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SECTOR-SPECIFIC COMPETITION ENFORCEMENT AT THE FCC

*JONATHAN B. BAKER**

The Federal Communications Commission's (FCC) charge to promote the public interest in the communications sector encompasses a mandate to foster competition.[1] The FCC is far from the only federal agency with an interest in competitive communications markets. The Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission (FTC), the nation's generalist antitrust enforcers, also seek to ensure that communications markets (as well as all other industries) perform competitively. These Remarks explain how and why sector-specific enforcement by the FCC complements generalist competition enforcement to the benefit of competition in the communications industry. These Remarks also discuss the ways in which a sector-specific agency such as the FCC can foster competition and promote other public goals, and compare merger reviews by the DOJ and the FCC in the wake of the 1996 Telecommunications Act.[2]

One might expect to see little difference in how the competitive effects of mergers are analyzed at the FCC versus the DOJ and the FTC. After all, the economists at these agencies have similar training and think about industrial organization economics in the same way. Indeed, some FCC economists have previously worked at

* Chief Economist, Federal Communications Commission (FCC); Professor of Law, Washington College of Law, American University. The views expressed are not necessarily those of the FCC. The Author has previously served in front office positions at the Federal Trade Commission (FTC) (as Director of the Bureau of Economics) and the Antitrust Division of the Department of Justice (DOJ) (as Special Assistant to the Deputy Assistant Attorney General for Economics), but his views are not necessarily those of those agencies. The Author is indebted to Stuart Benjamin, Jim Bird, Joel Rabinovitz, and Austin Schlick for helpful conversations and comments.

1. Recent FCC merger decisions, for example, routinely recite: "Our public interest evaluation necessarily encompasses the broad aims of the Communications Act, which include, among other things, a deeply rooted preference for preserving and enhancing competition in relevant markets . . . ." Applications Filed for the Transfer of Certain Spectrum Licenses and Section 214 Authorizations in the States of Me., N. H., and Vt. from Verizon Commc'ns Inc. and its Subsidiaries to FairPoint Commc'ns, Inc., 23 FCC Rcd. 514 para. 12 (2008) (internal quotations omitted).

2. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 133 (codified as amended in scattered sections of 47 U.S.C.).

the antitrust enforcement agencies, and vice versa. Moreover, the FCC often looks to the Horizontal Merger Guidelines promulgated by the DOJ and the FTC for guidance in analyzing horizontal mergers. For this reason, among others, some commentators claim that it is unnecessary and wasteful for multiple agencies to review communications industry mergers; these commentators typically recommend that the FCC defer to the antitrust enforcement agencies.[3] This view downplays the benefits of concurrent jurisdiction over competition questions.

The competition enforcers and the FCC do not necessarily see every proposed merger identically for a number of reasons unrelated to their similar approaches to analyzing the economic effects of a transaction. First, the agencies differ in the scope of their review. Both the FCC and the antitrust enforcers consider competition, but the FCC is also concerned with other public interest goals, such as protecting service quality for consumers of interstate telecommunications services, accelerating the private sector deployment of advanced telecommunications services, and ensuring that a diversity of information sources and viewpoints are available to the public.[4]

Second, the agencies differ in focus. Though the antitrust enforcers learn in some depth about some industries in which investigations recur (including some aspects of communications markets), they emphasize competitive analysis. The FCC focuses on communications, though it also frequently analyzes competition questions.[5]

3. *See, e.g.*, JONATHAN E. NUECHTERLEIN & PHILIP J. WEISER, DIGITAL CROSSROADS: AMERICAN TELECOMMUNICATIONS POLICY IN THE INTERNET AGE 426 (2005) ("It is debateable whether the public interest demands these additional, largely unchecked layers of intervention [from the FCC's independent merger review] beyond the basic inquiries already conducted by the Justice Department or FTC—inquiries that are considered more than adequate for other industries.").

4. *E.g.*, Applications for Consent to the Transfer of Control of Licenses, XM Satellite Radio Holdings Inc., transferor to Sirius Satelline Radio Inc., Transferee, 23 FCC Rcd. 12348 para. 31 (2008) (XM-Sirius Order) (describing elements of FCC's public interest evaluation of proposed mergers).

5. The difference in focus may be connected to a procedural difference among the agencies. The FCC must review every merger within the communications industries, as parties cannot consummate a transaction without FCC approval. *See* 47 U.S.C. § 310(d) (2006) (forbidding license transfers unless FCC finds "that the public interest, convenience, and necessity will be served thereby"). By contrast, the antitrust enforcement agencies have discretion over which mergers to investigate, are notified only as to the largest transactions before consummation, and have prosecutorial discretion to focus their resources on the transactions raising the greatest competitive concern. *See generally* ANDREW I. GAVIL, WILLIAM E. KOVACIC & JONATHAN B. BAKER, ANTITRUST LAW IN PERSPECTIVE: CASES, CONCEPTS

Third, the agencies differ in the statutory allocation of the burden of proof. The antitrust enforcers must ultimately prove harm to competition to a court (though nearly all transactions that raise concerns to the DOJ or the FTC are either remedied through settlement or abandoned by the parties).[6] By contrast, merging firms must prove to the FCC that their proposed transaction is in the public interest,[7] and the proposed transaction is subject to appellate review[8] (though nearly all concerns about acquisitions at the FCC are resolved by imposing conditions on the merged firm).[9]

Fourth, the agencies differ in how they collect and test evidence.[10] The antitrust enforcement agencies do so proactively in order to prepare for possible litigation. For example, these agencies may interview customers or depose executives from the merging firms. The FCC reviews information obtained directly from the parties, but tends to rely more than the antitrust agencies on voluntary submissions by third parties and its own expertise to test the evidence proffered by the merging firms.[11]

Fifth, the agencies differ in their culture. The antitrust enforcers, wary of ongoing supervision of merged firms, are more skeptical of conduct relief and more inclined toward structural relief than the FCC,[12] which has an ongoing interaction with all sectors of the communications industry. That ongoing interaction could in theory raise the risk that the sector-specific agency would be "captured" by the regulated industry, leading the agency to act to favor the interests of the industry rather than the public interest.[13] But a sector-

AND PROBLEMS IN COMPETITION POLICY 474–78 (2d ed. 2008) (describing U.S. merger enforcement process).

6. GAVIL ET AL., *supra* note 5, at 474–78.

7. 47 U.S.C. § 310(d) (2006).

8. *Id.* § 402(b).

9. ABA SECTION OF ANTITRUST LAW, 2007 ANNUAL REVIEW OF ANTITRUST LAW DEVELOPMENTS 1333 (2008).

10. This difference between the antitrust agencies and the FCC resembles a difference between U.S. enforcement agencies and the European Commission's Directorate General for Competition. *See* Jonathan B. Baker, *My Summer Vacation at the European Commission*, ANTITRUST SOURCE, Sept. 2005, *available at* http://www.abanet.org/antitrust/at-source/05/09/Sep05-Baker9=27.pdf.

11. Congress set up the FCC's merger review process to ensure greater transparency and public participation than normally occurs with the process at the antitrust enforcement agencies, at the cost of leaving the FCC with greater difficulty obtaining confidential business information relevant to merger review.

12. *E.g.*, Antitrust Div., U.S. Dep't of Justice, Antitrust Division Policy Guide to Merger Remedies, 7–9 (Oct. 2004), http://www.justice.gov/atr/public/guidelines/205108.pdf.

13. In a strict sense, agency capture requires that regulators expect, perhaps only with probability, to be rewarded with political support or future employment

specific agency can counteract a possible tendency toward systematic bias in favor of relying on evidence provided by the regulated firms. For example, the sector-specific agency may take internal steps to test evidence that are analogous to the kind of discipline the adversarial process imposes on the antitrust agencies, as with FCC Chairman Genachowski's emphasis on transparent, fact-based, and data-driven decisionmaking processes.[14]

Moreover, there are benefits from placing competition review in a sector-specific agency such as the FCC. The FCC has an advantage over the generalist antitrust agencies in fostering competition in communication markets because of the FCC's industry expertise and broad public interest mandate. These give the FCC the practical ability to take a longer view of the evolution of the industry than is possible for the antitrust agencies.[15] In addition, the FCC can address potential competition issues more easily than the competition enforcers can because of the hurdles the antitrust agencies

at a regulated firm for decisions favoring the regulated industry relative to how the polity would prefer it to act. Michael E. Levine, *Regulatory Capture*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 267, 269–70 (Peter Newman ed., 1998). The term is also used more broadly to encompass all regulatory decisions that favor the interests of regulated firms relative to the public interest regardless of whether the decisions were adopted by regulators anticipating some reward, and that usage is adopted here. *See, e.g.*, Theodore E. Keeler & Stephen E. Foreman, *Regulation and Deregulation*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra*, at 213–14. In a psychological sense, it may be natural for staff working only on matters involving one industry to see that industry as important, to identify with it, and to want the firms and their business experiments to succeed. Moreover, when it is costly for the sector-specific agency to learn about the regulated industry, the information on which agency decisions are based may become systematically biased toward what is provided by the regulated firms, leading staff to see issues the way the regulated firms do. In addition, if the political branches of government prefer the interests of regulated industries to what would be desired by the polity as a whole, those branches may use their supervisory levers—appointments, budget, legislation, and oversight hearings—to encourage sector-specific regulators to share their viewpoint.

14. *E.g.*, Julius Genachowski, Chairman, Fed. Commc'ns Comm'n, Preserving a Free and Open Internet: A Platform for Innovation, Opportunity, and Prosperity (Sept. 21, 2009), *available at* http://www.openinternet.gov/read-speech.html ("I will ensure that the rulemaking process will be fair, transparent, fact-based, and data-driven.").

15. *Cf.* Applications for Consent to the Transfer of Control of Licenses, XM Satellite Radio Holdings Inc.,transferor to Sirius Satelline Radio Inc., Transferee, 23 FCC Rcd. 12348 para. 32 (2008) (XM-Sirius Order) ("The Commission's competitive analysis under the public interest standard is somewhat broader [than that undertaken by DOJ pursuant to the Clayton Act] . . . and takes a more expansive view of potential and future competition and its impact on the relevant market.").

face in proving a potential competition case in court.[16] These FCC advantages were evident in the way the agencies addressed the possibility of telephone industry mergers in the immediate wake of the 1996 Telecommunications Act.[17] At that time, the FCC took a longer view than the DOJ and considered potential competition issues to the benefit of competition generally.

A year after the legislation, AT&T, which was then a long distance company, floated the idea of merging with SBC, a large local telephone service provider and one of the regional Bell operating companies.[18] From a purely competition perspective, even in 1997, this was a colorable possibility. Local and long distance telephone service are complements, not substitutes, and in general the antitrust scrutiny of mergers among sellers of complements is more relaxed than when the merger is horizontal (that is, among sellers of substitutes).[19] Moreover, the 1996 Act had specified a path for local telephone service providers to enter long distance service,[20] suggesting that Congress recognized the benefits of allowing providers to achieve scope economies in providing both services. The same legislative provisions also suggested that Congress believed that those benefits might outweigh the threat that a regulated local service provider, affiliated after merger with an unregulated long distance provider, could game the system to exercise market power.[21] In consequence, it is possible to imagine that in 1997, an antitrust agency would have concluded on balance that competition would be enhanced by a merger between AT&T and SBC.

By contrast, the FCC, the expert communications agency, had a vision of how the communications industry should evolve. The FCC aimed in 1997 to effectuate the central thrust of the 1996 Act

16. *See* 2007 Rev. Antitrust L. Dev., *supra* note 9, at 371–79 (describing elements government must prove to demonstrate harm to competition under "perceived potential competition" theory and "actual potential competition" theory); Herbert Hovenkamp, Federal Antitrust Policy: The Law of Competition and Its Practice § 13.4 (3d ed. 2005) (same).

17. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 133 (codified as amended in scattered sections of 47 U.S.C.).

18. Mark Landler, *AT&T Is Said to Break Off Merger Talks with SBC*, N.Y. Times, June 28, 1997, at 35 (recounting history of merger talks).

19. *See* Hovenkamp, *supra* note 16, at § 9.4, at 392 ("Prevailing judicial opinion now seems to be that vertical mergers should be condemned only in the most extreme circumstances.").

20. 47 U.S.C. § 271 (2006).

21. The merged firm might harm competition in the unregulated service by shifting common costs to the regulated service or by impeding or raising costs of interconnection to rivals in the unregulated service; competition problems such as these had led to the Bell System breakup.

by developing markets that would become so competitive as to permit deregulation to the extent possible.[22] In that vision there was no place for doing what the merger threatened in part to do: recreate the dangers presented by the old AT&T, which had been broken up more than a dozen years before.

The FCC at that time saw the long distance companies, particularly AT&T (the largest one), as important potential rivals for providing local telephone service; and they saw the local telephone companies as important potential rivals for the long distance companies.[23] The FCC's Chairman responded to the idea of an AT&T merger with SBC by declaring that the hypothetical AT&T merger was "unthinkable."[24] As a result the merger did not happen for eight more years—until the industry had evolved to the point where the only concerns that the FCC and the DOJ had in their merger reviews related to the effect of the transaction on certain lines and services provided mainly to local business customers in some locations.[25]

Bell Atlantic and NYNEX, two large local service providers (and former Bell system companies) had proposed a merger that was pending when AT&T suggested merging with SBC. In 1997, the FCC found that this merger would harm competition and secured relief.[26] Several months earlier, by contrast, the DOJ had allowed it to proceed without challenge.[27]

The FCC was concerned that the Bell Atlantic/NYNEX merger would mean the loss of potential competition to NYNEX in providing local phone service, particularly in New York City.[28] The Commission found that Bell Atlantic was one of four significant potential rivals to NYNEX in NYNEX's local service area, and that

22. STUART MINOR BENJAMIN, DOUGLAS GARY LICHTMAN, HOWARD SHELANSKI & PHILLIP J. WEISER, TELECOMMUNICATIONS LAW & POLICY 772 (2d ed. 2006); NUECHTERLEIN & WEISER, *supra* note 3, at 69–74.

23. Reed E. Hundt, Chairman, Fed. Commc'ns Comm'n, Thinking About Why Some Communications Mergers are Unthinkable (June 19, 1997), *available at* http://www.fcc.gov/Speeches/Hundt/spreh735.html.

24. *Id.*

25. *See* Competitive Impact Statement, United States v. SBC Commc'ns Inc., No.: 1:05CV02102 (D.D.C. Nov. 16, 2005), *available at* http://www.justice.gov/atr/cases/f213000/213026.htm; SBC Commc'ns Inc. and AT&T Corp. Applications for Approval of Transfer of Control, 20 FCC Rcd. 18,290 para. 40 (2005).

26. NYNEX Corp., 12 FCC Rcd. 19,985 paras. 144–45, 168 (1997).

27. Press Release, Antitrust Div., Dep't of Justice, Statement Regarding Bell Atlantic/NYNEX Merger (Apr. 24, 1997), *available at* http://www.justice.gov/atr/public/press_releases/1997/1113.htm. This transaction created the firm now known as Verizon.

28. *NYNEX Corp*, 12 FCC Rcd. para. 44.

Bell Atlantic was actually planning to enter New York from its adjacent territory in New Jersey.[29] The other three significant potential rivals were the large long distance providers (AT&T, Sprint, and MCI), but the FCC found that among these four potential competitors, Bell Atlantic was particularly well positioned to succeed after entry.[30] The Commission concluded that the loss of Bell Atlantic as a potential rival would remove an important competitive restraint on NYNEX.[31]

The FCC considered and rejected the efficiency arguments that the merging firms proffered in favor of the transaction, mainly on the ground that the efficiencies were not merger-specific.[32] The Commission resolved its concerns about the loss of potential competition by imposing conditions that were intended to encourage entry by even more distant potential rivals, for example, by requiring the merged firm to sell unbundled network elements at forward-looking cost.[33]

The DOJ came out differently and declined to sue, declaring that it did not believe the merger violated the antitrust laws.[34] The DOJ statement did not provide a detailed explanation of its reasoning, consistent with the usual practice when an antitrust agency declines to sue, but the Deputy Assistant Attorney General for Economics later suggested that the three long distance companies were roughly as good potential rivals as Bell Atlantic, and that three potential competitors were probably enough to protect competition.[35] Moreover, the Assistant Attorney General of the Antitrust Division explained that he resolved this "difficult case" against challenging the merger on the basis that "on balance the merger

29. *See id.* paras. 20, 44, 73.

30. *Id.* paras. 105–08.

31. *Id.* para. 102.

32. *Id.* para. 168.

33. *Id.* paras. 13–14. Consistent with the sector-specific agency's vision of developing more competitive communications markets, the FCC held that it in order to find the transaction in the public interest on competition grounds, the Commission needed to be convinced that the merger "will enhance competition." *Id.* para. 2.

34. Press Release, Antitrust Div., Dep't of Justice, *supra* note 27.

35. Andrew S. Joskow, *Potential Competition: The Bell Atlantic/NYNEX Merger*, 16 REV. INDUS. ORG. 185, 188 (2000). For a discussion of "legitimate economic theories of potentially exclusionary effects of a merger between geographically non-overlapping incumbents," see Marius Schwartz, *Discussant Comments on Papers by Andrew Joskow, Daniel Rubinfeld, and Janusz Ordover and Margaret Guerin-Calvert*, 16 REV. INDUS. ORG. 219, 220–22 (2000).

was likely to benefit consumers in that the resulting efficiencies would lead to improved services."[36]

One interpretation of the different outcomes is that the two agencies simply disagreed about whether the remaining potential competitors provided a sufficient competitive constraint and on how seriously to take the efficiency claims. But when disagreements between the DOJ or the FTC and an industry regulator occur, it is unusual to observe the sector-specific agency acting more aggressively to protect competition than the antitrust agency, so it may be that the DOJ's analysis of the facts was colored by the practical difficulty an antitrust enforcement agency would face in overcoming the legal hurdles involved in proving a potential competition case to a federal judge.[37]

This story illustrates the importance to competition policy of concurrent merger review by a competition enforcement agency alongside a sector-specific agency. In examining telephone industry mergers after the 1996 Act, concurrent review added to competition enforcement; its benefit was not simply from the ability of the expert agency to consider important non-competition public interest goals. The sector-specific agency has the expertise and ability to take a longer view of how the industry should evolve, allowing it to identify and address competitive issues that go beyond the practical ambit of antitrust enforcement. By drawing on the strengths of the sector-specific agency and the competition agency, concurrent review can thus enhance competition enforcement as a whole.

36. Joel I. Klein, Assistant Att'y Gen., Antitrust Div., Dep't of Justice, The Importance of Antitrust Enforcement in the New Economy (Jan. 29, 1998), *available at* http://www.justice.gov/atr/public/speeches/1338.htm.

37. In discussing the Justice Department's review of the Bell Atlantic/NYNEX merger, the former Deputy Assistant Attorney General for Economics hints at such a concern. Joskow, *supra* note 35, at 188–89. *Cf.* NUECHTERLEIN & WEISER, *supra* note 3, at 424 ("[A]ntitrust authorities may block mergers to protect 'potential' competition only in the narrowest of circumstances.").

INTELLECTUAL PROPERTY POLICY AND COMPETITION POLICY

*WILLIAM E. KOVACIC**

I. INTRODUCTION

Discussions among antitrust specialists about the relationship between competition policy and intellectual property policy focus predominantly on the appropriate design and application of antitrust rules to the accumulation and exercise of intellectual property (IP) rights.[1] For that reason, the term "antitrust" is typically equated with the enforcement of prohibitions against anticompetitive business practices.[2] The traditional focus of most competition agencies, including the Federal Trade Commission (FTC), is to bring cases against such practices.[3] Prosecuting antitrust cases is a vital element of a competition policy system. In devising a law enforcement strategy, a competition agency should direct its enforcement resources toward those practices that pose substantial dangers for consumers, and the cessation of which promises the largest rewards for society.[4] Because the role that IP rights play in competitive processes varies substantially from industry to industry,

* Commissioner, U.S. Federal Trade Commission (FTC); Professor, George Washington University Law School (on leave). The views stated here are the Author's alone. I am grateful to Suzanne Michel for many useful comments and suggestions.

1. *See, e.g.*, Herbert Hovenkamp et al., *Unilateral Refusals to License in the US*, *in* ANTITRUST, PATENTS AND COPYRIGHTS 12 (Francois Leveque & Howard Shelanski eds., 2005) [hereinafter Leveque & Shelanski] (discussing antitrust implications of refusals to license intellectual property); John Temple Lang, *The Application of the Essential Facility Doctrine to Intellectual Property Rights Under European Competition Law*, *in* Leveque & Shelanski at 36.

2. *See* William E. Kovacic, *Institutional Foundations for Economic Legal Reform in Transition Economies: The Case of Competition Policy and Antitrust Enforcement*, 77 CHI.-KENT L. REV. 265, 281 (2001) [hereinafter Kovacic, *Institutional Foundations*] (describing tendency by commentators to equate competition law and policy with prosecution of statutes that forbid various forms of business conduct).

3. *See* William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 ANTITRUST L.J. 377, 407–10 (2003) (discussing and criticizing case-centric conception of competition policy).

4. *See* Interview, *More Than Law Enforcement: The FTC's Many Tools—A Conversation with Tim Muris and Bob Pitofsky*, 72 ANTITRUST L.J. 773, 778 (2005) (discussing appropriate priorities for FTC antitrust law enforcement).

identifying such practices often requires extensive study and industry-specific knowledge.[5]

Though important, prosecuting antitrust cases is not the only vital element of a competition policy system. For any specific issue, antitrust enforcement might not always be the sole or even best instrument to use.[6] Properly understood, sound competition policy encompasses a larger collection of policy tools such as research, advocacy, and education.[7] One of the most important contributions of a competition policy system is to serve as an advocate within the government, and the country at large, for reliance on pro-competition policies.[8] This is true, for instance, when the root of an observed competition policy problem resides in other government regulatory programs that distort the competitive process.[9] In that case, the competition agency's aim should be to identify first-best solutions, which may involve reforms to the other regulatory regimes. These considerations motivated the FTC's 2003 report on the patent system and its recommendations for judicial and legislative reforms and adjustments to the operations of the Patent and Trademark Office (PTO).[10]

The FTC undertook its study of the patent system at a time when the interdependency of competition policy and intellectual

5. *See* William E. Kovacic & Andreas P. Reindl, *An Interdisciplinary Approach to Improving Competition Policy and Intellectual Property Policy*, 28 FORDHAM INT'L L.J. 1062, 1089–90 (2005) (discussing importance to competition agencies of pursuing research and analysis agenda concerning IP issues).

6. For example, improving the rigor of the mechanism by which IP rights such as patents are granted may be a superior way to correct competition problems, rather than using lawsuits premised on theories of monopolization or attempted monopolization in order to mandate access to what are arguably improvidently granted IP rights. *See id.* at 1066–67 (2005) (arguing that improvements in rights-granting process is superior, first-best solution to problems sometimes addressed through litigation of antitrust monopolization cases).

7. *See* WILLIAM E. KOVACIC, THE FEDERAL TRADE COMMISSION AT 100: INTO OUR 2ND CENTURY: THE CONTINUING PURSUIT OF BETTER PRACTICES 110–43 (2009) (discussing application of varied tools to solve competition policy problems); William E. Kovacic, *Measuring What Matters: The Federal Trade Commission and Investments in Competition Policy Research and Development*, 72 ANTITRUST L.J. 861 (2005) (discussing importance of policy instruments other than litigation).

8. *See generally* James C. Cooper et al., *Theory and Practice of Competition Advocacy at the FTC*, 72 ANTITRUST L.J. 1091 (2005) (discussing accomplishments of FTC's competition advocacy program).

9. *See* Kovacic & Reindl, *supra* note 5, at 1064–66 (discussing how imperfections in system for granting IP rights can distort competition).

10. FED. TRADE COMM'N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY (October 2003) [hereinafter FTC IP REPORT], *available at* http://www.ftc.gov/os/2003/10/innovationrpt.pdf.

property regimes was becoming more apparent due to the growth and increasing commercial significance of high technology and other IP-intensive industries.[11] There is broad agreement that the two systems are complementary in their efforts to promote innovation and consumer welfare.[12] Most observers also agree that the two systems use different methods to promote these goals and are not always equally successful in their promotion.[13] Better coordination is needed to ensure that both can more effectively encourage innovation and competition.

IP regimes (and in particular the patent system) and competition law and policy intersect—and therefore require coordination—in at least two areas. On the one hand, competition enforcement affects how patent owners can use their rights. Poorly functioning antitrust law at the patent interface can harm IP-driven innovation. The FTC and the Department of Justice Antitrust Division released a joint report in April 2007 that examined these issues.[14] On the other hand, systemic problems in the rights-granting process can also distort competition and chill innovation. This latter issue is the subject of the FTC report on the patent system on which I will focus in this Article.

II.
THE NEED TO BALANCE PATENT AND COMPETITION POLICY

Patents stimulate innovation by providing incentives to develop and commercialize inventions. Without patent protection, innova-

11. *See* Francois Leveque & Howard Shelanski, *Introduction*, *in* Leveque & Shelanski, *supra* note 1, at xvi–xvii (describing context in which FTC prepared report in 2003 about patent system).

12. *See* Atari Games Corp. v. Nintendo of Am., Inc., 897 F.2d 1572, 1576 (Fed. Cir. 1990) ("[T]he aims and objectives of patent and antitrust laws may seem, at first glance, wholly at odds. However, the two bodies of law are actually complementary, as both are aimed at encouraging innovation, industry and competition.") (citing Loctite Corp. v. Ultraseal Ltd., 781 F.2d 861, 876–77 (Fed. Cir. 1985)).

13. *See, e.g.*, Michael A. Carrier, *Resolving the Patent-Antitrust Paradox Through Tripartite Innovation*, 56 VAND. L. REV. 1047, 1049–53 (2003) (discussing different approaches to innovation taken by patent and antitrust law); Timothy J. Muris, Remarks before the American Bar Association Antitrust Section Fall Forum 2 (Nov. 15, 2001) (transcript available at http://www.ftc.gov/speeches/muris/intellectual. htm) (discussing limitations of antitrust and IP regimes as policy tools).

14. U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION 33, *available at* http://www.ftc.gov/reports/innovation/P040101Promoting InnovationandCompetitionrpt0704.pdf.

tors who produce intellectual property may not be able to appropriate the full benefits of their innovation because competitors are able to "free ride" on the innovators' efforts. In the pharmaceutical industry, for instance, patents enable companies to cover their fixed costs and regain the high levels of capital they invest in research and development (R&D).[15] Following the initial innovation, patent rights often allow inventors to attract funding and develop relationships needed to commercialize the invention. Many biotechnology companies, for example, conduct basic research to identify promising products and then partner with a pharmaceutical company to test and commercialize the product.[16] Patent protection can be essential to attract funds from capital markets, and facilitate licensing and joint venture relationships.[17] Moreover, the public disclosure of scientific and technical information made through a patent can stimulate further scientific progress.[18]

Competition also plays an important role in stimulating innovation and spurs invention of new products and more efficient processes. Competition drives firms to identify consumers' unmet needs and develop new products or services to satisfy them. In some industries, firms race to innovate in hopes of exploiting first-mover advantages. Companies strive to invent lower-cost manufacturing processes, thereby increasing their profits and enhancing their ability to compete.[19] Representatives of computer hardware and software companies reported that competition, more than patent protection, drives innovation in their industries.[20]

To optimally foster innovation, patent and competition policy must work together. Errors or systematic biases in how one policy's rules are interpreted and applied disrupt the other policy's effectiveness. It is important to note that the FTC Report confirms that patents play an important role in promoting innovation.[21] Nonetheless, it also raises concerns about the ability of those patents of questionable quality—those that are invalid or overly broad—to distort competition and harm innovation in several ways.

15. FTC IP Report, *supra* note 10, Ch. 3 at 9.

16. For example, the role of the patent system in attracting investment in the biopharmaceutical industry is examined in Fed. Trade Comm'n, Emerging Health Care Issues: Follow-On Biologic Drug Competition 28–30 (June 2009).

17. FTC IP Report, *supra* note 10, Ch. 3 at 15, 17–18.

18. *Id.* Ch. 2 at 3–7.

19. *Id.* at 9–12.

20. *Id.* Ch. 3 at 31–32, 46.

21. *Id.* Executive Summary at 2.

First, they may slow follow-on innovation by discouraging firms from conducting R&D in areas that the patent improperly covers.[22] When firms fear that they will infringe a questionable patent, the substantial costs and risks of litigation may persuade them to direct their resources into other areas. For example, biotechnology firms reported that they avoid infringing questionable patents and therefore will refrain from entering or continuing with a particular field of research that such patents appear to cover.[23] Such conditions deter market entry and follow-on innovation by competitors and increase the potential for the holder of a questionable patent to suppress competition.

Second, patents that should not have been granted raise costs when they are challenged in litigation.[24] If a competitor chooses to pursue R&D in the area covered by the patent without a license, it risks expensive and time-consuming litigation with the patent holder that wastes resources.[25] Questionable patents may also raise costs by inducing unnecessary licensing. If a competitor chooses to negotiate a license and pay royalties to avoid costly and unpredictable litigation, the costs of follow-on innovation and commercial development increase due to the unjustified royalties and transac-

22. Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting*, *in* INNOVATION POLICY AND THE ECONOMY 119, 126 (Adam B. Jaffe et al. eds., 2001).

23. FTC IP REPORT, *supra* note 10, Ch. 3 at 21–22.

24. *Id.* Ch. 5 at 2. "Large and small companies are increasingly being subjected to litigation (or its threat) on the basis of questionable patents." *United States Patent and Trademark Office Fee Modernization Act of 2003: Hearing on H.R. 1561 Before the Subcomm. on Courts, the Internet, and Intellectual Prop. of the H. Comm. on the Judiciary*, 108th Cong. 13 (2003) (statement of Michael K. Kirk, Executive Director, American Intellectual Property Law Association), *available at* http://www.aipla.org/Content/ContentGroups/Legislative_Action/108th_Congress1/Testimony2/Testimony_on_Fee_Legislation.htm.

25.

> If litigation does take place, it typically costs millions of dollars and takes years to resolve. The median cost to each party of proceeding through a patent infringement suit to a trial verdict is at least $500,000 when the stakes are relatively modest. When more than $25 million is at risk in a patent suit, the median litigation cost for the plaintiff and the defendant is $4 million each; and in the highest-stakes patent suit, costs can exceed this amount by more than fivefold.

A PATENT SYSTEM FOR THE 21ST CENTURY 68 (Stephen A. Merrill et al. eds., 2004), *available at* http://www.nap.edu/html/patentsystem [hereinafter PATENT SYSTEM]; *see also* FTC IP REPORT, *supra* note 10, Ch. 3 at 21–22, Ch. 5 at 2–3.

tion costs.[26] Questionable patents particularly contribute to increased licensing costs in industries with "patent thickets."[27]

Finally, firms facing patent thickets may spend resources obtaining "defensive patents," not to protect their own innovation from use by others, but to have "bargaining chips" to obtain access to others' patents through a cross-license, or to counter allegations of infringement. Some hearing participants believed that companies spend too many resources on creating and filing these defensive patents, instead of focusing on developing new technologies.[28] This is especially true when defensive patenting is conducted in response to, or results in, questionable patents.[29]

III.
RECOMMENDATIONS OF THE FTC IP REPORT

The FTC Report went beyond identifying ways in which flaws in the patent system undermine the ability of competition to promote innovation. It also recommended changes to help restore the balance of patent and competition policy. The courts have implemented some of these changes. Features of other recommendations have been incorporated into the pending patent reform legislation and rules changes proposed by the PTO.

Just as significant as the Report's specific recommendations, however, is its central theme on the need for patent policy to consider the value of competition in promoting innovation. Policymakers are increasingly incorporating that theme into the public debate on the appropriate scope of patent rights, as can be seen in a string of Supreme Court cases decided since the Report's release.

A. Recommendations to Minimize Issuance of Questionable Patents

The goal of the first group of recommendations was to minimize the issuance of questionable patents. In particular, the Report

26. *See* Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 Nw. U. L. Rev. 1495, 1517 (2001) ("Patent owners might try to game the system by seeking to license even clearly bad patents for royalty payments small enough that licensees decide that it is not worth going to court."); Shapiro, *supra* note 22, at 125; FTC IP Report, *supra* note 10, Ch. 5 at 2–3.

27. A "patent thicket" is a "dense web of overlapping intellectual property rights that a company must hack its way through in order to actually commercialize new technology." *See* Shapiro, *supra* note 22, at 120.

28. FTC IP Report, *supra* note 10, Executive Summary at 6–7 (citing *FTC/DOJ Hearings to Highlight Business and Economic Perspectives on Competition and Intellectual Property Policy*, statement of R. Jordan Greenhall, CEO, Divx Networks, Feb. 27, 2002 at 377, 420).

29. *Id.* Ch. 3 at 53–54.

recommended a tightening of the legal standards used to judge when a patent is obvious. The Supreme Court's decision in *KSR International Co. v. Teleflex Inc.*[30] directly addressed this issue.

As the Supreme Court explained in a seminal case, *Graham v. John Deere Co.*,[31] the goal of the statutory nonobviousness requirement is to provide a "means of weeding out those inventions which would not be disclosed or devised but for the inducement of a patent," and allow a patent only on those.[32] Because the requirement serves a crucial role as the primary gatekeeper, preventing the issuance of trivial patents having negative effects on competition and innovation, it is essential that the obviousness standard not be compromised.

The FTC Report identified the Federal Circuit's "teaching, suggestion, or motivation test" as a doctrine that compromised the obviousness standard because it required concrete suggestions to make a patented invention beyond those actually needed by a person with ordinary skill in the art. For that reason, the Report recommended that the obviousness analysis should better take into account the creativity and problem-solving skills of that person, including the ability to combine and modify the prior art.[33]

In *KSR*, the Supreme Court rejected the "teaching, suggestion or motivation test," calling it a "rigid rule that limits the obviousness inquiry" by overemphasizing the importance of published articles but failing to take account of the common sense and creativity of patent law's "person of ordinary skill in the art."[34] Affirming the role of the marketplace in promoting innovation, the Court stated that "[i]n many fields it may be that there is little discussion of obvious techniques or combinations, and it often may be the case that market demand, rather than scientific literature, will drive design trends."[35] Applying a common sense approach, the Court explained that if a person of ordinary skill in the art pursues a "predictable solution" and attains "anticipated success," the result is likely not the product of "innovation but of ordinary skill and common sense."[36]

In reaching this holding, the Court discussed the detrimental effects of obvious patents on innovation and the need to maintain

30. 550 U.S. 398 (2007).
31. 383 U.S. 1 (1966).
32. *Id.* at 11.
33. FTC IP REPORT, *supra* note 10, Executive Summary at 11–12, Ch. 4 at 15.
34. *KSR*, 550 U.S. at 418–20.
35. *Id.* at 419.
36. *Id.* at 421.

the proper balance of patent and competition policy. An obvious patent withdraws from the public what is already known and diminishes the resources available to support innovation.[37] The Court warned that "the results of ordinary innovation are not the subject of exclusive rights under the patent laws. Were it otherwise patents might stifle, rather than promote, the 'progress of useful arts' contemplated in our Constitution."[38]

Two other FTC recommendations that sought to minimize the issuance of questionable patents focused on the PTO. The first was to provide adequate funding for the PTO.[39] This recommendation, more than any other, received universal support from the patent community. The second recommendation suggested modifying PTO rules to help get additional and better information to patent examiners.[40] The basis for the recommendation recognized the time constraints under which patent examiners must work and the fact that patent applicants often have more knowledge of the technology and prior art than do examiners. Finding more efficient procedures for sharing that information with examiners would improve patent quality, to the benefit of everyone.

B. Recommendations Supporting the Elimination of Questionable Patents

A second group of recommendations sought to bolster a challenger's ability to eliminate questionable patents after they issue.[41] A key recommendation in this category suggested legislation to create a new administrative procedure for post-grant review and opposition to patents.[42]

37. *Id.* at 415–16.

38. *Id.* at 427.

39. FTC IP REPORT, *supra* note 10, Executive Summary at 12.

40. *Id.* at 13.

41. One recommendation falling within this category proposed legislation specifying that validity challenges be decided based on a "preponderance of the evidence" rather than "clear and convincing evidence." Although that controversial proposal has not been considered in legislation, challengers have raised it in court. *See* Petition for Writ of Certiorari, Microsoft Corp. v. z4 Techs., Inc., 507 F.3d 1340 (Fed. Cir. 2007) (No. 07-1243), *cert. dismissed*, 128 S. Ct. 2107 (No. 07-1243); *see also* KSR Int'l Co. v. Teleflex Inc., 550 U.S. 398, 426 (2007) (finding it "appropriate to note" that rationale underlying Federal Circuit's "clear and convincing" standard—"that the PTO, in its expertise, has approved the claim—seems much diminished" when defense of invalidity rests on evidence that PTO never considered).

42. FTC IP REPORT, *supra* note 10, Executive Summary at 7.

The Report argued that existing means for challenging questionable patents are inadequate. Patent prosecution is ex parte, involving only the PTO and the patent applicant, even though third parties in the same field as a patent applicant may have the best information and expertise with which to assist in the evaluation of a patent application. To enhance third-party involvement, Congress established limited *inter partes* reexamination procedures that allow third parties to participate in patent reexaminations.[43] Recent amendments have improved those procedures, but they still contain important restrictions and disincentives for their use.[44] Once a questionable patent has issued, the most effective way to challenge it is through litigation, but that path is extremely costly and lengthy. It is not an option unless the patent owner has asserted the patent against the potential challenger.

For these reasons, the FTC Report recommended institution of a meaningful post-grant review and opposition procedure and identified several characteristics that might contribute to its success. To be meaningful, post-grant review should be allowed to address important patentability issues, including novelty, nonobviousness, written description, enablement, and utility. An administrative patent judge should preside over the proceeding, which should allow cross-examination and carefully circumscribed discovery. Proceedings should be subject to a time limit and the use of appropriate sanctions authority. Patent applicants must be protected against undue delay in requesting post-grant review and against harassment through multiple petitions for review. The review petitioner should be required to make a suitable threshold showing. Finally, settlement agreements resolving post-grant proceedings should be filed with the PTO and, upon request, made available to other government agencies.[45]

The recommendation to institute a post-grant review process received broad support throughout the patent community, even though there is some disagreement on the details of how the process should work.[46] Patent reform legislation pending in both the

43. Optional *Inter Partes* Reexamination Procedure Act of 1999, Subtitle F (Optional *Inter Partes* Reexamination Procedures) of Tit. IV (American Inventors Protection Act of 1999), §§ 4601–08 of Intellectual Property and Communications Omnibus Reform Act of 1999, Pub. L. No. 106-113, Division B, Appendix I (S.1948), 106th Cong., 1st Sess., 113 Stat. 1501A-521, 1501A-567 to 1501A-572 (Nov. 29, 1999), *inter alia*, adding 35 U.S.C. Ch. 31, §§ 311–318.

44. FTC IP REPORT, *supra* note 10, Ch. 5 at 15–17.

45. *Id.* at 17–24.

46. *See* UNITED STATES PATENT AND TRADEMARK OFFICE, ACTION PAPER ON POST-GRANT REVIEW OF PATENT CLAIMS (2003), *available at* http://www.uspto.gov/

House and the Senate contains provisions establishing post-grant review.[47]

Although not related to a specific FTC recommendation, a second development is worth mentioning because it demonstrates the Supreme Court's awareness of the need to consider competition principles in forming patent policy. Just as the Court's *KSR* decision emphasized the importance of avoiding the issuance of questionable patents, the Court's decision in *MedImmune v. Genetech*[48] recognized the harm caused by those that do issue and the need to eliminate them. *MedImmune* allows a patent licensee to challenge a patent's validity through a declaratory judgment action because the harm of paying royalties on an invalid patent generates a "substantial controversy between parties having adverse legal interests," and so satisfies the Constitutional standing requirement.[49] As the Court explained in *Lear v. Adkins*,[50] an earlier case allowing a licensee to challenge patent validity, allowing such challenges to questionable patents vindicates "the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain."[51]

C. Recommendations Supporting the Disclosure Function of Patents

A third group of recommendations sought to promote the disclosure, teaching, and notice functions of patents. Providing reliable and early notice of the subject matter a patent covers enhances business certainty for competitors who wish to avoid infringement. The Report recommended that Congress enact legislation to require publication of all patent applications eighteen months after filing.[52] Both the House and Senate versions of patent reform legislation contain such a provision.[53]

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web/offices/com/strat21/action/sr2.htm (comparing pros and cons of various approaches to twelve different review process issues); AMERICAN INTELLECTUAL PROP ASS'N, AIPLA RESPONSE TO THE OCTOBER 2003 FEDERAL TRADE COMMISSION REPORT 2–4 (2004), *available at* http://www.aipla.org/Content/ContentGroups/Issues_and_Advocacy/Comments2/Patent_and_Trademark_Office/2004/ResponseToFTC.pdf; PATENT SYSTEM, *supra* note 25, at 96–101.

47. Patent Reform Act, H.R. 1908, 110th Cong. § 6 (2007); S. 1145, 110th Cong. (2007).

48. 549 U.S. 118 (2007).

49. *Id.* at 127 (quoting Maryland Casualty Co. v. Pacific Coal & Oil Co., 312 U.S. 270, 273 (1941)).

50. 395 U.S. 653 (1969).

51. *Id.* at 670.

52. FTC IP REPORT, *supra* note 10, Executive Summary at 15.

53. H.R. 1908; S. 1145.

To promote the disclosure function of patents, the FTC Report also recommended that Congress establish two alternative predicates for finding willful infringement. The patentee must show either actual written notice of infringement from the patentee sufficient to support declaratory judgment jurisdiction or deliberate copying of the patentee's invention. This recommendation was necessary because some firms complained that they do not read their competitors' patents out of concern for treble damage liability.[54] Failure to read competitors' patents can harm innovation and competition by undermining one of the primary benefits of the patent system—the public disclosure of new inventions. This encourages wasteful duplication of effort, delays follow-on innovation that could derive from patent disclosures, and discourages the development of competition. Failure to read competitors' patents also thwarts rational and efficient business planning and can jeopardize plans for a non-infringing business or research strategy. The FTC's recommendation would permit firms to read patents for their disclosure value and to survey the patent landscape to assess potential infringement issues, yet retain a viable willfulness doctrine that protects both wronged patentees and competition.[55] Both the House and Senate versions of patent reform legislation contain such a provision.[56]

In recent years, the Federal Circuit has raised the threshold for willful patent infringement. In *In re Seagate Technologies, Inc.*,[57] the court abandoned the nearly 25-year-old "duty of due care" standard and held that proof of willful infringement requires "at least a showing of objective recklessness."[58] To establish entitlement to treble damages, a patentee must show that accused infringer knew or should have known of an objectively high likelihood that its actions constituted infringement of a valid patent. This case significantly decreases the likelihood that any firm will be found liable for willful infringement. Whether legislation is still needed will depend on whether firms are now sufficiently comfortable that they will read patents for their disclosure value.

Another recommendation of the FTC Report that related to the disclosure function of patents and rational business planning addressed continuation applications. By filing a continuation application, a patent applicant literally "continues" the prosecution of an

54. FTC IP Report, *supra* note 10, Executive Summary at 16–17.
55. *Id.* Ch. 5 at 31.
56. H.R. 1908; S. 1145.
57. 497 F.3d. 1360 (Fed. Cir. 2007).
58. *Id.* at 1371.

application after an examiner either finally rejects or allows a patent application. Patent applicants frequently use continuation applications to pursue additional patents having claims of different scope than those previously allowed or rejected by the examiner. But some applicants have used multiple continuations as a strategy to continue patent prosecution so that they can later add claims based on new products discovered in the marketplace. The FTC proposed legislation to establishing prior user rights to protect the manufacturer of the new product in that situation.[59]

D. Recommendation to Consider Economics in Setting Policy

The final recommendation encouraged consideration of competition and economics in shaping patent policy. Many of the changes and proposed changes to the patent system that I have mentioned do exactly that. Although it does not relate to a more specific FTC recommendation, another important example of an analysis that considers economics stems from the Supreme Court's decision in *eBay v. MercExchange*.[60] In *eBay*, as in *KSR* and *MedImmune*, the Court again demonstrated a concern for the balance between patents and competition as the best means to promote innovation.

In *eBay*, the Court rejected the prevailing rule that courts must issue permanent injunctions against patent infringement except in exceptional circumstances. The Court held that instead "these familiar principles [of equity] apply" in patent cases.[61] Those principles require that a patent owner seeking a permanent injunction satisfy the traditional four-factor equitable test that examines irreparable injury, the adequacy of money damages, the balance of hardships, and the public interest.[62]

The content and flexibility of this test plays directly to the central theme of the FTC Report—the need to restore balance between competition and patent policy. The test allows consideration of the role of exclusivity and competition in promoting innovation, and the need to appropriately compensate patentees in order to provide incentives to innovate without unduly burdening competition. Analyzing these issues requires understanding the place of patents in the economic landscape faced by the parties, a topic that the FTC Report examines in depth.

59. FTC IP Report, *supra* note 10, Executive Summary at 16.
60. 547 U.S. 388 (2006).
61. *Id.* at 391.
62. *Id.*

In many cases, the patent owner's right to maintain control over the invention by obtaining an injunction is critical to its ability to appropriate the invention's value. A patent owner's goal may be to exclusively commercialize its own invention, as is often the case in the pharmaceutical industry.[63] Alternatively, a patent owner's goal may be to license its patent to another firm exclusively so that the licensee will have sufficient incentives to develop and commercialize the invention, as is more common in the biotechnology industry.[64]

In other cases, however, the threat of an automatic, permanent injunction can cause "hold-up." Hold-up typically arises when a patentee asserts its patent after the accused infringer has sunk substantial costs into design, development, and commercialization without knowledge of the patent. The threat of an automatic injunction following expensive patent litigation increases the patentee's leverage in the licensing negotiations beyond the value of the patent's inventive contribution and leads to higher royalties. This dynamic can be especially problematic when the patented invention is only a small component of the infringing product.[65] Justice Kennedy's concurrence, joined by three others, noted these problems and cited the FTC Report in support.[66] The concurrence explains that, for patent owners proposing nonexclusive licenses, "an injunction, and the potentially serious sanctions arising from its violation, can be employed as a bargaining tool to charge exorbitant fees to companies that seek to buy licenses to practice the patent."[67]

Since the Supreme Court issued its *eBay* decision, district courts have applied its equitable test in deciding whether to award a permanent injunction to a patent owner more than forty times.[68] They have taken variable approaches to the analysis, and the law in this area is still developing.[69]

63. FTC IP REPORT, *supra* note 10, Ch. 3 at 11–12.

64. *Id.* at 15, 17–18.

65. *Id.* Ch. 2 at 29, Ch. 3 at 37–38, 40.

66. *eBay Inc.*, 547 U.S. at 396 (Kennedy, J., concurring). The United States' amicus brief, prepared with input from FTC staff, iterated these points. Brief for the United States as Amicus Curiae Supporting Respondent at § I.C, *eBay Inc. v. MercExchange L.L.C.*, 547 U.S. 388 (2006) (No. 05-130), 2006 WL 622120.

67. *eBay Inc.*, 547 U.S. at 396 (Kennedy, J., concurring).

68. *See* Joseph Miller, *Injunctions*, THE FIRE OF GENIUS (Nov. 8, 2010, 12:00 PM), http://www.thefireofgenius.com/injunctions/ (listing court decisions to grant or deny injunctions in patent cases).

69. In some cases, courts have simply held that irreparable harm exists, without further discussion, where a firm offers an infringing product in direct competition with the patent holder. *See, e.g.*, O2 Micro Int'l Ltd. v. Beyond Innovation Technology Co., No. 2-040CV-32 (TJW), 2007 WL 869576, at *2 (E.D. Tex. Mar.

IV.
CONCLUSION

Much has changed in the world of patent law and policy since the FTC released its Report in 2003. More changes seem likely. Perhaps the most significant change, however, is the increased awareness that to promote maximum levels of innovation, we must understand the complex mechanisms through which patents and competition work together to drive innovation, consumer welfare, and our nation's prosperity. Policymakers seem to have reached a consensus that allowing more patents having greater breadth in more industries is not the best way to achieve our common goals.

But the questions raised by the quest to achieve the optimal balance of patent and competition policy are complex and always changing. They require continual study as industry dynamics shift, new business models emerge, and the law evolves. For that reason, the FTC has continued to study the role of patents and competition in promoting innovation, for the dual purposes of informing our antitrust enforcement actions and identifying opportunities for advocacy on patent issues. In 2008, the FTC held a workshop to examine the changes to the patent system since the Report's release and the implications of those changes for the Report's recommendations.[70] Only by carefully considering the road we have traveled can we formulate the best plan for moving forward.

21, 2007), *rev'd on other grounds*, 521 F.3d 1351, 1366 (Fed. Cir. 2008) (granting permanent injunction). Without further explanation, the court stated that "[t]he availability of the infringing products leads to loss of market share for plaintiff's products." *Id.* (quoting Tivo v. EchoStar Communications Corp., 446 F. Supp. 2d 664, 669 (E.D. Tex. 2006) (internal quotation marks omitted)). In others, they demand a full showing of harm, complete with economic analysis. *See, e.g.*, Praxair, Inc. v. ATMI, Inc., 479 F. Supp. 2d 440, 443–44 (D. Del. 2007) (denying injunction because plaintiff did not provide any "specific sales or market data to assist the court, nor has it identified precisely what market share, revenues, and customers Praxair has lost to ATMI").

70. *See* Press Release, Federal Trade Commission, FTC Announces First in Series of Hearings on Evolving Intellectual Property Marketplace (Nov. 6, 2008), http://www.ftc.gov/opa/2008/11/ipmarketplace.shtm.

LICENSING RESTRICTIONS ON FIELDS OF USE VS. ADJACENT MARKETS: A POTENTIAL ECONOMIC BASIS FOR DIFFERENT LEGAL TREATMENT

*MARIUS SCHWARTZ**

Thank you for inviting me. It is a pleasure to be here with such distinguished company and a great audience. My remarks reflect very preliminary thoughts, and I welcome your reactions. Since the title of my remarks may not be self evident, let me start with a little motivation.

I.
A MOTIVATING EXAMPLE: *MONSANTO V. DUPONT* BIOTECH LITIGATION

The idea for these remarks was triggered by the ongoing litigation between DuPont and Monsanto involving biotech traits in agriculture, specifically for corn and soybean seeds.[1] I am not involved in this litigation and am only peripherally familiar with the issues based on public information, especially DuPont's counterclaims.[2] I will ignore various issues in the litigation, like the validity of Monsanto's patents. The part that piqued my interest was the dispute about the licensing restrictions.

* Professor of Economics, Georgetown University, Washington, DC 20057-1036; mariusschwartz@me.com. These remarks are based on my comments on the Antitrust and Innovation Panel, New York University School of Law's *Annual Survey of American Law* 2010 Symposium: Critical Directions in Antitrust. In editing those remarks I have tried to preserve their informal tone, while elaborating on some points and adding citations. For helpful discussions I thank Paolo Ramezzana and George Rozanski.

1. At the time these Remarks were published, the Eastern District of Missouri decided the referenced litigation. *See generally* Monsanto v. E.I. Dupont de Nemours & Co., 2010 WL 3039210 (E.D. Mo. July 30, 2010).

2. Defendant's Answer and Counterclaims, Monsanto Co. v. E.I. du Pont de Nemours & Co. (E.D. Mo. June 16, 2009) (No. 4:09-cv-00686), *available at* http://www2.dupont.com/Media_Center/en_US/assets/downloads/pdf/20090616DuPontCounterclaim.pdf. For additional industry background and a broader discussion of competition issues, see Diana L. Moss, *Transgenic Seed Platforms: Competition Between a Rock and a Hard Place?*, AM. ANTITRUST INST. (Oct. 23, 2009), http://www.antitrustinstitute.org/sites/default/files/AAI_Platforms%20and%20Transgenic%20Seed_102320091053_0.pdf.

The basic facts as I understand them are as follows: DuPont's division Pioneer licenses from Monsanto a trait called Roundup Ready®, which can be put into seeds to make them tolerate the widely used herbicide Roundup®.[3] DuPont now wants to "stack," which means to add its own traits on top of Roundup Ready® to create improved products such as seeds that would have tolerance to other herbicides beyond Roundup or to insects, or have desirable "output features," like reduced trans fats.

According to DuPont's counterclaim, Monsanto also is planning to develop stacked traits, and Monsanto contends that DuPont's license to use Roundup Ready® does not entitle DuPont to stack other traits with it.[4] DuPont characterizes this as an attempt by Monsanto to extend its monopoly over Roundup Ready into emerging markets for stacked products—monopoly leverage, with all its negative connotations.[5] Monsanto might respond, "Now wait a minute. What we are talking about is a field-of-use restriction. We've licensed you for something. We want to keep the new emerging fields for ourselves. The law is generally pretty tolerant of field-of-use restrictions in licensing. So where is the problem?"

This got me thinking about what is meant by a "field of use" versus a "market" because the legal stance seems to differ depending on the characterization.

II.
WHY A SEEMINGLY MORE PERMISSIVE LEGAL STANCE TOWARD RESTRAINTS ON FIELDS OF USE THAN ON ADJACENT MARKETS?

I am not a lawyer, so please take the ensuing with a mountain rather than a grain of salt; an economist opining about the law is even more dangerous than the other way around. But my sense from having read a bit in the area is that the law allows an intellectual property (IP) holder with market power—and it's worth reiter-

3. Roundup® is Monsanto's brand of glyphosate, a broad-spectrum herbicide that is now off patent and available in generic versions.

4. In its Press Release of June 17, 2009, DuPont describes Monsanto's lawsuit as "seek[ing] to block innovative new soybean lines from . . . Pioneer Hi-Bred" and asserts that "we believe we have every right through our existing license agreement to 'stack' our Optimum GAT trait Pioneer soybeans already containing a Roundup Ready® trait." Press Release, E.I. DuPont de Nemours & Co., DuPont Asserts Anti-Trust, Patent Claims against Monsanto (June 16, 2009), http://vocuspr.vocus.com/VocusPR30/Newsroom/Query.aspx?SiteName=DupontNew&Entity=PRAsset&SF_PRAsset_PRAssetID_EQ=112532&XSL=PressRelease&Cache=.

5. *Id.*

ating that IP by itself need not confer market power—greater discretion (a) to impose field-of-use restrictions in licensing, thereby excluding licensees from certain fields than (b) to deny its IP to rivals that seek to compete with it in complementary markets requiring access to this IP, a scenario often described as monopoly leverage.

Let's start with field-of-use licensing. The Supreme Court, over seventy years ago, confirmed that patent owners are free to "grant licenses . . . limited to use in a defined field."[6] It viewed such limits as lawful exploitation of the patent, not an improper extension of the scope of the patent, and subsequent lower court decisions have taken a similarly permissive approach.[7] The federal antitrust agencies in their IP Licensing Guidelines also view field-of-use limitations as benign, stating that such limitations may increase the licensor's incentive to license by "protecting the licensor from competition in the licensor's own technology in a market niche that it wants to keep to itself."[8]

Turning to restrictions on adjacent markets, the law apparently is not categorically permissive. If an IP holder limits competitors' access to IP needed to compete in a "related" or "adjacent" or "secondary" market, such conduct may be scrutinized,[9] often under the guise of tying.[10] For example, if a company like Xerox or Kodak

6. Gen. Talking Pictures Corp. v. W. Elec. Co., 304 U.S. 175, 181 (1938), *aff'd on reh'g*, 305 U.S. 124 (1938). This remains the main Supreme Court decision on field-of-use licensing.

7. *See* Monsanto Co. v. Scruggs, 459 F.3d 1328, 1338 (Fed. Cir. 2006) (finding that field-of-use licensing restrictions "are also within the scope of the patent grant"); ABA SECTION OF ANTITRUST LAW, INTELLECTUAL PROPERTY AND ANTITRUST HANDBOOK 176 (2007); Mark Patterson, *Contractual Expansion of the Scope of Patent Infringement Through Field-of-Use Licensing*, 49 WM. & MARY L. REV. 157, 159 (2007) (noting that licensee may use patented invention only in "specified way"); *id.* at 171 (noting that *Monsanto Co.* eliminated all doubt that field-of-use licensing restrictions "are also within the scope of the patent grant").

8. U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY, § 2.3 (1995).

9. *See* ABA SECTION OF ANTITRUST LAW, *supra* note 7, at 11 (noting that unilateral refusal to license "may raise antitrust concerns when the refusal is directed against competition and the purpose is to create, maintain, or enlarge a monopoly") (quoting Intergraph Corp. v. Intel Corp., 195 F.3d 1346, 1358 (Fed. Circ. 1999)); *id.* at 218–19 (noting that charging discriminatory royalties is not grounds to establish patent misuse or antitrust violation "in the absence of some unique evidence to establish anticompetitive effects, *such as limiting competition with an affiliate of the licensor in a downstream market*") (emphasis added).

10. Mark R. Patterson, *When Is Property Intellectual? The Leveraging Problem*, 73 S. CAL. L. REV. 1133, 1137 (2000) (noting that "[t]he Supreme Court has been quite willing to discourage leveraging even when the seller's power is a product of intel-

refuses to supply its patented parts to independent service organizations that might use the parts to compete in servicing the durable good, and if servicing is portrayed as a different market, the conduct may be condemned as leveraging of IP-based market power in parts into the related market.[11]

In sum, the IP holder apparently has less of a carte blanche to restrict licensees' access to its IP when they use it to compete in a related "market" than when they use it to venture outside of a designated "field of use." But what do these labels mean? And are there economic reasons that could rationalize different legal treatment?

