



Federal Trade Commission

Intellectual Property Rights, Truncation, and *Actavis*: Who's Afraid of the Rule of Reason?

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I. INTRODUCTION

Good afternoon. I'm delighted to be here and am grateful for the opportunity to contribute to the discussion of antitrust enforcement in the context of intellectual property rights. I note at the outset that the views I express this afternoon are my own and are not those of the Commission or any of its other Commissioners.

[♦] The views stated here are my own and do not necessarily reflect the views of the Commission or any of its other Commissioners. I am grateful to my advisor, Angela Diveley, for her invaluable assistance in preparing these remarks.

Today I'd like to discuss an important concept in antitrust enforcement: truncated or so-called structured rule-of-reason analysis. In particular, I would like to focus upon an emerging demand by commentators and courts to apply truncated analysis in the context of business arrangements involving intellectual property rights, or IPRs.

Recent calls for truncated antitrust analysis to accommodate IPRs' unique features raise a number of interesting issues. One is to identify when truncated antitrust rules – that is, any antitrust analysis short of the full-blown rule of reason, including quick looks, presumptions, and *per se* rules – are appropriate as a general matter, and whether those conditions apply to business arrangements involving IPRs. Another interesting issue is whether IPRs require a special form of antitrust analysis. The demand for application of truncated antitrust analysis to evaluate business arrangements involving IPRs appears to be growing. To give just a few examples, antitrust commentators have proposed truncated antitrust analyses to evaluate standard essential patent holders seeking injunctions, the breach of SSO agreements by patent holders more generally, the business activities of patent assertion entities, and reverse payment settlements in the pharmaceutical industry.

Let me begin by discussing the economics of truncated antitrust analysis. The default method of evaluating antitrust-relevant conduct is the rule of reason, which, as

I'm sure many of you know first-hand, involves a costly, comprehensive weighing of any pro- and anticompetitive effects of the challenged conduct. Truncated antitrust analysis, by way of comparison, harnesses decision theory to develop shorthand analytical tools based upon judicial and market experience with the restraint at issue, as well as accumulated economic knowledge, to identify conduct that is likely to harm competition.

Truncated analysis is appropriate when it, rather than the full-blown or unstructured rule of reason, minimizes the sum of error costs and the administrative costs of adjudicating antitrust claims. The benefit of truncation is that it economizes on existing judicial and economic knowledge to produce more efficient legal rules. We should think of the development of truncated antitrust rules as a dynamic process – that is, antitrust rules evolve over time, and only after significant judicial experience with the challenged conduct or an empirical understanding of its competitive effects can be discerned.¹ In short, truncated analysis is at its core intended to be an easily administrable, effects-based application of the rule of reason.²

¹ See *Polygram v. FTC*, 416 F.3d 29 (D.C. Cir. 2005); *Polygram*, 136 F.T.C. 310 (2003); Timothy J. Muris & Brady P.P. Cummins, *Tools of Reason: Truncation Through Judicial Experience and Economic Learning*, ANTITRUST, Summer 2014, at 46.

² ANDREW I. GAVIL, WILLIAM E. KOVACIC & JONATHAN B. BAKER, *ANTITRUST LAW IN PERSPECTIVE: CASES, CONCEPTS AND PROBLEMS IN COMPETITION POLICY* 185-87 (2d ed. 2008); Muris & Cummins, *supra* note 1, at 46-47, 50.

Recent developments at the intersection of IPRs and antitrust appear to be producing truncated analyses that, although administrable, are inconsistent with traditional effects-based truncation as I have described it here. The rationale typically proffered in defense of these developments is that there is something special about IPRs that requires unique treatment under the antitrust laws. Students of antitrust history will recognize the claim that IPRs require a unique form of antitrust analysis. The zenith of the era of antitrust-IPR exceptionalism was the infamous and now-repudiated “Nine No-Nos.”³

The approach of IP-exceptionalism is generally rejected in modern antitrust analysis in favor of analytical parity between IPRs and real property rights while accounting for important institutional and factual differences where relevant. The parity principle is manifested in the FTC and DOJ’s joint “Antitrust Guidelines for the Licensing of Intellectual Property,”⁴ which set forth the general principle that “intellectual property [is] essentially comparable to any other form of property.”⁵ This parity principle provides a consistent and predictable theoretical framework in which to

³ Bruce B. Wilson, Deputy Assistant Attorney Gen., Patent and Know-How License Agreements: Field of Use, Territorial, Price and Quantity Restrictions, Remarks Before the Fourth New England Antitrust Conference (Nov. 6, 1970).

