shook, hardy & bacon

Antitrust News

december 2005

www.shb.com

Antitrust Deterrence: Immodest Proposals to the Antitrust Modernization Commission

By James R. Eiszner
Chairman, SHB Antitrust Practice Group
jeiszner@shb.com

Tasked with the job of evaluating the need for reforming the antitrust laws, the President's Antitrust Modernization Commission (the "Commission") invited public comment on a host of issues relating to the adequacy of current antitrust enforcement, including the adequacy of antitrust remedies. That invitation, which was extended on May 19, 2005, and required comments to be submitted less than one month later, drew a number of public comments, almost all of which purport to argue that the treble-damages remedy is either barely adequate or insufficient to deter cartel conduct. These proposals can be viewed at the Antitrust Modernization Commission's Web site, http://www.amc.gov/public_studies_fr28902/remedies.htm. All of these proposals rest on a flawed premise that the Commission itself seems to have assumed when it invited public comment: that the adequacy of the treble-damages remedy should be assessed independently of the criminal remedies available to deter antitrust violations, especially cartel behavior (price-fixing, output restrictions, market and customer allocations). Because the civil treble-damages remedy and the criminal remedies are not exclusive, the premise leads to the possibility of *over*-deterrence of antitrust violations.

Pros and Cons of Over-Deterrence. It is easy to see why the Commission should be concerned if the antitrust laws provide insufficient deterrence for cartel conduct. Cartels raise prices and restrict output and, if unchecked by competition laws, will cause consumers to get fewer products or services and to pay more for the products or services that are the subject of the cartel behavior.

On the other hand, because the conduct that gives rise to an antitrust violation is not desirable conduct, one could reason that over-deterrence of cartels is a good thing. After all, if cartels are bad for consumers, it would seem that there can never be enough deterrence for price-fixing. But this is a mistake. Because the antitrust laws exist to protect consumers, over-deterrence that leads to increased costs for consumers should be avoided. To be sure, there are criminal penalties involving incarceration that can over-deter without harming consumer welfare a great deal: imposing the death penalty for cartel behavior might over-deter but would cost consumers relatively little (costs of execution and incarceration prior to execution). Where, however, the penalty or remedy is monetary in nature—criminal fines or civil treble damages, for example—consumers can pay dearly for over-deterrence.

Measuring the Adequacy of Monetary Deterrence, and the Costs of Miscalculation. Deterrence in monetary form is adequate when a rational company would decide to refrain from cartel behavior because there is no profit to engaging in such behavior. In essence, the percentage

In This Issue

Antitrust Deterrence: Immodest Proposals to the Antitrust Modernization Commission

Courts Address Removal Issues Arising from the Class Action Fairness Act of 2005

Misuse Challenges to Licensing and Pricing of Patented Products Survive Attack Under Sherman Act Sections 1 or 2

D.C. Circuit Sings the Virtues of the FTC's "Three Tenors" Decision

Recent Publications from Shook, Hardy & Bacon's Antitrust Practice Group

chance of getting caught multiplied by the likely monetary penalties and damages must equal or slightly exceed the profits to be derived from the cartel behavior. For example, if we assume that there is a 10 percent chance of detection and $10 million in monetary deterrence for a violation, then this deterrence is adequate only for cartel behavior that would lead to increased profits of $1 million. But if we take the same facts, and instead impose $100 million in monetary deterrence, then there is over-deterrence of $90 million.

Who pays for this over-deterrence? In the first instance, it is the company that engages in cartel behavior and is caught. But that company will surely pass the $90 million on to its customers in the form of higher prices—which hurts, rather than helps, consumers. The Antitrust Modernization Commission, thus, needs to worry not only about adequacy of deterrence but also the possibility of over-deterrence. Yet, by inviting comments about the adequacy solely of civil treble damages as a deterrent, the Commission has ignored the possibility that the combination of criminal monetary penalties and civil treble damages could be over-deterring cartel behavior and harming consumers.

The Commission will be forgiven for overlooking the possibility of over-deterrence if monetary deterrence for cartel behavior is in fact inadequate. But there are reasons to believe that the treble-damages remedy, standing alone, may be more than adequate deterrence, *i.e.,* over-deterrence. Since treble damages are designed to make cartel companies pay three times the profits derived from their illegal activity, it would seem to follow that the treble-damages remedy, standing alone (no consideration of criminal fines), provides adequate deterrence if there is a one-in-three chance of getting caught. [The cartel obtains $*X* as illegal profits but must pay $3*X* in damages: The cartel behavior is only likely to be profitable if the chances of getting caught and successfully sued are less than one in three.] And many of the public comments on the adequacy of the treble-damages remedy follow this logic. Based on an old study that estimates the risks of detection to be one in 10, they argue that treble damages are inadequate. (Several commentators make the point that treble damages under state antitrust laws in states where indirect purchasers may sue help to make up for the inadequacy of the federal treble-damages remedy for direct purchasers and urge the Commission not to recommend any revisions to the federal antitrust laws that would preempt these state-law remedies.)

Factoring in Joint and Several Liability and Criminal Amnesty. Attractive as this argument may seem, it suffers from at least two fatal flaws: it ignores the concept of joint and several liability, and it ignores the drastic impact of the Antitrust Division's criminal antitrust leniency policy (which, in essence, provides a free pass on the criminal side to the first company that is not the instigator of the conspiracy to turn itself in and cooperate with the Division) on the likelihood that cartel behavior will be detected.

As to joint and several liability, this principle permits a successful antitrust plaintiff to recover the entirety of its treble-damage recovery from only one or some of the defendants. Thus, an individual rational conspirator cannot calculate its risk as the chances of detection multiplied by the damages (which are trebled) caused by just its sales of the price-fixed product. It must instead include some calculation of the chance that it pays *all* of the treble-damage award, the chance it pays *none* of the award (because the antitrust plaintiff seeks it entirely from other defendants), and the chance that it pays a *disproportionately greater or smaller share* of the treble-damage award. This is a difficult calculation for anyone, and there is little empirical experience on which to base a calculation. It is enough to note that, in order to maximize settlements, plaintiffs usually demand less of early settling defendants than they demand of later settling defendants and, for similar reasons, usually settle first with defendants having smaller shares. The result is that joint and several liability usually has an adverse impact on cartelists having the largest sales shares. Since the participation of the companies with the largest shares is usually necessary for the cartel to succeed, joint and several liability serves to increase the deterrent effect of the treble-damages remedy in a sensible way. No conclusion about the inadequate deterrent effect of treble damages should be made if it does not take into account this magnifying effect of joint and several liability on the treble-damages remedy. Yet, none of the commentators who urge that treble damages are an inadequate remedy discuss this magnifying effect.

As to the effect of the Antitrust Division's leniency program on the risk of detection, there is also no good empirical evidence. One can say with confidence that older studies on the risk of detection do not take the leniency program into account. One can also say with certainty that the Antitrust Division has seen a rise in amnesty and leniency applicants. *See, e.g.,* Scott D. Hammond, Deputy Assistant Attorney Gen. for

Criminal Enforcement, Antitrust Div., U.S. Dep't of Justice, *An Update of the Antitrust Division's Criminal Enforcement Program* 9-10 (Nov. 16, 2005), http://www.usdoj.gov/atr/public/speeches/213247.pdf (noting a "surge in amnesty applications" since revisions to the leniency program implemented in August 1993, from one application a year prior to the revisions to about two a month presently). While it seems possible that the promise of amnesty has made detection a near certainty—in which case the treble-damages remedy will overly deter antitrust violations at the expense of consumer welfare—none of the commentators who have argued that treble damages are an inadequate deterrent so much as address the impact of the amnesty program. The Commission will need to undertake its own review of how the amnesty program has impacted the risk of detection of cartel behavior, hopefully with the full cooperation of the Antitrust Division. In undertaking this review, it might also look at the impact of the leniency program on the deterrent effect of joint and several liability: because recent legislation limits civil defendants who have received amnesty from the Antitrust Division on the criminal side to single damages, plaintiffs in many cases settle with defendants who have amnesty for minimal amounts, making the remaining defendants more likely to pay more than their proportional share of treble damages based on market share.

Additional Considerations in Evaluating the Adequacy of Deterrence. There may be yet additional reasons to believe that treble damages are more than adequate as a stand-alone deterrent. First, because antitrust jurisprudence permits juries to infer a conspiracy from circumstantial evidence, the risk is created that the jury will find a conspiracy that is broader—whether in geographic, customer, product or temporal scope—than actually existed. To be sure, there is equally always a risk that a jury could fail to find a conspiracy that actually existed, but this is no different than the conspiracy going undetected and is already accounted for in the statistics concerning the risk of detection. In other words, there may be an inherent bias in any study that purports to examine the risks that cartel activity is detected, and this bias may serve to understate the deterrent effect of the treble-damages remedy. Second, antitrust cases are notoriously expensive to defend, involving substantial fees for lawyers and experts. *Cf.* Frank H. Easterbrook, *The Limits of Antitrust,* 63 Tex. L. Rev. 1, 12-13 (1984) ("Litigation costs are the product of vague rules combined with high stakes, and nowhere is that combination more deadly than in antitrust litigation under the Rule of Reason."). Yet, these expenses figure nowhere in the deterrence calculation. A simplistic calculation that looks only at cartel profits, the risk of detection, and antitrust damages will likely therefore understate the deterrent effect of the civil antitrust damages remedy.

The Antitrust Modernization Commission did not receive helpful public comment on the adequacy of the treble-damages remedy. Part of the problem may be that the Commission allowed less than one month for comments to be submitted, giving commentators insufficient time to provide thoughtful comment. Those who did supply comments and who argued that the treble-damages remedy is inadequate, ignored the fact that criminal fines supplement the deterrent effect of treble damages. They also overlooked the magnifying effect of joint and several liability for treble damages and the impact of the Antitrust Division's amnesty program on the risk of detection—and perhaps many other things as well. Treble damages may already be more than adequate deterrence to antitrust cartel behavior. If so, one hopes the Commission will propose appropriate adjustments, not out of sympathy for cartel members who bear the costs of over-deterrence, but to protect the consumers who pay the costs of over-deterrence or under-deterrence in the form of higher prices.

Courts Address Removal Issues Arising from the Class Action Fairness Act of 2005

By Laurie A. Novion
lnovion@shb.com

The Class Action Fairness Act of 2005 ("CAFA" or the "Act"), Pub. L. No. 109-2, 119 Stat. 4 (codified in scattered sections of and notes to 28 U.S.C.), was enacted on February 18, 2005. The Act contains several components, including provisions that amend the current diversity jurisdiction and removal statutes with respect to most interstate class actions (*see* 28 U.S.C. §§ 1332(d), 1446, and 1453). CAFA's Section 2—its statement of congressional findings and the statute's purposes—explains that the purpose of the Act, in part, was to "restore the intent of the framers of the United States Constitution by providing for Federal court consideration of interstate cases of national importance under diversity jurisdiction." 119 Stat. at 5, §§ 2(a)(4), 2(b)(2) (codified at 28 U.S.C. § 1711 note).