My hypothesis—and please tell me if it's wildly off base—is that perhaps these labels correlate in a rough way with different underlying economic conditions, specifically with the magnitude of the tradeoff between (a) total losses to other parties from allowing the IP holder greater discretion to impose licensing restrictions, and (b) the resulting increased profit to the IP holder. That trade off may be worse, on average, when restrictions pertain to adjacent markets than to fields of use. And if that is true, then maybe there is an economic rationale for looking more permissively, from a cost-benefit standpoint, at field-of-use restrictions. Let me flesh this out a bit.

III.
THE RELATIVE COST OF PROVIDING INCENTIVES TO INNOVATE

The patent system (a shorthand for intellectual property generally) gives a patent holder certain rights to exclude others from using its invention even though the total harm to other parties will often exceed its increased profit. Such an outcome is accepted, of

lectual property," and adding that in two leading tying cases, *International Salt Co. v. United States*, 332 U.S. 392 (1947) and *United States v. Paramount Pictures*, 334 U.S. 131 (1948), tying products involved patented machines and copyrighted films). IP law has also discouraged leveraging—the early antitrust tying cases relied on earlier patent infringement cases in which the Court found patent misuse. *Id.* at 1137; *see also id.* at 1150 ("[P]atent law offers ample reason to reject the view that the leveraging power of a product embodying an invention is necessarily a product of that invention.").

11. ABA Section of Antitrust Law, *supra* note 7, at 11–12. In *Image Technical Services v. Eastman Kodak Co.*, 125 F.3d 1195, 1219–20 (9th Cir. 1997), the Ninth Circuit upheld as reasonable the District Court's instructions that Kodak's refusal to sell patented parts to ISOs constituted monopoly leverage from parts to servicing. However, in *In re Independent Service Organizations Antitrust Litigation*, 203 F.3d 1322, 1329 (Fed. Cir. 2000), the Federal Circuit held that Xerox's refusal to sell patented parts to ISOs did not violate the antitrust laws.

course, on grounds that the prospect of ex post profit provides incentives to incur the investment needed to bring about inventions in the first place.[12] While the link between ex post profit and the incremental likelihood of innovation is imprecise and can vary across industries, a higher expected profit is widely presumed to encourage innovation.[13]

In assessing a policy that allows greater profit to a patent holder, however, it is also relevant to consider the increase in profit relative to the effect on other parties. Let V denote profit to the patent holder and S denote total surplus (economic benefit) to all other parties. Consider an action by the patent holder reflecting greater discretion that increases its profit by some amount $\Delta V > 0$, but decreases surplus to others by some amount $\Delta S < 0$.[14] The tradeoff ratio $t = \Delta S/\Delta V < 0$ reflects society's cost of providing incentives. The larger this ratio is in absolute value, the greater the loss is to other parties, post innovation, per dollar of additional profit to the patent holder. When the ratio exceeds 1—other parties' losses exceed the patent holder's gain (e.g., because total output falls)—it is common to say there is a loss in total welfare or a deadweight loss.[15]

12. Indeed, the argument applies to any form of property, intellectual or other. The need to provide incentives for investment is a powerful reason why U.S. antitrust laws permit a legitimately acquired monopoly and the right to charge a monopoly price.

13. *See, e.g.*, Stuart J.H. Graham & Ted Sichelman, *Why Do Start-Ups Patent?*, 23 Berkeley Tech L.J. 1063, 1071 (2008) (citing Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, *reprinted in* The Rate and Direction of Inventive Activities: Economic and Social Factors 609 (Richard R. Nelson ed., 1962)) (noting that "supernormal profits" are required for innovation).

14. There can be cases where both ΔV and $\Delta S > 0$, for example, if a patent holder's latitude to adopt price discrimination across markets instead of a uniform price leads it to maintain the same price in its initial market but give selective discounts to markets that it would not serve under uniform pricing. Extensions of this scenario are analyzed by David A. Malueg & Marius Schwartz, *Parallel Imports, Demand Dispersion, and International Price Discrimination*, 37 J. Int'l Econ. 167 (1994). The controversial cases, however, involve $\Delta V > 0$ but $\Delta S < 0$, i.e., when increased discretion to the patent holder imposes ex post harm on others.

15. Defining total welfare W as the sum S + V and the welfare tradeoff ratio $t_w = \Delta W/\Delta V$ implies that $t_w = (\Delta S + \Delta V)/\ \Delta V = t + 1$: the ratio of loss in total welfare per additional dollar profit to the patent holder (t_w) equals the loss to other parties per additional dollar profit (t) plus the number 1, because total welfare includes the patent holder's profit. For example, if $t = -3/2$ then $t_w = -1/2$. The ratio t_w can be interpreted as a "leakage ratio," the proportion of the loss to other parties that was not transferred to the patent holder as increased profit. The common definition of total welfare as W = S + V assigns equal weights to a dollar of profit as to a dollar of benefit to other parties; assigning different weights, however, would not

Example: A patent is vital for producing a certain product. Consumer demand for the product is a linear function of its price. The marginal cost of production is constant and equals c plus the per-unit royalty paid to the patent holder. Compulsory licensing at zero royalty would yield a competitive price downstream equal to c and an output q^c. If the patent holder is allowed to charge the monopoly royalty r^m to all producers, the competitive downstream price rises to $c+r^m$ and output falls to q^m. This output reduction causes the standard monopoly deadweight loss. Given linear demand and constant marginal cost, the tradeoff ratio from charging a monopoly rather than zero royalty is $\Delta S/\Delta V = -1.5/1$—i.e., consumers' loss from the price increase is fifty percent larger than the patent holder's gain—implying a short-run overall welfare loss of half a dollar per extra dollar of profit.[16]

By allowing a patent holder to engage in simple monopoly pricing, IP law and antitrust law both accept a tradeoff ratio larger than one (in absolute value)—some reduction in static, overall welfare—in order to provide incentives to invest in the first place. But granting a patent holder increased discretion becomes less attractive as this tradeoff worsens. Increased discretion then represents a relatively inefficient way of delivering additional profit to the innovator in terms of the costs imposed on other parties.

I used this concept almost twenty years ago in the international trade/IP area to argue that a particular regulation that gave U.S. patent holders stronger protection against infringing imports than against infringing domestic competitors can imply a substantially worse tradeoff than would occur under symmetric protection against all infringers.[17] Recently I learned from Suzanne Scotchmer's book that others have used the concept earlier, including Louis Kaplow in his celebrated 1984 article.[18] So I claim no novelty, but certainly good company.

alter the basic point that the welfare tradeoff from allowing increased discretion to the patent holder is worse the larger in absolute value is $\Delta S/\Delta V$.

16. The patent holder's profit rises from zero to $r^m q^m$, geometrically by a rectangle. Consumer surplus falls by the sum of two areas: (i) the same rectangle, reflecting the price increase for the output still being consumed, q^m, plus (ii) the triangle corresponding to the area under the demand curve and above the old price, between the old and new quantities q^c and q^m, representing the loss of consumer surplus due to the output reduction. Under the assumptions in the text, the area of the triangle is one half that of the rectangle.

17. *See generally* Marius Schwartz, *Patent Protection through Discriminatory Exclusion of Imports*, 6 REV. INDUS. ORG. 231 (1991).

18. SUZANNE SCOTCHMER, INNOVATION AND INCENTIVES 109–12, 113–20 (2004). Scotchmer attributes the "ratio test" to Pankaj Tandon, *Optimal Patents with*

Let's briefly discuss some factors that plausibly might worsen this welfare tradeoff, and then link the discussion to our licensing context.

IV.
CONDITIONS THAT PLAUSIBLY MIGHT WORSEN THE TRADEOFF

Start with the following hypothetical benchmark case. The IP is vital for producing a homogeneous downstream good whose demand and cost conditions are given and commonly known. Suppose further that the IP holder wants to prevent competition downstream, for example, in order to facilitate price discrimination among users of the good. The IP holder could profitably bring about a downstream monopoly without sacrificing cost efficiency. If some other firms would be better than it at producing the good, it could select the lowest cost among them, grant that firm a monopoly license at zero royalty (reflecting the true marginal cost of using the IP), and collect profit entirely through a lump sum payment from the monopolist licensee. Having a single firm downstream also does not sacrifice product variety, because the product is homogeneous by assumption.

In such an environment, permitting an unconstrained downstream monopoly might reduce overall welfare compared to the static first-best, of licensing priced at marginal cost, for two reasons. Total output will be too low, and price will exceed marginal cost. If, in addition, there is price discrimination between downstream consumers then the total output that is sold will be misallocated across

Compulsory Licensing, 90 J. POL. ECON. 470 (1982) and Louis Kaplow, *The Patent-Antitrust Intersection: A Reappraisal*, 97 HARV. L. REV. 1813 (1984). Scotchmer, *supra*, at 109 n.5. Kaplow applies the concept to assess on theoretical grounds the relative efficacy of raising a patent holder's profit through various practices that might attract antitrust scrutiny including price-restricted licensing, cross-licensing, restraints that facilitate price discrimination, and control of unpatented end products. Kaplow, *supra*, at 1855–88. Given informational and other constraints, however, he is ultimately skeptical about the practical ability to fine-tune the legal treatment of various practices based on this concept:

> [A]n approach must be developed for those cases (which may be all cases) in which the practice in question may have any number of effects, some leading to far lower ratios than others. Unless one has confidence in our ability to determine at moderate cost which of the many possible effects are relevant in any particular instance, the best that we can probably do is to prohibit at least those practices that exhibit a serious potential for substantial loss.

Kaplow, *supra*, at 1888.

consumers.[19] But that is basically the end of the story in terms of welfare losses.

Now let's consider some departures from the above stylized environment that could worsen the tradeoff between the welfare loss and the increased profit caused by permitting an unconstrained downstream monopoly.

Cost differences and asymmetric information: Suppose potential downstream producers have different costs and these are not perfectly known to the IP holder. If the IP holder decides not to license anybody and serve the downstream market itself, production costs may not be minimized. Of course, it is in the interest of the IP holder to try to select the lowest cost firm and profit from its superior efficiency through a higher lump sum fee. However, given asymmetric information about other firms' costs, the struggle over the division of the profits typically will yield an inefficiency: with positive probability the IP holder will end up producing instead of licensing a lower-cost firm. Downstream production cost then will be higher than under symmetric information, as assumed in the benchmark case, with adverse consequences all around. The inadvertent loss of productive efficiency reduces the innovator's profit. It also increases the loss to consumers through a higher price. For both reasons, letting the IP holder exercise unlimited discretion now gives us a worse tradeoff than in the benchmark case.

Product differentiation and imperfect contracting: Suppose that competing downstream firms would supply differentiated products—they would do somewhat different things with the IP. Product differentiation in general is valuable to consumers. Because of that, an IP holder would like to license multiple firms that offer differentiated products, *if* it could control their prices to prevent competition from eroding downstream rents. But such control is often imperfect, in which case the IP holder faces a profitability tradeoff: allowing competition adds product variety but limits pricing discretion downstream (notably, the ability to engage in price discrimination). The IP holder may then opt to sacrifice variety by having a monopolist seller downstream: itself or a sole licensee. The resulting loss of product variety would be another source of inefficiency that was absent in the benchmark case.

19. The misallocation arises because when different consumers face different marginal prices they will select quantities at which their respective marginal valuations are equal to the prices they face and, hence, will differ across consumers. Note that these two sources of welfare loss cannot simply be added; i.e., allowing price discrimination will misallocate the total output that is offered, but can expand output relative to uniform-price monopoly.

Complementary investments: The final departure from the benchmark scenario involves a situation in which the next stage is to make important complementary investments or follow-on innovations. There is economic literature on follow-on innovation. The basic story is that there is a basic innovation, but then other people can spend money to improve on it. Letting the first innovator charge an unconstrained monopoly price for its IP will reduce the return to follow-on innovators and can inefficiently reduce the probability of valuable subsequent investment.[20] This generates another downside to allowing the IP holder unfettered discretion that was absent in the benchmark case.

V.
REVISITING FIELD-OF-USE VS. ADJACENT-MARKET RESTRICTIONS

What does all this have to do with our story? Well, what is a field of use? Actually, U.S. courts have not put forward a definition,[21] but the Supreme Court's *Talking Pictures* decision refers to licenses that are "limited to use in a defined field."[22] The ability to define a field with enough precision suggests considerable knowledge about the industry contours. Consistent with this theme, a key regulation in Europe states that a field of use "must be defined objectively by reference to identified and meaningful technical characteristics of the licensed product."[23]

This language suggests an environment characterized by considerable knowledge about how the IP might be used and a reasonable ability to contract effectively with licensees. Such conditions

20. *See, e.g.*, John Vickers, *Competition Policy and Property Rights* 16 (Univ. of Oxford, Dep't of Econ., Paper No. 436, 2009), *available at* http://www.economics.ox.ac.uk/research/wp/pdf/paper436.pdf.

21. *See* Patterson, *supra* note 10, at 175.

22. Gen. Talking Pictures Corp. v. W. Elec. Co., 304 U.S. 175, 181, *aff'd on reh'g*, 305 U.S. 124 (1938).

23. Patterson, *supra* note 10, at 175. Patterson notes that, subject to certain conditions, field-of-use licensing can be exempt under the European Community's Technology Transfer Block Exemption Regulation (TTBER) of 2004. *Id.* at 172. The definition of field of use quoted in the text above is from the Guidelines accompanying the TTBER. Patterson emphasizes:

> That definition is critical in the TTBER because if a particular restriction were not in fact a field-of-use license, but some other restriction, the TTBER might not exempt it. Analogously, it is the characterization of these restrictions as use restrictions that leads to a deferential treatment of them in the U.S., despite the fact that the courts have not articulated a definition of a 'use' restriction.

Id. at 174.

are more likely to hold, for example, in a mature industry where the products and technology are relatively simple. By appropriately structuring its field-of-use licenses, the IP holder in such cases may be able to limit downstream competition that would erode profits and still attain the product variety or other benefits from licensing multiple firms. Granting each licensee a monopoly over its designated field could sustain price discrimination downstream while exploiting the advantages of different firms in serving different segments.[24] In sum, well-tailored licensing restrictions can greatly mitigate the conflict between maximizing the IP holder's profit and creating unwarranted inefficiencies downstream. The welfare losses from granting an IP holder complete latitude over which licensees may use its IP and for what purpose then may be confined to those in the benchmark case discussed earlier.

By contrast, the designation "adjacent market" may reflect settings that deviate significantly from this characterization. The IP holder may be less informed about industry conditions and their evolution and less able to contract efficiently. Its attempts to restrict competition in the adjacent market could then spawn one or more of the additional inefficiencies beyond those in the benchmark case. For example, without the ability to contract precisely over the scope of another firm's downstream presence, the IP holder may prefer to forego the variety or other benefits such a firm could bring in order to retain pricing discretion downstream. Allowing the IP holder great leeway to prevent competition could then impose greater collateral damage on overall welfare than in the field-of-use scenario.

As mentioned, these are very preliminary thoughts, so I'll conclude with a question: Is this a potentially useful perspective for assessing why the law is more permissive towards licensing restrictions in the context of fields of use than in the context of adjacent markets?

24. The facts in *General Talking Pictures* track this scenario. AT&T held patents for vacuum tube amplifiers used in various applications. It licensed a subsidiary to serve the commercial field, which included talking picture equipment for theaters, and another licensee to serve amateur uses. That licensee was found to have infringed its license when it sold to theaters. *Gen. Talking Pictures Corp.*, 304 U.S. at 179–80.

TOWARDS AN INTERNATIONAL DIALOGUE ON THE INSTITUTIONAL SIDE OF ANTITRUST

*PHILIP J. WEISER**

For the last twenty years, discussions on international antitrust convergence and cooperation have focused on potential divergences in substantive doctrine. Those discussions have taken place at important multilateral forums,[1] have covered an array of different substantive doctrines, have substantially bridged gaps between different jurisdictions, and have promoted greater levels of understanding. During this era, leaders of different antitrust jurisdictions have also engaged in important bilateral discussions, cooperated on individual matters, and joined academic discussions around the world. All of these developments have helped to move the antitrust world toward a common analytical framework. When reflecting on the progress made on this front, this accomplishment is nothing short of remarkable.

To appreciate the paradigm change in the globalized world of antitrust, consider the case of the U.S. Horizontal Merger Guidelines.[2] When Assistant Attorney General Jim Rill and Federal Trade Commission (FTC) Chair Janet Steiger oversaw the revision of the merger guidelines in the early 1990s, they spent little time thinking about how this enterprise related to jurisdictions outside the United States. Today, that could hardly be less true. In the effort to reevaluate the 1992 Horizontal Merger Guidelines, one of our first thoughts was to ask how this effort related to, could be informed by, and would affect other jurisdictions around the world. To that end,

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1. Two notable such forums are the Organisation for Economic Co-operation and Development (OECD), *see* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, http://www.oecd.org (last visited Oct. 4, 2010), and the International Competition Network (ICN), *see* INTERNATIONAL COMPETITION NETWORK, http://www.internationalcompetitionnetwork.com (last visited Oct. 4, 2010).

2. *See generally* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, U.S. HORIZONTAL MERGER GUIDELINES (1997) (as amended), *available at* http://www.justice.gov/atr/public/guidelines/hmg.pdf.

we committed to learn from related efforts around the world. We also committed to hearing from developing competition authorities insofar as they often look to our merger guidelines for guidance. To the extent that our guidelines are less than clear, feedback from developing authorities help us evaluate how our guidelines can be made more transparent, more practicable, and easier to understand.

The topic I want to discuss today is what I see as an under-explored dimension of antitrust law and policy: the institutional side of the equation. To my mind, the dialogue that competition authorities around the world need to have over the next twenty years should continue addressing not only substantive doctrinal issues, but also ones of institutional design, administrative practice, and legal culture. To that end, we all need to learn from one another's experiences, aspire to improve the institutional effectiveness of our competition regimes, and provide effective counsel to developing competition authorities that have the opportunity to learn from what traditions have served us well and what mistakes we have made along the way.

In my talk today, I will begin by discussing the perspective of new institutional economics on why institutional design matters. After so doing, I will reflect on some of the challenges of perfecting a commitment to transparency and procedural fairness. Finally, I will explain the Justice Department's approach to technical cooperation, drawing on some of the points discussed below with respect to procedural fairness.

I.
WHY INSTITUTIONAL DESIGN MATTERS

The field of new institutional economics is not, at least in its "new" incarnation, much older than the concept of international antitrust. One of the leaders of this movement, Nobel Prize winner Oliver Williamson, is a great friend to the Antitrust Division, having served in the Division in the position roughly akin to our current Deputy Assistant Attorney General for Economics.[3] The field of new institutional economics, which Williamson shaped more than anyone else (including coining the term), focuses on the economic

3. *See, e.g.*, Oliver E. Williamson, *Vertical Merger Guidelines: Interpreting the 1982 Reforms*, 71 CAL. L. REV. 604 (1983) (discussing institutional genesis of Vertical Merger Guidelines); Oliver E. Williamson, *Why Law, Economics, and Organization?*, 1 ANN. REV. L. & SOC. SCI. 369 (2005) (analyzing role of firm and market in organizing transactions and economizing transaction costs).

significance and role of institutions. As defined by Douglas North, institutions consist of "the humanly devised constraints that shape human interaction."[4] According to North, institutions consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, property rights).[5]

Williamson's academic work has focused largely on how private institutions develop to address marketplace dilemmas. Take, for example, two companies that must deal with one another, such as a power generation company and an electric power distribution company. Williamson would focus on how these companies can develop mechanisms for minimizing transaction costs in negotiating bilateral contracts. In thinking through this sort of challenge, he has offered an array of observations, insights, and suggestions, including the colorful metaphor that firms that relate to one another in this fashion (which is sometimes called a "bilateral monopoly") can use the approach of "offer[ing] hostages" to ensure that the two firms deal fairly with one another.[6] The teachings of new institutional economics also provide a helpful framework for evaluating regulatory responses that have developed to oversee such relationships, including ones between local governments and cable TV providers, independent power producers and electric utilities, and franchisors and their franchisees.

The question of how to design and operate public institutions is often relegated to a second order consideration and takes a backseat to the analysis of substantive policy issues. In the case of telecommunications regulation, for example, U.S. discussions around whether to mandate some form of "network neutrality regulation" have consumed far more energy than the relevant institutional questions about how any such regime would be managed. In particular, few commentators or policymakers have focused on the question of what institutional strategy, structure, or set of processes—co-regulation, self-regulation, command-and-control regulation, or adjudication—to use and how any such regime would operate in prac-

4. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (1990).

5. *See id.* at 4.

6. Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 519–20 (1983).

tice.[7] To be fair, I should note that a self-conscious institutional analysis is more prevalent in Europe than the U.S.[8]

The impact of institutional issues as an influence on the ultimate success of an agency is grossly underappreciated.[9] To be sure, particular positions on substantive policy issues are often more accessible and their analysis often promises higher short term payoffs than evaluating improvements in institutional structure and process. In the long term, however, the investment in institutional effectiveness and improved processes will pay great dividends. As FTC Commissioner Bill Kovacic put it, "What are you doing today to make sure that your successors will prosper five or ten years hence?"[10] Consequently, any focus on agency effectiveness needs to ask how an agency is doing its work and not merely what work it purports to be doing. Indeed, even the best-crafted statutory or regulatory regime will fail if the institutional structure, processes, and culture undermine the ability to implement the regime's goals effectively.

Going forward, competition authorities and academics around the world have an opportunity to engage in a discussion focused on comparative institutional competence and comparative institutional practice. To that end, the emerging traditions among different authorities and different procedural mechanisms provide an opportunity for benchmarking and a challenge in terms of thinking about institutional change. Specifically, we have the opportunity to evaluate alternative practices and processes, the impact of institutional structure on culture and habits of mind, and how different institutional strategies can lead to different substantive outcomes. The

7. For an exception to this point that argues for co-regulation, see Philip J. Weiser, *The Future of Internet Regulation*, 43 U.C. DAVIS L. REV. 529 (2009).

8. *See, e.g.*, OFCOM, IDENTIFYING APPROPRIATE REGULATORY SOLUTIONS: PRINCIPLES FOR ANALYSING SELF- AND CO-REGULATION § 2.14 (2008), *available at* http://www.ofcom.org.uk/consult/condocs/coregulation/statement/statement.pdf; OFCOM, INITIAL ASSESSMENTS OF WHEN TO ADOPT SELF- OR CO-REGULATION § 2.17 (2008), *available at* http://www.ofcom.org.uk/consult/condocs/coregulation/condoc.pdf.

9. For two exceptions, see William E. Kovacic, *Rating the Competition Agencies: What Constitutes Good Performance*, 16 GEO. MASON L. REV. 903, 907 (2009) ("[G]ood agency process includes the establishment of effective internal quality control mechanisms, the adoption of transparency and accountability tools to increase public understanding of its activities, and a commitment to seek continuing improvements in its operations and in its substantive programs."), and Philip J. Weiser, *Institutional Design, FCC Reform, and the Hidden Side of the Administrative State*, 61 ADMIN. L. REV. 675 (2009) (discussing importance of institutional structure, processes, and culture).

10. Kovacic, *supra* note 9, at 906 (quoting Fred Hilmer).

challenge is that, even when it is clear that there are better institutional approaches out there, institutional change is hard.

II. INSTITUTIONAL DESIGN AND TRANSPARENCY

For purposes of my talk today, I'd like to focus on one critical dimension of institutional design and administrative procedure: transparency. By transparency, I mean making an agency's operations visible to the public. The how, of course, is multidimensional—the substantive standards employed by the relevant agency, the particular procedures it uses, and its willingness to talk openly about underlying factual concerns in particular cases as well as the relevant legal and economic theories. Let me discuss each of these points in turn.

A. Transparency About Substantive Standards

In the United States, antitrust law is a common law enterprise. It is thus incumbent upon antitrust enforcers and the courts to give meaning to the broad directives of the Sherman[11] and Clayton Acts.[12] Judging which mergers may "substantially lessen competition or tend toward monopoly" is not, for example, a task free from ambiguity. Indeed, over the course of the last fifty years, courts have differed on how to interpret this standard from the Clayton Act.[13] More recently, with our adoption of a pre-merger notification regime under the Hart Scott Rodino Act in 1976,[14] litigation over merger cases has become less frequent, and the Supreme Court has essentially provided no guidance on the meaning of the Clayton Act during that time.

When judicial guidance is less forthcoming, the need for transparency as to the standards used by the antitrust agencies becomes even more important. To that end, the Horizontal Merger Guidelines have provided an important means of explaining the substantive standards used by the antitrust agencies. Both the 1984 version

11. Sherman Act, 15 U.S.C. §§ 1–7 (2006).

12. Clayton Act, ch. 323, 38 Stat. 730, 731–32 (1914) (current version at 15 U.S.C. § 18 (2006)).

13. *Compare* United States v. Von's Grocery Co., 384 U.S. 270 (1966) (holding that merger between third and sixth largest supermarkets in geographic area was illegal), *with* United States v. Baker Hughes Inc., 908 F.2d 981, 990–92 (D.C. Cir. 1990) (Thomas, J.) (allowing merger and casting doubt on continued vitality of *Von's Grocery*).

14. Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435 (1976) (current version at 15 U.S.C. § 18a (2006)).

and the 1992 revision provide considerable insight into the analytical framework used by the agencies.

Over the last eighteen years, experience with the guidelines and new economic learning have arguably nudged the agencies away from the standards set forth in the 1992 guidelines. To that end, in 2006 the agencies released commentaries on the Merger Guidelines, making clear that certain of the approaches set forth in the Guidelines do not necessarily operate in practice as specified by the guidelines.[15] In order to evaluate the need for the Guidelines to be updated to better account for actual merger review practice, the Department and FTC embarked upon an effort to evaluate whether the guidelines should be updated and, if so, how.[16]

In deciding to review the guidelines, one essential rationale was the possibility of promoting a greater degree of transparency. In particular, we sought to ensure that the guidelines actually reflect the realities of agency practice. Some have suggested, however, that this is not important and that we should abstain from any alterations because, even if current practice differs from that set forth in the guidelines, "everyone" knows how the agencies really operate and any changes to the guidelines could be disruptive. Our skepticism about that argument relates to the suggestion that "everyone" knows about the potential for a divergence of the stated standards and actual practice. Both as the international deputy and as someone who recently came back to Washington D.C. from Colorado, I am personally confident that not everyone knows that the guidelines may be misleading. Notably, countries around the world look to the guidelines for guidance and presume that they reflect the state of the art, not merely a fixed point in early 1990s American antitrust practice that time has left behind. Similarly, practitioners not among the antitrust cognoscenti are very likely to assume that the guidelines are what they say they are. Thus, to the extent that

15. *See generally* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, COMMENTARY ON THE HORIZONTAL MERGER GUIDELINES (2006), *available at* http://www.justice.gov/atr/public/guidelines/215247.htm; Carl Shapiro, *Updating the Merger Guidelines: Issues for the Upcoming Workshops*, 2009 A.B.A. SEC. ANTITRUST, *available at* http://www.justice.gov/atr/public/speeches/251858.pdf.

16. Press Release, U.S. Dep't of Justice, Antitrust Div., Department of Justice and Federal Trade Commission to Hold Workshops Concerning Horizontal Merger Guidelines (Sept. 22, 2009), *available at* http://www.justice.gov/atr/public/press_releases/2009/250236.htm; *see also* Christine A. Varney, Assistant Attorney Gen. for the Antitrust Div., U.S. Dep't of Justice, Antitrust Div., Speech at the Third Annual Georgetown Law Global Antitrust Enforcement Symposium: Merger Guidelines Workshops (Sept. 22, 2009), *available at* http://www.justice.gov/atr/public/speeches/250238.pdf; Shapiro, *supra* note 15, at 1.

an update enables all sorts of communities that consult the guidelines to recognize areas where they have been misleading, I view that as a very healthy result.

I should add that the guidelines are only a first step for communicating our merger review standards in a transparent fashion. In particular, we provide valuable guidance through our regular practice of issuing competitive impact statements as part of any settlement and, taking a page from the European Commission, we issue closing statements on increasing occasions. And when we take a case to court, we must outline our core rationale, provide evidence to back up our theory of the case, and test our views through the crucible of a contested proceeding.

B. Transparency About Process and Best Practices

A general principle of good government is to be transparent as to how government acts and why it takes certain approaches. Such transparency can enable businesses to make reasonable planning decisions and also ensures that governmental actions are accountable to public scrutiny. One concern about being more transparent about agency process is that it restricts the options available to the agency and thus might limit the agency's effectiveness. Consider, for example, whether to provide parties with the right to confront the decisionmaker and the right to offer a settlement before final decision. On the one hand, making such a commitment might lead to a slower process in certain cases where the agency has reason to believe that this step is not time well spent. On the other hand, precommitting to such a tradition can provide an important safeguard to facilitate fair treatment of the affected parties and to help to ensure that the decision-maker is confronted with all relevant facts before making a judgment with important legal consequences.

At the Department, the commitment to all parties that they will have an opportunity to meet with the Assistant Attorney General before she decides to file an action in court is viewed as a quasi-religious tradition. Such meetings, which I have attended during my earlier and current time at the Department, are taken very seriously, prepared for with care, and almost universally valuable. It is thus easy for me to understand why the International Competition Network (ICN) has adopted a similar measure as a best practice.[17]

17. *See* INT'L COMPETITION NETWORK, RECOMMENDED PRACTICES FOR MERGER NOTIFICATION PROCEDURES 19 (last visited Oct. 4, 2010), *available at* http://www.internationalcompetitionnetwork.org/uploads/library/doc588.pdf ("Prior to a final adverse enforcement decision on the merits, merging parties should be provided with sufficient and timely information on the facts and the competitive

To my mind, the rationale for such meetings is equally powerful in the civil non-merger context as well.[18]

Our commitment to providing parties with a chance to meet before filing suit is valuable not merely because it allows for an informal give-and-take between the Assistant Attorney General (AAG) and the parties, but also because it requires the staff and the AAG to think carefully about all relevant issues before bringing a case. Notably, if a key form of evidence (say, data showing a price increase) or a theory of competitive harm (say, raising rivals' costs) underlies the case, the AAG will be in a position to evaluate that information closely and observe for herself the parties' response to the issue. Indeed, one "second order" effect of the commitment to providing parties with such a meeting is that the Department will sometimes use "red team-blue team" mock arguments that test the claims made both by the Department and the opposing party. This exercise is further internalized by the practice of ensuring that all documents developed by the Department reflect an awareness of the perspectives of the opposing party and an intellectually honest response to them.

A final reason why the tradition of an AAG meeting with the parties is important is not related to transparency per se, but the ability to promote more effective decisionmaking. Notably, that tradition enshrines the notion that the AAG decisionmaking process is separate and apart from that of the Department staff and that the staff traditionally develops its own recommendation.[19] In this sense, the AAG (and her front office) constitutes a separate layer of review—a fresh set of eyes, as it were—that can evaluate the merits of a case (or a proposed settlement) independent of the judgment of those who develop the case. When determining how to proceed in a given case, the AAG benefits from the array of perspectives and the different recommendations received from both front office personnel and career staff, which consists of lawyers and economists. This structure provides a healthy second look at a case, brings a valuable (and broader) perspective to the evaluation of the merits of individual cases, and is a good example of the new institutional economics lesson that "organizations can be structured to optimize the bene-

concerns that form the basis for the proposed adverse decision and should have a meaningful opportunity to respond to such concerns.").

18. I should add here that the procedural issues differ in the criminal area for good reasons, and my remarks today do not address that context.

19. In practice, such recommendations are communicated to the parties and the AAG in advance of a meeting between the parties and the AAG.

fits and costs of expert decisionmaking."[20] It also, like judicial oversight, ensures the evaluation of the evidence in a detached and more critical fashion. After all, the lawyers who develop the case may well assume the posture of an advocate for a particular position whereas a more detached person—i.e., one who has invested far less time in it—can evaluate the evidence in a manner closer to that of a judge weighing the evidence in an impartial manner.

To my mind, the effort to narrow the relevant issues of disagreement by the parties subject to a Justice Department investigation and the investigating staff attorneys is one of the healthiest byproducts of transparency. In requesting documents, for example, an openness about the theories of harm provides a basis for identifying what sort of limitations are appropriate. By contrast, an unwillingness or inability to communicate meaningfully on such issues leaves the investigated parties guessing about the Department's areas of competitive concern and thus less able to be responsive, both in providing documents and in developing a "white paper" addressing those concerns. In my experience, discussions based on an open exchange of ideas are far more effective than ones where parties are unable to understand the relevant issues and develop an articulated basis for their concerns.[21]

One final area where procedural transparency can be quite important is the openness to discussing a possible settlement. Parties are free to suggest potential settlements with us at appropriate points in our process and, given our tradition of being open about the relevant theories of harm, parties should be in a position where they can be responsive to our competitive concerns. By contrast, to the extent that one "hides the ball"—for strategic purposes or to gain an advantage in litigation—that makes it far more difficult to reach an effective settlement. In our experience, it is important to be open to considering settlements because, where firms are willing to settle competitive concerns, addressing such issues cooperatively can solve problems more quickly and enable us to focus our attention on issues that are not so easily resolved.

20. Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 Cornell L. Rev. 549, 561 (2002).

21. For a discussion of the failings of a model that devalues transparency and proceeds in an ad hoc fashion, see my criticism of the Federal Communications Commission in Weiser, *supra* note 9, at 680–90.

C. Open Engagement on the Relevant Facts as well as the Legal and Economic Theories

It bears mention that the opportunity for engagement around issues of competitive concern is becoming easier on account of advances in communications technology. Redmond, Washington is quite a distance from Brussels, for example, but the recent discussions in the European Commission's recent "Browser" investigation of Microsoft followed just the sort of model outlined above. As Microsoft General Counsel Brad Smith related:

> And so we've had extensive discussions really over the last couple of years. We've been able to use those discussions to understand better what the Commission's objectives and concerns have been. We've been able to work to clarify the issues. We've been able to work creatively to take additional steps. We've spent a lot of time talking with each other. Just over the last four or five months we had almost 20 videoconferences between Redmond and Brussels. So, in effect we've spent a lot of time in what has felt like the same room, even if it wasn't always the same room on a literal basis.[22]

It is also worth noting that this form of open and ongoing engagement—which is only possible on account of a transparent process—produced what both Microsoft and the European Commission hailed as a productive resolution. As Smith explained, "I think out of that we've been able to reach the point where we are today, where we have something that I think works for the industry, it works for competition law, and we think we can apply it in a way that our engineers can implement."[23] Similarly, the European Commission welcomed Microsoft's proposal, explaining that "it has the potential to give European consumers real choice over how they access and use the internet."[24] For our part, we welcomed the settlement, "commend[ing] the efforts of the European Commission and Microsoft Corporation, which have announced that they have

22. Brad Smith, Gen. Counsel, Microsoft Corp., Microsoft on the European Commission Market Testing Announcement (Oct. 7, 2009), *available at* http://www.microsoft.com/presspass/exec/bradsmith/2009/10-7ec.mspx.

23. *Id.*

24. Press Release, European Comm'n, Antitrust: Commission Market Tests Microsoft's Proposal to Ensure Consumer Choice of Web Browsers, Welcomes Further Improvements in Field of Interoperability (Oct. 7, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/439.

reached a comprehensive settlement resolving their disputes under European competition law."[25]

One important point adheres in all the principles outlined above: parties should be invited to present their perspective on the facts and the law at all parts of the process. But this openness to dialogue only works in an environment of mutual respect and decorum. Just as enforcers should not keep parties guessing about what their concerns are, private parties should not engage in disrespectful or obstructive advocacy. Private parties that engage in bullying tactics and are not interested in an honest interchange of ideas chill the environment for reasonable discussion. Thankfully, I have found such experiences rare during my time at the Department, but I acknowledge that such experiences are not unheard of.

D. Procedural Fairness, Agency Effectiveness, and Multilateral Engagement

In short, it is our sincere belief that, by identifying the relevant theories of harm as early as possible in the process and communicating them in a straightforward fashion, antitrust agencies can be both more effective and more efficient. As AAG Varney put it, "open and frequent dialogue between competition law enforcers and those under investigation not only helps ensure fairness to the parties but also facilitates more effective enforcement."[26] In light of this tradition, the Organisation for Economic Co-operation and Development's Working Party 3 has focused on a set of issues that fall under the heading of procedural fairness.[27] More broadly, we believe that this topic is one that fits well with the ICN's focus on practical issues.[28] Over the last few years, the ICN has begun work on institutional issues of this nature. In 2009, the European Com-

25. Press Release, Christine Varney, Assistant Att'y Gen. for the Antitrust Div., U.S. Dep't of Justice, Antitrust Div., Statement on European Commission Microsoft Settlement (Dec. 16, 2009), *available at* http://www.justice.gov/atr/public/press_releases/2009/253175.htm.

26. Christine A. Varney, Assistant Attorney Gen. for the Antitrust Div., U.S. Dep't of Justice, Antitrust Div., Speech at the 13th Annual Competition Conference of the International Bar Association: Procedural Fairness 2–3 (Sept. 12, 2009), *available at* http://www.justice.gov/atr/public/speeches/249974.pdf.

27. *See generally* Roundtable on Procedural Fairness: Transparency Issues in Civil and Administrative Proceedings, Organisation for Economic Co-operation and Development Working Party No. 3 (Feb. 16, 2010), *available at* http://www.ftc.gov/bc/international/docs/transparency_us.pdf.

28. *See generally* International Competition Network, ICN Factsheet and Key Messages (Apr. 2009), *available at* http://www.internationalcompetitionnetwork.org/uploads/library/doc608.pdf (discussing ICN's emphasis on practical recommendations and solutions).

mission hosted a meeting among heads of competition agencies, focusing on sharing experiences on the practical issues involved in running an agency, such as strategic planning, prioritization, and communications strategies. To advance our collective thinking on the valuable ideas that came out of the conference, the ICN has established a new working group on agency effectiveness.

We believe that these many forums provide the international community with an important opportunity to focus on procedural fairness. As is well recognized, these efforts are important because procedural fairness promotes the kind of "transparent and predictable business environment" that attracts international investment and entrepreneurial activity.[29] It is also, of course, the very thing that enables lawyers to engage in effective counseling and businesses to effectively self-regulate based on the anticipated concerns of antitrust authorities. In a more opaque environment, by contrast, such private compliance with public goals is much harder to accomplish.

III.
TECHNICAL COOPERATION AGENDA

Recognizing the importance of institution building and transparency underscores that work with emerging antitrust authorities is time well spent. To that end, the Department and the FTC held a workshop and authored a report that re-evaluated their approach to what historically was called "technical assistance," developing some important guiding principles that I would like to discuss today.[30]

Two foundational principles bear particular mention. First, engagement with emerging antitrust authorities is not merely an effort to help the recipient of the technical assistance. Rather, as our use of the term "technical cooperation" underscores, the interaction in technical assistance is a two-way street. Stated simply, a focus on best practices, basic investigative techniques, institutional strategies, and substantive principles requires us to look carefully at how we are operating in practice. After all, the need to communicate

29. International Competition Network, Competition Policy Implementation Working Group Sub group 1, Agency Effectiveness Project 11 (2008), *available at* http://www.internationalcompetitionnetwork.org/uploads/library/doc367.pdf.

30. Fed. Trade Comm'n Staff & U.S. Dep't of Justice, Charting the Future Course of International Technical Assistance At the Federal Trade Commission and U.S. Department of Justice (2009), *available at* http://www.ftc.gov/oia/wkshp/docs/exp.pdf.

how an agency handles merger review requires that agency to step back and articulate its best practices, enabling it to ask whether it adheres to such standards. Moreover, the time spent with emerging antitrust authorities paves the way for continued cooperation after the formal technical assistance program has ended by building relationships that can pay long term dividends. Second, effective technical assistance efforts cannot be "one-off" teaching efforts or ad hoc cooperation—they must be part of a long-term relationship. To that end, our recent report suggested that such relationships should last as long as ten years, enabling the providers of support to learn about the relevant local conditions and establish a trusted working relationship.

To provide a greater level of strategic focus and direction for our technical cooperation efforts, the Department and the FTC called for the development of memoranda of understanding (MOUs) with our foreign antitrust partners as a means of framing the nature and extent of that cooperation. In particular, such MOUs would, as our joint report put it, "establish a framework for the provision of technical assistance, aim to facilitate informal consultations on cases and policy matters, and include a commitment to hold periodic meetings among policy-level officials."[31] By putting the MOU into writing, the agencies can capture both their expectations for the cooperation and their commitment to it, as opposed to an ad hoc approach. In principle, such MOUs should "facilitate ongoing communication between the agencies outside the context of a particular training event and encourage relationship-building at the staff level," aim "to ensure that expectations are being met," and, quite significantly, "stress the importance of developing the capacity of supporting institutions (e.g., universities, bar associations, and the judiciary)."[32] I am very glad to report that such an aspiration is not merely theoretical, as illustrated by the adoption of such an arrangement with the Russian Federal Anti-Monopoly Service.[33]

CONCLUSION

The antitrust world is increasingly globalized and interconnected. The need to promote convergence on substantive doctrines has received, and will continue to receive, considerable attention.

31. *Id.* at 8.
32. *Id.*
33. Memorandum of Understanding on Antitrust Cooperation, U.S.-Russ., Nov. 10, 2009, *available at* http://www.justice.gov/atr/public/international/251836.htm.

As that discussion goes forward, however, it is increasingly important that it be joined by a focus on institutional design and practice, particularly as to the promotion of transparency in the conduct of antitrust investigations. In that respect, all our agencies can improve operations. Indeed, one of the healthy aspects of a multijurisdictional world is that sister agencies can challenge one another and model means of improving our institutional practices. In our case, we will do our best to encourage this discussion and to improve our adherence to best practices in this important area.

ANTITRUST CLASS CERTIFICATION: TOWARDS AN ECONOMIC FRAMEWORK

*BRET M. DICKEY AND DANIEL L. RUBINFELD**

INTRODUCTION

Class action lawsuits offer a valuable and often viable mechanism for case management in private antitrust litigation when the number of potential plaintiffs is large. From a plaintiff's perspective, the class certification mechanism is an effective and often efficient device that provides individuals, who might otherwise find it unaffordable, access to the legal system. By comparison, defendants find class certification to be a costly and burdensome process that leads to over-deterrence and social waste. This Article takes a position between these two views, determines that there is room for substantial improvement in the system's efficiency, and offers suggestions for improvement.

To be certified according to the Rules of Civil Procedure, a putative class of direct or indirect purchasers must satisfy several criteria. First, the putative class must meet the four prerequisites specified in Rule 23(a):

> (1) the class is so numerous that joinder of all members is impracticable ["numerosity"];
> (2) there are questions of law or fact common to the class ["commonality"];
> (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class ["typicality"]; and
> (4) the representative parties will fairly and adequately protect the interests of the class ["adequacy"].[1]

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1. Fed. R. Civ. P. 23(a) (brackets added).

In addition, a putative class must also demonstrate that the requirements of one Rule 23(b) subsection have been met. Typically, antitrust plaintiffs rely on subsection 23(b)(3), which requires that "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy ["predominance"]."[2]

Courts have frequently certified classes in antitrust cases, particularly when the numerosity prong has been satisfied. Moreover, when there are numerous putative plaintiffs, the class certification debate has often focused on commonality and predominance—do common elements predominate over individual elements? While many plaintiffs have cleared these hurdles, some recent decisions against class certification suggest that courts have begun to raise the bar for class certification, particularly with respect to the predominance requirement.[3] One notable recent decision is the Third Circuit's unanimous opinion in *In re Hydrogen Peroxide Litigation*.[4] However, judicial commentary on the economics underlying the commonality/predominance issue has been limited because courts have struggled to find a framework in which to evaluate whether common issues are subject to generalized proof and whether those common issues predominate over individual issues.

This Article seeks to advance the debate concerning the conditions for class certification towards a more coherent economic

2. Fed. R. Civ. P. 23(b)(3).

3. For decisions pointing to higher class certification hurdles for plaintiffs, see *In re* New Motor Vehicles Canadian Exp. Antitrust Litig., 522 F.3d 6 (1st Cir. 2008); Blades v. Monsanto Co., 400 F.3d 562 (8th Cir. 2005); Reed v. Advocate Health Care, No. 06 C 3337, 2009 WL 3146999, at *1 (N.D. Ill. Sept. 28, 2009); Fleischman v. Albany Med. Ctr., No. 1:06-CV-765, 2008 WL 2945993 (N.D.N.Y. July 28, 2008); *In re* NCAA I-A Walk-On Football Players Litig., No. C04-1254C, 2006 WL 1207915, at *3 (W.D. Wash. May 3, 2006); *In re* Pub. Offering Fee Antitrust Litig., No. 98 Civ. 7890 LMM, 00 Civ. 7804 LMM, 2006 WL 1120498 (S.D.N.Y. Apr. 26, 2006).

4. *See In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d 305 (3d Cir. 2008); *see also* Paul E. Godek & Janusz A. Ordover, *Economic Analysis in Antitrust Class Certification: Hydrogen Peroxide*, 24 ANTITRUST 62, 62–63 (2009). According to the Third Circuit, the "district court must formulate some prediction as to how specific issues will play out in order to determine whether common or individual issues predominate in given case." *In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d at 311 (internal quotation marks and citation omitted). Furthermore, "the court must resolve all factual or legal disputes relevant to class certification, even if they overlap with the merits . . . ." *Id.* at 307. Other circuits have not been as explicit as the Third Circuit. *See, e.g.*, *In re* Cardizem CD Antitrust Litig., 391 F.3d 812 (6th Cir. 2004).

framework. It begins by commenting on the commonality issue, which has recently received significant consideration by economists.[5] It explains why substantial price dispersion (i.e., different prices paid by different purchasers) should not, in itself, be a sufficient basis to defeat class certification when the numerosity prong is clearly satisfied. It then suggests when variability in the harms allegedly suffered by plaintiffs should be a concern. It emphasizes that common elements will not predominate if a significant number of putative plaintiffs were not injured by the alleged wrongful antitrust actions.

This Article also highlights the economic issues that support the need for greater emphasis on typicality and adequacy. Specifically, it explains that class certification should be seen as problematic when there is an inherent conflict as to the appropriate damages framework between the named plaintiff(s) and other putative class members.

This Article is organized as follows. Section I provides a characterization of the economic concerns that generally surround commonality and predominance issues in class certification, using two recent class certification case as examples. Section II provides an overview of the issues relating to typicality and adequacy that are highlighted in two recent class certification cases. Section III offers some concluding remarks.

I. COMMONALITY/PREDOMINANCE

A. *A Class Certification Framework*

A central issue in class certification involves whether common elements dominate individual elements.[6] As Johnson and Leonard point out, there is an inherent paradox as plaintiffs are expected to demonstrate that individual data is not required to prove causation or damages; yet plaintiffs often do not have access to all of the individual data needed to evaluate the question.[7] This Article agrees

5. *See, e.g.*, Pierre Cremieux, Ian Simmons & Edward A. Snyder, *Proof of Common Impact in Antitrust Litigation: The Value of Regression Analysis*, 17 GEO. MASON L. REV 939 (2010); James F. Nieberding & Robin A. Cantor, *Price Dispersion and Class Certification in Antitrust Cases: An Economic Analysis*, 14 J. LEGAL ECON. 61 (2007); John H. Johnson & Gregory K. Leonard, *Economics and the Rigorous Analysis of Class Certification in Antitrust Cases*, 3 J. COMPETITION L. & ECON. 341 (2007).

6. Class certification issues can arise with respect to antitrust liability, impact (causation), and damages. To simplify the discussion that follows, this Article focuses solely on impact and damages.

7. Johnson & Leonard, *supra* note 5, at 342.

with Johnson and Leonard that the right approach should involve (i) a valid theoretical framework that builds on a specific economic theory of the case and (ii) the presentation of sufficient empirical evidence to assess damages on a class-wide basis and show that common proof can demonstrate impact on all (or almost all) class members.[8] The remainder of this section offers an overview of how such a class certification exercise might proceed.

Assume that the case at issue involves a conspiracy to fix prices. Plaintiffs propose a class of direct purchasers, claiming that all such purchasers were overcharged as the result of the conspiracy. Plaintiffs agree that the prices paid by individual purchasers vary, but claim the price variation is irrelevant since there was individual price variation both before and after the alleged conspiracy. According to plaintiffs, the effect of the price fixing was to raise prices for all putative class members. Plaintiffs further claim that the overcharge may vary among class members, but the variation in prices can be taken into account through the use of multiple regression.[9]

In its most basic form, the economic model of overcharge would focus on price as the variable affected by the alleged conspiracy. Price is presumed to have been determined by supply and demand in a pre-conspiracy period.[10] To model this for a sample of N individuals or firms, let

P_{it} = the price paid by the i^{th} individual at time t (i = 1, 2, . . . N);

X_{it} = a list of explanatory variables ("covariates") not affected by the conspiracy, whose values are individual specific;[11]

D_t = a dummy variable indicating the period of the alleged conspiracy.

The economic model underlying the theory of overcharge is given by:

$$P_{it} = \alpha_i + X_{it}\beta_i + \theta_i D_t + \varepsilon_{it} \qquad (1)$$

8. *Id.* at 344.

9. Multiple regression analysis has been widely accepted by the courts for use in a variety of contexts, including class certification. *See, e.g.*, Daniel Rubinfeld, *Reference Guide on Multiple Regression*, *in* REFERENCE MANUAL ON SCIENTIFIC EVIDENCE 179 (Fed. Judicial Ctr. ed., 2d ed. 2000).

10. There is no loss of generality; the same analysis would apply if there were data for a post-conspiracy period only, or for a combination of pre- and post-conspiracy periods.

11. To simplify, it is assumed that all of the covariates are exogenous. Note that some of the covariates may vary over time, but not over individuals, and thus will be common to all members of the putative class. We do not separately treat those variables because they do not raise class certification concerns.

This relatively general specification takes into account the possibility that the alleged conspiracy will directly affect the price, as given by given by $\theta_i D_t$ (e.g., through an increase in price at each point in time in the damage period).[12]

Note that Equation (1) allows for the possibility that the prices paid by putative class members will vary among individuals (through the α_i), that the effects of the supply and demand variables on price may also be individual specific (through the β_i), and that the effect of the alleged conspiracy on price may be individual specific (through the θ_i).

While (1) appears as a single equation, it is in fact a simple representation of *N* separate regression equations, one for each individual in the putative class. If (1) is the appropriate model, then individual elements will predominate, unless the covariates take on values that are similar across all putative class members. The key here is that the θ_i coefficients, which measure the overcharge per-unit of output, may vary among individuals. This variation will be lost if one were to run a single regression of the average price in each time period on the average values of X and D. This will generate at best an estimate of the average effect of the alleged conspiracy, which will be measured as the average of the θ_i. It follows that the single regression approach will not provide accurate measures of individual effects. It is important to note that even if there is a measurable average adverse effect of the conspiracy, if one relies on the estimation of a single regression, the possibility that a substantial number of putative class members will not have been injured cannot be ruled out.

The central empirical issue surrounds the distribution of the θ_i. If the distribution has a very small variance, then the mean (or average) of the elements of the distribution will provide a reasonable estimate of the individual overcharges. However, if the distribution has a large variance, the mean will not reliability characterize individual elements. Moreover, even with a positive mean that is statistically significantly different from zero, a substantial number of individuals may not have been injured (those for whom the θ_i are negative).

To illustrate, assume that the distribution of harms associated with an antitrust violation is normally distributed with a mean of \$1000 and a standard deviation of \$1000, as shown in Figure 1, at-

12. A more complete model would take the form: $P_{it} = \alpha_i + X_{it}\beta_i + \theta_i D_t + \gamma_i D_t X_{it} + e_{it}$. This version of the model takes into account the possibility that the effect of the conspiracy will also be felt through one or more of the supply and demand variables, as given by the term $\gamma_i D_t X_{it}$.

tached. With the normal distribution, it is well known that approximately sixteen percent of those affected by the violation will be more than one standard deviation below the mean, as the figure illustrates.[13] It follows that sixteen percent of the putative class will have benefited and not been harmed by the antitrust violation.

B. Do Common Issues Predominate?

In support of class certification, plaintiffs in the prototypical price-fixing case might put forward an alternative model, as shown in the following equation:

$$\bar{P}_t = \alpha + \bar{X}_t\beta_i + \theta D_t + \varepsilon_t \qquad (2)$$

Here the variables $\bar{P}_t$ and $\bar{X}_t$ represent the means of the original price and covariates at each time period. Note that Equation (2) is a special case of Equation (1), where α, β and θ do not vary across individuals. If (2) is the appropriate model specification, then common elements will predominate and questions concerning antitrust impact and damages can be evaluated for the class as a whole.[14]

Defendants will likely object to the specification given by Equation (2), since the specification *presumes* that there are dominant common elements. However, if one could estimate the set of regressions inherent in Equation (1) as well as Equation (2), one could readily test to see whether the parameter restrictions implied by model (2) are reasonable, but this is the point at which the paradox pointed out by Johnson and Leonard comes to the fore. In many cases, it will not be possible to estimate the model given by Equation (1) because often such specific pricing information is not available. How is it decided whether Equation (2) is appropriate? While there is no easy answer, it is suggested below how the analysis might proceed.

Suppose that the number of putative class members is large and that the court is looking to find the most suitable means of litigating causation and damages. Assume further that the *N* individual putative class members can reasonably be assigned to a series of S potential subclasses (s runs from 1 to S). These subclasses

13. *See, e.g.*, ROBERT S. PINDYCK & DANIEL L. RUBINFELD, ECONOMETRIC MODELS AND ECONOMIC FORECASTS, tbl. 1 at 561 (3d ed. 1991).

14. Again for simplicity, the Article focuses on antitrust impact and the average effect of the alleged conspiracy. For a discussion of the econometric issues associated with damage estimation, see Daniel L. Rubinfeld, *Quantitative Methods in Antitrust*, *in* 1 ABA ANTITRUST SECTION, ISSUES IN COMPETITION LAW AND POLICY 739–42 (Wayne D. Collins ed. 2008); Justin McCrary & Daniel L. Rubinfeld, *Measuring Benchmark Damages in Antitrust Litigation* (Oct. 2009), *available at* http://ec.europa.eu/competition/antitrust/actionsdamages/rubinfeld_mccrary.pdf.

might account for individual differences such as the volume of product purchased, the geographical location (or market) in which the purchase was made, and so on. The class certification issue can then be thought of as involving a choice between Equation (1) and Equation (2), where the number of subclasses, S, is to be determined as part of the class certification investigation. If S is determined to be one, a single class should be certified. If S is determined to be greater than one, but small, then it will be plausible to consider the certification of a series of subclasses. However, if S is determined to be large, then class certification is not appropriate.[15]

Using this framework, the following set of equations describes the relevant pricing model:

$$\bar{P}_s = \alpha_s + \bar{X}_{st}\beta_s + \theta_s D_t + \varepsilon_{st} \tag{3}$$

While this specification is similar to that of Equation (1), there are now S individual equations, one for each subclass (rather than one for each individual). According to Equation (3), the damages per unit of output are given by θ_s for each of the subclasses. At this point, the variance in per-unit damages measured across potential subclasses should be analyzed. If the variance of the θ_s across subclasses is equal to zero or is relatively small, then it is appropriate to certify the putative class. However, if the variance is relatively large, then a single class should not be certified.

Even if it is determined that the certification of a single class is inappropriate, it may still be appropriate to certify a set of subclasses. To evaluate this question, ideally the variance of the θ_s as the number of subclasses S is increased would be determined. As the number of subclasses increases the variance across subclasses will grow, while the variance within each (now smaller) subclass will decline. The appropriate number of subclasses would be resolved by trading off any decrease in variance within classes as the number of subclasses increases against the resulting increases in the cost of litigation.

To illustrate, assume that the distribution of harms is given by a normally distributed bell-shaped curve similar to the one shown in Figure 1. Assume also that there are three "types" of putative class members: (1) type *L* members place a relatively low value on the

15. Failure to certify a class does not necessarily mean that plaintiffs cannot pursue their cases further. An alternative approach would be for a number of individual plaintiffs to pursue their cases in separate trials. If successful, plaintiffs are likely (given the high cost of litigation) to be able to leverage those successes into settlements of many other cases.

product whose price has allegedly been increased as the result of price fixing, (2) type *H* places a high value on the product, and (3) type *M* are in the middle. Figures 2A and 2B, attached, show two possible characterizations of the distributions of harms of the three types of direct purchasers. In Figure 2A, the distributions of harms for each of the three types have relatively little variance and therefore relatively little overlap. Here the case for subclasses (rather than a single class) is strong. In Figure 2B, however, the distributions have relatively high variance and high overlap. Consequently, there is a stronger case for the certification of a single class.

