Exclusionary Business Conduct
Under Antitrust Laws
Navigating the Evolving Standards and Enforcement for Refusals to Deal, Predatory Pricing and Other Activities

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STRAFFORD WEBINAR

Use and Abuse of Standard Essential Patents to Exclude Antitrust and Other Legal Responses

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Use and Abuse of Standard Essential Patents to Exclude

- Standards influence the direction of competition and impact competitors.
  - A key weapon the current smart phone wars.
- Enforcement interest in patent practices is high.
  - DOJ and FTC informal hearing in D.C. in this month.
  - Speeches and actions by both agencies.
- Standards come from Standard Setting Organizations or “SSOs.”
- SSOs come in all shapes, sizes, and industrial settings.
- Standard Essential Patents or “SEPs” are patents that “read on” industrial standards such that to implement the standard one must practice the patent
Use and Abuse of Standard Essential Patents to Exclude

- SEPs are not the only antitrust issue with SSOs.
  - SSOs are akin to trade associations and the antitrust risks there.
  - SSOs commonly include competitors and entities in vertical relationships.
  - Standards emerge from extensive discussion and agreement of the members with the potential for classic collusion on price and other terms, the stuff of Section 1 of the Sherman Act.
  - SSOs are potentially subject to capture by a dominant company, the stuff of Section 2 of the Sherman Act.

- For today we assume that the SEP was created by an open SSO using a proper deliberative process.
Use and Abuse of Standard Essential Patents to Exclude

- SSOs and their standards provide significant efficiencies.
  - Expand interoperability.
  - Ease entry by lowering development and marketing costs.
  - Facilitate comparison shopping.
  - Protect public safety.
  - SSO rules can reduce exploitation.

- Standard setting in network industries is preferable to *de facto* monopoly, which is eventually likely as winners emerge.
  - SSOs can constrain supra-competitive pricing through FRAND.
  - *De facto* standards tend to create durable market power.

- Courts generally have applied the Rule of Reason.
Use and Abuse of Standard Essential Patents to Exclude

- The concern is that a patent can gain market power by being in the standard.
  - This is particularly likely in network industries where everyone must use the standard, leading to standards with market power.
  - Companies seeking to implement the standard are “locked in” to the SEPs.

- All patents give the right to exclude.

- But not all patents give market power. *Illinois Tool Works, Inc. v. Independent Ink, Inc.*

- Before the standard, there could be multiple ways to do what the patented technology does.
Use and Abuse of Standard Essential Patents to Exclude

- Once the patent is included in the standard, users of the standard can be “locked in” and subject to “patent hold-up.”
- SSOs have recognized this potential problem and adopted by-laws to try to deal with it.
- But because of fear of antitrust exposure, a number of those efforts historically have been timid.
- At least until recently, there has not been great consistency across SSOs.
- And the individual by-laws have not been models of clarity.
Use and Abuse of Standard Essential Patents to Exclude

- SSOs now increasingly require participating members to commit to two things:
  - First, to disclose any patents (or patent applications) that read on the standard—allows standard setters to make an informed decision as to whether to include that technology.
  - Second, to license the SEPs for use in the standard on FRAND terms—provides limitation on standard-created market power.
    - FRAND means “fair, reasonable, and non-discriminatory.”
    - RAND is another term for the same commitment.
    - FRAND terms are not self-defining, but the commitment is important.
Use and Abuse of Standard Essential Patents to Exclude

- Based on the by-laws of different SSOs, courts have had to address a variety of issues, including:
  - How clear is the duty to disclose and what does it cover?
    - In *Rambus v. FTC*, the D.C. Circuit found the rules too vague to support a duty to disclose.
  - To whom is the duty owed? To the SSO? To the SSO’s participating members? To the SSO’s non-participating members? To non-members? To the public? This affects who can invoke the standard in court
  - Who owes the duty? The SSO participating member? Any SSO member? Purchasers of the SEP from a person with the duty?
  - Courts have applied general principles of common law, such as contract, fraud, third-party beneficiary, and estoppel.
Use and Abuse of Standard Essential Patents to Exclude

- Where companies participating in the SSO fail to disclose or fail to comply with their FRAND commitments, courts have found liability on theories other than antitrust.