⁴ U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (1995).

⁵ *Id.* at § 2.0(a).

analyze IPRs, and it recognizes that strong, clearly defined property rights are essential to dynamic competition. The Supreme Court endorsed these benefits and the parity principle in *Independent Ink*⁶ when it rejected the presumption that a patent necessarily confers market power.⁷

Recent developments in antitrust analysis of IPRs suggest a rejection of the parity principle,⁸ and in particular, the adoption of truncated antitrust analyses for business arrangements involving IPRs. For example, the FTC has invoked its “unfair methods of competition” authority under Section 5 of the FTC Act to condemn standard essential patent (“SEP”) holders seeking injunctions.⁹ Of particular concern is the concept that such conduct is in breach of implied contracts to license SEPs on fair, reasonable, and non-discriminatory (“F/RAND”) terms.¹⁰ Outside of IPRs, antitrust law does not

⁶ *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28, 28-29, 38-43 (2006); see also Joshua D. Wright, *Missed Opportunities in Independent Ink*, 2006 CATO SUP. CT. REV. 333 (2006); Bruce H. Kobayashi, *Spilled Ink or Economic Progress? The Supreme Court’s Decision in Illinois Tool Works v. Independent Ink*, 53 ANTITRUST BULLETIN 5 (2008).

⁷ Joshua D. Wright & Douglas H. Ginsburg, *Whither Symmetry? Antitrust Analysis of Intellectual Property Rights at the FTC and DOJ*, COMPETITION POL’Y INT’L, Autumn 2013, at 41, 43 (“an avowed endorsement of symmetrical antitrust analysis.”).

⁸ See *id.* at 44-48.

⁹ See Complaint ¶¶ 25-26, 31, Motorola Mobility LLC, FTC Docket No. C-4410 (July 23, 2013), available at <https://www.ftc.gov/sites/default/files/documents/cases/2013/07/130724googlemotorolacmpt.pdf>; Complaint ¶¶ 20-21, Robert Bosch GmbH, FTC Docket No. C-4377 (Nov. 21, 2012), available at <https://www.ftc.gov/sites/default/files/documents/cases/2012/11/121126boschcmpt.pdf>; Complaint ¶¶ 26-38, Negotiated Data Solutions LLC, FTC Docket No. C-4234 (Sept. 22, 2008), available at <https://www.ftc.gov/sites/default/files/documents/cases/2008/09/080923ndscomplaint.pdf>.

¹⁰ See Statement of the Fed. Trade Comm’n 1, Motorola Mobility LLC, FTC File No. 121-0120 (Jan. 3, 2013) (“Motorola reneged on a licensing commitment made to several standard-setting bodies to license its

recognize claims involving “garden variety breach-of-contract . . . disputes.”¹¹ To do so within the context of IPRs rejects the parity principle and singles out IPRs as deserving special antitrust treatment.

Some scholars have also rejected the parity principle in the context of patent assertion entities (“PAEs”), calling for a presumption that the PAE business model of asserting and licensing IPRs is anticompetitive.¹² The argument that PAEs inherently harm competition rests explicitly upon the assumption that IPRs are fundamentally different from real property rights and should therefore be subjected to stricter antitrust scrutiny.¹³

In the pharmaceutical sector, lower courts are increasingly relying primarily upon the language in *Actavis* to use the size of reverse payment settlements as a proxy

standard-essential patents relating to smartphones, tablet computers, and video game systems on FRAND terms by seeking injunctions against willing licensees of those SEPs.”); Statement of the Fed. Trade Comm’n 1, Robert Bosch GmbH, FTC File No. 121-0081 (Nov. 26, 2012); Statement of the Fed. Trade Comm’n 1, Negotiated Data Solutions LLC, FTC File No. 051-0094 (Jan. 23, 2008).

¹¹ Dissenting Statement of Commissioner Maureen K. Ohlhausen 3, Robert Bosch GmbH, FTC File No. 121-0081 (observing rejection of the parity principle and stating, “The Commission statement emphasizes the context here (*i.e.*, standard setting); however, it is not clear why the type of conduct that is targeted here (*i.e.*, a breach of an allegedly implied contract term with no allegation of deception) would not be targeted by the Commission in any other context where the Commission believes consumer harm may result”).

¹² See Fiona Scott Morton & Carl Shapiro, *Strategic Patent Acquisitions*, 79 ANTITRUST L.J. 463, 464, 494 (2014); see also Joshua D. Wright & Douglas H. Ginsburg, *Patent Assertion Entities and Antitrust: A Competition Cure for a Litigation Disease?*, 79 ANTITRUST L.J. 501, 506, n.20 (2014) (describing and criticizing the presumption).