I. A Rough Sketch of CAFA's Federal Diversity Jurisdiction Provisions

The Act applies to all civil actions (with limited exceptions) "commenced" on or after February 18, 2005, the date that CAFA was enacted (119 Stat. at 14, § 9 (codified at 28 U.S.C. § 1332 note)), and expands federal diversity jurisdiction over multi-state class actions by vesting federal district courts with original jurisdiction of any class action involving a proposed class of at least 100 members in which there is minimal diversity and the matter in controversy exceeds $5 million, exclusive of interest and costs. 119 Stat. at 9-10, § 4(a)(2) (codified at 28 U.S.C. §§ 1332(d)(2), (d)(5)). The claims of individual putative class members may be aggregated to satisfy the $5 million amount-in-controversy requirement. *Id.* at 10, § 4(a)(2) (codified at 28 U.S.C. § 1332(d)(6)). Additionally, the one-year limitation in 28 U.S.C. § 1446(b) does not apply to the new removal provisions enacted pursuant to CAFA. 119 Stat. at 12, § 5(a) (codified at 28 U.S.C. § 1453(b)).

Under CAFA, federal district courts must decline jurisdiction, however, if greater than two-thirds of the members of the proposed class are citizens of the state where the action was filed and either of the following two conditions exist:

(a) (i) at least one defendant is a citizen of that same state "from whom significant relief is sought" and "whose alleged conduct forms a significant basis for the claims asserted"; and (ii) the principal alleged injuries from the alleged conduct or any related conduct of each defendant were incurred in the state where the action was originally filed; and (iii) in the prior three years, no other class actions have been filed asserting the same or similar allegations against any of the defendants on behalf of the same persons (the "local controversy" exception); or

(b) the primary defendants are citizens of the state where the action was filed (one of the two "home state controversy" exceptions).

119 Stat. at 10, § 4(a) (codified at 28 U.S.C. § 1332(d)(4)). Finally, federal district courts have the discretion to decline to exercise federal jurisdiction over a class action under the CAFA provisions where greater than one-third but less than two-thirds of the members of the proposed class are citizens of the state where the action was filed, and where the primary defendants are citizens of that same state, after consideration of various enumerated factors (the second "home state controversy" exception). 119 Stat. at 9-10, § 4(a) (codified at 28 U.S.C. § 1332(d)(3)).

In anticipation of the enactment of CAFA, class actions were filed in state courts across the country in the days prior to February 18, 2005. Many of these cases were subsequently removed to federal court by defendants. As a result, federal courts have had to grapple with issues concerning the meaning of "commencement" under the Act and which party should bear the burden of proof with respect to removal/remand.

II. Meaning of "Commencement"

A. Date of Removal to Federal Court?

So far, the First, Seventh, Ninth, and Tenth Circuits have addressed the issue of whether the filing of a notice of removal "commences" an action in federal court pursuant to CAFA. Defendants have raised this argument in factual situations where the complaint or petition was originally filed in state court prior to February 18, 2005, but where the case was later removed to federal court after the date of CAFA's enactment. Those circuits all held that the date of removal does not commence an action; instead an action commences on the date an initial pleading is filed in a court of competent jurisdiction (or occasionally by some other act, such as service of the complaint, as dictated by the relevant state's law).

The Tenth Circuit was the first circuit to rule on this issue. In *Pritchett v. Office Depot, Inc.,* 420 F.3d 1090 (10th Cir. 2005), *amending and superceding* 404 F.3d 1232 (10th Cir. 2005), it rejected a defendant's argument that the class action commenced in federal court, for purposes of CAFA, as of the date of removal. Instead, it held that a civil action, at least under Kansas law, commences "at the time of filing." The court recognized, however, that in other jurisdictions, an action may commence "at the time of service." *Id.* at 1094. In support of its decision, the court commented that: (a) it is a general rule that a lawsuit is commenced upon the filing of the original complaint in a court of competent jurisdiction (unless state law provides that some other act, such as service of process, commences an action); (b) "removal statutes are to be narrowly construed"; and (c) the Act's legislative history evinces an intent to "narrow the removal provisions of the Act to exclude currently pending suits." *Id.* at 1094-96.

The Seventh Circuit reached a similar conclusion in *Knudsen v. Liberty Mutual Insurance Co.,* 411 F.3d 805 (7th Cir. 2005). In denying a petition to appeal the district court's remand order, it stated that "[e]quating filing with commencement is the norm in civil practice." *Id.* at 806. Additionally, the court emphasized that Section 9 of the Act—the statutory "effective date" provision—"must be taken seriously." *Id.*

Other federal appellate decisions have followed the Seventh and Tenth Circuits' analysis in *Knudsen* and *Pritchett,* respectively. *See, e.g., Bush v. Cheaptickets, Inc.,* 425 F.3d 683, 686-89 (9th Cir. 2005) (concluding that because California law provides that an action commences upon filing, the class action did not commence at time of removal to federal court or when defendants received service of process). For example, in *Pfizer, Inc. v. Lott,* the Seventh Circuit refused to distinguish that case, which was removed within the 30-day deadline, from *Pritchett* and *Knudsen,* where those cases had been pending in state court for several years prior to removal. 417 F.3d 725, 726 (7th Cir. 2005) (concluding that "under Illinois law the filing of the complaint had 'commenced' the suit"). The First Circuit also refused to draw such a distinction in *Natale v. Pfizer, Inc.,* 424 F.3d 43 (1st Cir. 2005) (concluding that under Massachusetts law, a civil action is commenced by filing of the complaint). As support for its decision, the First Circuit concluded that the Act expressly states that it applies only "to actions commenced on or after the date of enactment" and that to accept defendant's argument "would have us rewrite the statute by carving out a class of late-filed actions." *Id.* at 44.

Furthermore, district court cases ruling on this issue have unanimously held that the date of removal of a class action to federal court does not commence an action under CAFA. *See, e.g., New Century Health Quality Alliance, Inc. v. Blue Cross & Blue Shield of Kansas City, Inc.,* No. 05-0555-CVWSOW, 2005 WL 2219827, at *2 (W.D. Mo. Sept. 13, 2005); *Yescavage v. Wyeth, Inc.,* No. 205CV294FTM33SPC, 2005 WL 2088429, at *2-3 (M.D. Fla. Aug. 30, 2005); *see also In re Gen. Motors Corp. "Piston Slap" Prods. Liab. Litig.,* No. MDL-04-1600, 2005 WL 1606445, at *3 (W.D. Okla. July 6, 2005); *Sneddon v. Hotwire, Inc.,* Nos. C 05-0951 to -0953 SI, 2005 WL 1593593, at *2-3 (N.D. Cal. June 29, 2005); *In re Expedia Hotel Taxes & Fees Litig.,* 377 F. Supp. 2d 904, 905-06 (W.D. Wash. 2005) (concluding that class action did not commence on the date the state court consolidated the original action or the date the notice of removal was filed); *Lussier v. Dollar Tree Stores, Inc.,* No. CV 05-768-BR, 2005 WL 2211094, at *3 (D. Or. Sept. 8, 2005) ("If Congress had intended to include within the reach of federal jurisdiction actions filed but not served at the time CAFA was enacted despite state law governing commencement of an action to the contrary, Congress would have said so.").

B. Date of Amendment of Pleadings?

Although the *Pritchett* and *Knudsen* decisions specifically held that the date of removal does not commence a class action under CAFA, both decisions contain *dicta* that suggest, in certain limited circumstances, a case may commence on a date later than its original filing in state court. The Tenth Circuit acknowledged that

"some unique circumstances [exist] in which some action other than filing a complaint in court is deemed to commence a lawsuit." *Pritchett,* 420 F.3d at 1094. In *Knudsen,* the Seventh Circuit addressed this potential in more detail: "a new claim for relief (a new 'cause of action' in state practice), the addition of a new defendant, or any other step sufficiently distinct that courts would treat it as independent for limitations purposes, could well commence a new piece of litigation for federal purposes even if it bears an old docket number for state purposes." 411 F.3d at 807. The court went on to explain: "We imagine, though we need not hold, that a similar approach will apply under the 2005 Act, perhaps modeled on Fed. R. Civ. P. 15(c), which specified when a claim relates back to the original complaint . . . and when it is sufficiently independent of the original contentions that it must be treated as fresh litigation." *Id.*

Defendants have latched onto this analysis and have asserted, with varying degrees of success, that the filing of an amended pleading that adds plaintiffs or defendants, substantially modifies the proposed class definition, or asserts new causes of action should commence a new action for purposes of CAFA. In most cases, these arguments hinge upon a determination that the amendments do not relate back to the original filing date under Fed. R. Civ. P. 15(c) for statute of limitations purposes.

Adding a New Party. At least two district court cases have held that the addition of a defendant or plaintiff creates a newly commenced action for purposes of CAFA. In *Adams v. Federal Materials Co., Inc.,* No. Civ.A. 5:05CV-90-R, 2005 WL 1862378 (W.D. Ky. July 28, 2005), the plaintiff amended the complaint to assert a claim against a new defendant after February 18, 2005. Relying on the Seventh Circuit's analysis in *Knudsen,* as well as general principles concerning removal and statute of limitations issues with respect to newly added defendants, the court concluded that the addition of the new defendant

> presents precisely the situation in which it can and should be said that a new action has "commenced" for purposes of removal pursuant to CAFA. This is both a logical extension of pre-existing removal practice and in keeping with the general intent of Congress in passing the CAFA—that is, extending the privilege of removal to federal courts to defendants in large class actions on the basis of minimal diversity.

Id. at *4.

Similarly, in *Heaphy v. State Farm Mutual Automobile Insurance Co.,* No. C05 5404RBL, 2005 WL 1950244 (W.D. Wash. Aug. 15, 2005), the U.S. District Court for the Western District of Washington held that the addition of a new plaintiff who purported to assert claims on behalf of an expanded proposed class (as well as other amendments) commenced a new action under the CAFA provisions. There, the new plaintiff was not a member of the original proposed class, and the "factual context" of the new plaintiff's claims was unique to him. The court concluded that the original complaint

> cannot serve as "adequate" notice of all claims on behalf of all plaintiffs who might someday fall within the class definition. This is particularly true where, as here, the claims of the only class representative had been fully adjudicated prior to the [amended complaint], the new Plaintiff's claims were materially different from those of the original plaintiffs, and the [amended complaint] sought to add new substantive claims on behalf of both plaintiffs.

Id. at *4. Analyzing the relation-back factors under Fed. R. Civ. P. 15, the court concluded that the amended complaint did not relate back to the original complaint and therefore commenced a new action. *Id.* at *4-5.