Figure 2A

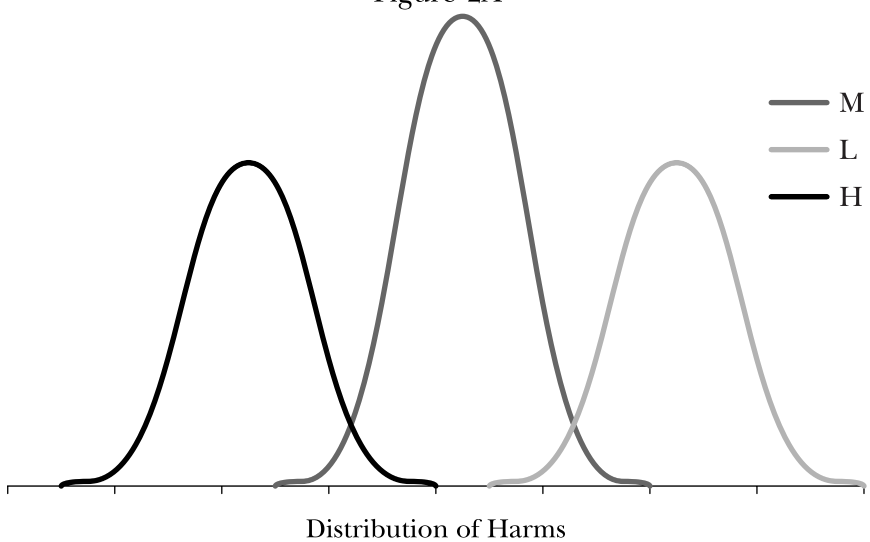
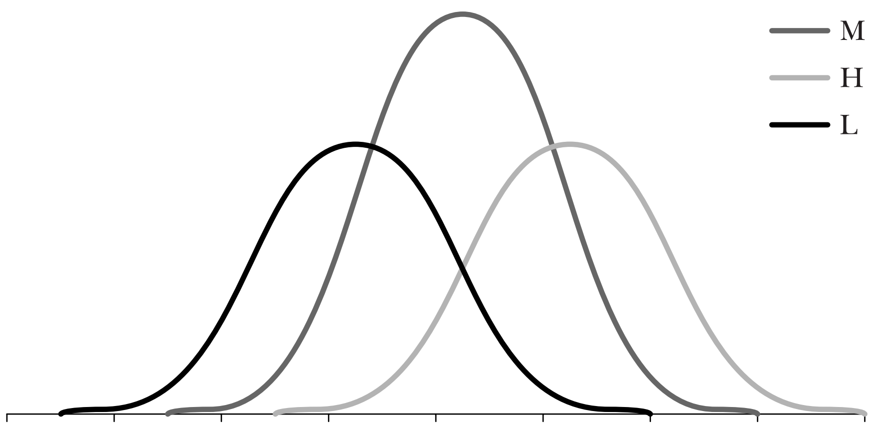


Figure 2B



Distribution of Harms

Of course, one cannot avoid entirely the paradox of class certification. Nevertheless, the approach just described does offer some useful insights. First, a key element in the analysis is the variation in the per-unit damage measure, not the variance in the supply-demand variables themselves. This analysis suggests that, where plaintiffs put forward a credible case for class certification, including a model that would allow for the evaluation of issues relating to both injury and damages, defendants should not be able to defeat class certification by showing only that there is substantial variation in one or more explanatory variables. Rather, defendants should be expected to explain why the variation in the demand and supply variables is likely to lead to variation in per-unit damages.

Simply put, if the plaintiffs propose a pricing model such as the model given by Equation (2), defendants might argue that each purchase by an individual plaintiff occurs at a different price due, for example, to the presence of volume discounts or individual contract negotiations. If this is the case, Equation (1) rather than Equation (2) is appropriate, which argues against class certification. Plaintiffs might respond that the individual pricing associated with these differences arose both before and during the alleged conspiracy, and that the per-unit damage is the same for all individuals. In that special case, an analysis of average prices as given in Equation (2) can be used to evaluate injury and damages issues. The debate would then most likely continue with the defendants seeking to explain that the effects of the alleged conspiracy will be differentiated among putative class members, and as a consequence, plaintiffs' response is not dispositive.

C. The Glass Containers Antitrust Litigation*: Subclasses Certified*[16]

Plaintiffs brought a price-fixing case against the major manufacturers of glass containers, including Owens-Illinois, Brockway, and Dart.[17] Plaintiffs sought to certify a single, national class that included all direct purchasers of manufactured glass containers. Plaintiffs' experts supported class certification, arguing that common questions of law and fact predominated over the questions affecting only individual members. Furthermore, plaintiffs offered a methodology that purported to allow for the determination of aggregate damages to the class.

In its simplest form, plaintiffs' economic and statistical argument was that profit margins prior to the alleged price fixing conspiracy would serve as a suitable benchmark for what profit margins would have been during the conspiracy period but-for the conspiracy. In essence, the methodology would allow the calculation of a series of but-for profit margins, which when compared to actual profit margins during the conspiracy period, would provide a measure of aggregate overcharges.[18] In opposition to class certification, defendants' economic expert argued that there was substantial price variation among different types of glass containers (e.g., wine bottles versus wide-mouth containers for refrigerated products). He argued further that the price variation was evidence that any harm that might have been suffered by putative class members would have varied substantially among individuals.

In order to assist in the resolution of this difficult class certification matter, the district court judge appointed a neutral court-appointed expert. After further discovery, the court-appointed expert analyzed the variation in glass container prices among putative class members and among the major categories of glass containers. Focusing on profit margins as well as prices, the court-appointed expert was able to estimate models similar to those given by Equation (3) for each of the glass container categories. Comparing those

16. Daniel Rubinfeld, co-author of this Article, served as a court-appointed expert in this case. Due to the confidential nature of portions of the proceedings, certain relevant documents are still under seal or covered by protective order. Where citation is not provided, the statements reflect confidential documents in his possession that are covered by the protective order. Where available, citation is provided to publicly available documents.

17. Superior Beverage Co. v. Owens-Illinois, Inc., No. 83 C 512, 1989 U.S. Dist. LEXIS 6662, at *11 (N.D. Ill. June 5, 1989).

18. The use of profit margins to determine a measure of overcharges requires an assumption that the conspiracy did not affect costs or an in-depth analysis of how costs were affected by the conspiracy.

results to the estimation associated with a comparable version of Equation (2), the expert concluded that common elements did not predominate. In essence, the variance in the distribution of the θ_i was very substantial. At best, there was an uncertain case to be made for the certification of a set of subclasses given the available information. The set of subclasses, made up of a variety of types of glass containers, was chosen in a manner that substantially reduced the within-class price variation in alleged damages per class member (the vast majority of which purchased only one type of container), while maintaining substantial variation in alleged damages across classes.

After a hearing and a post-hearing debate as to the appropriate burden shifting with respect to the proposed set of subclasses, the Court chose to follow the proposed framework, and to certify a set of subclasses.

D. In re K-Dur Antitrust Litigation*: Lack of Predominance*[19]

In re K-Dur Antitrust Litigation[20] provides an example in which the distribution of the θ_i had a variance that was so large that θ_i was negative for a large number of putative class members. *K-Dur* was a consolidated private action which followed the Federal Trade Commission (FTC) investigation of Schering-Plough's patent settlement agreements with generic companies Upsher-Smith and ESI Lederle.[21] Schering-Plough had a patent on the potassium chloride drug K-Dur. Upsher-Smith and ESI Lederle filed Abbreviated New Drug Applications (ANDAs) with the Food and Drug Administration, indicating their desire to enter with generic versions of K-Dur prior to patent expiration. Schering-Plough sued both companies and eventually settled the patent litigation with each. Under the settlement with Upsher-Smith, Upsher was able to enter with a generic version of K-Dur in September 2001, five years prior to the expiration of the patent. Schering also paid Upsher-Smith $60 million to license a portfolio of Upsher drugs. Under the settlement

19. Daniel Rubinfeld and Bret Dickey, co-authors of this Article, served as expert witness and consultant, respectively, for defense in this case. Due to the confidential nature of portions of the proceedings, certain relevant documents are still under seal or covered by protective order. Where citation is not provided, the statements reflect confidential documents in their possession that are covered by the protective order. Where available, citation is provided to publicly available documents.

20. *In re* K-Dur Antitrust Litig., No. 01-1652 (JAG) (D.N.J. Apr. 23, 2008).

21. This section relies on the factual background of the litigation presented in the Eleventh Circuit's opinion *Schering-Plough Corp. v. FTC*, 402 F.3d 1056, 1058–61 (11th Cir. 2005).

with ESI Lederle, a subsidiary of American Home Products (now Wyeth), ESI Lederle was able to enter with a generic version of K-Dur in January 2004. The agreement called for payments of up to $30 million to ESI, including payment for the licensing of two ESI drugs.

The consolidated private action included several groups of plaintiffs, including a putative class of direct purchasers, a putative class of indirect purchasers, and several direct and indirect purchasers suing individually. This Article focuses on the class action motion of the putative class of indirect purchasers.[22] The proposed class representatives included two health insurers, eight labor union health and welfare funds, and six individual consumers.[23] The class representatives were attempting to represent a putative class that included the ultimate "purchasers" of K-Dur—i.e., the individuals and entities that made the final payments. The putative class included private managed care organizations and insurance companies, uninsured consumers, and individuals who made co-payments and co-insurance payments in order to fill prescriptions for K-Dur.[24]

The indirect purchaser plaintiffs' theory of antitrust harm was similar to that of the FTC and the other private plaintiffs, in that the payments to Upsher-Smith and ESI Lederle were payments to delay entry, disguised as licensing fees. The plaintiffs argued that but-for the payment, Upsher-Smith would have entered the market in November 1998. In response, Schering argued that the settlements did not delay generic entry; rather, the payments were legitimate licensing fees.[25] Moreover, according to Schering, the settlement benefited the parties and society by eliminating the cost and uncertainty associated with the patent litigation.[26]

22. The direct purchaser class was certified by the Court.

23. Special Master's Report and Recommendation on the Indirect Purchaser Plaintiffs' Amended Motion for Class Certification at 3 n.3, *In re* K-Dur Antitrust Litig., No. 01-1652 (JAG) (Consolidated Cases), MDL Docket No. 1419 (D.N.J. Feb. 6, 2009) [hereinafter Special Master's Report]. As noted in the Special Master's Report, plaintiffs withdrew several class representatives and the claims of several others were dismissed on summary judgment, leaving only two insurers, two health and welfare funds, and one consumer. *Id.*

24. The class definition excluded state government entities (e.g., Medicaid) that reimbursed pharmacies for *K-Dur*.

25. In the initial case brought by the Federal Trade Commission, the Eleventh Circuit ultimately determined that the settlement agreements were not anticompetitive. Schering-Plough Corp., 402 F.3d at 1076.

26. *See id.* at 1075. There is considerable debate in the legal and economic fields about the conditions under which such settlements are anticompetitive. For a discussion in the context of the FTC's challenge of the *K-Dur* settlements, see

The plaintiffs sought certification pursuant to Rule 23(b)(3), i.e., a finding that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy."[27] In their motion for class certification, the indirect purchaser plaintiffs' economist argued that if defendants' conduct had delayed generic entry, such a delay would have harmed all members of the indirect purchaser class, since all would have paid more for K-Dur than they would have for its generic equivalents.

The plaintiffs' economist primarily relied on two types of evidence. First, he applied the actual experience of K-Dur after generic manufacturers entered in September 2001, pursuant to the settlement agreement. Using IMS Health data on retail pharmacy prescriptions, he demonstrated that after September 2001 the vast majority of K-Dur prescriptions were written for generic potassium chloride.[28] He also demonstrated that the average retail price of generic potassium chloride was lower than the average retail price of K-Dur. He performed similar analyses on manufacturer prices of K-Dur and its generics and found similar results. Second, the plaintiffs' expert referred to academic studies analyzing the competitive effects of generic entry. The studies relied on by plaintiffs' expert found that generic entry lowered average prices.[29]

It is notable that all of this evidence relates to the effect of generic entry on *average* prices. The IMS Health data relied on by plaintiffs' expert provides information only on total prescriptions and total dollars by month. The data does not offer information about the variation in prices paid for a given product in a given

John P. Bigelow & Robert D. Willig, *"Reverse Payments" in Settlements of Patent Litigation: Schering-Plough, K-Dur, and the FTC (2005)*, *in* THE ANTITRUST REVOLUTION: ECONOMICS, COMPETITION, AND POLICY 248 (John E. Kwoka, Jr. & Lawrence J. White eds., 2009). For a more comprehensive discussion of the economic issues, see Bret Dickey, Jonathan Orszag & Laura Tyson, *An Economic Assessment of Patent Settlements in the Pharmaceutical Industry*, 19 ANNALS HEALTH L. 367 (2010).

27. Special Master's Report, *supra* note 23, at 14 (citing to Fed. R. Civ. P. 23(b)(3)).

28. Specifically, he relied upon the IMS National Prescription Audit data.

29. *See, e.g.*, Henry Grabowski & John Vernon, *Longer Patents for Increased Generic Competition in the U.S.: The Waxman-Hatch Act after One Decade*, 10 PHARMACOECONOMICS 110 (1996) [hereinafter Grabowski & Vernon]; Duane M. Kirking et al., *Economics and Structure of the Generic Pharmaceutical Industry*, 41 J. AM. PHARM. ASS'N 578 (2001).

month.[30] Similarly, the expert's analysis of manufacturer data examined differences in averages (and manufacturer prices say little about any variation in the downstream prices paid by indirect purchasers). Thus, the economic analysis of plaintiffs' expert failed to investigate a key class certification question—were all or almost all class members injured?

The expert's analysis suffered from an even more significant flaw: all of the analysis focused on the average retail price. However, the pharmaceutical industry is unusual in that payment for prescription drugs is typically shared by multiple purchasers. The vast majority of prescription drug purchases are covered by insurance. When an insured patient fills a prescription, the cost of that prescription is typically paid in part by the patient and in part by the insurer. The patient's cost will be limited to a co-payment (either a dollar amount or a percentage of the prescription's cost).

As noted above, the putative class included both insurers and consumers. Where payment for a prescription is shared between insurer and consumer, the appropriate class certification question is not whether the total retail price is lower on average after generic entry but whether each individual class member (i.e., the insurer and consumer separately) would have paid a lower price had generic entry occurred earlier. Moreover, simply because the average price would have been lower does not mean that both the patient and the insurer would have shared in the savings; it is quite possible that the savings would be enjoyed entirely by one and not by the other.

In the *K-Dur* case, an evaluation of the evidence made it clear that there were broad groups of insured consumers that would not have benefited from lower generic prices. First, some insurance plans have a flat co-payment, whereby the patient pays the same amount (e.g., $5) for all drugs. Patients covered by these plans would not have shared in any savings resulting from the entry of generic K-Dur.[31] Second, for various reasons, including brand loyalty and perceived and actual differences between the generic and branded versions, not all consumers are prescribed, dispensed, and/or take home the generic version when it is available.[32] Be-

30. The academic literature relies on IMS and other similar data and therefore is similarly incapable of shedding any light on variations. *See, e.g.*, Grabowski & Vernon, *supra* note 29, at 116.

31. Flat co-payments are much less common today than they were a decade ago, but they were still prevalent during the class period.

32. Indeed, one of the named plaintiffs switched back to branded K-Dur after trying the generic version.

cause branded manufacturers may have an incentive to increase prices after generic entry, cash-paying customers might have paid a higher price, not a lower price.[33]

Moreover, insured brand loyalists in a tiered co-payment system are likely to have been worse off.[34] In a three-tiered co-payment system, the branded drug typically moves from the second tier (which covers the preferred or formulary brand) to the third tier (which covers non-preferred, non-formulary drugs) upon entry of a generic version of that drug. As a result, brand loyalists will typically see their co-payment increase from the lower tier two co-payment to the higher tier three co-payment. Thus several types of consumers, collectively accounting for a substantial share of consumers, are not likely to have been harmed by a delay in generic entry.

A more detailed analysis demonstrated that the *K-Dur* experience was somewhat unusual. Not only did many consumers not benefit from generic entry, the same was true for many insurers. This is a surprising result because insurers typically benefit from the lower costs associated with generic entry. Indeed, because of the likely savings from generic entry, insurers typically provide incentives for doctors to prescribe and pharmacists to dispense generics when they are available.

Nevertheless, insurers do not always benefit. K-Dur is unusual in that it is a relatively low-priced branded drug. The average retail cost of a thirty pill prescription for K-Dur at a twenty milligram dosage was roughly $15 in 2001. Insurers with tiered co-payments provide an incentive in the form of a lower co-payment to consumers to use the generic. Typically, this difference is on the order of $5. Furthermore, because the co-pays are set without respect to the price of the drug, this co-pay differential holds whether the branded drug costs $200 or $20. With K-Dur being a very low-priced drug, and a drug with relatively few generic competitors, the difference in the average retail price between K-Dur and its generic competitors was well under $5 after generic entry. Thus, for K-Dur,

33. *See, e.g.*, Henry G. Grabowski & John M. Vernon, *Brand Loyalty, Entry, and Price Competition in Pharmaceuticals After the 1984 Drug Act*, 35 J.L. & ECON. 331, 339 (1992); and Richard G. Frank & David S. Salkever, *Generic Entry and the Pricing of Pharmaceuticals*, 6 J. ECON. & MGMT. STRATEGY 75, 75–77, 89–90 (1997). *See generally* Henry Grabowski & John Vernon, *Longer Patents Lower Initiation Barriers: The 1984 Drug Act*, 76 AM. ECON. REV. 195, 195–98 (1986).

34. In a tiered co-payment system, the patient pays a small co-pay when filling a generic prescription that is on the insurer's formulary, a larger co-pay for a branded drug on the formulary, and an even larger co-pay or full price for drugs not on the formulary. *See, e.g.*, Ernst R. Berndt, *Pharmaceuticals in U.S. Health Care: Determinants of Quantity and Price*, 16 J. ECON. PERSP. 45, 50–52 (2002).

consumers on average obtained more than a one hundred percent of the cost savings associated with generic entry. Indeed, net of co-payments, insurers actually ended up reimbursing *more* per prescription for the generic than for the brand.

As with consumers, there are several different types of insurers that would have been affected very differently by the alleged delay in generic entry. Insurers that provided little incentive for consumers to switch to generic drugs (e.g., insurers with flat co-payment structures or only small differences between tiers) may have been harmed by a delay in generic entry. Insurers that provided strong incentives for consumers to switch (e.g., insurers with large differences in co-payments between tiers) would in fact have shifted all of the generic savings and may in fact have paid more for generic potassium chloride. Using data produced by the named plaintiffs, the defendants' expert demonstrated that several of the class representatives actually paid more for generic potassium chloride than they did for K-Dur.

Plaintiffs did not dispute this evidence. Rather they advanced a novel "joint purchaser theory," arguing that in an insured transaction the insurer and the consumer are a single purchaser. According to plaintiffs' theory, what is relevant is the change in total retail price, not the change in the portion of the price paid by any particular entity. The Special Master rejected this theory.[35] Relying heavily on the analysis of the defendants' expert, the Special Master recommended denial of the plaintiffs' motion for class certification. Specifically, the Special Master concluded that the plaintiffs satisfied neither the predominance nor the superiority requirements of Rule 23(b)(3). He concluded that "individual issues of impact predominate in this case and preclude certification of the proposed class."[36] He also concluded that, where predominance does not exist, the economies of scale do not justify aggregating claims in a class action, and, therefore, a class action was not the appropriate setting for adjudication of the merits.[37] Following the

35. The Special Master called such a theory "unprecedented" and pointed to several other decisions that specifically excluded indirect purchaser plaintiffs that could not demonstrate individual injury. Special Master's Report, *supra* note 23, at 26 (citing *In re* Terazosin Hydrochloride Antitrust Litig., 223 F.R.D. 666 (S.D. Fla. 2004); *In re* Relafen Antitrust Litig., 231 F.R.D. 52 (D. Mass. 2005); *In re* Cardizem CD Antitrust Litig., 481 F.3d 355 (6th Cir. 2007)).

36. Special Master's Report, *supra* note 23, at 19.

37. *Id.* at 27–28. In their reply brief, plaintiffs proposed an alternative class that was essentially composed of six subclasses of payors that would have been harmed by a delay in generic entry. The Special Master rejected this class as well, in part because plaintiffs' expert had not proposed methodology by which impact

Special Master's ruling, the plaintiffs voluntarily dismissed all claims.[38]

II. TYPICALITY/ADEQUACY: CONFLICTS AMONG CLASS MEMBERS

In class certification cases, substantial attention has been devoted to the economic analysis of common proof. At the same time, however, the economic evaluation of conflicts between the members of the putative classes has been relatively overlooked. Class definitions are often crafted quite broadly, encompassing firms that directly compete with one another, firms with different business models, and firms having different relationships with the defendants. As a result, it is not surprising that real and substantial conflicts can exist between putative class members over litigation strategy (or whether to challenge the conduct at issue at all).

An analysis of the economic incentives of putative class members can shed light on potential conflicts that might exist among putative class members. This section describes two cases in which an evaluation of the economic issues proved to be fundamental in the battle over class certification. In the first case, the analysis shows a conflict between those who were harmed by the anticompetitive behavior and those that benefitted. In the second case, there was a conflict between those putative class members that had an incentive to pursue an overcharge theory and those that had an incentive to pursue a lost profits theory.

A. Valley Drug*: Conflict between Those Benefited and Those Harmed*

Arguably the most fundamental conflict in a class certification case is the conflict between parties that benefited from the challenged conduct and those that were harmed by the challenged conduct. The Eleventh Circuit in *Valley Drug Co. v. Geneva Pharmaceuticals, Inc.*[39] confronted the question of whether it was appropriate to certify a class when it was likely that certain class members not only did not suffer harm, but in fact benefited from the alleged wrongful conduct.

and damages could be established for this alternative class by common proof. *Id.* at 26–28.

38. Order at 2, *In re* K-Dur Antitrust Litig., No. 01-1652 (JAG) (D.N.J. Apr. 23, 2008).

39. 350 F.3d 1181 (11th Cir. 2003).

Valley Drug involved allegations similar to those in *K-Dur*. Specifically, plaintiffs alleged that a patent settlement agreement between branded and generic pharmaceutical manufacturers delayed generic entry and caused purchasers to pay more for prescription drugs.[40] In *Valley Drug*, two regional pharmaceutical wholesalers brought suit on behalf of a putative class of direct purchasers after defendant Abbott Laboratories (Abbott), a manufacturer of branded pharmaceutical drugs, entered into settlement agreements with generic drug manufacturers Geneva Pharmaceuticals (Geneva) and Zenith Goldline Pharmaceuticals (Zenith).[41] The settlement agreements allegedly preserved Abbott's monopoly position regarding "the drug terazosin hydrochloride by keeping Geneva and Zenith's less expensive generic [drugs] off the market."[42] The plaintiffs claimed that these settlement agreements were in violation of the Sherman and Clayton Acts.[43]

The proposed class in *Valley Drug* was "all entities who purchased Hytrin, also known by the chemical name terazosin hydrochloride, directly from Abbott at any time during the period commencing March 31, 1998, through August 13, 1999."[44] The district court certified this class, and Defendants appealed to the Eleventh Circuit.[45]

The court in *Valley Drug* mainly concerned itself with the adequacy prong of Rule 23. The court stated that "'adequacy of representation' analysis 'encompasses two separate inquiries: (1) whether any substantial conflicts of interest exist between the representatives and the class; and (2) whether the representatives will adequately prosecute the action.'"[46] With respect to the conflict

40. Whereas *K-Dur* involved final settlement agreements (i.e., settlement agreements that ended the litigation), *Valley Drug* involved an "interim" or "partial" settlement agreement that did not settle the litigation, but under which, Geneva agreed not to launch its generic product until the patent litigation had been resolved. Schering-Plough Corp. v. FTC, 402 F.3d 1056, 1061, 1063 (11th Cir. 2005). For a more complete discussion of the economic issues involved in the *Hytrin* case and of "interim" or "partial" settlement agreements more generally, see James Langenfeld & Wenqing Li, *Intellectual Property and Agreements to Settle Patent Disputes: The Case of Settlement Agreements with Payments from Branded to Generic Drug Manufacturers*, 70 ANTITRUST L.J. 777 (2003).

41. *Valley Drug Co.*, 350 F.3d at 1183.

42. *Id.* at 1183–84.

43. *Id.* at 1183; Sherman Act, 15 U.S.C. §§ 1–7 (2006); Clayton Act, 15 U.S.C. §§ 12–27, 29 U.S.C. §§ 52–53 (2006).

44. *Valley Drug Co.*, 350 F.3d at 1184 n.4.

45. *Id.* at 1184.

46. *Id.* at 1189 (quoting *In re* HealthSouth Corp. Sec. Litig., 213 F.R.D. 447, 460–61 (N.D. Ala. 2003)).

analysis of point (1), the court noted that "the existence of minor conflicts alone will not defeat a party's claim to class certification: the conflict must be a 'fundamental' one going to the specific issues in controversy."[47] In determining whether a conflict is fundamental, the court found that "[a] fundamental conflict exists where some party members claim to have been harmed by the same conduct that benefited other members of the class."[48] Tying the first adequacy requirement to the second, the court stated that "[i]n such a situation, the named representatives cannot 'vigorously prosecute the interests of the class through qualified counsel' because their interests are actually or potentially antagonistic to, or in conflict with, the interests and objectives of other class members."[49]

Applying these rules to the facts in *Valley Drug*, the Eleventh Circuit found that the plaintiffs had not met their burden of demonstrating the absence of a fundamental conflict within the class. The defendants argued that the three national pharmaceutical wholesalers, which were the largest members of the putative class, experienced a net gain from the delay in entry of generic terazosin hydrochloride.[50] The rationale was that these three national wholesalers sell their products on a "cost-plus" basis, where they charge a percentage mark-up on both branded and generic drugs.[51] Because of this pricing structure and the fact that drugs such as terazosin hydrochloride were considered "maintenance drugs" (drugs taken continuously to treat a severe chronic condition) with inelastic demand, the national wholesalers arguably made more money on the sale of higher-priced branded products than they would have on lower-priced generic products.[52] The defendants further argued that national wholesalers benefited from the suppression of generic competitors because wholesalers "are often bypassed in the distribution chain for many generic sales, causing them to lose sales."[53]

The court appears to have been persuaded by these arguments, and the accompanying record supporting them, holding that "[c]lass certification under these circumstances would be inappropriate."[54] The court made clear that it was not passing judgment on the ultimate legitimacy of the arguments but instead concluded

47. *Id.*
48. *Id.*
49. *Id.* (quoting *In re* HealthSouth, 213 F.R.D. at 461–63)
50. *Id.* at 1190.
51. *Id.*
52. *Id.* at 1191.
53. *Id.*
54. *Id.*

that the current record provided an inadequate basis to decide the issue.[55]

As a result of the potential benefit that the patent settlement agreements might have afforded to national wholesaler class members, the court held that national wholesalers could "have divergent interests and objectives from the named representatives with respect to the fundamental issues in controversy in this litigation."[56] In support of its conclusion, the court noted that the class representatives were "two regional wholesalers with relatively small claims who d[id] not sell on a cost-plus basis."[57] Finally, the court pointed out that "the defendant does not have to show actual antagonistic interest; the potentiality is enough."[58]

Thus, in *Valley Drug*, an adequacy problem was created because the economic analysis showed that the class representatives would not adequately represent the interests of all putative class members. The problem arose because some of the class members were not injured, and in reality, benefitted from the alleged anticompetitive conduct.

The Eleventh Circuit ruled that, in certifying the class, the district court failed to evaluate the adequacy of representation prong of Rule 23(a) and, therefore, abused its discretion.[59] Specifically, the district court failed to evaluate whether large wholesalers' alleged gains from the conduct resulted in conflicts of interest between the class representatives and the national wholesalers (AmerisourceBergen, Cardinal, and McKesson).[60] Relying on *Hanover Shoe*[61] and *Illinois Brick*,[62] the district court refused to allow the defendants "downstream" discovery, or discovery on the prices at which wholesalers sold Hytrin and generic terazosin to their customers.[63]

55. *Id.* at 1191–92. The court determined that the district court, relying on the holdings of *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968), and *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977), had also abused its discretion by not letting the defendants engage in discovery regarding the wholesalers' sales practices. *Valley Drug Co.*, 350 F.3d at 1192. However, *Hanover Shoe* and *Illinois Brick* dealt with standing in antitrust suits rather than class certification. *Id.*

56. *Id.* at 1193.

57. *Id.*

58. *Id.* at 1194 (quoting *In re* HealthSouth Corp. Sec. Litig., 213 F.R.D. 447, 462 (N.D. Ala. 2003)).

59. *Id.* at 1188.

60. *Id.* at 1190–91.

61. *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968).

62. *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977).

63. *Valley Drug Co.*, 350 F.3d at 1192.

After the remand from the Eleventh Circuit, the district court allowed such discovery with respect to a sample of the largest putative class members. An economic analysis of the data that was produced through this discovery revealed that some sample class members did appear to benefit from delayed generic entry as they earned higher profits on sales of branded Hytrin than they did on sales of generic potassium chloride.[64] In contrast, other sample class members earned higher profits on generic potassium chloride than on branded Hytrin. Based on the analysis of the economist retained by defendants, and on the Eleventh Circuit's decision, the district court denied plaintiffs' motion for class certification.[65]

B. Bradburn v. 3M*: Conflict Over Choice of Damages Theory*

Even if all putative class members were harmed by the challenged conduct, it is quite possible that different groups of class members would have different incentives with respect to which litigation strategy to pursue. For example, while all of the previous discussions have presumed that all putative class members would pursue an overcharge theory of damages, it is possible that some of the putative class members would find it advantageous to pursue a lost profits theory rather than an overcharge theory.

To see why, let Q_{it} represent the purchases of the *i*th individual during time period t. In assessing impact on lost profits, it is important to account for the possibility that the per-unit impact might be reduced in a lost profits claim if some of the overcharge is passed on in the form of higher prices downstream.

Assuming for simplicity that the pass-through proportion $1\text{-}\lambda$ is the same for all individuals, and recalling that θ_i is a measure of the per-unit damage to the *i*th direct purchaser, then $\lambda\theta_i$ will measure the per-unit impact of an alleged conspiracy on the profit of each direct purchaser.[66] In this case, overcharges can be measured (for the conspiracy period) by the following equation:

$$\text{Overcharges} = \sum \theta_i Q_i \qquad (4)$$

However, lost profits are measured by the change in the variable profit margin (which is assumed, for simplicity, to be given by $\lambda\theta_i$) aggregated over but-for purchases.[67] In general, but-for purchases

64. *In re* Terazosin Hydrochloride Antitrust Litig., 223 F.R.D 666, 674 n.18 (S.D. Fla. 2004).

65. *Id.* at 675.

66. Recall that in Equation (1) θ_i represents the impact of the conspiracy on the price per-unit of output.

67. This presumes that the alleged conspiracy had no effect on cost.

will be higher than actual purchases, with the difference between but-for and actual purchases being greater the greater the magnitude of the price elasticity of demand for the product.

As a result, for those individuals who are unable to pass-through a substantial part of the overcharge, but for whom the price elasticity of demand is relatively large, lost profits will be greater than overcharges. Those are the individuals who may face a conflict of interest with respect to other putative class members. If the lost profits approach is indeed in the interest of some individuals, even after accounting for possible differences in litigation costs, then those individuals would presumably opt out of the class when given an opportunity to do so.[68]

The *Bradburn v. 3M* cases exemplify such a conflict over damages methodology. The allegations in *Bradburn I*[69] and *Bradburn II*[70] were that 3M, a manufacturer of many products, including invisible and transparent tape, had "unlawfully maintained its monopoly in the transparent tape market through its bundled rebate programs[71] and through exclusive dealing arrangements with various retailers."[72] This conduct, plaintiffs alleged, was a violation of section 2 of the Sherman Act.[73]

The proposed class in *Bradburn I* included those "who directly purchased invisible and transparent tape from Defendant from October 2, 1998 until the present."[74]

With respect to the adequacy issue, the court stated that it was important to demonstrate "that the class representatives do not have interests antagonistic to the interests of the class."[75] The defendant argued that the plaintiff could not demonstrate this and

68. That opportunity might not come until after the class is certified. While opting out is a possibility as a matter of theory, an early post-certification settlement might never give the "lost-profits plaintiffs" an opportunity to do so.

69. Bradburn Parent/Teacher Store, Inc. v. 3M, No. Civ.A. 02-7676, 2004 WL 414047, at *1 (E.D. Pa. Mar. 1, 2004) [hereinafter *Bradburn I*].

70. Bradburn Parent/Teacher Store, Inc. v. 3M, No. Civ.A.02-7676, 2004 WL 1842987, at *1 (E.D. Pa. Aug. 18, 2004) [hereinafter *Bradburn II*].

71. The bundled rebate program gave significant discounts to purchasers of 3M's products, but the availability and size of the rebates were dependent on purchasers buying products from multiple product lines. *Bradburn I*, 2004 WL 414047, at *2 n.1 (citing *LePage's, Inc. v. 3M*, 324 F.3d 141, 154–55 (3d Cir. 2003)).

72. *Id.* at *2.

73. *Id.* at *1. For a discussion of the economic issues underlying this case, see Daniel L. Rubinfeld, *3M's Bundled Rebates: An Economic Perspective*, 72 U. CHI. L. REV. 243 (2005).

74. *Bradburn I*, 2004 WL 414047, at *1.

75. *Id.* at *3 (quoting *In re* Linerboard Antitrust Litig., 203 F.R.D. 197, 207 (E.D. Pa. 2001)).

that in fact the class representative's interests were in direct conflict with the interests of many of the potential class members.[76]

In further discussing the antagonistic interests prong of the adequacy requirement, the court noted that "the adequacy of representation requirement is not satisfied where 'the named representative's interest in maximizing its own recovery provides a strong incentive to minimize the recovery of other class members.' "[77]

The defendant's challenge to the adequacy of the representative was that the proposed class included large-volume retailers who "occupy a significantly different position in the transparent tape market than [the representative]."[78] The distinction was that the "large-volume retailers purchase[d] significant quantities of 'private label' tape from competitors of [the defendant]" whereas Bradburn, the class representative, "never purchased such private label tape itself" nor did it purchase tape from a supplier other than the defendant.[79]

The plaintiffs' liability theory was that 3M's bundled rebates induced customers to purchase 3M's branded tape (Scotch) rather than cheaper private label tape produced by smaller manufacturers such as LePage's, and that 3M's bundled discount program prevented the emergence of what would have been very significant competition from private label tape. The proposed class in *Bradburn I* contained companies that were in very different positions with respect to increased competition from private label tape. Bradburn only sold 3M-branded tape and did not sell private label tape. Several other large-volume putative class members, including office superstores such as Staples, sold significant volumes of private label tape.

The defendant argued that the "[class representative] and the large-volume retailers compete with each other in the market for transparent tape by selling different products, thereby creating incentives for [the class representative] and the large-volume retailers to pursue widely differing strategies in order to maximize their potential recovery in this lawsuit."[80]

The defendant also claimed that the large-volume retailers would argue that, absent the defendant's anticompetitive conduct,

76. *Id.*
77. *Id.* (quoting Yeager's Fuel v. Pa. Power & Light Co., 162 F.R.D. 471, 478 (E.D. Pa. 1995)).
78. *Id.* at *4.
79. *Id.*
80. *Id.*

> private label tape would have gained market share at the expense of the market share enjoyed by [the defendant]'s branded tape, because large volume retailers are in a position to profit from any such shift in market share from [the defendant's] branded tape to private label tape. Utilizing this theory, large-volume retailers could pursue recovery of the unrealized profits that they would have received from their ability to take advantage of the market shift from [the defendant's] branded tape to private label tape.[81]

To put the argument somewhat differently, the large-volume retailers would have an incentive to argue that there would have been a *decrease* in the sales of branded tape because consumers would have switched to private-label tape—on which retailers typically earn significantly higher margins than on branded tape. On the other hand, the class representative would be solely pursuing an overcharge theory of damages and would seek to recover the difference between the price of the defendant's branded tape it purchased during the damages period and the price that such tape would have commanded absent the defendant's anti-competitive conduct. Thus, the class representative would have incentive to minimize the loss in market share that the defendant's branded tape would have suffered absent defendant's anti-competitive conduct. The class representative also would have further incentive to argue that, in order to maintain its market share, defendant would have substantially lowered the prices for the defendant's branded tape. Indeed, the class representative would argue that there would have been an *increase* in the sales of branded tape because of the lower prices and that there would not have been a switch from branded tape to private-label tape.

The plaintiff made several counterarguments. First, the plaintiff responded that the defendant's argument was speculative. Indeed, the court noted that "a conflict between class members must be more than merely speculative or hypothetical before a named representative can be deemed inadequate."[82] However, the court found that the defendant's argument was neither speculative nor hypothetical, because even though the data used were based on hypothetical numbers, the fact that there was no empirical proof that the lost profits theory was preferable to some class members did not render the proposed conflict speculative.[83] The court was appar-

81. *Id.*

82. *Id.* at *5 (quoting JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 23.25(4)(b) (3d ed. 2003)).

83. *Id.* at *6.

ently persuaded by the lack of plaintiffs' evidence contradicting the argument that the lost profits theory would be beneficial for some class members and the evidence presented in a related trial that tended to support the defendant's theory.

Second, the plaintiff argued that the lost profits theory (the theory that the large retailers would pursue the sales of private label transparent tape) rarely produces a greater amount of recovery than an overcharge theory (the theory the class representative would pursue). The court rejected this argument, referring to defendant's example in which a lost profits theory would produce a greater amount of recovery than an overcharge theory.[84]

Third, the class representative argued that the conflict between itself and the large retailer class members was "illusory, because it could have taken advantage of any shift to private label tape in the but-for world by purchasing private label tape itself."[85] The court rejected this argument because there was no support in the record.[86]

The court then further analyzed the economic theories which would lead to a result in which branded tape prices remained the same despite the entry of generic substitutes. The court noted that when generic products enter the market, some economists believe that branded product prices would fall. However, the court also acknowledged that economists also believed that branded products' prices may increase when a generic product enters the market because there would be market segmentation.[87] With market segmentation, there is a group of consumers who are attached to a particular brand of product, i.e., their demand is relatively inelastic. For these consumers, the product will occupy a different and higher-priced niche than for those consumers who are price sensitive. With respect to pharmaceutical pricing, where there is substantial evidence supporting market segmentation, this is consistent with a lower-priced generic and a higher-priced branded product.[88]

Although expert testimony was received on whether the market segmentation theory was applicable in this situation, the court found there was conflicting plausible testimony. Ultimately, however, it did not matter which theory was or was not found to be empirically valid. The court decided that the economic plausibility

84. *Id.*
85. *Id.* at *8.
86. *Id.*
87. *Id.* at *7.
88. *See, e.g.*, Grabowski & Vernon, *Brand Loyalty, Entry, and Price Competition in Pharmaceuticals After the 1984 Drug Act*, *supra* note 33.

of the market segmentation theory itself created a conflict between the class members as to which theory to pursue at trial.[89]

As a final argument in response to the court's inadequacy view, the class representative argued that the conflict would be cured under the opt-out procedure in Rule 23(c)(2).[90] The court rejected this argument by noting Supreme Court precedent requiring the named plaintiff to adequately represent the interests of the absent class members *at all times*.[91]

In the end, the court held that, "because Plaintiff's theory of damages is antagonistic to an alternative theory that many class members will likely wish to pursue, and because Plaintiff is not in a position to pursue this alternative theory itself, Plaintiff's interests are antagonistic to those of other members of the proposed class."[92] For these reasons, the court found that the named plaintiff would not adequately represent the interests of all of the proposed class members and declined to certify the proposed class. As to typicality, the court noted that the requirements were quite similar to the adequacy requirements and held that, because of the conflict described in the adequacy section of its opinion, the typicality requirement also could not be met.[93]

After the motion was denied, plaintiffs' counsel amended their proposed class to exclude those entities that purchased private label tape (and that therefore, under the logic presented by 3M's economist, may have an incentive to pursue a lost-profits theory). These entities were typically the largest purchasers of 3M tape and, therefore, the new putative class was much smaller than the original putative class. Specifically, the new putative class was defined to include:

> All persons who directly purchased invisible or transparent tape from 3M Company between October 2, 1998 and the present, who have not purchased, for resale under the class member's own label, any "private label" invisible or transparent tape from 3M Company or any of 3M Company's competitors at any time from October 2, 1988 to the present.[94]

89. *See Bradburn I*, 2004 WL 414047, at *7.

90. *Id.* at *9.

91. *Id.* (quoting Phillips Petroleum v. Shutts, 472 U.S. 797, 812 (1985)).

92. *Id.* The Court may have also been influenced by the amicus brief in support of 3M's effort to convince the Supreme Court to grant certiorari filed by Staples, a putative class member.

93. *Id.* Because class certification was denied on adequacy and typicality grounds, the court did not address whether the requirements of Rule 23(b) had been established. *Id.* at *9–10.

94. *Bradburn II*, 2004 WL 1842987, at *3.

The plaintiff then intended to "pursue an overcharge theory."[95] The Court granted plaintiffs' motion to certify the amended class.

IV.
CONCLUDING REMARKS

It would be advantageous from a policy perspective if courts were to utilize a more consistent and coherent economic framework in evaluating class certification issues. Currently, the outcomes of class certification claims by plaintiffs are not easily predictable because of the variation in precedents across circuits and the variation in case outcomes within each circuit.[96]

The objectives of this Article are limited in scope. With illustrations based on actual cases, it suggests ways in which courts can move toward the use of a consistent economic framework. The suggested framework takes into account the fact that class certification is rarely defeated only by suggesting that price variation demonstrates that individual elements predominate. In addition, the framework suggests that class certification can (appropriately) be defeated by a deeper analysis of commonality/predominance, and by a close examination of typicality and adequacy. This is consistent with the Third Circuit's view that courts should acknowledge that class certification investigations must go, to some extent, into the merits on causation and damages. Indeed, courts are beginning to demand that plaintiffs' economic experts put forward an explicit methodology for evaluating causation and damages on a class-wide basis.

However, note the preliminary nature of the proposed framework. A complete policy analysis of class certification would need to take into account a host of concerns not explicitly discussed here: the goals of private enforcement (deterrence versus compensation), the social costs of Type 1 errors (improperly finding a defendant liable) and Type 2 errors (failing to find liability when there has been a violation), and the public and private costs of litigation. A further analysis would also evaluate class certification issues in mass tort cases and other cases outside the realm of antitrust.[97]

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95. *Id.*

96. For example, the Third Circuit's *Hydrogren Peroxide* decision contrasts with the D.C. Circuit's approach in *In re Nifedipine Antitrust Litig.*, No 08-8014, 2009 U.S. App. LEXIS 3643 (D.C. Cir. 2009). For a more general discussion of differences in Courts' application of Rule 23, see Donald Hawthorne & Margaret Sanderson, *Rigorous Analysis of Economic Evidence on Class Certification in Antitrust Cases*, 24 ANTITRUST 55–56 (2009).

97. *See, e.g.*, Amchem Products, Inc. v. Windsor, 521 U.S. 591 (1997).

POST-SALE RESTRAINTS AND COMPETITIVE HARM: THE FIRST SALE DOCTRINE IN PERSPECTIVE

*HERBERT HOVENKAMP**

INTRODUCTION: SOURCES OF LEGAL POLICY TOWARD VERTICAL RESTRAINTS

This Article examines one particular question at the intersection of competition policy and intellectual property (IP) doctrine: are there sufficient reasons within either IP policy or competition law for treating post-sale restraints on patented or copyrighted goods differently from those on other goods? This Article also considers whether we should treat restraints contained in license agreements that do not involve a technical sale differently from those contained in other types of contracts.[1]

The term "post-sale restraint" refers generically to any restriction imposed by a seller on how a purchased good can be used or resold after the initial sale. In the context of the term "post-sale restraint," "sale" includes leases, licenses, or other transfers of interest short of a technical sale. The differences among these various types of transfers can be decisive in legal policy. For example, IP law's "first sale" doctrine applies only to true sales, as does the antitrust law of resale price maintenance. By contrast, "tying" law applies to sales, leases, and licenses without significant differentiation. Despite these legal distinctions, differences in the type of transfer are typically unimportant for understanding the fundamental economics of post-sale restraints, although they can be in some instances, such as where product durability is a problem for the monopolist.[2] In 2008 the Supreme Court decided an important post-sale restraint case involving patents and a form of quasi-exclusive dealing.[3] At this writing, an equally divided Supreme Court has

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1. On the use of such restraints in copyright licenses, see Christina Bohannan, *Copyright Preemption of Contracts*, 67 MD. L. REV. 616 (2008).

2. *See infra* notes 182–89 and accompanying text.

3. Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008).

affirmed another first sale decision involving copyrights and resale price maintenance.[4]

In antitrust, the relevant law is that of vertical restraints, sometimes called "restricted distribution" or "vertical restrictions."[5] Vertical restraints are typically classified as "intrabrand" or "interbrand." An intrabrand restraint limits the way a seller's own product can be distributed or used. The classic example is resale price maintenance (RPM), in which the seller of a product stipulates its resale price.[6] There are also intrabrand nonprice restraints, which might, for example, limit the locations in which downstream parties can resell the product, segregate commercial from noncommercial users,[7] or specify in detail the conditions under which a product may be resold. Most field of use restrictions in patent law are intrabrand restraints.[8] By contrast, an interbrand restraint limits either the purchaser's ability to use the product with things produced by other suppliers, or a reseller's ability to sell the goods of other sellers. The most common interbrand restraints are tying and exclusive dealing. A tying arrangement requires that the purchaser of a "tying" product (say, a printer) use it exclusively with that seller's own "tied" product (ink).[9] Exclusive dealing forbids a reseller han-

4. Omega S.A. v. Costco Wholesale Corp., 541 F.3d 982 (9th Cir. 2008) (holding that copyright's statutory first sale doctrine did not apply to good that was manufactured outside United States but that bore design registered in United States Copyright Office; infringement defendant allegedly sold watch at lower price than that which plaintiff had stipulated in license), *aff'd by an equally divided court*, 131 S. Ct. 565, No. 08-1423, 2010 WL 5058406 (U.S. Dec. 13, 2010) (Kagan, J., not participating).

5. On vertical restraints under the antitrust laws, see PHILLIP E. AREEDA, EINER ELHAUGE & HERBERT HOVENKAMP, ANTITRUST LAW ch. 17 (2d ed. 2004) (tying); PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ch. 16 (3d ed. 2010) (intrabrand restraints); HERBERT HOVENKAMP, ANTITRUST LAW ch. 18 (2d ed. 2005) (exclusive dealing).

6. Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373, 408 (1911) (resale price maintenance per se unlawful under antitrust laws), *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (applying rule of reason).

7. *See, e.g.*, ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449–50 (7th Cir. 1996) (software licensing agreement distinguishing commercial and noncommercial users).

8. *See, e.g.*, Ethyl Gasoline Corp. v. United States, 309 U.S. 436, 456–59 (1940) (resale price maintenance); Gen. Talking Pictures Corp. v. W. Elec. Co., 305 U.S. 124, 126 (1938) (limitation to noncommercial uses). Field of use restrictions can also facilitate horizontal market division. *See, e.g.*, Hartford-Empire Co. v. United States, 323 U.S. 386, 400 (1945).

9. *See, e.g.*, Ill. Tool Works, Inc. v. Indep. Ink, Inc., 547 U.S. 28, 45–46 (2006) (refusing to condemn printer-ink tie after upsetting judicially created presumption that patent in tying product conferred market power); Henry v. A.B. Dick & Co.,

dling the seller's product from also dealing in the competing product of any rival. For example, a Ford dealership might be forbidden by its franchise contract to sell new cars made by rival manufacturers.[10]

Throughout their legal history, vertical restraints have been controversial, and their effects on competition and welfare have proven notoriously difficult to assess. A purely vertical restraint does not eliminate competition between rivals or reduce the number of firms in any market. Nor does it make any firm larger.[11] As a result, the twin concerns of competition policy, collusion and dominant firm exclusion, are often hard to identify. In some cases vertical restraints may channel or restrict future development in ways that restrain innovation.[12] On the other side, long-term vertical contracting typically reduces firms' costs, and IP restraints are essential devices for enabling firms to share risk or to enhance the sharing of technology. More generally, vertical restrictions are a very important compromise between unrestricted market transactions and vertical integration through ownership. They permit business entities to have some of the advantages of the market-displacing mechanisms of the business firm but without all of the costs that outright ownership entails.[13]

224 U.S. 1, 35–36 (1912) (refusing to apply first sale rule to post-sale tying condition), *overruled by* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917); *see also* Erik Hovenkamp & Herbert Hovenkamp, *Tying Arrangements and Antitrust Harm*, 52 ARIZ. L. REV. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1443284.

10. *See, e.g.*, Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 636–38 (2008) (refusing to enforce post-sale restraint forbidding purchasers from combining goods with parts not made by Intel); United States v. Dentsply Int'l, Inc., 399 F.3d 181, 191–96 (3d Cir. 2005) (condemning arrangement under which monopoly manufacturer of dental materials forbade dealers from selling rivals' goods). The classic antitrust decision is *Standard Oil Co. of California v. United States,* 337 U.S. 293, 314 (1949) (condemning oil refiner's restraint forbidding gasoline stations from selling other brands of gasoline).

11. However, to the extent a restraint reduces a firm's costs or excludes rivals, increased size or market share may result.

12. *E.g.*, Lasercomb Am., Inc. v. Reynolds, 911 F.2d 970, 979 (4th Cir. 1990) (licensee of software not permitted to develop competing software; found to be unlawful copyright misuse); *see also* United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001) (condemning under antitrust laws many restraints that Microsoft imposed on computer manufacturers and software producers to limit the development of rival internet browser Netscape), *cert. denied*, 534 U.S. 952 (2001).

13. *See* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 280–81 (1996); Herbert Hovenkamp, *Harvard, Chicago, and Transaction Cost Economics in Antitrust Analysis*, ANTITRUST BULL. (forthcoming 2010) (manuscript at 2–3), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1592476.

But the use of contracts rather than ownership can also threaten competition in ways that ownership integration typically does not. For example, many of the rationales for condemning intrabrand restraints are based, not on the market power of upstream sellers or IP right holders, but rather on concern about powerful dealers or cartels of dealers that may force suppliers to impose anticompetitive restrictions on these dealers' rivals.[14] A vertically integrated firm has no incentive to make its distribution system less efficient internally. But independent dealers can profit by limiting the competition between themselves and rival dealers.[15] Indeed, the *Dr. Miles* decision,[16] which first brought resale price maintenance under a per se rule, involved a cartel of retail druggists that forced suppliers to impose price restraints on the cartel's price-cutting rivals.[17]

Vertical restraints often involve IP rights because most of these restraints are specific to particular brands and technologies. Someone selling a commodity such as potatoes typically has little to gain by providing that they can be used only a certain way or resold only under certain terms, unless of course the potatoes themselves are patented.[18] But that is often not true of manufactured goods, particularly if the goods create an "aftermarket." For example, purchase of a printer, computer, or automobile may create ongoing demand for ink, software, unique replacement parts, or maintenance. Further, dealers must make long-run commitments to a particular seller's good because effective selling requires training in

14. *See* 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1604 (3d ed. 2010).

15. *Id.*

16. Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

17. *Id.* at 394, *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007). On the druggists' cartel, see HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836–1937, at 331–48 (1991).

18. *See* Monsanto Co. vs. McFarling, 488 F.3d 973, 976–77 (Fed. Cir. 2007) (upholding post-sale restraint forbidding farmers from developing their own seed from plants produced from patented seeds, without finding antitrust violation or misuse and without discussing first sale doctrine); *see also* Monsanto Co. v. Scruggs, 459 F.3d 1328, 1335–36 (Fed. Cir. 2006) (finding the first sale doctrine did not apply for two reasons: first, the sale was conditional under *Mallinckrodt, Inc. v. Medipart, Inc.,* 976 F.2d 700, 701 (Fed. Cir. 1992), a case that was subsequently overruled in *Quanta Computer, Inc. v. LG Elecs., Inc.*, 553 U.S. 617 (2008), and second, the restriction on reuse did not operate on the original seed that Monsanto sold to farmers, which was physically incapable of reuse; rather it applied to second generation seed produced from that seed for which there had never been an earlier sale).

the characteristics and maintenance of specific brands. Most vertical restraints in modern distribution systems arise in markets where trademarks, copyrights, and patents are important components.

The modern law of distribution restraints originated in nineteenth-century IP doctrine, long before there were any antitrust laws. The first significant body of distribution restraints law in the United States was the judge-made “first sale” doctrine, often referred to as patent “exhaustion,” which limited a patentee’s ability to place restrictions on a patented good after it had been sold. Where the first sale bar did not apply, a breach of these restrictions could be enforced by a patent infringement action as well as a breach of contract suit. The second body of legal rules originated with the Sherman Antitrust Act, whose first section condemns contracts that restrain trade, without any exceptional treatment for IP license restrictions.[19] Later on, the Clayton Act expressly condemned tying and exclusive dealing in both patented and unpatented goods.[20] The third body of law concerns IP “misuse,” another judge made doctrine that renders unenforceable an IP right held by a patentee or copyright holder who violates IP policy by limiting sales or use until the improper limitation is purged.[21]

These three doctrines—first sale, antitrust, and misuse—have distinct histories, different technical requirements, and can be invoked in different situations. At the same time, however, the amount of policy overlap is significant. For example, the famous *Motion Picture Patents* case of 1917 denied enforcement to a classic tying arrangement.[22] The patentee forbade anyone using its projector from using films made by rivals. The main body of the Supreme Court’s discussion concerned the first sale doctrine.[23] But the

19. Sherman Act, ch. 647, § 1, 26 Stat. 209, 209 (1890) (current version at 15 U.S.C. § 1 (2006)).

20. Clayton Act, ch. 323, § 3, 38 Stat. 730, 731 (1914) (current version at 15 U.S.C. § 14 (2006)).

21. *See* Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 493 (1942) (misuse renders patent unenforceable until the misuse is purged). On the scope of misuse doctrine under IP policy, see Christina Bohannan, *IP Misuse as Foreclosure*, 96 IOWA L. REV. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1474407.

22. Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917).

23. *See infra* notes 94–98 and accompanying text.

Court also cited the Clayton Act as supporting its decision.[24] Today the decision is also widely regarded as a "misuse" case.[25]

The Supreme Court missed an opportunity to make the law of post-sale restraints more coherent in its recent *Quanta Computer* decision, where it reverted to a strict application of the first sale rule not clearly related to any policy of furthering competition or innovation.[26] Until *Quanta*, the case law over the last two generations had consistently pursued two themes: a benign attitude toward vertical restraints and a belief that IP rights are not inherently monopolistic. The *Quanta* decision is a reversion to an older form of patent "exceptionalism" that viewed post-sale restraints on patented articles as inherently suspicious.

The *Quanta* case poses three questions. First, what kinds of post-sale restraints are justifiable? Second, when should they be enforced by contract law, and when by infringement actions? And third, when does the presence of an IP right make a difference?

On the first question, good reasons exist for limiting certain vertical restrictions: (a) they might injure competition by reducing output or raising price; (b) they might restrain innovation; and (c) they might serve to deny public access to public domain technology or information.[27] But these reasons do not exist in every case, or even in a majority of them. As a result, harmful effects must be proven.

On the second and third questions, breach of contract actions and infringement actions have different advantages and pose different problems. Contracts are the least problematic because they can generally be enforced only against people who are in privity. By contrast, infringement actions can run against all who infringe an IP right, and even those who knowingly contribute to the infringements of others. This increases the risk that such actions will be imposed on unsuspecting violators, although that problem can be addressed with a notice restriction.[28] For these very reasons, however, infringement actions are also a more efficient mechanism for enforcing legitimate, welfare-enhancing restraints. For example, imagine a regime of real property rights in which servitudes such as

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24. *See Motion Picture Patents*, 243 U.S. at 517–18 (citing § 13 of Clayton Act in support of its conclusion under first sale doctrine).

25. *See, e.g.*, Robert P. Merges, Peter S. Menell & Mark A. Lemley, Intellectual Property in the New Technological Age 331 (rev. 4th ed. 2007) (using *Motion Picture Patents* as example of misuse).

26. Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 636–38 (2008).

27. *Cf.* Bohannan, *supra* note 21 (manuscript at 4).

28. *See infra* notes 118–30 and accompanying text.

easements or building restrictions had to be contracted and re-contracted every time a piece of property was resold. There are good reasons for preferring infringement actions over contracts to enforce post-sale restraints in some situations but not others. The *Quanta* decision did not discuss the issue.

The existence of three doctrinal avenues for assessing the effects of vertical restraints involving IP rights has served to make the legal policy incoherent over most of its history. Often condemnation or approval rests on a contract detail that has no obvious relation to either innovation policy or competition policy. For example, under the first sale doctrine, all restraints become unenforceable as a matter of IP infringement actions, whether or not they are anticompetitive or serve to restrain innovation. At the other extreme, the antitrust laws were historically hostile to vertical restraints, but today they rarely condemn vertical restraints even if they serve to limit innovation substantially. The competitive rationale for the "misuse" doctrine has never been articulated properly in the courts, except for attempts to identify it with antitrust policy or to identify the harm as an improper "extension" of an IP right.[29]

The history of legal policy concerning post-sale IP restraints sheds some light on why the doctrine is both so complicated and so wide of the mark. The principal harms that can result from post-sale conditions are restraints on competition and restraints on innovation. Restraints on competition occur when a practice reduces output, increases prices, or unreasonably excludes firms from a market. Restraints on innovation occur when a practice acts to hinder rather than to promote innovation, typically by imposing limitations on the innovations of others.[30] Under the system that we have developed, antitrust law and misuse law are concerned almost exclusively with restraints on competition, and occasionally with restraints on innovation. Under *Quanta*, the first sale doctrine is not concerned with either one. Rather, when it applies, it blocks enforcement of post-sale restrictions as a matter of IP policy without regard to competitive impact or effect on innovation.

