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ANTITRUST

Expert Analysis

Supreme Court: Patent Settlements Must Face Antitrust Scrutiny

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The U.S. Supreme Court ruled that "reverse payment" settlements of patent disputes could be unlawful, rejecting the view that restrictions within the "scope of the patent" could not violate antitrust law. The Supreme Court also decided that courts must enforce a contractual provision prohibiting class arbitration despite the contention that the cost of pursuing individual antitrust claims exceeded the likely recovery, effectively deterring the vindication of statutory rights.

Other antitrust developments of note included a district court's judgment that Apple facilitated a conspiracy among publishers to increase e-book prices and the U.S. Court of Appeals for the Fourth Circuit's affirmance of the FTC's challenge to efforts to restrict teeth-whitening services by non-dentists in North Carolina.

Patent Settlements

Addressing a practice that had divided the courts and generated considerable debate in the antitrust community for more than a decade, the Supreme Court decided in *FTC v. Actavis*, No. 12-416 (June 17, 2013), that "reverse payment" settlements of pharmaceutical patent disputes can violate the antitrust laws notwithstanding the ability of the owner of a valid patent to exclude or limit competition. However, the court did not, as the Federal Trade Commission (FTC) urged (and at least one circuit had held), classify "reverse payment" settlements—where the alleged infringer receives payments from the patentee and delays entering the market—as presumptively unlawful, stating that they should instead be evaluated under the rule of reason.

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The Supreme Court rejected the approach, adopted by a number of circuits, that upheld such settlement agreements as long as the restrictions were within the "scope of the patent."

In 2003, Solvay Pharmaceuticals obtained a patent for its brand-name testosterone-replacement drug AndroGel. Later that same year, Actavis Inc. and two other generic drug manufacturers sought approval from the Food and Drug Administration (FDA) to market generic versions of AndroGel, certifying under the Hatch-Waxman Act that Solvay's patent was invalid and that their drugs did not infringe it.

Solvay subsequently initiated a patent infringement suit against the generic manufacturers, and in 2006, all of the parties settled. Under the terms of the settlement, Actavis and the other generic manufacturers agreed to delay marketing their drugs for around nine years but prior to the expiration of Solvay's patent. Solvay agreed to pay each of the generic manufacturers millions of dollars.

The FTC brought an antitrust suit, which was dismissed by the lower court. The U.S. Court of Appeals for the Eleventh Circuit affirmed, stating that "a reverse payment settlement is immune from antitrust attack so long as its anticompetitive effects fall within the scope of the exclusionary potential of the patent." The Eleventh Circuit emphasized the public policy favoring settlements and noted that patent holders "have a lawful right to exclude others from the market."

In a 5-3 opinion (with Justice Samuel Alito recused) delivered by Justice Stephen Breyer, the Supreme Court reversed, holding that reverse payment settlements "can sometimes violate the antitrust laws" and should be evaluated using the rule of reason.

While recognizing the desirability of settlements, especially given the expense and complexity of patent litigation, the court emphasized that patent concerns should not immunize "pay-for-delay" settlements from antitrust scrutiny given that "patent and antitrust policies are both relevant in determining the 'scope of the patent monopoly.'" The majority focused upon the unique position occupied by first filers under the Hatch-Waxman Act, stating that "a reverse payment settlement with the first filer" removes "the most motivated challenger, and the one closest to introducing competition."

Given that the likelihood that a reverse payment will have anticompetitive effects depends, inter alia, upon "its size, its scale in relation to the payor's anticipated future litigation costs, [and] its independence from other services for which it might represent payment," the court decided that the more nuanced analysis of the rule of reason approach was appropriate. The court noted that "by examining the size of the payment" courts may be able to assess the likely anticompetitive effects "without litigating the validity of the patent."

Chief Justice John Roberts, together with Justices Antonin Scalia and Clarence Thomas, dissented, emphasizing that patents carve out "an exception to the applicability of antitrust laws" and that therefore the "correct approach" is to examine whether a settlement gives "monopoly power beyond what the patent already gave." The dissenting justices further argued that

the majority's decision will have the effect of discouraging settlements and may "discourage generics from challenging pharmaceutical patents in the first place."

The court's decision makes clear that a patent will no longer be presumed to be valid in this context. It remains to be seen whether the decision's impact will be restricted to the context of settlements arising under the unique and complex statutory scheme fashioned by the Hatch-Waxman Act, as it should, or whether plaintiffs will try to expand its impact to other contexts involving patents and settlements.

Class Arbitration

A restaurant's charge-card merchant agreement with American Express required all disputes to be resolved by arbitration and included a waiver of the restaurant's right to arbitration on a class action basis. The restaurant brought suit against American Express alleging unlawful tying arrangements in violation of antitrust law and American Express sought to compel arbitration.

The U.S. Court of Appeals for the Second Circuit found the class action waiver provision unenforceable because the cost of individually prosecuting a claim—including hiring experts—would exceed the anticipated recovery and effectively prevent merchants from asserting claims.