¹³ See Wright & Ginsburg, *supra* note 12, at 506 n.20.

for patent strength to determine the legality of the settlements under the antitrust laws, and scholars have provided economic analyses attempting to map out a relationship between payment size and likely competitive effects.

To illustrate the potential dangers to competition and consumers of truncation before it is adequately supported by judicial and economic learning, I will focus upon recent proposals for truncated rule-of-reason analysis in the reverse payment context based upon reverse payment size. I will contend that, for reasons I will explain shortly, economic analysis to date does not support a presumption of anticompetitive effect based upon a comparison of payment size and litigation costs.

II. TRUNCATED ANTITRUST ANALYSIS

Let's begin with a quick primer on truncation in antitrust analysis. The rule of reason arose in recognition of the fact that the antitrust laws were intended to address competitively harmful conduct and not all restraints of trade.¹⁴ As modern economic knowledge has been infused into antitrust analysis, the rule of reason has displaced bright-line *per se* rules of liability.¹⁵ The antitrust analysis of maximum and minimum resale price maintenance, exclusive territories, tying arrangements, block booking, exclusive dealing, vertical mergers, and franchise agreements, among others, have

¹⁴ See *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1, 62-66 (1911).

¹⁵ See, e.g., *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 878-80 (2007); *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 36-37 (1977).

benefitted tremendously from the greater incorporation of economic reasoning into antitrust standards.

There is one rule of reason, which is best understood as a continuum with the *per se* rule on one end and the full-blown rule of reason on the other.¹⁶ The optimal standard or rule for a particular type of business conduct will depend upon its likely competitive effects, the accuracy with which the legal rule can identify anticompetitive conduct, and the costs of applying the rule in practice. As economic knowledge and judicial experience with particular restraints accumulates, truncated analyses have developed where efficient – that is, where a less costly rule can replace a more cumbersome standard without an offsetting loss in the accuracy with which competitive effects can be predicted.

The *per se* rule is the easiest example of truncation. It applies where experience indicates a given type of conduct “always or almost always tend[s] to restrict competition or decrease output.”¹⁷ The most illustrative example of such conduct is naked price fixing. The harm is clear: consumers pay higher prices than they would otherwise pay under competitive conditions. Furthermore, there are no procompetitive justifications for price fixing. Thus, the bright-line, *per se* rule is appropriate here; it

¹⁶ Muris & Cummins, *supra* note 1, at 46 (citing Cal. Dental Ass’n v. FTC, 526 U.S. 726, 779 (1999)).

¹⁷ Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 19-20 (1979).

reliably captures anticompetitive conduct with little risk of prohibiting procompetitive conduct, and it is easy to administer. While it is theoretically possible that naked price-fixing behavior increases consumer welfare in some instances, the *per se* prohibition is optimal because the cost savings from administering the bright-line rule is greater than any loss to consumers from false positives.

Antitrust analysis is more nuanced where the challenged conduct appears likely to harm competition but still has potential procompetitive virtue. A prime example of the application of the truncated framework to conduct that might plausibly involve procompetitive virtues is *Polygram*.¹⁸ There, both the Commission and the D.C. Circuit acknowledged the tradeoff between the lower administrative costs incurred under easily administrable rules and the potential for greater error costs arising from less accurate prediction. The D.C. Circuit also acknowledged the benefits of applying “an enquiry meet for the case,” namely the mode of analysis on the rule-of-reason continuum that minimizes total error and administrative costs.¹⁹

The D.C. Circuit determined the agreement in *Polygram* was “inherently suspect,” raised an inference of competitive harm, and shifted the burden to Polygram to raise procompetitive justifications because it “look[ed] suspiciously like a naked price

¹⁸ See *Polygram v. FTC*, 416 F.3d 29, 35-36 (D.C. Cir. 2005); *Polygram*, 136 F.T.C. 310, 348-51 (2003).

¹⁹ See *Polygram*, 416 F.3d at 34.

fixing agreement between competitors” and bore a “close family resemblance [to] another practice that already stands convicted in the court of consumer welfare.”²⁰ This framework is consistent with the Supreme Court’s rationale in *California Dental* that truncated analysis is appropriate only where judicial experience and economic knowledge suggest the challenged conduct will routinely be treated the same way under a full-blown rule of reason.²¹

Importantly, decision-theoretic analysis does not always support truncated antitrust rules. Sometimes significant experience analyzing a given class of conduct indicates the full-blown rule of reason is the most appropriate analytical standard. For example, the vast majority of mergers are not anticompetitive and therefore do not violate the Clayton Act.²² Antitrust law and policy recognize there is no single form of truncated analysis that can be applied in the merger context that would efficiently minimize error costs.