While these three doctrines—first sale, antitrust, and misuse—originated at different times and addressed different issues, they largely merged during the first half of the twentieth century. The first sale doctrine grew out of the common law's strong policy against restraints on alienation, which had little to do with the pro-

29. *See* Bohannan, *supra* note 21 (manuscript at 17).

30. *See id.* (manuscript at 32–34); Herbert Hovenkamp, *Restraints on Innovation*, 29 CARDOZO L. REV. 247 (2007).

tection of competition, except in the sense that it prevented wealthy landowners from tying up land in their families indefinitely. Harvard Law School Professor John Chipman Gray's influential 1890s treatise *Restraints on the Alienation of Property* regarded the common law rules prohibiting restraints on alienation as virtually sacred and a fixed part of nature.[31] These concerns dominated the development of patent law's first sale doctrine, but they later merged with very little friction into the antitrust law of vertical restraints. When the Supreme Court first applied the antitrust laws to condemn resale price limitations on goods that dealers had purchased, it relied on both Gray's treatise and the English common law limiting restraints on alienation to hold that a supplier could not impose a post-sale restraint on resale prices.[32]

The treatment offered here illustrates some of the relative advantages and disadvantages of legislation vs. judge-made rules as law reform devices in rapidly changing technological environments. One comparative advantage of judge-made rules is their relative freedom from interest-group capture—something that has plagued the IP laws since their inception.[33] However, one significant disadvantage that judges face is that they decide disputes one at a time and often in a single doctrinal context. This severely limits their opportunity to articulate a coherent policy about multi-faceted issues such as competition policy and the encouragement of innovation. A well-designed system of IP laws designed to encourage innovation while not limiting competition unnecessarily would almost certainly not require three different doctrines that are often overlapping, sometimes inconsistent, and more often than not provide no value added whatsoever.

31. JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY iii–viii (2d ed. 1895).

32. Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373, 404–05 (1911), *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

33. On copyright, see Christina Bohannan, *Reclaiming Copyright*, 23 CARDOZO ARTS & ENT. L.J. 567 (2006); on patents, particularly during the formative era, see generally Andrew P. Morriss & Craig Allen Nard, *Institutional Choice and Interest Groups in the Development of American Patent Law: 1790–1870* (Univ. of Ill. College of Law Program in Law, Behavior & Social Science Research, Paper No. LE07-007, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262970.

I.
EARLY DISTRIBUTION RESTRAINTS AND FIRST SALE RULE

In the mid-nineteenth century, manufacturing firms began integrating vertically into distribution and sale through individually franchised dealers rather than manufacturer-owned outlets. For example, the McCormick Harvesting Co. used a set of regional patent and trademark licenses to create ongoing franchise-like relationships with local manufacturers/dealers, who could produce their machines locally and sell them to farmers, thus making national shipment of this bulky equipment unnecessary.[34] The arrangement also permitted McCormick to share the risk and cost of developing a nationwide distribution system. Such a licensee might agree to be the exclusive resale agent for McCormick's reapers in a certain territory, or it might agree that it would not sell any reapers other than McCormick's. Singer Corp. did something similar with its sewing machines, except that the machines were produced centrally and shipped to dealers rather than being produced by the dealers themselves.[35]

Competitive differences between the two methods chosen by McCormick and Singer are not significant, and a firm chose the one that was least costly and most effective for its own particular business. For McCormick's bulky but fairly simple wooden reapers, authorizing local dealers to manufacture them saved transportation costs. Today, for many fast-food franchises the food itself is "manufactured" at the restaurant from local ingredients rather than shipped in finished form from the franchisor's location. Coca-Cola sells and ships concentrated syrup to its franchised dealers, who then add water, carbon dioxide, and bottling, so in a real sense part

34. *See* Seymour v. McCormick, 57 U.S. (16 How.) 480, 490 (1853) (describing arrangement). McCormick later changed to a more centralized distribution system with wholly owned outlets. On the company's history, see ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 305–07, 402–08 (1977); THOMAS S. DICKE, FRANCHISING IN AMERICA: THE DEVELOPMENT OF A BUSINESS METHOD, 1840–1980, at 18–19 (1992). On the place of these practices in the history of United States policy toward vertical integration, see generally Herbert J. Hovenkamp, *The Law of Vertical Integration and the Business Firm: 1880-1960*, 95 IOWA L. REV. 863 (2010).

35. *See* RUTH BRANDON, SINGER AND THE SEWING MACHINE: A CAPITALIST ROMANCE (1977); Andrew Godley, *Selling the Sewing Machine Around the World: Singer's International Marketing Strategies, 1850–1920*, 7 ENTERPRISE & SOC'Y 266, 272, 280–87 (2006); Andrew B. Jack, *The Channels of Distribution for an Innovation: The Sewing-Machine Industry in America, 1860–1865*, 9 EXPLORATIONS IN ENTREPRENEURIAL HIST. 113, 127–31 (1957).

of a finished Coke is manufactured centrally by the franchisor and part locally by each franchisee.[36] By contrast, both today and in the past Ford automobiles were manufactured at a central plant and shipped to dealers, who prior to the sale did little more than cleanup and dealer prep work. The first sale doctrine limits Ford's ability to impose post-delivery restraints on its automobiles, but not McCormick's ability to restrain the resale of its locally manufactured reapers. This is because in the Ford case the dealers are receiving a manufactured product, while in the McCormick case they are receiving only a license to manufacture, which is not covered by the first sale doctrine.

Patent law's first sale rule states that once the patentee sells or authorizes the sale of a patented article, he has exhausted his rights with respect to that article and cannot restrain subsequent purchasers. The Court's most forceful nineteenth century statement of the doctrine was *Adams v. Burke,* which was a vertical territorial restraint case.[37] *Adams* involved a Civil War era patentee of coffin lids who had created a controlled distribution system by licensing various makers to produce them for sale in defined geographic areas and also restricted the areas in which the lids could be used. The firm of Lockhart and Seelye had acquired the right to make and sell the coffin lids within ten miles of Boston, while Adams had the right to make and sell them everywhere else. Lockhart and Seelye then manufactured the lid in question and placed it on a coffin that it sold to Burke, a mortician who used the coffin for a burial in Natick, Massachusetts, about seventeen miles from Boston. The patentee claimed that the burial violated the terms of the territorial limitation in the patent license and thus constituted infringement.[38]

The Court assumed that the geographic restriction imposed on Lockhart and Seelye's manufacturing license was enforceable, but that once a finished coffin lid was produced and sold to another, the purchaser took it free and clear of all patent obligations and could use the lid for a burial wherever he pleased. As a result, long before the antitrust laws were passed, the first sale doctrine per-

36. *See* MARK PENDERGRAST, FOR GOD, COUNTRY, AND COCA-COLA: THE DEFINITIVE HISTORY OF THE GREAT AMERICAN SOFT DRINK AND THE COMPANY THAT MAKES IT 71 (2000).

37. 84 U.S. (17 Wall.) 453 (1873). For a fuller statement of the facts, see *Adams v. Burks*, 1 F. Cas. 100 (C.C. Mass. 1871) (No. 50). The Supreme Court originally announced the doctrine in *Bloomer v. McQuewan*, 55 U.S. (14 How.) 539, 549 (1853) ("[W]hen the machine passes to the hands of the purchaser, it is no longer within the limits of the [patent] monopoly.").

38. *Burke*, 84 U.S. at 454.

formed an "antitrust" function through the patent licensing system by limiting the ability of manufacturers to impose territorial restraints on the resale of products. As the Supreme Court stated:

> [I]n the essential nature of things, when the patentee, or the person having his rights, sells a machine or instrument whose sole value is in its use, he receives the consideration for its use and he parts with the right to restrict that use. The article, in the language of the court, passes without the limit of the monopoly. That is to say, the patentee or his assignee having in the act of sale received all the royalty or consideration which he claims for the use of his invention in that particular machine or instrument, it is open to the use of the purchaser without further restriction on account of the monopoly of the patentees.[39]

The Supreme Court extended the first sale rule to copyrights in 1908, in *Bobbs-Merrill Co. v. Straus*, which refused to enforce a resale price maintenance restriction created in the context of an early restricted distribution system.[40] Bobbs-Merrill published *The Castaway*, a novel written by Hallie Ermine Rives, a writer of popular and historical novels and books on etiquette.[41] The book contained a notice printed on the copyright page prohibiting anyone from reselling the book for less than $1.00 per copy. Macy's stores had purchased the book from a distributor and then resold it to a customer for 89 cents. Relying on both the patent exhaustion cases and the general policy against restraints on alienation, the Court held that the sale of the book exhausted all rights conferred by the Copyright Act, leaving Macy's free to resell it at any price it chose. [42]

Significantly for the development of future distribution law, the Court observed that the price restriction was contained in the copyright license and not in a distribution contract that the publisher had with Macy's department stores. Macy's was not in privity

39. *Id.* at 456; *see also* Keeler v. Standard Folding Bed Co., 157 U.S. 659, 664 (1895) (finding a bedstead patentee could not enforce a territorial limitation against a subsequent purchaser). Some early cases raised an issue analogous to first sale when patentees attempted to draft patents so as to cover both machines and consumables that would be used in them. *See* Morgan Envelope Co. v. Albany Perforated Wrapping Paper Co., 152 U.S. 425 (1894) (finding the patentee's combination patent covered both a device for dispensing toilet paper rolls and the consumable rolls themselves). The *Morgan Envelope* Court rejected the claim covering the rolls and held that it was not infringement for users of the device to purchase their toilet paper elsewhere. *Id.* at 432–33.

40. 210 U.S. 339, 349–51 (1908).

41. HALLIE ERMINIE RIVES, THE CASTAWAY (1904).

42. *Bobbs-Merrill*, 210 U.S. at 350–51.

of contract with the publisher, and the case had been presented and argued completely as one of copyright infringement rather than breach of a distribution contract.[43] That distinction was to prove critical in the future. As the law stood in 1908, any post-sale restraint on a patented or copyrighted article that was imposed by means of a licensing restriction and enforced by an infringement action was unenforceable. However, the courts had not yet addressed the legality of restricted distribution agreements under the Sherman Act.

Supreme Court jurisprudence concerning the first sale doctrine has been largely consistent and absolute through most of its history. The doctrine applies no matter how competitively structured the market is, and whether or not anyone is excluded—that is, it reaches far beyond conventional antitrust analysis. The first sale rule applies equally to intrabrand restraints, such as location clauses or resale price maintenance, and also to interbrand restraints such as tying or exclusive dealing. The rule applies whether or not the restraint in question serves to promote or restrain innovation; indeed, that question is not even relevant. The Court's reaffirmance of the first sale doctrine in the 2008 *Quanta* decision stated it in this broad, unqualified way,[44] despite the Court's recognition after more than 30 years of antitrust jurisprudence that most post-sale restraints are competitively harmless.

There have been two important historical exceptions to this consistent and aggressive application of the first sale rule, one very briefly recognized by the Supreme Court and one recognized nearly a century later by the Federal Circuit. The first exception was a pair of decisions written by Justice Lurton in 1896 and 1912, the first when he was on the Sixth Circuit and the second after his appointment to the Supreme Court. Both decisions involved tying ar-

43. *See id.* at 346, 350:

> The learned counsel for the appellant in this case, in the argument at bar, disclaims relief because of any contract, and relies solely upon the copyright statutes, and rights therein conferred. . . . There is no claim in this case of contract limitation, nor license agreement controlling the subsequent sales of the book . . . . In our view the copyright statutes, while protecting the owner of the copyright in his right to multiply and sell his production, do not create the right to impose, by notice, such as is disclosed in this case, a limitation at which the book shall be sold at retail by future purchasers, with whom there is no privity of contract.

Cf. Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 637 n.7 (2008) (refusing to decide whether application of first sale doctrine had any implications for breach of contract suits).

44. *Quanta*, 553 U.S. at 636–37.

rangements with a patented tying product and unpatented tied products, a practice that would later become the subject of sharp antitrust controversy. In the *Button-Fastener* case in 1896, the Sixth Circuit held that the first sale rule did not undermine a license restriction requiring purchasers of the patentee's patented button fastening machine to use only its own fastening staples.[45] The restriction was written in the form of a servitude, with a right of reverter upon violation. Judge Lurton effectively turned the first sale doctrine into a licensing default rule by holding that it applied only to "unconditional" sales. Clearly, he reasoned, a patentee's right to "use" his invention implied the right to license others subject to similar use restrictions—that is, if the patentee could use his patented fastener only with his own staples, he could also place the same restriction on licensees.[46] The only limitation that Lurton recognized on this power was where a monopoly in the "unpatented article" might be created.[47] In the present case, however, there was no prospect of monopoly in the unpatented staples, and the patentee's only apparent purpose in using the tie was to meter use of the machine for purposes of computing royalties.[48] Such a use "may or may not result in the engrossment of the market for staples," and there was no evidence that it did so in this case.[49]

Judge Lurton ignored the Supreme Court's concern with restraints on alienation and attempted to import a competition policy into the first sale doctrine by holding that a post-sale tying restraint ought to be unlawful only if it led to a monopoly in the tied product. Lurton's analysis is remarkably similar to the way the Supreme Court began assessing tying arrangements under the antitrust laws a generation later. Even in that case, Lurton suggested, the monopoly in fasteners would not be odious if it resulted from the superiority of the patentee's stapling machine.[50] Except for a possible

45. Heaton-Penninsular Button-Fastener Co. v. Eureka Specialty Co., 77 F. 288, 289–90 (6th Cir. 1896). The restriction read: "This machine is sold and purchased to use only with fasteners made by the Peninsular Novelty Company, to whom the title to said machine immediately reverts upon violation of this contract of sale." *Id.* at 290.

46. *Id.* at 292 ("If, then, the patentee has the exclusive right to the use of his invention or discovery, during the term of his patent, it would seem to follow that any use by another, unauthorized by the patentee, would be an infringement of his monopoly.").

47. *Id.* at 294.

48. *See id.* at 296 ("The fasteners are thus made the counters by which the royalty proportioned to the actual use of the machine is determined.").

49. *Id.*

50. *Id.* Judge Lurton did rely on the Supreme Court's decision in *American Cotton-Tie Co. v. Simmons*, 106 U.S. 89 (1882), in which the patentee sold metal ties

reference to restraints on trade, the opinion never cited the Sherman Act, which had been passed six years earlier.[51]

Judge Lurton was appointed to the Supreme Court in 1909 by President Taft, who had also been a Judge on the Sixth Circuit and had been on the panel with Judge Lurton in the *Button-Fastener* case. In 1912, Lurton wrote the Court's opinion in *Henry v. A.B. Dick Co.*, stating in a shorter version what he had said earlier in the *Button-Fastener* case.[52] In this case the patentee posted a license on its mimeograph copy machine requiring purchasers to use its paper, ink, and stencils exclusively. It sold a copy of the machine with the affixed license to Christina B. Skou, who subsequently purchased a can of ink from Sidney Henry, an office supply salesman, in violation of the restriction. The machine itself was sold at a price of cost or less, indicating that A.B. Dick was earning its profits from the tied supplies, and thus probably using the tie as a price discrimination device, effectively earning a higher rate of return from higher volume users.[53] The action was brought against Henry for

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for cotton bales with a printed restriction that they were authorized for a single use only. The defendant was in the business of salvaging the used ties and piecing them together for resale. The Supreme Court found infringement, but did not address the first sale issue. Rather, it held that the defendant's conduct in piecing the broken parts of the ties together constituted a reconstruction rather than a repair of the ties, and thus constituted patent infringement.

51. The possible reference is this passage:

> This brings us to consider the objections urged against the rather novel restrictions contained in the licenses granted by complainant. The very able counsel for appellees have urged very forcibly an argument based upon principles of public policy in respect of monopolies and contracts in restraint of trade, and have contended that public policy forbids a patentee from so contracting with reference to his monopoly as to create another monopoly in an unpatented article.

Id. at 292. The court rejected the contention with no further reference to the public policy against monopolies and contracts in restraint of trade, concluding that any monopoly created by the restriction was justifiably within the patent grant. *Id.* at 296.

52. Henry v. A.B. Dick Co., 224 U.S. 1 (1912), *overruled by* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917).

53. On this fact, see *Bauer & Cie v. O'Donnell*, 229 U.S. 1, 14–15 (1913) (characterizing the facts of *Henry*). When the dominant firm shifts the monopoly overcharge to a tied product that is used in variable proportions, the rate of return on the package increases as the number of units of tied product increases. For example, suppose that the machine is sold at cost, $100, while the can of ink costs $5 and is sold for $15. If a buyer takes one unit of the machine and one can of ink the return is 115(price)/105(cost), or 9.5%. If the buyers uses two cans of ink the return is 130/110, or 18%. If the buyer uses ten cans of ink the return is 250/150, or 67%. The premise underlying such schemes is that more intense users value the machine by a greater amount than less intense users. On the use of ties as price

contributory patent infringement.[54] Once again, Lurton distinguished conditional and unconditional sales and held that the first sale doctrine did not preclude enforcement of a restraint contained in a conditioned sale. The reasoning was mainly that, because the patentee could refuse to sell altogether, it could sell subject to any condition it pleased. The Court pointed out that no monopoly of the tied stencils, paper, and ink was in prospect:

> The stencil, the paper, and the ink made by the patentee, will continue to be unpatented. Anyone will be as free to make, sell, and use like articles as they would be without this restriction, save in one particular—namely, they may not be sold to a user of one of the patentee's machines with intent that they shall be used in violation of the license.[55]

In 1914 Congress responded to *Henry* by passing § 3 of the Clayton Act, which made anticompetitive ties unlawful whether the tying products were leased or sold, and whether they were patented or unpatented.[56] *Henry* was then resoundingly overruled by the Supreme Court in 1917 in the *Motion Picture Patents* decision, which is discussed later.[57] While the Court found support for its decision condemning the patent tie in the newly passed Clayton Act, the decision's analysis was based almost exclusively on the first sale doctrine.[58] *Motion Picture Patents* is one of many situations in which the Supreme Court commingled the first sale doctrine and antitrust concerns so as to produce a unitary policy.[59]

The second historical exception to first sale aggressiveness occurred more recently, when the Court of Appeals for the Federal Circuit revived Justice Lurton's attempt to make the doctrine turn

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discrimination devices, and impact on competition or consumers, see Hovenkamp & Hovenkamp, *supra* note 9.

54. Contributory infringement occurs when one knowingly aids or abets the infringement of someone else. 35 U.S.C. § 271(c) (2000). Contributory infringement is not specified in the Copyright Act but is a judge made rule with similar requirements. *See* Metro-Goldwyn-Mayer Studies, Inc. v. Grokster, Ltd., 545 U.S 913, 930–31, 940–41 (2005) (vacating summary judgment that did not find copyright contributory infringement); Sony Corp. of Am. v. Universal City Studios, Inc., 464 U.S. 417, 433 (1984) (finding fair use defense by consumers undermined contributory infringement claim against provider of videotape recorder).

55. *Henry*, 224 U.S. at 31–32.

56. 15 U.S.C. § 14, 38 Stat. 731 (Oct. 15, 1914).

57. *See* Motion Picture Patents Co. v. Universal Film Mfg Co., 243 U.S. 502, 518 (1917) ("[T]he decision in *Henry* must be regarded as overruled.") (citations omitted); *see also infra* notes 94–98 and accompanying text.

58. *See generally id.*

59. *See infra* notes 60–68 and accompanying text.

on realistic threats of monopoly.[60] The *Mallinckrodt* case once again distinguished "conditional" sales, which occur when the patentee places restrictions on the rights of purchasers, thus conveying away less than its entire patent interest in the article in question.[61] Because these conditions are couched in terms of the patentee's withholding of a portion of its patent rights, violations of the restrictions are regarded as patent infringements.[62] And because the first purchaser cannot transfer a larger interest than it owns, subsequent purchasers acquire the good subject to the same conditions and are also subject to patent infringement suits if the conditions are violated. Finally, this condition can be created either by agreement with the first purchaser, or simply by the patentee's attachment of a notice to the patented article. The only limitation the court found on this ability to condition sales of patented goods is that the condition may not be one that falls outside of the patent grant—meaning that the condition may not violate the antitrust laws, constitute patent misuse, or be contrary to public policy for some other reason.[63] In sum, the court created a patentee-initiated exception to the first sale doctrine for restraints that did not violate the antitrust laws or other competition policy.

In its 2008 *Quanta* decision the Supreme Court unanimously rejected the Federal Circuit's approach and restored the first sale rule to its original broad scope.[64] "The authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights and prevents the patent holder from invoking patent law to control post-sale use of the article."[65] The opinion failed to articulate any rationale for the doctrine other than naked precedent and stare decisis. The Court largely ignored the historical concern with restraints on alienation or the later concerns with competition policy. Following the views of the Solicitor General, it indicated that while conditions may be imposed at the time patented goods are sold, these must be done by means of license restrictions rather than conditional sales.[66] This means that the conditions can be enforced only by breach of contracts suits, not by infringement suits, and only against persons who are in privity with respect to the con-

60. Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700 (Fed. Cir. 1992), *abrogated by* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008).

61. *Id.* at 706–08; *see also* B. Braun Med., Inc. v. Abbott Labs., 124 F.3d 1419, 1426 (Fed. Cir. 1997).

62. *See, e.g.*, *Mallinckrodt*, 976 F.2d at 706–08.

63. *Id.* at 708.

64. Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 636–38 (2008).

65. *Id.* at 638.

66. *Id.* at 636–38.

tract that is being enforced. The Court expressed "no opinion on whether contract damages might be available even though exhaustion operates to eliminate patent damages."[67]

II. THE CONSISTENCY BETWEEN THE FIRST SALE DOCTRINE AND COMPETITION POLICY

The *Quanta* decision leaves the impression that the first sale doctrine never had anything to do with competition policy.[68] But that is hardly the case. Most of the first sale cases in the century between *Henry* (1912) and *Quanta* (2008) involved either resale price maintenance or tying. While after *Henry* the Supreme Court was consistent in its application of the first sale rule, it also invariably linked the first sale doctrine to antitrust policy. For example, the technical requirements of the first sale doctrine itself also identified the boundary of unlawful RPM. Like the first sale doctrine, the rule against RPM applied only when there was a sale of an object and then a qualifying resale; it did not apply to services, processes, or production licenses.[69] Whether tying law would also have tracked the first sale doctrine is difficult to say because § 3 of the Clayton Act intervened, making clear that antitrust tying rules applied to both sales and leases, and thus extending the range of antitrust into areas where the first sale doctrine would not apply.

The aggressiveness with which the first sale rule was applied during this period is hardly surprising, and is not inconsistent with the proposition that the Supreme Court had competition policy in mind in first sale decisions. During the same period, the Supreme Court was regularly hostile toward these same restraints when they were analyzed under either antitrust rules or misuse doctrine. Indeed, virtually every Supreme Court case that applied the first sale

67. *Id.* at 637 n.7. The Court quoted the following passage from *Keeler v. Standard Folding Bed Co.*, 157 U.S. 659, 666 (1895):

> Whether a patentee may protect himself and his assignees by special contracts brought home to the purchasers is not a question before us, and upon which we express no opinion. It is, however, obvious that such a question would arise as a question of contract, and not as one under the inherent meaning and effect of the patent laws.

68. The Court's only mention of the antitrust laws was a brief reference to the fact that the *Univis Lens* decision had contained an antitrust issue. *See Quanta*, 553 U.S. at 627 (discussing United States v. Univis Lens Co., 316 U.S. 241, 248–49 (1942)). Beyond that, the decision contains no discussion of competition policy.

69. *See infra* notes 148–59 and accompanying text.

doctrine would have come out the same way[70] under antitrust or, in procedurally appropriate circumstances,[71] misuse doctrine. Many of the decisions expressly referenced the antitrust laws as well, just as *Motion Picture Patents* did.[72] *Henry* was anomalous for two reasons: first, it deviated from Supreme Court first sale doctrine; second, it stood alone among Supreme Court decisions in its benign attitude toward patent tying arrangements—a position that was not to change until the late 1970s.[73]

Indeed, if the first sale doctrine does not find its purpose in either competition policy or innovation policy, then it is difficult to find any value for it other than precedent—a fact that did not trouble the Supreme Court in *Quanta*. Over history, most of the Supreme Court's decisions on the first sale doctrine have attached its rationale to competition policy. Most decisions that have applied the rule have involved either tying arrangements or RPM, and the Court was typically not very subtle about noting that the first sale rule and antitrust law pulled in tandem. This trend was exacerbated by the extraordinary difficulty that courts have had in understanding the economics of restricted distribution. Lacking a rationale for explaining why vertical restrictions were anticompetitive in the traditional sense of leading to reduced output and higher prices, antitrust itself imported from the first sale doctrine the common law's concern with restraints on alienation.

A. Tying and Resale Price Maintenance, 1908–1917

In its *Dr. Miles* decision, three years after *Bobbs-Merrill*, the Supreme Court cited both the first sale doctrine and the Sherman Act for the proposition that even an explicit RPM agreement between a manufacturer of a patent medicine and a retailer was contrary to legal policy.[74] The Court expressly incorporated the common law

70. That is, it would have refused to enforce the restriction—not that the first sale doctrine could justify an award of antitrust's treble damages under 15 U.S.C. § 15(a) (2006).

71. "Misuse" typically arises only as a defense to an infringement action. *See* Bohannan, *supra* note 21 (manuscript at 3).

72. *See infra* notes 97–98 and accompanying text.

73. The Supreme Court began to develop a more benign attitude toward tying in *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984) and *U.S. Steel Corp. v. Fortner Enters., Inc.*, 429 U.S. 610 (1977); *see also* AREEDA, ELHAUGE & HOVENKAMP, *supra* note 5, ¶ 1733.

74. Interestingly, by that time Justice Lurton, who recused himself from *Dr. Miles*, was already on record as believing that resale price maintenance was unlawful under the antitrust laws. While on the Sixth Circuit he had written the *Dr. Miles* decision, which the Supreme Court ultimately affirmed. *See* Dr. Miles Med. Co. v.

policy against restraints on alienation into its interpretation of the Sherman Act, quoting from *Coke upon Littleton*, an early seventeenth-century edition of a fifteenth century treatise on property law.[75] Even the *Schwinn* decision more than a half century later, which condemned a dealer distribution system that involved territo-

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John D. Park & Sons Co., 164 F. 803 (6th Cir. 1908), *aff'd*, 220 U.S. 373 (1911). Lurton rested the rationale on the fact that Dr. Miles medicines were not patented and that the resale price maintenance agreement was imposed by contract rather than license agreement. One important difference, Lurton observed, was that a patent is of finite duration while contracts can be extended indefinitely. As a result any monopoly thereby created would be more odious:

> Any other conclusion would be to sanction a monopoly in that class of goods vastly more far-reaching than the monopoly extended upon high grounds of public policy to the inventor. The statutory monopoly has a limitation of a few years. To obtain it the inventor must put on record his invention. At the end of the term the public will be free to employ the discovery without the burden theretofore imposed as a compensation to the inventor. Not so with the monopoly asked for by those who control the enormous proprietary trade of this country. Their monopoly will go on forever. . . .

See id. at 806. The strong implication was that if the medicines had been patented and the RPM carried out by patent license rather than distribution contract, Lurton would have applied his *Button-Fastener* and *Henry* analysis instead. In sum, for Lurton both tying and resale price maintenance were lawful if imposed on patent goods by means of a patent license. RPM was unlawful if imposed on unpatented goods by a simple contract. Soon-to-be Supreme Court Justice Van Devanter, while still on the Eighth Circuit, took that same position with respect to resale price maintenance, holding that an RPM restriction placed on a license to resell patented goods could be enforced by means of a patent infringement action. *See* Nat'l Phonograph Co. v. Schlegel, 128 F. 733 (8th Cir. 1904). By contrast, in *Dr. Miles* the Supreme Court found the resale price maintenance agreement to be fully covered by the first sale doctrine announced in *Bobbs-Merrill*. *See Dr. Miles*, 220 U.S. at 405 (analogizing to facts of *Bobbs-Merrill*, observing that Dr. Miles' medicines were neither patented nor copyrighted, and concluding that "It will hardly be contended, with respect to such a matter, that the manufacturer of an article of commerce not protected by any statutory grant is in any better case.").

75. The Court was referring to Lord Chief Justice Edward Coke's statement that if someone

> be possessed . . . of a horse or of any other chattel, real or personal, and give or sell his whole interest or property therein, upon condition that the donee or vendee shall not alien the same, the same is void, because the whole interest and property is out of him, so as he hath no possibility of a reverter; and it is against trade and traffic and bargaining and contracting between man and man.

Dr. Miles, 220 U.S. at 404–05 (quoting EDWARD COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND: A COMMENTARY UPON LITTLETON § 360 (London, W. Clarke 16th ed. 1809) (1628). The Court also referenced John Chipman Gray's RESTRAINTS ON ALIENATION OF PROPERTY, §§ 27, 28 (2d ed. 1895). *See supra* notes 31-32 and accompanying text. Gray's book never mentioned patented or copyrighted goods.

rial restraints, cited this "ancient rule against restraints on alienation" as a rationale for applying the antitrust laws.[76] *Schwinn* did not connect a policy limiting restraints on alienation to lower output or higher prices.

The Court finally repudiated this rationale for applying antitrust to distribution restraints in its 1977 *Sylvania* decision, which very largely brought an end to antitrust condemnation of nonprice distribution restraints.[77] During the interval from *Sylvania* to *Quanta*, the Supreme Court never considered a first sale case and thus never had the opportunity to decide whether more lenient treatment of vertical nonprice restraints also entailed some loosening of the first sale doctrine. In its *Leegin* decision in 2007, which overruled *Dr. Miles*, the Court rejected common law policies against restraints on alienation as a justification for the per se rule against RPM. Such rules, it said, reflected "formalistic line drawing" rather than "demonstrable economic effect."[78] By contrast, the *Quanta* decision a year later renewed the full-blown historical first sale doctrine with no mention of competition policy or, for that matter, any policy whatsoever except stare decisis.

Following the first sale doctrine, the Sherman Act created a second body of federal law that could be applied to anticompetitive restrictions on sale and use. While patents were not mentioned in the Act, its passage occurred during a milieu of growing hostility toward big business. Increasingly, patents came to be viewed as one of the principal vehicles by which large firms perpetuated and extended their power. Early in the twentieth century, both patent doctrine and antitrust law evolved more aggressive and focused rules to deal with perceived problems of patent overreaching. Much of this development occurred as a result of the reaction to the *Henry* deci-

76. United States v. Arnold, Schwinn & Co., 388 U.S. 365, 380 (1967) ("But to allow this freedom where the manufacturer has parted with dominion over the goods—the usual marketing situation—would violate the ancient rule against restraints on alienation and open the door to exclusivity of outlets and limitation of territory further than prudence permits."); *see also id.* at 391 (Stewart, J. concurring in part and dissenting in part) (citing Coke upon Littleton and accusing the majority of embracing a legal rule "merely on grounds of its antiquity").

77. Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 57–59 (1977).

78. Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 887 (2007) (quoting Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 59 (1977)).

sion, which had held that a post-sale tying condition on a patented good violated neither the first sale rule nor the Sherman Act.[79]

While *Henry*'s formal demise did not occur until after § 3 of the Clayton Act was passed in 1914, the Court largely undermined it and restored the original first sale doctrine in 1913 in a RPM case. In *Bauer*, decided a year after *Henry*, the Court held that the first sale doctrine precluded a firm from using a patent license restriction to impose RPM on a patented medicine called Sanatogen.[80] The restriction was printed on each package of the medicine with a warning that a violation would lead to a patent infringement action.[81] The Court had three choices: it could have followed *Bobbs-Merrill* by holding that the first sale doctrine rendered the RPM clause unenforceable, followed *Henry* by enforcing the restriction, or followed *Dr. Miles*, then only two years old, by holding that the license agreement amounted to an unlawful contract in restraint of trade.

The Court followed both *Bobbs-Merrill* and *Dr. Miles*. As far as the first sale doctrine was concerned, the Court noted that *Henry* had distinguished *Bobbs-Merrill* by observing that the Patent Act, unlike the Copyright Act, gave the patentee the exclusive right to "use" its invention, and the tying restriction was a restriction on how the machine could be used.[82] However, a price restriction is not a restriction on use; as a result, the sale of a unit of the drug deprived the patentee of any right to control the resale price of that unit.[83] With respect to *Dr. Miles*, the Court observed that it had declared that RPM agreements were contrary to public policy and unenforceable.[84] Of course, Congress had the power to create an exception in the Patent Act, but there was no evidence that it had done so. So *Bauer* was in fact a first sale decision, which observed consistency with the policy of the Sherman Act.

79. Henry v. A.B. Dick & Co., 224 U.S. 1, 11 (1912), *overruled by* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917); *see also supra* notes 54–57 and accompanying text.

80. Bauer & Cie v. O'Donnell, 229 U.S. 1, 17 (1913).

81. *Id.* at 8:

> This size package of Sanatogen is licensed by us for sale and use at a price not less than one dollar ($1). Any sale in violation of this condition, or use when so sold, will constitute an infringement of our patent No. 601,995, under which Sanatogen is manufactured, and all persons so selling or using packages or contents will be liable to injunction and damages.

82. *Id.* at 15.

83. *Id.* at 15–16.

84. *Id.* at 12.

The effective merger of the first sale rule and antitrust policy occurred in two decisions issued on the same day in April 1917. *Straus v. Victor Talking Machine* involved RPM, and the much better known *Motion Picture Patents* decision involved a tying arrangement.[85] The facts of *Straus* suggest a ham-handed attempt to evade *Dr. Miles*, which had condemned contractual RPM, and also *Bauer*, which had involved a post-sale restraint on the sale of a patented product, by using what purported to be a non-sale patent license instead. The patentee "licensed" a phonograph machine to dealers, together with the right to "sublicense" the machine to customers.[86] The license restrictions included both a tying clause requiring the use of the patentee's needles and other supplies, and also a clause stipulating the minimum price at which the machine could be transferred from dealers to customers.[87] While denominated a "license," these transfers of the phonograph resembled sales in every other respect. The patentee brought a patent infringement action against a New York merchant who undercut the stipulated price.[88]

The Court found that the scheme was "in substance, the one dealt with by this court in *Dr. Miles* . . . and in *Bauer*" and that the license language was a subterfuge to disguise what was in fact a sale.[89] It then declared the condition unenforceable, relying mainly on first sale cases extending back to *Adams v. Burke*.[90]

85. Straus v. Victor Talking Mach. Co., 243 U.S. 490 (1917); Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917).

86. *Straus*, 243 U.S. at 491.

87. *Id.* at 494–95.

88. *Id.* at 496.

89. *Id.* at 498.

90. *Id.* at 501 (citing Adams v. Burke, 84 U.S. (17 Wall.) 453, 456 (1873)); *see supra* notes 37–40 and accompanying text. A year later, in *Boston Store of Chicago v. American Graphophone Co.*, 246 U.S. 8 (1918), the Supreme Court struck down under the first sale doctrine a license restriction compelling resale price maintenance.

Since *Dr. Miles* had been written six years earlier, there was no question that a contract imposing resale price maintenance was unlawful and unenforceable. But the Supreme Court made clear that one could not accomplish the same purpose by means of a license restriction. In so doing it applied the orthodox first sale rule, that:

> by virtue of the patent law one who had sold a patented machine and received the price and had thus placed the machine so sold beyond the confines of the patent law, could not by qualifying restrictions as to use keep under the patent monopoly a subject to which the monopoly no longer applied.

Straus, 243 U.S. at 24. In a concurring opinion, Justice Brandeis protested that the legality of resale price maintenance "is an economic question" which requires analysis of the market facts. *Id.* at 28 (Brandeis, J., concurring).

Motion Picture Patents is far better known than *Straus*, and its language is a swirl of ideas that determined the future course of the first sale doctrine, misuse doctrine, and antitrust.[91] In 1914 an angry Congress responded to the *Henry* decision by passing § 3 of the Clayton Act, which condemned anticompetitive ties, including those involving patented tying products.[92] In *Motion Picture Patents* the Supreme Court overruled *Henry*. It also gave the first hints of what subsequently would become the doctrine of patent "misuse," an affirmative defense in a patent infringement action that occurs when a patentee is said to have expanded the scope of its patent improperly.[93]

Motion Picture Patents condemned an arrangement under which the seller of a theater motion picture projector limited its use to the showing of the seller's own films. The restriction was a lingering portion of a failed attempt by interests who owned Thomas Edison's projector and film patents[94] to monopolize the entire United States motion picture industry. The attempt even included blacklisting actors and actresses who had agreed to work on films produced by competitors of the Company.[95] By the time the Supreme Court decided the case, the monopoly had fallen apart. Nevertheless, the Clayton Act had been passed and the Court used *Motion Picture Patents* as an opportunity to state that the new statute "confirmed" its pre-*Henry* first sale cases.

91. Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917).

92. 15 U.S.C. § 14 (2006).

93. *See, e.g.*, Carbice Corp. v. Am. Patents Dev. Corp., 283 U.S. 27, 31–33 (1931) (finding tying of dry ice to patented ice box constituted misuse and rejecting patentee's attempt to distinguish *Motion Picture Patents* by pointing out that, as in *Henry*, tied products were essential to functioning of patented product); Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 489 (1942) (tying of salt to salt injecting machine used by canners resulted in misuse).

94. While not the earliest inventor, Edison was one of the earliest commercial developers of the sprocketed projector take up wheel and film with little holes on the side that engaged the sprocket, thus permitting the film to run smoothly and eliminating the jerkiness that often appeared in very early motion pictures. Ownership of the technology itself was disputed. *See* Charles Musser, *The Emergence of Cinema: The American Screen to 1907*, *in* HISTORY OF THE AMERICAN CINEMA 130–80, (Charles Harpole ed., Scribner's 1990).

95. For background history on the business practices of the motion picture industry, see MICHAEL CONANT, ANTITRUST IN THE MOTION PICTURE INDUSTRY: ECONOMIC AND LEGAL ANALYSIS 16–21 (1960); BENJAMIN B. HAMPTON, A HISTORY OF THE MOVIES (THE LITERATURE OF CINEMA) 8–11, 17–24, 34, 64–76, 79–81 (1931); LEWIS JACOBS, THE RISE OF THE AMERICAN FILM: A CRITICAL HISTORY, 1921–1947, at 81–85, 88, 164–65, 291–92 (1968).

Today *Motion Picture Patents* is widely treated as both an early patent "misuse" decision[96] as well as an antitrust decision.[97] In fact, its analysis is mainly of patent "exhaustion," or first sale. As the Court wrote:

> [T]he right to vend is exhausted by a single, unconditional sale, the article sold being thereby carried outside the monopoly of the patent law and rendered free of every restriction which the vendor may attempt to put upon it. The statutory authority to grant the exclusive right to 'use' a patented machine is not greater, indeed, it is precisely the same, as the authority to grant the exclusive right to 'vend,' and, looking to that authority, for the reasons stated in this opinion, we are convinced that the exclusive right granted in every patent must be limited to the invention described in the claims of the patent, and that it is not competent for the owner of a patent, by notice attached to its machine, to, in effect, extend the scope of its patent monopoly by restricting the use of it to materials necessary in its operation, but which are no part of the patented invention, or to send its machines forth into the channels of trade of the country subject to conditions as to use or royalty to be paid, to be imposed thereafter at the discretion of such patent owner. The patent law furnishes no warrant for such a practice, and the cost, inconvenience, and annoyance to the public which the opposite conclusion would occasion forbid it.[98]

96. *See* AREEDA, ELHAUGE & HOVENKAMP, *supra* note 5, ¶ 1781; HERBERT HOVENKAMP, MARK D. JANIS, MARK A. LEMLEY & CHRISTOPHER R. LESLIE, IP AND ANTITRUST: AN ANALYSIS OF ANTITRUST PRINCIPLES APPLIED TO INTELLECTUAL PROPERTY LAW, ch. 3 (2d ed. 2010); ROBERT P. MERGES, PETER S. MENELL & MARK A. LEMLEY, INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE 331 (rev. 4th ed. 2007) (reprinting *Motion Picture Patents* as a misuse decision in the casebook); Bohannan, *supra* note 21 (manuscript at 4); Thomas F. Cotter, *Misuse*, 44 HOUS. L. REV. 901, 904–06 (2007).

97. *See* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 517–18 (1917). In *Motion Picture Patents*, the Court stated it was "confirmed" in its conclusion by the recently passed § 3 of the Clayton Act; its conclusion on the first sale doctrine, however, made it "unnecessary to make the application of this statute to the case at bar." *Id.* at 517. Nevertheless, the Clayton Act provision was "a most persuasive expression of the public policy of our country with respect to the question before us." *Id.*

98. *Id.* at 515–16.

B. The First Sale Rule in the Development of Modern Competition Policy

As they became more refined and technical, the developing doctrines of exhaustion, antitrust, and misuse all addressed practices thought to be anticompetitive, such as tying, but they also moved in different directions. Briefly:

The first sale rule, which was entirely judge-made in patent and added to the copyright statute only in 1976,[99] applied only to sales of the patented or copyrighted good. The remedy was non-enforcement of the restriction, or alternatively, a defense to an infringement action for violating the restriction. As the Supreme Court summarized the doctrine in its recent *Quanta* decision, the rule applies without any inquiry into either competitive effects or innovative restraint.[100]

Misuse, another judge-made doctrine that was not fully developed until the 1942 *Morton Salt* decision,[101] could apply to both sales and leases of a patented good as well as licenses; thus it applied in many situations when the first sale doctrine would not. Misuse served as a defense to an infringement action, but under *Morton Salt* the patent became unenforceable against all infringers until such time as the misuse was purged. The law developed antitrust-like criteria for determining when patent misuse occurs, although current law reaches more broadly in copyright misuse cases.[102]

If the appropriate anticompetitive effects are shown, a restraint can also violate the antitrust laws, passed by statute in 1890[103] and 1914,[104] and provide the basis for an affirmative challenge by the government in an equity case or by private plaintiffs seeking treble

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99. In copyright, Congress addressed the problem by expressly permitting parties to contract around the first sale doctrine, but then limiting the parties to contract remedies if they do so. *See* 17 U.S.C. § 109(a) (2006) (stating first sale doctrine); House Committee, Notes accompanying section 109(a), Notes of Comm. on the Judiciary, H.R. REP. NO. 94-1476, at 79 (1976), *reprinted in* 1976 U.S.C.C.A.N. 5659, 5693; *see generally* Bohannan, *supra* note 1; David A. Rice, *Licensing the Use of Computer Program Copies and the Copyright Act First Sale Doctrine*, 30 JURIMETRICS J. 157 (1990) (discussing copy use license agreements as a method to contract around the first sale doctrine).

100. Quanta Computer, Inc. v. LG Elecs, Inc., 553 U.S. 617, 630 (2008).

101. Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 490 (1942).

102. For more information on the scope of misuse, see Bohannan, *supra* note 21.

103. Sherman Act, ch. 647, §§ 1–7, 26 Stat. 209, 209–10 (current version at 15 U.S.C. §§ 1–7 (2006)).

104. Primarily section 3 of the Clayton Act. Clayton Act, ch. 323, § 3, 38 Stat. 730, 731 (1914) (current version at 15 U.S.C. § 14 (2006)).

damages or an injunction. The Clayton Act provision applies equally to the sale of patented products, leases, and to licenses.[105]

In subsequent legal development, patent misuse law loosely tracked antitrust principles.[106] Patent misuse has been a broader concept in the case law, however, particularly in that of the Federal Circuit,[107] and copyright misuse is broader still.[108] The first sale doctrine has never been cabined in this way, and under *Quanta* applies without any query into harmful effects. So the operative distinctions are that the first sale doctrine is substantively broader, reaching even conditions not seen as anticompetitive or in violation of antitrust law or as restraints on innovation. However, the doctrine is more limited in the sense that it applies only to the authorized sale of a patented or copyrighted article, not to leases or licenses.

105. *See, e.g.*, Int'l Salt Co. v. United States, 332 U.S. 392 (1947) (condemning salt tie); Int'l Bus. Machs. Corp. v. United States, 298 U.S. 131 (1936) (condemning a lease requiring the lessees of tabulating machines to use the lessor's punch cards).

106. *See, e.g.*, AREEDA, ELHAUGE & HOVENKAMP, *supra* note 5, ¶ 1781 (advocating a relatively close adherence to antitrust principles); HOVENKAMP, JANIS, LEMLEY & LESLIE, *supra* note 96, ch. 3, § 3.2 (noting that misuse doctrine is largely coextensive with antitrust doctrine, though the Federal Circuit has held misuse doctrine to be broader); Cotter, *supra* note 96, at 949–59 (arguing that misuse should follow antitrust principles). *But see* Bohannan, *supra* note 21 (manuscript at 46) (arguing that misuse should apply when there is an antitrust violation, an unreasonable restraint on innovation, or an unreasonable sequestering of public domain information or technology).

107. *See, e.g.*, Princo v. Int'l Trade Comm'n, 616 F.3d 1318, 1329 (Fed. Cir. 2010) (en banc) (finding proof of an antitrust violation insufficient to show misuse where the conduct was not actually outside scope of the patent grant); Senza-Gel Corp. v. Seiffhart, 803 F.2d 661, 668 (Fed. Cir. 1986) (finding potential misuse for tying even though antitrust's "separate products" requirement was not met); *cf.* Transitron Elec. Corp. v. Hughes Aircraft Co., 487 F. Supp. 885, 892 (D. Mass. 1980) ("[P]atent misuse may be seen as having a less stringent standing requirement and a lesser burden of proof than an antitrust claim."), *aff'd*, 649 F.2d 871 (1st Cir. 1981). *Contra* USM Corp. v. SPS Techs., 694 F.2d 505, 511–12 (7th Cir. 1982) (finding patent misuse should be addressed under antitrust principles), *cert. denied*, 462 U.S. 1107 (1983).

108. *See, e.g.*, Apple, Inc. v. Psystar Corp., No. C 08-03251 WHA, 2009 WL 303046, at *4–5 (N.D. Cal. Feb. 6, 2009) (recognizing possible copyright misuse claim even though antitrust claim had been dismissed); Assessment Techs. of Wis., LLC v. WIREdata, Inc., 350 F.3d 640, 647 (7th Cir. 2003) (suggesting copyright misuse could be found without an antitrust violation); Lasercomb Am., Inc. v. Reynolds, 911 F.2d 970, 978–79 (4th Cir. 1990) (finding copyright misuse without any corresponding violation of antitrust law); *see also* Bohannan, *supra* note 21 (manuscript at 13–14).

The result is far too much doctrine, pointing in too many different directions. Further, the first sale doctrine fails to address in any comprehensive way the two policy concerns that should be fundamental to the analysis of such restraints. First, they must not impair competition unreasonably, with "competition" defined as the state of affairs when prices are kept close to cost and output is maximized. Second, they must not serve unreasonably to restrain innovation or sequester the public domain. Antitrust policy is concerned with competition but has had great difficulty developing good theory about when such restraints are anticompetitive. By contrast, both the first sale rule and IP misuse are thought of as developing within IP, where the underlying goal is to further innovation. But facilitation of innovation has never been articulated as a goal of first sale doctrine.

In its pre-*Quanta* case law the Supreme Court had developed rationales for the first sale doctrine other than limiting restraints on alienation. These concerns then bled into both antitrust policy and the IP law of foreclosure.

1. Multiple Royalties and Leveraging

One historical concern that the courts raised in first sale cases was that permitting the patentee to place post-sale license restrictions on patented goods would entitle the patentee to collect multiple royalties. This concern appeared and reappeared in the law of the first sale doctrine and later merged into both the doctrine of patent misuse and the antitrust law of tying arrangements. As early as 1863 the Supreme Court declared that the first sale doctrine was essential because patentees:

> are entitled to but one royalty for a patented machine, and consequently when a patentee has himself constructed the machine and sold it, or authorized another to construct and sell it, or to construct and use and operate it, and the consideration has been paid to him for the right, he has then to that extent parted with his monopoly, and ceased to have any interest whatever in the machine so sold or so authorized to be constructed and operated.[109]

109. Bloomer v. Millinger, 68 U.S. 340, 350 (1863); *see also* United States v. Masonite Corp., 316 U.S. 265, 278 (1942) (determination of exhaustion rests on "whether or not there has been such a disposition of the article that it may fairly be said that the patentee has received his reward for the use of the article").

That concern was most recently stated by the now vindicated district court decision in *Quanta,* which justified the first sale doctrine as prohibiting "double" royalties.[110]

This concern about double monopoly profits was largely the same as the concern that drove patent tying misuse cases, as well as those involving contractual extensions of royalty-like payments. For example, in the *Carbice* decision, which applied the first sale doctrine but was treated later as a misuse case, Justice Brandeis opined that a patentee's tie of a refrigerated transport box to its dry ice refrigerant was bad because it enabled the patentee to earn a monopoly profit not merely on the box but also on the unpatented ice.[111] And in *Brulotte v. Thys,* which applied patent misuse doctrine, Justice Douglas declared that contracts requiring post-expiration payments akin to royalties were bad because they enabled the patentee to multiply the amount of royalties that it could receive: "[T]o use that leverage [of the patent] to project those royalty payments beyond the life of the patent is analogous to an effort to enlarge the monopoly of the patent by tying the sale or use of the patented article to the purchase or use of unpatented ones."[112]

In the 1950s, this leverage theory of monopoly tying was largely discredited by Chicago School writers, who showed that a monopolist of a product that uses complements or that is subject to further downstream sales can earn all of the available monopoly profits in

110. LG Elecs., Inc. v. Asustek Computer, Inc., No. C 01-00326 CW, 2002 WL 31996860, at *4 (N.D. Cal. Aug 20, 2002) (first sale doctrine "designed to prevent a patentee from receiving a double royalty on a single patented invention"), *clarified by* 248 F. Supp. 2d 912 (N.D. Cal. 2003), *rev'd sub nom.* LG Elecs., Inc. v. Bizcom Elecs., Inc., 453 F.3d 1364 (Fed. Cir. 2006), *rev'd sub. nom.* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008). On the question of whether a sale was "authorized," see *Gen. Talking Pictures Corp. v. W. Elec. Co.*, 305 U.S. 124, 126 (1938) ("[A]s [buyer] ordered, purchased and leased [patented products from licensee] knowing [licensee was not authorized to sell for that purpose], [buyer] also was an infringer.").

111. Carbice Corp. v. Am. Patents Dev. Corp., 283 U.S. 27, 31–32 (1931) (internal citations omitted) (opining that patent tie enabled

> [T]he patent-owner to "derive its profit, not from the invention on which the law gives it a monopoly, but from the unpatented supplies with which it is used" [and which are] "wholly without the scope of the patent monopoly." If a monopoly could be so expanded, the owner of a patent for a product might conceivably monopolize the commerce in a large part of [the] unpatented materials used in its manufacture. The owner of a patent for a machine might thereby secure a partial monopoly on the unpatented supplies consumed in its operation.).

112. Brulotte v. Thys Co., 379 U.S. 29, 33 (1964).

the initial sale of the primary monopoly product itself.[113] Or to say this differently, in any multi-stage distribution chain there is but a single monopoly profit to be earned. For example, customers' willingness-to-pay for the ice box in the *Carbice* case is a function of their willingness-to-pay for the ice box and dry ice combination. One who sells both products together can charge the monopoly price for one or the other or spread it over some combination of the two. But it cannot charge the full monopoly price for the box, predicated on a competitive price for the ice, and then charge a second monopoly price for the ice.

The first sale doctrine was historically justified by a variation of the leverage theory, but the Chicago School showed that one who owns a patented good subject to subsequent downstream resales or uses as a component in another product can charge a price in the primary transaction that gives it the full markup that is available from downstream purchasers or other users. To illustrate, suppose the patentee sells a patented microprocessor to Alpha Company, which places the chip on a memory circuit board and then sells the board to Beta Company, which installs the board as a component in a computer.[114] The patentee might be able to collect a $5 royalty from Alpha and use the license restriction to obtain an additional $3 royalty from Beta. Alternatively, it could charge the entire $8 markup to Alpha, who presumably would pass on the $3 charge in its transaction with Beta. But assuming that the profit-maximizing value of the royalties in this distribution chain is $8 for a single monopolist, the patentee could not profitably charge an $8 royalty to Alpha *plus* the $3 royalty to Beta. The first sale doctrine would require the patentee to obtain the entire $8 royalty charge from Alpha, leaving Alpha free to charge whatever it needed to in its secondary transaction with Beta, but the profit earned by patentee is substantially the same either way.

113. *See, e.g.*, Ward S. Bowman Jr., *Tying Arrangements and the Leverage Problem*, 67 YALE L.J. 19 (1958); *see also* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE §10.6a (3d ed. 2005). For a recent attempt to restore a version of the leverage theory, see Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397, 409–10, 431 n.89 (2009). For a reply defending the established arguments against leveraging, see Hovenkamp & Hovenkamp, *supra* note 9.

114. The facts loosely track those of the *Quanta* decision. *See* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 623–24 (2008).

2. Transaction Costs, Holdup, and Notice

In the simple story the first sale doctrine reduces downstream transaction costs: the patentee obtains its entire $8 in its initial transaction with Alpha, the first purchaser. If it obtains only $5 from Alpha it must then search out Beta, who purchases subsequently from Alpha, in order to collect the additional $3 of royalty that its patent position makes available. Further, the firms in Beta's position might be numerous and perhaps hard to identify. Indeed, spreading out the royalty obligation can create information costs on both sides. First, it may be difficult and costly for the patentee to identify the firms in Beta's position—certainly more difficult than simply charging the full royalty in the initial transaction with Alpha. Of course, to the extent this is a problem it seems to be self-correcting. Why would the patentee divide its royalty between Alpha and the Betas if it believed it would ultimately not be able to find and collect the full value of the Betas' royalty obligations? It would accordingly charge the full royalty to Alpha and leave Alpha to pass on whatever it could in its transactions with Beta.

The story on the other side of the transaction is somewhat different, particularly in a market in which license terms are difficult to discover. Suppose that the patentee assesses the post-sale license requirement in its initial transaction with Alpha but that subsequent Betas purchasing from Alpha do not all have notice of the restriction. They may pay Alpha too much because they find out only after the transaction has been consummated that they also owe $3 to the patentee. The fact that subsequent purchasers did not know about the restriction is generally not a defense in a patent infringement action.[115] As a result, they will take more of the patentee's chip than they would otherwise have purchased, or they may forego a rival's chip that would have been a better choice had they known the true cost of this patentee's chip.

An ineffectively communicated post-sale restriction can yield overconsumption by indirect purchasers because they did not have adequate notice of the restriction at the time they purchased the technology. This problem is potentially quite serious given that patent licenses, as opposed to patents themselves, are not recorded

115. Patent liability is a strict liability offense and lack of knowledge of the patent is not a defense; in cases of license restrictions, it essentially means the potential infringer has no license and therefore is guilty of infringement. *Cf.* Mark A. Lemley, *Should Patent Infringement Require Proof of Copying?*, 105 MICH. L. REV. 1525 (2007); Samson Vermont, *Independent Invention as a Defense to Patent Infringement*, 105 MICH. L. REV. 475 (2006); Carl Shapiro, *Prior User Rights*, 96 AM. ECON. REV. 92 (2006).

and publicized in a searchable form.[116] If the patentee can catch downstream violators by surprise it will be in a position to extract much higher royalty rates than it could if the infringement notification were more timely.[117] For example, computer assemblers selecting components from Intel without notice of the conditional sale from LG to Intel would make that choice on the premise that all IP rights necessary for the use of such products traveled with the sale. That would affect their decision to use Intel components rather than those of a rival. However, they might find out later that they owe another royalty to LG, only after they have made structural commitments to Intel's technology.

One reason for post-sale infringement claims, as in the *Quanta* case, may be to defer royalty negotiation until after the purchaser has made a commitment from which reversal is costly. If the patentee were required to charge its full royalty to the initial purchaser, who is uncommitted as to technology and in competition with others, then the royalty charged would reflect quite a different set of market realities.[118]

But this problem can be addressed by making timely notice a condition of enforcement, which was the approach that Justice Lur-

116. *See* Mark A. Lemley & Nathan Myhrvold, *How to Make a Patent Market*, 36 HOFSTRA L. REV. 257, 257 (2008); Mark A. Lemley & Carl Shapiro, *Patent Holdup and Royalty Stacking*, 85 TEX. L. REV. 1991, 2022 (2007); Richard H. Stern, *Post-Sale Patent Restrictions After Mallinckrodt – An Idea in Search of Definition*, 5 ALB. L.J. SCI. & TECH. 1, 12–19 (1994).