The Supreme Court reversed, noting that courts must "rigorously enforce arbitration agreements according to their terms." *American Express v. Italian Colors Restaurant*, No. 12-133 (June 20, 2013). In a 5-3 decision (Justice Sonia Sotomayor did not participate), the majority opinion, penned by Justice Scalia, observed that "the antitrust laws do not guarantee an affordable procedural path to vindication of every claim" and declined to apply the effective vindication doctrine because the waiver eliminated the restaurant's financial incentive to pursue its claim, not its legal right to do so.

E-Books

After a bench trial, a federal judge in Manhattan found that Apple, the computer device maker and digital retailer, "played a central role" in an illegal price-fixing scheme with five major book publishers to raise the prices of e-books and limit retail price competition. The Department of Justice and 33 states alleged that Apple and the five book publishers violated Section 1 of the Sherman Act and state antitrust laws by conspiring with each other to raise e-book prices. All five publishers settled.

In 2009, almost 90 percent of e-books were sold by Amazon, which charged $9.99 for many new releases and bestsellers. Print and digital books were distributed using a wholesale pricing model, wherein publishers sold books to retailers at a wholesale price and the retailers then set the prices paid by consumers. Amazon's $9.99 price point, which "roughly matched the wholesale price of many of its e-books," caused considerable consternation among book publishers who feared that it would deter consumers from purchasing more expensive hardcover books and that prices would be eroded in the long-term as consumers became accustomed to paying less for books. (The facts are drawn from the court's decision.)

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In December 2009, Apple, hoping to enter the e-book market in conjunction with its planned launch of the iPad in January 2010, began discussions with six of the largest book publishers in the United States, stressing that its entry into the market "represented a once-in-a-lifetime opportunity to eliminate Amazon's control over pricing." Apple proposed moving to an agency model where publishers would set the retail price and Apple would sell the e-book as the publisher's agent, taking a 30 percent commission for each transaction. To ensure that prices were "realistic," Apple further proposed that e-book prices in certain categories be capped at $12.99 and $14.99. The agency agreements also included a most favored nation clause (MFN) effectively requiring the publishers to make sure no other e-book retailers, including Amazon, sell e-books at a lower price than Apple.

Throughout the negotiations, Apple kept individual publishers informed of the state of negotiations with other publishers. Five of the six publishers ultimately executed agency contracts with Apple, and the iPad and iBookstore launched on Jan. 27, 2010. Soon after, the five publishers moved to an agency arrangement with Amazon, which thereafter raised its e-book prices.

In its ruling in *United States v. Apple,* No. 12-CIV-2826 (S.D.N.Y. July 10, 2013), the district court found that the Justice Department had proven a per se violation of the Sherman Act given the "compelling direct and circumstantial evidence" that "Apple participated in and facilitated a horizontal price-fixing conspiracy." The court emphasized that there was "little dispute that the Publisher Defendants conspired together to raise the prices of their e-books," noting that beginning in late 2008 such publishers "collectively" attempted "to pressure Amazon to raise the prices of their e-books," that through the agency agreements the publishers "simultaneously switched from a wholesale to an agency model for the distribution of their e-books," and that they used "their new pricing authority to raise the prices of their e-books overnight and substantially."

In finding Apple liable, the court noted that the "price-fixing conspiracy would not have succeeded without the active facilitation and encouragement of Apple," which, aware of the publishers' discontent with Amazon's pricing, "seized the moment" and "presented a strategy—the agency Agreements—that would allow the Publishers to take control of and raise e-book retail prices in a matter of weeks." The court stressed that the inclusion of the MFNs "stiffened the spines" of the publishers by "impos[ing] a severe financial penalty" if they "did not force Amazon" to switch to an agency model and raise its prices. This is because if Amazon, still operating under the old wholesale model sold at or below cost—for example, if Amazon bought an e-book from a publisher at a $13 wholesale price and resold it at a $9.99 retail price—under the MFN, the publishers would have to match that price on the iBookstore and still pay Apple a 30 percent commission, leading to substantially reduced publisher revenues—in this example only $7 instead of $13.

Furthermore, Apple was essential to the conspiracy, given that the "chief stumbling block to raising e-book prices" was the publishers' fear of retaliation by Amazon. By assuring individual publishers that a "critical mass" of publishers would participate, "Apple created a mechanism and environment that enabled them to act together in a matter of weeks to eliminate all retail price competition for their e-books." The court further noted that "compelling evidence of Apple's participation in the conspiracy came from the words uttered by Steve Jobs, Apple's founder, CEO, and visionary," pointing to emails and statements made by Jobs as evidence that Apple knew that the publishers were displeased with Amazon's pricing and that Apple's entry into the market would drive up e-book prices.

The court rejected Apple's argument that because it was a vertical player vis-à-vis the publishers, the case had to be analyzed using the rule of reason, noting that "Apple directly participated in a horizontal price-fixing conspiracy." Because the agreement was horizontal

in nature, "it is not properly viewed as either a vertical price restraint or solely through the lens of traditional 'hub and spoke' conspiracies."