Similarly, a truncated analysis has failed to develop in the context of resale price maintenance. In *Leegin*, the Supreme Court charged lower courts with constructing the proper analytical framework for analyzing RPM based upon “experience considering the effects of these restraints by applying the rule of reason over the course of

²⁰ *Polygram*, 416 F.3d at 37; see also *Polygram*, 136 F.T.C. at 353-57.

²¹ See *Cal. Dental Ass’n*, 526 U.S. at 781; see also *Polygram*, 416 F.3d at 35.

²² *Muris & Cummins*, *supra* note 1, at 47.

decisions.”²³ The Court suggested shorthand rules or presumptions may arise “to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones.”²⁴ It is clear from *Leegin* that the Court intended for truncated analysis to develop only if and when significant judicial and market experience weighs in its favor.

Lower courts have thus far been reluctant to adopt a truncated analysis for RPM,²⁵ opting instead for analysis consistent with the traditional rule of reason, requiring proof of actual anticompetitive effects in order to shift the burden to defendants to proffer offsetting procompetitive justifications.²⁶ This outcome is consistent with the current economic understanding that minimum RPM is quite often not only competitively neutral but procompetitive.²⁷ Thus, as with mergers, courts are thus far properly reluctant to apply truncated rules to minimum RPM.

²³ *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 898 (2007).

²⁴ *Id.* at 899.

²⁵ See Theodore Voorhees, Jr., *Reasoning Through the Rule of Reason for RPM*, ANTITRUST, Fall 2013, at 60.

²⁶ See *id.*, at 60; see, e.g., *House of Brides, Inc. v. Alfred Angelo, Inc.*, No. 11 C 07834, 2014 WL 64657, at *7 (N.D. Ill. Jan. 8, 2014); *P & M Distributors, Inc. v. Prairie Farms Dairy, Inc.*, No. 11-3145, 2013 WL 5509191, at *8 (C.D. Ill. Oct. 4, 2013); *Bel Canto Design, Ltd. v. MSS HiFi, Inc.*, 11-cv-6353 CM, 2012 WL 2376466, at *13 (S.D.N.Y. June 20, 2012) (dismissing antitrust counterclaim as “counterclaimants have not alleged any adverse effects on the interbrand market. . . . [N]or has it pleaded that [the plaintiff] has power in that market.”); *Jacobs v. Tempur-Pedic Int’l, Inc.*, 626 F.3d 1327 (11th Cir. 2010) (affirming dismissal for failure to allege a valid product market).

²⁷ See Thomas A. Lambert & Michael Sykuta, *Why the New Evidence on Minimum Resale Price Maintenance Does not Justify a Per Se or “Quick Look” Approach*, CPI Antitrust Chron., Nov. 2013, at 7-8 (re-analysis of prior economic study, finding only 1.6% of RPM product categories surveyed had both an increase in

III. TRUNCATED RULES IN INTELLECTUAL PROPERTY: REVERSE PAYMENT SETTLEMENTS

Let me turn now to one example of truncation of antitrust rules in the context of IPRs.

1. *Actavis and Truncation*

After *Actavis*, lower courts are faced with another call to develop and to apply a structured rule-of-reason analysis in the context of IPRs. In *Actavis*, recall that the Supreme Court held the traditional rule of reason is the proper analytical framework for determining whether a reverse payment settlement violates the antitrust laws.²⁸ The Supreme Court rejected other forms of truncated analysis. It rejected the scope of the patent test, which would have rendered reverse payment settlements *per se* lawful if they did not extend the rights of the patent holders beyond the scope of the patent.²⁹ The Court also explicitly rejected the Commission's invitation to apply another form of truncated analysis, pursuant to which all reverse payment settlements would be

price *and* a decrease in quantity in states that shifted to rule of reason); Joshua D. Wright, The Economics of Resale Price Maintenance & Implications for Competition Law and Policy, Remarks Before the British Institute of International Comparative Law 21 (April 9, 2014) (finding that vertical restraints are generally competitive neutral); *see generally* James C. Cooper, et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639, 658 (2005) ("virtually no studies can claim to have identified instances where vertical practices were likely to have harmed competition."); Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., 2008) (vertical contracts tend to benefit consumers in higher quality products and better service).

²⁸ See *FTC v. Actavis, Inc.*, 133 S. Ct. 2223, 2238 (2013).