117. The situation is analogous to the patent holdup problem that occurs when a participant in a standard setting process surreptitiously files patent continuations on a previously existing patent, writing on technology that the standard setting organization is in the process of adopting, and surprising them with its patent after participants are locked in. *See, e.g.*, Rambus, Inc., No. 9302, 2006 WL 2330117 (F.T.C. Aug. 2, 2006), *vacated*, 522 F.3d 456 (D.C. Cir. 2008), *cert. denied*, 129 S. Ct. 1318 (2009); *see also* Hynix Semiconductor Inc. v. Rambus, Inc., 527 F. Supp. 2d 1084, 1103 (N.D. Cal. 2007) (refusing to strike pre-trial jury demand with respect to above described claims); Union Oil Co. of Calif., No. 9305, 2004 FTC LEXIS 115 (F.T.C. July 7, 2004) (discussing liability for misrepresentations made to a state agency in the process of promulgating standards); PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 712 (3d ed. 2008); JAMES BESSEN & MICHAEL J. MEURER, PATENT FAILURE: HOW JUDGES, BUREAUCRATS, AND LAWYERS PUT INNOVATORS AT RISK 62–65 (2008); Mark A. Lemley & Kimberly A. Moore, *Ending Abuse of Patent Continuations*, 84 B.U. L. REV. 63, 79 n.62 (2004).

118. *Cf.* FED. TRADE COMM'N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY, ch. 2, at 29 (2003), *available at* http://www.ftc.gov/os/2003/10/innovationrpt.pdf ("If . . . [a] producer learns that it has infringed a patent only after it has committed sunk costs to its . . . production—and [is] thus locked in to the effort—the patentee may be in a position to demand supra-competitive royalty rates.").

ton took for the Supreme Court in *Henry*. Although the Court set the first sale rule aside under the circumstances of that case, he limited infringement actions to situations where the purchaser had "notice that he buys with only a qualified right of use. He has a right to assume, in the absence of knowledge, that the seller passes an unconditional title to the machine, with no limitations upon the use . . . ."[119] As noted later, the law of real property servitudes requires either privity of contract or effective and timely notice as a prerequisite to enforcement,[120] and IP law should do the same.

In *Henry*, as in *Motion Picture Patents*, a notice of the requirement that purchasers of the machine use only the patentee's aftermarket products was attached to the machine,[121] so one can assume that the original purchaser of the machine had notice. Subsequent purchasers probably had notice as well, assuming that the notice had not been removed. What made *Henry* interesting, however, was that Henry himself was not a purchaser of the machine at all, but rather a stationer who sold ink to the machine's owner with knowledge and the "expectation" that the ink would be used in the machine in conflict with the notice restriction.[122] That makes the *Henry* facts a little unusual, because ordinarily an office supply store selling ink would not be in a position to know what kind of notice is printed on an ink-consuming machine back at the purchaser's office. A breach of contract action against *Henry* would not have worked, since he was not in privity of contract with A.B. Dick. Presumably, the Supreme Court would not have permitted A.B. Dick to pursue its infringement claim in the more typical case where the seller of a commodity had no knowledge of precisely how it was going to be used. However, the law of contributory infringement, unlike the law of direct infringement, does require notice, and clearly did so require when *Henry* was decided.[123]

In *Adams*, where the Supreme Court first developed the first sale rule, it did not discuss notice, although the lower court ap-

119. Henry v. A.B. Dick Co., 224 U.S. 1, 26 (1912), *overruled by* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917); *see also supra* text accompanying notes 56–60.

120. *See infra* notes 132–34 and accompanying text.

121. *Henry*, 224 U.S. at 11.

122. *Id.* at 11–12.

123. *See* 35 U.S.C. § 271(c) (2006). On the requirement in the early twentieth century, see *Cortelyou v. Charles E. Johnson & Co.*, 145 F. 933, 935–37 (2d Cir. 1906) (dismissing contributory infringement claim because defendant lacked notice of restriction), *aff'd*, 207 U.S. 196 (1907).

peared to assume that notice existed.[124] In *Bobbs-Merrill*, which applied the first sale rule, the license restriction limiting the resale price was printed in the copies of each book, so the subsequent seller clearly had notice of it, as the Court's opinion observed.[125] In the Federal Circuit's more recent *Mallinckrodt* decision, more or less following *Henry*, the infringement defendant had actual knowledge of the "single use only" restriction that it violated.[126] Because notice was not in dispute the court left for another day the question of what type of notice would be sufficient; clearly, however, it assumed that notice of some type was necessary.[127]

Most recently, in *Quanta* the first purchaser of the patented chip, Intel, had signed an agreement with the patentee promising to give notice to its own downstream purchasers about the restriction on use of the patented product in conjunction with non-Intel parts.[128] The Court also observed that Quanta, the downstream purchaser against whom the post-sale restraint would have been imposed, purchased with actual notice of the restriction.[129] The Court applied the first sale doctrine and refused to enforce the restraint notwithstanding the notice.[130]

To the extent that post-sale restraints have any social value, the first sale rule seems to be an excessive way of addressing any problem of lack of notice and the patent holdup that results. A much better solution would be to give the patentee the incentive to ensure that any person upon whom a post-sale restraint will be imposed has notice of the restraint prior to making a commitment from which extraction would be costly. The Federal Circuit recently adopted such an approach in a different setting, holding that one who lied about patents during a standard setting process in which its patented technology was adopted would later be equitably

124. *See* Adams v. Burke, 84 U.S. (17 Wall.) 453 (1873); Adams v. Burks, 1 F. Cas. 100 (C.C. Mass. 1871) (No. 50); *see also supra* notes 37–43 and accompanying text.

125. Bobbs-Merrill Co. v. Straus, 210 U.S. 339, 342 (1908)*; see also supra* notes 40–42 and accompanying text. The Supreme Court's brief opinion in *Cortelyou v. Charles Eneu Johnson & Co.*, 207 U.S. 196 (1907), dismissed an infringement suit whose facts were similar to *Henry*, because the defendant lacked notice of the restriction. The action was one of contributory infringement, however, which has its own independent notice requirement. *See id.* at 199.

126. Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 706–08 (Fed. Cir. 1992)

127. *Id.* at 706.

128. *See* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 623–24 (2008).

129. *Id.* at 624.

130. *Id.* at 637–38.

stopped from asserting those patents against the covered standard.[131] In the first sale context, the patentee would not be able to maintain its infringement suit against a subsequent purchaser or another who did not have objectively reasonable notice. If the original purchaser breached an agreement to provide notice to downstream purchasers, then the appropriate remedy would be a breach of contract action against the first purchaser.

The real property law of servitudes has coped quite well with a land use system that recognizes the value of both contract and remote (i.e., nonprivity) claims as enforcement vehicles. For example, suppose I sell you a parcel of land adjacent to my house, and impose on it a post-sale restraint that the land never be used for commercial purposes. This restriction can be enforced either as a "real covenant" or an "equitable servitude." The classic law of real covenants is contractual in nature and depends on privity—either privity of contract if the agreement is being enforced between the original parties, or "privity of estate," which acts as a substitute when one of the parcels of land has been transferred. For example, if you resold the parcel to X, who then began building a gasoline station on the property, I could enforce the covenant against X by showing that the restriction is contractual and that the transfer of the land from you to X created privity of estate between X and me, which would then substitute for privity of contract.[132]

However, privity would not be necessary if I had placed the no-commercial-use covenant in the deed and the deed had been properly recorded. In that case the restriction could be enforced as an equitable servitude against anyone with actual or constructive notice of the restraint, and privity would not matter.[133] Most courts hold that the servitude must be properly recorded in the chain of title of all persons against whom subsequent enforcement is sought.[134] The reasoning is fairly simple: it is much cheaper to record an interest in a known chain of title than it is to search many

131. Qualcomm, Inc. v. Broadcom Corp., 548 F.3d 1004 (Fed. Cir. 2008).

132. *See, e.g.*, SHELDON F. KURTZ & HERBERT HOVENKAMP, AMERICAN PROPERTY LAW 623–755 (5th ed. 2007).

133. Trustees of Columbia Coll. v. Lynch, 70 N.Y. 440 (1877) (enforcing recorded agreement between predecessors in title to build only single family homes on their respective lots, notwithstanding lack of privity); *see also* KURTZ & HOVENKAMP, *supra* note 132, at 623–755.

134. *See, e.g.*, Genovese Drug Stores, Inc. v. Conn. Packing Co., 732 F.2d 286, 290 (2d Cir. 1984); Witter v. Taggart, 577 N.E.2d 338, 340–41 (N.Y. 1991); Basore v. Johnson, 689 S.W.2d 103, 109 (Mo. Ct. App. 1985). For the analogy to patents, see Herbert Hovenkamp, *Notice and Patent Remedies*, 88 TEXAS L. REV. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596789.

unknown ones. The same reasoning can be applied in the IP context. For example, the purchaser of a coffin would have to track down every patent covering it, determine whether the patent was still enforceable, and then query whether in some prior transfer to a component manufacturer the patentee had imposed a post-sale restraint.

If post-sale restraints serve potentially valuable functions and the only objection to post-sale restraints is that they can take subsequent users or purchasers by surprise, a notice requirement seems much more suitable to the problem than the more draconian route of forbidding such restraints altogether.

3. Intermediate Technology Transfers and Method Patents

Even under the expansive definition of the first sale doctrine revitalized in *Quanta*, not every post-transfer restraint on IP is unenforceable. The doctrine may not apply to "intermediate" transfers of IP rights, in particular when the transfer does not include any patented article at all, but only a license to manufacture.

Under the logic of the Supreme Court's first sale decisions, when the patentee sells a patented article it gives up its power as to that particular unit and only that unit. The patentee still controls the patent and other copies of the article that it may choose to make. By contrast, when the patentee licenses production rights to someone else there is no inherent limit on the number of patented articles that the licensee can make or what their disposition will be. That means that post-transfer conditions are essential and generally enforceable, including by means of infringement actions, unless they are anticompetitive or in violation of patent policy. However, the transfer of a single unit of a good subject to a further process covered by a method patent is still no more than a transfer of a single unit, and the scope of the restraint is limited accordingly.[135]

Under these principles:

1. Under the first sale doctrine, when a finished patented article is sold to the first purchaser the patentee's interests in

135. United States v. Univis Levins Co., 316 U.S. 241, 250–51 (1942) (holding that sale of uncompleted article together with implied license to method patent to finish it exhausted patentee's right "so far as it is or may be embodied in that particular article"). Contrast this with the Federal Circuit's rather categorical holding that method patents are not subject to exhaustion, LG Elecs., Inc. v. Bizcom Elecs., Inc., 453 F.3d 1364, 1370 (Fed. Cir. 2006) (relying on Glass Equip. Dev., Inc. v. Besten, Inc., 174 F.3d 1337, 1341 n.1 (Fed. Cir. 1999)), *rev'd sub nom.* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008); Bandag, Inc. v. Al Bolser's Tire Stores, Inc., 750 F.2d 903, 924 (Fed. Cir. 1984).

that copy of the article are at an end; any limitations on further disposition of the article are governed by contract law and state public policy concerning restraints on alienation.

2. When the patentee sells an unfinished article that requires application of the patentee's method patents in order to make that particular copy of the article useable or marketable the first sale doctrine also applies. Further, both the technology embodied in the article and the process patents needed to finish it are exhausted as to that copy. That is the only way to make sense of the Supreme Court's conclusion in *Quanta* that the first sale decision applies to method patents.[136] One way to view this problem is to say that the sale of the unfinished good requiring further application of the defendant's patented method carries with it an implied license to the purchaser to finish that particular copy of the good, and exhaustion applies to both the article and the attached method license.[137]

3. When the subject of the license is not a finished or semi-finished article but rather a general license to use the patentee's method, process, or technology to produce articles "in gross," the first sale doctrine does not ordinarily apply to the licensing of the process itself. However, if the patentee places restraints on the disposition of articles made by the licensee under the patent, the sale of those goods exhausts the patent with respect to them; that is, authorized sales of the article by the licensee are also subject to exhaustion with respect to the article sold.

These rules rest on principles that date back to Blackstone's distinction between land interests "appurtenant" and "in gross," particularly in relation to commons property. As Blackstone observed, if farmers share grazing rights on commons that is appurtenant to their own farms, then their use is naturally limited: they cannot graze more cattle on the commons than their own farms support. However, if they own commons "in gross," or personally, then there is no natural limit on their use of the common right, and artificial limits have to be imposed.[138]

136. *See Quanta*, 553 U.S. at 628–29 (2008).

137. *Cf.* Julia E. Cohen & Mark A. Lemley, *Patent Scope and Innovation in the Software Industry*, 89 CAL. L. REV. 1, 30–35 (2001) (discussing implied licenses and exhaustion in the context of reverse engineering).

138. *See* 3 WILLIAM BLACKSTONE, COMMENTARIES *237–38:

> Another disturbance of common is by surcharging it; or putting more cattle therein than the pasture and herbage will sustain, or the party hath a right to do. In this case he that surcharges does an injury to the rest of the owners, by

Blackstone's distinction is applied today in the law of real property easements and covenants. An easement appurtenant is attached to and benefits a particular piece of land and cannot be used except to benefit that land.[139] By contrast, an easement in gross is personal to the grantor, creating the possibility of excessive use. The common law responded by making easements in gross indivisible,[140] while an easement appurtenant could be divided when the dominant estate to which it was attached was divided.[141]

The sale of an unfinished article along with the implied license to finish it is akin to an easement appurtenant, which creates a license to improve or finish, but only with respect to the article being transferred. By contrast, the mere license of the right to make a good is incorporeal and could be used without limit unless limits are expressly attached to it. The first sale rule properly applies to the sale of the unfinished good with the single use license because the only thing that is taken from the patentee is the patent protection with respect to that unit. Exhaustion does not properly apply to the incorporeal interest, however, because once the interest is created there is nothing inherent in it that prevents the licensee's rights from swallowing up the whole. In *Adams v. Burke*, for example, the patentee could license another to manufacture coffin lids and place any territorial limits he pleased. That is the way a patentee could organize production in conjunction with its licensee.[142] But he could not sell a finished lid subject to a territorial limitation on where it could be used, and if the lid were unfinished and required a patent license in order to finish it, he could not place a

depriving them of their respective portions, or at least contracting them into a smaller compass. This injury by surcharging can properly speaking only happen, where the common is appendant or appurtenant, and of course limitable by law; or where, when in gross, it is expressly limited and certain: for where a man hath common in gross . . . he cannot be a surcharger.

139. *See, e.g.*, Penn Bowling Recreation Center v. Hot Shoppes, Inc., 179 F.2d 64, 66 (D.C. Cir. 1949) (applying common law rule forbidding owner of an easement in gross from using it to benefit lands other than the dominant estate).

140. *See, e.g.*, Miller v. Lutheran Conference & Camp Ass'n, 200 A. 646, 651 (Pa. 1938). The classic discussion is *Lord Mountjoy's Case*, [1583] 78 Eng. Rep. 11 (K.B.), which held that an interest in gross could not be divided unless the multiple parties operated it as "one stock," that is, a single enterprise such as a joint venture or partnership. For a detailed application of the decision in the United States, see *Chandler v. Hart*, 119 P. 516, 520–22 (Cal. 1911); *see also* Lewis Mallalieu Simes, *The Assignability of Easements in Gross in American Law*, 22 MICH. L. REV. 521, 528 (1924).

141. *See, e.g.*, Martin v. Music, 254 S.W.2d 701, 703 (Ky. 1953).

142. Adams v. Burke, 84 U.S. (17 Wall.) 453 (1873).

territorial limitation on the process insofar as it covered that particular lid.

The first sale rule thus served to distinguish situations in which the patentee was able to appropriate the value of the invention from those in which it was not.[143] A pure manufacturing license without a post-contract restriction would place no limit on the licensee's ability to produce as much as it wished and sell wherever and to whomever it pleased. By contrast, when a single copy of the patented good is sold, the patentee is able to appropriate the full value of that copy in the purchase price. Purchase of a single unit does not permit the buyer to make other copies or license others to make copies; it does not even permit buyers to "reconstruct" the patented good when it wears out.[144]

Of course, this is an argument for permitting post-sale restraints on manufacturing licenses; it is not necessarily an argument for prohibiting post-sale restraints on the sale of individual copies of goods that are protected by IP rights. The rationale for the prohibition requires some reason why they are socially harmful.

The Supreme Court's decisions involving transfers of intermediate patent rights—that is, something falling short of the finished good—are consistent with these Blackstonian principles. First, the Court's 1926 decision in *United States v. General Electric Co.* held that a patentee's pure manufacturing license did not exhaust any rights in the patent.[145] GE sold Westinghouse a license to manufacture light bulbs covered by its patent; GE did not sell Westinghouse the light bulbs themselves. The Court held that GE could stipulate the price at which Westinghouse sold those bulbs to consumers. Thus even a RPM agreement—per se unlawful at the time as a matter of antitrust law[146]—would be upheld if it was found to be within the patent grant.

143. *See* WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW 125–27, 297–306 (2003); Yonatan Even, *Appropriability, First Sale & Exhaustion* (Sept. 28, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1274822.

144. In general, the purchaser of a patented good may repair it but not "reconstruct" it. Making the distinction has proven extraordinarily difficult. *See, e.g.*, Jazz Photo Corp. v. Int'l Trade Comm'n, 264 F.3d 1094, 1102–05 (Fed. Cir. 2001) (discussing the differences with respect to patented disposable cameras intended for a single use but technologically capable of being refurbished).

145. United States v. Gen. Elec. Co., 272 U.S. 476, 490 (1926) (first sale doctrine did not apply to restriction placed on manufacturing licensee as opposed to one who purchased the patented product).

146. Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373, 408 (1911), *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

Both *Univis Len*s and *General Talking Pictures* involved more complex arrangements, including transfers of an intermediate article and a license to apply a patented process.[147] The Supreme Court applied the first sale doctrine in the first case but not the second.[148]

In *Univis*, the Supreme Court's most recent application of the first sale rule prior to *Quanta*, the defendant patentee sold lens blanks for use in bifocal eyeglasses. The lens blanks were not useable in glasses as sold, but had to be ground to meet the wearer's prescription needs before they could be mounted into frames.[149] Univis' patents extended not only to the lenses but also to the grinding technology used by purchasers of the raw lenses.[150] Univis sold the lens blanks subject to a RPM restriction that the Court ultimately found unlawful, but only after an intermediate finding that the restriction violated the first sale rule.[151]

The Supreme Court conceded that the patented article was not "finished" and was necessarily subject to future refinements that were also covered by Univis' patents. Nevertheless, "the only use to which it could be put and the only object of the sale is to enable the latter to grind and polish it for use as a lens by the prospective wearer."[152] That is, implicit in the sale of the lens blank was a right given to the purchaser to employ Univis' grinding technology in order to turn that particular blank into a marketable set of eyeglasses. The right to finish was "appurtenant," in Blackstone's terminology, to the particular copy of the patented article that the purchaser bought.[153] The process license and the blanks were tied

147. United States v. Univis Lens Co., 316 U.S. 241 (1942); Gen. Talking Pictures Corp. v. W. Elec. Co., 305 U.S. 124 (1938).

148. *See Univis*, 316 U.S. at 250; *Gen. Talking Pictures Corp.*, 305 U.S. at 127.

149. *Univis*, 316 U.S. at 244–45.

150. *Id.* at 249.

151. *Id.* at 250–52.

152. *Id.* at 249.

153. *See id.* at 251:

> Our decisions have uniformly recognized that the purpose of the patent law is fulfilled with respect to any particular article when the patentee has received his reward for the use of his invention by the sale of the article, and that once that purpose is realized the patent law affords no basis for restraining the use and enjoyment of the thing sold . . . . Whether the licensee sells the patented article in its completed form or sells it before completion for the purpose of enabling the buyer to finish and sell it, he has equally parted with the article, and made it the vehicle for transferring to the buyer ownership of the invention with respect to that article. To that extent he has parted with his patent monopoly in either case, and has received in the purchase price every benefit of that monopoly which the patent law secures to him.

together in a one-to-one ratio. Key to the Court's decision was that the lens blank was useless unless subjected to the defendant's patented method for grinding it into a finished lens. In that case, it saw the purchase of the unfinished lens as "inherently" including the right to complete the process needed in order to bring the lens to market.[154]

The analogy has been applied to software patents. While making a copy of a patented article is typically infringement, one cannot use computer software without making a temporary copy of part of the software code. This code resides in the computer while the software is being used. Prohibiting such "copying" would effectively make the software useless.[155] But consistent with *Univis*, software that was sold subject to this implied license could itself be subject to the first sale doctrine, prohibiting the patentee from imposing post-sale restraints via the threat of infringement actions.[156]

In contrast, the Supreme Court presented *General Talking Pictures* as concerned not with the sale of a patented device, but rather with a license to manufacture a finished combination, in this case a sound system subject to a post-sale field-of-use restriction for non-

154. *See id.* at 249:

> . . . it is plain that where the sale of the blank is by the patentee or his licensee—here the Lens Company—to a finisher, the only use to which it could be put and the only object of the sale is to enable the latter to grind and polish it for use as a lens by the prospective wearer. An incident to the purchase of any article, whether patented or unpatented, is the right to use and sell it, and upon familiar principles the authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to the article sold.

See also Dawson Chem. Co. v. Rohm & Haas Co., 448 U.S. 176, 186 (1980) (implicitly accepting that sale of *un*patented chemical with no use other than that in conjunction with the seller's patented method exhausted method patent with respect to that combination); Ethyl Gasoline Corp. v. United States, 309 U.S. 436, 452 (1940) (finding that first sale rule covered gasoline additive and method patent for burning it).

155. *See* Cohen & Lemley, *supra* note 137, at 32. For a discussion of the problems involved in treating the automatic copy-making as direct patent infringement, see Keith E. Witek, *Software Patent Infringement on the Internet and on Modern Computer Systems—Who Is Liable for Damages?*, 14 SANTA CLARA COMPUTER & HIGH TECH. L.J. 303, 369–71 (1998).

156. Of course, breach of contract suits for violations of a valid license agreement might still be possible. *See* ProCD, Inc. v. Zeidenberg, 86 F.3d 1447 (7th Cir. 1996). The *ProCD* decision has not been without its critics, however. *See, e.g.*, Bohannan, *supra* note 1, at 632 (criticizing *ProCD* for sweeping too broadly); Mark A. Lemley, *Beyond Preemption: The Law and Policy of Intellectual Property Licensing*, 87 CAL. L. REV. 111, 147–50 (1999) (criticizing *ProCD* decision for failure to confront preemption issue).

commercial use.[157] The Court upheld the restriction with scant reference to the first sale doctrine.[158] The Court distinguished earlier first sale cases in two ways: (1) as in *General Electric*,[159] the patentee did not sell a patented product to the first buyer but rather licensed that buyer to manufacture the patented product, subject to the field-of-use restriction; (2) the licensee then sold the finished product without restriction in violation of the license agreement. As a result of (2), the first sale of a completed good in the transaction was not "authorized" by the patentee, and thus the first sale rule did not attach.[160]

Another distinction between *Univis* and *General Talking Pictures* is more relevant to competition policy. *Univis* involved a restriction on the resale price that resellers of the patented lenses were required to charge. At the time resale price maintenance was unlawful per se under the Sherman Act.[161] Read together, *Univis* and the Supreme Court's 1926 *General Electric* case stand for two propositions. First *Univis* declares that one may not sell a good, even if unfinished, and impose RPM on resellers, if the unfinished good has no use unless the patented process is applied to it; in that case the license is appurtenant to the good. By contrast, a pure manufacturing license that is not appurtenant to the sale of a good fails to exhaust the patent and thus the licensor is free to impose additional limits enforceable by infringement actions. However one characterizes the transaction in *General Talking Pictures*, the field-of-use restraint at issue was a vertical nonprice restraint, and the Su-

157. Gen. Talking Pictures Corp. v. W. Elec. Co., 305 U.S. 124 (1938).

158. *See id.* at 125–27.

159. United States v. Gen. Elec. Co., 272 U.S. 476 (1926).

160. In a strong dissent Justice Black, joined by Justice Reed, argued that the first sale doctrine should have applied. *See Gen. Talking Pictures*, 305 U.S. at 128 (Black, J., dissenting). Indeed, according to the district court's opinion the licensee purchased vacuum tubes manufactured by the patentee and the boxes containing the tubes bore the challenged field-of-use restriction. *See* W. Elec. Co. v. Gen. Talking Pictures Corp., 16 F. Supp. 293, 295 (S.D.N.Y. 1936). It then manufactured the amplifiers employing these tubes, under license from the patentee. It appears that the tubes could be used in any amplifier manufactured by the patentee as well as the amplifiers of others. The Government emphasized this point in its amicus brief to the Supreme Court in *Quanta*. *See* Brief for the United States as Amicus Curiae Supporting Petitioners at 17, Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008) (No. 06-937), 2007 WL 3353102.

161. Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373, 408 (1911), *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

preme Court had not yet determined the appropriate antitrust response to these.[162]

The Federal Circuit largely disregarded these distinctions when it concluded quite categorically that when a patented good is subject to further application of a patented method the transaction is not subject to the first sale doctrine, for sale of the device does not exhaust the patentee's interest in it.[163] In its *Quanta* decision, the Supreme Court categorically held that the first sale doctrine applies to method patents attached to an article or device with almost no discussion of the policy implications.[164] Neither line of decisions does much to illuminate the important issues.

4. *Mallinckrodt* and the Durability Problem

The Federal Circuit's now overruled *Mallinckrodt* decision had departed from Supreme Court precedent by permitting a patentee to enforce a post-sale restraint on some patented articles by distinguishing unconditional from conditional sales.[165] Further, the condition could be enforced by either a breach of contract action or a patent infringement action.[166]

The restriction in question prohibited the purchaser of a medical device from reusing it.[167] Although such a restriction could have different explanations, it was very possibly the patentee's attempt to address a durable goods problem.[168] The monopolist or oligopolist tries to avoid durability because it fears that its own product will

162. Antitrust challenges to vertical nonprice restraints emerged in the early 1960s, after which the Court changed its mind twice. *See* White Motor Co. v. United States, 372 U.S. 253, 261 (1963) (declining to condemn vertical nonprice restraints); United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) (condemning vertical nonprice restraints under per se rule), *overruled by* Continental T.V. v. GTE Sylvania, Inc., 433 U.S. 36, 57–59 (1977) (overruling *Schwinn* and applying rule of reason to vertical nonprice restraints instead of per se rule).

163. *See* LG Elecs., Inc. v. Bizcom Elecs., Inc., 453 F.3d 1364, 1371 (Fed. Cir. 2006), *rev'd sub nom.* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008); Glass Equip. Dev., Inc. v. Besten, Inc., 174 F.3d 1337, 1341 n.1 (Fed. Cir. 1999); Bandag, Inc. v. Al Bolser's Tire Stores, Inc., 750 F.2d 903, 924 (Fed. Cir. 1984).

164. *Quanta*, 553 U.S. at 628–30.

165. Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 708 (Fed. Cir. 1992), *abrogated by* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008).

166. *See id.* at 701.

167. The decision seems directly at odds with the Supreme Court's decision a century earlier in *American Cotton-Tie Co. v. Simmons*, 106 U.S. 89 (1882), where the Court applied the first sale doctrine to invalidate a patentee's restriction on reuse of a belt buckle subject to a single use limitation.

168. For one early observation of the problem, see Edward H. Chamberlin, *The Product as an Economic Variable*, 67 Q.J. ECON. 1, 23–24 (1953), observing that,

come back to compete with itself. As a result it may resort to such tactics as leasing rather than selling its output.[169] For example, in *United Shoe Machinery*,[170] *Xerox*,[171] and *IBM*,[172] when they controlled the markets in their respective durable products, they leased rather than sold them. In that case no competitive market arises for the used good. In a perfectly competitive market, competition would force the firms to sell if selling were cost effective and what customers wanted.

In a well-functioning market the patentee monopolist should be able to capture the full value of all downstream uses and reuses of its good—that is, the purchaser who intends to use it multiple times would be willing to pay the present value of repeated future uses, less anticipated costs.[173] Of course, these incentives may be altered in markets with agency problems such as third-party payment, which characterizes the medical industry generally.

One possible justification for the single use only restriction rests on the observation that inherent in the patent grant is the right to limit output. A patentee has the right to produce any amount of the patented good it pleases, right down to zero.[174] A single use restriction is in fact a type of output reduction. At its

> [B]ecause durability can be varied, a producer has to face the question of how durable to make his product. Evidently if he makes it too durable, as soon as people have bought one unit they will not need another for a substantial period during which there will be no "repeat demand" for his product. He has an interest then in making it less durable so that people will come back that much sooner . . . .

For a comprehensive review and critique, see Barak Y. Orbach, *The Durapolist Puzzle: Monopoly Power in Durable-Goods Markets*, 21 YALE J. ON REG. 67 (2004).

169. *See* Ronald H. Coase, *Durability and Monopoly*, 15 J.L. & ECON. 143 (1972); *see also* Michael Waldman, *Durable Goods Theory for Real World Markets*, 17 J. ECON. PERSP. 131 (2003).

170. United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 297 (D. Mass. 1953), *aff'd mem.*, 347 U.S. 521 (1954) (per curiam). For a critique, see Scott E. Masten & Edward A. Snyder, *United States versus United Shoe Machinery Corporation: On the Merits*, 36 J.L. & ECON. 33 (1993).

171. *See In re* Xerox Corp., 86 F.T.C. 364, 364 (1975); Timothy F. Bresnahan, *Post-Entry Competition in the Plain Paper Copier Market*, 75 AM. ECON. REV. 15, 16 (1985).

172. United States v. Int'l Bus. Machs. Corp., 1956 Trade Cas. (CCH) ¶ 68, 245 (S.D.N.Y. 1956); FRANKLIN M. FISHER, ET AL., FOLDED, SPINDLED AND MUTILATED: ECONOMIC ANALYSIS IN U.S. V. IBM 191–95 (1983).

173. *See* Wolfhard Ramm, *On the Durability of Capital Goods Under Imperfect Market Conditions*, 64 AM. ECON. REV. 787 (1974).

174. *See* Continental Paper Bag Co. v. E. Bag Co., 210 U.S. 405, 429 (1908) (patentee has right to bring infringement action even though it is not practicing the patent in question).

choosing, the patentee could make 1000 copies of its good or 100. If it makes 100, it can impose a single use restriction, thus limiting the right of purchasers to turn that 100 into 200 or more by using each copy two or more times.

But single use restrictions can be more harmful than simple output restrictions because they consume actual resources. Suppose a patented good is capable of being used twice before it wears out and under competition 1000 copies of the good, or 2000 uses, would be sold. Suppose further, however, that the patentee maximizes its profits by cutting output back to 1000 uses and setting a higher royalty rate. It could attain this result either by (1) producing 500 copies of the good without a restriction, leading each customer to use a copy twice; or (2) producing 1000 copies of the good but imposing a single use restriction on each. While both alternatives yield 1000 uses, the second one consumes more resources. In that case the single use restriction is a socially harmful solution to the durability problem. It not only prevents the rise of a used goods market but limits the use of each good to a single cycle.

Of course, to the extent such conduct is costly, it would also seem to be self-deterring. Why would the manufacturer produce 1000 units of the good subject to single use restrictions when it could obtain the same price by producing 500 units and permitting customers to use them twice? Further, there might be perfectly good technological reasons for such a limitation. Perhaps the device would be hazardous or unreliable if reused and could not effectively be refurbished. The defendant in *Mallinckrodt* apparently thought otherwise, for it was in the business of refurbishing the medical device in question, and hospitals were willing to purchase the refurbished units. The patentee stated that there were reasons related to health and liability for prohibiting reuse, but the Federal Circuit found it unnecessary to inquire into the merits of these explanations.[175]

175. The device in question delivered therapeutic radioactive material into the lungs in the form of an aerosol mist, as part of a treatment for pulmonary disease. Use of the device contaminated it with the radioactive materials as well as other possibly harmful materials, and refurbishing included a radiation sterilization process. Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 701, 701–02 (1992). The Federal Circuit went on to reverse the lower court's summary judgment ruling that the patents were unenforceable based on the single use restriction. *Id.* at 709.

The Lexmark print cartridge litigation also addressed single use restrictions and refurbishment. The restrictions in that case were originally allowed. *See* Ariz. Cartridge Remanufacturers Ass'n, Inc. v. Lexmark Int'l, Inc., 421 F.3d 981, 988 (9th Cir. 2005) (upholding patentee's restriction on its printer cartridges, requiring the cartridges be returned after single use in exchange for price discount);

By not asking whether the restraint on reuse was technologically justified, the Federal Circuit effectively concluded that the patent grant contained within it the power to force post-sale users to use the product inefficiently. This social cost would undoubtedly be largest if Mallinckrodt were a monopolist in the device. But it could be substantial even if the device were sold by a non-monopolist in a product differentiated market. The most likely explanation for why hospitals might accept Mallinckrodt's terms is that a third-party payment mechanism for health insurance covered the device, thus reducing the transparency of true costs.

At the same time, the first sale rule, which operates as a per se restraint, seems excessive given the self-deterring nature of harmful reuse restrictions and the alternative explanations for at least some of them. Rule of reason analysis under the antitrust laws or perhaps patent misuse doctrine seems more appropriate to the task. Indeed, the first sale doctrine as *Quanta* revitalized it would not even approve a post-sale restraint on reuse in cases where reuse was dangerous. A patentee could certainly warn against reuse, but it could not restrain reuse by means of a patent infringement suit. To be sure, *Quanta* might permit the patentee to maintain a breach of contract suit to enforce the single use restriction, but enforcement would depend on the vagaries of the privity requirement. For example, if the hospital disposed of the device after a single use but the waste disposal firm sold them to a renewal firm, a contract claim could not run against the latter even though notice was clear.

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accord Static Control Components, Inc. v. Lexmark Int'l, Inc., 487 F. Supp. 2d 830, 847–48 (E.D. Ky. 2007) (inferring non-exhaustion from fact that patentee received lower price for cartridges subject to single-use restriction than for other cartridges and therefore patentee did not receive full reward for lower price cartridge). However, in the wake of *Quanta Computer, Inc. v. LG Elecs., Inc.*, 553 U.S. 617 (2008), the court changed its mind and held that the first sale doctrine applied so as to invalidate the tie. *See* Static Control Components, Inc. v. Lexmark Intern., Inc., 615 F. Supp. 2d 575, 576–77 (E.D. Ky. 2009).

For other cases on patent exhaustion and reuse, see Jazz Photo Corp. v. Int'l Trade Comm'n, 264 F.3d 1094 (Fed. Cir. 2001) (design patent exhausted by unrestricted sale; not infringement for foreign firm to repair patentee's "single use" camera for reuse); Kendall Co. v. Progressive Med. Tech., Inc., 85 F.3d 1570, 1574–75 (Fed. Cir. 1996) (refusing to infer prohibition on reuse from simple fact that one element of patented product was spent with each use; device itself capable of roughly three years use); Monsanto Co. v. Scruggs, 459 F.3d 1328 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1342 (2007) (exhaustion did not apply to self-replicating seed where second generation seed was identical to first generation; because the second generation seed was never sold at all, patent was not exhausted; further use of the seed required a license from the patentee); Monsanto Co. v. McFarling, 302 F.3d 1291 (Fed. Cir. 2002).

5. Price Discrimination

Price discrimination occurs when a seller obtains different ratios of price to marginal cost from different buyers. Price discrimination is generally said to come in three kinds, or "degrees." Virtually all instances of actual price discrimination are either third-degree or second-degree discrimination.

In third-degree price discrimination the seller is able ex ante to segregate customers into different groups based on the group's willingness to pay and offer different prices to different groups. A common example in the IP context is offering different prices to commercial and personal users, as in both *General Talking Pictures* and *ProCD*.[176] One characteristic of third-degree price discrimination is a discontinuity in buyer substitution that denies the good to some high-value purchasers while giving the good to others for whom the good is less valuable. For example, if I charge commercial purchasers of my sound amplifiers $1000 and personal users $500, the commercial users will purchase down to the point that their marginal value reaches $1000 and no more. A commercial user who values the next amplifier at $950 will not buy it even though other users, the personal ones, are actually buying at a price of $500. So a $950 purchaser is turned away while a $500 is served. This denial to high-value purchasers and sale to low-value purchases means that third-degree price discrimination reduces welfare unless the seller brings in new purchasers under the price discrimination scheme. As a result, economists since at least Arthur Cecil Pigou have concluded that third-degree price discrimination reduces welfare unless it increases total market output.[177]

By contrast, second-degree price discrimination occurs when the seller offers a price schedule with differing prices. Customers self-select the price by choosing where to place themselves on the schedule. Quantity discounts are an example, as are divisions between first and coach class airline tickets to the extent that price differences are not proportional to cost differences. Variable proportion tying arrangements, in which different customers use the tied product in differing amounts, are an instance of second-degree price discrimination because the tying product is offered at one price to everyone and so is the tied product. Customers "select" the rate of return the arrangement produces to the seller by choosing

176. Gen. Talking Pictures Corp. v. Western Elec. Co., 305 U.S. 124 (1938); ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449 (7th Cir. 1996).

177. *See* ARTHUR CECIL PIGOU, THE ECONOMICS OF WELFARE, II.14.13 (4th ed. 1932); Marius Schwartz, *Third-Degree Price Discrimination and Output: Generalizing a Welfare Result*, 80 AM. ECON. REV. 1259 (1990).

the number of tied units to purchase.[178] For example, in a printer/ink cartridge tie the seller typically cuts the price of the printer from its standalone profit maximizing level, builds a monopoly overcharge into the ink cartridge, and then requires all users of the printer to purchase its cartridges.[179] The result is that monopoly returns on the printer/cartridge package are higher for higher volume users. However, everyone purchases ink cartridges down to the point that marginal value equals the purchase price, with the purchase price being the same for all. So for example, if the printer manufacturer reduces the price of the printer and increases the price of tied ink cartridges from $15 to $20, every buyer will purchase down to the point that the marginal value of a cartridge to her equals $20. This distinctive feature of second-degree price discrimination has produced some confusion in the antitrust literature. It is not the case that variable proportion ties systematically transfer output from higher- to lower-value customers; only third-degree price discrimination does that.[180] To be sure, variable proportion ties typically result in a reduced price for the tying product and a higher price for the tied product, and this is a distortion from perfect competition. But it is not the same distortion that third-degree price discrimination produces.[181]

The final type of price discrimination is first-degree, or "perfect" price discrimination, which occurs when a seller is able to sell each unit at the highest price that any buyer is willing to pay for it. Variable proportion ties almost never come close to being first-degree price discrimination. While a highly accurate variable proportion tie might be able to meter the relationship between consumer value and the number of units a customer uses, it cannot capture the residual value that different customers place on the good. To illustrate, both a printer of handbills for garage sales and a law firm printing offering statements for IPOs might require precisely 1000 pages of printing per week. After that, their willingness to pay falls sharply. If they purchase identical printers under identical ties they will end up paying the same amount. However, the garage sale printer might value the printouts at very close to the incremental

178. *See, e.g.*, Jean Tirole, The Theory of Industrial Organization 147 (1988); Richard A. Posner, *Vertical Restraints and Antitrust Policy*, 72 U. Chi. L. Rev. 229, 236 (2005).

179. *See, e.g.*, *Static Control Components*, 615 F. Supp. 2d at 576–77 (applying first sale doctrine to invalidate printer/ink cartridge tie).

180. *Cf.* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 Harv. L. Rev. 397, 431 n.89 (2009) (suggesting that variable proportion ties reallocate output from high-value to low-value users).

181. *See* Hovenkamp & Hovenkamp, *supra* note 9 (manuscript at 10).

price of, say, 3 cents per page, while the law firm values them at $12 per page. In that case there will be a great deal of unclaimed consumer surplus remaining from the law firm purchaser and the price discrimination scheme must be classified as second-degree.

Most variable proportion ties involve a price reduction in the tying product, sometimes to the competitive level and sometimes even to zero, accompanied by an increase in the price of the tied product.[182] Depending on the magnitude of (1) the price cut in the tying product, (2) the price increase in the tied product, and (3) the output effects, a variable proportion tie can either increase or decrease both general and consumer welfare.[183] Further, since there are three variables, not just one, it is impossible to make categorical judgments about the relationship between output and welfare. In any event, most price discrimination ties probably increase output, and many do so substantially.[184] In such cases there is no warrant for believing they are harmful to either general welfare or consumer welfare. Further, their profitability does not depend on the exclusion of any rival, and price discrimination ties are common even in moderately competitive markets, such as fast-food franchising.[185] As a result there is no warrant for condemning them as a matter of competition policy, and certainly not with a categorical per se rule.

The 1912 *Henry* decision was the last occasion that the Supreme Court refused to apply the first sale rule to the sale of a patented good subject to a variable proportion tie.[186] In that case the manufacturer sold mimeograph machines at below cost and recouped its profits on overcharges on the consumable supplies.[187]

182. Virtually every decision that has discussed the issue has indicated that the defendant reduced rather than increased the price of the tying product when it engaged in tying. *See id.* at *18–19. For an example of a zero price tying product, see Kentmaster Mfg. Co. v. Jarvis Prods. Corp., 146 F.3d 691 (9th Cir. 1998), *amended by* 164 F.3d 1243 (9th Cir. 1999) (defendant provided durable meat cutting equipment at no charge to meat cutters but charged high prices for aftermarket parts); *see also* Xerox Corp. v. Media Scis., Inc., 660 F. Supp. 2d 535, 539 (S.D.N.Y. 2009) ("As is true of other printer manufacturers, Xerox generally sells its printers at a low margin or a loss, hoping to earn a profit through later sales of high-margin ink.").

183. *See* Hovenkamp & Hovenkamp, *supra* note 9 (manuscript at 19–28).

184. *See id.* at 6.

185. *See, e.g.*, Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971).

186. Henry v. A.B. Dick & Co., 224 U.S. 1 (1912), *overruled by* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917); *see also supra* notes 54–57 and accompanying text.

187. The lower court's decision discusses the facts of the case. *See* A.B. Dick Co. v. Henry, 149 F. 424, 425 (C.C.N.Y. 1907) ("The evidence establishes that the

Henry was overruled by *Motion Picture Patents*, which involved yet another variable proportion tying arrangement that facilitated price discrimination.[188] Since *Motion Picture Patents* was decided, patentees have largely relied on contract restrictions to impose ties rather than post-sale restraints—a result that the Supreme Court itself suggested in that case.[189] Otherwise they have avoided the first sale rule by leasing the patented durable goods rather than selling it.[190]

The Patent Misuse Reform Act of 1988 provides that patent ties of this sort are not misuse unless the patentee has market power in the patented tying product.[191] Interestingly, that provision appears to permit patent ties accompanying the sale of a patented product, in violation of the first sale doctrine. The provision states that a patentee will not be guilty of "illegal extension of the patent right" if it "conditioned . . . the sale of the patented product on the . . . purchase of a separate product" unless the patentee has market

complainants sell the machines at a loss, less than the actual cost of making, relying on sales of supplies therefor for a profit."); *see also* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 516 (1917) (noting patentee's argument that the public benefitted "by the sale of the machine at what is practically its cost").

188. *Motion Picture Patents*, 243 U.S. at 516; *see also supra* notes 57–58 and accompanying text.

189. *See Motion Picture Patents*, 243 U.S. at 509 ("The extent to which the use of the patented machine may validly be restricted to specific supplies or otherwise by special contract between the owner of a patent and the purchaser . . . [is] a question outside the patent law . . . ."). For an example, see *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006) (refusing to condemn a tie of a patented printer to unpatented ink after overturning presumption that patented tying product confers market power). While the patentee in *Illinois Tool Works* initially took the position that the ink was covered by its patent it later amended that position and what had started out as an infringement action became an antitrust challenge to the license agreement. *See* Indep. Ink, Inc. v. Ill. Tool Works, 396 F.3d 1342, 1345 (Fed. Cir. 2005).

190. *See, e.g.*, Int'l Salt Co. v. United States, 332 U.S. 392 (1947) (leased machines with provision requiring lessee to use patentee's salt); Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 489 (1942) (finding patent misuse when patent holder leased salt injecting machine with lease provision requiring lessee to use the patentee's salt tablets); Int'l Bus. Machs. Corp. v. United States, 298 U.S. 131 (1936) (lease requiring lessees of tabulating machines to use lessor's punch cards).

191. 35 U.S.C. § 271(d)(5) (2000), providing that a patentee shall not be deemed guilty of misuse or illegal extension of the patent if it has:

> [C]onditioned 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, 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.

power.[192] Since *Quanta* involved exclusive dealing and not tying, this provision was not implicated. However, in *Motion Picture Patents* the sale of the patented projector was conditioned on the purchase of a separate product.[193] As the *Motion Picture Patents* decision described the first sale doctrine, it clearly involved an improper extension of the patent right.[194] Indeed, while the "illegal extension of the patent" concern has been widely stated in misuse law,[195] it actually originated in first sale law.[196] So it is difficult to escape the conclusion that the Patent Misuse Reform Act operates to create a statutory exception to the first sale doctrine for tying arrangements. Nevertheless, no decision of which I am aware has interpreted the statute in that way. In any event, the antitrust law governing ties has evolved significantly and today regards them as relatively benign.[197] By contrast, the first sale doctrine recognizes no exception for competitively harmless restraints.

The statutory misuse provision and the permissive attitude of modern antitrust law should not be read as a broad congressional policy of permitting price discrimination by means of variable proportion tying arrangements. The Patent Misuse Reform Act exonerates patent ties from misuse claims only when the seller lacks market power in the patented product, and at least minimal market power is necessary for price discrimination.[198] In *Illinois Tool Works* the Supreme Court equated this requirement for misuse with the antitrust laws as well.[199] By contrast, assuming that the Patent Misuse Reform Act does not create an exception, the first sale doctrine applies what is effectively a per se rule to price discrimination ties on patented goods without any inquiry into market power or anticompetitive effects.

While second-degree price discrimination is the typical result of variable proportion tying arrangements, third-degree price dis-

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192. *Id.*

193. *Motion Picture Patents*, 243 U.S. at 506 (1917); *see supra* notes 92–97 and accompanying text.

194. *Id.* at 516 ("[T]he exclusive right granted in every patent must be limited to the invention described in the claims of the patent, and that it is not competent for the owner of a patent, by notice attached to its machine, to, in effect, extend the scope of its patent monopoly by restricting the use of it to materials necessary in its operation, but which are no part of the patented invention . . . .").

195. *See* Bohannan, *supra* note 21 (manuscript at 10 n.43, 18–20).

196. *See supra* notes 101–02 and accompanying text.

197. *See generally* AREEDA, ELHAUGE & HOVENKAMP, *supra* note 5, ch. 17.

198. *See* AREEDA & HOVENKAMP, *supra* note 117, ¶ 721.

199. Ill. Tool Works Inc. v. Indep. Ink, Inc., 547 U.S. 28 (2006) (equating misuse and antitrust standards for tying arrangements).

crimination that can be facilitated by post-sale restraints typically arises from field-of-use restrictions. For example, a "noncommercial use only" restriction is likely to be a way that a patentee can charge a higher price for commercial than for noncommercial users of its product. While the patentee might make the initial sale of the noncommercial version to a noncommercial user, the restriction would be needed to restrain further transactions to commercial purchasers—that is, to prevent arbitrage.[200] By the same token, selectively used "single use" restrictions may discriminate between those licensed to make unlimited uses and those subject to the restrictions.[201] A restriction that results in different prices for different categories of users, such as commercial and residential, does in fact transfer sales from high value to lower value purchasers, and thus reduces welfare unless output increases.[202]

Given that most price discrimination ties are lawful today, the "first sale" question is whether they should be enforced by infringement suits rather than breach of contract suits. That question can be important in situations where contributory infringers are easy to detect but primary infringers are not. For example, Lexmark may wish to tie printers and ink cartridges. However, if it is unable to use a technological lock to exclude non-Lexmark cartridges, the tying restriction could be very difficult to enforce against Lexmark's customers. It would be very costly to monitor customer aftermarket purchasing behavior. By contrast, widespread manufacturing of cartridges designed for Lexmark printers might be easy to detect. These "pirate" manufacturers would be guilty of contributory infringement if the tie was enforceable by an infringement action, but they are not in privity of contract with Lexmark and so a purely contractual tie will not bind them. If notice is essential, Lexmark could take care of that problem by informing these cartridge manufacturers of the restriction.

Perhaps there is no good policy argument for giving the holder of an IP right a greater power to engage in price discrimination

200. *See, e.g.*, ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1450 (7th Cir. 1996) (discussing arbitrage issues with licenses that attempt to price discriminate).

201. *See, e.g.*, Static Control Components, Inc. v. Lexmark Int'l., Inc., 487 F. Supp. 2d 830, 836 (E.D. Ky. 2007) (printer manufacturer sold patented cartridges at a lower price subject to condition that they not be refilled); *cf.* Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 706–08 (Fed. Cir. 1992) (illustrating that single-use restrictions might not involve higher prices for the sale of the same article without the restriction).

202. *See supra* notes 179–80 and accompanying text.

than the owner of any tangible asset.[203] But state policy respecting post-sale restraints on personal property is mixed, with a trend toward enforcing them.[204] In any event, there is no obvious reason why federal competition or patent policy should prevent post-sale restraints imposed on those with proper notice, simply because they might facilitate price discrimination but with no query into social or consumer harm. If price discrimination can be shown to injure competition or work as a disincentive to innovation it should be condemned as a matter of competition policy. The per se rule contained in the first sale doctrine thus seems seriously overdeterrent to the extent that it condemns the tying condition with no query whatsoever into competitive effects or propensity for harm.

6. Restraints on Innovation

A restraint on innovation can arise when the purchaser of a good is prevented from developing a competing good.[205] For example, in *Lasercomb* the Fourth Circuit found misuse in a software licensor's condition prohibiting the licensee from developing any product that competed with the licensed software.[206] While *Lasercomb* involved a license restriction on a copyright, the same principle could apply to the sale of a patented product subject to the condition that the purchaser does not develop a competing product.[207] The cost of a lost opportunity to innovate can be sub-

203. *See generally* Mark R. Patterson, *Contractual Expansion of the Scope of Patent Infringement Through Field-of-Use Licensing*, 49 WM. & MARY L. REV. 157, 221–24 (2007) (discussing issues with price discrimination of patented products); *see also* Wendy J. Gordon, *Intellectual Property as Price Discrimination: Implications for Contract*, 73 CHI.-KENT L. REV. 1367, 1386–90 (1998) (questioning justifications for price discrimination); Louis Kaplow, *The Patent-Antitrust Intersection: A Reappraisal*, 97 HARV. L. REV. 1813, 1874–78 (1984) (reviewing problems created by price discrimination). *But see* Makan Delrahim, *The Long and Winding Road: Convergence in the Application of Antitrust to Intellectual Property*, 13 GEO. MASON L. REV. 259, 264 (2005) ("[A]llowing the firm that developed the software to price discriminate may increase social welfare by promoting the efficient commercialization of the asset.").

204. *See generally* Glen O. Robinson, *Personal Property Servitudes*, 71 U. CHI. L. REV. 1449 (2004).

205. *See* Bohannan, *supra* note 21 (manuscript at 35).

206. Lasercomb Am., Inc. v. Reynolds, 911 F.2d 970, 979 (4th Cir. 1990).

207. Princo Corp. v. Int'l Trade Comm'n, 563 F.3d 1301, 1313–14 (Fed. Cir. 2009) (finding possible misuse in package licensing arrangement that may have prevented licensee from developing a competing product), *rev'd en banc*, 616 F.3d 1318 (Fed. Cir. 2010); McCullough v. Kammerer Corp., 166 F.2d 759, 764 (9th Cir. 1948) (finding patent misuse when patentee licensed patent subject to condition that licensee not develop competing technology); Nat'l Lockwasher Co. v. George K. Garrett Co., 137 F.2d 255, 256 (3d Cir. 1943) (finding misuse when patentee conditioned manufacturing license on licensee's promise not to manufacture com-

stantial,[208] and that harm could result whether or not the patentee had significant market power in its patented good.[209] Concern about post-sale restraints on purchasers' innovations in competition with the patented device could be a perfectly good reason for denying enforcement of particular restrictions, such as exclusive use or noncompetition covenants. However, this concern hardly justifies a draconian rule that prohibits every post-sale restraint without any inquiry into the nature or likely effects of the challenged restriction.

III. DOES THE FIRST SALE DOCTRINE SERVE A USEFUL PURPOSE?

Those decisions that have enforced a patentee's "conditional" sales inconsistently with the Supreme Court's exhaustion doctrine recognize violators as infringers or contributory infringers.[210] By contrast, licensing agreements themselves are governed by contract law and generally enforced in state court. They do not implicate first sale doctrine, but they can be enforced only by breach of contract actions.[211] Federal Circuit jurisprudence has not always been

peting goods); Apple, Inc. v. Psystar Corp., 673 F. Supp. 2d 931, 939–40 No. C 08-03251 WHA, 2009 WL 303046, at *4 (N.D. Cal. Feb. 6, 2009) (finding possible misuse when Apple prevented use of its computer operating system on a non-Apple computer, thus restraining development of rival's machine designed to use Apple and Microsoft operating systems interchangeably). A later decision upset the misuse finding. *See* Apple, Inc. v. Psystar Corp., 673 F. Supp. 2d 931, 939–40 (N.D. Cal. 2009).

208. *See* Herbert Hovenkamp, *Restraints on Innovation*, 29 CARDOZO L. REV. 247 (2007).

209. *See* Bohannan, *supra* note 21 (manuscript at 17, 45–46).

210. *See, e.g.*, Henry v. A.B. Dick & Co., 224 U.S. 1 (1912), *overruled by* Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 518 (1917). In *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 706–08 (Fed. Cir. 1992), the Federal Circuit essentially returned to the *Henry* rule. *See* Patterson, *supra* note 203, at 167–71; Edwin E. Richards, *Drafting Licenses to Guide Whether Potential Disputes Lie in Contract or Infringement*, 7 COMPUTER L. REV. & TECH. J. 45 (2002) (implying continued use of patented product after breach of conditional license may support an infringement claim).

211. The Court observed this distinction already in the late nineteenth century. *See* Keeler v. Standard Folding Bed Co., 157 U.S. 659, 665 (1895):

> Whether a patentee may protect himself and his assignees by special contracts brought home to the purchasers is not a question before us, and upon which we express no opinion. It is, however, obvious that such a question would arise as a question of contract, and not as one under the inherent meaning and effect of the patent laws.

clear on the condition versus contract distinction.[212] That court has spoken of conditional sales that evade the exhaustion requirement as requiring "a restriction having contractual significance . . . ."[213] However, when these "contracts" are to be enforced, the Federal Circuit has permitted enforcement via patent infringement actions rather than breach of contract actions.[214]

Without stating any policy argument for its preservation, the Supreme Court nevertheless soundly reaffirmed the first sale doctrine in its 2008 *Quanta* decision.[215] Further, it did so with the enthusiastic support of the Solicitor General and the Department of Justice's Antitrust Division. In its amicus brief the government had argued very forcefully that "[r]estrictions on downstream use or resale may arise as a matter of state contract law, but not patent law."[216] Ironically, this was the same Antitrust Division that had argued a year earlier that the per se rule against RPM should be overruled,[217] and that has very severely cut back enforcement of the law against vertical restraints. So why such a hard line against post-sale conditions that can be enforced by IP infringement suits, with so much tolerance of contractual arrangements that can accomplish the same thing?

The answer must be that the government is not particularly concerned about the substance of the restraint at issue—whether it be tying or RPM or some form of exclusivity—but with its form.

212. *See* Cohen & Lemley, *supra* note 137, at 34–35, 56 (criticizing the Federal Circuit's ambiguous and incorrect use of contract doctrine).

213. Hewlett-Packard Co. v. Repeat-O-Type Stencil Mfg. Corp., 123 F.3d 1445, 1453 (Fed. Cir. 1997); *see also* Jazz Photo Corp. v. Int'l Trade Comm'n, 264 F.3d 1094, 1108 (Fed. Cir. 2001) (conditional sale requires an "express contractual undertaking by the purchaser").

214. *See, e.g.*, LG Elecs., Inc. v. Asustek Computer, Inc., 453 F.3d 1364 (Fed. Cir. 2006), *rev'd sub. nom* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008); Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700 (Fed. Cir. 1992). Interestingly, both *LG* and *Mallinckrodt* relied on U.C.C. provisions stating the existence of a contract in order to find that the condition existed. *See LG Elecs.*, 453 F.3d at 1370; *Mallinckrodt*, 976 F.2d at 708 n.7.

215. Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008).

216. Brief for the United States as Amicus Curiae Supporting Petitioners at *175, Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008) (No. 06-937), 2007 WL 3353102. Or, as the government articulated the first sale doctrine in opening its argument: "The doctrine bars the use of patent law (but not contract law) to enforce restrictions on a purchaser's use or resale of a patented article that was purchased from the patentee or from someone authorized by the patentee to sell the article." *Id.* at *7.

217. *See* Brief for the United States as Amicus Curiae Supporting Petitioner at 3, Leegin Creative Leather Prods., Inc. v. PSKS Inc., 551 U.S. 877 (2007) (No. 06-480), 2007 WL 173650.

That is, there must be something inherently wrong about using licensing conditions plus the threat of infringement suits, as opposed to simple breach of contract actions. Further, notice must be inadequate to address the issue.

The worst problem of the first sale rule is that it lacks subtlety. To be sure, there is a set of technical rules that determines when a qualifying "sale" of a patented or copyrighted good has occurred. However, once such a sale is found enforcement of the post-sale restraint is denied automatically, with no consideration of the restraint's purpose or effect. This means that market power, competitive effects and implications for innovation are all irrelevant. That naturally invites the question whether the first sale doctrine serves any useful purpose at all. Is there a set of cases where simple contract enforcement is inadequate and where the antitrust and misuse rules will fail to police every behavior that we want to see controlled?

