead; and (3) specially designed, but unpatented, ink. Petitioners sell their systems to original equipment manufacturers (OEMs) who are licensed to incorporate the printheads and containers into printers that are in turn sold to companies for use in printing barcodes on cartons and packaging materials. The OEMs agree that they will purchase their ink exclusively from petitioners, and that neither they nor their customers will refill the patented containers with ink of any kind.

Respondent, Independent Ink, Inc., has developed an ink with the same chemical composition as the ink sold by petitioners. After an infringement action brought by Trident against Independent was dismissed for lack of personal jurisdiction, Independent ... alleged that petitioners are engaged in illegal tying and monopolization in violation of §§1 and 2 of the Sherman Act.

After discovery, the District Court granted petitioners’ motion for summary judgment on the Sherman Act claims. It rejected respondent’s submission that petitioners “necessarily have market power in the market for the tying product as a matter of law solely by virtue of the patent on their printhead system, thereby rendering [the] tying arrangements *per se* violations of the antitrust laws.” Finding that respondent had submitted no affirmative evidence defining the relevant market or establishing petitioners’ power within it, the court concluded that respondent could not prevail on either antitrust claim.

After a careful review of the “long history of Supreme Court consideration of the legality of tying arrangements,” the Court of Appeals for the Federal Circuit reversed the District Court’s decision as to respondent’s §1 claim. We granted certiorari to undertake a fresh examination of the history of both the judicial and legislative appraisals of tying arrangements. Our review is informed by extensive scholarly comment and a change in position by the administrative agencies charged with enforcement of the antitrust laws.

II

American courts first encountered tying arrangements in the course of patent infringement litigation. Such a case came before this Court in *Henry v. A. B. Dick Co.*, 224 U. S. 1 (1912), in which, as in the case we decide today, unpatented ink was the product that was “tied” to the use of a patented product through the use of a licensing agreement. Without commenting on the tying arrangement, the Court held that use of a competitor’s ink in violation of a condition of the agreement—that the rotary mimeograph “may be used only with the stencil, paper, ink and other supplies made by A. B. Dick Co.”—constituted infringement of the patent on the machine. Chief Justice White dissented, explaining his disagreement with the Court’s approval of a practice that he regarded as an “attempt to increase the scope of the monopoly granted by a patent ... which tend[s] to increase monopoly and to burden the public in the exercise of their common rights.” [I]n this Court’s subsequent cases reviewing the legality of tying arrangements we, too, embraced Chief Justice White’s disapproval of those arrangements.

In the years since *A. B. Dick*, four different rules of law have supported challenges to tying arrangements. They have been condemned as improper extensions of the patent monopoly under the patent misuse doctrine, as unfair methods of competition under §5 of the Federal Trade Commission Act, as contracts tending to create a monopoly under §3 of the Clayton Act, and as contracts in restraint of trade under §1 of the Sherman Act. In all of those instances, the justification for the challenge rested on either an assumption or a showing that the defendant’s position of power in the market for the tying product was being used to restrain competition in the market for the tied product. As we explained in *Jefferson Parish*, “[o]ur cases have concluded that the essential characteristic of an invalid tying arrangement lies in the seller’s exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.”

Over the years, however, this Court’s strong disapproval of tying arrangements has substantially diminished. Rather than relying on assumptions, in its more recent opinions the Court has required a showing of market power in the tying product. Our early opinions consistently assumed that “[t]ying arrangements serve hardly any purpose beyond the suppression of competition.” *Standard Oil Co.*, 337 U. S., at 305–306. In 1962, in *Loew’s*, 371 U. S., at 47–48, the Court relied on this assumption despite evidence of significant competition in the market for the tying product. And as recently as 1969, Justice Black, writing for the majority, relied on the assumption as support for the proposition “that, at least when certain prerequisites are met, arrangements of this kind are illegal in and of themselves, and no specific showing of unreasonable competitive effect is required.” *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U. S. 495, 498–499 (*Fortner I*). Explaining the Court’s decision to allow the suit to proceed to trial, he stated that “decisions rejecting the need for proof of truly dominant power over the tying product have all been based on a recognition that because tying arrangements generally serve no legitimate business purpose that cannot be achieved in some less restrictive way, the presence of any appreciable restraint on competition provides a sufficient reason for invalidating the tie.”

Reflecting a changing view of tying arrangements, four Justices dissented in *Fortner I*, arguing that the challenged “tie”—the extension of a \$2 million line of credit on condition that the borrower purchase prefabricated houses from the defendant—might well have served a legitimate purpose. In his opinion, Justice White noted that promotional tie-ins

may provide “uniquely advantageous deals” to purchasers. And Justice Fortas concluded that the arrangement was best characterized as “a sale of a single product with the incidental provision of financing.”

The dissenters’ view that tying arrangements may well be procompetitive ultimately prevailed; indeed, it did so in the very same lawsuit. After the Court remanded the suit in *Fortner I*, a bench trial resulted in judgment for the plaintiff, and the case eventually made its way back to this Court. Upon return, we unanimously held that the plaintiff’s failure of proof on the issue of market power was fatal to its case—the plaintiff had proved “nothing more than a willingness to provide cheap financing in order to sell expensive houses.” *United States Steel Corp. v. Fortner Enterprises, Inc.*, 429 U. S. 610, 622 (1977) (*Fortner II*).

The assumption that “[t]ying arrangements serve hardly any purpose beyond the suppression of competition,” rejected in *Fortner II*, has not been endorsed in any opinion since. Instead, it was again rejected just seven years later in *Jefferson Parish*, where, as in *Fortner II*, we unanimously reversed a Court of Appeals judgment holding that an alleged tying arrangement constituted a *per se* violation of §1 of the Sherman Act. Like the product at issue in the *Fortner* cases, the tying product in *Jefferson Parish*—hospital services—was unpatented, and our holding again rested on the conclusion that the plaintiff had failed to prove sufficient power in the tying product market to restrain competition in the market for the tied product—services of anesthesiologists.

In rejecting the application of a *per se* rule that all tying arrangements constitute anti-trust violations, we explained:

[W]e have condemned tying arrangements when the seller has some special ability—usually called “market power”—to force a purchaser to do something that he would not do in a competitive market ...

Per se condemnation—condemnation without inquiry into actual market conditions—is only appropriate if the existence of forcing is probable. Thus, application of the *per se* rule focuses on the probability of anticompetitive consequences ...

For example, if the Government has granted the seller a patent or similar monopoly over a product, it is fair to presume that the inability to buy the product elsewhere gives the seller market power. Any effort to enlarge the scope of the patent monopoly by using the market power it confers to restrain competition in the market for a second product will undermine competition on the merits in that second market. Thus, the sale or lease of a patented item on condition that the buyer make all his purchases of a separate tied product from the patentee is unlawful.

Notably, nothing in our opinion suggested a rebuttable presumption of market power applicable to tying arrangements involving a patent on the tying good. Instead, it described the rule that a contract to sell a patented product on condition that the purchaser buy unpatented goods exclusively from the patentee is a *per se* violation of §1 of the Sherman Act.

Justice O’Connor wrote separately in *Jefferson Parish*. In her opinion, she questioned not only the propriety of treating any tying arrangement as a *per se* violation of the Sherman Act, but also the validity of the presumption that a patent always gives the patentee significant market power, observing that the presumption was actually a product of our patent misuse cases rather than our antitrust jurisprudence. It is that presumption, a vestige of the Court’s historical distrust of tying arrangements, that we address squarely today.

III

Justice O'Connor was, of course, correct in her assertion that the presumption that a patent confers market power arose outside the antitrust context as part of the patent misuse doctrine. That doctrine had its origins in *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U. S. 502 (1917), which found no support in the patent laws for the proposition that a patentee may “prescribe by notice attached to a patented machine the conditions of its use and the supplies which must be used in the operation of it, under pain of infringement of the patent.” Although *Motion Picture Patents Co.* simply narrowed the scope of possible patent infringement claims, it formed the basis for the Court’s subsequent decisions creating a patent misuse defense to infringement claims when a patentee uses its patent “as the effective means of restraining competition with its sale of an unpatented article.” *Morton Salt Co. v. G. S. Suppiger Co.*, 314 U.S. 488, 490 (1942).

Without any analysis of actual market conditions, these patent misuse decisions assumed that, by tying the purchase of unpatented goods to the sale of the patented good, the patentee was “restraining competition,” *Morton Salt*, 314 U. S., at 490, or “secur[ing] a limited monopoly of an unpatented material,” *Mercoïd*, 320 U. S., at 664. In other words, these decisions presumed “[t]he requisite economic power” over the tying product such that the patentee could “extend [its] economic control to unpatented products.” *Loew’s*, 371 U. S., at 45–46.