²⁹ *Id.* at 2230.

presumed unlawful, shifting the burden to the settling parties to proffer evidence of the procompetitive effects of the settlement.³⁰ Instead, as it did in *Leegin*, the Court held reverse payment settlements should be analyzed under the traditional rule-of-reason framework, and it delegated the task of structuring the rule of reason to the lower courts.³¹

The Court did provide some general guidance for lower courts to structure the contours of that analysis, emphasizing the potential analytical link between reverse payment size, patent strength, and anticompetitive effects. The Court observed that the plaintiff's *prima facie* demonstration of a settlement's anticompetitive effects necessarily "depends upon its size, its scale in relation to the payor's anticipated future litigation costs, its independence from other services for which it might represent payment, and the lack of any other convincing justification."³²

Assessing the strength of the patent at issue has always been key to any competitive effects analysis of reverse payment settlements. The Court suggested a "workable surrogate" for patent strength under the rule of reason: reverse payment size. The Court observed "a reverse payment, where large and unjustified, can bring

³⁰ *Id.* at 2237.

³¹ *Id.* at 2238.

³² *Id.* at 2237-38.

with it the risk of significant anticompetitive effects.”³³ Recognizing the practical difficulties of embedding a full-blown patent validity trial within an antitrust proceeding, the Court also further suggested “a court, by examining the size of the payment, may well be able to assess its likely anticompetitive effects along with its potential justifications without litigating the validity of the patent.”³⁴

The critical question implicated by the Court’s ruling is what evidence will be sufficient to dispel the plaintiff’s *prima facie* burden? In particular, given the Court’s emphasis on the role of payment size and the complexity of litigating patent validity, it is completely unsurprising that courts, including the Supreme Court, are eager to identify an appropriate and workable proxy for patent strength in antitrust litigation of reverse payment settlements rather than embracing the full-blown rule of reason. It is also quite understandable that lower courts and academics have focused on the potential for payment size to serve as the basis for a truncated analysis. Economic analysis, however, is required to assess the strength of any relationship between payment size and likelihood of anticompetitive effects.

Academic economists and lawyers have answered the call for economic analysis of that relationship. Specifically, Aaron Edlin, Scott Hemphill, Herbert Hovenkamp,

³³ FTC v. Actavis, Inc., 133 S. Ct. 2223, 2237 (2013).

³⁴ *Id.*

and Carl Shapiro (“EHHS”), who published jointly an article, entitled “Activating *Actavis*,” just a few months after the *Actavis* decision, favor what might be described as the “avoided-litigation-cost” benchmark for assessing the legality of reverse payment settlements.³⁵ EHHS argue that if the payment size is positive after deducting the patent holder’s avoided litigation costs and the value of any goods, services, or other consideration provided by the claimed infringer to the patentee, the remaining payment likely reflects a relatively weak patent and “may be understood to be payment for delaying entry.”³⁶

Some lower courts have now adopted reverse payment size as a proxy for patent strength and inferred anticompetitive effects from the existence of “large and unjustified” reverse payments.³⁷ At least some courts have determined that the

³⁵ See Aaron Edlin, Scott Hemphill, Herbert Hovenkamp & Carl Shapiro, *Activating Actavis*, ANTITRUST, Fall 2013, at 16; Aaron Edlin, Scott Hemphill, Herbert Hovenkamp & Carl Shapiro, *Actavis and Error Costs: A Reply to Critics*, ANTITRUST SOURCE, Oct. 2014 [hereinafter *Actavis and Error Costs*]; Aaron Edlin, Scott Hemphill, Herbert Hovenkamp & Carl Shapiro, *The Actavis Inference: Theory and Practice* (Feb. 5, 2015) (unpublished) (manuscript at 4), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2560107. For a critique of the first article, see Barry C. Harris, Kevin M. Murphy, Robert D. Willig & Matthew B. Wright, *Activating Actavis: A More Complete Story*, ANTITRUST, Spring 2014, at 83.

³⁶ Edlin, Hemphill, Hovenkamp & Shapiro, *Activating Actavis*, *supra* note 35, at 18.