Other courts, however, have refused to apply CAFA to class actions where amended pleadings that added new defendants were filed after the Act's enactment. In those cases, the amendments in question were commonly described by the courts as "oversights," "scrivener's errors," or substitutions to correct errors or "misnomers" that do not commence a new action, even after applying a relation-back analysis. *See, e.g., Schillinger v. Union Pac. R.R. Co.,* 425 F.3d 330, 333 (7th Cir. 2005) (concluding that the naming of an additional defendant in an amended complaint "was a scrivener's error" that did not commence a new action for purposes of CAFA; a "case should not come to federal court if the only ground for jurisdiction is a clerical error, however careless"); *Eufaula Drugs, Inc. v. Scripsolutions,* No. 2:05CV370-A, 2005 WL 2465746, at *3-4 (M.D. Ala. Oct. 6, 2005) (holding that action was not commenced under CAFA by amendment of complaint to substitute defendants and thus correct an error in the identification of the defendant named in the original complaint); *New Century Health Quality Alliance, Inc.,* 2005 WL 2219827, at *1, 4 (holding that an amendment that corrects a misnomer (suing the right party by the wrong name) relates back to

the original complaint and does not commence a new action); *Morgan v. Am. Int'l Group, Inc.,* No. C-05-2798 MMC, 2005 WL 2172001, at *2-3 (N.D. Cal. Sept. 8, 2005) (concluding that the adding of the defendant did not commence an action pursuant to CAFA because, when an amendment merely "corrects a 'misnomer,'" the amendment will be found to relate back to the original pleading; similarly holding that the addition of two named plaintiffs did not commence a new action because as putative class members, their claims were previously asserted by the original class representatives in the original complaint); *see also Heaphy,* 2005 WL 1950244, at *3 ("The court does not believe that the remand question can or should turn on the short lived, mistaken addition of a related party"—a new defendant who was quickly dismissed by plaintiffs and "who was in fact initially a party").

Expanding the Class Definition. The Seventh Circuit's *Knudsen* opinion concluded fairly quickly that "as a matter of normal language (and normal legal practice) a new development in a pending suit no more commences a new suit than does its removal." 411 F.3d at 806. Applying this logic, the court held that "the change in class definition does not present a novel claim for relief or add a new party" sufficient to commence a new action to which CAFA could be applied. *Id.* at 807. The majority of subsequent court decisions have followed *Knudsen*'s lead and ruled that modification of class definitions, even substantial expansions, do not commence a new action for purposes of CAFA. *See, e.g., Judy v. Pfizer, Inc.,* No. 4:05CV1208RWS, 2005 WL 2240088, at *3 (E.D. Mo. Sept. 14, 2005) (holding that the refinement of class allegations does not "present a novel claim for relief or add a new party" sufficient to commence a new action); *Weekley v. Guidant Corp.,* No. 1:05CV00064 JLH, 2005 WL 2348476, at *1-3 (E.D. Ark. Sept. 23, 2005) (holding, with respect to an amendment that converted an individual action into a proposed nationwide class action, that "[t]hose new claims may dramatically change the action" and "may or may not 'relate back' to the original complaint for limitations purposes," but whether they do or not is irrelevant, since "a civil action, viewed as the entirety of the case or the entirety of the proceeding, commenced when the initial complaint was filed").

In particular, the Seventh Circuit has held its ground on this position. For example, in *Schorsch v. Hewlett-Packard Co.,* 417 F.3d 748 (7th Cir. 2005), plaintiffs expanded the class definition to include not merely purchasers of defendant's printer drum kits but instead all purchasers of any of defendant's "printer consumables that contain EEPROM chips." The court disagreed with defendant's argument that the class definition added new parties because the "class members are represented vicariously but are not litigants themselves." *Id.* at 749-50. Ultimately, the court concluded that the amended class definition related back to the original complaint because it "furnished to the defendant all the information necessary . . . to prepare a defense to the claim subsequently asserted in the amended complaint," further commenting: "Amendments to class definitions do not commence new suits. We can imagine amendments that kick off wholly distinct claims, but the workaday changes routine in class suits do not." *Id.* at 751.

Subsequently, in another case involving an amendment expanding the proposed class from a single-state to a nationwide class, the Seventh Circuit again concluded that the modification of a proposed class definition does not commence a new action. There, the court concluded that even after the amendments, "this suit is still between [plaintiffs] and others similarly situated (whomever they may turn out to include) and [defendant], and it concerns the same claim alleged in the original complaint." *Schillinger,* 425 F.3d at 334. Although the defendant may suffer greater repercussions if the proposed nationwide class is certified, compared to the single-state proposed class in the original complaint, the court commented that "the potential for a larger amount of legal research and discovery in and of itself is not a significant enough step to create new litigation." *Id.*

Despite the weight of decisions to the contrary, defendants have successfully asserted that an expanded class definition commences a new action under CAFA in at least two cases. In one district court decision, plaintiff's amended petition added a request for certification of a proposed class to what had been an individual action brought by a single plaintiff and asserted new claims for fraud and bad faith. *Plummer v. Farmers Group, Inc.,* No. CIV-05-242-WH, 2005 WL 2292174, at *1 (E.D. Okla. Sept. 15, 2005). Applying various relation-back factors, the court concluded that "for purposes of Rule 15(c) the Amended Complaint is equivalent to filing a new cause of action" and is therefore removable under CAFA. *Id.* at *4-5. The U.S. District Court for the Southern District of Georgia reached a similar holding in *Senterfitt v. Suntrust Mortgage, Inc.,* 385 F. Supp. 2d 1377 (S.D. Ga. 2005). There, the court concluded that an amendment that expanded the proposed class to cover an additional 16-year period "did not provide adequate notice of the size of the new prospective class": "neither [plaintiff's] original complaint nor the

First Amended Complaint adequately notified [defendant] of its obligation to defend against a significantly larger class whose claims stretch twenty years into the past." *Id.* at 1380. Additionally, the court found that defendant was unfairly prejudiced by having to expand its defense to cover the modified class definition. Thus, the amendments did not relate back to the original complaint, and the amended complaint therefore commenced a new action under CAFA. *Id.* at 1381. It is difficult to reconcile these holdings with the conflicting decisions in *Schorsch, Schillinger* and *Weekley.*

Adding New Causes of Action. A few district court decisions have dealt with whether amended pleadings adding new causes of action commence a new action pursuant to CAFA. Of those decisions, at least two have found the assertion of new causes of action sufficient to commence new litigation.

In *Heaphy,* for instance, the amended complaint, along with other significant changes previously discussed, added three new causes of action. Additionally, at the time of the amendment, although the original complaint was technically still pending, all claims of the original plaintiff had been fully adjudicated through arbitration. *Id.* at *3. Based on these facts, the court concluded that as of the date of the arbitration award, there were no claims remaining, and therefore there was not a class action pending at that time. *Id.* Under these unique circumstances, the U.S. District Court for the Western District of Washington held that the plaintiff "may or may not have had the right to assert new claims arising out of the same transaction at the time she sought to do so . . . but any new pleading seeking to assert such claims was necessarily a new action, and did not relate back to her original, fully adjudicated complaint." *Id.; see also Plummer,* 2005 WL 2100594, at *1-5.

In contrast, the U.S. District Court for the Eastern District of Missouri reached an opposite conclusion in *Judy v. Pfizer, Inc.* There, the amended complaint added four new claims for relief: negligence, negligence *per se,* breach of express warranty and breach of implied warranty. 2005 WL 2240088, at *2. Nevertheless, the court concluded that these new claims did not, in essence, commence a new action because (a) "the breach of warranty claims were contemplated in the original petition" and (b) "the warranty claims and the negligence claims . . . satisfy the relates back provision of Rule 15(c) because these claims arise out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading." *Id.* at *3.

Amending General Allegations. In the few decisions to address it directly, district courts have consistently held that amendments that refine or amend general allegations do not commence a new action under CAFA. In one such decision, *Lee v. Citimortgage, Inc.,* No. 4:05CV1216JCH, 2005 WL 2456955 (E.D. Mo. Oct. 5, 2005), the plaintiff filed an amended complaint in which factual allegations concerning the named plaintiffs were pleaded with more specificity and other factual allegations were added to "elaborate Plaintiff's original claims." *Id.* at *1-2. As the amended petition "did not change the substance of [plaintiff's claims] but merely provided further information," the district court held that the filing of the amended complaint did relate back to the original proceeding under Fed. R. Civ. P. 15(c) and thus did not commence a new action under CAFA. *Id.* at *2; *see also Judy,* 2005 WL 2240088, at *3 (concluding that plaintiff's amended pleading "adds additional factual allegations which elaborate her original claims . . . [but] does not change the substance of those claims"); *New Century Health Quality Alliance, Inc.,* 2005 WL 2219827, at *4 (holding that none of the amendments to the general allegations are "'sufficiently independent of the original contentions' to constitute 'fresh litigation'"); *see generally Knudsen,* 411 F.3d at 806-07.

III. Burden of Proof

In the past, the standard rule was that the party asserting federal jurisdiction (usually the defendant) bears the burden of showing the propriety of federal jurisdiction. Since the enactment of CAFA, however, the federal district courts are split as to whether CAFA reversed the burden of proof with respect to interstate class actions governed by its provisions. The federal circuit courts of appeal have yet to weigh in on this issue.

The majority of district courts to address this issue have held, based on the CAFA amendments to the removal and federal jurisdiction statutes, that the party opposing removal of a class action under 28 U.S.C. § 1332(d) now "bears the initial burden of demonstrating that an action should be remanded." *See Harvey v. Blockbuster, Inc.,* 384 F. Supp. 2d 749, 752 (D.N.J. 2005). In reaching that decision, courts have analyzed the Act's legislative history. *See id.*

For example, in *Berry v. American Express Publishing Corp.,* 381 F. Supp. 2d 1118 (C.D. Cal. 2005), the court acknowledged that "a statute cannot address all possible outcomes and situations, and language inevitably contains some imprecision; where the text does not provide a clear answer, a faithful interpretation

of the statute necessarily involves more that the text itself." *Id.* at 1122. The court concluded that "legislative history is a proper tool of statutory construction" and rejected plaintiffs' position that the lack of discussion regarding the burden of proof in the Act "evinces an explicit intent to maintain the status quo" because such a conclusion is not consistent with "the uncontradicted statements contained in the [Senate Judiciary] Committee Report." *Id.* In holding that CAFA's legislative history shifted the burden of proof to the party seeking remand, the court suggested that "the failure to address the burden of proof in the statute reflects the Legislature's expectation that the clear statements in the Senate Report would be sufficient to shift the burden of proof." *Id.* In further support, the court commented that its decision was "consistent with the tradition of placing the burden on the moving party." *Id.* at 1123.