The presumption that a patent confers market power migrated from patent law to antitrust law in *International Salt*. In that case, we affirmed a District Court decision holding that leases of patented machines requiring the lessees to use the defendant’s unpatented salt products violated §1 of the Sherman Act and §3 of the Clayton Act as a matter of law. Although the Court’s opinion does not discuss market power or the patent misuse doctrine, it assumes that “[t]he volume of business affected by these contracts cannot be said to be insignificant or insubstantial and the tendency of the arrangement to accomplishment of monopoly seems obvious.”

Indeed, later in the same Term we cited *International Salt* for the proposition that the license of “a patented device on condition that unpatented materials be employed in conjunction with the patented device” is an example of a restraint that is “illegal per se.” And in subsequent cases we have repeatedly grounded the presumption of market power over a patented device in *International Salt*.

IV

Although the patent misuse doctrine and our antitrust jurisprudence became intertwined in *International Salt*, subsequent events initiated their untwining. This process has ultimately led to today’s reexamination of the presumption of per se illegality of a tying arrangement involving a patented product, the first case since 1947 in which we have granted review to consider the presumption’s continuing validity.

Three years before we decided *International Salt*, this Court had expanded the scope of the patent misuse doctrine to include not only supplies or materials used by a patented device, but also tying arrangements involving a combination patent and “unpatented material or [a] device [that] is itself an integral part of the structure embodying the patent.” *Mercoïd*, 320 U. S., at 665. In reaching this conclusion, the Court explained that it could see “no difference in principle” between cases involving elements essential to the inventive character of the patent and elements peripheral to it; both, in the Court’s view, were attempts to “expan[d] the patent beyond the legitimate scope of its monopoly.”

[See discussion of the Patent Misuse Reform Act of 1988 in [Section 24.2](#).]

While the 1988 [Patent Act] amendment does not expressly refer to the antitrust laws, it certainly invites a reappraisal of the *per se* rule announced in *International Salt*. A rule denying a patentee the right to enjoin an infringer is significantly less severe than a rule that makes the conduct at issue a federal crime punishable by up to 10 years in prison. It would be absurd to assume that Congress intended to provide that the use of a patent that merited punishment as a felony would not constitute “misuse.” Moreover, given the fact that the patent misuse doctrine provided the basis for the market power presumption, it would be anomalous to preserve the presumption in antitrust after Congress has eliminated its foundation.

After considering the congressional judgment reflected in the 1988 amendment, we conclude that tying arrangements involving patented products should be evaluated under the standards applied in cases like *Fortner II* and *Jefferson Parish* rather than under the *per se* rule applied in *Morton Salt* and *Loew’s*. While some such arrangements are still unlawful, such as those that are the product of a true monopoly or a marketwide conspiracy, that conclusion must be supported by proof of power in the relevant market rather than by a mere presumption thereof.

V

Rather than arguing that we should retain the rule of *per se* illegality, respondent contends that we should endorse a rebuttable presumption that patentees possess market power when they condition the purchase of the patented product on an agreement to buy unpatented goods exclusively from the patentee. Respondent recognizes that a large number of valid patents have little, if any, commercial significance, but submits that those that are used to impose tying arrangements on unwilling purchasers likely do exert significant market power. Hence, in respondent’s view, the presumption would have no impact on patents of only slight value and would be justified, subject to being rebutted by evidence offered by the patentee, in cases in which the patent has sufficient value to enable the patentee to insist on acceptance of the tie.

As we have already noted, the vast majority of academic literature recognizes that a patent does not necessarily confer market power. Similarly, while price discrimination may provide evidence of market power, particularly if buttressed by evidence that the patentee has charged an above-market price for the tied package, it is generally recognized that it also occurs in fully competitive markets. We are not persuaded that the combination of these two factors should give rise to a presumption of market power when neither is sufficient to do so standing alone. Rather, the lesson to be learned from *International Salt* and the academic commentary is the same: Many tying arrangements, even those involving patents and requirements ties, are fully consistent with a free, competitive market. For this reason, we reject both respondent’s proposed rebuttable presumption and their narrower alternative.

Congress, the antitrust enforcement agencies, and most economists have all reached the conclusion that a patent does not necessarily confer market power upon the patentee. Today, we reach the same conclusion, and therefore hold that, in all cases involving a tying arrangement, the plaintiff must prove that the defendant has market power in the tying product.

Reversed.

Notes and Questions

1. *The prevalence of market power.* The existence of power in a defined market is not only relevant to tying cases like *Illinois Tool Works*, but also to antitrust cases involving monopolization and to horizontal arrangements among competitors that are evaluated under the rule of reason. For an agreement to be condemned under the rule of reason, the parties must be shown both to have restrained competition in a defined product and geographic market, and to have played a significant role in that market. Why is market power so central to antitrust analysis? Why aren't arrangements that are otherwise intended to disadvantage competitors condemned absent market power?
2. *When does IP create market power?* The Court in *Illinois Tool Works* held that the existence of a patent covering a product does not automatically result in market power in any relevant market. But when might a patent or other IP right confer market power on its owner? Would this determination depend on the industry? For example, would it be more likely to find that a patent holder had market power in the pharmaceutical industry versus the software industry?
3. *The DOJ–FTC Guidelines.* The Court in *Illinois Tool Works* notes that in their 1995 Guidelines on Antitrust and IP, the DOJ and FTC state that they “will not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner.” This position appears to have influenced the Court in eliminating its own presumption that IP rights do create market power. What weight should courts, and the Supreme Court in particular, give to the prosecutorial views of the antitrust enforcement agencies? The DOJ and FTC revised their IP Guidelines in 2017, leaving their discussion of market power largely unchanged. But what if the agencies had reversed course and again established a presumption – to be used as a guide in their enforcement activities – that IP rights do create market power? Should the Court reassess its decision in *Illinois Tool Works* based on the revised DOJ–FTC position? Does it matter that the leaders of the DOJ and FTC are political appointees who change office periodically, particularly in election years?³¹
4. *Standards-essential patents and market power.* In [Chapter 20](#) we discussed technical standards bodies and standards-essential patents (SEPs). Assume that a SEP is essential to a standard that is used in 80 percent of all smartphones in the world. Does that SEP confer market power on its owner? What if the SEP is only one of 40,000 SEPs covering that standard? Professor Herbert Hovenkamp, one of the leading authorities on US antitrust law, writes:

Questions about the market power of individual SEP patents are ... heavily derivative of questions about the power of the standard setting organization for which the patent is essential. If a patent is truly essential, then it has whatever power is enjoyed by the standard to which it is essential. Most large SSOs that employ SEPs and dominate their industries presumably have significant power. In that case, a properly identified SEP can be presumed to have market power as well. In many other settings, however, standards are less likely to have power for the simple reason that the organization is only one of many alternative standard setting organizations, or else because compliance with a standard is not all that valuable.³²

With the above caveat in mind, Professor Hovenkamp suggests that “FRAND status create a presumption of sufficient market power, which can be defeated by a showing that firms

³¹ For some of the implications of such changes see Jorge L. Contreras, *Taking it to the Limit: Shifting U.S. Antitrust Policy Toward Standards Development*, 103 Minn. L. Rev. Headnotes 66 (2018).

³² Herbert Hovenkamp, *FRAND and Antitrust*, 105 Cornell L. Rev. 101, 119 (2020).

operating under the SSO can find a suitable substitute for the FRAND-encumbered patent in question, readily and at low cost.” Do you agree? Under what circumstances might the ownership of a SEP not create market power?

5. *IP misuse versus antitrust*. The Court in *Illinois Tool Works* states that “[a]lthough the patent misuse doctrine and our antitrust jurisprudence became intertwined in *International Salt*, subsequent events initiated their untwining.” As discussed in [Chapter 24](#), patent misuse today is treated as a distinct category of wrong under the patent laws, and not as a form of antitrust violation. This means, of course, that an action for patent misuse can succeed without the elements that are necessary to prove an antitrust case, including, notably, the requirement of market power. Is this a good result? Are there reasons why patent misuse and antitrust law should be “retwined”?
6. *Barriers to entry*. Having a large share of a defined market alone is not sufficient to prove market power. An antitrust plaintiff must also show that the market occupied by an accused monopolist is subject to significant barriers to entry. For example, patents covering the major features of a product could make it impossible for competitors to enter the market for that product. But barriers to entry need not be imposed by formal legal exclusivities. In *United States v. Microsoft*, the court considered structural features of the software operating system market dominated by Microsoft’s Windows. It concluded that

(1) most consumers prefer operating systems for which a large number of applications have already been written; and (2) most developers prefer to write for operating systems that already have a substantial consumer base. This “chicken-and-egg” situation ensures that applications



FIGURE 25.7 Microsoft’s Windows operating system captured 95 percent of the relevant operating system market.

will continue to be written for the already dominant Windows, which in turn ensures that consumers will continue to prefer it over other operating systems.³³

Accordingly, Microsoft's 95 percent share of the relevant operating system market plus the inherent difficulty that would be faced by any competing operating system combined to demonstrate that Microsoft possessed market power in the relevant market. What other forms of "structural" barriers to entry might play a role in a market power determination?