³⁷ See e.g., *In re Aggrenox Antitrust Litigation*, No. 3:14-md-2516 (SRU), 2015 WL 1311352, at *11 (D. Conn. Mar. 23, 2015) (“The salient question is . . . whether the settlement included a large and unjustified reverse payment leading to the inference of profit-sharing to avoid the risk of competition.”); *United Food and Commercial Workers Local 1776 v. Teikoku Pharma USA, Inc.*, No. 14-md-02521-WHO, 2014 WL 6465235, at *16 (N.D. Cal. Nov. 17, 2014) (“plaintiffs have plausibly alleged that the terms were large and unjustified reverse payments, which is sufficient to support plaintiffs’ theories of injury at this juncture”); *King Drug Co. of Florence v. Cephalon, Inc.*, Nos. 2:06-cv-1797, 2:06-cv-1833, 2:06-cv-2768, 2:08-cv-2141, 2015 WL 356913, at *10 (E.D. Pa. Jan. 28, 2015) (rejecting, on a motion for summary

existence of a large reverse payment settlement is sufficient to satisfy the plaintiff's *prima facie* burden under the rule of reason.³⁸

The demand for truncated analyses by lower courts and the instinct of academic economists and lawyers to supply them are understandable and desirable, but the fundamental question remains: are truncated analyses based upon payment size truly shedding light upon the settlements most likely to prove anticompetitive or are they closer to the analytical equivalent of the way a drunk uses a lamppost – for support rather than illumination?³⁹

Assessing whether this focus upon the size of the reverse payment is an efficient form of truncated analysis requires an understanding of the economic conditions under which inferences about competitive harm can reliably be drawn from a large payment.

I turn to that question next.

judgment, the assertion that a demonstration of actual anticompetitive effects is necessary and instead finding that only “evidence of a large payment is required for a plaintiff to satisfy its initial burden of demonstrating anticompetitive effects under the *Actavis* rule of reason analysis”).

³⁸ See e.g., *In re Aggrenox*, 2015 WL 1311352, at *9 (“The anticompetitive harm, under *Actavis*, is that the reverse-payment settlement ‘seeks to prevent the risk of competition’ The plaintiffs . . . must plead facts sufficient to infer (and they must ultimately prove, within the rule-of-reason framework) that a large and otherwise unjustified reverse-payment was made as part of the settlement in order to shore up some perceived risk of the ‘577 patent’s invalidity.”); *United Food and Commercial Workers*, 2014 WL 6465235, at *13; *King Drug Co. of Florence*, *supra* note 37.

³⁹ See Michael A. Salinger, Dir. Bureau of Econ., Fed. Trade Comm’n, Looking for the Keys under the Lamppost: Insights from Economics into Standards for Unilateral Conduct, Comments for ABA Section of Antitrust Law: Econ. and Section 2 Comm. Brownbag 2 (July 24, 2006), available at https://www.ftc.gov/sites/default/files/documents/public_statements/looking-keys-under-lamppost-insights-economics-standards-unilateral-conduct/060731lookingforthekeys_0.pdf.

2. *The Monopoly-to-Duopoly Model and the Avoided-Litigation-Cost*

Benchmark

As discussed, the avoided-litigation-cost benchmark posits simply that reverse payments greater than avoided litigation costs after netting out the value of any goods, services, or other consideration provided by the claimed infringer to the patentee reflect a weak patent, are properly understood as “payment for delaying entry,” and should be presumptively unlawful. Proponents of the avoided-litigation-cost benchmark contend that it is an efficient form of truncation because it accurately identifies anticompetitive reverse payment settlements, does not deter procompetitive settlements, and reduces administrative costs associated with the application of the full-blown rule of reason.

The case for the avoided-litigation-cost standard as efficient truncation turns on whether it provides a reliable link to the competitive effects of reverse payment settlements and whether the rule minimizes the sum of relevant error costs. I will argue that the avoided-litigation-cost benchmark fails on both of these dimensions for at least two reasons. First, the analytical link between payment size and competitive harm is far weaker than the economic model providing its rationale presumes. Second, the benchmark ignores the error costs associated with “forgone innovation due to the reduced incentives from erroneous invalidation of patents and the *in terrorem* settlements paid to avoid that outcome.”

Prior economic analyses of reverse payment settlements are based upon a monopoly-to-duopoly model that assumes a single generic entrant. Specifically, these economic analyses model the Brand's decision to litigate or settle based upon the assumption that if the Brand loses litigation to a generic entrant it will subsequently share duopoly profits with a single generic entrant. The avoided-litigation-cost benchmark is based upon the result from these monopoly-to-duopoly models that settlements must reduce consumer welfare if the size of the reverse payment exceeds the patentee's litigation costs.⁴⁰

The basic monopoly-to-duopoly model is based upon two flawed assumptions about competition after litigation results in invalidation of a patent: (1) duopoly profits of the brand and generic hold until expiration of the patent, and (2) only a single generic would enter the market. The monopoly-to-duopoly model effectively assumes that the marketing-exclusivity period lasts precisely until the expiration of the patent. Under this assumption, there is a single ANDA generic entrant prior to the expiration of the