Several district courts have reached similar conclusions. *See, e.g., Natale v. Pfizer Inc.,* 379 F. Supp. 2d 161, 168 (D. Mass. 2005) (citing to *Berry* in support), *aff'd on other grounds,* 424 F.3d 43 (1st Cir. 2005); *In re Textainer P'ship Sec. Litig.,* No. C 05-0969 MMC, 2005 WL 1791559, at *3-4 (N.D. Cal. July 27, 2005) ("CAFA's legislative history indicates that the plaintiff has the burden of proving that an action removed under CAFA should be remanded."); *Waitt v. Merck & Co., Inc.,* No. C05-0759L, 2005 WL 1799740, at *1-2 (W.D. Wash. July 27, 2005) (concluding that even though the Act lacks specific burden-shifting language, the legislative history clearly demonstrates that under CAFA, "it is plaintiff's responsibility to demonstrate that removal from state court was improvident"); *Yeroushalmi v. Blockbuster Inc.,* No. CV 05-225-AHM(RCX), 2005 WL 2083008, at *3 (C.D. Cal. July 11, 2005) (holding that although the Act is silent on the issue of the burden of proof with respect to removal jurisdiction, "it [was] the intent of the [Senate Judiciary] Committee that the named plaintiff(s) should bear the burden of demonstrating that a case should be remanded to state court").

Other district courts—so far the minority—nevertheless have held that defendants still have the burden of proof of establishing federal-court jurisdiction. *See Schwartz v. Comcast Corp.,* No. Civ.A. 05-2340, 2005 WL 1799414 (E.D. Pa. July 28, 2005). The *Schwartz* court was not persuaded by legislative comments included in the Act's legislative history. In fact, because the court determined that Section 1332(d) was not ambiguous, it was unwilling to consider the Act's legislative history. *Id.* at *4-7. In support of its holding, the court commented that "by making substantive changes with respect to the aggregation rule, but failing to express a concomitant change in the burden of proof, Congress implicitly acknowledged and adopted the longstanding rule that a removing defendant bears the burden of proof for establishing diversity jurisdiction. Had Congress intended to make a change in the law with respect to the burden of proof, it would have done so expressly in the statute." *Id.* at *7. *See also Judy,* 2005 WL 2240088, at *2 (holding that it is inappropriate to analyze and refer to the Act's legislative history because "the omission of a burden of proof standard in the CAFA does not create an ambiguity"; "Had Congress wished to change which party bears the burden of proof in a removal action under the CAFA it could have explicitly done so."); *Plummer,* 2005 WL 2292174, at *6 (refusing to modify the traditional rule with respect to the burden of proof on removal because "it is not the role of the judiciary to correct drafting errors").

IV. Conclusion

It is likely that courts will continue addressing issues relating to the meaning of "commencement" in the near term, as courts continue to rule on pending motions to remand in cases that were filed before CAFA's enactment but that were subsequently removed to federal court based on arguments such as those described in this article, and as those decisions (to the extent petitions for leave to appeal are filed) are then resolved by the federal circuit courts of appeal. However, these "commencement" issues appear to be narrow, short-lived issues whose significance will fade over time. In their place, there is likely to be significant litigation addressing burden of proof issues, which are far from resolved, as well as application of CAFA's "home state controversy" and "local controversy" exceptions.

Misuse Challenges to Licensing and Pricing of Patented Products Survive Attack Under Sherman Act Sections 1 or 2

By Matthew C. Miller
mmiller@shb.com

and

Scott E. DuPree
sdupree@shb.com

How far can a patent holder go in marketing two patented inventions without triggering antitrust liability? In recent months, two federal courts have probed some of the unsettled frontier of a patent holder's rights to license or sell a popular patented invention in a manner that increases costs for competitors and/or consumers. In both cases, the courts found the challenged practice to fall within the scope of the patent grant and therefore immune from antitrust liability.

On September 21, 2005, a panel of the Federal Circuit issued a landmark decision in *U.S. Philips Corporation v. International Trade Commission,* 424 F.3d 1179 (Fed. Cir. 2005) (Bryson, J.) (*"Philips"*), reversing a ruling of the U.S. International Trade Commission ("ITC") that U.S. Philips Corporation's ("Philips") practice of licensing a package of six compact disc ("CD") patents instead of licensing them individually constituted patent misuse.

Two months earlier, in a case of first impression for Seventh Circuit courts, the U.S. District Court for the Northern District of Illinois dismissed claims that the holder of a patent for a pharmaceutical product had improperly leveraged its putative monopoly in a market for the patented product to impair competition in an alleged secondary market for combination products using that product. *Schor v. Abbott Labs.,* 378 F. Supp. 2d 850 (N.D. Ill. 2005) (Gettleman, J.) (*"Schor"*). The defendant, which marketed its own combination therapy, was alleged to have acted unlawfully by raising the price of its patented component to competitors without factoring a comparable increase into the price of its own combination product. In rejecting plaintiff's Sherman Act Section 2 claims, the court declined to follow the lead of a California federal district court that, just a few months earlier, had found that similar claims involving the same practices, product and defendant sufficiently stated a claim for monopoly leveraging under Ninth Circuit law to survive a motion to dismiss. *See Serv. Employees Int'l Union Health & Welfare Fund v. Abbott Labs.,* No. C 04-4203 CW, 2005 WL 528323, at *3 (N.D. Cal. Mar. 2, 2005) (Wilken, J.).

I. *Philips:* Package Licensing Including Supposedly "Nonessential" Patents Is Not Unlawful Tying

Philips' Package Licensing Practices and the ITC's Finding of Unlawful Tying. Philips owns a number of patents relating to the manufacture of recordable and rewritable compact discs (commonly known as "CD-Rs" and "CD-RWs," respectively). It refused to license those patents individually, instead licensing them in packages, and it insisted that the same royalties were due for each CD-R or CD-RW manufactured, regardless of the number of patents used. Philips offered the patents in several packages, some of them constituting "pools" that included patents owned by other companies and others being packages of patents deemed "essential" or "nonessential" for the production of CDs. *Philips,* 424 F.3d at 1182.

In the 1990s, Philips entered into licensing agreements with Princo Corporation, Princo America Corporation, GigaStorage Corporation Taiwan, GigaStorage Corporation USA, and Linberg Enterprise Inc. Those licensees eventually stopped paying the agreed fees, and Philips brought a complaint before the ITC challenging the importation of CD-Rs and CD-RWs that infringed six of Philips' patents. The ITC promptly investigated the matter and identified a total of 19 respondents. A number of other parties intervened as respondents. *Id.* at 1182-83.

During the course of the proceedings before an administrative law judge ("ALJ"), the respondents raised the affirmative defense of patent misuse. Specifically, the respondents argued that Philips had forced them improperly to purchase the licenses to patents not necessary for the manufacture of their products by (among other things) selling certain patents in the "essential" package that were not essential and otherwise forcing them to license "nonessential" patents as a condition to licensing patents that were needed to manufacture CD-Rs or CD-RWs. The ALJ agreed, holding that although the respondents had infringed certain of Philips' patents, those patents were unenforceable because of Philips' patent misuse. Among

the grounds cited for patent misuse was the conclusion that Philips' packaging practices constituted tying arrangements that were illegal under antitrust law. *Id.* at 1183.

Philips sought review of the ALJ's decision by the ITC, but the ITC affirmed its ALJ's ruling that Philips' package licensing practices "constitute[d] patent misuse *per se* as a tying arrangement" between patents that were legitimately "essential" to the manufacture of CD-Rs and CD-RWs and those that were not "essential," and that Philips had acted improperly in refusing to provide the option to license its patents individually. *Id.* at 1183-84. The ITC found that various patents included in the pools were "nonessential" because "viable alternative" methods existed for manufacturing CD-Rs and CD-RWs without using the inventions in these patents. *Id.* As an alternative to its determination of *per se* patent misuse, the ITC held that Philips' patent packaging constituted "patent misuse under the rule of reason" because the anticompetitive effects of the package licensing outweighed its procompetitive benefits. *Id.* at 1184. Philips then appealed to the Federal Circuit.

The Federal Circuit Rejects the ITC's Tying Analysis. A panel of the Federal Circuit unanimously reversed the ITC's holding, finding the ITC's decision riddled with factual and legal errors. The court began by examining several U.S. Supreme Court and appellate decisions on tying arrangements as patent misuse. It read these decisions as standing for the proposition that tying arrangements are *per se* unlawful only where they constitute "a 'naked restrain[t] of trade with no purpose except stifling of competition' and 'always or almost always tend to restrict competition and decrease output' in some substantial portion of a market." *Id.* at 1185 (quoting *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.,* 441 U.S. 1, 19-20 (1979)).

The court also looked to federal statutes—particularly the Patent Act—for guidance as to whether and when various practices do or do not constitute patent misuse. As amended by the Patent Misuse Reform Act, the Patent Act now provides that the "condition[ing] [of] the license of any rights to the patent or the sale of the patented product on the acquisition of a license to rights in another patent or purchase of a separate product" is not deemed to constitute "misuse or [an] illegal extension of the patent right . . . unless, in view of the circumstances, the patent owner has market power in the relevant market for the patent or patented product on which the license or sale is conditioned." 35 U.S.C. § 271(d)(5). According to the court, this "statute makes clear that the defense of patent misuse differs from traditional antitrust law principles in an important respect, as applied to tying arrangements involving patent rights"—namely, that there is no presumption that a patent confers market power in the context of patent misuse: "To establish the defense of patent misuse, the accused infringer must show that the patentee has power in the market for the tying product." *Philips,* 424 F.3d at 1186. (By contrast, the status of such a presumption in the context of antitrust tying claims is currently being litigated before the U.S. Supreme Court, oral argument on the issue having been scheduled to occur November 29, 2005. *See Indep. Ink, Inc. v. Ill. Tool Works, Inc.,* 396 F.3d 1342 (Fed. Cir. 2005), *cert. granted,* 125 S. Ct. 2937 (U.S. June 20, 2005) (No. 04-1329) (*"Independent Ink"*).

Even Assuming Market Power, Philips' Package Licensing Not Deemed *Per Se* Unlawful. Philips first argued that it did not have sufficient market power under 35 U.S.C. § 271(d), insulating it from liability. The Federal Circuit disagreed, based on the ITC ALJ's "detailed analysis" of market conditions existing at the time Philips entered into its package licensing agreements with the repudiating licensees against whom it had initiated the ITC action. The Federal Circuit panel therefore sustained the ITC's holding that Philips had adequate market power to make the 35 U.S.C. § 271(d) safe harbor inapplicable to the case. *Philips,* 424 F.3d at 1186.

Philips next argued that the ITC erred as a matter of law in holding that the package licenses were so anticompetitive that they warranted condemnation as *per se* illegal. The ITC, for its part, argued that "mandatory package licensing" constituted *per se* patent misuse as a matter of "hornbook law." *Id.* at 1187.

The Federal Circuit put a finer point on it. It noted that a package licensing arrangement that includes both "essential" and "nonessential" patents does not *require* the licensee to use any particular patent, and it found that the package licenses essentially constituted promises not to sue for infringement. *Id.* at 1188, 1189. On this basis, the court distinguished the U.S. Supreme Court's "block-booking" decisions—decisions that had condemned as *per se* unlawful "the practice in which a [motion picture film] distributor licenses one feature or group of features to exhibitors on the condition that the exhibitors agree to license another (presumably inferior) feature or group of features released by the distributor during a given period"—and the classic tying decisions on which the ITC had relied to find Philips' package licensing *per se* unlawful.