25.7 REFUSALS TO DEAL: UNILATERAL AND CONCERTED

In general, a party is free to choose its business partners.³⁴ This precept is especially true with respect to IP. As discussed in [Section 24.2](#), the Patent Misuse Reform Act of 1988 makes it clear that a patent holder is not liable for patent misuse because it "refused to license or use any rights to the patent" (35 U.S.C. § 271(d)(4)). Analogous rules exist under copyright and trade secret law. Thus, absent a contractual or other voluntary commitment to license IP rights to others (e.g., the FRAND commitments as discussed in [Chapter 20](#)), an IP owner may freely choose to grant licenses to some and refuse to grant licenses to others. Even the possession of market power does not automatically "impose on [an] intellectual property owner an obligation to license the use of that property to others."³⁵

One potential exception to this general rule arises via the so-called "essential facilities" doctrine, under which a monopolist may be required to make available to its competitors some resource or facility that is essential to compete in the market.³⁶ The origin of this principle is often traced to *United States v. Terminal R.R. Ass'n of St. Louis*, 224 U.S. 383, 391–97 (1912), in which thirty-eight companies conspired to prevent their competitors from utilizing "every feasible means of railroad access to St. Louis," including its only two rail bridges and ferry service. The Supreme Court struck down the arrangement as an unlawful restraint of trade and ordered the defendants to open membership in their association to "any existing or future railroad." Though several cases have raised the specter that an IP right may be treated as an essential facility under the right circumstances, no case has yet held this.³⁷

Unlike unilateral refusals to grant licenses, which are seldom found to violate the antitrust laws, agreements to do so among competitors – colloquially known as "group boycotts" – are subject to *per se* liability under Section 1 of the Sherman Act. The following case explores this practice in the context of the distribution of copyrighted films.

The Movie 1 & 2 v. United Artists Communications

909 F.2d 1245 (9th Cir. 1990)

BREWSTER, DISTRICT JUDGE

The Movie 1 & 2 ("The Movie") appeals a district court judgment dismissing its case against numerous antitrust defendants. This case involves allegations that two motion

³³ 253 F.3d at 54.

³⁴ This freedom of association does not apply in the context of consumer transactions, as to which a variety of antidiscrimination and common carrier rules apply.

³⁵ DOJ–FTC, 2017 Licensing Guidelines, *supra* [note 15](#), at 4.

³⁶ See *MCI Comm. Corp. v. AT&T*, 708 F.2d 1081, 1132–33 (7th Cir. 1983).

³⁷ For a discussion and summary of the case law, see Herbert Hovenkamp, Mark D. Janis & Mark A. Lemley, *Unilateral Refusals to License*, 2 J. Comp. L. & Econ. 1 (2006).

picture exhibitors in Santa Cruz, California, entered into an illegal film licensing agreement in which 19 national film distributors participated, and that the exhibitors attempted to monopolize, conspired to monopolize, and did monopolize the film exhibition market in Santa Cruz. The United States District Court for the Northern District of California ... granted the defendants' multiple motions for summary judgment as to all of the antitrust claims.

Background

Appellant The Movie is a general partnership consisting of Harold Snyder and his two sons, David and Larry Snyder. In February of 1984, the Snyders opened a motion picture theatre in Santa Cruz, California. The two-screen theatre, which has 225 seats in each auditorium, is located in downtown Santa Cruz in a converted storefront which it shares with a moped shop. The Snyders' intent was to exhibit both "commercial" and "art" films on a first-run basis.

The exhibitor defendants in this case were two of The Movie's competitors, UA, which operates five theaters in Santa Cruz with a total of twelve screens, and the Nickelodeon, which operates two theatres with a total of four screens. The distributor defendants included ten major motion picture distributors ("Group I") and nine smaller independent distribution companies ("Group II").

The relevant geographic market in this case is the greater Santa Cruz area, which includes Aptos, Scotts Valley, and Capitola. The relevant product market is first-run motion pictures. Although theatres can either show "first-run" films or subsequently run "sub-run" films, first-run films provide the greatest grossing potential. The Santa Cruz area has only ten theatres at present. UA's five theatres exhibit primarily first-run "commercial" films. The Nickelodeon's two theatres exhibit primarily first-run and vintage "art" films. The only other competitors in Santa Cruz are two non-defendant independent exhibitors who apparently show primarily sub-run films.

This circuit has recognized the existence of relevant submarkets within a product market. We are satisfied with the appellant's division of the relevant market in this case into two categories, "commercial" and "art" films.

The appellant alleges that The Movie was unable to obtain licenses to first-run commercial or art films from the defendant distributors, who concertedly refused to deal with it. Appellant alleges that the distributors cooperated in an illegal "split agreement" between UA and the Nickelodeon, whereby nearly all first-run commercial films were licensed to UA and nearly all first-run art films were licensed to the Nickelodeon. A split agreement is an exhibitor agreement which divides a normally competitive market by allocating films to particular members with the understanding that there will be no bidding among members for licensing rights to the films assigned.

Appellant alleges that the split agreement in this case was part of a boycott against The Movie, which had the purpose of eliminating it as a competitor, a restraint of trade in violation of section 1 of the Sherman Act.

Discussion

Section 1 of the Sherman Act prohibits "[e]very contract, combination ... or conspiracy, in restraint of trade." Appellant's section 1 claims allege an illegal agreement between the exhibitors and the distributors in the form of a "group boycott" aimed at excluding The Movie from the Santa Cruz theatre market.



FIGURE 25.8 The Nickelodeon Theater in Santa Cruz, Cal.

The Supreme Court has emphasized, however, that the Sherman Act does not restrict “the long recognized right of a trader ... engaged in an entirely private business, freely to exercise his own independent discretion as to the parties with whom he will deal.” *United States v. Colgate Co.*, 250 U.S. 300, 307 (1919). Because of a supplier’s right to choose his customers and set his own terms, antitrust plaintiffs are required to do more than merely allege conspiracy and unequal treatment in order to take a case to trial. According to the law of this circuit, once a defendant rebuts the allegations of conspiracy with “probative evidence supporting an alternative interpretation of a defendant’s conduct,” the plaintiff must come forward with specific factual support of its conspiracy allegations to avoid summary judgment.

The defendants in this case did offer some evidence from which a trier of fact could reasonably have found that their refusal to deal with The Movie was based on legitimate and sound business judgment. Following such a showing of a plausible and justifiable reason for a defendant’s conduct, a plaintiff must provide specific factual support for its allegations of conspiracy which tends to show that the defendant was not acting independently. Accordingly, we examine appellant’s evidence in support of its conspiracy allegations.

The Distributor Defendants

The distributors possessed an absolute right to refuse to license films to The Movie as long as their decisions were based upon independent business judgment. The distributors presented evidence to the trial court from which a trier of fact could find that the decision to license films to UA and the Nickelodeon rather than to The Movie was based on

such factors as the perceived inferiority and consequently lower grossing potential of The Movie's theatre house and the allegedly inferior terms offered in The Movie's bids. Thus ... the defendants rebutted the allegations of conspiracy, and it was incumbent upon the plaintiff to come forward with specific factual support of its conspiracy claim. We believe the plaintiff did present ample evidence to rebut defendants' evidence of independent business decisions and to support plaintiff's allegations of an illegal boycott. We, therefore, reverse the trial court's summary adjudication of the section 1 claims against all of the Group I distributor defendants.

Appellees contend that the lower court's record contained no admissible evidence or assertion of any defendant distributors' having received superior bids from The Movie and having rejected them in favor of defendant exhibitors. While it could be argued, as appellees also urge here, that none of the appellant's bids were superior, that determination is an issue of fact which should be decided by summary judgment only if the trial court can find that no reasonable jury could find on that question in favor of the non-moving party. Some of the bids were arguably superior.

There was evidence before the trial court indicating that these distributors had refused to even receive bids from The Movie until they received threatening correspondence from The Movie's attorney. The distributors have cited no legitimate business justification for a refusal to even receive an exhibitor's bid, nor can this court conceive of how such conduct could reflect sound business judgment. To the contrary, such behavior raises the inference that the distributors would not have licensed films to The Movie even if presented with consistent lucrative bids superior to those of the other exhibitors. This circuit has recognized that a distributor's repeated rejection of lucrative bids in an anticompetitive market environment raises an inference of conspiratorial antitrust conduct. The evidence that UA reaped roughly 96.9% of all revenues from first-run commercial films shown in Santa Cruz reflects an anticompetitive market situation. In such an environment, the distributors' refusal to even receive a new exhibitor's bids "tends to exclude the possibility of independent action," and at least raises an issue of fact as to their participation in the alleged boycott.