- Fraud / Deception
  - But only if the obligation is clear. See *Rambus v. FTC*.

- Estoppel / Waiver
  - In *Qualcomm v. Broadcom*, the Federal Circuit held failure to disclose waived right to enforce against companies seeking to practice the standard.

- Contract
Use and Abuse of Standard Essential Patents to Exclude

- The DOJ has been urging SSO’s to tighten up their by-laws to solve these problems by:
  - Requiring careful consideration of patents that read on the standard.
  - Requiring commitments to “run with the patent” and protect anyone implementing the standard.
  - Providing for an option for all cash licensing.
  - Limiting injunctions to defendants unwilling to take FRAND terms.
  - Providing a process for deciding what FRAND requires in detail.

- These changes will be important in the future.
- But the lesson is that one must study the rules of the relevant SSO in each case.
Use and Abuse of Standard Essential Patents to Exclude

- Better SSO by-laws cannot solve all problems.
- Patent owners may choose not to participate in SSOs.
  - No duty to disclose and no duty to license or to license on FRAND terms if not involved in the SSO process.
  - Patents with *ex ante* alternatives may be included because of lack of knowledge—requires independent research by SSOs.
- Even with disclosure, the patent may be included anyway because it is necessary.
  - FRAND terms should reflect that legitimate market power.
- Also *de facto* standards may emerge outside the standard setting process.
  - No duty to license or to license on FRAND terms.
Use and Abuse of Standard Essential Patents to Exclude

- As a general rule, leaving aside SSO commitments, there is no obligation on a patent owner to license its patent or any limits on the royalties if it is licensed.
- Federal Circuit in *In re Independent Service Organization* held no violation for refusal to license within term of patent if not tying, fraud on PTO, or sham litigation.
- Ninth Circuit in *Image Technical Services v. Eastman Kodak Co.*, held presumption of legitimacy for refusal to license, but with potential to rebut by showing pretext.
- The Supreme Court has recognized that charging a monopoly price alone is not a violation of the antitrust laws.
Use and Abuse of Standard Essential Patents to Exclude

- FTC has been particularly active in this space.
- FTC consent decree against Dell in 1995 for misleading SSO.
- FTC consent decree against N-Data in 2008 for failing to follow its predecessor’s RAND commitment.
- Bosch consent decree in November 2012 requiring an agreement not seek injunctions on SEPs as a condition of a merger approval.
  - Controversial mixing of issues.
  - FTC announced that it would use Section 5 authority against patent holders who seek injunctions against willing licensees of FRAND-encumbered SEPs.
- This apparently is one of the issues in the FTC’s investigation of Google, based on the practices of its Motorola Mobility unit.
**Use and Abuse of Standard Essential Patents to Exclude (continued)**

- Threat of injunction may lead to rates higher than promised.
- Both the FTC and DOJ have expressed concern about injunctions based on FRAND-committed patents.
- FTC recently used Section 5 of the FTC Act to require commitment not to seek injunctions for SEPs for merger clearance in Bosch’s acquisition of SPX Service Solutions U.S.
- FTC filed an amicus brief with the Federal Circuit to support Judge Posner’s the denial of an injunction in *Apple Inc. v. Motorola Inc.*
  - FRAND commitment acknowledges adequacy of legal remedy.
- DOJ and FTC officials have expressed concern about patent holders seeking exclusion orders from the International Trade Commission as a way of avoiding their FRAND commitments.
Use and Abuse of Standard Essential Patents to Exclude

- Antitrust will apply to failure to disclose sometimes, but not all the time.
- Attempted monopolization elements for failure to disclose:
  - Specific intent.
  - Anticompetitive conduct.
  - Dangerous probability of success.
- The conduct must harm competition, not just competitors.
- Recent cases focus on the propriety of the conduct, with intent being a secondary factor.
- Business justification is a significant factor.
Use and Abuse of Standard Essential Patents to Exclude (continued)

- Antitrust liability for failure to disclose will be limited to where the nondisclosure was both motivated by a desire to capture market share and likely to do so.