Id. at 1187-91. Finally, the court gave weight to evidence of the procompetitive efficiencies of Philips' licensing practices that the ITC had ignored. *Id.* at 1192-93.

- **Distinguishing Block-Booking.** The court held that the "block-booking" decision in *United States v. Paramount Pictures, Inc.,* 334 U.S. 131 (1948), did not apply because that decision involved "patent-to-product" tying arrangements (arrangements in which a patent license is conditioned on or tied to the purchase of a separate product). By contrast, it found Philips' package licensing to involve "patent-to-patent" arrangements. While the *Paramount* block-bookers *required* their licensees to show all of the tied features, Philips did not compel its licensees to use all of its patents, thereby not interfering with any market for other patents. *Philips,* 424 F.3d at 1188.

  The court also rejected the application of the "block-booking" decision in *United States v. Loew's, Inc.,* 371 U.S. 38 (1962), finding that unlike *Loew's,* there was no evidence that Philips' royalties were attributable to the "nonessential" patents. *Philips,* 424 F.3d at 1189. Instead, Philips charged a uniform royalty based on the number of products (covered by one or more of the patents) that the licensee produced, "regardless of which, or how many, of the patents in the package the licensee chooses to use in its manufacturing process." *Id.* at 1188. As a result, the court found that there was no expectation or evidence that the patents would have been less expensive on an individual basis. *Id.* at 1189, 1190-91.

- **Distinguishing Tying.** As a mere "promise not to sue for infringement" of any of a package of patents in exchange for a uniform licensing fee, the package licensing arrangement did not foreclose the licensing of competing technologies. It "merely put[] the competitor in the same position he would be in if he were competing with unpatented technology" or if Philips surrendered its "nonessential" patents or if Philips announced its intention not to enforce its "nonessential" patents (either against the whole world or against licensees of its "essential" patents). *Id.* at 1189-90, 1192. As a result, this form of package license did not cause any cognizable competitive harm, the way a classic tying arrangement (in which a licensee is obligated to purchase an unwanted tied product) would. *Id.* at 1190, 1192.

  On the other hand, a rule that effectively bans this form of package license "would have the perverse effect of potentially putting a party owning both an essential and a nonessential but related patent"—who "would be barred from extracting [the] maximum licensing fee for its essential patent and assuring the manufacturer that it would not be subject to suit on the nonessential patent"—"in a worse position than a party owning only the essential patent," who "would be free to charge any licensing fee up to the maximum that a [licensee] would be willing to pay." *Id.* at 1192 n.5.

- **Efficiencies.** The court found at least three procompetitive efficiencies that Philips' licenses served but that the ITC ignored. First, the licenses reduced litigation risks and investment uncertainties by "provid[ing] the parties a way of ensuring that a single licensing fee will cover all the patents needed to practice a particular technology and protecting against the unpleasant surprise for a licensee who learns, after making a substantial investment, that he needed a license to more patents than he originally obtained." *Id.* at 1193. Second, they "reduce[d] transaction costs by eliminating the need for multiple contracts" and simplifying administration, policing and enforcement. *Id.* at 1192. Third, the package licenses enhanced the parties' ability to value the licenses more reliably by "allow[ing] the parties to price the package based on their estimate of what it is worth to practice a particular technology, which is typically much easier to calculate than determining the marginal benefit provided by a license to each individual patent." *Id.* at 1193.

"In light of the efficiencies of package patent licensing and the important differences between product-to-patent tying arrangements and arrangements involving group licensing of patents," the court rejected application of a "rule of *per se* illegality to [Philips'] package licensing agreements" and its concomitant presumption that the agreements were unreasonable and lacked any redeeming virtues. *Id.* at 1193.

Competitive Harm Lacking Where Inadequate Showing of Viable Substitutes. Philips further argued that the ITC erred factually in determining that the package licenses "reflect the use of market power in one market to foreclose competition in a separate market." The Federal Circuit agreed. It reviewed case law holding that, to find that a tying arrangement is *per se* unlawful, the complainant must show that the arrangement links two separate products and has an anticompetitive effect in the market for the second product. *Id.* at 1193-94. The court noted that patents that are part of a package may be regarded as "nonessential" only where there are "commercially feasible" alternatives to the patents:

> If there are no commercially practicable alternatives to the allegedly nonessential patents, packaging those patents together with so-called essential patents can have no anticompetitive effect in the marketplace, because no competition for a viable alternative product is foreclosed. In such a case, the only effect of finding *per se* patent misuse is to give licensees a way of avoiding their obligations under the licensing agreements, with no corresponding benefit to competition in any real-world market.

Id. at 1194. Reviewing the factual record, the court held that the ITC's factual findings were flawed because the ITC had not shown there were commercially viable substitutes for the patents at issue that disc manufacturers desired to use instead of the supposedly "nonessential" patents to produce discs conforming to accepted industry standards—and, as a result, there was insufficient evidence that the packages had an *actual* anticompetitive effect. *Id.* at 1194-96.

Avoiding a "Creeping Liability" Dilemma. Beyond this factual defect, the court found that the ITC's decision exhibited "a more fundamental problem with applying the *per se* rule of illegality to patent packages such as the ones at issue in this case"—specifically, that this approach could result in the invalidation of patents for misuse solely because of changing circumstances that transform one or more patents that may have been "essential" at the inception of a package licensing arrangement into "nonessential" patents after the agreement had been in effect for some period of time. *Id.* at 1196-97. "If a patentholder has a package of patents, all of which are necessary to enable a licensee to practice particular technology, it is well established that the patentee may lawfully insist on licensing the patents as a package and may refuse to license them individually, since the group of patents could not reasonably be viewed as distinct products." *Id.* at 1196. However, as alternative technologies develop over time—particularly in a rapidly developing area such as the compact disc field at issue here—questions can be expected to arise as to whether one or more patents in the pool continue to be essential to, and without adequate alternatives for, the manufacture of products meeting industry standards. *Id.*

> Under the [ITC's] approach, an agreement that was perfectly lawful when executed could be challenged as *per se* patent misuse due to developments in the technology of which the patentees are unaware, or which have just become commercially viable. Such a rule would make patents subject to being declared unenforceable due to developments that occurred after execution of the license or were unknown to the parties at the time of licensing. Not only would such a rule render licenses subject to invalidation on grounds unknown at the time of licensing, but it would also provide a strong incentive to litigation by any licensee, since the reward for showing that even a single license in a package was "nonessential" would be to render all the patents in the package unenforceable.

Id. at 1197. Because this result could serve no procompetitive purpose, the court found the ITC's analysis of Philips' package licensing scheme to be both conceptually and factually defective.

Rule of Reason Claims Suffer from Same Defects as *Per Se* Allegation. Finally, the court rejected the ITC's finding that Philips' package licenses qualified as patent misuse under the rule of reason. Noting that a packaging practice was not patent misuse if it was reasonably within the patent grant and did not broaden the scope of the patent (temporally or in subject matter), the court upheld Philips' packaging practices. *Id.* at 1197-98. Perhaps because the ITC's "analysis under the rule of reason largely tracked the analysis that led it to conclude that the package licensing agreements constituted *per se* patent misuse," the court found the ITC's rule of reason analysis to suffer from many of the defects that invalidated its *per se* decision. *Id.* Specifically, the court found that: (1) there was insufficient evidence of negative competitive effects on existing, commercially available alternative technologies; (2) the ITC's rule of reason analysis gave insufficient, or no, consideration to the problems and costs created by individually

licensing patents relating to aspects of a common technology and by technological changes that "could render some patents that were indisputably essential at the time of licensing arguably nonessential at some later point in the life of the license"; and (3) the ITC decision gave inadequate attention to efficiencies generated by package licenses whose royalties are keyed to "number of units produced" (rather than number of patents licensed) by resolving in advance potential disputes over whether a licensee's products or technologies infringe potentially applicable ancillary patents of the licensor. *Id.* at 1198.

Given its holdings, the Federal Circuit reversed the ITC's decision and remanded the case for further proceedings.

II. *Schor:* Pricing of a Patented Product That Impacts a Second Market Is Not "Monopoly Leveraging" When the Second Market Falls Within the Patent's Scope

Whereas the *Philips* court was confronted with novel horizontal restraint claims against package licensing practices under Section 1 of the Sherman Act, the *Schor* court was asked to choose among two developing lines of authority under Section 2 of the Sherman Act concerning the extent to which a patent holder can be held liable for unlawful monopolization based on a monopoly leveraging theory.

Abbott's Wholesale Price Increase and Its Significance to Consumers in a Second Alleged Product Market. *Schor* centered on pricing behavior by Abbott Laboratories ("Abbott") with respect to its patented protease inhibitor, Norvir, a drug used to inhibit the spread of the AIDS virus in infected patients. Protease inhibitors are apparently among the most effective treatments currently available to treat this virus, and plaintiff alleged that neither reasonably substitutable drug products nor generic versions of Norvir were on the market. The downside to Norvir was that it produced severe side effects when taken alone. The upside to Norvir was that it had the apparently unique ability to boost the effectiveness of almost any other protease inhibitor on the market (in both potency and effective life) when used in combination with those products, and such combination therapy reduced the constituent products' adverse side effects. As a result, competitors of Abbott marketed at least seven different protease inhibitor combination products—so-called "boosted PIs"—that used Norvir as their "booster." In addition, in September 2000, Abbott launched its own patented Norvir-based "boosted PI," under the brand name Kaletra. *Schor,* 378 F. Supp. 2d at 852, 860.

According to plaintiff, Kaletra began to lose sales sometime in 2003. Abbott responded by raising the wholesale price of Norvir to third-party purchasers by more than 400 percent at the end of 2003. It did not, however, pass this price increase through to purchasers of Kaletra. *Id.* at 852.

Plaintiff, on behalf of himself and a putative class of similarly situated AIDS patients, alleged that Abbott abused its ostensible monopoly power in an alleged U.S. market for Norvir—which, owing to the lack of generic or otherwise interchangeable substitutes, Abbott controlled in its entirety through various patents—to injure competition in a second alleged market, consisting of "PIs boosted by Norvir," by effectively increasing the cost to consumers of combination therapies that compete with Kaletra. He asserted that the increased cost of these competing therapies injured the putative class in part because AIDS patients depend upon the availability of various types of protease inhibitors as alternatives in the event that they build up a tolerance to a particular drug combination. *Id.* at 852, 855. In other words, the fact that at least one "boosted PI" product (Abbott's Kaletra) might continue to be priced at competitive levels would not prevent consumers from being harmed by a steep hike in the wholesale price that other manufacturers would be required to pay for the "booster" used in virtually all of the products in this category.

Defining the Issues and Mapping the Legal Terrain. Plaintiff constructed its Sherman Act claim exclusively around a form of alleged patent misuse—specifically, "on an extension of the monopoly leveraging theory to patent holders, under which antitrust liability may be based on the improper use of a monopoly in one market to strengthen or create a monopoly in another market." He did "not dispute the validity of the Norvir patents or defendant's lawful monopoly in the Norvir market." *Id.* at 856. In the court's view, the claim presented two issues "of first impression in the Seventh Circuit": (1) "whether a patent holder may be liable under the monopoly leveraging theory"; and (2) "whether the Sherman Act limits a patentee's right to exclude others from more than one relevant market." *Id.* at 857.