This circuit has recognized that it is not necessary for a plaintiff to show an explicit agreement among defendants in support of a Sherman Act conspiracy, and that concerted action may be inferred from circumstantial evidence of the defendant's conduct and course of dealings. We conclude, therefore, that appellant did present sufficient evidence to present a triable issue on the section 1 claim of conspiracy to restrain trade in the form of a group boycott of appellant through split agreements. Our conclusion is reached in the context of evidence before the trial court of awards of films without any bids at all, bid negotiations excluding appellant, bid-tipping, adjustments to licensing agreements made to UA regularly, but to appellant rarely, if ever, and the statistics of film licenses awarded. The appellant should, therefore, have been allowed to proceed to trial on the section 1 claims against the Group I distributors. We accordingly reverse the trial court's grant of summary judgment as to these defendants.

Evaluation of the Unreasonable Restraint of Trade Allegations Under the "Per Se" Rule or the "Rule of Reason"

To the extent that the district court held that a split agreement should be evaluated under the rule of reason because it constituted a non-price restraint of trade, the court erred. It should have applied the illegal per se rule.

Appellees contend that the district court referred to the rule of reason in mere dicta and, therefore, that the issue to which it referred cannot be the basis for a reversal. They argue that the district court never reached the question whether the rule of reason or the per se analysis should be used because both first require proof of an agreement, such as a split agreement, which the court failed to find. Since we find an issue of fact exists regarding the existence of a split agreement, we address the applicability of the “rule of reason” analysis.

This circuit has recently ruled on this issue. In *Harkins*, 850 F.2d at 486, we noted that per se treatment is appropriate “where joint efforts by firms disadvantage competitors by inducing suppliers or customers to deny relationships the competitors need in order to compete.” We concluded that an alleged split agreement, if proven, would be illegal per se. Appellees dispute the appellant’s reliance on *Harkins* on several grounds. First, they claim that the “per se rule” in that case was only dicta. Second, they claim that all cases finding per se treatment appropriate for a split agreement have demonstrated that the agreement was to depress film rentals to the distributors, eliminate guarantees to those distributors, or otherwise affect the terms of licensing for films, i.e., antitrust injury. Appellees contend that appellants have failed to even allege these factors. One of the cases relied on in *Harkins*, appellees point out, *Northwest Wholesale Stationers, Inc. v. Pacific Stationery Printing Co.*, 472 U.S. 284 (1985), supports the proposition that a per se analysis is not appropriate where no antitrust injury has been alleged. The United States Supreme Court in that case found that plaintiff failed to prove an antitrust violation when it demonstrated injury to itself but not to competition.

In the instant case, however, the split agreement is allegedly employed to restrict entry of other exhibitors into the Santa Cruz market for any film. If so, such conduct would cause antitrust injury in the form of a boycott, a conspiracy in restraint of trade in violation of 15 U.S.C. § 1. In fact, in *Northwest Wholesale Stationers*, the court opined that in cases of group boycotts that directly or indirectly cut off necessary access to customers or suppliers, the per se rule applies because the likelihood of antitrust injury is clear.

On remand, the trial court should instruct the jury accordingly.

Notes and Questions

1. *Unilateral versus concerted conduct*. Why are unilateral refusals to license IP generally tolerated under the antitrust laws, but concerted refusals to license are not? Why is it that the Supreme Court has labeled collusion as “the supreme evil of antitrust”? *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 408 (2004).
2. *Market allocation or group boycott*? As explained by the court in *The Movie*, “A split agreement is an exhibitor agreement which divides a normally competitive market by allocating films to particular members with the understanding that there will be no bidding among members for licensing rights to the films assigned.” On its face, this sounds like a market allocation scheme discussed in [Section 25.3](#). Why did *The Movie* instead challenge the split agreement as a group boycott? How might the antitrust have differed between these two theories?
3. *Antitrust injury*. In *Northwest Wholesale Stationers*, the Supreme Court held that the plaintiff failed to prove an antitrust violation when it demonstrated injury to itself but not to competition. Why should that matter? Isn’t the plaintiff’s job in a lawsuit to prove that it was injured? Why would the Supreme Court deny recovery to a private plaintiff because it failed

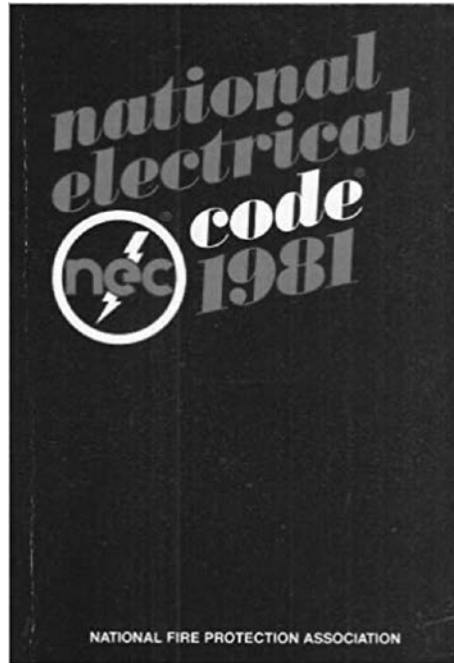


FIGURE 25.9 The National Electrical Code is published by the National Fire Protection Association.

to prove injury to “competition” broadly writ? Should safeguarding overall market competition be the responsibility of the enforcement agencies rather than private plaintiffs?

25.8 ANTITRUST ISSUES AND DUE PROCESS IN STANDARD SETTING

As discussed in [Chapter 20](#), the development of technical interoperability standards is often conducted by groups of competitors under the auspices of one or more standards-development organizations (SDOs). Given the coordinated work of dozens of different competitors to produce shared technical specifications, standardization has long been the subject of antitrust scrutiny.

Today, the conduct of participants within an SDO is typically governed by detailed rules imposed by SDOs in order to limit antitrust liability, both for the SDO and for its participants. But this was not always the case. The following case explores some of the ways that participants in an SDO can act in a manner that is anticompetitive.

Allied Tube v. Indian Head, Inc.

486 U.S. 492 (1988)

BRENNAN, JUSTICE

I

The National Fire Protection Association (Association) is a private, voluntary organization with more than 31,500 individual and group members representing industry, labor, academia, insurers, organized medicine, firefighters, and government. The Association, among

other things, publishes product standards and codes related to fire protection through a process known as “consensus standard making.” One of the codes it publishes is the National Electrical Code (Code), which establishes product and performance requirements for the design and installation of electrical wiring systems. Revised every three years, the Code is the most influential electrical code in the nation. A substantial number of state and local governments routinely adopt the Code into law with little or no change; private certification laboratories, such as Underwriters Laboratories, normally will not list and label an electrical product that does not meet Code standards; many underwriters will refuse to insure structures that are not built in conformity with the Code, and many electrical inspectors, contractors, and distributors will not use a product that falls outside the Code.

Among the electrical products covered by the Code is electrical conduit, the hollow tubing used as a raceway to carry electrical wires through the walls and floors of buildings. Throughout the relevant period, the Code permitted using electrical conduit made of steel, and almost all conduit sold was in fact steel conduit. Starting in 1980, respondent began to offer plastic conduit made of polyvinyl chloride. Respondent claims its plastic conduit offers significant competitive advantages over steel conduit, including pliability, lower installed cost, and lower susceptibility to short circuiting. In 1980, however, there was also a scientific basis for concern that, during fires in high-rise buildings, polyvinyl chloride conduit might burn and emit toxic fumes.

Respondent initiated a proposal to include polyvinyl chloride conduit as an approved type of electrical conduit in the 1981 edition of the Code. Following approval by one of the Association’s professional panels, this proposal was scheduled for consideration at the 1980 annual meeting, where it could be adopted or rejected by a simple majority of the members present. Alarmed that, if approved, respondent’s product might pose a competitive threat to steel conduit, petitioner, the Nation’s largest producer of steel conduit, met to plan strategy with, among others, members of the steel industry, other steel conduit manufacturers, and its independent sales agents. They collectively agreed to exclude respondent’s product from the 1981 Code by packing the upcoming annual meeting with new Association members whose only function would be to vote against the polyvinyl chloride proposal.