⁴⁰ Carl Shapiro, *Antitrust Limits to Patent Settlements*, 34 RAND J. ECON. 391 (2003); Edlin, Hemphill, Hovenkamp & Shapiro, *Activating Actavis*, *supra* note 35; Actavis and Error Costs, *supra* note 35; Murat Mungan, *Reverse Payments, Perverse Incentives*, 27 HARV. J.L. & TECH. 1 (2013); Einer Elhauge & Alex Krueger, *Solving the Patent Settlement Puzzle*, 91 TEX. L. REV. 283 (2012). *But see* Harris, Murphy, Willig & Wright, *Activating Actavis: A More Complete Story*, *supra* note 35 (using monopoly-duopoly model, but criticizing antitrust limits on reverse settlements); Mark R. Patterson, *Leveraging Information About Patents: Settlements, Portfolios and Holdups*, 50 HOUS. L. REV. 483 (2012) (analyzing the informational effect of patent challenges and estoppel rules).

patent and the first ANDA entrant that invalidates the brand patent obtains duopoly profits until the patent expires.

In a recent analysis I co-authored with Bruce Kobayashi, Judge Douglas Ginsburg, and Joanna Tsai, we revise these two assumptions and model the competitive effects of the decision to litigate or settle. We incorporate the more realistic assumption that entry by multiple firms can follow the invalidation of a patent. Relatedly, we also incorporate the more realistic assumption that invalidation would provide only 180 days of exclusivity to the generic that won the litigation, and after that period, both the brand with the invalidated patent and the generic entrant that successfully invalidated the patent in litigation obtain only the lower profits associated with free entry. Revising these features of the simple monopoly-to-duopoly model, we conclude that the range of feasible settlements is significantly larger than predicted under the single-entrant model.⁴¹

The economic intuition for this result – a much broader set of feasible settlements – is straightforward. The reduced payoff for the first generic entrant increases its incentive to litigate, as well as the amount for which it will settle. At the same time, litigating a patent under a rule of defensive non-party, non-mutual collateral estoppel

⁴¹ Bruce H. Kobayashi, Joshua D. Wright, Douglas H. Ginsburg & Joanna Tsai, *Actavis and Multiple ANDA Entrants: Beyond the Temporary Duopoly*, ANTITRUST, Spring 2015, at 89.

under *Blonder-Tongue v. University of Illinois Foundation*,⁴² which prevents the patentee with an invalidated patent from relitigating the validity of the patent against subsequent generic entrants, imposes greater losses upon the patentee than under the original model. This decreases the patentee's incentive to litigate due to the increased litigation risk, reduces the minimum entry time for a given reverse settlement, and increases the acceptable reverse payment for a given entry time. This produces a wider range of feasible settlements to which patentees and potential generic entrants would agree.

The wider feasible-settlement range when accounting for the possibility of multiple entrants after patent invalidation indicates that the avoided-litigation-cost benchmark is not a reliable predictor of anticompetitive settlements. Rather, the primary conclusion that can be taken from the wider settlement range is that the competitive setting generated by the interaction of the Hatch-Waxman regime and collateral estoppel rules generate stronger incentives to settle than assumed in prior analyses, and that the incentives are attributable to much more than simply avoiding "the risk of competition" contemplated as the relevant antitrust harm in *Actavis*. Critically, incorporating multiple, serial entrants into the model weakens significantly any relationship between patent strength and the size of the settlement and thus

⁴² *Blonder-Tongue Lab., Inc. v. Univ. of Ill. Found.*, 402 U.S. 313 (1971).

undermines the assertion that payment size can truly be a “workable surrogate” for the validity of a patent and can accurately predict whether a reverse payment settlement is anticompetitive and violates the antitrust laws.

The first point – that incorporation of serial, multiple entrants after patent validation fundamentally alters the litigation-settlement calculus – is an important institutional detail to include in any economic model designed to capture the costs and benefits of litigation and settlement.

The second point in our analysis is equally important, but more conceptual in nature: the economic analyses underlying the avoided-litigation-cost benchmark, and EHHS in particular, do not incorporate the risk of what I will describe as dynamic Type I errors into their analysis. EHHS contend that competitive harm caused by invalidating a valid patent in litigation is appropriately ignored when designing the optimal antitrust rule. I do not think that makes economic sense as a general matter, but it makes the least economic sense when discussing the intersection of IPRs and antitrust. At the heart of IP-antitrust policy is the notion that efficiency requires tradeoffs between the use of IPRs and their creation. This is the classic tradeoff, well known within antitrust circles and evident in nearly every competition policy discussion involving innovation, between the welfare gains from broader use of an innovation and the incentive to innovate.