Post-sale conditions enforced by infringement actions seem superior to contract suits when the restraint is socially beneficial and a large and diverse number of downstream people are affected. Consider the servitudes problem in real property again.[218] If Alpha does not want commercial uses on Blackacre, she can impose a servitude on the land, have it properly recorded, and that is the end of the matter. Everyone who wants to buy or build on Blackacre has constructive notice of the restriction. Alternatively, Alpha could contract with the initial purchaser of Blackacre and agree that this purchaser upon pain of damages will impose the restriction on all parties downstream, and potentially we could have an endless series of such contracts. But this solution is much messier and increases transaction costs very significantly by requiring ongoing contracting and re-contracting. In sum, the "infringement" action permits enforcement of the restriction at much lower transaction costs than the endless series of breach of contract actions.

Clearly, however, notice is key. The law of servitudes on real property generally provides that if the servitude is not properly recorded, then the servitude cannot be enforced against a subsequent bona fide purchaser without actual notice. That requirement makes the market for servitudes function very well and has largely eliminated holdup problems—for example, the intending developer who buys land for a subdivision and finds out only after development has begun that there is a non-development servitude in place. Unfortunately, IP rights and IP licenses have nothing approaching

218. *See supra* notes 132–35 and accompanying text.

the rather effective recordation and notice provisions that apply to land titles. So if such limitations are to be enforced this places on the enforcer the obligation to see to it that notice is effective under the circumstances.[219]

As a general matter one can be guilty of patent infringement without having any notice whatsoever.[220] If that rule were applied to post-sale restraints, the result could be a significant problem of hold-up, as innocent subsequent purchasers could be sued for patent infringement for violating conditions they knew nothing about. But as noted previously, those courts that have enforced post-sale restraints have either required that timely notice of the restriction be given to the offender or else they have observed that notice was in fact given.[221] If notice had been the government's only concern in *Quanta*, it could have urged the court to uphold the Federal Circuit's departure from the historical first sale rule, but conditioned it on adequate downstream notice to affected parties.

To be sure, a notice is not the same thing as a contract. First of all, notices are typically unilateral acts and can be incomplete as to content, target, and communication.[222] One who sees "This copy machine may be maintained only by Alpha Corp." printed on a machine does not know if she is looking at a restraint on an unpatented good, which may or may not be enforceable under state law; whether the patent has expired; or, depending on the language, the precise meaning of the terms. Further, the notice may not be apparent to every person who might later be in a position to do maintenance on the machine; it could be removed, or it might not be contained on a particular component that is sent in for servicing. Under *Henry* a complete stranger to any transaction having to do with the machine, but who knew of the notice, would be guilty of patent infringement if he replaced a gasket or perhaps even if he dusted off the glass cover.

The notice problem also gets much trickier when a good changes hands many times, particularly if it is incorporated by the production process into other goods, as in *Quanta*. Just as real property covenants "run with the land," patent conditions, if enforceable, travel with the good from one owner to another. In real property law we deal with this problem with a largely effective set of recording provisions. But patented goods have no equivalent system and so it is much more likely that the good will pass to some-

219. *See* Hovenkamp, *supra* note 134.
220. *See supra* note 115.
221. *See supra* notes 119–21 and accompanying text.
222. *See* 5 DONALD S. CHISUM, CHISUM ON PATENTS § 16.02 (2010).

one who does not have adequate notice.[223] Once again, however, the solution seems to be to make patent infringement in such cases depend on reasonably communicated notice and to place the burden of providing effective and timely notice on the licensing patentee.

Also important is the fact that unlike breach of contract actions, patent infringement actions have historically incorporated a preference for injunctive relief. The right to bring an infringement action for an injunction could yield a holdup problem in situations where the subsequent purchaser lacked adequate notice of the restrictions, but that problem is addressed by an effective notice requirement. In any event, under the Supreme Court's *eBay* decision, injunctions are to be issued for patent infringement only when the plaintiff meets the same criteria as apply to equitable actions generally.[224] It is not obvious today that the right to an injunction to enforce a post-sale restraint via patent law would be any broader than the right to enforce it by a contract suit.

Contract remedies would probably be expectation damages in most situations.[225] Most actions would be filed in state court unless there is diversity jurisdiction in federal court. By contrast, a patent infringement suit could be filed in a single federal court against all infringers, including both the first purchaser made subject to the restriction and its customers, users, service personnel, and the like.[226] Damages can be the reasonable royalty rate together with interest and costs[227] or up to treble damages for willful infringers, which presumably includes downstream customers who took with actual notice of the restriction.[228] Of course, successful antitrust challenges can do the same thing, and in that case treble damages would be mandatory.[229]

223. *See* BESSEN & MEURER, *supra* note 117, at 46–72 (2008).

224. *See* eBay Inc. v. MercExchange, LLC, 547 U.S. 388, 390 (2006); *see also* Andrew Beckerman-Rodau, *The Aftermath of* eBay v. MercExchange*, 126 S. Ct. 1837 (2006): A Review of Subsequent Judicial Decisions*, 89 J. PAT. & TRADEMARK OFF. SOC'Y 631, 657 (2007) (finding that after *eBay*, permanent injunctions tend to be issued when patentee and infringer are direct competitors and tend not to be issued when patentee is a non-practicing entity).

225. *See* U.C.C. § 2-714 (2005); Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428, 1446 (2004).

226. *See* 28 U.S.C. § 1338(a) (2006).

227. 35 U.S.C. § 284 (2006).

228. *Id.* To prove willful infringement, the patentee must show the infringer was objectively reckless in determining whether they would infringe the patent. *In re* Seagate Tech., LLC, 497 F.3d 1360, 1370 (Fed. Cir. 2007).

229. 15 U.S.C. § 15 (2006).

Another possible difference between post-sale conditions and contract terms is jurisdictional. The Federal Circuit's now defunct jurisprudence permitting post-sale restraints implied that the conditions could be enforced by patent infringement actions, and appeals from these actions go automatically and exclusively to the Federal Circuit.[230] By contrast, breach of contract actions ordinarily go into state court, reaching the federal courts only upon the happenstance of diversity of citizenship or a suitable federal question. Appeals would go to the appropriate regional Circuit.

The government also argued in *Quanta* that restrictions that are found to be within the patent grant may be relatively free from antitrust scrutiny, while licensing agreements are not.[231] But that argument seems quite hollow in a world where antitrust treatment of vertical restrictions is minimal and in any event patent "misuse" is governed by antitrust principles. There is little reason to think that an anticompetitive restraint imposed as a condition would be treated differently from the same restraint imposed by contract. Cases such as *Univis* make clear that in the process of applying the first sale doctrine the Court was also expressing a policy about RPM, which was unlawful per se at the time *Univis* was decided.[232]

So traditional antitrust analysis could be used to address post-sale restraints no matter how they are treated. Indeed, to the extent that the law of patent and copyright "misuse" deviates from antitrust principles, it condemns more rather than less.[233] Further, "misuse" law derives from the IP statutes themselves and clearly applies to notice restrictions that are intended to be enforced by in-

230. 28 U.S.C. § 1295(a)(1) (2006) (giving Federal Circuit exclusive jurisdiction over appeals from cases arising under Patent Act); *see also* Holmes Group, Inc. v. Vornado Air Circulation Sys., Inc., 535 U.S. 826, 829 (2002) ("[T]he Federal Circuit's jurisdiction is fixed with reference to that of the district court, and turns on whether the action arises under federal patent law.").

231. *See* Brief for the United States as Amicus Curiae Supporting Petitioners at 29, Quanta Computer, Inc. v. LG Elecs., Inc., 128 S. Ct. 2109 (2008) (No. 06-937), 2007 WL 3353102 ("The Federal Circuit's approach also has the potential to erode downstream competition by permitting patentees to avoid anti-trust scrutiny of restrictions on the use and resale of products embodying their inventions."). Some examples include *Bement v. Nat'l Harrow Co.*, 186 U.S. 70, 91–95 (1902) (upholding price restriction as within the scope of the patent), and *United States v. General Electric Co.*, 272 U.S. 476, 489 (1936) (upholding price restrictions "reasonably" within the scope of the patent grant).

232. United States v. Univis Lens Co., 316 U.S. 241 (1942); *see supra* notes 149–154 and accompanying text.

233. *See* Bohannan, *supra* note 21 (manuscript at 18).

fringement actions.[234] Today, resale price restrictions such as those in *General Electric* or *Univis* would rarely be unlawful, given that the per se rules against both minimum and maximum RPM have been overturned.[235] Tying and exclusive dealing or related practices could still be actionable. While tying is arguably still covered by a per se rule,[236] exclusive dealing is addressed under the rule of reason and, in any event, both require a traditional showing of market power—i.e., market power cannot be presumed from the existence of the patent itself.[237]

The post-sale restriction that the Federal Circuit enforced in *Quanta* resembles tying or exclusive dealing, but it seems unlikely that this was its intended purpose.[238] The restriction forbade downstream purchasers of parts manufactured by Intel under the patentee's license from using them in combination with any non-Intel components. Ordinarily a restriction limiting the purchaser or licensee to using only the seller's brand would be exclusive dealing, or tying if multiple products were involved.[239] In this case, however, Intel made only a tiny minority of the numerous components that go into a computer. It would be a little like Firestone Tire Co. entering into a contract with General Motors agreeing to supply tires to GM but only on the condition that GM not use any non-Firestone products in its automobiles. It would simply be impossible for GM to comply with the condition. The purpose of the restriction must have been to turn the downstream computer assemblers into infringers, presumably so that the patentee could extract additional royalties from purchasers who had already made specific commit-

234. *See, e.g.*, Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 492 (1942); Carbice Corp. v. Am. Patents Dev. Corp., 283 U.S. 27 (1931); Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917). All three decisions involved notice restrictions and patent infringement suits for their violation.

235. Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (overturning per se rule against minimum resale price maintenance); State Oil Co. v. Khan, 522 U.S. 3, 18 (1997) (overturning per se rule against maximum resale price maintenance); *see* AREEDA & HOVENKAMP, *supra* note 5, ¶¶ 1620 (minimum RPM), 1635 (maximum RPM).

236. On this point, see 9 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1720 (2d ed. 2005 & Supp. 2005).

237. Ill. Tool Works, Inc. v. Indep. Ink, Inc., 547 U.S. 28 (2006) (upsetting presumption of market power for patented tying products); *see* 2B PHILLIP E. AREEDA, JOHN L. SOLOW & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 518 (3d ed. 2007).

238. *See* LG Elecs., Inc. v. Bizcom Elecs., Inc., 453 F.3d 1364 (Fed. Cir. 2006), *rev'd sub nom.* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008).

239. *See* HOVENKAMP, *supra* note 5, ¶ 1821.

ments to the patentee's technology. That was the position that the government took in its amicus brief to the Supreme Court.[240]

IV.
CONCLUSION: POST-SALE RESTRAINT DOCTRINE

The problem of reaching downstream parties disturbed both sides of the *Quanta* dispute, but seems to favor the Federal Circuit's approach. Those favoring the Federal Circuit's approach speak of the great difficulty of identifying downstream purchasers and negotiating individual licenses with them. Those favoring the contract approach speak of the problem of taking downstream users by surprise by means of ineffectively communicated restrictions and a set of infringement rules that can be enforced without regard to privity of contract and the limitations inherent in contract damage rules.

The Supreme Court and the government's position in *Quanta* seems excessively draconian, yielding a per se rule against a practice that was not clearly shown to be more harmful than its alternatives, at least when infringement actions are conditioned on effective notice communicated in a timely manner. In a world in which both post-sale conditions and license restrictions are available one would expect the parties to negotiate the one that was most profitable to them. It is not obvious that one is more harmful than the other, at least in those circumstances when adequate notice is given to potential downstream infringers.

In the sixty-year interval between *Univis* and *Quanta*, the Supreme Court's most recent two first sale cases, the Court (1) adopted and later rejected a per se rule for vertical nonprice restraints;[241] (2) abandoned the per se rule against maximum RPM in 1997[242] and minimum RPM in 2007;[243] (3) greatly loosened the law

240. *See* Brief for the United States as Amicus Curiae Supporting Petitioners at 27, Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617 (2008) (No. 06-937), 2007 WL 3353102:

> This case provides an illustration. Absent patent exhaustion, the lawful purchase of an article useful only for practicing the patent provides no value to the purchaser until completion of further negotiations and a further payment for the right to use or to resell. Moreover, the need for further negotiations and payments may depend on a court's after-the-fact determination whether the seller adequately expressed a limitation on the rights conveyed.

241. *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) (condemning vertical nonprice restraints under per se rule), *overruled by* Continental T.V. v. GTE Sylvania, Inc., 433 U.S. 36 (1977); *see also supra* notes 74–77 and accompanying text.

242. *See* State Oil Co. v. Khan, 522 U.S. 3, 18 (1997).

against tying arrangements;[244] and (4) developed more lenient standards for exclusive dealing. The *Illinois Tool Works* decision upsetting the market power presumption for patented tying products is particularly instructive, because the court made it clear that both antitrust and misuse doctrine had evolved toward considerably greater toleration of post-sale tying restrictions on patented goods.[245]

The reversion in *Quanta* requires an explanation. A coherent legal doctrine of post-sale IP restraints must first identify the set of goals it is designed to serve. In this case there are two: restraints on competition and restraints on innovation, together with a more residual concern to protect access to the public domain. As a policy matter, whether the restraint is carried out by a condition and enforced by an infringement action, or by a contract term enforceable through state law, is a detail that depends greatly on the communication of effective notice, but otherwise has little effect on either competition or innovation policy. If the Supreme Court had viewed the problem this way it could have produced a more unified and useful set of legal rules governing post-sale restraints that threaten either competition or innovation.

243. *See* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

244. *See* Ill. Tool Works, Inc. v. Indep. Ink, Inc., 547 U.S. 28 (2006); Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2 (1984); U.S. Steel Corp. v. Fortner Enters., Inc., 429 U.S. 610 (1977).

245. *Ill. Tool Works*, 547 U.S. at 33–37.

CURTAILING THE IMPACT OF CLASS ACTIONS ON ANTITRUST POLICY

*JONATHAN M. JACOBSON & JOYCE CHOI**

Thou shalt not grant or deny class certification based on an analysis of the probability of success on the merits of the plaintiffs' claim. That fundamental principle of procedural jurisprudence was announced over 25 years ago in *Eisen v. Carlisle & Jacquelin*[1] and remains bedrock law today. But the principle has had increasingly negative consequences, has helped lead to an undue narrowing of substantive antitrust rules, and is no longer supported by the reasons originally given for it. This Article, therefore, suggests that *Eisen* has outlived its usefulness and should be overruled.

I.

The complaint in *Eisen* challenged the "odd-lot differential"—a markup imposed on those who traded odd lots (typically, those amounts not rounding to 100)—on the New York Stock Exchange.[2] The charge was that the broker defendants had monopolized odd-lot trading and had elevated the markup in violation of the antitrust and securities laws.[3] The action was brought on behalf of a putative class of all traders who had purchased securities in odd lots on the Exchange for the period allowed by the statute of limitations.[4]

The district court initially denied class certification, but the U.S. Court of Appeals for the Second Circuit reversed that determination and remanded for consideration of a number of issues, most prominently the matter of notice under Rule 23(c)(2).[5] On remand, the district court concluded that, although the named plaintiff's claim was for just $70, the cost of providing notice was much higher. Notice by publication would only cost $21,720; personal notice by mail was estimated to cost $225,000.[6] The plaintiff made

* Partner and associate, respectively, Wilson Sonsini Goodrich & Rosati, New York. Many thanks to Professor Daniel Rubinfeld for helpful comments.

1. 417 U.S. 156 (1974).
2. *Id.* at 160.
3. *Id.*
4. *Id.*
5. Eisen v. Carlisle & Jacquelin, 391 F.2d 555, 568–70 (2d Cir. 1968) (remanding for evidentiary hearing on what type of publication would suffice to comply with Rule 23(c)(2) provisions and due process considerations).
6. *Eisen*, 417 U.S. at 167.

clear that he could not pay even the lower amount,[7] and would not pay given the disparity compared to his claim.[8] The court decided, however, that the plaintiff's inability to pay the cost of notice did not by itself mean that he was an inadequate class representative.[9] Instead, the district court concluded that the determination of who would bear the notice costs would be based on an assessment of the merits following a preliminary hearing.[10] The court held such a hearing, found that the plaintiff was "more than likely" to prevail at trial, and ruled that the defendants should therefore bear 90 percent of the cost of notice.[11] On appeal, the Second Circuit again reversed.[12] The court concluded that publication notice was not sufficient and individual notice was required.[13] More importantly for present purposes, the court concluded that a preliminary inquiry into the merits was improper and that the plaintiff, as the proponent of class treatment, bore the full responsibility for funding the notice.[14] Because the plaintiff refused to do so, the court denied class certification.[15]

The Supreme Court granted certiorari and effectively affirmed.[16] Writing for the Court, Justice Powell's opinion first agreed with the Second Circuit that, because the names of class members were "identifiable through reasonable effort," notice by mail was required notwithstanding the expense.[17] Further, the Court rejected the idea that an inquiry into the merits was permissi-

7. Eisen v. Carlisle & Jacquelin, 52 F.R.D. 253, 269 (S.D.N.Y. 1971).
8. *Eisen*, 417 U.S. at 167–68.
9. *Eisen*, 52 F.R.D. at 269–70.
10. *Id.* at 270–71.
11. Eisen v. Carlisle & Jacquelin, 54 F.R.D. 565, 567 (S.D.N.Y. 1972).
12. Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1008 (2d Cir. 1973).
13. *Id.* at 1015.
14. *Id.* at 1015–17.
15. *Id.* at 1016–17.
16. Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974). At the time, district courts (and some circuit courts) were divided on the propriety of preliminary merits hearings. In favor of preliminary merits hearings: Dolgow v. Anderson, 43 F.R.D. 472, 501 (E.D.N.Y. 1968), *rev'd on other grounds,* 438 F.2d 825 (2d Cir. 1971); Milberg v. W. Pac. R.R., 51 F.R.D. 280, 282 (S.D.N.Y. 1970); City of Phila. v. Emhart Corp., 50 F.R.D. 232, 234–35 (E.D. Pa. 1970). Against preliminary merits hearings: Kahan v. Rosenstiel, 424 F.2d 161, 169 (3d Cir. 1970); Miller v. Mackey Int'l, Inc., 452 F.2d 424, 429–30 (5th Cir. 1971); Mersay v. First Republic Corp. of Am., 43 F.R.D. 465, 469 (S.D.N.Y. 1968); Fogel v. Wolfgang, 47 F.R.D. 213, 215 n.4 (S.D.N.Y. 1969); Cannon v. Tex. Gulf Sulphur Co., 47 F.R.D. 60, 65–66 (S.D.N.Y. 1969); Berland v. Mack, 48 F.R.D. 121, 132 (S.D.N.Y. 1969); Katz v. Carte Blanche Corp., 52 F.R.D. 510, 513 (W.D. Pa. 1971); Dorfman v. First Boston Corp., 62 F.R.D. 466, 472 (E.D. Pa. 1973).
17. *Eisen*, 417 U.S. at 175–76.

ble to determine whether the case warranted treatment as a class action.[18] The Court maintained that inquiring into the merits would give the plaintiff some of the benefits of class certification before a class was even certified, that defendants might be prejudiced by such a preliminary determination, and that an early merits conclusion was inconsistent with Rule 23's requirement that the certification determination be made "as soon as practicable after the commencement of the action."[19]

II.

For many years, *Eisen* made class certification progressively easier. Courts carefully avoided any discussion of the merits, sometimes even in contexts in which a determination whether the plaintiff had satisfied the elements of Rule 23 necessarily touched on merits-related issues. Indeed, notwithstanding the Supreme Court's recognition in *Coopers & Lybrand v. Livesay*[20] that the certification decision is often enmeshed with merits issues,[21] and its determination in *General Telephone Co. v. Falcon*[22] that a "rigorous analysis" is required before class certification can be granted,[23] grants of class certification in antitrust cases quickly became routine. Courts proceeded from the premise that "the substantive allegations of the complaint [should be taken] as true,"[24] and concluded that any doubts had to be resolved "in favor of certifying the class."[25] Many decisions indicated that class certification was especially appropriate in antitrust cases and that common proof of the issue of violation alone was sufficient to satisfy the predominance requirement of Rule 23(b)(3).[26] And even though the critical issue in many cases was whether each class member incurred

18. *Id.* at 177.

19. *Id.* at 177–78 (internal citations omitted). Rule 23(c)(1) has since been amended. It now states that certification must be determined "[a]t an early practicable time." FED. R. CIV. P. 23(c)(1)(A). The change was made in recognition that "[t]ime may be needed to gather information necessary to make the certification decision." FED. R. CIV. P. 23(c)(1)(A) advisory committee's note on 2003 amendments (2003).

20. 437 U.S. 463 (1978).

21. *Id.* at 469 n.12.

22. 457 U.S. 147 (1982).

23. *Id.* at 160–61.

24. Blackie v. Barrack, 524 F.2d 891, 901 n.17 (9th Cir. 1975).

25. *In re* Playmobil Antitrust Litig., 35 F. Supp. 2d 231, 239 (E.D.N.Y. 1998) (citing *In re* Control Data Corp. Sec. Litig., 116 F.R.D. 216, 219 (D. Minn. 1986)).

26. *See* HERBERT NEWBERG ET AL., NEWBERG ON CLASS ACTIONS §§ 18:25–18:26 (4th ed. 2009) [hereinafter NEWBERG]; *see, e.g.*, *In re* Warfarin Sodium Antitrust Litig., 391 F.3d 516, 528–29 (3d Cir. 2004) (citing Amchem Prods., Inc. v. Wind-

similar injuries in a similar fashion from the conduct at issue, courts regularly rejected defense protests to certification with the principle that "[a]t this stage in the proceedings, the Court only must find that plaintiffs have set forth a valid methodology for proving antitrust impact common to the class, not that they will prove it."[27]

Decisions in the Second, Third, and Ninth Circuits took these principles to extremes. In *Caridad v. Metro-North Commuter Railroad*,[28] the Second Circuit prohibited district courts from weighing conflicting expert evidence or engaging in a "battle of experts" concerning the elements of Rule 23.[29] That court went further in *In re Visa Check/MasterMoney Antitrust Litigation*,[30] concluding that challenges to the presentation of the plaintiffs' expert—often the only source of evidence supporting class certification—were limited to determining whether the expert's "proposed methods are so insubstantial as to amount to no method at all."[31] The Third Circuit followed similar reasoning in its decision in *In re Linerboard Antitrust Litigation*,[32] as did the Ninth Circuit in its original panel decision in *Dukes v. Wal-Mart, Inc.*[33]

Within the past few years, a number of these permissive rulings have been curtailed. Starting with a non-antitrust decision by Judge Easterbrook in the Seventh Circuit, courts began to recognize that a plaintiff had to establish the requirements of Rule 23 even if proof of one or more of the Rule's requirements overlapped with an evaluation of the merits.[34] Recognizing this point in *Heerwagen v. Clear Channel Communications*,[35] the Second Circuit denied certification of a national class of concert-goers.[36] The court recognized that "rock concert" markets are necessarily local, not national[37]—a point that plainly overlapped with the merits issue of the scope of

sor, 521 U.S. 591, 623–24 (1997)); Mularkey v. Holsum Bakery, Inc., 120 F.R.D. 118, 122 (D. Ariz. 1988).

27. *In re* Magnetic Audiotape Antitrust Litig., No. 99 CIV. 1580(LMM), 2001 WL 619305, at *6 (S.D.N.Y. June 6, 2001).

28. 191 F.3d 283 (2d Cir. 1999).

29. *Id.* at 292–93.

30. 280 F.3d 124 (2d Cir. 2001).

31. *Id.* at 134–35 (quoting *In re* Potash Antitrust Litig., 159 F.R.D. 682, 697 (D. Minn. 1995)).

32. 305 F.3d 145, 155 (3d Cir. 2002).

33. 474 F.3d 1214, 1227 (9th Cir.), *withdrawn & superseded*, 509 F.3d 1168, 1178–79 n.2 (9th Cir. 2007), *on reh'g en banc*, 603 F.3d 571 (9th Cir. 2010), *petition for cert. filed*, 79 U.S.L.W. 3114 (U.S. Aug. 25, 2010) (No. 10-277).

34. Szabo v. Bridgeport Machs., Inc., 249 F.3d 672, 676 (7th Cir. 2001).

35. 435 F.3d 219 (2d Cir. 2006).

36. *Id.* at 222–23, 235.

37. *Id.* at 228–229.

the national market, but that also went to the heart of Rule 23(b)(3)'s requirement that common questions predominate. With multiple local markets rather than a single national market, the violation issue could not be common to all members of a putative national class.[38] Instead, the proof would vary from one area to another, precluding any finding of commonality under Rule 23(b)(3). Certification was therefore denied.[39]

Heerwagen was followed by the Second Circuit's landmark decision in *In re Initial Public Offering Securities Litigation*,[40] which expressly overruled *Caridad* and *Visa Check* and established that merits inquiries are permissible in class certification to the extent required to determine whether Rule 23's requirements have been satisfied.[41] The Third Circuit followed suit in *In re Hydrogen Peroxide Antitrust Litigation*,[42] as did the Ninth Circuit en banc in *Dukes*.[43] Despite the occasional outlier,[44] it now appears settled that merits inquiries are permitted to the limited extent of determining whether a plaintiff's claims are typical, whether common questions predominate, or whether the other requirements specified in Rule 23 have been met. Critically, however, what is still *not* permitted is an analysis of the merits to determine whether the case is sufficiently meritorious to warrant class action treatment—or, in the language of the Rule, whether the strength of the case on the merits makes class action treatment superior to non-class resolution.

III.

Since *Eisen*, class actions have become increasingly prevalent.[45] Class actions follow not only criminal antitrust convictions, but they also regularly follow closely on the heels of simple announcements of grand jury investigations.[46] Others are brought by purported

38. *Id.* at 229.
39. *Id.* at 229, 235.
40. 471 F.3d 24, 41 (2d Cir. 2006).
41. *Id.* at 41–42.
42. 552 F.3d 305, 320 (3d Cir. 2008).
43. Dukes v. Wal-Mart, Inc., 603 F.3d 571 (9th Cir. 2010), *cert. granted*, 79 U.S.L.W. 3342 (U.S. Dec. 06, 2010) (No. 10-277).
44. *E.g.*, *In re* Nifedipine Antitrust Litig., 246 F.R.D. 365 (D.D.C. 2007).
45. *See generally* ABA SECTION OF ANTITRUST LAW, ANTITRUST CLASS ACTIONS HANDBOOK 4–24 (2010).
46. For examples of guilty pleas, see *In re* Dynamic Random Access Memory (DRAM) Antitrust Litig., 546 F.3d 981 (9th Cir. 2008); *e.g.*, Press Release, U.S. Dep't of Justice, Antitrust Div., Samsung Agrees to Plead Guilty and to Pay $300 Million Criminal Fine for Role in Price Fixing Conspiracy (Oct. 13, 2005), *available at* http://www.justice.gov/atr/public/press_releases/2005/212002.htm; Press Re-

classes of purchasers who have simply copied civil complaints filed,[47] for example, by competitors. Still others are based on nothing more than stories cobbled together from news clippings.[48]

These cases are rarely easy to confine. Because of the lure of large attorneys' fees resulting from significant settlements, any class action complaint that appears likely to survive a motion to dismiss tends to attract follow-on cases. Direct purchaser cases are often followed by indirect purchaser cases under applicable state laws.[49] Later-filed cases are often brought in other federal district courts, or removed to federal court under the Class Action Fairness Act,[50] frequently resulting in proceedings before the Judicial Panel on Multidistrict Litigation. Then, once the cases are consolidated before a single district judge, the plaintiffs' counsel bargain among themselves for positions as lead counsel, liaison counsel, or members of the executive committee—all of which are expected to lead to large fee awards when the case is eventually settled.

The key moment in many of these cases is the determination of whether a class should be certified. If class certification is granted, the potential exposure is often so great as to make settlement the only prudent course, whether the case has any merit or not. To take a hypothetical but realistic example, certification of a class of two million members, each with a claim averaging $1000, increases the defendants' exposure from $1000 to $2 billion, or $6 billion after trebling.[51] Even if a case is severely lacking in merit so that the defendants have a 90 percent likelihood of prevailing, the expected

lease, U.S. Dep't of Justice Antitrust Div., Four Infineon Technologies Executives Agree to Plead Guilty in International DRAM price-fixing conspiracy (Dec. 2, 2004), *available at* http://www.justice.gov/opa/pr/2004/December/04_at_773.htm. The first of the *DRAM* class actions was brought within days of the announcement of a grand jury investigation. *See* Complaint, Nespole v. Micron Tech., Inc., 228 F. Supp. 2d 1379 (S.D.N.Y. June 21, 2002) (No. 02 CV 4798) (class action complaint); *In re* Micron Techs. Inc. Sec. Litig., 247 F.R.D. 627, 631 (D. Idaho 2007) ("On June 17, 2002, the U.S. Department of Justice (DOJ) issued a federal grand jury subpoena to Micron, seeking documents relating to communications between DRAM manufacturers regarding the pricing and sales of DRAM chips. DOJ also issued subpoenas to the other two largest global manufacturers of DRAM, Samsung and Infineon Technologies.").

47. *See, e.g.*, *In re* Live Concert Antitrust Litig., 247 F.R.D. 98, 102 (C.D. Cal. 2007).

48. *In re* Online DVD Rental Antitrust Litig., No. M 09-2029 PJH, 2010 WL 2680837, at *3–4 (N.D. Cal. July 6, 2010).

49. *See generally* ABA SECTION OF ANTITRUST LAW, INDIRECT PURCHASER LITIGATION HANDBOOK (2007).

50. *See* 28 U.S.C. § 1332(d) (2006).

51. Trebling of damages in antitrust cases is mandatory under 15 U.S.C. § 15(a) (2006).

exposure is 10 percent of $6 billion, or $600 million. Paying hundreds of millions to settle this unmeritorious case still makes sense.

The late Milton Handler was often prone to hyperbole, but his comments on this process bear repetition:

> Any device which is workable only because it utilizes the threat of unmanageable and expensive litigation to compel settlement is not a rule of procedure — it is a form of legalized blackmail. If defendants who maintain their innocence have no practical alternative but to settle, they have been de facto deprived of their constitutional right to a trial on the merits. The distinctions between innocent and guilty defendants and between those whose violations have worked great injury and those who have done little if any harm become blurred, if not invisible. The only significant issue becomes the size of the ransom to be paid for total peace.[52]

IV.

It seems plain that the potential excesses inherent in antitrust class action litigation have had some impact on the Supreme Court. Unfortunately, the impact has not been felt in class certification determinations, as the Court has not considered the requirements of Rule 23 in any depth for over twenty years. What the Court has done, instead, is to narrow the *substantive* scope of the antitrust laws—sometimes in an excessive and unfortunate way.

Since the partial victory for the plaintiffs in *Hartford Fire Insurance Co. v. California*[53] in 1993, no plaintiff has prevailed in whole or in part in any substantive antitrust decision on the merits in the Supreme Court. Many of the cases since then were relatively uncontroversial decisions, such as *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*[54] and *Texaco Inc. v. Dagher*,[55] but others have involved serious questions of law and policy. The defendants have prevailed every time, and in most of the cases the vote has not even been close.

In *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP*,[56] for example, the Court significantly narrowed the scope of Section 2 of the Sherman Act.[57] The Court concluded that it was

52. MILTON HANDLER, 25 YEARS OF ANTITRUST 864–65 (1973).
53. 509 U.S. 764 (1993).
54. 549 U.S. 312 (2007).
55. 547 U.S. 1 (2006).
56. 540 U.S. 398 (2004).
57. *Id.* at 415–16.

lawful for Verizon, which had a local telephone lines monopoly, to discriminate against would-be rivals and thus exclude them from competing effectively in the local telephone service market.[58] Seemingly contrary to decades of precedent holding that there was no implied immunity from the presence of federal regulatory oversight,[59] the Court concluded that the presence of regulation limited the need for antitrust intervention—doing so in the face of an express statutory "savings clause" that was intended to preclude, or so Congress thought, any finding of implied immunity.[60] In addition, in addressing whether Verizon's de facto refusal to deal was actionable, the Court expressly limited its prior 1985 decision—a unanimous one—in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*,[61] stating, gratuitously, that "*Aspen Skiing* is at or near the outer boundary of § 2 liability."[62] The decision, moreover, was a lopsided 9–0 (although Justices Stevens, Souter, and Thomas concurred only in the result, stating that they would have dismissed the case instead for lack of standing).[63]

The decision in *Bell Atlantic Corp. v. Twombly*,[64] decided in 2007, reached further. Like *Trinko*, the case arose on a motion to dismiss, and the industry setting was again local telephone service.[65] The plaintiffs alleged that the business decision of each of the nation's local carriers, including Bell Atlantic, AT&T/SBC, Bell South, and Qwest, not to enter each other's local market, was the product of an unlawful conspiracy.[66] The Second Circuit had sustained the complaint on a questionable basis, relying principally on the allegations of parallel conduct,[67] although the complaint also alleged communications in trade association-type settings, quotations from news reports, and conduct said to be contrary to individual self interest.[68] The Supreme Court might well have simply reversed under the traditional doctrine that parallel conduct, without more, is not

58. *Id.* at 410–11, 415–16.

59. *See, e.g.*, Nat'l Gerimedical Hosp. & Gerontology Ctr. v. Blue Cross of Kan. City, 452 U.S. 378, 388–89 (1981).

60. *Trinko*, 540 U.S. at 412–15.

61. 472 U.S. 585 (1985).

62. *Trinko*, 540 U.S. at 408–10 (discussing *Aspen*, 472 U.S. 585).

63. *Id.* at 416–18.

64. 550 U.S. 544 (2007).

65. *Id.* at 549.

66. *Id.* at 550–51.

67. *See id.* at 553.

68. *See id.* at 552, 567–69.

conspiracy[69] and that the additional facts alleged really added nothing more. Instead, however, the Court reached out to overrule the decades-old standard of *Conley v. Gibson*,[70] which had established that complaints could not be dismissed unless it was clear that the plaintiff would be unable to prove any set of facts that would entitle him to relief.[71] In its place, the Court articulated a new requirement that a plaintiff allege facts with sufficient specificity to state a claim for relief that is "plausible."[72] Allegations merely consistent with unlawful conduct are not enough; rather, there has to be enough "factual enhancement" or "heft" to suggest a plausible violation.[73] The Court gave the provisions of Rule 8, requiring just "a short and plain statement of the claim," lip service only.[74] The vote was 7–2, with only Justices Stevens and Ginsburg dissenting.[75]

Roughly a month after *Twombly*, the Supreme Court decided *Credit Suisse Securities (USA) LLC v. Billing*.[76] As in *Trinko* and *Twombly*, the case arose on a motion to dismiss under Rule 12(b)(6).[77] The plaintiffs alleged that the defendant investment banks violated the Sherman Act by forming syndicates that raised the prices paid by investors in initial public offerings (IPOs) by technology companies through a variety of practices not authorized under the securities laws or by any Securities and Exchange Commission regulation or order;[78] these included practices such as: "laddering" (requiring buyers to purchase additional shares at escalating prices); fixing commission rates at unusually high levels; and tying purchases of desirable IPO shares to commitments to purchase shares in less desirable IPOs.[79] As in *Trinko*, there was a savings clause intended to preclude antitrust immunity.[80] Additionally, prior case law had established, without controversy, that immunity from the antitrust laws could not be implied (even without a savings clause) from the presence of a regulatory regime unless there was a showing of a "clear repugnancy" that the two sets of laws

69. *See, e.g.*, Theatre Enters. v. Paramount Film Distrib. Corp., 346 U.S. 537, 540–41 (1954).
70. 355 U.S. 41 (1957).
71. *Id.* at 45–46.
72. *Twombly*, 550 U.S. 544, 556 (2007).
73. *Id.* at 557.
74. *Id.* at 555–60.
75. *Id.* at 570.
76. 551 U.S. 264 (2007).
77. *Id.* at 270.
78. *Id.* at 278.
79. *Id.* at 268–70.
80. *Id.* at 275.

could not coexist in tandem.[81] Nevertheless, the Supreme Court held that the complaint failed to state a claim based on implied immunity of these practices due to overlapping securities laws regulation.[82] The Court reasoned that although there was no current conflict, it was possible that one might arise in the future.[83] Prior law, requiring an actual and irreconcilable conflict,[84] was simply ignored. Only Justice Thomas dissented, although Justice Stevens concurred in the result only.[85]

In addition to *Trinko*, *Twombly*, and *Billing*, several other recent decisions have cut back on the scope of the antitrust laws. *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*[86] overruled the century-old per se rule against vertical price fixing.[87] *Illinois Tool Works Inc. v. Independent Ink, Inc.*[88] overruled the presumption of market power from the possession of a patent and clearly implied overruling of the per se rule for tying.[89] *Weyerhauser* made predatory buying cases virtually impossible,[90] and *Pacific Bell Telephone Co. v. LinkLine Communications*[91] eliminated any prospect of price squeeze liability.[92] Apart from *Leegin*, none of these decisions can be viewed as especially controversial. But as a group, especially when combined with *Trinko*, *Twombly*, and *Billing*, they highlight the current Court's commitment to curtailing the antitrust laws.

The procedural implications of *Twombly* have been particularly profound. Until the 1980s, antitrust litigation had been largely a trial practice. Summary judgment was disfavored[93] and Rule 12 dismissals almost unthinkable. By 1986, however, antitrust had become largely a summary judgment practice. The decisions in *Celotex*

81. *See, e.g.*, ANTITRUST MODERNIZATION COMMISSION, REPORT & RECOMMENDATIONS 357–66 (2007).

82. *Billing*, 551 U.S. at 267–68.

83. *Id.* at 279–84.

84. *See, e.g.*, Nat'l Gerimedical Hosp. & Gerontology Ctr. v. Blue Cross of Kan. City, 452 U.S. 378, 388–89 (1981).

85. *Billing*, 551 U.S. at 285 (Stevens, J., concurring), 287 (Thomas, J., concurring).

86. 551 U.S. 877 (2007).

87. *Id.* at 882.

88. 547 U.S. 28 (2006).

89. *Id.* at 31.

90. Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 549 U.S. 312, 325 (2007).

91. 129 S. Ct. 1109 (2009).

92. *Id.* at 1114–15.

93. Poller v. CBS, 368 U.S. 464, 473 (1962) ("[S]ummary procedures should be used sparingly in complex antitrust litigation.").

Corp. v. Catrett,[94] *Anderson v. Liberty Lobby, Inc.*,[95] and *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*[96] made summary judgment the focus of virtually every case such that the few plaintiffs' cases that survived summary judgment typically settled for significant value. Only a tiny percentage of cases ever reached trial. By 2002, the Second Circuit was able to say, persuasively, that summary judgment in antitrust cases is "particularly favored."[97] Now, antitrust has become a motion to dismiss practice. Scarcely a case is filed that is not met with a motion to dismiss. And because most courts, in another change from prior practice, typically stay all discovery pending resolution of the motion,[98] the incentive for a defendant to seek dismissal (and thus delay discovery) is heightened even further.

The overhang of private litigation generally, and class actions in particular, in these decisions is apparent. *Trinko*, *Twombly*, and *Billing* were all putative class actions. The Court was especially concerned about potentially abusive litigation in *Twombly*. Recognizing the "extensive scope of discovery in antitrust cases," and the reality that "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases,"[99] the Court justified its new pleading standard on the need to avoid such abuse:

> [D]iscovery accounts for as much as 90 percent of litigation costs when discovery is actively employed. . . . That potential expense is obvious enough in the present case: plaintiffs represent a putative class of at least 90 percent of all subscribers to local telephone or high-speed Internet service in the continental United States, in an action against America's largest telecommunications firms (with many thousands of employees generating reams and gigabytes of business records) for unspecified (if any) instances of antitrust violations that allegedly occurred over a period of seven years.[100]

94. 477 U.S. 317 (1986).

95. 477 U.S. 242 (1986).

96. 475 U.S. 574 (1986).

97. PepsiCo, Inc. v. Coca-Cola Co., 315 F.3d 101, 104 (2d Cir. 2002).

98. *E.g.*, Wagner v. Circle W. Mastiffs, No. 2:09-cv-0172, 2009 WL 5195862, at *2 (S.D. Ohio Dec. 22, 2009) (staying all discovery related to the antitrust claims).

99. *Twombly*, 550 U.S. at 558–59.

100. *Id.* at 559 (citing Memorandum from Paul V. Niemeyer, Chair, Advisory Comm. on Civil Rules, to Hon. Anthony J. Scirica, Chair, Comm. on Rules of Practice and Procedure (May 11, 1999), 192 F.R.D. 354, 357 (2000)) (internal punctuation omitted).

Similar concerns were echoed in *Billing*.[101]

V.

The concerns expressed about private litigation in *Twombly* and *Billing* have contributed significantly to the reality, pointed out recently by Federal Trade Commissioner Rosch, that "the Supreme Court has steadily been 'shrinking' the ambit of the Sherman Act both procedurally and substantively."[102] This shrinkage has been problematic. Decisions in the late 1970s through the early 1990s made clear that the focus of the antitrust laws was on the promotion of consumer welfare; this perspective commanded unusually broad support in the academy, the enforcement agencies, and the private bar. The perspective has been noticeably absent, however, from the Court's more recent decisions; the focus, instead, has been on the harms potentially caused by false positives. Moreover, many of these decisions are at least debatable on their merits and some aspects of their reasoning. For example, the expansion of implied immunity in the face of congressional savings clauses in both *Trinko* and *Billing* seems wrong. *Twombly*, moreover, cuts an especially broad swath. It curtails not only cases without merit, but has at least equal potential to inhibit potentially meritorious cases filed based on a view of the facts that can be substantiated only after some discovery has been taken.[103]

The Supreme Court's evident concern with the potential abuse of antitrust law seems overbroad. Although thirty-five years ago, precedents such as *Utah Pie*,[104] *Schwinn*,[105] *Pabst*,[106] *Fortner I*,[107] and *Topco*[108] gave rise to legitimate concerns of substantive false positives, those decisions have all now been overruled either expressly or in practical effect. They have been replaced by a regime under which horizontal restraints are governed by *BMI*[109] and *Dagher*,[110]

101. Credit Suisse Sec. (USA) LLC v. Billings, 551 U.S. 264, 281–84 (2007) (noting risk "that antitrust courts are likely to make unusually serious mistakes" where securities markets are involved).

102. Intel Corp., No. 9341, 2009 WL 49999728 (Fed. Trade Comm'n Dec. 16 2009) (Rosch, Comm'r, concurring in part and dissenting in part).

103. For a recent and potentially important decision appearing to limit the reach of *Twombly*, however, see Starr v. Sony BMG Music Entm't., 592 F.3d 314, 323 (2d Cir. 2010).

104. Utah Pie Co. v. Cont'l Baking Co., 386 U.S. 685 (1967).

105. United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

106. United States v. Pabst Brewing Co., 384 U.S. 546 (1966).

107. Fortner Enters. v. U.S. Steel Corp., 394 U.S. 495 (1969).

108. United States v. Topco Assocs., 405 U.S. 596 (1972).

109. Broad. Music, Inc. v. CBS, 441 U.S. 1 (1979).

vertical restraints by *Sylvania*[111] and *Khan*,[112] tying by *Fortner II*[113] and *Illinois Tool*,[114] predatory pricing by *Brooke Group*,[115] and mergers by *General Dynamics.*[116] The prospects for false positives have been reduced dramatically and can no longer reasonably be viewed as a basis for narrowing substantive antitrust laws further.[117] The risk now is one of false negatives, and that risk may be becoming increasingly serious.[118] Worse, although the Court seems predominantly concerned with the potential for abuse in private litigation, the Court's limitations on substantive antitrust in cases such as *Billing* and *Trinko* extend more broadly. The effects of these cases may well limit even government enforcement.[119]

The general concerns about private litigation appear to be likewise overbroad. Individual private cases are typically not subject to the same abuses as class action litigation. Individual litigants must hurdle the antitrust injury requirement,[120] and the plaintiffs must bear their share of the burden and the cost of discovery. Importantly, discovery goes both ways, thus carrying a threat of "mutual assured destruction" if matters get out of hand. Individual plaintiffs normally have no incentive, therefore, to increase the cost of discovery to pressure defendants into settling. Often, in fact, in individual litigation, the incentives may be reversed, with defendants

110. Texaco Inc. v. Dagher, 547 U.S. 1, 5–8 (2006).

111. Cont'l T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 58–59 (1977).

112. State Oil Co. v. Khan, 522 U.S. 3 (1997).

113. U.S. Steel Corp. v. Fortner Enters., Inc., 429 U.S. 610 (1977).

114. Ill. Tool Works Inc. v. Indep. Ink, Inc., 547 U.S. 28, 36 (2006).

115. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

116. United States v. Gen. Dynamics Corp., 415 U.S. 486 (1974).

117. For an excellent discussion, see Andrew I. Gavil, *Antitrust Bookends: The 2006 Supreme Court Term in Historical Context*, 22 ANTITRUST 21 (2007).

118. For a recent and especially narrow construction of section 2, in the context of a putative class action, see Allied Orthopedic Appliances Inc. v. Tyco Health Care Grp. LP, 592 F.3d 991, 998–1000 (9th Cir. 2010). Perhaps because class certification had been denied and the "value" of the case had thus been diminished, the class plaintiffs in the case did not even seek rehearing en banc in *Allied*, notwithstanding the opinion's articulated conflict with the D.C. Circuit's opinion in the *Microsoft* case.

119. *Cf.* Rambus Inc. v. FTC, 522 F.3d 456, 463 (D.C. Cir. 2008).

120. Atl. Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 334 (1990); Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 489 (1977). Antitrust injury is a requirement in all cases but is easily satisfied in class action cases brought by purchasers claiming overcharges. It can be a difficult hurdle for cases brought by competitors. *See generally* Jonathan M. Jacobson & Tracy Greer, *Twenty-One Years of Antitrust Injury: Down the Alley with* Brunswick v. Pueblo Bowl-O-Mat, 66 ANTITRUST L.J. 273 (1998).

seeking to enhance the scope of discovery to pressure the individual plaintiff to yield.

Class actions, however, are different. In consumer cases, discovery is almost entirely one-sided, with the defendants bearing virtually the entire burden of production and the lion's share of the cost. The imbalance may be less acute in business-to-business class actions, but even there the costs and burdens are borne overwhelmingly by defendants. The upshot is a built-in incentive for discovery abuse, especially in consumer cases. Typical cases involve some or all of the following:

- Refusal to agree on custodian limits
- Refusal to agree on search terms for electronic data
- Unrealistic demands for document preservation, imposing significant information systems and storage costs
- Costly data demands
- Insistence on senior executive depositions irrespective of basis

Concerns that appear, at least in part, to have motivated the Supreme Court's recent campaign to narrow the scope of the antitrust laws, are valid when confined to an identifiable minority of cases, namely, class actions. There is no evidence to support the view that there continue to be false positives sufficient to warrant further curtailment of substantive antitrust doctrine,[121] nor evidence to suggest any prevalence of abusive behavior in non-class action private litigation. The problem is in the class action arena, and logic suggests that the solution should be in that arena as well.

VI.

The rationale underlying the class action device, and Rule 23 generally, remains entirely valid. In the antitrust context, if there is a violation affecting many who are injured in a similar fashion, having the issues adjudicated in one proceeding rather than many (or, more realistically, none) makes good sense. Importantly, class actions also provide a useful means for defendants to buy universal peace by settling consensually with all similarly situated who might be prompted to sue.

Problems arise, however, when contested class certifications are too easy. The basic Rule 23 requirements for class certification

121. *See* Jonathan Jacobson, *Towards a Consistent Antitrust Policy for Unilateral Conduct*, THE ANTITRUST SOURCE, Feb. 2009, at 3, *available at* http://www.abanet.org/antitrust/at-source/09/02/Feb09-Jacobson2-26f.pdf.

have due process overtones and cannot be ignored.[122] Classes should never be certified, for example, unless the members of the putative class can assert that they were injured by the same conduct in the same way. The recent elevation of the requirements for class certification, as reflected in *Szabo*, *Heerwagen*, *IPO*, *Hydrogen Peroxide*, and *Dukes II*, was therefore essential to correct the error in the *Caridad* line of cases that allowed classes to be certified based on little more than some expert's unsupported say-so. *Szabo* and the cases following it do not, however, truly solve the basic problem. In many cases, the requirements of Rule 23 can be satisfied even if the underlying case lacks merit, and the potential for a legalized blackmail effect will persist in any such case where the pleading requirements of *Twombly* can be met.

The problem can be resolved, or at least mitigated substantially, by overruling *Eisen* and requiring that a case be shown to have merit before class certification is granted. The standard for the requisite showing on the merits need not be insuperable, but at a minimum there should be some showing of at least a 40 percent likelihood of success—one that could be described as a "substantial possibility of success on the merits." Arguments could be made for a higher standard, such as a "reasonable probability" of success on the merits (meaning 50.1 percent or more), but whatever the precise standard, a requirement of proof that the case have *some* significant merit would be beneficial.

Such a requirement could most easily and effectively be achieved by amending Rule 23. That approach would involve approval of both the Supreme Court and Congress through the rules amendment process and would allow all affected constituencies to express their views. Alternatively, the Supreme Court could simply overrule *Eisen* through the certiorari process. That, however, would require the "right" case to come along, the issue to be preserved throughout the trial and appellate process, and the Supreme Court then to grant certiorari. Given that: (i) few class certification orders are reviewed on an interlocutory basis under Rule 23(f), (ii) the Supreme Court has never granted certiorari from a denial of Rule 23(f) review, (iii) class actions are so rarely tried, (iv) final judgments after trial in class action cases are almost unheard of, and (v)

122. *See* FED. R. CIV. P. 23(d)(2) advisory committee's note ("[M]andatory notice pursuant to subdivision (c)(2), together with any discretionary notice which the court may find it advisable to give under subdivision (d)(2), is designed to fulfill the requirements of due process to which class action procedure is of course subject."); Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950) (pointing out that notice is an integral part of due process).

the Supreme Court has not granted review on any Rule 23 class certification issue in years, the prospects for the issue to reach the Supreme Court anytime soon must be viewed as dim.[123]

That said, a compelling argument can nevertheless be made for overruling *Eisen* even without amending Rule 23. The present text of Rule 23(b)(3) requires that in any action for damages, the proponent of certification demonstrate "that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy."[124] As others have argued in the past, this wording provides textual support for express consideration of the merits, beyond their relationship to the other elements of Rule 23, in determining whether a class should be certified.[125]

Moreover, the reasons given in *Eisen* for avoiding consideration of the merits no longer seem valid, if indeed they ever were. The *Eisen* Court's first point was that an inquiry into the merits would give the plaintiff some of the benefits of class certification before certification was granted.[126] However, events since *Eisen* have demonstrated that *declining* to inquire into the merits effectively resolves the merits in the plaintiffs' favor (if certification is granted) by compelling settlement to avoid the threat of ruinous liability. Given a choice between these two options, evaluating the merits preliminarily would seem to be the lesser of the evils.

The Court's second rationale was that evaluating the merits prior to class certification might prejudice defendants by denying them the discovery needed to mount an appropriate defense.[127] That argument does not hold up. At least in the antitrust context, it is a rare case indeed in which an antitrust defendant cannot make out at least a preliminary defense before all discovery has been completed. In some cases, nonparty discovery may be necessary, but there is no reason why that discovery could not be taken in advance of the certification decision. Discovery prior to class certification is the norm in most contexts anyway.

123. The Supreme Court recently denied certiorari in a case that would have allowed it to pass on a number of significant issues under Rule 23. Kohen v. Pac. Inv. Mgmt. Co., 571 F.3d 672, 679–80 (7th Cir. 2009), *cert. denied*, 130 S. Ct. 1504 (2010). Still, the continuing validity of *Eisen* was not among the questions presented.

124. FED. R. CIV. P. 23(b)(3).

125. Douglas M. Towns, *Merit-Based Class Action Certification: Old Wine in New Bottle,* 78 VA. L. REV. 1001, 1009 (1992); Bartlett H. McGuire, *The Death Knell for* Eisen: Why the Class Action Analysis Should Include an Assessment of the Merits, 168 F.R.D. 366, 382 (1996).

126. Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177–78 (1974).

127. *Id.* at 178.

The third reason articulated by the *Eisen* Court was that allowing a preliminary ruling on probable merits was inconsistent with Rule 23's requirement that certification be determined "as soon as practicable after commencement of [the] action."[128] Practice under the Rule, however, has long permitted discovery prior to class certification. In any event, the text of the Rule has since been amended and now provides that certification should be determined "[a]t an early practicable time."[129]

Accordingly, none of the reasons advanced in support of the *Eisen* decision provides any reasoned basis for rejecting a preliminary inquiry into the merits in the current legal environment. So, if precedent does not compel adherence to *Eisen*, and if the text of Rule 23 permits an inquiry into the merits, the remaining question is whether or not permitting a preliminary evaluation of the merits is supported by considerations of policy. The view here is that policy considerations militate strongly in favor of abandoning the rule of *Eisen*. While there would be negatives as well as positives, the positives appear to outweigh the negatives significantly.

A. *Negatives.*

On the negative side, with *Eisen* gone, on average, more discovery would be required before certification is determined. The change here, though, should be modest. Some discovery has long been permitted prior to class certification and, after *IPO* and *Hydrogen Peroxide*, it is now clear that that this discovery may be quite substantial and may overlap significantly with merits discovery. The overlap is sufficiently great, in fact, that some courts today are considering class certification together with motions for summary judgment.[130]

Another more significant negative is that abandoning *Eisen* will tend to make the already crucial class action certification even more critical. District court judges already have considerable discretion in class certification, as appeals under Rule 23(f) are granted only rarely,[131] and allowing a single judge to make a determination

128. *Id.* (citing the then-current version of FED. R. CIV. P. 23(c)(1)).

129. FED. R. CIV. P. 23(c)(1)(A).

130. *See, e.g.*, Marcus Corp. v. Am. Express Co., No. 04 Civ. 5432 (S.D.N.Y. March 30, 2009) (denying class certification without prejudice to renew, if warranted, following determination of motions for summary judgment).

131. NEWBERG, *supra* note 26, § 7:38 (citing Prado-Steiman *ex rel.* Prado v. Bush, 221 F.3d 1266, 1276–77 (11th Cir. 2000) ("[I]nterlocutory appeals are inherently 'disruptive, time-consuming, and expensive,' and consequently are generally disfavored. . . . We will therefore use restraint in accepting Rule 23(f) petitions,

on both certification and preliminary merit means that determination will go far in dictating the outcome of the case.[132]

Despite the significance of this negative, it seems doubtful that it will reflect a truly significant change from the reality that defendants face today—namely, that a grant of class certification increases the pressure to settle irrespective of the perceived strength of the defense on the merits. Today, if certification is granted, the case will likely settle. If certification is granted and summary judgment for the defendants is denied, settlement is almost certain. Without the rule of *Eisen*, a grant of class certification will have an effect similar to a post-certification denial of summary judgment today. Any differences are unlikely to be dramatic.

B. Positives.

The positive effects of overruling *Eisen* appear to be far stronger. Low-merit cases will be discouraged ex ante. No longer will plaintiffs be encouraged to file cases based on arguments of common impact alone. Instead, plaintiffs will have an incentive to sue only in those cases where the prospects for ultimate success appear strong. Their incentives, then, will more closely mirror the incentives of individual plaintiffs in deciding whether to sue. Correspondingly, for those cases having substantial merit, the incentives of defendants to settle for reasonable value will be high.

Relatedly, without *Eisen,* plaintiffs will have to make greater monetary investments in document review, depositions, and experts before class certification. These are investments that should be encouraged for meritorious cases but discouraged for cases brought primarily for their *in terrorem* value in inducing settlement. Likely effects include: (1) a more even distribution of settlement bargaining leverage by causing a more equal distribution of pre-certification litigation costs, and (2) a reduction in the number of false negatives prompted by *Twombly* by discouraging premature dismissals of potentially meritorious complaints. Today, the text and subtext of *Twombly* call out to district courts to err on the side of dismissal of antitrust cases to avoid settlements induced by the

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and these interlocutory petitions will not be accepted as a matter of course.")); *see* FED. R. CIV. P. 23(f) advisory committee's note ("The court of appeals is given unfettered discretion whether to permit the [Rule 23(f)] appeal, akin to the discretion exercised by the Supreme Court in acting on a petition for certiorari.").

132. Nothing in the text of Rule 23(f) or the advisory committee comment to the provision's addition in 1998 suggests that appeals under the rule should be permitted as rarely as existing appellate practice suggests. Overruling *Eisen* might have the odd, but beneficial effect, of causing more 23(f) appeals to be allowed.