Combined, the steel interests recruited 230 persons to join the Association and to attend the annual meeting to vote against the proposal. Petitioner alone recruited 155 persons – including employees, executives, sales agents, the agents’ employees, employees from two divisions that did not sell electrical products, and the wife of a national sales director. Petitioner and the other steel interests also paid over \$100,000 for the membership, registration, and attendance expenses of these voters. At the annual meeting, the steel group voters were instructed where to sit and how and when to vote by group leaders who used walkie-talkies and hand signals to facilitate communication. Few of the steel group voters had any of the technical documentation necessary to follow the meeting. None of them spoke at the meeting to give their reasons for opposing the proposal to approve polyvinyl chloride conduit. Nonetheless, with their solid vote in opposition, the proposal was rejected and returned to committee by a vote of 394 to 390. Respondent appealed the membership’s vote to the Association’s Board of Directors, but the Board denied the appeal on the ground that, although the Association’s rules had been circumvented, they had not been violated.³⁸

³⁸ Respondent also sought a tentative interim amendment to the Code, but that was denied on the ground that there was not sufficient exigency to merit an interim amendment. The Association subsequently approved use of polyvinyl chloride conduit for buildings of less than three stories in the 1984 Code, and for all buildings in the 1987 Code.

In October, 1981, respondent brought this suit in Federal District Court, alleging that petitioner and others had unreasonably restrained trade in the electrical conduit market in violation of § 1 of the Sherman Act. A bifurcated jury trial began in March, 1985. Petitioner conceded that it had conspired with the other steel interests to exclude respondent's product from the Code, and that it had a pecuniary interest to do so. The jury, instructed under the rule of reason that respondent carried the burden of showing that the anticompetitive effects of petitioner's actions outweighed any procompetitive benefits of standard-setting, found petitioner liable. In answers to special interrogatories, the jury found that petitioner did not violate any rules of the Association and acted, at least in part, based on a genuine belief that plastic conduit was unsafe, but that petitioner nonetheless did "subvert" the consensus standard-making process of the Association. The jury also made special findings that petitioner's actions had an adverse impact on competition, were not the least restrictive means of expressing petitioner's opposition to the use of polyvinyl chloride conduit in the marketplace, and unreasonably restrained trade in violation of the antitrust laws. The jury then awarded respondent damages, to be trebled, of \$3.8 million for lost profits resulting from the effect that excluding polyvinyl chloride conduit from the 1981 Code had of its own force in the marketplace. No damages were awarded for injuries stemming from the adoption of the 1981 Code by governmental entities.

II

[The Court's discussion of the Noerr-Pennington doctrine, which immunizes certain conduct that can be characterized as petitioning the government, is omitted.]

Typically, private standard-setting associations, like the Association in this case, include members having horizontal and vertical business relations. There is no doubt that the members of such associations often have economic incentives to restrain competition and that the product standards set by such associations have a serious potential for anticompetitive harm. See *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U. S. 556 (1982). Agreement on a product standard is, after all, implicitly an agreement not to manufacture, distribute, or purchase certain types of products. Accordingly, private standard-setting associations have traditionally been objects of antitrust scrutiny. When, however, private associations promulgate safety standards based on the merits of objective expert judgments and through procedures that prevent the standard-setting process from being biased by members with economic interests in stifling product competition, those private standards can have significant procompetitive advantages. It is this potential for procompetitive benefits that has led most lower courts to apply rule-of-reason analysis to product standard-setting by private associations.

[T]he validity of [petitioner's efforts to influence the Code] must ... be evaluated under the standards of conduct set forth by the antitrust laws that govern the private standard-setting process. The antitrust validity of these efforts is not established, without more, by petitioner's literal compliance with the rules of the Association, for the hope of procompetitive benefits depends upon the existence of safeguards sufficient to prevent the standard-setting process from being biased by members with economic interests in restraining competition. An association cannot validate the anticompetitive activities of its members simply by adopting rules that fail to provide such safeguards ...

What petitioner may not do (without exposing itself to possible antitrust liability for direct injuries) is bias the process by, as in this case, stacking the private standard-setting body with decisionmakers sharing their economic interest in restraining competition.

Notes and Questions

1. *The antitrust issue.* The *Allied Tube* case was not decided on antitrust grounds, and the Court's discussion of the antitrust issues is largely dicta. Nevertheless, the Court clearly recognized the potential for antitrust violations in the defendants' conduct. Under what theories might antitrust liability lie in this case?
2. *Inadvertent collusion?* The Court in *Allied Tube* notes that "the jury found that petitioner did not violate any rules of the Association and acted, at least in part, based on a genuine belief that plastic conduit was unsafe, but that petitioner nonetheless did 'subvert' the consensus standard-making process of the Association." If *Allied Tube* did not violate any NFPA rules, and actually thought that plastic was an unsafe material for electrical conduit, could it be found liable for violating the Sherman Act? Should there be liability for inadvertent or negligent harm to competition?
3. *More bad behavior at SDOs.* The Court in *Allied Tube* cites its earlier decision involving the American Society of Mechanical Engineers (ASME). Like *Allied Tube*, *ASME v. Hydrolevel*, 456 U.S. 556 (1982), involved allegedly bad behavior at a large SDO. Specifically, the chair of an ASME subcommittee responsible for certifying the compliance of boiler pressure valves with ASME standards ruled that a competitor's valves did not meet the standards and were thus unsafe. The Supreme Court held that ASME itself could be held liable for these misrepresentations, as the weight of the SDO's reputation greatly enhanced the anticompetitive effects of its members' conduct. Why do you think SDOs offer a particularly attractive venue for anticompetitive conduct? Unlike ASME, the NFPA itself was not charged with anticompetitive conduct. To what degree do you think SDOs should be liable for the anticompetitive conduct of their members? Based on the facts of *Allied Tube*, should NFPA have shared antitrust liability with *Allied Tube* and its allies?
4. *Circular A-119 and SDO due process.* In the late 1970s, observers began to appreciate both the power of SDOs to shape industry practices and their potential to foster anticompetitive behavior. At the same time, there was a strong movement in the United States to shift technical activity from the government to the private sector. In 1980, the Office of Management and Budget (OMB) released a memorandum known as OMB Circular A-119 to the heads of federal agencies.³⁹ Circular A-119 encouraged each federal agency to adopt privately developed "voluntary standards" in lieu of governmentally developed standards when specifying the characteristics of goods and services to be procured by the agency. In order to qualify as an SDO developing "voluntary standards," the SDO had to abide by a list of "due process and other basic criteria" set out in Circular A-119. These criteria included having public meetings, broadly based representation, consensus decision-making, an appeals process and so forth. Circular A-119 has evolved over the years, and now covers both federal procurement and regulatory activities. Due in part to Circular A-119, the Supreme Court's holdings in *ASME* and *Allied Tube* and other national and international legal developments, most SDOs today have adopted rules imposing due process requirements (openness, balance, consensus, appeal) on their standardization activities.⁴⁰ Why are due process requirements important for technical standards development, which might seem like a value-neutral technical activity?

³⁹ Off. Mgt. Budget, Federal Participation in the Development and Use of Voluntary Standards; Final Issuance, 45 Fed. Reg. 4326 (1980).

⁴⁰ For a brief history of these developments, see Justus Baron, Jorge L. Contreras & Pierre Larouche, *Balance and Standardization: Implications for Competition and Antitrust Analysis*, 84 Antitrust L.J. 301 (2022).

5. *Due process and policy making.* The anticompetitive activity condemned in cases like *ASME* and *Allied Tube* related to an SDO's standardization activities – is a particular pressure valve compliant? Is PVC an appropriate material for electrical conduit? As a result, the due process requirements that SDOs implemented in the wake of these cases and Circular A-119 focused largely on the standardization process: how standards are proposed, developed, debated and approved at an SDO. But what about the SDO's own internal policies? Must the SDO members follow similar due process requirements when formulating, say, the SDO's patent policy? This question has been hotly debated in recent years as SDOs such as the IEEE have adopted policies that are opposed by some SDO members (see [Chapter 20](#)). Is adopting an SDO policy different than developing a technical standard? Is the antitrust risk the same for SDO policies as it is for technical standards? Should the same due process requirements apply in both contexts?⁴

25.9 REVERSE PAYMENT SETTLEMENTS: “PAY FOR DELAY”

Federal Trade Commission v. Actavis, Inc.

570 U.S. 136 (2013)

BREYER, JUSTICE,

Company A sues Company B for patent infringement. The two companies settle under terms that require (1) Company B, the claimed infringer, not to produce the patented product until the patent's term expires, and (2) Company A, the patentee, to pay B many millions of dollars. Because the settlement requires the patentee to pay the alleged infringer, rather than the other way around, this kind of settlement agreement is often called a “reverse payment” settlement agreement. And the basic question here is whether such an agreement can sometimes unreasonably diminish competition in violation of the antitrust laws. See, e.g., 15 U.S.C. § 1 (Sherman Act prohibition of “restraint[s] of trade or commerce”).