In reviewing plaintiff's claim, the court could find only "sparse case law"—and no U.S. Supreme Court precedent—"regarding if or how the monopoly leveraging theory applies to conduct by a patentee, and what little case law there is does not concern a price increase by a patent holder." *Id.* at 856. Concluding that he should seek guidance from antitrust decisions considering patentees' refusals to deal ("because if a patentee

has the right to refuse to sell its product altogether, it has the right to raise the price"), District Judge Robert W. Gettleman noted that the Ninth Circuit and the Federal Circuit had split over the applicability of monopoly leveraging to patent holders accused of unlawful monopolization for refusing to sell patented parts to third parties that competed with the patent holder in a second machine-servicing market in which those parts were used. *Id.* at 856-57.

Choosing Sides in a Circuit Split. Eight years before *Schor,* a Ninth Circuit panel had found for the first time that a patent holder could be subject to antitrust liability on a monopoly leveraging theory. It held that a patent holder "who acquires a dominant position in one market through patents . . . may violate § 2 if [it] exploits that dominant position to enhance a monopoly in another market." *Image Technical Servs., Inc. v. Eastman Kodak Co.,* 125 F.3d 1195, 1214, 1216 (9th Cir. 1997) (Beezer, J.). The "markets" for these purposes were to be defined by economic conditions according to antitrust principles and not according to the limits of the patent claims; liability would turn on the extent to which "the [second] market falls 'reasonably within the patent . . . grant' for the purpose of determining the extent of the exclusive rights conveyed." *Id.* at 1216-17. The Ninth Circuit panel further held that the patent created a mere "rebuttable presumption" that a refusal to sell patented products was supported by a valid business justification and therefore lawful, but did not provide the patent holder with blanket immunity from antitrust liability for its refusal to sell. *Id.* at 1218-20.

Two and a half years after *Image Technical Services,* a panel of the Federal Circuit disagreed with the Ninth Circuit. Rejecting a Sherman Act claim that the holder of an apparently lawfully acquired patent for copier parts unlawfully leveraged its position in the parts market by refusing to sell its patented parts to independent service organizations, the Federal Circuit panel held that "absent exceptional circumstances, a patent may confer the right to exclude competition altogether in more than one antitrust market" and suggested that the holder of a lawfully obtained patent may "refuse to sell or license" its patented invention in any "markets within the scope of the statutory patent grant." *In re Indep. Serv. Orgs. Antitrust Litig.,* 203 F.3d 1322, 1326-27 (Fed. Cir. 2000) (Mayer, C.J.). A patentee would not risk antitrust liability for exercising his or her statutory right to exclude others from making, using or selling his or her invention unless a challenger produced evidence "of illegal tying, fraud in the Patent and Trademark Office, or sham litigation," and the court "will not inquire into his [or her] subjective motivation for exerting [these] statutory rights, even though his [or her] refusal to sell or license [the] patented invention may have an anticompetitive effect, so long as that anticompetitive effect is not illegally extended beyond the statutory patent grant." *Id.* at 1327-28.

Finding the Federal Circuit's reasoning to be more persuasive and to offer "a sounder approach to a patentee's antitrust liability in a second market," Judge Gettleman concluded "that subject to narrow limitations, not at issue in the instant case"—generally involving circumstances where a patentee attempts to "exclud[e] others from inventions beyond the scope of the patent"—"a patentee's exercise of its statutorily-granted market power does not constitute a Sherman Act violation, even if such conduct affects a second market." *Schor,* 378 F. Supp. 2d at 858. It followed from this premise that plaintiff's antitrust claims could not survive Abbott's motion to dismiss because Abbott "may not be held liable for a violation of § 2 of the Sherman Act for increasing the price of its patented product, even though that price increase may affect competition in a second market." *Id.* at 860.

According to the court, this outcome boils down to the proposition "that a patentee is not liable for conduct within the scope of its valid patent grant" and is not only "in keeping with the case law and the statutory language suggesting that a court must consider the scope of the patent grant when determining whether an antitrust violation has occurred," *id.* at 858, but also supported by the factual record before it:

- **Case Law.** As to case law, the court read U.S. Supreme Court decisions as "suggest[ing] that the Sherman Act does not limit the patent holder's right to exclude others from the protected invention to a single market, but rather that the right is coextensive with the scope of the patent grant." *Id.* at 859. It criticized the Ninth Circuit's contrary interpretation of a footnote in *Eastman Kodak Co. v. Image Technical Services, Inc.,* 504 U.S. 451, 479 n.29 (1992)—to the effect "that a patentee's expansion into a second market may be an antitrust violation"—as a misreading of that decision and a misapplication of that decision's tying analysis (which occurred in a context where "no patents had been asserted in defense of the antitrust claims") to the evaluation of monopoly leveraging claims based on alleged patent misuse.

According to the *Schor* court's reading of U.S. Supreme Court decisions, "patent law extends to protect a patent holder from antitrust liability in a second market that is encompassed by the patent claims." *Schor,* 378 F. Supp. 2d at 859.

- **Statutory Language.** Like the *Philips* panel, the *Schor* court also found support in Section 271(d) of the Patent Act—specifically, Section 271(d)(4), which provides, in pertinent part, that a "patent owner otherwise entitled to relief for infringement" will not be "deemed guilty of misuse or illegal extension of the patent right by reason of his having . . . refused to license or use any rights to the patent." 35 U.S.C. § 271(d)(4). Reading this language against U.S. Supreme Court opinions describing circumstances in which a patentee may unlawfully attempt to enlarge its patent rights in violation of federal antitrust law, Judge Gettleman understood this provision to

> indicate[] that a patent holder is not liable for an antitrust violation for refusing [to] sell or license a patented product within the scope of the patent grant, and that this immunity is not limited to a single market. Thus, if the product is encompassed within the patent claims, the Sherman Act does not limit the patent holder's refusal to license or sell that item, or limit the patent holder's right to charge a higher price, in any market.

Schor, 378 F. Supp. 2d at 859.

- **Factual Setting.** Finally, the scope of Abbott's patent gave Abbott a particularly strong argument in support of its claimed right under the patent laws to engage in the challenged pricing behavior. Abbott's Norvir patent included claims for Norvir alone and for its use in a "boosted PI." Plaintiff did "not argue that defendant's use of Norvir in Kaletra or its sale of Norvir as a booster for competitors' boosted PIs exceeds the patent grant," nor did it "dispute[] that the use of the patented invention in [the] second market [was] within the scope of the patent claims." *Id.* at 860. Moreover, Abbott had not refused to sell Norvir to other "boosted PI" manufacturers altogether, but had instead aggressively priced the drug to wholesale customers.

  In the court's view, both of these facts distinguished Abbott's actions from those previously faced by the Ninth and Federal Circuits and further supported Abbott's assertion that its pricing behavior was lawful. *Id.*

The court concluded that "[t]o accept plaintiff's argument would seem to impose antitrust liability on any manufacturer who holds patents for a product when used alone as well as for its use as a component in products manufactured by the patentee and competitors, and raises the price it charges competitors for its patented component." *Id.* Because it declined this invitation, the court dismissed the class complaint against Abbott.

III. Common Ground

Although arising under different sections of the Sherman Act and different theories of antitrust liability, *Philips* and *Schor* provide complementary interpretations of the synthesis of antitrust and patent law. Particularly since the *Schor* court expressly embraced the Federal Circuit's reasoning in reaching its decision, this result is hardly surprising.

But because both decisions effectively elaborate on Federal Circuit law, their impact is likely to be limited by the extent to which other federal courts question or reject the Federal Circuit's orientation to these issues. For example, *Schor* has already been declared a dead letter in nearly identical litigation pending in federal court in California, for no other reason than that it embraced the Federal Circuit's approach to patent-based monopoly leveraging claims. *See In re Abbott Labs. Norvir Antitrust Litig.,* No. C 04-1511 CW, C 04-4203 CW, 2005 WL 2206700, at *4 (N.D. Cal. Sept. 12, 2005) (Wilken, J.) (rejecting attempt by Abbott to "rel[y] upon a district court's July 12, 2005 ruling granting its motion to dismiss in *Schor v. Abbott Laboratories"* because "that court expressly declined to follow the Ninth Circuit's ruling in *Image Technical* that recognized the monopoly leveraging theory" and *"Image Technical* is binding on this Court"). And the U.S. Supreme Court is currently considering, by way of the *Independent Ink* appeal, a challenge to the market power presumption in patent tying cases that (as the Federal Circuit acknowledged) could affect the evaluation of "the patent misuse issue presented by [the *Philips*] case." *See Philips,* 424 F.3d at 1193 n.6. (Describing *Independent Ink* as "involving a tying arrangement involving a patent and an unpatented product," the Federal Circuit panel "determined" nonetheless "that the proper course is to resolve [the *Philips*] appeal without

waiting for the Supreme Court's decision" in view of its conclusion that "the circumstances of the two cases are quite different." *Id.*)

Nevertheless, both decisions should enhance the ongoing debate over the interplay of intellectual property and antitrust law. In particular, both decisions appear to embrace the notion that the scope and exclusionary power of an allegedly misused patent must be assessed before antitrust liability can be asserted against the patent holder and that antitrust liability will not attach to actions that fall within the scope of the patent grant. *See, e.g., Philips,* 424 F.3d at 1197 ("Under the rule of reason, the finder of fact must determine if the practice at issue is 'reasonably within the patent grant, i.e., that it relates to subject matter within the scope of the patent claims,'" and if "the practice does not 'broaden the scope of the patent, either in terms of covered subject matter or temporally,' then the patentee is not chargeable with patent misuse"); *Schor,* 378 F. Supp. 2d at 859 ("the patent holder's right to exclude others from the protected invention . . . is coextensive with the scope of the patent grant" and is not limited by the Sherman Act "to a single market"). This framework for reconciling the exclusionary power of a patent with the competition-protecting objectives of the antitrust laws has some logical appeal and may be a part of what appears to be a growing trend in federal decisions—one that has been particularly noticeable in recent antitrust decisions involving pharmaceutical patent settlement agreements. *See, e.g., Schering-Plough Corp. v. FTC,* 402 F.3d 1056, 1066 (11th Cir. 2005) (in pharmaceutical patent settlement context, "we think the proper analysis of antitrust liability requires an examination of: (1) the scope of the exclusionary potential of the patent; (2) the extent to which the agreements exceed that scope; and (3) the resulting anticompetitive effects"); *In re Ciprofloxacin Hydrochloride Antitrust Litig.,* 363 F. Supp. 2d 514, 536 (E.D.N.Y. 2005) (defendants "cannot be penalized just because plaintiffs can imagine a more pro-competitive settlement, if the agreement they did reach does not adversely affect competition beyond the scope of the [allegedly infringed] patent").