- FTC may use Section 5 powers to fill the gap.
  - But two Commissioners dissented in Bosch merger case.

- Not all or even most standards through SSOs will control their markets.

- Market control is most likely when:
  - SSO members collective have a dominant share of the market,
  - Past standards have dominated the market,
  - Only one standard can be selected, and
  - The IP owner is unwilling to license on FRAND terms.
Use and Abuse of Standard Essential Patents to Exclude

- A misrepresentation on willingness to license on FRAND terms can have anticompetitive consequences.
- Potential of raising rivals’ costs.
- In Broadcom Corp. v. Qualcomm Inc., the Third Circuit found a claim for monopolization in allegation of falsely promising to license on FRAND terms.
- In Rambus v. FTC, the D.C. Circuit held that deception alone as to FRAND was not exclusionary conduct.
Use and Abuse of Standard Essential Patents to Exclude

- While a FRAND commitment is important, it is not self-evident what it actually means in practice.
  - In concept, the goal would a royalty based on pre-standard value.
  - Some patents may have significant market power because of no alternatives.
- If other companies in the same space have taken licenses, that is of a reasonable rate.
- For many standards there are licensing organizations that administer licensing pools for SEPs.
  - The royalties obtained by companies that license through such pools could be evidence of the FRAND rate for companies that do not.
Pricing, Predation and Costs: Where Are We Now?
Overview

- Predation, Areeda-Turner and *Matsushita*
- Cost standards, *Linkline* and “recoupment”
- Two wrongs do not make right
- Discounting, rebates and loyalty pricing
- A ZF *Meritor* revolution?
- Why pricing still matters
- Conclusions
Pricing and “costing” are gateway issues for unilateral Section 2 predation claims

Prices must be below some relevant measure of costs (Brooke Group)

- Correct economic standard has beguiled courts since seminal Harv. L. Rev. “AVC” (incremental) proposal
- Supreme Court has bypassed opportunities to clarify standard and resolve circuit splits

Under Matsushita, predation is “rarely tried, and even more rarely successful”

- Inherent policy tension between price cutting and putative monopolization liability
Cost Standards, *Linkline* & “Recoupment”

- **Pre-Matsushita,** 9th Circuit prominently rejected AVC screen (*Inglis*)
- *Brooke* settled elements — below-cost prices and likelihood of recoupment — but refused to specify cost standard
  - Recoupment requires added Section 2 showing that exclusionary conduct will be profitable
  - After *Brooke,* 90%+ predation cases resolved for Ds under Rule 56
- *Linkline* jettisoned “end run” of price squeeze theory for dual-distribution defendants
  - No viable price squeeze claim when there is no duty to deal at wholesale level and price to retailers is > cost
“Trinko holds that a defendant with no antitrust duty to deal with its rivals has no duty to deal under the terms and conditions preferred by those rivals. *Brooke Group* holds that low prices are only actionable under the Sherman Act when the prices are below cost and there is a dangerous probability that the predator will be able to recoup the profits it loses from the low prices.

“In this case, plaintiffs have not stated a duty-to-deal claim under *Trinko* and have not stated a predatory pricing claim under *Brooke Group*. They have nonetheless tried to join a wholesale claim that cannot succeed with a retail claim that cannot succeed, and alchemize them into a new form of antitrust liability never before recognized by this Court. We decline the invitation to recognize such claims. Two wrong claims do not make one that is right.”
Discounting, Rebates & Loyalty Pricing

- **DOJ Section 2 Report (2008)** = even though bundled discounts typically result in lower consumer prices, they “may nonetheless harm competition in some circumstances”

  - Widely criticized for providing inadequate guidance to market
  - “Discount attribution rule” of **PeaceHealth** applied in 2011 DOJ settlement
A ZF Meritor Revolution?