In this case, the Eleventh Circuit dismissed a Federal Trade Commission (FTC) complaint claiming that a particular reverse payment settlement agreement violated the antitrust laws. In doing so, the Circuit stated that a reverse payment settlement agreement generally is “immune from antitrust attack so long as its anticompetitive effects fall within the scope of the exclusionary potential of the patent.” And since the alleged infringer's promise not to enter the patentee's market expired before the patent's term ended, the Circuit found the agreement legal and dismissed the FTC complaint. In our view, however, reverse payment settlements such as the agreement alleged in the complaint before us can sometimes violate the antitrust laws. We consequently hold that the Eleventh Circuit should have allowed the FTC's lawsuit to proceed.

I A

Apparently most if not all reverse payment settlement agreements arise in the context of pharmaceutical drug regulation, and specifically in the context of suits brought under statutory provisions allowing a generic drug manufacturer (seeking speedy marketing

⁴ For an overview and analysis of this question, see Justus Baron, et al., *Making the Rules: The Governance of Standard Development Organizations and their Policies on Intellectual Property Rights*, JRC Science for Policy Report EUR 29655 at 148–64 (March 2019).

approval) to challenge the validity of a patent owned by an already-approved brand-name drug owner. We consequently describe four key features of the relevant drug-regulatory framework established by the Drug Price Competition and Patent Term Restoration Act of 1984. That Act is commonly known as the Hatch–Waxman Act.

First, a drug manufacturer, wishing to market a new prescription drug, must submit a New Drug Application to the federal Food and Drug Administration (FDA) and undergo a long, comprehensive, and costly testing process, after which, if successful, the manufacturer will receive marketing approval from the FDA.

Second, once the FDA has approved a brand-name drug for marketing, a manufacturer of a generic drug can obtain similar marketing approval through use of abbreviated procedures. The Hatch–Waxman Act permits a generic manufacturer to file an Abbreviated New Drug Application specifying that the generic has the “same active ingredients as,” and is “biologically equivalent” to, the already-approved brand-name drug. In this way the generic manufacturer can obtain approval while avoiding the “costly and time-consuming studies” needed to obtain approval “for a pioneer drug.”

Third, the Hatch–Waxman Act sets forth special procedures for identifying, and resolving, related patent disputes. It requires the pioneer brand-name manufacturer to list in its New Drug Application the “number and the expiration date” of any relevant patent. And it requires the generic manufacturer in its Abbreviated New Drug Application to “assure the FDA” that the generic “will not infringe” the brand-name’s patents.

The generic can provide this assurance in one of several ways. It can certify that the brand-name manufacturer has not listed any relevant patents. It can certify that any relevant patents have expired. It can request approval to market beginning when any still-in-force patents expire. Or, it can certify that any listed, relevant patent “is invalid or will not be infringed by the manufacture, use, or sale” of the drug described in the Abbreviated New Drug Application. Taking this last-mentioned route (called the “paragraph IV” route), automatically counts as patent infringement, and often “means provoking litigation.” If the brand-name patentee brings an infringement suit within 45 days, the FDA then must withhold approving the generic, usually for a 30-month period, while the parties litigate patent validity (or infringement) in court.

Fourth, Hatch–Waxman provides a special incentive for a generic to be the first to file an Abbreviated New Drug Application taking the paragraph IV route. That applicant will enjoy a period of 180 days of exclusivity (from the first commercial marketing of its drug). During that period of exclusivity no other generic can compete with the brand-name drug. If the first-to-file generic manufacturer can overcome any patent obstacle and bring the generic to market, this 180-day period of exclusivity can prove valuable, possibly worth several hundred million dollars. Indeed, the Generic Pharmaceutical Association said in 2006 that the “vast majority of potential profits for a generic drug manufacturer materialize during the 180-day exclusivity period.” The 180-day exclusivity period, however, can belong only to the first generic to file.

B. 1

In 1999, Solvay Pharmaceuticals, a respondent here, filed a New Drug Application for a brand-name drug called AndroGel. The FDA approved the application in 2000. In 2003, Solvay obtained a relevant patent and disclosed that fact to the FDA, as Hatch–Waxman requires.

Later the same year another respondent, Actavis, Inc. (then known as Watson Pharmaceuticals), filed an Abbreviated New Drug Application for a generic drug modeled after AndroGel. Subsequently, Paddock Laboratories, also a respondent, separately filed an Abbreviated New Drug Application for its own generic product. Both Actavis and Paddock certified under paragraph IV that Solvay's listed patent was invalid and their drugs did not infringe it. A fourth manufacturer, Par Pharmaceutical, likewise a respondent, did not file an application of its own but joined forces with Paddock, agreeing to share the patent litigation costs in return for a share of profits if Paddock obtained approval for its generic drug.

Solvay initiated paragraph IV patent litigation against Actavis and Paddock. Thirty months later the FDA approved Actavis' first-to-file generic product, but, in 2006, the patent-litigation parties all settled. Under the terms of the settlement Actavis agreed that it would not bring its generic to market until August 31, 2015, 65 months before Solvay's patent expired (unless someone else marketed a generic sooner). Actavis also agreed to promote AndroGel to urologists. The other generic manufacturers made roughly similar promises. And Solvay agreed to pay millions of dollars to each generic—\$12 million in total to Paddock; \$60 million in total to Par; and an estimated \$19–\$30 million annually, for nine years, to Actavis. The companies described these payments as compensation for other services the generics promised to perform, but the FTC contends the other services had little value. According to the FTC the true point of the payments was to compensate the generics for agreeing not to compete against AndroGel until 2015.

2

On January 29, 2009, the FTC filed this lawsuit against all the settling parties, namely, Solvay, Actavis, Paddock, and Par. The FTC's complaint (as since amended) alleged that respondents violated § 5 of the Federal Trade Commission Act by unlawfully agreeing "to share in Solvay's monopoly profits, abandon their patent challenges, and refrain from launching their low-cost generic products to compete with AndroGel for nine years." The District Court held that these allegations did not set forth an antitrust law violation. It accordingly dismissed the FTC's complaint. The FTC appealed.

The Court of Appeals for the Eleventh Circuit affirmed the District Court. It wrote that "absent sham litigation or fraud in obtaining the patent, a reverse payment settlement is immune from antitrust attack so long as its anticompetitive effects fall within the scope of the exclusionary potential of the patent."

The FTC sought certiorari. Because different courts have reached different conclusions about the application of the antitrust laws to Hatch–Waxman-related patent settlements, we granted the FTC's petition.

II A

Solvay's patent, if valid and infringed, might have permitted it to charge drug prices sufficient to recoup the reverse settlement payments it agreed to make to its potential generic competitors. And we are willing to take this fact as evidence that the agreement's "anticompetitive effects fall within the scope of the exclusionary potential of the patent." But we do not agree that that fact, or characterization, can immunize the agreement from antitrust attack.

For one thing, to refer, as the Circuit referred, simply to what the holder of a valid patent could do does not by itself answer the antitrust question. The patent here may or may not

be valid, and may or may not be infringed. “[A] valid patent excludes all except its owner from the use of the protected process or product”. And that exclusion may permit the patent owner to charge a higher-than-competitive price for the patented product. But an invalidated patent carries with it no such right. And even a valid patent confers no right to exclude products or processes that do not actually infringe. The paragraph IV litigation in this case put the patent’s validity at issue, as well as its actual preclusive scope. The parties’ settlement ended that litigation. The FTC alleges that in substance, the plaintiff agreed to pay the defendants many millions of dollars to stay out of its market, even though the defendants did not have any claim that the plaintiff was liable to them for damages. That form of settlement is unusual. And, for reasons discussed in Part II-B, *infra*, there is reason for concern that settlements taking this form tend to have significant adverse effects on competition.

Given these factors, it would be incongruous to determine antitrust legality by measuring the settlement’s anticompetitive effects solely against patent law policy, rather than by measuring them against procompetitive antitrust policies as well. And indeed, contrary to the Circuit’s view that the only pertinent question is whether “the settlement agreement ... fall[s] within” the legitimate “scope” of the patent’s “exclusionary potential,” this Court has indicated that patent and antitrust policies are both relevant in determining the “scope of the patent monopoly”—and consequently antitrust law immunity—that is conferred by a patent.

Thus, the Court in *Line Material* explained that “the improper use of [a patent] monopoly,” is “invalid” under the antitrust laws and resolved the antitrust question in that case by seeking an accommodation “between the lawful restraint on trade of the patent monopoly and the illegal restraint prohibited broadly by the Sherman Act.” To strike that balance, the Court asked questions such as whether “the patent statute specifically gives a right” to restrain competition in the manner challenged; and whether “competition is impeded to a greater degree” by the restraint at issue than other restraints previously approved as reasonable. In short, rather than measure the length or amount of a restriction solely against the length of the patent’s term or its earning potential, as the Court of Appeals apparently did here, this Court answered the antitrust question by considering traditional antitrust factors such as likely anticompetitive effects, redeeming virtues, market power, and potentially offsetting legal considerations present in the circumstances, such as here those related to patents. See Part II-B, *infra*. Whether a particular restraint lies “beyond the limits of the patent monopoly” is a conclusion that flows from that analysis and not, as the Chief Justice suggests, its starting point.