Of course, even if these recent decisions add up to a federal trend, this approach is not universally accepted by federal antitrust courts, as decisions by Ninth Circuit courts suggest. Moreover, a challenge to the use of such an approach in the pharmaceutical patent settlement context, which is currently pending before the U.S. Supreme Court, has the potential to influence the framework for analysis of antitrust claims asserted in that context—and perhaps in other patent-related contexts as well. *See* Petition for a Writ of Certiorari at 14-19, *FTC v. Schering-Plough Corp.,* No. 05-273, 2005 WL 2105243 (U.S. Aug. 29, 2005) (arguing that "the 'probabilistic' nature of the property interest created by the patent laws makes it especially important to take such uncertainty into account" in assessing the anticompetitive potential of pharmaceutical patent settlements, notwithstanding the patent's scope). Although not the "last word" on these issues, *Schor* and *Philips* add to the weight of authority promoting the view that the scope of the patent must be evaluated before antitrust liability may be assigned (if at all)—at least until the U.S. Supreme Court weighs in on the issue.

D.C. Circuit Sings the Virtues of the FTC's "Three Tenors" Decision

By Thomas Chabanis
tchabanis@shb.com
and
Scott E. DuPree
sdupree@shb.com

In a decision written by Chief Judge Douglas H. Ginsburg, a panel of the D.C. Circuit unanimously found that the Commission ("Commission") of the U.S. Federal Trade Commission (the "FTC") correctly decided that an agreement between two record companies constituted an unfair method of competition under Section 5 of the FTC Act, 15 U.S.C. § 45. *PolyGram Holding, Inc. v. FTC,* 416 F.3d 29 (D.C. Cir. 2005) (Ginsburg, J.) *("PHI")*. The agreement stated that neither Warner Communications, Inc. ("Warner") nor PolyGram Holding, Inc. ("PolyGram") would market previously recorded albums by opera's "Three Tenors" in an effort to promote the artists' new album.

In condemning this agreement as anticompetitive, the FTC revived an analytical framework that it had first introduced in *Massachusetts Board of Registration in Optometry,* 110 F.T.C. 549 (1988) (*"Mass. Board"*). Under that framework, the FTC adopts a rebuttable presumption that conduct that appears on its face likely to be anticompetitive (unless saved by a *bona fide* efficiency justification) is unreasonable under Section 5 of the FTC Act. The court's detailed review of this "inherently suspect" analysis may foreshadow changes in the way federal courts and the Commission evaluate potentially anticompetitive conduct. This decision also reminds us of the importance of proper legal planning when setting up a joint venture or partnership with an actual or potential competitor.

Overture—Three Tenors, Two Joint Venturers and One Competitive Restraint. This case involves the marketing of records by "The Three Tenors" (José Carreras, Placido Domingo and Luciano Pavarotti) for concerts given during the 1990, 1994 and 1998 World Cup of Soccer. PolyGram had distributed the 1990 concert recording, and Warner had distributed the 1994 concert album. The two companies agreed to distribute jointly the 1998 album, with Warner (the holder of the worldwide distribution rights for that recording) retaining the rights for the United States while exclusively licensing PolyGram to distribute the record in the rest of the world. The companies also agreed to consult one another on all "marketing and promotional activities" for the 1998 album and to collaborate on future "Three Tenors" releases through August 2002. *PHI,* 416 F.3d at 31.

In preparing for the marketing of the 1998 record, PolyGram and Warner became concerned that the marketing of their respective earlier concert recordings could undercut sales of the 1998 concert recording, particularly after learning that the repertoire for the 1998 concert promised to duplicate substantial portions of the 1990 and 1994 programs. To ensure the commercial success of the new record, the two companies agreed to a commercial moratorium on the marketing of the previously released records. Pursuant to this agreement, the companies were to cease all promotions and discounts on the two previous albums for 10 weeks prior to launch of the latest record. *Id.* at 32.

Act I—The FTC Enjoins a Putative Section 5 Violation Without Demonstrating Actual Competitive Harm. In 2001, the FTC charged the companies with engaging in an unfair method of competition in violation of Section 5 of the FTC Act. Warner settled out early, agreeing to a consent order that prohibited it from engaging in similar conduct in the future. *Warner Commc'ns Inc.,* FTC Dkt. No. C-4025 (issued Sept. 17, 2001), *available at* http://www.ftc.gov/os/ 2001/09/warnerdo.htm. PolyGram chose to litigate its case before an FTC administrative law judge ("ALJ"), who ultimately found that the agreement violated Section 5 and ordered PolyGram, like Warner, to cease and desist from similar agreements in the future. *PolyGram Holding, Inc.,* FTC Dkt. No. 9298, 2002 WL 1422222 (F.T.C. June 20, 2002) (Timony, ALJ).

On administrative appeal, the FTC's Commission affirmed the ALJ's decision, purporting to apply an analysis under Section 5 of the FTC Act similar to the analysis applied to an alleged violation of Section 1 of the Sherman Act, 15 U.S.C. § 1. Under the FTC's analysis, conduct is deemed "inherently suspect" if it "appears likely, absent an efficiency justification, to restrict competition and decrease output." The Commission rejected PolyGram's efficiency argument—namely, that the agreement deterred free-riding on the promotional efforts for the joint enterprise by means of opportunistic selling of the earlier recordings and thus incentivized the joint venturers to promote the new product vigorously and increase output—as legally insufficient. *PolyGram Holding, Inc.,* FTC Dkt. No. 9298, 2003 WL 21770765 (F.T.C. July 24, 2003) (Muris, Chairman).

PolyGram appealed the Commission's decision to the D.C. Circuit, arguing that: (1) the Commission should have proven, but did not prove, that the challenged conduct actually was harmful to competition before shifting the burden to PolyGram to come forward with a procompetitive justification; (2) the Commission should have accepted PolyGram's free-rider justification, since this demonstrated a procompetitive purpose for the agreement; and (3) the Commission's remedy was unreasonable because the sanctioned conduct was unlikely to recur. *PHI,* 416 F.3d at 33.

Act II—The D.C. Circuit Endorses the FTC's Methodology. As to the first issue, PolyGram maintained that the legal standard adopted by the Commission to evaluate and condemn PolyGram's agreement was out of step with prevailing U.S. Supreme Court decisions. Rather than employ traditional rule of reason analysis or established standards of *per se* illegality, the Commission had resorted to a multi-step "legal framework" that it had first articulated in *Mass. Board.* As outlined by the court, that framework involves a progressive shifting of apparently increasing burdens of persuasion among FTC and an antitrust defendant, with the legality of the challenged practice hanging in the balance:

1. **FTC bears the initial burden.** "First, the Commission must determine whether it is obvious from the nature of the challenged conduct that it will likely harm consumers." If so, the restraint is deemed "inherently suspect." *Id.* at 35-36.

2. **The defendant must rebut FTC's "inherently suspect" determination.** The antitrust defendant must "come[] forward with some plausible (and legally cognizable) competitive justification for the restraint." If it fails to do so, the analysis ends, and the challenged practice is "summarily condemned." *Id.* at 36. If the defendant asserts an adequate justification—which "may consist of plausible reasons why practices that are competitively suspect as a general matter may not be expected to have adverse consequences in the context of the particular market in question, or . . . of reasons why the practices are likely to have beneficial effects for consumers"—the burden shifts back to FTC. *Id.* (quoting the Commission's *PolyGram Holding* decision).

3. **FTC must make more searching examination of the challenged practice.** When proper justification is offered, the Commission can either "explain why it can confidently conclude, without adducing evidence, that the restraint very likely harmed consumers" or "provide the tribunal with sufficient evidence to show that anticompetitive effects are in fact likely." *Id.* Although this would apparently entail a more substantial analysis than the one required for FTC to satisfy its initial burden, the Commission would apparently require of itself a demonstration—either by simple explanation or by evidence of "likely" competitive impact—that falls substantially short of a showing of *actual* anticompetitive effects. If FTC fails to satisfy this somewhat relaxed standard, its challenge to the practice presumably should fail. If FTC offers an adequate explanation or adequate evidence of likely anticompetitive effects, "the evidentiary burden shifts [back] to the defendant." *Id.*

4. **The defendant must demonstrate that the challenged practice was competitively neutral or beneficial.** The defendant must rebut the Commission's probabilistic showing of "likely" competitive harm with *actual* evidence of competitive virtue. Specifically, it must "show the restraint in fact does not harm consumers or has 'procompetitive virtues' that outweigh its burden upon consumers." *Id.* If a defendant can carry this burden, before the Commission or (probably more likely) on appeal, the FTC's challenge must fail. If it cannot, the practice will be held to violate the FTC Act.

PolyGram asserted that the standard employed by the Commission was defective and that the Commission had not satisfied its burden of proof under governing U.S. Supreme Court decisions, because in a case such as this where the challenged agreement is not alleged to be *per se* unlawful, the rule of reason applies and requires that the Commission first come forward with "proof of actual anticompetitive effect (or market power as its surrogate)" before shifting the burden of proof to PolyGram. The appellate panel disagreed, dismissing as outdated the static rule of reason-*per se* dichotomy proposed by PolyGram: "[W]e reject PolyGram's attempt to locate the appropriate analysis, and the

concomitant burden of proof, by reference to the vestigial line separating *per se* analysis from the rule of reason." *Id.*

In the opinion of the panel, Supreme Court decisions in recent years have moved "from a dichotomous categorical approach to a more nuanced and case-specific inquiry" in evaluating restraints—"away from any reliance upon fixed categories and toward a continuum" of antitrust analysis—and the standard applied by the Commission in this case was consistent with that approach. *Id.* at 33-34, 35, 36. While purporting to "accept the Commission's analytical framework," the panel appears to have adopted a simpler, two-step rebuttable presumption instead of the FTC's slightly more elaborate four-step hierarchy of shifting burdens:

> If, based upon economic learning and the experience of the market, it is obvious that a restraint of trade likely impairs competition, then the restraint is presumed unlawful and, in order to avoid liability, the defendant must either identify some reason the restraint is unlikely to harm consumers or identify some competitive benefit that plausibly offsets the apparent or anticipated harm.