- Third Circuit 2-1 decision (2012) affirmed jury verdict that D’s market-share discounts were unlawful “de facto partial exclusive” dealing although prices always > cost
- Meritor declined to apply price-cost test to exclusive dealing unless “price is the clearly predominant mechanism of exclusion”
  - Overruled LaPage’s for market-share or volume rebates offered by suppliers within a single-product market
  - Recognizes “safe harbor for above-cost discounting” w/r/t predatory pricing involving a single product under Brooke
- Vigorous and vituperative dissent suggests other circuits will examine closely
- Supreme Court’s two decade unwillingness to take up purely unilateral predation case portends continued viability of Section 2 (non-price) claims not alleging below-cost pricing
Modern consensus economic view that predatory pricing can be successful business strategy, but courts rely on earlier theory
- *Meritor* shows that pricing can be separated from non-price exclusion without “monopoly broth” objection
- Lower courts remain conscious that AVC is short-run, static test, thus continue to temporize on cost standard
- Current literature suggests emerging trend recognizing “efficient” price predation which may allow price-based Section 2 claims through the cracks
Legal advocacy favors price-cost test due to SJ potential and economically conservative bench

Despite *Linkline* and *Brooke*, still room for aggressive and thoughtful P claims

Given politicization of Section 2 enforcement, government complaint to settle price-cost applicability quite unlikely

Over the long term, apparent that Supreme Court will apply *Brooke* to all price-related unilateral conduct claims due to perceived risk of false positives

Another 35+ years before resolution?
What is “exclusive dealing”?

• Exclusive dealing is ubiquitous in a modern market economy.
• Generally, exclusive dealing is a practice whereby a buyer agrees to purchase a set amount of products or services from a single supplier over a period of time.
• Exclusive dealing comes in many forms:
  – Partial or full requirements contracts
  – Retail shelf space
  – Conditional exclusive contracts (e.g., supplier offers a discount if customer provides complete or partial exclusivity)
Why Do Sellers Engage in Exclusive Dealing?

• **Prevent Free Riding:** Ensure retailer does not use manufacturer’s promotional funds to market a rival’s product.
  
  – Absent exclusivity, monitoring and enforcing the use of promotional payments may be difficult.
  

• **Uncertainty:** Exclusivity helps seller plan ahead and offer discounts based on uncertain sales volume, demand, or costs.

• **Protection from Rivals’ Exclusive Dealing:** Seller may be vulnerable if exclusive dealing is common industry practice.
Why Do Buyers Engage in Exclusive Dealing?

• **Lower Prices:** Buyers offer exclusivity as a bargaining chip to negotiate the lowest possible price. Offering exclusivity raises the stakes for competing sellers, who may compete more intensively for the buyer’s business.

• **Uncertainty:** Buyer may be unwilling or unable to obtain a volume discount, or may not know how much it will purchase in the future, so full or partial exclusivity may be an alternative.

• **Small Risk of Losing Customers:** Exclusivity agreements may reduce downstream customer choice, but customers may value lower prices over more choices.
Is Exclusive Dealing Good for Consumers?

• In the vast majority of cases, yes
  – Exclusivity intensifies competition between manufacturers, who must bid for exclusivity.
  – Ultimate consumer may have fewer choices; retailers make brand preference decision for consumer.

• Over-enforcement risks discouraging pro-consumer conduct (e.g., lowering prices).
Which Federal Antitrust Statutes Address Exclusive Dealing?

• Section 1 of the Sherman Act (15 U.S.C. § 1)
  – Addresses exclusivity agreements between seller and buyer that unreasonably restrain trade
  – “Rule of reason” analysis – exclusive dealing is not per se illegal

• Section 2 of the Sherman Act (15 U.S.C. § 2)
  – Addresses unilateral exclusive dealing conduct
  – Monopoly power

• Section 3 of the Clayton Act (15 U.S.C. § 14)
  – Applies to arrangements involving products, not services

• Section 5 of the FTC Act (15 U.S.C. § 45)
  – Only FTC can bring cause of action
Standard Stations

- *Standard Oil Co. v. United States (Standard Stations)*, 337 U.S. 293 (1949)
  
  - Supreme Court recognized potential benefits of exclusive dealing arrangements, and observed that exclusive dealing should be treated more leniently than tying arrangements.
  