For another thing, this Court’s precedents make clear that patent-related settlement agreements can sometimes violate the antitrust laws. In *United States v. Singer Mfg. Co.*, 374 U.S. 174 (1963), for example, two sewing machine companies possessed competing patent claims; a third company sought a patent under circumstances where doing so might lead to the disclosure of information that would invalidate the other two firms’ patents. All three firms settled their patent-related disagreements while assigning the broadest claims to the firm best able to enforce the patent against yet other potential competitors. The Court did not examine whether, on the assumption that all three patents were valid, patent law would have allowed the patents’ holders to do the same. Rather, emphasizing that the Sherman Act “imposes strict limitations on the concerted activities in which patent owners may lawfully engage,” it held that the agreements, although settling patent disputes, violated the antitrust laws. And that, in important part, was because “the public interest in

granting patent monopolies” exists only to the extent that “the public is given a novel and useful invention” in “consideration for its grant.”

Similarly, both within the settlement context and without, the Court has struck down overly restrictive patent licensing agreements—irrespective of whether those agreements produced supra-patent-permitted revenues. We concede that in *United States v. General Elec. Co.*, 272 U.S. 476 (1926), the Court permitted a single patentee to grant to a single licensee a license containing a minimum resale price requirement. But in *Line Material*, the Court held that the antitrust laws forbid a group of patentees, each owning one or more patents, to cross-license each other, and, in doing so, to insist that each licensee maintain retail prices set collectively by the patent holders. The Court was willing to presume that the single-patentee practice approved in General Electric was a “reasonable restraint” that “accords with the patent monopoly granted by the patent law,” but declined to extend that conclusion to multiple-patentee agreements: “As the Sherman Act prohibits agreements to fix prices, any arrangement between patentees runs afoul of that prohibition and is outside the patent monopoly.” In *New Wrinkle*, 342 U.S., at 378, the Court held roughly the same, this time in respect to a similar arrangement in settlement of a litigation between two patentees, each of which contended that its own patent gave it the exclusive right to control production. That one or the other company (we may presume) was right about its patent did not lead the Court to confer antitrust immunity. Far from it, the agreement was found to violate the Sherman Act.

Finally in *Standard Oil Co. (Indiana)*, the Court upheld cross-licensing agreements among patentees that settled actual and impending patent litigation, which agreements set royalty rates to be charged third parties for a license to practice all the patents at issue (and which divided resulting revenues). But, in doing so, Justice Brandeis, writing for the Court, warned that such an arrangement would have violated the Sherman Act had the patent holders thereby “dominate[d]” the industry and “curtail[ed]” the manufacture and supply of an unpatented product.” These cases do not simply ask whether a hypothetically valid patent’s holder would be able to charge, e.g., the high prices that the challenged patent-related term allowed. Rather, they seek to accommodate patent and antitrust policies, finding challenged terms and conditions unlawful unless patent law policy offsets the antitrust law policy strongly favoring competition.

Finally, the Hatch–Waxman Act itself does not embody a statutory policy that supports the Eleventh Circuit’s view. Rather, the general procompetitive thrust of the statute, its specific provisions facilitating challenges to a patent’s validity, see Part I-A, *supra*, and its later-added provisions requiring parties to a patent dispute triggered by a paragraph IV filing to report settlement terms to the FTC and the Antitrust Division of the Department of Justice, all suggest the contrary. Those interested in legislative history may also wish to examine the statements of individual Members of Congress condemning reverse payment settlements in advance of the 2003 amendments. See, e.g., 148 Cong. Rec. 14437 (2002) (remarks of Sen. Hatch) (“It was and is very clear that the [Hatch–Waxman Act] was not designed to allow deals between brand and generic companies to delay competition”).

B

The Eleventh Circuit’s conclusion finds some degree of support in a general legal policy favoring the settlement of disputes. The Circuit’s related underlying practical concern consists of its fear that antitrust scrutiny of a reverse payment agreement would require the parties to litigate the validity of the patent in order to demonstrate what would have

happened to competition in the absence of the settlement. Any such litigation will prove time consuming, complex, and expensive. The antitrust game, the Circuit may believe, would not be worth that litigation candle.

We recognize the value of settlements and the patent litigation problem. But we nonetheless conclude that this patent-related factor should not determine the result here. Rather, five sets of considerations lead us to conclude that the FTC should have been given the opportunity to prove its antitrust claim.

First, the specific restraint at issue has the “potential for genuine adverse effects on competition.” The payment in effect amounts to a purchase by the patentee of the exclusive right to sell its product, a right it already claims but would lose if the patent litigation were to continue and the patent were held invalid or not infringed by the generic product. Suppose, for example, that the exclusive right to sell produces \$50 million in supracompetitive profits per year for the patentee. And suppose further that the patent has 10 more years to run. Continued litigation, if it results in patent invalidation or a finding of noninfringement, could cost the patentee \$500 million in lost revenues, a sum that then would flow in large part to consumers in the form of lower prices.

We concede that settlement on terms permitting the patent challenger to enter the market before the patent expires would also bring about competition, again to the consumer’s benefit. But settlement on the terms said by the FTC to be at issue here—payment in return for staying out of the market—simply keeps prices at patentee-set levels, potentially producing the full patent-related \$500 million monopoly return while dividing that return between the challenged patentee and the patent challenger. The patentee and the challenger gain; the consumer loses. Indeed, there are indications that patentees sometimes pay a generic challenger a sum even larger than what the generic would gain in profits if it won the paragraph IV litigation and entered the market. The rationale behind a payment of this size cannot in every case be supported by traditional settlement considerations. The payment may instead provide strong evidence that the patentee seeks to induce the generic challenger to abandon its claim with a share of its monopoly profits that would otherwise be lost in the competitive market.

But, one might ask, as a practical matter would the parties be able to enter into such an anticompetitive agreement? Would not a high reverse payment signal to other potential challengers that the patentee lacks confidence in its patent, thereby provoking additional challenges, perhaps too many for the patentee to “buy off?” Two special features of Hatch–Waxman mean that the answer to this question is “not necessarily so.” First, under Hatch–Waxman only the first challenger gains the special advantage of 180 days of an exclusive right to sell a generic version of the brand-name product. See Part I-A, *supra*. And as noted, that right has proved valuable—indeed, it can be worth several hundred million dollars. Subsequent challengers cannot secure that exclusivity period, and thus stand to win significantly less than the first if they bring a successful paragraph IV challenge. That is, if subsequent litigation results in invalidation of the patent, or a ruling that the patent is not infringed, that litigation victory will free not just the challenger to compete, but all other potential competitors too (once they obtain FDA approval). The potential reward available to a subsequent challenger being significantly less, the patentee’s payment to the initial challenger (in return for not pressing the patent challenge) will not necessarily provoke subsequent challenges. Second, a generic that files a paragraph IV after learning that the first filer has settled will (if sued by the brand-name) have to wait out a stay period of (roughly) 30 months before the FDA may approve its application, just as the first filer did.

These features together mean that a reverse payment settlement with the first filer (or, as in this case, all of the initial filers) “removes from consideration the most motivated challenger, and the one closest to introducing competition.” The dissent may doubt these provisions matter, but scholars in the field tell us that “where only one party owns a patent, it is virtually unheard of outside of pharmaceuticals for that party to pay an accused infringer to settle the lawsuit.”¹ H. Hovenkamp, M. Janis, M. Lemley, & C. Leslie, *IP and Antitrust* § 15.3, p. 15–45, n. 161 (2d ed. Supp. 2011). It may well be that Hatch–Waxman’s unique regulatory framework, including the special advantage that the 180-day exclusivity period gives to first filers, does much to explain why in this context, but not others, the patentee’s ordinary incentives to resist paying off challengers (i.e., the fear of provoking myriad other challengers) appear to be more frequently overcome.

Second, these anticompetitive consequences will at least sometimes prove unjustified. As the FTC admits, offsetting or redeeming virtues are sometimes present. The reverse payment, for example, may amount to no more than a rough approximation of the litigation expenses saved through the settlement. That payment may reflect compensation for other services that the generic has promised to perform—such as distributing the patented item or helping to develop a market for that item. There may be other justifications. Where a reverse payment reflects traditional settlement considerations, such as avoided litigation costs or fair value for services, there is not the same concern that a patentee is using its monopoly profits to avoid the risk of patent invalidation or a finding of noninfringement. In such cases, the parties may have provided for a reverse payment without having sought or brought about the anticompetitive consequences we mentioned above. But that possibility does not justify dismissing the FTC’s complaint. An antitrust defendant may show in the antitrust proceeding that legitimate justifications are present, thereby explaining the presence of the challenged term and showing the lawfulness of that term under the rule of reason.