The court added that Apple would still be liable even under a rule of reason analysis, noting that the pro-competitive effects that Apple had pointed to, including "its launch of the iBookstore, the technical novelties of the iPad, and the evolution of digital publishing more generally," would have occurred even without the agency agreements. Furthermore, such agreements "did not promote competition, but destroyed it," given that they "removed the ability of retailers to set the prices of their e-books and compete with each other on price, relieved Apple of the need to compete on price, and allowed the Publisher Defendants to raise the prices for their e-books."

The decision's exploration of MFNs—including the statement that entirely lawful contracts may include MFNs—adds to recent debate and litigation on the topic, but must be understood in the unique context of an MFN that was found to facilitate horizontal price fixing and that in practice bears significant resemblance to resale price maintenance arrangements, where the goal is to control resellers' pricing to consumers.

The decision also highlights the risks of introducing business practices that may enable horizontal competitors to coordinate their conduct, even if there are legitimate reasons for those practices.

Some commentators suggested that policy considerations broader than antitrust law should have been taken into account in prosecuting this case because very low retail prices may keep the publishing industry from investing in books that require extensive research and editing.

Teeth-Whitening

Evaluating arguments raised under the state action doctrine and the intracorporate immunity doctrine, the Fourth Circuit affirmed an FTC order finding that the North Carolina State Board of Dental Examiners engaged in unfair competition in the market for teeth-whitening services in North Carolina. The board, a state agency, is comprised of eight members most of whom are licensed dentists elected by other dentists.

Teeth-whitening has been available in North Carolina in several ways, including as an in-office dental procedure and as a treatment provided by non-dentists in malls and other locations, as well as over-the-counter. The board issued dozens of cease-and-desist letters to non-dentist teeth-whitening providers asserting that they were practicing dentistry illegally. Following an administrative trial, the FTC decided that the board violated the FTC Act by excluding non-dentists from the teeth-whitening market and the board petitioned the Fourth Circuit for review, arguing that it was exempt from antitrust laws under the state action doctrine, that it did not engage in concerted action under §1 of the Sherman Act, and that its activities did not unreasonably restrain trade. The appellate court affirmed in *The North Carolina State Board of Dental Examiners v. FTC*, No. 12-1172 (4th Cir. May 31, 2013).

In evaluating whether the board's conduct qualified for state action immunity, the Fourth Circuit noted that under *California Retail Liquor Dealers Association v. Midcal Aluminum*, 445 U.S. 97, 105 (1980), private parties who act pursuant to a "clearly articulated and affirmatively expressed" state policy and whose behavior is "actively supervised by the State itself" may be exempt from the antitrust laws. The court rejected the argument that, as a state agency, the board did not have to satisfy *Midcal's* second prong because it was effectively a private actor, "operated by market participants who are elected by other market participants." The court then found that the board could not satisfy the active supervision prong, noting that the "cease-and-desist letters were sent without state oversight and without the required judicial authorization."

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The Fourth Circuit next examined the board's argument under the intracorporate immunity doctrine that it could not have violated §1 of the Sherman Act because as a single entity it was "incapable of conspiring with itself." The appellate court noted that in *American Needle v. National Football League*, 130 S.Ct. 2201, 2211-12 (2010), the Supreme Court recognized that the key inquiry is whether there is a conspiracy between "separate economic actors pursuing separate economic interests, such that the agreement deprives the marketplace of independent centers of decision making." Noting that all board members other than the consumer member were required to maintain an active dentistry practice and that several members provided teeth-whitening services, the court found that "the Board's members are separate economic actors who cannot escape liability under §1 simply by organizing under a single umbrella."

The court further stated that anticompetitive acts are not immune if "they are performed by a professional organization" and emphasized that "it is not difficult to understand that forcing low-cost teeth-whitening providers from the market has a tendency to increase a consumer's price for that service." Yet, it has been observed elsewhere that many professions effectively limit competition by restricting the right to practice to those who have passed a demanding exam or met other licensing requirements.

In a concurring opinion, Judge Barbara Keenan emphasized that the court's decision "turn[ed] on the fact that the members of the Board, who are market participants, are elected by other private participants in the market."

Information Exchange

The FTC settled charges that Bosley Inc. violated §5 of the FTC Act by repeatedly exchanging competitively sensitive nonpublic information with HC (USA) Inc. (Hair Club), its competitor in the market for hair loss treatments. *In the Matter of Bosley*, FTC File No. 121 0184 (Final order, June 5, 2013). The FTC alleged that for at least four years, the chief executive officers of Bosley and Hair Club "exchanged detailed information about future product offerings, surgical hair transplantation price floors, discounting, forward looking expansion and contraction plans, and operations and performance."

The complaint further alleged that the information exchanges had the effect of reducing the companies' uncertainty regarding a competitor's plans for product offerings, pricing and marketing and therefore "facilitated coordination and endangered competition." Under the settlement, Bosley is prohibited from communicating any competitively sensitive nonpublic information to any competitor and from requesting, encouraging, or facilitating the communication of such information from any of its competitors.

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