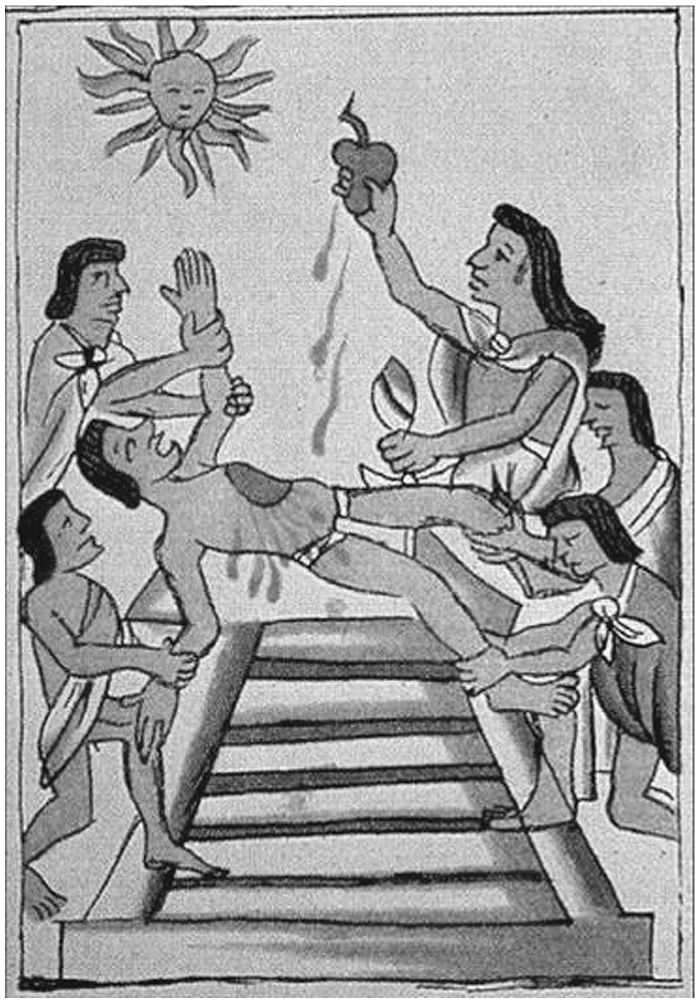
threat of onerous discovery. But if judges are aware that only cases with substantial merit will be certified as class actions, this effect is likely to recede over time. Without *Eisen*, courts will be freer to focus on the merits of a case. Less important issues, such as the degree of similarity or dissimilarity of the impact of an alleged violation on class members, will have less impact on ultimate outcomes.

It must also be acknowledged that overruling *Eisen* would mean that fewer cases would be certified as class actions. Proponents of class treatment would have to satisfy all the elements of Rule 23 that they must satisfy today, and they would face the additional hurdle of convincing a court that their case has substantive merit. Costs for financing class actions would rise. The inevitable result would be to decrease the number of cases allowed to proceed on a class basis.

But decreasing the number of classes that are certified is likely to have beneficial effects on balance. As mentioned, it will discourage unmeritorious cases ex ante and focus courts more precisely on the substantive issues—the issues that truly matter—in resolving the case. Most importantly, from a longer-term perspective, it will reduce the factors motivating the Supreme Court to curtail the substantive reach of the antitrust laws. If fewer class actions translate into Supreme Court decisionmaking that is focused on consumer welfare, rather than the need to curtail private litigation excesses, we will all be better off.

HEART OF DARKNESS: A SATIRICAL COMMENTARY

*J. DOUGLAS RICHARDS**



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Even the most enlightened mind will occasionally fall into a dark pattern of thought. Jonathan Jacobson is an exceptionally enlightened commentator on issues of antitrust law and policy. However, even Jacobson may fall into a dark pattern of thought from time to time. Indeed, Jacobson's strong attachment to the goals and ideals of antitrust could engender an emotional engagement on his part that may bring more primal impulses to the fore when, as in today's courts, powers that be are acting in unfortunate and sometimes irrational ways to curtail and stifle antitrust enforcement. I believe that to be what has happened in Jacobson's article.

Jacobson's core thesis, succinctly stated, is that in view of his perception that the conservative judiciary has been curtailing substantive antitrust law due to concerns about class actions, the courts should erect a new procedural requirement that, in order to have a class certified, the court must first make a finding that the plaintiff class has at least a forty-percent probability of success. The underlying notion is that to constrain class actions in that manner would cause the courts to cease unwarranted curtailments in substantive antitrust law.[1]

The darker pattern of thought into which I suggest Jacobson has fallen is the spirit of ritual sacrifice. That spirit has been with us forever. It has affected many cultures, at one time or another, and has been a core human institution in many. It has a natural, if largely irrational, grasp on our thinking. As Katherine Hepburn famously observed to Humphrey Bogart in *The African Queen*, however, "Nature, Mr. Allnut, is what we are put in this world to rise above."[2]

Accompanying this Article is a drawing on which one might profitably meditate when attempting to disentangle the various aspects of ritual sacrifice as a social phenomenon. What is it exactly that is wrong and irrational in the depicted way of ordering human affairs?

I suggest that there are four essential elements to its particular wrongness and irrationality. First, the "gods" to which it is addressed will not be appeased. As a method of protecting the broader community from misfortune, it just does not work. Second, the chosen victim has done nothing to deserve it. Third, it channels the energies of the community in an unconstructive direction. Fourth, it is politically unwise.

1. *See generally* Jonathan M. Jacobson & Joyce Choi, *Curtailing the Impact of Class Actions on Antitrust Policy*, 66 ANN. SURV. AM. L. 549 (2010).

2. THE AFRICAN QUEEN (Horizon Pictures & Romulus Films Ltd. 1951).

To test my perception that this pattern inheres in Jacobson's thesis, I analyze his thesis below against the framework of those four key elements. I leave it to the reader to judge whether, as to each element, Jacobson's thesis fairly meets the four proposed criteria for classification as an expression of ritual sacrifice, and what that signifies about the desirability of the procedural reform in class actions that Jacobson suggests in his article.

I.
THE GODS WILL NOT BE APPEASED

Jacobson rightly points out that the Supreme Court in recent years has unjustifiably curtailed the scope of antitrust—often without persuasively reasoned consideration of traditional rationales and policies of antitrust law. Examples that Jacobson offers are the Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*,[3] *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*,[4] and *Credit Suisse Securities (USA) LLC v. Billing*.[5] However, similar observations about several of the Court's other most recent decisions in the field of antitrust would be appropriate.[6]

The suggestion at the core of Jacobson's article is that the Supreme Court's recent decisions have drawn their impetus from an antipathy toward class actions, and not a broader antipathy toward antitrust law as such.[7] By erecting new hurdles to be surmounted in any successful antitrust class action, Jacobson suggests that the Court's iconoclastic impulses would be channeled away from deci-

3. 550 U.S. 544 (2007).
4. 540 U.S. 398 (2004).
5. 551 U.S. 264 (2007).
6. *E.g.*, Stolt-Nielsen, S.A. v. Animalfeeds Int'l Corp., 130 S. Ct. 1758 (2010) (holding that contractual arbitration clause that was concededly "silent" as to class arbitration proceedings cannot be interpreted by arbitration panel to permit class arbitration); Pacific Bell Tel. Co. v. Linkline Commc'ns, Inc., 129 S. Ct. 1109 (2009) (rejecting "price squeeze" antitrust theory because absent predatory pricing, AT&T had no obligation to provide DSL service to competing internet service providers at rates profitable for them); Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (overturning longstanding per se rule prohibiting resale price maintenance); Weyerhaeuser Co. v. Ross-Simmons Lumber Co., 549 U.S. 312 (2007) (applying same legal test to both predatory pricing and predatory bidding); Illinois Tool Works v. Indep. Ink, Inc., 547 U.S. 28 (2006) (rejecting presumption of market power arising from a patent); Texaco Inc. v. Dagher, 547 U.S. 1 (2006) (finding it was not per se unlawful for joint venture of competitors to set single price for gasoline produced by joint venture and sold separately by both); F. Hoffman-LaRoche Ltd. v. Empagran S.A., 542 U.S. 155 (2004) (curtailing application of U.S. antitrust law to transactions involving international commerce).
7. *See generally* Jacobson & Choi, *supra* note 1.

sions that undermine substantive antitrust law and instead toward a procedural direction that would trammel antitrust law to a lesser degree. Conservative judges would be satisfied by such procedural hindrances to class actions, Jacobson suggests, and would then stop doing unjustified damage to substantive antitrust law.[8] In short, the gods (i.e., Supreme Court justices and other conservative jurists) would be placated.

Importantly, however, pertinent opinions of the Supreme Court contain nothing substantial to support Jacobson's view. In *Trinko, Credit Suisse* and *Twombly*, the words "class action" make no appearance at all in the Court's reasoning, appearing only once or twice, at the most in each opinion in the course of mere descriptions of prior procedure in the cases.[9] Surely, if there were merit in Jacobson's core assertion that concerns about class actions are the driving force behind these opinions, the fact that many of the recent cases were class actions would have played some role in the Court's stated reasoning. To suggest otherwise would seem to require a belief that the Supreme Court has essentially "repressed" its true motivations, concealing a special animus against class actions in reasoning that expresses no special criticism of class actions at all.

Nor can any inference of a special desire to curtail class actions be drawn from the fact that some of the recent decisions have been class actions rather than other private cases or government cases. *Linkline, Leegin, Weyerhaeuser, Illinois Tool* and *Dagher* were not class actions, yet that did not stop the Supreme Court from revealing on apparent antipathy toward strong antitrust enforcement in those cases. Moreover, the vast majority of antitrust cases are private actions rather than government cases. As observed in *Reiter v. Sonotone Corp.*,[10] in the late 1970s "nearly 20 times as many private antitrust actions [were] pending in the federal courts as [were] actions filed by the Department of Justice." Since 1978 the number of private actions has declined significantly in percentage terms, but the num-

8. *See id.* Part VI.B.

9. In *Trinko* the phrase "class action" does not appear at all except in the Syllabus, which does not constitute part of the opinion. Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 398 (2004). Likewise in *Twombly* the words "class action" appear only once, in the opinion's second sentence, where the Court merely states that the question presented had arisen "in this putative class action." Bell Atl. Corp. v. Twombly, 550 U.S. 544, 548 (2007). In *Credit Suisse*, similarly, the phrase "class-action [sic]" appears only once, in a first sentence of mere procedural history. 551 U.S. at 269.

10. 442 U.S. 330, 344 (1979)

ber of government actions has fallen, on average, even more.[11] That none of the recent Supreme Court decisions curtailing antitrust law have been government cases likely reflects only the relative scarcity of Court of Appeals decisions in government antitrust cases.

In two recent cases the Supreme Court has squarely addressed class action issues. In *Shady Grove Orthopedic Associates, P.A. v. Allstate Insurance Co.*,[12] it addressed whether restrictions on class action enforcement that exist in New York procedural law should apply to actions in federal court based on New York substantive law. Similarly, in *Stolt-Nielsen*,[13] it addressed whether an arbitration clause that was considered "silent" on the issue of class proceedings could fairly be construed by the arbitrator to permit class arbitration. Even though both cases explicitly involved class action issues, nothing critical of class actions appears in the majority opinion in either case. The only commentary in either case that appears colorably critical of class actions is Justice Ginsberg's dissenting opinion in *Shady Grove*, which expresses a view that class actions can result in "ruinous liability" and create extraordinary "pressures to settle."[14] However, that statement cannot reflect a negative view of antitrust class actions on the part of the Court's conservatives who have issued opinions curtailing substantive antitrust law, both because *Shady Grove* was not an antitrust case and because Justice Ginsberg is not part of the conservative majority that has endorsed the curtailment of substantive antitrust law upon which Jacobson rests his argument.[15] Moreover, the majority opinion in *Shady Grove*, which was authored by Justice Scalia and joined by both the Chief Justice and Justice Thomas, says things arguably favorable toward class actions, for example, that "Rule 23 unambiguously authorizes *any* plaintiff, in *any* proceeding, to maintain a class action if the Rules prerequisites are met," and that aggregation of claims through a class action "alter[s] only how the claims are processed."[16] Thus, the few recent Supreme Court decisions that have squarely ad-

11. *See* SOURCEBOOK FOR CRIMINAL JUSTICE STATISTICS ONLINE, tbl. 5.41.2009, http://www.albany.edu/sourcebook/pdf/t5412009.pdf (2009).

12. 130 S. Ct. 1431 (2010).

13. Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp., 130 S. Ct. 1758, 1768 (2010).

14. 130 S.Ct. at 1465 n.3 (internal quotation marks omitted).

15. Justice Ginsburg dissented or joined in vigorous dissents in some of the recent cases curtailing antitrust law, including *Twombly, Leegin* and *Stolt-Nielsen*.

16. 130 S. Ct. at 1442–43. This statement is arguably in tension with the majority's observation, in *Stolt* that there are "fundamental" and "crucial" differences between individual disputes and class actions. *Stolt-Nielsen*, 130 S. Ct. at 1776. The latter is so neutral in tone, however, that it can scarcely even be characterized as criticism.

dressed class action issues tend further to rebut Jacobson's premise that animus toward class actions, and not toward antitrust as such, is behind the conservative majority's recent thinking.[17]

In sharp contrast, ample language in the opinions on which Jacobson focuses supports an alternative interpretation that the Supreme Court's concern in these cases involved issues with broad application to most aspects of antitrust enforcement, such as treble damages, a risk of false positives, and jury verdicts. The reasoning in *Twombly* rests heavily on a risk of conspiracy inferences from ambiguous evidence,[18] and on expressed goals of "checking discovery abuse" and "the threat of discovery expense,"[19] none of which are unique in any way to class actions. The reasoning in *Credit Suisse* rests on "line-drawing problems," dangers of false positives, "nonexpert judges" and "nonexpert juries," and the danger that misguided antitrust penalties "could seriously alter" affirmatively desirable conduct, which likewise have no special bearing on class actions.[20] Similarly, the reasoning in *Trinko* rests fundamentally on a perceived danger of "[m]istaken inferences and the resulting false condemnations," (i.e., false positives), and institutional limitations of "a generalist antitrust court,"[21] which have no unique applicability in the class action context. An inference that such concerns about judicial "line drawing," false positives, and the like lie at the core of the Supreme Court's antitrust concerns is further bolstered by statements in other relatively recent Supreme Court decisions such as *Linkline*,[22] which observed that "mistaken inferences are 'especially costly' [in] . . . predatory pricing" cases and *Brooke Group Ltd. v.*

17. A new case argued in November, 2010 before the Supreme Court, *Laster v. AT&T Mobility LLC*, 584 F.3d 840 (2d Cir. 2009), *cert. granted sub. nom. AT&T Mobility LLC v. Concepcion*, 130 S. Ct. 3322 (2010) (No. 09-893), may well elicit interesting information about the Supreme Court's attitudes concerning class actions, given the core contention of the Chamber of Commerce and other conservative amici in the case that class actions do little for class members. Brief of The Chamber of Commerce of the United States as Amicus Curiae in Support of Petitioner at 3–4, AT&T Mobility LLC v. Concepcion, No. 09-893 (Aug. 9, 2010). That contention is unfounded, at least in antitrust cases. *See infra* note 62. It is also unsupported in the amicus brief with any sort of empirical support or analysis.

18. Bell Atl. Corp. v. Twombly, 550 U.S. 544, 554 (2007).

19. *Id.* at 559.

20. Credit Suisse Securities (USA) LLC v. Billing, 551 U.S. 264, 279-85 (2007).

21. Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 414 (2004).

22. Pacific Bell Tel. Co. v Linkline Commc'ns, Inc., 129 S.Ct 1109, 1120 (2009).

Brown & Williamson Tobacco Corp., which stated that the "costs of an erroneous finding of liability are high" in predatory pricing cases.[23]

Commentary by other astute antitrust commentators has not attributed recent changes in substantive antitrust law solely or primarily to class actions, as Jacobson strains to do. William E. Kovacic, former Chairman of the Federal Trade Commission (FTC), has attributed the "dramatic retrenchment" of antitrust liability standards to numerous aspects of antitrust litigation of which class actions are only a tertiary one, and has identified as the primary motivation a perceived danger of deterring legitimate conduct.[24] Similarly, The FTC has recently argued that "the Court's decisions in *Credit Suisse* and *Trinko*" were motivated by "heightened concerns about the high costs and questionable benefits of antitrust enforcement in regulated industries."[25] A similar interpretation that the Supreme Court's core motivations relate to regulated industry issues could also be applied to *Twombly*.[26] It is noteworthy that even when opining explicitly on what motivated the Supreme Court in both *Credit Suisse* and *Trinko*, the FTC says nothing substantial about class actions.

If fears of chilling pro-competitive conduct in regulated industries were legitimate, they would be equally applicable in private antitrust litigation other than class actions, and most of them would apply to many government proceedings as well. Since concerns equally applicable to non-class private antitrust litigation seem to be the true driving force behind the Supreme Court's recent curtail-

23. 509 U.S. 209, 226 (1993).

24. William E. Kovacic, Chairman, FTC, Speech at the Bates White Fifth Annual Antitrust Conference Competition Policy in the European Union and the United States: Convergence or Divergence? 14 (June 2, 2008), *available at* http://www.ftc.gov/speeches/kovacic/08060bateswhite.pdf ("[J]udicial fears that the U.S. style of private rights of action—with mandatory treble damages, asymmetric shifting of costs, broad rights of discovery, class actions, and jury trials—excessively deter legitimate conduct have spurred a dramatic retrenchment of antitrust liability standards.").

25. Is There Life After Trinko and Credit Suisse? The Role of Antitrust in Regulated Industries: Hearing Before the Subcomm. on Courts & Competition Policy of the H. Comm. on the Judiciary (statement of Howard Shelanski, Deputy Director of Antitrust, FTC), 111th Cong. 1 (2010), *available at* http://www.ftc.gov/os/testimony/100615antitrusttestimony.pdf.

26. *See* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 567–68 (2007) (stating that "[i]n a traditionally unregulated industry" circumstances such as those alleged "could very well signify illegal agreement, but here . . . monopoly was the norm in telecommunications, not the exception"); *see also* J. Douglas Richards, *Three Limitations of Twombly: Antitrust Conspiracy Inferences in a Context of Historical Monopoly*, 82 ST. JOHN'S L. REV. 849, 854–59 (2008) (discussing regulatory context of *Twombly* as significant element of Court's decision).

ments of antitrust, there is no reason to suppose that to burden class actions with additional hindrances, as Jacobson proposes, would lead to any of the hypothesized positive consequences that Jacobson posits as his primary justifying rationale. Like strategies of ritual sacrifice generally, Jacobson's proposal would do nothing to advance the objectives that he offers to attempt to justify them.

II.
THE VICTIM HAS DONE NOTHING TO DESERVE IT

Another defining characteristic of ritual sacrifice strategies is that the victims have done little or nothing to justify their unfortunate treatment. That is likewise true here. For decades, the Chamber of Commerce and others have worked openly and aggressively to popularize rhetoric regarding so-called class action "nuisance suits," "frivolous litigation," "hydraulic pressure to settle," and the like, as a basis for curtailing class actions.[27] However, thoughtful scholarly commentary has correctly pointed out that precious little statistical study, or even orderly analysis, has ever been offered to support any of these characterizations.[28] Even when a thorough re-

27. *See, e.g.*, Jeffrey Rosen, *Supreme Court Inc.,* N.Y. TIMES MAG., Mar. 16, 2008, at 38. (arguing that the Supreme Court's recent conservative jurisprudence favoring corporate interests represents the "culmination of a carefully planned, behind-the-scenes campaign over several decades"); JACOB S. HACKER & PAUL PIERSON, WINNER-TAKE-ALL POLITICS 115–84 (2010) (providing details about behind-the-scenes political campaigns campaign to advance coordinated political interests of corporations, beginning with 1971 memorandum authored by Lewis Powell when he was chair of Education Committee of the Chamber of Commerce). One example of the type of campaign recently pursued by the Chamber of Commerce was its nationwide "Faces of Lawsuit Abuse" campaign, in May 2009. The Chamber of Commerce released four movie trailers, for exhibition in connection with feature films, which presented one-sided propaganda concerning allegedly "costly and frivolous" lawsuits. Kimberly Atkins, *Now Playing at Your Local Theater: Tort Reform Videos!*, D.C. DICTA (Apr. 29, 2009), http://lawyersusaonline.com/dcdicta/2009/04/.

28. *See, e.g.*, *Open Access to Courts Act of 2009: Hearing on H.R. 5115 Before the Subcomm. on Courts and Competition Policy, H. Comm. on the Judiciary*, 111th Cong. (2009) (written testimony of Joshua P. Davis, Professor, Univ. of San Francisco Sch. of Law) ("As far as I know—and I have spent a considerable amount of time and effort researching the issue—there is no empirical evidence that plaintiffs often file and defendants often settle antitrust claims that have no significant merit."); Arthur R. Miller, *From Conley to Twombly to Iqbal: A Double Play on the Federal Rules of Civil Procedure*, 60 DUKE L.J. 1, 53 (2010) ("[T]he picture generally portrayed is incomplete and is distorted by a lack of definition and empirical data regarding the alleged negative aspects of federal litigation. This generates rhetoric that often reflects ideology or economic self-interest, rather than reality."); *id.* at 83 ("[T]he alleged phenomena that have driven pretrial policy decisions over the past few

view of nearly every aspect of antitrust law and policy was conducted in recent years by the Antitrust Modernization Commission (AMC), of which Jacobson was a member, the Commission ultimately acknowledged that not one of the many witnesses before the Commission or groups that had presented it with data and information had identified any "actual cases or evidence of systematic overdeterrence" in antitrust enforcement.[29]

An anecdote from my own experience illustrates the point. I was the plaintiffs' attorney in *Twombly*. Much of the defendants' briefing in *Twombly* in the district court, the Second Circuit, and the Supreme Court was focused heavily on asserted widespread problems with antitrust "nuisance suits." In our briefing for the plaintiffs in all three courts, we emphasized that the defendants had offered nothing to substantiate the existence of any such problem in the antitrust context. In the district court and the Second Circuit, however, the defendants essentially ignored that point, evidently hoping that the courts would merely take it for granted that a widespread problem of this sort actually exists, in light of the empty rhetoric that has been popularized for so long by the Chamber of Commerce and others. In the Second Circuit's opinion there is evidence that defendants' rhetoric gained some traction with the court, notwithstanding that the Second Circuit ruled for the plaintiffs and that the defendants had offered no study of any kind to support their unsubstantiated rhetoric.[30]

Finally, on reply in the Supreme Court, we had raised such a fuss in our brief about the lack of any data or even examples to

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decades remain largely subjective, unquantified, and anecdotal."); Letter regarding Hearing on H.R. 415, Open Access to Courts Act of 2009 from David Shapiro, Professor of Law, Harvard Law School, to Matthew Weiner, Senate Judicary Committee (Nov. 23, 2009) (on file with the N.Y.U. Annual Survey of American Law) (stating that Twombly and Iqbal rest "in my view, on untested and unwarranted empirical assumptions about the need to block access to the federal courts at the gate in order to stem the tide of meritless lawsuits"); Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 520 (1997) (noting that "[r]eliable empirical data is extremely limited").

29. ANTITRUST MODERNIZATION COMM'N, REPORT AND RECOMMENDATIONS 247 (2007).

30. *See* Twombly v. Bell Atl. Corp., 425 F.3d 99 (2d Cir. 2005) ("We are mindful that a balance is being struck here, that on one side of that balance is the sometimes colossal expense of undergoing discovery, that such costs themselves likely lead defendants to pay plaintiffs to settle what would ultimately be shown to be meritless claims, that the success of such meritless claims encourages others to be brought, and that the overall result may well be a burden on the courts and a deleterious effect on the manner in which and efficiency with which business is conducted."), *rev'd*, 550 U.S. 544 (2007).

substantiate defendants' professed concerns about "nuisance suits" and the like,[31] that the defendants evidently felt that they could no longer simply ignore our plea for evidence and rationality. What defendants then tellingly wrote, in their reply brief to the Supreme Court, was that the supposed problems with antitrust nuisance suits "are too well documented to require or to allow great elaboration here."[32]

In its opinion, the Supreme Court clearly was heavily influenced by defendants' mere rhetoric about supposed antitrust conspiracy "nuisance suits," writing that summary judgment was not adequate protection against frivolous suits because "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those proceedings. Probably, then, it is only by [erecting a 'plausibility' pleading standard] that we can hope to avoid the potentially enormous expense of discovery in" frivolous cases.[33] Elsewhere in *Twombly*, the Court likewise makes clear that concerns about "nuisance suits" were a primary motivation for its decision, emphasizing that a plaintiff with a largely groundless claim should not be "allowed to take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value.' "[34] To support the existence of such problems with "nuisance suits" and "*in terrorem* settlements," however, all the Supreme Court offered was a quotation from a nearly twenty-year-old law review article by Judge Easterbrook,[35] which in turn contained no empirical data or analysis.[36] The Supreme Court evidently simply took petitioners at their word, that supposed problems with antitrust nuisance suits that were the

31. Part II of the four-part Brief for Respondents in *Twombly* was a seven-page showing that the Petitioners and their numerous amici had not offered even minimal evidence that "nuisance suits" for antitrust conspiracy are common, or that various supposed widespread problems that Respondents offered as their basic rationale for a change in the law existed at all in the antitrust context. *See* Brief for Respondents at 11–17, Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007) (No. 05-1126), 2006 WL 3089915, at *11–17.

32. Reply Brief for Petitioners at 13, Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007) (No. 05-1126), 2006 WL 3265610, at *13.

33. Bell Atl. Corp. v. Twombly, 550 U.S. at 559 (2007).

34. *Id.* at 558 (internal quotation marks omitted).

35. *Id.* at 560 n.6.

36. Judge Easterbrook's article is instead a theoretical examination of the supposed incentives plaintiffs have, and the means by which they hypothetically might "abuse" discovery. Frank Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 637–38 (1989).

ostensible basis for its decision "required or allowed" no empirical evaluation whatsoever.[37]

Since the date of the *Twombly* decision, I have spoken publicly about it several times. On several of those occasions, I have challenged defense lawyers who were present to identify even one example of an antitrust "nuisance suit" along the lines posited by the Second Circuit and the Supreme Court in *Twombly*—i.e., an antitrust case that settled early, and before any ruling denying a defendant's motion for summary judgment, for a sum that could plausibly be suggested to have been paid for the purpose of avoiding attorneys' fees. No defense lawyer present on such occasions has yet offered even one good example of such a case, much less any sort of reputable study showing such cases to be a substantial or systemic problem. Instead, the few cases that defense counsel have identified to me on those occasions have tended to be cases that settled for very large sums of money, often after a summary judgment motion by the defendants had been denied by a court.[38] In-

37. *See* Stephen B. Burbank, *Back to the Future: Pleading Again in the Age of Dickens*? 17 (2010) (paper presented to Pound Civil Justice Institute, 2010 Forum for State Appellate Court Judges) (characterizing *Twombly* and *Iqbal* as "decisions in two cases by nine justices who lacked relevant personal experience, reliable empirical data (as opposed to cosmic anecdotes and economic theory undisciplined by facts) and adequately diverse perspectives on litigation and its roles in American society").

38. Cases cited by defense counsel (other than Jacobson) to date, as their best examples of supposed antitrust "nuisance suits," include the cases reported in part at *In re Ins. Brokerage Antitrust Litig.*, No. 07-4046, Nos. 08-1455 & 08-1777, 2010 U.S. App. LEXIS 17107 (3d Cir. 2010) (reversing summary judgment in part and remanding to district court), *Hyland v. Homeservices of America, Inc.*, No. 3:05-CV-612-R. 2008 U.S. Dist. LEXIS 90892 (W.D. Ky. Nov. 6, 2008) (granting class certification) and *Hyland*, 2008 U.S. Dist. LEXIS 65250 (W.D. Ky. Aug. 25, 2008) (denying motion to dismiss), and *In re Brand Name Prescription Drugs Antitrust Litig.*, 123 F.3d 599 (7th Cir. 1997) (Posner, J.) (finding enough evidence of unlawful conduct to withstand summary judgment). None of these cases can reasonably qualify as an antitrust nuisance suit, because courts found some merit in all of them, and none of them were settled early or for small, colorably "nuisance suit" amounts. On the contrary, the first and last of these three involved settlements of hundreds of millions of dollars and $121 million, respectively. *In re* Brand Name Prescription Drugs Antitrust Litig., No. 94 C 897, 2000 WL 204112, at *1 (N.D. Ill. 2000) (noting settling defendants agreed to pay out more than $700 million in cash award); *In re* Ins. Brokerage Antitrust Litig., 579 F.3d 241 (3d Cir. 2009) (noting that settling defendants agreed to $121 million in settlements). All three cases involved extremely protracted proceedings and not early settlements. Indeed, the *Insurance Brokererage* and *Hyland* cases are still proceeding, many years after they were begun. The only seeming common denominator in the citations to these cases by defense counsel is that in each case the citing attorney had been among the defense counsel in the case in question—tending to bear out Arthur Miller's observation, with

deed, when this point was made in the presentations at New York University School of Law that led to these papers, Jacobson conceded that he "only has [his] own personal experience"[39] and nothing in the way of any statistical study or quantitative analysis that could establish the actual existence of any problem with antitrust conspiracy or class action "nuisance suits."[40]

As in most ritual sacrifice contexts, no objective basis exists on which to conclude that antitrust class actions in any sense "deserve" the special hindrances that Jacobson's proposal would impose upon them. Instead, like most victims of ritual sacrifice, class actions would be singled out for uniquely burdensome procedures under Jacobson's proposal based, not on any sort of objective empirical analysis or study, but instead on rhetorically generated and largely irrational fears and biases.[41] Jacobson's failure to acknowledge the threadbare nature of theories about antitrust "nuisance suits" and

regard to his unsuccessful efforts to identify consistent principles in laments about "abusive" or "frivolous" litigation, that the only consistently applicable principles were "[f]irst, frivolous litigation is the lawsuit the other side brings against one's client; second, abuse is whatever the opposing counsel does." Miller, *supra* note 28, at 82.

39. Jonathan Jacobson, Remarks at the Annual Survey of American Law Symposium: Critical Directions in Antitrust, (Mar. 2, 2010), *available at* http://www.youtube.com/watch?v=a0T-rtsCTNs .

40. The only example Jacobson offered at the symposium of a supposedly "abusive" antitrust class action from his own experience was the case reported in part at *In re Currency Conversion Fee Antitrust Litig.*, MDL No. 1409, M 21-95, 04 Civ. 5723 (WHP), 264 F.R.D. 100 (S.D.N.Y. 2010) and 2005 U.S. Dist. LEXIS 21084 (S.D.N.Y. 2005), *rev'd in part sub. nom. Ross v. v. Am. Express Co.*, 547 F.3d 137 (2d Cir. 2008). Jacobson, Remarks, Annual Survey of American Law: Critical Directions in Antitrust, *supra* note 39. However, that case has been in litigation for over five years, and the district court in the case has relied in part on apparently extensive evidence that "[i]ndustry collaboration is a recurring item on Coalition agendas." *In re* Currency Conversion Fee, 2005 U.S. Dist. LEXIS 21084, at *27. Not only does the case continue to be actively litigated rather than settled, but it appears to rest on substantial evidence of unlawful collusion.

41. Some commentators, even while recognizing the dearth of concrete information to substantiate concerns that the Chamber of Commerce has worked so industriously to popularize, have nonetheless sought to credit them on the basis of perception rather than reality, and concerns of international competitiveness. *E.g.*, Michael R. Bloomberg & Charles E. Schumer, *Foreword* to SUSTAINING NEW YORK'S AND THE US'S GLOBAL FINANCIAL SERVICES LEADERSHIP i, ii (2008) (stating that although perceptions that U.S. civil justice system is "arbitrary and unfair . . . may be overblown," U.S. courts nonetheless should "consider legal reforms [to] reduce spurious and meritless litigation" because even if incorrect, that perception "diminishes our attractiveness to international companies"). To the extent that untrue perceptions may have been propagated with sufficient effectiveness to influence opinions abroad, such developments would warrant clarification of the facts, not the adoption of unjustified national policies based on irrational fears.

the like in his article is especially disappointing when contrasted with his prior acknowledgment of a closely analogous dearth of facts and data to support similar overheated rhetoric in the substantive antitrust law context about "false positives."[42]

In making those observations, Jacobson rightly observes the want of any objective information, to support a broader *laissez faire* attack on substantive antitrust law, that is equally lacking to support his narrower thesis of defects in class actions. Ever since Judge Posner's opinion in *In re Rhone-Poulenc Rorer, Inc.*,[43] conservative jurists and defense interests have occasionally asserted, with little orderly analysis or effort at substantiation, that some sort of systemic but only vaguely expressed "blackmail settlement" problem inheres in class actions. That notion has been reinforced through frequent repetition, including in prominent recent case law.[44] Thorough and thoughtful commentary has explained in painstaking detail that those claims are baseless, vague and rhetorical and not logical.[45] Jacobson's thesis seems to rest in substantial part on recycling of those unfounded and rhetorical assertions, yet he writes as though major policy decisions should be based on them without any need even to articulate the supposed problems clearly, much

42. *See* Jonathan M. Jacobson, *Towards a Consistent Antitrust Policy for Unilateral Conduct,* ANTITRUST SOURCE, Feb. 2009, at 1, *available at* http://www.abanet.org/antitrust/at-source/09/02/Feb09-Jacobson2-26f.pdf (observing that "[t]he risk of false positives is ephemeral. The DOJ [Single Firm Conduct] Report cites no example of a harmful false positive over the entire 118-year history of Section 2, and none comes to mind. Reasonable observers can differ over the correctness of the outcomes in particular cases, but there is simply no reason to believe that false positives are any more prevalent than false negatives").

43. 51 F.3d 1293, 1299–1300 (7th Cir. 1995).

44. *E.g.*, Sheet Metal Workers Local 441 Health & Welfare Plan v. Glaxosmithkline, PLC, No. 04-5898, slip op. at 12 (E.D. Pa. Sept. 30, 2010) (declining to grant class certification based in part on observations that class certification can "create unwarranted pressure to settle nonmeritorous claims on the part of the defendants") (citing Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 162 (3d Cir. 2001)).

45. See Charles Silver, *"We're Scared to Death": Class Certification and Blackmail*, 78 N.Y.U. L. REV. 1357 (2003), where the author rightly explains why none of the "blackmail settlements" attacks on class actions "survives scrutiny" and that "judges should stop making blackmail claims." *Id.* at 1357, 1360. The "blackmail settlement" has been very effective in rallying political and judicial opposition to class actions, yet it seems never to have been thoughtfully defined, much less substantiated with supporting evidence beyond posterchildren such as the famous McDonald's coffee case and similar isolated anecdotes. *See also* A. Kanner & T. Nagy, *Exploding the Blackmail Myth: A New Perspective on Class Action Settlements*, 57 BAYLOR L. REV. 681 (2005).

less to substantiate any connection between those assertions and real world events.

If, as Jacobson recognizes elsewhere, antitrust institutions have been able to resolve the innumerable antitrust controversies raised in "the entire 118-year history of Section 2" of the Sherman Act without any convincing "false positives," then the underpinnings of Jacobson's criticisms of class actions cannot reasonably include any notion that class action defendants are somehow compelled to settle claims that have no merit.[46] Otherwise, instead of settling them, defendants would take their cases to trial, confident that "false positives" are very unlikely. At least absent any evidence that cases in fact tend to settle early enough and for sums small enough to be plausibly based on a desire to avoid attorneys' fees—and no such evidence exists—the decisions of class action defendants to settle must be based on risks that defendants might lose the cases against them on the merits. As commentators have rightly pointed out, however, "Nothing is self-evidently wrong with a settlement that occurs because a defendant fears losing at trial."[47] Just as in ritual sacrifice generally, nothing that actually occurs in class actions, or that Jacobson even attempts to identify in his article, justifies the burdensome procedures that Jacboson advocates inflicting on the class action process.

III. JACOBSON'S PROPOSAL WOULD CHANNEL COMMUNITY ENERGIES IN UNCONSTRUCTIVE DIRECTIONS

Jacobson's analysis does not attempt to show that the burdensome new procedure he recommends for class actions would improve the class action process make class actions more fair and effective. On the contrary, implicit in Jacobson's thesis that class actions should be burdened in order to relieve perceived pressures on substantive antitrust law is a view that class actions should be hindered rather than made to work better. In this respect, Jacobson's thesis mirrors emblematic aspects of traditional ritual sacrifice strategies. In ritual sacrifice, little pretense is generally made that the victims are helped or benefited by their treatment. Similarly,

46. As was appropriate to its context of commentary on the Bush Administration's single firm conduct report, Jacobson's observation is limited to cases involving violations of Section 2 of the Sherman Act. It is impossible to posit any reason, however, why "false positives" could be more probable or frequent in cases involving violations of Section 1. Jacobson & Choi, *supra* note 1, at Part V.

47. Silver, *supra* note 45, at 1359.

little in Jacobson's article even attempts to conceal his fundamental goal of burdening the pretrial process.

Federal procedure already contains sequential hurdles that often work in practice like sequential trials on the merits, including "plausibility" motions under *Twombly*,[48] summary judgment motions under *Matsushita*,[49] expert exclusion motions under *Daubert*,[50] and hearings into the predominance of "common questions" under recent cases such as *Hydrogen Peroxide*.[51] How many sequential merits evaluations can one impose on complex antitrust cases before they become hopeless quagmires of expense and energy both for counsel and for the courts? Thoughtful commentators have rightly observed that such expansions of pretrial process involve vast increases in cost, which can overwhelm any savings to the process as a whole that may have been an original objective.[52] Class certification hearings under *Hydrogen Peroxide* have become particularly byzantine, often requiring many months or even years for briefing and argument and a multiple-day hearing, which governing case law has made clear must be carried out "rigorously."[53] In the course of the class certification hearing, all of the critical evidence is frequently reviewed in nearly as much detail as it would be in a trial on the merits. Nonetheless, this resolves nothing on the merits, because all the proceedings are designed to determine in the first place is whether the case is "susceptible" or "capable" of proof through common evidence.[54] Thus, after going through an entire trial process once with only a limited objective, the parties are then obliged to repeat everything again in the context of trial on the merits. Jacobson evidently proposes to add his "forty-percent probability"[55] trial as yet another mini-trial on top of all the others, so that class action plaintiffs would be required essentially to try their cases and win them several times over before they could get a judgment. The

48. 550 U.S. 544 (2007).

49. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 792 (1986).

50. Daubert v. Merrell Dow Pharms., 509 U.S. 579 (1993).

51. *In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d 305 (3d Cir. 2008).

52. *See* Samuel Issacharoff & George Lowenstein, *Second Thoughts About Summary Judgment*, 100 YALE L.J. 73, 103 (1990); D. Theodore Rave, Note, *Questioning the Efficiency of Summary Judgment*, 81 N.Y.U. L. REV. 875 (2006).

53. Gen. Tel. Co. of Sw. v. Falcon, 457 U.S. 147, 161 (1982); *In re* Initial Pub. Offering Sec. Litig., 471 F.3d 24, 29 (2d Cir. 2006).

54. *See* J. Douglas Richards & Benjamin D. Brown, *Predominance of Common Questions—Common Mistakes in Applying the Class Action Standard*, 41 RUTGERS L.J. 161 (2010).

55. *See* Jacobson & Choi, *supra* note 1, at Part VI ("[A]t a minimum there should be some showing of at least a 40 percent likelihood of success . . . .").

burdens that Jacobson's proposal would impose on judicial process boggle the mind, yet Jacobson's article seems to give no recognition or consideration at all to the monumental added burdens, costs, and repetitive processes that his proposal would entail.

The longstanding line of separation between merits evaluations and class certification analysis that is enshrined in *General Telephone Company of Southwest v. Falcon*,[56] which Jacobson recognizes would have to be overturned in order to effectuate his proposal, has been firmly in place for many decades and makes eminent sense. Federal procedure already includes tools for evaluating merits questions prior to any trial, traditionally at summary judgment, and now also on motions to dismiss under *Twombly* and its progeny. Jacobson makes no compelling showing as to why those two tests are insufficient to perform whatever screening role for cases that lack merit may be necessary. Class certification is not designed to serve that purpose at all. Instead, it is meant to collect sufficiently aligned claims in one forum, so that they can be most efficiently resolved, whether positively or negatively—"thumbs up" or "thumbs down" as it were. With either outcome, it is procedurally desirable—assuming due class notice, adequate representation, and the like—that the result on the merits would be binding on the certified class so that it finally resolves the pertinent dispute as broadly as possible. Jacobson's proposal would turn those orderly and sensible procedures upside down, by eliminating the valuable function of binding the class to negative resolutions of ultimately unmeritorious claims. Even if there were some defect or insufficiency in standards for summary judgment—which *Jacobson* does not show to be true—the sensible remedy would be to study and revise summary judgment standards if and as necessary. It would not be to confuse and conflate two different procedural devices that have entirely different purposes, as Jacobson does.

It is ironic that those who advocate erection of ever more complex and numerous procedural hindrances to antitrust class actions so often profess to justify them based on litigation expense. Defense firms, who bill by the hour, routinely argue that increasingly burdensome litigation processes should be employed for the purpose of controlling assertedly out-of-control litigation costs.[57] But in real-

56. 457 U.S. 147 (1982).

57. *See, e.g.*, INST. FOR ADVANCEMENT OF AM. LEGAL SYS., FINAL REPORT ON THE JOINT PROJECT OF THE AMERICAN COLLEGE OF TRIAL LAWYERS TASK FORCE ON DISCOVERY AND THE INSTITUTE FOR THE ADVANCEMENT OF THE AMERICAN LEGAL SYSTEM (2009). (describing "task force" consisting mainly of defense attorneys proposing "radical" changes to rules of procedure, including numerous complex new proce-

ity, what such added procedures create is merely more opportunity for defense lawyers to dedicate countless billable hours to wasteful and largely duplicative stages of litigation, which do not end the case even when a plaintiff prevails because the defendants then receive yet another hearing on largely the same merits issues, sometimes with a different factfinder. Such redundant and cumbersome procedures do not generally benefit litigants, whose disputes become ever more interminable and expensive. They do not benefit courts, which are required to hold repetitive and burdensome preliminary hearings on the merits solely for the purpose of determining whether the plaintiff will be permitted to progress to yet another hearing on another stage of the case involving duplicative issues. It seems that the principal beneficiaries of the resulting interminable proceedings are defense lawyers, who bill endlessly for repetitious controversy over the same basic issues without ever having to confront the responsibility for a day of judgment until after the entire system has been procedurally taxed into exhaustion.[58]

Others have made arguments that are analogous in some ways to Jacobson's, but have been significantly more constructive. For example, Howard Shelanski presented a speech for the Federal Trade Commission on June 15, 2010, in which he argued persuasively that restrictive views of the scope of antitrust law in regulated industries, as reflected in *Trinko* and *Credit Suisse*, are less appropriately applied to public enforcement actions by government agencies than to private litigants.[59] Like Jacobson's article, Shelanski's speech attempts to distinguish between public enforcement proceedings and all private antitrust litigation—importantly not identi-

dures, ostensibly to address concerns that the American court system "costs too much"); *see also* J. Douglas Richards & John Vail, *A Misguided Mission to Revamp the Rules*, TRIAL MAG., Nov. 2009, at 52 (criticizing IAALS Report and showing that its proposals are not genuinely supported by survey results offered to justify them). IAALS has refused, including in response to inquiries made by this Author, to identify the source of half of its funding, which it has stated only is "anonymous."

58. A recent amicus brief to the Supreme Court by the Center for Class Action Fairness, represented by defense firm O'Melveny & Myers, argues that class actions "frequently do not provide consumers with meaningful relief" on the basis that "even when the class action results in a recovery for class members, obtaining relief may require navigating byzantine procedures that impose significant transaction costs." Brief of the Center for Class Action Fairness as Amicus Curiae in Support of Petitioner at 5–6, AT&T Mobility LLC v. Concepcion, No. 09-893, (Aug. 9, 2010). Thus, even defense interests are beginning to acknowledge that procedural hindrances to class actions, such as those advocated in Jacobson's article, have begun seriously to compromise the effectiveness and fairness of class actions.

59. *Is There Life After Trinko and Credit Suisse? The Role of Antitrust in Regulated Industries*, *supra* note 25, at 1.

fying concerns about class actions as the courts' hypothesized motivation, but instead attributing the Court's motivation to the regulated industry contexts that cases such as those of *Trinko* and *Credit Suisse*. A vital distinction between Shelanski's speech and Jacobson's article, however, is that Shelanski's constructive goal is to make public enforcement actions work more effectively. Jacobson's goal, by contrast, appears to be to make private class actions work less effectively. Like other ritual sacrifice strategies, the root impulse of Jacobson's proposal is a destructive one.

IV.
POLITICALLY UNWISE

A last aspect of ritual sacrifice strategies is that they can be politically unwise. Although scapegoating strategies can be effective in the short term, they introduce long-term tensions between groups within a community that can damage the group cohesion needed to facilitate work toward common goals.

As the Supreme Court has long recognized, antitrust class actions are an indispensable component of effective antitrust enforcement.[60] Indeed, the bipartisan AMC, of which Jacobson was a member, recently identified "the U.S. class action mechanism, which allows plaintiffs to sue on behalf of both themselves and similarly situated, absent plaintiffs" as one of two factors (along with "treble damages plus costs and attorneys' fees") to which "the vitality of private antitrust enforcement . . . is largely attributable."[61] The AMC rightly recognized that class actions, like other antitrust enforcement mechanisms, play a positive and beneficial role in advancing the cause of effective antitrust enforcement, and accordingly suggested no substantial modification of class action procedures of the type that Jacobson now advocates in his article.

Surely, antitrust class actions do not work perfectly. But it is easy enough to identify serious shortcomings in other methods of antitrust enforcement as well. For example, Professors Lande and

60. Hawaii v. Standard Oil Co. of Cal., 405 U.S. 251, 266 (1972) ("[C]lass actions . . . may enhance the efficacy of private [antitrust] actions by permitting citizens to combine their limited resources to achieve a more powerful litigation posture."); Reiter v. Sonotone Corp., 442 U.S. 330, 343 n.6 (1979) (noting that "the treble-damages remedy of § 4 took on new practical significance for consumers with the advent of Fed.Rule Civ.Proc. 23"); *In re* Lorazepam & Clorazepoate Antitrust Litig., 202 F.R.D. 12, 21 (D.D.C. 2001) ("[L]ong ago the Supreme Court recognized the importance that class actions play in the private enforcement of antitrust actions.").

61. ANTITRUST MODERNIZATION COMM'N, *supra* note 29, at 241.

Davis have rightly pointed out that "government cannot be expected to do all or even most of the necessary enforcement" due to such considerations as "the unfortunate, but undeniable, reality that government enforcement (or non-enforcement) decisions are, at times, politically motivated."[62] Even when federal government antitrust enforcers do take action, they virtually never seek substantial restitution for injured victims, despite largely theoretical authority to do so, generally confining their objectives instead to criminal fines that are modest in relation to damages suffered, and to other criminal penalties.[63] State attorneys general likewise have very limited resources and limited effectiveness in obtaining compensation for antitrust injuries.[64] Even a superficial familiarity with antitrust law immediately suggests serious structural and motivational concerns with private enforcement through competitor cases, which are almost never brought as class actions.[65]

62. Robert H. Lande & Joshua P. Davis, *Benefits from Antitrust Enforcement: An Analysis of Forty Cases*, 42 U.S.F. L. REV. 879, 906 (2008). Other factors identified by Lande and Davis that often prevent effective government antitrust enforcement include budgetary constraints, undue fear of losing cases, high turnover rates among government attorneys and lack of awareness of specific industry conditions. *Id.* Even Professor Baxter, who was the DOJ antitrust chief in the Reagan administration, noted that private litigants with specialized knowledge "may have a comparative advantage over the Division in the cost of and efficiency in prosecuting a given case." William F. Baxter, *Separation of Powers, Prosecutorial Discretion, and the "Common Law" Nature of Antitrust Law*, 60 TEX. L. REV. 661, 690 (1982). On the other end of the spectrum, a recent, detailed study by Lande and Davis indicates that "private antitrust enforcement probably deters more anticompetitive conduct than the U.S. Department of Justice's anti-cartel program." Robert H. Lande & Joshua P. Davis, *Comparative Deterrence From Private Enforcement and Criminal Enforcement of the U.S. Antitrust Laws* 2 (Univ. of San Francisco Law Research Paper No. 2010-17, 2010), *available at* http://ssrn.com/abstract=1565693.

63. The Department of Justice generally declines to seek restitution. *See, e.g.*, Plea Agreement at 9, United States v. Embraco N. Am. Inc. No. 20–577 (E.D. Mich. Sept. 30, 2010) ("In light of the availability of civil causes of actions, which potentially provide for recovery of a multiple of actual damages, the United States agrees that it will not seek a restitution order for the offense . . . ."). Whether the Federal Trade Commission even has authority to seek restitution is in doubt. *See* F.T.C. v. Mylan Labs. Inc., 62 F. Supp. 2d 25, 40–42 (D.D.C. 1999). But at all events, it very seldom does so. *See* Federal Trade Comm'n, Policy Statement on Monetary Equitable Remedies in Competition Cases, 68 Fed. Reg. 45,820 (Aug. 4, 2003).

64. RICHARD A. POSNER, ANTITRUST LAW 281 (2nd ed. 2001) (proposing that state attorneys general be largely "stripped of their authority to bring antitrust suits, federal or state" due to their asserted lack of genuine resources for antitrust enforcement and because they are often "excessively influenced by interest groups that may represent a potential antitrust defendant's competitors").

65. Since first expressing the point in *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962), the Supreme Court has repeatedly emphasized that the purpose of antitrust law is "the protection of *competition*, not *competitors.*" *Id.* at 324. *E.g.*,

For those who believe the goals of antitrust enforcement to be important, the better political strategy is not to denigrate or hinder one method of enforcement in the hope of advancing another, but rather to make each aspect of mutually complementary antitrust enforcement regimes work together more efficiently and effectively.[66] Cohesion among those who participate in antitrust enforcement is particularly important in light of the recent expansion of *laissez faire* ideologies that would curtail antitrust enforcement across the board, in order further to advance the interests of concentrated and unaccountable corporate power.[67] Given Jacobson's evident general support of traditional antitrust policies, it seems unlikely that his purpose is primarily to advance such *laissez faire* ideologies. It seems more likely, instead, that his views may stem from so-called "cognitive illiberalism," arising from his extensive personal experience representing defendants in prominent antitrust class actions.[68] Whatever Jacobson's reasons, however, solidarity among

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Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 906 (2007); Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993). The Department of Justice and FTC recognize in the class action context that "buyers have usually been preferred plaintiffs in private antitrust litigation" and that "[t]he recovery by direct purchasers would not duplicate the recovery by competitors because each group suffers direct, but distinct injuries with non-overlapping measures of damages." Brief for the United States and Federal Trade Commission as Amici Curiae Supporting Plaintiffs-Appellants at 6, 10, *In re* DDAVP Direct Purchaser Antitrust Litig., 585 F.3d 677 (2d Cir. 2009) (No. 06-5525). Moreover, in many antitrust cases—including most horizontal price-fixing cases—competitors have no injury and instead benefit from the unlawful conduct. Competitor cases therefore clearly cannot replicate the compensatory and deterrent functions of antitrust class actions by overpriced purchasers.

66. *See, e.g.*, Fed. Trade Comm'n, Policy Statement on Monetary Equitable Remedies in Competition Cases, 68 Fed. Reg. 45,820 (Aug. 4, 2003) ("[I]t is important and beneficial that there be a number of flexible tools, as well as a number of potential enforcers, available to address competitive problems in a particular case.").

67. *See In re* Travel Agent Comm'n Antitrust Litig., 583 F.3d 896, 915–16 (6th Cir. 2009) (Merritt, J., dissenting) ("There are many, including my colleagues, whose preference for an unregulated *laissez faire* marketplace is so strong that they would eliminate market regulation through private antitrust enforcement . . . . Over time, the antitrust laws fall further into desuetude as the legal system and the market place are manipulated to benefit economic power, cartels, and oligopolies capable of setting prices."); Burbank, *supra* note 37, at 3 (characterizing *Twombly* as being "at root concerned with power and its distribution"—more specifically the distribution of power "as between plaintiff and defendants" and "between haves and have-nots").

68. For a thought-provoking recent discussion of current tendencies in the Supreme Court toward "cognitive illiberalism," see Dan M. Kahan et al., *Whose Eyes Are Your Going to Believe?* Scott v. Harris *and the Perils of Cognitive Illiberalism*, 122 HARV. L. REV. 838 (2009).

those who work in complementary aspects of antitrust enforcement does not seem to be among the goals of his article. Even more disappointingly, he seems to be unintentionally advancing a broader agenda of *laissez faire* ideology that one might have expected him to find common cause in opposing, given his evident core belief in the value of substantive antitrust law and effective antitrust enforcement.

EPILOGUE

If any one river were a best metaphor for the American experience, perhaps it would have been, at one time, the Mississippi. Despite rough and sometimes ugly social surroundings lampooned so well in *Huckleberry Finn*, its more fundamental cultural penumbras, I would submit, include innocence, openness, freedom, greatness, confidence in the future, and the glory of American political institutions. It would have been a fitting metaphor for the postwar era vividly described by Judge William Young of the District of Massachusetts, in which "Americans turned to law as never before to solve society's ills. This faith in law drove the great expansion of constitutional criminal procedure, the courageous dismantling of our 'separate but equal' doctrines, and our largely peaceful civil rights revolution."[69] As Judge Young has pointed out, class actions were born in that era from "the genius of Benjamin Kaplan," and were "hailed as perhaps the consumer's most potent procedural tool to check corporate misconduct."[70] I came of age in that era, and it was those cultural values surrounding class actions that drew me into class action practice, and that remain a core motivation for those of us who devote our careers to class action representation.

Today, however, we live in an oddly changed era, in which Judge Young notes that there has been "a general turning away from the law."[71] As to class actions, Judge Young has observed that "[t]oday, society sees Rule 23 primarily as a[n] unwarranted obstacle to private capital formation."[72] Since Judge Young's comments

69. *In re* Relafen Antitrust Litig., 231 F.R.D. 52, 89 (D. Mass. 2005). Notably, Professor Arthur Miller's magnificent, recent article is dedicated to Benjamin Kaplan. *See* Miller, *supra* note 28, at 1.

70. *In re Relafen Antitrust Litig.*, 231 F.R.D. at 84. *See also* Miller, *supra* note 28, at 5 ("The Rules were intended to support a central philosophical principle: the procedural system of the federal courts should be premised on equality of treatment of all parties and claims in the civil adjudication process. . . .The simple but ambitious notion was that the legal rights of citizens should be enforced.").

71. *In re Relafen Antitrust Litig.*, 231 F.R.D. at 89.

72. *Id.* at 84.

were written, the view that class actions are an obstacle to capital formation, and to American "competitiveness," has had unceasingly prominent spokespersons.[73] Troublingly, these changes in "perceptions" have developed, as to class actions, in an absence of virtually any rationally considered analysis or study to support the accompanying rhetoric about supposed but ill-defined "abuse," "blackmail settlements," "nuisance suits," and the like. These developments have stemmed instead, I submit, principally from self-interested and unsubstantiated propaganda initially disseminated by wealthy corporate interests such as the Chamber of Commerce, secondarily by those catering to those interests such as the editorial page of the *Wall Street Journal*[74] along with defense lawyers who serve such interests, and ultimately percolating through American culture to the extent that scurrilous rhetoric now appears occasionally even in law review commentary.[75] The coarsening and irrationality of the sheer propaganda often used about supposed lawsuit and class action "abuse" and the like is not unique to adjudicatory life, but mirrors strident and inflammatory rhetoric increasingly found in America's polarized political controversies. The more fitting fluvial metaphors for American life would increasingly seem to be the Congo River, as

73. SUSTAINING NEW YORK'S AND THE US'S GLOBAL FINANCIAL SERVICES LEADERSHIP, *supra* note 41, at 75 (basing analysis of capital markets challenges on surveys of "corporate executives" and stating that "[w]hen asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem"). As referenced above, however, this report acknowledges that "perceptions" that the American legal system is arbitrary and unfair "may be overblown." Michael R. Bloomberg & Charles E. Schumer, *Foreword* to SUSTAINING NEW YORK'S AND THE US'S GLOBAL FINANCIAL SERVICES LEADERSHIP, *supra* note 41, at ii.

74. An illustrative example of the lack of editorial objectivity of the *Wall Street Journal* on such matters would be its quote of my argument in *Twombly*, in which it claimed I had argued that under established rules "proving the facts alleged is not a plaintiff's burden." Editorial, *A Tort Conspiracy Theory*, WALL STREET J., Dec. 11, 2006, at A18. The actual statement at argument was that "proving the facts alleged is not a plaintiff's burden in the complaint." Transcript of Oral Argument at 30, Bell Atl. Corp. v Twombly, 550 U.S. 544 (2007) (No. 05–1126).

75. *See, e.g.*, Christopher R. Leslie, *The Role of Consumers in* Walker Process *Litigation,* 13 SW. J. L. & TRADE AM. 281, 300 (2007) (seeking to justify restricting standing of purchasers to assert claims under *Walker Process* to state attorneys general only, on basis that to permit private suits would create risk that it could induce "nefarious class counsel" to "target every patentee who has some degree of market power with *Walker Process* lawsuits"). *Cf.* Brief for the United States and Federal Trade Commission as Amici Curiae Supporting Plaintiffs-Appellants at 16, *In re* DDAVP Direct Purchaser Antitrust Litig., 585 F.3d 677 (2d Cir. 2009) (No. 06-5525 (clarifying that the "factual reliability" of hyperbolic rhetoric about a flood of purchaser *Walker Process* cases was "open to serious question" because legal standards for such cases are high, and such cases "are rare").

depicted in *Heart of Darkness*, or perhaps even the Nung in *Apocalypse Now*.