Third, where a reverse payment threatens to work unjustified anticompetitive harm, the patentee likely possesses the power to bring that harm about in practice. At least, the “size of the payment from a branded drug manufacturer to a prospective generic is itself a strong indicator of power”—namely, the power to charge prices higher than the competitive level. An important patent itself helps to assure such power. Neither is a firm without that power likely to pay “large sums” to induce “others to stay out of its market.” In any event, the Commission has referred to studies showing that reverse payment agreements are associated with the presence of higher-than-competitive profits—a strong indication of market power.

Fourth, an antitrust action is likely to prove more feasible administratively than the Eleventh Circuit believed. The Circuit’s holding does avoid the need to litigate the patent’s validity (and also, any question of infringement). But to do so, it throws the baby out with the bath water, and there is no need to take that drastic step. That is because it is normally not necessary to litigate patent validity to answer the antitrust question (unless, perhaps, to determine whether the patent litigation is a sham). An unexplained large reverse payment itself would normally suggest that the patentee has serious doubts about the patent’s survival. And that fact, in turn, suggests that the payment’s objective is to maintain supracompetitive prices to be shared among the patentee and the challenger rather than face what might have been a competitive market—the very anticompetitive consequence that underlies the claim of antitrust unlawfulness. The owner of a particularly valuable patent might contend, of course, that even a small risk of invalidity justifies a large payment. But, be that as it may, the payment (if otherwise unexplained) likely seeks to prevent the risk of competition. And, as we have said, that consequence constitutes the relevant

anticompetitive harm. In a word, the size of the unexplained reverse payment can provide a workable surrogate for a patent's weakness, all without forcing a court to conduct a detailed exploration of the validity of the patent itself.

Fifth, the fact that a large, unjustified reverse payment risks antitrust liability does not prevent litigating parties from settling their lawsuit. They may, as in other industries, settle in other ways, for example, by allowing the generic manufacturer to enter the patentee's market prior to the patent's expiration, without the patentee paying the challenger to stay out prior to that point. Although the parties may have reasons to prefer settlements that include reverse payments, the relevant antitrust question is: What are those reasons? If the basic reason is a desire to maintain and to share patent-generated monopoly profits, then, in the absence of some other justification, the antitrust laws are likely to forbid the arrangement.

In sum, a reverse payment, where large and unjustified, can bring with it the risk of significant anticompetitive effects; one who makes such a payment may be unable to explain and to justify it; such a firm or individual may well possess market power derived from the patent; a court, by examining the size of the payment, may well be able to assess its likely anticompetitive effects along with its potential justifications without litigating the validity of the patent; and parties may well find ways to settle patent disputes without the use of reverse payments. In our view, these considerations, taken together, outweigh the single strong consideration—the desirability of settlements—that led the Eleventh Circuit to provide near-automatic antitrust immunity to reverse payment settlements.

III

The FTC urges us to hold that reverse payment settlement agreements are presumptively unlawful and that courts reviewing such agreements should proceed via a “quick look” approach, rather than applying a “rule of reason.” We decline to do so. In *California Dental*, we held (unanimously) that abandonment of the “rule of reason” in favor of presumptive rules (or a “quick-look” approach) is appropriate only where “an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets.” (Breyer, J., concurring in part and dissenting in part). We do not believe that reverse payment settlements, in the context we here discuss, meet this criterion.

That is because the likelihood of a reverse payment bringing about anticompetitive effects depends upon its size, its scale in relation to the payor's anticipated future litigation costs, its independence from other services for which it might represent payment, and the lack of any other convincing justification. The existence and degree of any anticompetitive consequence may also vary as among industries. These complexities lead us to conclude that the FTC must prove its case as in other rule-of-reason cases.

It is so ordered.

Notes and Questions

1. *Size matters.* In *Actavis*, Justice Breyer repeatedly focuses on the size of the settlement payment (up to \$270 million to Actavis over nine years, and lesser amounts to two other generic manufacturers), reasoning that “a court, by examining the size of the payment, may well be able to assess its likely anticompetitive effects along with its potential justifications without litigating the validity of the patent.” How can the size of a payment give clues as

to anticompetitive conduct? Does the overall size of the market matter? For instance, is Solvay's \$171–270 million payment to Actavis large in comparison to its \$500 million in anticipated profits from AndroGel?

2. *Market power.* In a dissenting opinion, Chief Justice Roberts suggests that the Court should have asked whether the challenged settlement agreement “gives Solvay monopoly power beyond what the patent already gave it.” Why does he feel that this is the relevant legal question? How does Justice Breyer address this concern?
3. *Injury.* Justice Breyer states that under the terms of the settlement agreement, “the consumer loses,” as generic entry typically drives down the price of prescription drugs. But while consumer prices may be higher than they otherwise would be, is this a harm to competition constituting a violation of the antitrust laws (see [Section 25.7](#), Note 3)? How so? Are any competitors harmed by the settlement among Solvay and the generic manufacturers?
4. *Permissible settlements.* Notwithstanding the result in *Actavis*, branded pharmaceutical manufacturers continue to settle patents disputes with generic drug manufacturers. In fact, the number of such settlements has increased since the *Actavis* decision. According to the FTC (which collects data on pharmaceutical patent settlements),⁴² in fiscal year 2012 pharmaceutical companies reported 88 final settlements of patent litigation. That figure increased to 232 settlements in 2016. The difference, of course, is that far fewer of the settlements post-*Actavis* contained reverse payments or other forms of compensation to the generic manufacturer. Thus, in 2004, none of the final settlements reported to the FTC included reverse payments. Then, when lower courts started to approve such payments in 2005, the number of reverse payments began to increase. The FTC reports that in 2006 and 2007, 40–50 percent of all final settlements filed with the FTC included reverse payments. By 2016, no reverse payment settlements were reported. What do these statistics imply about the responsiveness of private industry to changes in the antitrust laws?
5. *No-AG agreements.* In the aftermath of *Actavis*, pharmaceutical firms found creative ways to structure patent settlements to delay generic entry, while at the same time avoiding explicit pay-for-delay arrangements. One of those methods involved a branded pharmaceutical firm's ability, after patent expiration, to launch a generic version of its own drug, called an “authorized generic,” or AG. An AG is not prohibited from entering the market during the first generic filer's 180-day exclusivity period under the Hatch–Waxman Act. Price competition between the AG and the first-filer's generic have the potential to erode the first-filer's profit during the 180-day exclusivity period by up to 60 percent. For lucrative drugs, that margin can translate into hundreds of millions of dollars.⁴³ Thus, pharmaceutical firms realized that a branded manufacturer's promise to refrain from introducing an AG during the first-filer's exclusivity period had a clear cash value. Accordingly, firms began to enter into settlement agreements in which a generic first-filer would withdraw its challenge to a pharmaceutical patent and agree not to enter the market for a number of years. Instead of paying the generic firm (as Solvay did in *Actavis*), the pharmaceutical firm would agree not to release its own generic version of the drug during the generic manufacturer's 180-day period of exclusivity. Not surprisingly, these no-AG agreements were soon found to be equivalent to the pay-for-delay settlements condemned in *Actavis*. See *King Drug Co. of Florence, Inc. v. SmithKline Beecham Corp.*, 791 F.3d 388 (3d Cir. 2015) (Lamictal Direct Purchaser Litigation).

⁴² See FTC, *Then, Now, and Down the Road: Trends in Pharmaceutical Patent Settlements after FTC v. Actavis*, May 28, 2019, www.ftc.gov/news-events/blogs/competition-matters/2019/05/then-now-down-road-trends-pharmaceutical-patent.

⁴³ See FTC, *Authorized Generic Drugs: Short-Term Effects and Long-Term Impact*, August 2011.

6. *Other forms of compensation.* Even with direct pay-for-delay and no-AG settlements out of the picture, enterprising pharmaceutical firms have found ways to entice generic manufacturers to delay their entry into lucrative drug markets. These arrangements include declining royalty structures in which a generic's obligation to pay royalties to a branded pharmaceutical manufacturer is substantially reduced or eliminated if the branded manufacturer sells an AG, or the transfer of valuable products or equipment by the branded pharmaceutical manufacturer to the generic manufacturer. Is it realistic to hope that all such arrangements will eventually be addressed (and prohibited) by the courts, or is it inevitable that creative attorneys will constantly figure out ways to circumvent the latest judicial decision to achieve the ends of their clients? Would legislation in this area help? If so, what legislation might you propose?