EHHS argue that the optimal antitrust rule should only account for losses to consumers arising from erroneous condemnation of procompetitive settlements. As an aside, careful observers will note that this approach does not support a rule of reason analysis at all, but rather a *per se* condemnation of all reverse payment settlements, not just those limited to litigation costs, because we can safely ignore any welfare costs arising from “errors” in litigation. Serious intellectual gymnastics are required to square this conclusion with the language of *Actavis*.⁴³ Further, even more careful observers will detect that the argument that dynamic Type I errors should be ignored also implies we should have a no-settlement rule if the marginal costs of litigation are not large, as the benefits of patent litigation (the invalidation of bad patents) are only achieved through litigation and not settlement. I will leave as an exercise to the reader what the implications of this analysis are for whether we should have patents in the first place.

However, as is well understood, welfare losses can arise not only from the erroneous condemnation of reverse payment settlements in litigation, which results in the limitation of the legal rights associated with patents, but also from the innovation

⁴³ See *Actavis*, 133 S. Ct. at 2234 (“We recognize the value of settlements and the patent litigation problem.”).

forgone as a result of patentees' inability to hedge against the risk of erroneous invalidation of patents.

To ignore the costs of forgone innovation is antithetical to the underlying purposes of both the antitrust and the patent laws. The FTC and DOJ's IP Guidelines summarize this concept, stating that the intellectual property laws establish enforceable property rights, the absence of which would permit imitators to exploit the IP holders' efforts, which in turn reduces the commercial value of the IPRs and the incentives to invest in innovation to obtain them.⁴⁴ The rationale is also supported in case law,⁴⁵ economics,⁴⁶ and the policies underlying the Hatch-Waxman Act,⁴⁷ not to mention the Patent Clause of the Constitution itself.⁴⁸

⁴⁴ U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *supra* note 4, § 1.0 ("The intellectual property laws and the antitrust laws share the common purpose of promoting innovation and enhancing consumer welfare. The intellectual property laws provide incentives for innovation and its dissemination and commercialization by establishing enforceable property rights for the creators of new and useful products, more efficient processes, and original works of expression. In the absence of intellectual property rights, imitators could more rapidly exploit the efforts of innovators and investors without compensation. Rapid imitation would reduce the commercial value of innovation and erode incentives to invest, ultimately to the detriment of consumers. The antitrust laws promote innovation and consumer welfare by prohibiting certain actions that may harm competition with respect to either existing or new ways of serving consumers.").

⁴⁵ See *e.g.*, *United States v. Glaxo Group*, 410 U.S. 52, 58 (1973) ("It is as important to the public that competition should not be repressed by worthless patents, as that the patentee of a really valuable invention should be protected in his monopoly.").

⁴⁶ See WARD S. BOWMAN, *PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL* (1973); HERBERT HOVENKAMP ET AL., *IP AND ANTITRUST: AN ANALYSIS OF ANTITRUST PRINCIPLES APPLIED TO INTELLECTUAL PROPERTY LAW* 1–13 (2d ed. 2013) (stating that the antitrust and patent laws "are complementary efforts to promote an efficient marketplace and long-run, dynamic competition through innovation").

In conclusion, we should be extremely wary of adopting an antitrust rule so inconsistent with competition policy and so disjointed from the competitive effects of the challenged restraint. For reverse payment settlements specifically and IPRs generally, as with all other conduct subject to the antitrust laws, the rule of reason is the most appropriate analysis unless and until judicial and economic experience suggest a truncated analysis minimizes the error costs associated with its application. The avoided-litigation-cost benchmark fails to provide an efficient and procompetitive form of truncated analysis. For now, we are left with the traditional rule of reason.

Thank you for your time.

⁴⁷ See *In re Ciprofloxacin Hydrochloride Antitrust Litigation*, 261 F.Supp.2d 188, 192 (E.D.N.Y. 2003) (“[T]he Hatch–Waxman Amendments embody Congress’ attempt to balance two conflicting policy objectives: to induce name-brand pharmaceutical firms to make the investments necessary to research and develop new drug products, while simultaneously enabling competitors to bring cheaper, generic copies of those drugs to market.” (internal quotation marks omitted)).

⁴⁸ U.S. CONST. art. I, § 8 (“To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.”).