  - Court adopted test that turned on the percentage of the relevant market “foreclosed” by the exclusive dealing, relying almost entirely on “proof that competition has been foreclosed in a substantial share of the line of commerce affected.”
  
  - Despite recognizing benefits of exclusive dealing, the Court declined to examine efficiencies.
Tampa Electric

• In *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961) the Supreme Court emphasized the need to go beyond “foreclosure.”

• When addressing exclusive dealing, courts must consider:
  
  – **The Relevant Market:** “[T]he relevant area of competition” impacted by the conduct.
  
  – **Effect on Competition:** “[T]he probably immediate and future effects which [the exclusive contract] might have on effective competition.”

• To evaluate the second prong (competitive effects), courts must consider:
  
  – **Business Realities:** The “particularized considerations of the parties’ operations.”
  
  – **Effect on Opportunities to Compete:** Whether the contract “significantly limited” rivals’ opportunities to “enter or remain on the market.”
Dentsply

• In *United States v. Dentsply Int’l, Inc.*, 399 F.3d 181 (3d Cir. 2005), defendant manufacturer found liable for policy precluding dealers from carrying rival products.
  
  – Defendant had 75-80% share of artificial teeth market.

• Dentsply’s “Dealer Criterion 6” prohibited authorized dealers from carrying rival artificial teeth.

• Evidence that Dentsply vigorously enforced Dealer Criterion 6 by threatening to cut off dealers that carried rival products.

• Evidence that rival manufacturers could not effectively sell through alternative channels (e.g., direct).
NicSand

• In NicSand, Inc. v. 3M Co., 507 F.3d 442 (6th Cir. 2007), court held that supplier did not suffer requisite antitrust injury from rival’s exclusive dealing practices.

• NicSand challenged 3M’s up-front payments to retail customers, multi-year terms, and exclusivity of 3M’s customer contracts. All three practices were upheld:
  1. Up-front payments were effectively price discounts, and could not be anticompetitive absent evidence that discounted price was below cost.
  2. Multi-year term of contracts were justified by 3M’s need to recoup investment (up-front payments and other costs).
  3. Retail customers demanded exclusivity from manufacturers, and NicSand had opportunities to compete.
**Meritor**

- In *ZF Meritor LLC v. Eaton Corp.*, the Third Circuit upheld a jury verdict in favor of plaintiffs based on exclusive dealing theory.

- Third Circuit acknowledged that price-cost test applies if antitrust claim relies primarily on price as method of exclusion (e.g., market share or volume discounts).

- According to the Third Circuit, however, plaintiffs “did not rely solely on the exclusionary effect of [defendant]’s prices.”
  - Instead, court concluded that plaintiffs’ claims were based primarily on non-price provisions of defendant’s contracts.

- Court held defendant’s agreements amounted to “de facto partial exclusive dealing.”
Problems with *Meritor*

- Court created artificial distinction between share discounts, which were price-related, and purportedly non-price provisions.
  - But share discounts were conditioned on buyers’ purchases; defendant would not have offered discounts without non-price provisions.

- Defendant appeared to have competed on the merits.
  - Plaintiffs’ prices were higher than defendant’s at all times.
  - By dispensing with price-cost test, court had no way to determine whether defendant excluded equally efficient competitor.

- Unlike *Dentsply*, there was no evidence that defendant coerced buyers.

- No evidence that defendant’s conduct raised market-wide prices, or reduced output or innovation. *See Sterling Merchandising, Inc. v. Nestle, S.A.*, 656 F.3d 112 (1st Cir. 2011) (dismissing exclusive dealing claim, in part, because no evidence of adverse impact on market-wide prices or output).
Exclusive Dealing: Some Considerations

- Does seller have monopoly or market power?
- Do the arrangements provide for full or partial exclusivity?
- What is the term (duration) of the exclusivity?
- Are seller’s prices (including any up-front payments and discounts to buyer) above cost?
- What percentage of the relevant market is “foreclosed” by the exclusivity?
- Is exclusive dealing common practice in the industry?
- Did the buyer propose discounts/up-front payments in exchange for exclusivity?
- Is there evidence that the allegedly excluded rival offered lower prices or better quality?
- What are the justifications for the arrangements?