Id. at 36. The "class of restraints subject to summary adjudication" in this manner will change over time "as economic learning and market experience evolve." *Id.* at 37. However, the court had no problem affirming the Commission's determination that the Warner-PolyGram agreement likely caused anticompetitive effects, even on the current state of economic and legal knowledge, because the agreement resembled a type of restraint that has traditionally been condemned as unlawful *per se:* "An agreement between joint venturers to restrain price cutting and advertising with respect to products not part of the joint venture looks suspiciously like a naked price fixing agreement between competitors, which would ordinarily be condemned as *per se* unlawful." *Id.* As a result, the Commission satisfied its threshold burden, and "PolyGram's fate in this case therefore rests upon the plausibility of the sole competitive justification it proffered for the moratorium agreement." *Id.*

***Intermezzo*—"Efficiencies" That Offend the Sherman Act.** PolyGram argued that the marketing moratorium on the 1990 and 1994 albums prevented the companies from free-riding on each other's promotional efforts for the 1998 release. This, in turn, "enhanced the long-term profitability of all three concert albums and promoted the 'Three Tenors' brand." *Id.*

Although finding PolyGram's efficiencies argument to be facially plausible, on closer inspection the court concluded that PolyGram's purported justification amounted to little more than "a frontal assault on the basic policy of the Sherman Act" and therefore legally insufficient to satisfy PolyGram's burden. *Id.* at 37-38 (quoting *Nat'l Soc'y of Prof'l Eng'rs v. United States,* 435 U.S. 679, 695 (1978)). This is because the free-riding identified by PolyGram "to be eliminated by the moratorium agreement . . . was nothing more than the competition of products that were not part of the joint undertaking." *Id.* at 38. Although the restraint on marketing these products may have made the joint venture's new product more profitable, a "restraint cannot be justified solely on the ground that it increases the profitability of the enterprise that introduces the new product, regardless whether that enterprise is a joint venture or a solo undertaking." *Id.* Moreover, "one must seriously wonder whether consumers are genuinely benefitted by the new product" if "the only way [it] can profitably be introduced is to restrain the legitimate competition of older products." *Id.*

As a result, the D.C. Circuit panel upheld the Commission's findings that "the moratorium agreement could not have had any such procompetitive effect but instead simply shielded the 1998 concert album from the competition of the two earlier albums." *Id.* at 33.

Act III—An Injunction Tailored to Recurring Circumstances in the Affected Industry. Finally, the panel rejected PolyGram's suggestion that the challenged conduct was unlikely to recur and therefore determined that the Commission's remedy—prohibiting the parties from entering into similar arrangements in the future—was reasonable. *Id.* at 33, 38. The court found substantial evidence in the record to support the conclusion that "the condition that gave rise to the moratorium agreement—namely, the company 'fear[ed] that a new release by one of [its] recording artists may lose sales to the artist's older albums owned by a competitor,' . . . —is a recurrent one in the record industry" in which PolyGram and Warner compete. *Id.* at 38-39. Absent the injunction ordered by the FTC, this recurring business condition could be expected to provide PolyGram with "the same incentive in the future to enter into other agreements to restrain advertising and price discounting." *Id.* at 39.

Denouement—Fallout From the Search for An "Enquiry Meet for the Case." While continuing to refer to "categories of analysis of anticompetitive effect," a majority of the U.S. Supreme Court opined in *California Dental*

Ass'n v. Federal Trade Commission that these categories "are less fixed than terms like *'per se,'* 'quick look,' and 'rule of reason' tend to make them appear" and that "there is generally no categorical line to be drawn between restraints that give rise to an intuitively obvious inference of anticompetitive effect and those that call for more detailed treatment." 526 U.S. 756, 779, 780-81 (1999). "What is required, rather, is an enquiry meet for the case, looking to the circumstances, details, and logic of a restraint," the objective being "to see whether the experience of the market has been so clear, or necessarily will be, that a confident conclusion about the principal tendency of a restriction will follow from a quick (or at least quicker) look, in place of a more sedulous one." *Id.* at 781.

The D.C. Circuit's *PHI* decision is significant because it attempts to interpret and give meaning to this language, first by suggesting that categories of analysis be replaced by a "continuum" and then by attempting to chart a workable path through the "no-man's-land" it thereby created "between *'per se'* condemnation and full-blown 'rule of reason' treatment." *See PHI,* 416 F.3d at 35. Whether other circuits will embrace this "continuum"—with its potential to increase district judges' discretion in determining the quality and scope of analysis that they deem "meet for [a particular] case" and to inhibit propagation of workable, generalizable standards to guide courts in the exercise of this discretion—remains to be seen. *Compare, e.g., Craftsmen Limousine, Inc. v. Ford Motor Co.,* 363 F.3d 761, 772-73 (8th Cir. 2004) (suggesting just last year that the "United States Supreme Court has set forth three methods for analyzing the reasonableness of a restraint on trade: rule of reason analysis, *per se* analysis, and quick look analysis. The rule of reason is the 'prevailing standard' for determining a restraint's effect upon competition in a relevant market . . . . When a restraint's negative impact on competition is immediately discernable and the restraint has no redeeming virtue, the *per se* mode of analysis applies . . . . In cases where the repercussions of a suspicious restraint are unclear, courts may make a truncated inquiry [or "quick look"] into the restraint's output or price effects before deciding which mode of analysis to apply."); *Worldwide Basketball & Sport Tours, Inc. v. NCAA,* 388 F.3d 955, 959, 960 (6th Cir. 2004) (suggesting, at the end of last year and while specifically noting the language of *California Dental Association* quoted above, that "[w]hether an agreement *unreasonably* restrains trade is determined under one of two approaches: the *per se* rule and the rule of reason," and that "[w]hen applying the rule of reason, the courts have occasionally applied what has come to be called an abbreviated or 'quick-look' analysis" (emphasis in original)). Moreover, whether the D.C. Circuit's opinion will provide sufficient standards to guide other courts seeking to find their way in the *ad hoc* world of antitrust analysis that the court seems to propose, without at the same time seeing those standards calcify into merely another category of antitrust analysis (alongside, or perhaps as an articulation of, the rule of reason, the "quick look," or *per se* analysis), will have to await further development and elaboration in the federal courts.

The D.C. Circuit's decision is also notable for having approved the Commission's probabilistic *Mass. Board* approach to antitrust analysis, "at least as the Commission applied it in this case," *PHI,* 416 F.3d at 36, and for apparently being the first federal court decision to have expressly done so. Having been blessed by a federal appellate court, this legal framework—which appears to impose higher burdens on respondents (who apparently must show *actual* competitive virtues that outweigh any potential consumer harm) than on the FTC (which apparently need only explain *or* provide evidence of *likely* anticompetitive effects), *see id.* at 35-36—may become increasingly common in FTC administrative decisions. As a moniker to denote (in the words of the D.C. Circuit) "those restraints that judicial experience and economic learning have shown to be likely to harm consumers," *id.* at 36-37, the meaning of the term "inherently suspect" can be expected to evolve and take shape over the course of many more cases to come.

Finally, this case is a reminder that good legal planning is an essential element of good business planning. In this case, the potential free-riding issue appears to have been identified only after the joint venture was formed, *see id.* at 31-32; legal counsel apparently was not consulted until well after the partners' business representatives had decided on and firmly committed to their moratorium agreement as the solution to this perceived problem, *see id.* at 32; and the parties apparently determined to respond to the eleventh-hour legal advice by merely attempting to alter the appearance, but not the substance, of their arrangement, *see id.* Had counsel been included in the venture's ongoing consultation on "marketing and operational issues," a more benign solution might have been found that could have spared PolyGram four years of antitrust litigation with the FTC.

Recent Publications from Shook, Hardy & Bacon's Antitrust Practice Group

Lawyers in SHB's Antitrust Practice Group have recently published the following articles of interest:

James R. Eiszner and Guy A. Lewis, *Theories of Corporate Crime and Truly Effective Compliance Programs, in* ABA Section of Antitrust Law, *Antitrust Compliance: Perspectives and Resources for Corporate Counselors* 29, 29-36 (2005).

Michael L. Koon, *AWP Through the Looking Glass—Industrywide Litigation by Definition,* For the Defense, Oct. 2005, at 45, 45-51.

Victor E. Schwartz and Cary Silverman, *Punitive Damages and Compliance with Regulatory Standards: Should a Manufacturer or Service Provider Be Punished When It Follows the Law?* (Nat'l Legal Ctr. for the Pub. Int., White Paper, vol. 12, no. 1, Sept. 2005).

Antitrust Practice Group

Chaired by Jim Eiszner, the Antitrust Practice Group of Shook, Hardy & Bacon, L.L.P., specializes in all aspects of antitrust litigation and counseling under U.S. law. If you wish to discuss any of the newsletter articles with us or find out more about our practice, please contact us.

Jim Eiszner, Partner and Chairman
jeiszner@shb.com. . . . . . .(816) 559-2140

Kansas City . . . . (816) 474-6550

Brad Bodamer, Partner
bbodamer@shb.com . . . (816) 559-2073

Mike Koon, Partner
mkoon@shb.com. . . . . . (816) 559-2285

Joe Matye, Partner
jmatye@shb.com. . . . . . (816) 559-2147

John Monica, Partner
jmonica@shb.com . . . . . (816) 474-6550

Laurie Novion, Partner
lnovion@shb.com . . . . . (816) 559-2352

Joe Rebein, Partner
jrebein@shb.com. . . . . . (816) 559-2227

Bill Sampson, Partner
bsampson@shb.com . . . (816) 559-2482

Lori Schultz, Partner
lschultz@shb.com . . . . . (816) 559-2039

John Dods, Of Counsel
jdods@shb.com. . . . . . . (816) 559-2203

Scott DuPree, Of Counsel
sdupree@shb.com . . . . (816) 559-2217

Matt Miller, Of Counsel
dmmiller@shb.com . . . . (816) 559-2075

Lisa Burke, Associate
eburke@shb.com . . . . . (816) 559-2420

Charles Eblen, Associate
ceblen@shb.com. . . . . . (816) 559-2139

Ed Gramling, Associate
egramling@shb.com . . . (816) 559-2178

Jeanne Janchar, Associate
jjanchar@shb.com. . . . . (816) 559-2170

Zheng Lu, Associate
zlu@shb.com. . . . . (816) 559-2347

Dana Mehrer, Associate
dmehrer@shb.com . . . . (816) 559-2035

Kirsten Page, Associate
kpage@shb.com . . . . . . (816) 559-2511

Washington, D.C.. . . . . (202) 783-8400

Paul Schleifman, Partner
pschleifman@shb.com . (202) 639-5611

Thomas Chabanis, Of Counsel
tchabanis@shb.com . . . (202) 662-4866

Carlos Provencio, Associate
cprovencio@shb.com . . (202) 639-5606

Overland Park . . . . (913) 451-6060

Dave Rameden, Partner
drameden@shb.com . . . (913) 663-8935

Matt Wiltanger, Partner
mwiltanger@shb.com . . (193) 663-8962

Miami . . . . (305) 358-5171

Darrell Payne, Partner
dpayne@shb.com . . . . . (305) 960-6991

Richard Smith, Partner
rcsmith@shb.com . . . . . (305) 960-6924

Steven Naclerio, Of Counsel
snaclerio@shb.com. . . . (305) 960-6959

San Francisco . . . . (415) 544-1900

Pat Gregory, Partner
pgregory@shb.com . . . . (415) 544-1929

Gabrielle Handler Marks, Associate
gmarks@shb.com . . . . . (415) 544-1933

Special thanks to **Mary Boyd** and **Lisa Caplan** for editorial and production assistance and to **Cynthia Owen** and **Jeff Sewell** for research assistance.

This newsletter is provided as an informational service to our clients and friends. Our objective is to provide information and stimulate thought, not to provide legal advice. Nothing in this newsletter should be construed as imparting legal advice.