As to procedural innovations such as that suggested in Jacobson's article, I submit that the road out of darkness is best found by heeding Professor Miller's appeal, in his recent article, that "[i]f assumptions about litigation costs, judicial management, and abusive use of the system are driving pretrial process changes, the policymakers must strive to understand these matters fully and appraise what is real and what is illusion before the procedure is altered any further."[76] If an actual, defined and existing problem can be shown to exist in judicial procedure, and a plan to improve the procedure can be developed to address it rationally and constructively, that would be an endeavor worthy of the American adjudicatory inheritance. To propose radical changes like those Jacobson proposes, without first carefully defining the supposed problem in question and showing that actually exists, is not worthy of that great legacy. I suggest that Jacobson has not well defined the supposed problem of "abuse" on which he premises his paper, nor has he shown that such a problem actually exists. As a society—to paraphrase Katherine Hepburn again in connection with her own cinematic river journey—that is a style of policymaking that we should strive to rise above.

76. Miller, *supra* note 28, at 54.

A SEPARATION OF POWERS DEFENSE OF FEDERAL RULEMAKING POWER

*BY MICHAEL BLASIE**

Fundamental to the structure of our federal government is the theory of the separation of powers;[1] yet the Federal Constitution contains no clause establishing such a structure. The most relevant text appears in the following phrases: "All legislative Powers herein granted shall be vested in a Congress of the United States,"[2] "The executive Power shall be vested in a President of the United States of America,"[3] and "The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish."[4] These clauses, combined with portions of the Federalist Papers and our belief that the works of Locke and Montesquieu influenced the Founding Fathers, are the sources from which we derive the concept of the separation of powers.[5] On its face the theory is simple: the three branches of the federal government exercise three corresponding functions. The legislative branch creates the law, the executive branch enforces the law, and the judicial branch interprets

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1. "This Court consistently has given voice to, and has reaffirmed, the central judgment of the Framers of the constitution that, within our political scheme, the separation of governmental powers into three coordinate Branches is essential to the preservation of liberty." Mistretta v. United States, 488 U.S. 361, 380 (1989).

2. U.S. CONST. art. I, § 1, cl. 1.

3. *Id.* art. II, § 1, cl. 1.

4. *Id.* art. III, § 1, cl. 1.

5. *See* Morrison v. Olson, 487 U.S. 654, 697–98 (1988) (Scalia, J., dissenting) (noting that separation of powers stems from three constitutional clauses and referencing Federalist 47); *Ex parte* Grossman, 267 U.S. 87, 119–20 (1925) (discussing constitutional basis for the separation of powers); Tom Clark, *Separation of Powers*, 11 WILLAMETTE L.J. 1, 2 (1974) (noting that Madison appealed to Montesquieu); JOHN LOCKE, *The Second Treatise of Government*, *in* TWO TREATISES OF GOVERNMENT §§ 143–48, at 382–84 (Peter Laslett ed., Cambridge Univ. Press 1960) (1690); CHARLES-LOUIS DE SECONDAT MONTESQUIEU, SPIRIT OF THE LAWS 151–52, 196–205 (Thomas Nugent trans. & ed., 1949); THE FEDERALIST No. 47, at 301 (James Madison) (New American Library ed., 1961).

the law.[6] However, application of the theory has proven to be complicated.

There are two major competing theories of the separation of powers: functionalism and formalism.[7] Under the functionalist approach, the branches of government are interdependent and share powers.[8] Synonymous with pragmatism, functionalism assigns a power to the branch or branches best capable of exercising that power.[9] In contrast, according to the formalist theory, each branch may exert only the powers allocated to it by the Constitution under a strict construction of the Constitution's first three articles.[10] Underlying this theory is the idea that structure itself is an effective and necessary check on the massive power wielded by the federal government. The structural requirement of inter-branch consensus before government action, for example, safeguards individuals' constitutional rights. Case law has appealed to both theories, causing the Supreme Court to acknowledge that its "precedents in this area do not admit of easy synthesis."[11]

Judicial rulemaking—the methods by which federal courts create federal procedural rules—represents a paradigmatic clash between the functionalist and formalist theories of the separation of powers. There exist compelling practical reasons to invest such power in the judiciary, yet the Constitution's text does not explicitly confer such power on any branch. Scholarship on the subject generally approves of the current process based on a classic functionalist separation of powers justification: the systemic benefits of the

6. The closely related principle of checks and balances allows branches to negate some of the functions allocated to other branches without permitting a usurping of such powers. For example, Congress can write laws but the President can veto them; the veto power, however, grants only the power to negate the law, not the power to write laws.

7. Linda S. Mullenix, *Unconstitutional Rulemaking: The Civil Justice Reform Act and Separation of Powers*, 77 MINN. L. REV. 1283, 1291–92 (1992) (referencing competing theories as formalist or functionalist).

8. *Id.* at 1292.

9. Often this view rests upon traditional assumptions about the benefits of each branch: the executive is efficient and specialized, the judiciary is insulated and familiar with the application of laws to cases, and the legislature is representative of the citizenry and capable of debate and compromise. *See* Bruce E. Peabody & John D. Nugent, *Toward a Unifying Theory of Separation of the Powers*, 53 AM. U. L. REV. 1, 22 (2003) (noting that positivist view relies in part upon distinctive qualities and functions associated with each branch or division of government).

10. Mullenix, *supra* note 7, at 1291.

11. Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 847 (1986); *see also* Mistretta v. United States, 488 U.S. 361, 380–83 (1989) (explaining recent separation of powers jurisprudence and concepts of encroachment and aggrandizement).

process outweigh the defects, partly because the judiciary is best equipped to make the rules that guide it.[12]

This Note comprehensively examines the separation of powers issues raised by the current federal rulemaking process under the formalist theory of the separation of powers in light of modern precedent. Part I details the current procedure for creating the federal rules, summarizes the relevant scholarship, and examines the few Supreme Court decisions on the constitutionality of portions of the process. Part II clarifies the process of creating the federal rules of procedure, concluding that, despite the substantive role played by rulemaking committees and Congress's influence over the process, the Supreme Court creates the rules. Part III describes the statutory and constitutional sources of power that federal courts have referenced in creating the rules and the viable constitutional bases for these sources. It draws conclusions about both the limits on Congress's regulation of federal court procedure and limits on a federal court's constitutional power to create procedure. Part IV examines why the Constitution permits Congress's delegation of such power despite potential conflicts with the non-delegation doctrine, the Case or Controversy Clause, and the Judicial Power Clause. Part V discusses potential constitutional challenges to Congress's "legislative veto" over rules promulgated by the Supreme Court and to the supersession clause of the Rules Enabling Act.[13]

12. *See, e.g.*, JACK B. WEINSTEIN, REFORM OF COURT RULE-MAKING PROCEDURES 54 (1977) ("The rule-making power is one of the most important examples of practical necessity dictating that a twilight area be created where activities of the separate branches merge."); Roscoe Pound, *The Rule-Making Power of the Courts*, 12 A.B.A. J. 599, 601 (1926) (arguing that courts should have complete control over court procedure); *cf.* WEINSTEIN, *supra*, at 33 ("It appears, therefore, that no one of the three branches of Government is, by the theory of the Constitution or the character of the duty, so peculiarly fitted for this work that the other two must be excluded from consideration. In such a position, the guiding principle becomes one of expediency.") (citation omitted). What little mention there is of formalist separation of powers justification focuses on the need of the judiciary to control its own procedure to remain an independent branch of government: "Rule-making, in this view, is a crucial facet of an independent judiciary; to deprive the judiciary [of] rule-making authority is to mar its vital independence and impair its role as a guardian of due process." *Id.* at 21. Judge Weinstein later noted Hamilton's emphasis on an independent judiciary in the *Federalist Papers*. *Id.* at 75–82. However, one scholar argues that Congress will blame judges for problems with the judge-dominated Judicial Conference's rules, thereby hurting judicial independence. Stephen C. Yeazell, *Judicial Independence and Accountability: Judging Rules, Ruling Judges*, 61 LAW & CONTEMP. PROBS. 229, 241 (1998).

13. This Note will argue that what some commentators have referred to as a "legislative veto" is actually a simple notice requirement. *See infra* Part IV.

I.
BACKGROUND

A. *Federal Rulemaking Process*

This section details the statutory authority and procedures for the creation of the federal rules of procedure. The Rules Enabling Act (REA)[14] declares that the Supreme Court of the United States "shall have the power to prescribe general rules of practice and procedure and rules of evidence for cases" in federal courts.[15] However, these rules "shall not abridge, enlarge, or modify any substantive right."[16] Also noteworthy, the statute contains what is known as the supersession clause, which voids all laws conflicting with the rules promulgated under this statute.[17] The federal rules of evidence, civil procedure, criminal procedure, and appellate procedure fall under the language of "general rules of practice and procedure and rules of evidence."[18] Congress later granted the Supreme Court near-identical authority to create bankruptcy rules.[19]

According to the REA, the Supreme Court must submit each rule promulgated under this act's authority to Congress.[20] The proposed rules take effect only if Congress fails to veto them,[21] with one exception: rules "creating, abolishing, or modifying" evidentiary privileges require an act of Congress.[22]

Despite the language of the REA, most rules are developed not by the United States Supreme Court, but by a congressionally created body known as the Judicial Conference, whose mission is to develop rules and evaluate those currently in effect.[23] It is com-

14. 28 U.S.C. § 2072 (2006). *See generally* Edson R. Sunderland, *The Grant of Rule-Making Power to the Supreme Court of the United States*, 32 MICH. L. REV. 1116, 1117–19 (1933) (detailing history of passage of Rules Enabling Act).

15. 28 U.S.C. § 2072(a).

16. *Id*. This provision prompted the great substance versus procedure debate that led to the *Erie, York*, and *Hanna* line of cases; which rules are procedural and which are substantive is an ongoing debate amongst scholars and courts. *See* Hanna v. Plumer, 380 U.S. 460 (1965); Guaranty Trust Co. v. York, 326 U.S. 99 (1945); Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

17. 28 U.S.C. § 2072(b)

18. *See* 30 F.R.D. 73, 101 (1962); WEINSTEIN, *supra* note 12, at 57–74, 100.

19. This Note, however, focuses primarily on the rules of practice, procedure, and evidence created under the REA.

20. 28 U.S.C. § 2074 (2006).

21. Robert G. Bone, *The Process of Making Process: Court Rulemaking, Democratic Legitimacy, and Procedural Efficacy*, 87 GEO. L.J. 887, 893 (1999) (noting that vetos are rarely used).

22. 28 U.S.C. § 2074 (2006).

23. *Id.* § 331.

posed of the Chief Justice of the United States, the chief judge of every federal circuit court, the Chief Judge of the Court of International Trade, and a district judge from each circuit.[24] The Chief Justice of the United States must submit an annual report to Congress on the Judicial Conference along with its recommendations for legislation.[25] The Conference may hold hearings, take testimony, and issue subpoenas,[26] and it may also create advisory committees to recommend and assist in the creation of rules.[27] After a proposal passes an advisory committee, the Conference's standing committee reviews the proposal.[28]

These two types of committees generally include members of the bar, law professors, state chief justices, a Department of Justice representative, and federal judges, with a law professor serving as the reporter in the case of an advisory committee.[29] Notably, Congress required such committees to consist of members of the bar as well as both trial and appellate judges,[30] though the Chief Justice of the United States has the sole authority to make all committee appointments.[31]

The Conference tends to welcome outside participation in the process. For example, suggestions for rule amendments come from members of the Judicial Conference and its committees, judges at every level, organizations, attorneys, agencies, law professors, and the public.[32] Also, committee meetings and minutes are usually

24. *Id.* For information on the predecessors to the Judicial Conference, see the U.S. Courts website, http://www.uscourts.gov/FederalCourts/JudicialConference.aspx (last visited January 17, 2010).

25. *Id.*

26. *Id.*

27. 28 U.S.C. § 2073(a)(2) (2006). The Conference may also place limits on membership. For information on the tenure of committee members see the U.S. Courts website, http://www.uscourts.gov/FederalCourts/JudicialConference.aspx.

28. The text of section 2073 suggests the Conference *must* create a standing committee, whereas the language in section 331 suggests that the Conference *may*, but is not required to, create such a committee. 28 U.S.C. § 331 (2008); 28 U.S.C. § 2073(b) (2006). Regardless, the Conference traditionally has had a standing committee.

29. *See also* WINIFRED R. BROWN, FEDERAL RULEMAKING: PROBLEMS AND POSSIBILITIES, FEDERAL JUDICIAL CENTER 9–12, 25–27 (1981) (discussing membership of advisory and standing committees); U.S. Courts website, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/RulemakingProcess.aspx (containing links to lists of current committee members).

30. 28 U.S.C. § 2073(a)(2).

31. U.S. Courts website, http://www.uscourts.gov/FederalCourts/JudicialConference.aspx (last visited January 17, 2011); BROWN, supra note 29, at 13–15.

32. U.S. Courts website, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/RulemakingProcess.aspx (last visited January 17, 2011); BROWN, *supra*

public.[33] Although not required by statute, advisory committees send their rule proposals to over ten thousand people and organizations for comment and provide the general public with six months to comment on their proposals.[34]

The general process of drafting by an advisory committee, followed by approval from the standing committee, Judicial Conference, and the Supreme Court, with submission of the rules to Congress has been, with few exceptions, the procedure for decades.[35] There are several notable observations about this process. First, the REA grants the Supreme Court the power to create rules but does not require the Court to exert that power. Second, the REA does not require the Court to use the Judicial Conference to promulgate rules. Third, the Supreme Court need not follow the recommendations of the Judicial Conference. In the past, the Supreme Court has rejected,[36] modified,[37] and taken no action[38] on proposed rules.[39]

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note 29, at 9–11 (noting that suggestions for rule amendments come from variety of public and governmental sources).

33. U.S. Courts website, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/RulemakingProcess.aspx (last visited January 17, 2011); *see also* BROWN, *supra* note 29, at 17–23.

34. U.S. Courts website, http://www.uscourts.gov/FederalCourts/JudicialConference.aspx (last visited January 17, 2011); *cf.* 5 U.S.C. § 553 (Administrative Procedure Act) (rule 12.3.2).

35. Congress has intervened only rarely in the rulemaking process. *See* Karen Nelson Moore, *The Supreme Court's Role in Interpreting the Federal Rules of Civil Procedure*, 44 HASTINGS L.J. 1039, 1054–1060 (1992) (tracing Congress's role in amending rules). For a general discussion of the history of proposed rules and Congress's reaction to them, see WEINSTEIN, *supra* note 12, at 57–74, 100.

36. WEINSTEIN, *supra* note 12, at 100 (noting that court rejected proposed work product rule because of pending case).

37. *See* BROWN, *supra* note 29, at 31; 4 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1004 (3d ed. 2008) (describing how Supreme Court made changes to first proposed set of the Federal Rules of Civil Procedure).

38. *See* WRIGHT & MILLER, *supra* note 37, at § 1006 (referencing 1955 rule proposals); Stephen B. Burbank, *Ignorance and Procedural Law Reform: A Call for a Moratorium*, 59 BROOK. L. REV. 841, 843 (1993) (noting that Court refused to transmit amendment implicating foreign relations).

39. There is a separate rulemaking process for, and separate bodies that develop and review, the creation of a federal court's local rules. *See* 28 U.S.C. § 331 (2008); 28 U.S.C. § 332 (2002); 28 U.S.C § 2071 (1988); 28 U.S.C. § 2077(b) (1990). This Note focuses on the federal rules applicable to all federal courts, but its analysis likely applies with equal force to the local rules.

B. Scholarship

Since the inception of the Judicial Conference, scholars have criticized and made suggestions to improve the rulemaking process. Almost all proposed modifications suggested more public access, more expansive membership in the Judicial Conference, debates on the role of the United States Supreme Court, or discussions about how active Congress should be in the process.[40] Aside from these practical critiques, the theoretical and constitutional critiques have focused on two issues. First, even with the limitation that rules cannot abridge or modify substantive rights, procedural rules, such as those concerning pleadings and class actions, have profound substantive implications for litigants.[41] Therefore, issues of democratic process and accountability arise from the magnitude of procedural power and present themselves in criticisms of the membership of the Judicial Conference, public access to the process, the role of the legislature, and the degree of judicial scrutiny.[42] Second, the role of federal judges, especially the United States Supreme Court and its Chief Justice, has caused concerns about the ability of courts to re-

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40. *See, e.g.*, 368 U.S. 1011, 1012–14 (1961) (Black, J., dissenting) (preferring that Congress amend Federal Rules of Civil Procedure directly); BROWN, *supra* note 29, at 79–86 (evaluating five different proposals); Yeazell, *supra* note 12, at 239–48 (supporting elimination of Supreme Court and Judicial Conference from process because neither provides meaningful judicial review, and encouraging greater transparency by increasing number and types of attorneys and judges consulted); *cf.* Linda S. Mullenix, *Hope Over Experience: Mandatory Informal Discovery and the Politics of Rulemaking*, 69 N.C.L. REV. 795, 832–34, 838–42, 856 (1990) (describing benefits and costs of increased participation and concluding that opening rulemaking process to more participants risks influx of lobbying and loss of neutrality, but that keeping process closed risks abdicating power to Congress).

41. *See* CHARLES W. GRAU, JUDICIAL RULEMAKING: ADMINISTRATION, ACCESS AND ACCOUNTABILITY 11–13 (American Judicature Society 1978) (arguing that procedure inevitably effects substantive rights); Mullenix, *supra* note 40, at 835–56 ("Those few who observe judicial rulemaking are far more likely today to see social and economic consequences in what the Committee does than were earlier generations of observers . . . .").

42. *See, e.g.*, Howard Lesnick, *The Federal Rule-Making Process: A Time for Re-Examination*, 61 A.B.A. J. 579, 579–83 (1975) (citing limited attorney and public participation, and criticizing lack of legislative control over process); GRAU, *supra* note 41, at 1–13 (noting simultaneous independence and unaccountability of rulemakers). *But see* Bone, *supra* note 22, at 890 (arguing that judiciary is better able to identify legal principles and trends and that legitimacy of rules stems from principled deliberation similar to common law reasoning rather than from public participation).

view the rules impartially and about their influence over the Judicial Conference.[43]

Despite these concerns, the vast majority of scholars, courts, legislatures, and organizations approve of the Judicial Conference's role and procedures and, more generally, the creation of the rules by the judicial branch.[44] Indeed, the judiciary has had authority to author procedural rules for the vast majority of the history of the United States[45] and United Kingdom.[46] Inevitably, scholars conducting cost-benefit analyses have concluded that the judiciary makes "better" procedural rules than the legislature for at least two reasons.[47] First, the judiciary is well suited for this responsibility with its unique expertise in procedure from its daily experiences.[48] Second, it is more efficient for the courts to make such rules because the judiciary can add, amend, and delete rules more quickly

43. *See, e.g.*, 374 U.S. 861, 865–70 (1963) (Black & Douglas, JJ., dissenting); WEINSTEIN, *supra* note 12, at x–xi, 5-11, 96–104 (noting lack of public comment and adversarial system in process; citing concern for impartiality and breadth of Court's interpretation of procedure, Congress injuring Court's prestige when it uses legislative veto, and Chief Justice's influence over committee choices). *But see* Charles E. Clark, *The Role of the Supreme Court in Federal Rule-Making*, 46 J. AM. JUD. SOC. 250, 256–58 (1962) (defending role of Supreme Court in rulemaking process).

44. BROWN, *supra* note 29, at 36 ("[M]ost imply little or no criticism of the way in which the rule makers have discharged their responsibility or of the way the rules have operated to regulate practice and procedure."); GRAU, *supra* note 41, at 17 (reviewing proposals of scholars Pound, Wigmore, Levien, Amsterdam, Joiner, Miller, and Weinstein).

45. *See also* WEINSTEIN, *supra* note 12, at 57–74; Edson R. Sunderland, *Implementing the Rule-Making Power*, 25 N.Y.U. L. REV. 27, 29–32 (1950). Sunderland also discusses the history of rulemaking processes amongst states. *Id.* at 35–40.

46. WEINSTEIN, *supra* note 12, at 22–33; Abraham Gertner, *The Inherent Power of Courts to Make Rules*, 10 U. CIN. L. REV. 32, 32–38 (1936).

47. *See, e.g.*, Geoffrey C. Hazard, *Undemocratic Legislation*, 87 YALE L.J. 1284, 1287–88, 1291–92 (1977) (defending current method against criticism).

48. WEINSTEIN, *supra* note 12, at 19–21 (concluding that courts are better positioned than legislatures to determine their own procedural and evidentiary needs); Bone, *supra* note 21, at 890, 920–27, 935–37, 949 (arguing that judiciary is better able to identify legal principles and trends and that legitimacy of rules stems from principled deliberation similar to common law reasoning rather than from public participation). *But see* Hazard, *supra* note 47, at 1293 ("[I]t seems fair to say that it is not the superior expertise of the judiciary in such matters but rather these political circumstances that have been the real impetus for removing procedural Rulemaking from the legislature."). Those noting judicial expertise neglect, however, the fact that many Members of Congress lack daily experience with environmental, insurance, and criminal issues; yet Congress retains control over these arenas.

than the legislature,[49] which allows the legislature more time to spend on "bigger issues."[50]

In recent decades, discussions of the constitutionality of federal judicial rulemaking have come up rarely. One possible explanation for this is that many of the concerns about membership and public access have been addressed by congressional amendments and changes to the Judicial Conference's procedure, negating the largest cause for criticism.[51] Also, the federal rules have long been considered a success; by all indications the process works well, so there is little reason to exert resources advocating change.[52] Third, with the rise of administrative agencies, the legal profession has become accustomed to functionalist reasoning, often emphasizing efficiency and the role of experts.[53] This view leaves unaddressed the issue of whether a formalist analysis can support the current federal rulemaking process.

C. *Supreme Court Decisions*

Debate about the validity of the rules rarely focuses on the separation of powers. Instead, the Supreme Court has focused on

49. Pound, *supra* note 12, at 602 (noting that judiciary can gradually and conservatively overhaul and reshape rules, that rules change with legal growth instead of waiting years for legislative intervention, and that rules are less rigid and can be tried and molded); *see also* Bone, *supra* note 21, at 927–30 (noting flexibility and discretion in rules versus strictness of statutes).

50. James Wm. Moore & Helen I. Bendix, *Congress, Evidence and Rulemaking*, 84 YALE L.J. 1, 38 (1974) (noting that Congress lacks staff and is unlikely to duplicate Judicial Conference committees because most members are unpaid and may be unwilling to work for Congress; and also noting that Judicial Conference affords premium time for scholarly examination of rules); Pound, *supra* note 12, at 602.

51. A. Leo Levin & Anthony G. Amsterdam, *Legislative Control Over Judicial Rule-Making: A Problem in Constitutional Revision*, 107 U. PA. L. REV. 1, 12–14 (1958) (claiming that concerns about courts not exercising rulemaking power, lack of public hearings and techniques, and concern about role of Supreme Court have all been quelled by history); Moore, *supra* note 35, at 1062-64 (1992) (discussing Judicial Improvements Act); Mullenix, *supra* note 40, at 832 (discussing impact of Judicial Improvements and Access to Justice Act).

52. Moore & Bendix, *supra* note 50, at 1, 11 ("As finally promulgated by the Court, the rules are well conceived and structured, neither radical nor conservative, and thoroughly professional."); Hazard, *supra* note 47, at 1294 ("A quite undemocratic legislative process has proven capable of producing a very satisfactory product. Correlatively, the archetype of institutionalized democracy—the legislature—has mishandled the same work when it has gotten it."); John H. Wigmore, *A Critique of the Federal Court Rules Draft—Three Larger Aspects of the Work Which Require Further Consideration*, 22 A.B.A. J. 811, 811–12 (1936) (discussing American Bar Association's long-time advocacy of judiciary writing procedural rules).

53. *See generally* WEINSTEIN, *supra* note 12, at 12–21 (noting expansion of government and growing power of judiciary).

whether the federal rules were made within the authority granted by the REA.[54] In *Mississippi Publishing Corp. v. Murphree*,[55] the Supreme Court held that parties can contest the validity of rules made under the REA.[56] It later established a presumption of validity for all of the federal rules.[57] This analysis implies that the REA is constitutionally valid.[58]

Other precedents discussing rulemaking power likely foreclose contests to the constitutionality of the bulk of the REA. In *Hanna v. Plumer*,[59] the Court referenced Congress's power to make rules of practice and pleading in federal courts.[60] In *Sibbach v. Wilson & Co.*,[61] the Court held that Congress can regulate federal court procedure and can delegate this authority to federal courts.[62] Later, in *Mistretta v. United States*,[63] the Court suggested in dicta that this delegation of power was constitutional and that Congress has the authority to create entities like the Judicial Conference.[64]

Although these cases suggest that the REA's delegation of power is constitutional, no court has ever justified the process against all potential separation of powers challenges. To remain constitutional, the rules must survive more than a non-delegation challenge. Further, courts and scholars alike have overlooked rudi-

54. Ralph U. Whitten, *Separation of Powers Restrictions on Judicial Rulemaking: A Case Study of Federal Rule 4*, 40 ME. L. REV. 41, 44–45 (1988).

55. 326 U.S. 438 (1946).

56. *Id.* (contesting Federal Rule of Civil Procedure 4(f)); *see also* Grand Bahama Petroleum Co., Ltd. v. Canadian Transp. Agencies, Ltd., 450 F. Supp. 447, 449–50 (W.D. Wash., 1978) (discussing constitutionality of Supplemental Rule B(1) of Federal Rules of Criminal Procedure).

57. Burlington N. R.R. v. Woods, 480 U.S. 1, 6–8 (1987) (noting that presumption stemmed from approval by advisory committee, Supreme Court, and review by Congress); *see* Mississippi Pub. Corp. v. Murphree, 326 U.S. 438, 446 (1946) (noting that meaning of rules given by Advisory Committee warrants special weight). *But see* Hanna v. Plumer, 380 U.S. 460, 476 (Harlan, J., concurring) (claiming that integrity of federal rules is absolute because of availability of review by advisory committee, judicial conference, and Court). There is, however, no indication that this presumption applies to local rules, which neither the Supreme Court nor Congress reviews.

58. For examples of cases challenging the constitutionality of local rules and not referencing a presumption of validity, see *Colgrove v. Battin*, 413 U.S. 149 (1973), *Chi. Council of Lawyers v. Bauer*, 522 F.2d 242 (7th Cir. 1975), and *United States v. Furey*, 514 F.2d 1098 (2d Cir. 1975).

59. 380 U.S. 460 (1965).

60. *Id.* at 471–72.

61. 312 U.S. 1 (1941).

62. *Id.* at 9–10.

63. 488 U.S. 361 (1989).

64. *Id.* at 387–89.

mentary decisions and classifications about who or what makes the federal rules and under what authority. The answers to these issues are prerequisites to a separation of powers analysis.

II.
WHO MAKES THE RULES?

A. Background

Depending on who makes the rules and within which branch they operate, different constitutional restraints, requirements, and concerns apply. Thus, knowing which branch asserts rulemaking power is imperative to a separation of powers analysis. Although this Note agrees with virtually all other scholarship in determining that the judicial branch makes the rules,[65] it takes the extra step of exploring the basis for this conclusion. This Note concludes, based on an analysis of statutory text and Supreme Court opinions, that the power to make the federal rules lies with the Supreme Court, acting as the head the judicial branch.

The first question concerning the federal rules is whether the Judicial Conference or the Supreme Court makes the rules. Under the REA, the Supreme Court may promulgate rules of practice and procedure. This suggests that the power belongs to the Supreme Court; but the Court has suggested that, in practice, the Judicial Conference makes the rules.

The Court has repeatedly emphasized the central role the Judicial Conference plays in the rulemaking process. In *Murphree*,[66] the Court noted that although it promulgates the rules, lower courts should give substantial weight to the Advisory Committee's construction of the rules.[67] Bolstering the reasoning behind such a claim is the Chief Justice's cover letter to Congress in the 1993 transmission of suggested rule amendments: "While the Court is satisfied that the required procedures have been observed, this transmittal does not necessarily indicate that the Court itself would have proposed these amendments in the form submitted."[68] In the same message, Justice White, although noting that the Court reviews the proposed rules thoroughly and does not "rubber stamp"

65. Universally, scholars and courts assume that the judicial branch creates all of the federal rules, barring an explicit statute on point. *See infra* notes 72–75 and accompanying text.

66. 326 U.S. 438 (1946).

67. *Id.* at 444.

68. 146 F.R.D. 401, 403 (1993).

the proposals,[69] stated that Congress could not have intended the Supreme Court to be a full layer of review because it would take too much of the Court's time, and the Judicial Conference is far better equipped to make decisions about the rules.[70]

Despite acknowledging the large role the Judicial Conference plays, the Court has consistently maintained that the rulemaking power resides with the Court. In *Sibbach*, the Court explained that "Congress has undoubted power to regulate the practice and procedure of federal courts, and may exercise that power by delegating *to this or other federal courts* authority to make rules . . . ."[71] The *Mistretta* Court noted, "Pursuant to this power to delegate rulemaking authority to the Judicial Branch, Congress expressly has authorized this Court to establish rules . . . ."[72] In both cases the Court established explicitly that the authority had been delegated to the Court.

Statutory language supports this position. In *Mistretta*, the Court affirmed its earlier holding that the REA "conferred upon the Judiciary the power to promulgate federal rules of civil procedure,"[73] citing to § 2072 (granting the Supreme Court rulemaking power) and not to §§ 2073–75 (discussing the process of rulemaking via the Judicial Conference). The statutory text supports the

69. Justice White cited some of the many dissents over history and one instance where the Court refused to transmit a proposal. *Id.* at 502, 505; *see also, e.g.*, 368 U.S. 1011, 1012–14 (1961) (Douglas, J., dissenting) (contesting one proposed rule as contrary to congressional policy); 383 U.S. 1029, 1032, 1034 (1966) (Black, J., dissenting) (arguing that some of the Federal Rules of Criminal Procedure border on being unconstitutional); 461 U.S. 1117, 1119 (1982) (O'Connor, J., dissenting) (disagreeing with ambiguous language of one rule). *But see* Krugler v. Helfant, 421 U.S. 1019, 1022 (1975) (Douglas, J., dissenting) (arguing that the court is acting as rubber stamp).

70. 146 F.R.D. 401, 505 (1993) ("Hence, as I have seen the Court's role over the years, it is to transmit the Judicial Conference's recommendations without change and without careful study, as long as there is no suggestion that the committee system has not operated with integrity."). Justice White also mentioned that on multiple occasions he had serious questions about the wisdom of some amendments, yet voted to pass them anyway. *Id.* at 505; *cf.* 383 U.S. 1029, 1032 (1966) (Black, J., dissenting) ("Whether by this transmittal the individual members of the Court who voted to transmit the rules intended to express approval of the varied policy decisions the rules embody I am not sure. I am reasonably certain, however, that the Court's transmittal does not carry with it a decision that the amended rules are all constitutional. For such a decision would be the equivalent of an advisory opinion which, I assume the Court would unanimously agree, we are without constitutional power to give.").

71. Sibbach v. Wilson & Co., 312 U.S. 1, 24 (1941) (emphasis added) (citations omitted).

72. Mistretta v. United States, 488 U.S. 361, 387 (1989).

73. *Id.* at 383 (citing 28 U.S.C. § 2072).

Court's conclusion because the Judicial Conference can only "recommend" rules to the Supreme Court.[74] Further, there is no requirement that the Supreme Court must rely upon or obtain the consent of the Judicial Conference; it is an independent grant of rulemaking authority.[75]

Thus, based on statutory text and precedent, the Judicial Conference is a tool Congress supplied to the Supreme Court to exercise the Court's powers under § 2072. History suggests that this was necessary; the Supreme Court often failed to act under its independent grant of rulemaking authority.[76] A body charged with continually evaluating the rules would likely prompt the Supreme Court to act.[77] Therefore, Justice White is likely correct that, in practice, the Judicial Conference, and particularly its committees, plays the most substantive role in the creation of the rules, but, as a matter of law, the power of federal rulemaking rests with the Supreme Court.[78]

B. Fitting the Rule-Makers Into a Branch of Government

Having decided who makes the rules, the second inquiry requires determining within which branch the Supreme Court acts when it exerts its rulemaking power.[79] The rulemaking process does not permit a claim that the executive branch exerts rulemaking power.[80] Aside from the presidential power to appoint federal judges and the Justices of the Supreme Court, and the existence of Department of Justice representatives on the Judicial Conference, the executive branch has no control over the appointments and tenure of members of the Judicial Conference, nor any control over the content of proposals or their approval. At best, the executive has some influence, but certainly no actual control over the process.

One could more plausibly argue that the legislature exerts federal rulemaking power. An advocate of this stance would argue that

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74. 28 U.S.C. § 2073 (1994).

75. *See supra* notes 67–69 and accompanying text (giving examples of Court being proactive or rejecting or modifying conference's recommendations).

76. *See* Eli J. Warach, Note, *The Rule-Making Power: Subject to Law?*, 5 RUTGERS L. REV. 376, 388–90 (1951).

77. *Id.*

78. 374 U.S. 861, 869–70 (1963) (Black, J. & Douglas, J., dissenting) (recommending giving power to Judicial Conference but acknowledging that currently the Supreme Court makes rules).

79. This Note assumes that, under the formalist view, power must rest with and be exerted by one branch.

80. Executive control over agencies and their internal operating procedure is beyond the scope of this Note.

the REA drafts the Justices and other members of the federal judiciary into a legislative agency or committee. As far-fetched as this may seem, there is support for the point. First, many non-Article III personnel sit on the rulemaking committees.[81] Second, at least one court has described the Supreme Court as acting in an administrative, non-judicial capacity when it evaluates the proposed rules.[82] Similarly, the Supreme Court has described a state supreme court as acting in a legislative capacity when prescribing a code of ethics.[83] Third, the Supreme Court has labeled its control over the federal rulemaking process as control of an "extrajudicial" activity.[84]

These arguments, however, do not establish whether the legislature or the judiciary exerts authority. Rather, they prompt questions about whether Congress can delegate non-judicial responsibilities to the federal courts and whether it can create an independent agency, composed of Article III and non-Article III members, within the judiciary. The Court answered both of these questions in the affirmative.[85] Therefore, neither the exertion of non-judicial powers by federal judges and the Supreme Court, nor the mixed membership and independent agency status of the Judicial Conference, prohibits placement in the judiciary.[86]

Ultimately, the argument that federal rulemaking authority rests with the legislative branch turns on the role of legislative inaction. The Supreme Court must present all of its proposed rules to Congress, which could intervene in the process and reject the rule.[87] But just as a president's vetoing a bill rather than signing it

81. *See* BROWN, *supra* note 29, at 9–12; U.S. Courts, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/RulemakingProcess.aspx (last visited January 17, 2011).

82. Grand Bahama Petroleum Co. v. Canadian Transp. Agencies, Ltd., 450 F.Supp. 447 , 449–50 (W.D. Wash., 1978).

83. Supreme Court of Va. v. Consumers Union, Inc., 446 U.S. 719, 722–27, 734 (1980) (holding that members of Virginia Supreme Court had legislative immunity when acting in their legislative capacity by disciplining attorneys and prescribing code of ethics).

84. Mistretta v. United States, 488 U.S. 361, 389–90 (1989); *see infra* Part III.C.

85. *Mistretta*, 488 U.S. 361 (1989). The case concerned the constitutionality of the United States Sentencing Commission, a body composed of some federal judges and some non-Article III appointees of the President that Congress placed explicitly in the judicial branch. *Id.* at 368–69, 385–86.

86. *See* Stephen C. Garvito, *Separation of Powers and the Federal Rules of Evidence*, 26 HASTINGS L.J. 1059, 1078-79 (1974) (arguing that Judicial Conference can give advisory opinions because it is not a strictly judicial organ, is not sitting as a court of law, and is not a high court.).

87. 28 U.S.C. § 331 (2008).

does not mean he makes the law, Congress's authority to veto the proposed rules does not mean it makes the rules.

In the seminal *Sibbach* case*,* the Court was clear that Congress had delegated rulemaking authority to the judiciary: "Congress has undoubted power to regulate the practice and procedure of federal courts, and may exercise that power by delegating to this or other federal courts authority to make rules not inconsistent with the statutes or Constitution of the United States."[88] The Court continued: "That no adverse action was taken by Congress indicates, at least, that no transgression of legislative policy was found."[89] Thus, the majority placed emphasis on Congress' reaction, or lack thereof, to the rules. Years later, the Court reinforced this stance in *Business Guides, Inc. v. Chromatic Communications Enterprises, Inc.*,[90] stating that "[t]he Federal Rules of Civil Procedure are not enacted by Congress, but Congress participates in the rulemaking process."[91] There, the Court also held that a rule passed through such a process will only fail if the advisory committee, the Supreme Court, and Congress erred, thus establishing a strong presumption of validity for most federal rules.[92] Although Congress participates, as Justice Frankfurter noted in his *Sibbach* dissent, "Plainly, the Rules are not acts of Congress and cannot be treated as such."[93]

Therefore, the specific language in *Sibbach* and *Business Guides* establishes unmistakably that the judicial branch exerts rulemaking power under the REA, whereas the language about Congress's role refers to whether or not the rule at issue conflicts with congressional policy.[94]

88. 312 U.S. 1, 3 (1941).

89. *Id.* at 6.

90. 498 U.S. 533, 552 (1991) (holding that Rule 11 of Federal Rules of Civil Procedure is not fee-shifting statute).

91. *Id.* at 552 (citation omitted) (internal quotation marks omitted).

92. *Id.* at 552 (citation omitted); *see* Burlington N. R.R. Co. v. Woods, 480 U.S. 1, 6–8 (1987) (granting presumptive constitutional validity to all federal rules because advisory committee and Supreme Court approve them and Congress reviews them); Hanna v. Plumer, 380 U.S. 460, 476 (1965) (Harlan, J., concurring) ("Since the members of the Advisory Committee, the Judicial Conference, and this Court who formulated the Federal Rules are presumably reasonable men, it follows that the integrity of the Federal Rules is absolute.").

93. Sibbach v. Wilson & Co., 312 U.S. 1, 6 (1941). Frankfurter continued, "Having due regard to the mechanics of legislation and the practical conditions surrounding the business of Congress when the rules were submitted, to draw any inference of tacit approval from non-action by Congress is to appeal to unreality." *Id.*

94. Nonetheless, the Court's repeated emphasis on the role of Congress in the process and the presumption of validity it correspondingly granted to the rules

III. UNDER WHAT AUTHORITY DOES THE JUDICIAL BRANCH MAKE THE RULES?

A. *Background*

Once it is established that the judiciary makes the rules, the next separation of powers inquiry seeks to determine under what authority the judicial branch makes rules. The text of the Constitution details the sources of authority for all branches of the federal government. Congress has four constitutional sources of power to regulate the federal courts. Congress may "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States,"[95] "constitute Tribunals inferior to the supreme Court,"[96] and "make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers."[97] The Constitution only creates one court, the United States Supreme Court.[98] Congress's fourth power is the power to create every other federal court and control every detail about those courts, such as location, the number of judges, and the standard of review.[99] Congress controls the jurisdiction of these lower federal courts[100] and the appellate jurisdiction of the Supreme Court.[101]

In contrast, federal courts have little explicit constitutional power beyond the phrase, "The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish."[102] Furthermore, this judicial power only extends to cases or controver-

is reminiscent of Justice Jackson's approach to separation of powers in *Youngstown*. *See* Mistretta v. United States, 488 U.S. 361, 386 (1989) (referencing 343 U.S. 549, 638–55 (1952) (Jackson, J., concurring)).

95. U.S. Const. art I, § 8.

96. *Id.*

97. *Id.*

98. *Id.* art III, § 1.

99. Gary Lawson, *Controlling Precedent: Congressional Regulation of Judicial Decision-Making*, 18 Const. Comment. 191, 200–201 (2001).

100. Turner v. Bank of N. Am., 4 U.S. (4 Dall.) 8 (1799) (holding that Congress must grant jurisdiction for federal court to hear case).

101. *See, e.g.*, *Ex parte* McCardle, 74 U.S. 506 (1868) (holding that Congress's repealing of court jurisdiction over pending habeas case deprived court of jurisdiction to hear case).

102. U.S. Const. art. III, § 1; *see* N. Pipeline Const. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 64 (1982) (holding that historical and constitutional reasoning allows some judicial power to be vested in legislative branch, thus allowing very limited types of Article I courts to have Article III judicial power).

sies,[103] which limits the judicial power of Article III courts to powers associated with the adversarial process.[104] There is thus a strong concern with advisory opinions in the current process of promulgating rules for two reasons. First, the Supreme Court approves the rules submitted via the Judicial Conference and thus potentially evaluates their constitutionality outside of a case or controversy. Second, during the rulemaking process federal courts make rules applicable to cases generally and not as applied to a specific conflict between particular parties.[105]

B. *Federal Courts Have Statutory Authority to Create Procedural Rules*

The first premise of a statutory authority argument—the notion that Congress has delegated the power to make rules to the federal courts—is that Congress has the power to make the rules governing federal courts. This is because Congress cannot delegate to the judiciary power that it does not have.[106] The Court has consistently recognized this premise. In the oft-cited 1825 case of *Way-*

103. U.S. CONST. art III, § 2; *see* Muskrat v. United States, 219 U.S. 346, 356 (1911) ("As we have already seen, by the express terms of the Constitution, the exercise of the judicial power is limited to 'cases' and 'controversies.' Beyond this it does not extend, and unless it is asserted in a case or controversy within the meaning of the Constitution, the power to exercise it is nowhere conferred."); Flast v. Cohen, 392 U.S. 83, 95–96, 99 (1967).

104. *See Flast*, 392 U.S. at 96 ("The oldest and most consistent thread in the federal law of justiciability is that the federal courts will not give advisory opinions."). Even after deciding if a rule is valid constitutionally, there may be additional inquiries into whether or not it applies to a particular case, hence the *Erie* doctrine. *See* 19 ALLAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE, § 4501 (3d. ed. 2008). For explanations on the constitutional ban on advisory opinions, see WEINSTEIN, *supra* note 12, at 50–55; Garvito, *supra* note 86, at 1076.

105. "Whether by this transmittal the individual members of the Court who voted to transmit the rules intended to express approval of the varied policy decisions the rules embody I am not sure. I am reasonably certain, however, that the Court's transmittal does not carry with it a decision that the amended rules are all constitutional. For such a decision would be the equivalent of an advisory opinion which, I assume the Court would unanimously agree, we are without constitutional power to give." 383 U.S. 1029, 1032 (1966) (Black, J., dissenting); Jack B. Weinstein, *Rendering Advisory Opinions—Do We, Should We?*, 54 JUDICATURE 140, 140 (1970).

106. "The rulemaking power delegated by Congress to the Supreme Court is limited in scope to those powers that the Congress could have rightfully exercised." Grand Bahama Petroleum Co. v. Canadian Transp. Agencies, Ltd., 450 F.Supp. 447, 450 (W.D. Wash. 1978). *See also* Whitten, *supra* note 54, at 69 (arguing that Congress has control exclusively even if it does not act). Additionally, even if Congress has a power, there may be constitutional barriers to it delegating that power to another branch.

man v. Southard,[107] the Court established that Congress has the power to make laws regarding the execution of judgments by the judiciary, explaining "[t]hat a power to make laws for carrying into execution all the judgments which the judicial department has power to pronounce, is expressly conferred by [the Necessary and Proper Clause], seems to be one of those plain propositions which reasoning cannot render plainer."[108] Ten years later in 1835, the Court reinforced the view that Congress has the power to regulate the jurisdictional and rulemaking authority of the federal courts by holding that Congress has the power to create inferior courts "[a]nd that the power to ordain and establish, carries with it the power to prescribe and regulate the modes of proceeding in such courts, admits of as little doubt."[109] Thus, the power to create the courts includes the power to regulate their procedure. That same year, the Court upheld the delegation of procedural rulemaking authority to the federal courts and the Supreme Court by the Process Acts of 1789.[110] Later, in *Sibbach*, the Court wrote that "Congress has the power to regulate federal practice and procedure, and may delegate to the courts power to make rules not inconsistent with the Constitution or acts of Congress."[111] In 1992, the Court reaffirmed this position.[112] Neither the Supreme Court nor any federal court has challenged Congress's authority over rulemaking or

107. 23 U.S. (10 Wheat.) 1 (1825). The Court continued, "The courts, for example, may make rules, directing the returning of writs and processes, the filing of declarations and other pleadings, and other things of the same description. It will not be contended that these things might not be done by the legislature, without the intervention of the courts; yet it is not alleged that the power may not be conferred on the judicial department." *Id.* at 43.

108. *Id.* at 22.

109. Livingston v. Story, 34 U.S. (13 Pet.) 632, 656 (1835).

110. Beers v. Haughton, 34 U.S. (9 Pet.) 329, 360 (1835).

111. Sibbach v. Wilson & Co., 312 U.S. 1, 9 (1941). Later, in *Hanna*, the Court wrote,

> [T]he constitutional provision for the federal court system (augmented by the Necessary and Proper Clause) carries with it congressional power to make rules governing the practice and pleading in those courts, which in turn includes a power to regulate matters which, though falling within the uncertain area between substance and procedure, are rationally capable of classification as either.

Hanna v. Plumer, 380 U.S. 460, 471–72 (1965).

112. *See* Willy v. Coastal Corp., 503 U.S. 131, 136 (1992) ("Congress, acting pursuant to its authority to make all laws 'necessary and proper' to [the] establishment [of the lower federal courts], also may enact laws regulating the conduct of those courts and the means by which their judgments are enforced.").

its power to modify this process,[113] and at least one court has pointed to the delegation theory as the locus of power for Congress to give or rescind the authority of the courts to make the rules or override the rules by statute.[114]

The second premise of a statutory authority argument is that the Supreme Court has relied upon the congressional delegation via the REA as the source of its power to promulgate the rules. As the Court explained in *Hanna*,

> Erie and its offspring cast no doubt on the long-recognized power of Congress to prescribe housekeeping rules for federal courts . . . . To hold that a Federal Rule of Civil Procedure must cease to function whenever it alters the mode of enforcing state-created rights would be to disembowel either the Constitution's grant of power over federal procedure or Congress' attempt to exercise that power in the Enabling Act.[115]

The unmistakable language of the Supreme Court's holdings throughout American history establishes that the Court has and does promulgate the federal rules under the authority delegated to it by the REA. Indeed, "the [notion that] Federal courts have power, or may be empowered, to make rules of procedure for the conduct of litigation has been settled for a century."[116] Accordingly, as the preeminent treatise on civil procedure declares,

> The whole history of federal judicial procedure, the submission of the Federal Rules of Civil Procedure and the amendments thereto to Congress in accordance with the Rules Enabling Act of 1934, and the decisions of the Supreme Court, all are premised on the authority of Congress to make procedural rules and to delegate that power to the Supreme Court.[117]

113. WEINSTEIN, *supra* note 12, at 104; *see also* Whitten, *supra* note 54, at 54–56 (arguing that text and history of Article III courts demonstrates that Congress, exclusively, has controlled makeup of federal courts); Richard S. Ka, *The Rule-Making Authority and Separation of Powers in Connecticut*, 8 CONN. L. REV. 1, 41 (1975) (critiquing Connecticut Supreme Court decision and favoring legislative power over judicial supremacy because the latter is unchecked power).

114. WEINSTEIN, *supra* note 12, at 134–35 (noting that Court did so with evidentiary privileges).

115. *Hanna*, 380 U.S. at 473–74; *see also* BROWN, *supra* note 29, at 39.

116. 30 F.R.D. 73, 101 (1962). Most scholars conclude that the judiciary creates the federal rules under the delegated authority of the REA. *See, e.g.*, Bone, *supra* note 21, at 889–97; Yeazell, *supra* note 12, at 232–35, 243–44.

117. WRIGHT & MILLER, *supra* note 37, at, § 1001. As one submission of proposed federal rules to Congress noted, "[T]he [notion that] Federal courts have power, or may be empowered, to make rules of procedure for the conduct of litiga-

C. Federal Courts Rely, in Part, on Inherent Authority to Create Rules

The statutory authority argument fails to address two crucial scenarios. First, it fails to account for court rules outside the bounds of, or filling the gaps of, the federal rules. Second, there may exist constitutional authority to make some or all of the rules, but courts have not had to address this issue because of the REA's wide grant of statutory authority[118] and the doctrine of constitutional avoidance.[119] Federal and state courts have asserted an "inherent authority" to create rules in both of these scenarios.[120] In fact, despite 28 U.S.C. § 2071(a) (1988), granting the Supreme Court and all federal courts authority to prescribe rules of conduct for themselves, federal courts have chosen, in select situations, to exert an alternative inherent power to make the rules.[121]

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tion has been settled for a century." 30 F.R.D. 73, 101. One of the standing committee's preliminary reports on the issuance of the Federal Rules of Evidence asserted that the Supreme Court had power to promulgate those rules because it had authority under the REA, had rulemaking power for over one-hundred years, evidentiary rules are procedural and not substantive, and portions of the Federal Rules of Civil and Criminal Procedure that had already been passed concerned evidence. *Id.* at 100–03.

118. *See* Gertner, *supra* note 46, at 44–48 (discussing redundancy of some state enabling statutes with inherent power, but noting that it may function to stimulate court use of procedural power).

119. *See* Business Guides, Inc. v. Chromatic Comms. Enters., 498 U.S. 533, 564–68 (1991) (Kennedy, J., dissenting) (holding that Rule 11 of Federal Rules of Civil Procedure is not fee-shifting statute) ("The rules we prescribe have a statutory authorization and need not always track the inherent authority of the federal courts. At the same time, the further our rules depart from our traditional practices, the more troubling the question of our rulemaking authority . . . Congress desired the courts to regulate 'practice and procedure' an area where we have expertise and some degree of inherent authority . . . the construction of Rule 11 adopted today extends our role far beyond its traditional and accepted boundaries."); *see also* Bank of the U.S. v. Halstead, 23 U.S. (10 Wheat) 51, 64 (1825) (holding that all courts need not rely on their inherent power to command officers to comply with their duty because statutory authority exists).

120. *See infra* note 162 and accompanying text; Eash v. Riggins Trucking, Inc., 757 F.2d 557 (3d Cir. 1985); *see also* Arthur J. Goldberg, *The Supreme Court, Congress, and Rules of Evidence*, 5 SETON HALL L. REV. 667, 669 (1973) (describing how then-retired Justice Goldberg argued that portions of the rules of evidence were beyond Court's "inherent and delegated authority," thus acknowledging existence of inherent authority).

121. One explanation for this may be that the grant of authority to district courts under § 2071 applies to rules made by the entire district court and thus does not bestow any authority upon individual judges to create rules. Whether a district court can create a rule delegating such power to its judges is an interesting question. *See* 28 U.S.C. § 2071(a) (1988).

There are two absolutist positions on rulemaking authority. The first position asserts that courts have inherent authority to control all of their own procedure, and the legislature cannot interfere or override this prerogative.[122] Dean Roscoe Pound, the main proponent of this position, based this conclusion on primarily historical criteria, noting the judicial control of procedure in the United Kingdom and colonies.[123] Others have cited the freedom the legislature and executive enjoy in shaping their own procedure.[124] For example, John Wigmore asserted that courts may regulate their own procedure because of the limited enumerated powers of Congress, the broad grant of authority to courts under the Judicial Power Clause, and the practical advantages of efficiency and neutrality that courts have over the legislature.[125] For similar reasons, many state courts have reached the same conclusion under their respective state constitutions.[126] Yet, regardless of its merits, no federal court has adopted this position.[127]

The other absolutist position is that Congress can control every aspect of federal courts by virtue of both its authority to create the lower federal courts and its powers under the Necessary and Proper

122. Pound, *supra* note 12, at 600–01 ("In truth procedure of courts is something that belongs to the courts rather than to the legislature, whether we look at the subject analytically or historically. It is a misfortune that the courts ever gave it up.").

123. *Id.* at 60. *See also* Goldberg, *supra* note 120, at 668–70. *But see* Whitten, *supra* note 54, at 53–54 (noting limitations on court power over procedure in the Judiciary and Process Acts and explaining why history is not conclusive); Dan Byron Dobbs, *Judicial Regulation of Procedure*, 9 ARK. L. REV. 146, 147–49 (1954) (arguing that inherent judicial power over procedure limited historically to trivial matters and subject to legislative override).

124. *See* Pound, *supra* note 12, at 601; Josiah Marvel, *The Rule-Making Power of the Courts*, 12 J. AM. JUD. SOC. 55, 55–57 (1928).

125. John H. Wigmore, Editorial Note, *All Legislative Rules For Judiciary Procedure are Void Constitutionally*, 23 ILL. L. REV. 276, 277–78 (1928).

126. *See* Gertner, *supra* note 46, at 37–41 (listing state court assertions of inherent power); Charles W. Joiner & Oscar J. Miller, *Rules of Practice and Procedure: A Study of Judicial Rule Making*, 55 MICH. L. REV. 623, 624–25 (1976) (surveying state enabling statutes and state court assertions of inherent authority); Levin & Amsterdam, *supra* note 51, at 5–6 (detailing state constitutional grants of rulemaking power to high courts); *cf.* Joiner & Miller, *supra*, at 626 (concluding that Michigan Supreme Court views inherent and express constitutional grants of powers over procedure as two different sources of power).

127. Its only textual basis is that the term "judicial power" encompasses all procedural rules. Originalists are free to debate its historical meaning, but no court has concluded as such and a historical analysis is beyond the scope of this Note.

Clause.[128] According to this view, Congress has the ability to control how courts administer the substantive rights and laws it creates.[129] Although Congress has some authority to regulate court procedure, this absolutist stance is wrong because the text of the Judicial Power Clause specifies that the Supreme Court and all inferior courts, even though created by Congress, have judicial power.[130] Thus, if judicial power covers some or all procedural rulemaking powers, then courts have a textual basis of rulemaking authority that Congress cannot strip away.

Courts have adopted neither of these two absolutist stances and instead have used the phrase "inherent authority" in multiple contexts.[131] The term itself is, however, quite misleading because "[n]either Congress nor the federal courts can, under the guise of formulating rules of decision for federal courts, fashion rules which are not supported by a grant of federal authority contained in Article I or some other section of the constitution."[132] However, as will be explained below, there is a textual basis for the assertion of such inherent authority, suggesting that there is nothing inherent about it.

The Third Circuit thoroughly described the history of assertions of inherent powers by federal courts in *Eash v. Riggins Trucking, Inc.*[133] The *Eash* court explained that the scope and definition of inherent power is unclear because courts rarely assert it and thus rarely explain it.[134] Courts use it as a generic term for three differ-

128. *See generally* James S. Liebman & William F. Ryan, "*Some Effectual Power": the Quantity and Quality of Decisionmaking Required of Article III Courts*, 98 COLUM. L. REV. 696, 714–19 (1998) (discussing Madisonian Compromise).

129. N. Pipeline Const. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 84 n.35 (1982) ("The interaction between the Legislative and Judicial Branches is at its height where courts are adjudicating rights wholly of Congress' creation. Thus where Congress creates a substantive right, pursuant to one of its broad powers to make laws, Congress may have something to say about the proper manner of adjudicating that right.").

130. U.S. CONST. art. III, §1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.").

131. *See* Tyrrell Williams, *The Source of Authority For Rules of Court Affecting Procedure*, 22 WASH. U.L.Q. 459, 473–74 (1937).

132. Hanna v. Plumer, 380 U.S. 460, 471 (1965); *see also* Epstein v. State, 128 N.E. 353 (Ind. 1920) ("This court is a constitutional court, and as such receives its essential and inherent powers, rights, and jurisdiction from the Constitution, and not from the legislature, and it has power to prescribe rules for its own direct government independent of legislative enactment.").

133. 757 F.2d 557 (3d Cir. 1985).

134. *Id.*

ent types of power.[135] First, Congress's creation of a lower federal court immediately imbues it with Article III judicial power and authorizes courts to act in contradiction to legislative enactments:

> This use of inherent power, which might be termed irreducible inherent authority, encompasses an extremely narrow range of authority involving activity so fundamental to the essence of a court as a constitutional tribunal that to divest the court of absolute command within this sphere is really to render practically meaningless the terms 'court' and 'judicial power.'[136]

Although the boundaries of this power are unclear, the Court listed several examples, including control over the structure of court opinions, control over the docket, control over the implementation of a judgment, and the disqualification of judges.[137]

The second type of inherent power is described as being either "implied from strict functional necessity" or "essential to the administration of justice."[138] The most common form of this power is the power to issue a contempt sanction.[139] Because it arises from necessity, even though it may be subject to congressional regulation, Congress can neither eliminate it nor render it inoperative.[140]

The third form of inherent power is the ability of a court to equip itself with certain tools to adjudicate cases.[141] Because these tools are useful but not necessary, the power exists only in the absence of contrary legislation.[142] Examples of this power include the ability to appoint an auditor, to certify issues of state law to state courts, to grant bail in a situation not covered by statute, to dismiss a case under the doctrine of forum non conveniens, and a general power to dismiss cases.[143] The court distinguished rules formed under inherent power from local rules and upheld the constitutionality of inherent powers.[144]

135. *Id.* at 561–62 (3d. Cir. 1985).

136. *Id.* at 562.

137. *Id.* at 562 n.7 (citing multiple state court cases).

138. *Id.* at 562-63; *see also* Dobbs, *supra* note 123, at 148–150 (arguing that inherent power includes what is necessary to administer courts).

139. *Eash*, 757 F.2d at 563.

140. *Id.*

141. The court noted that this power may stem from the equity powers of chancery courts. *Id.* at 563–64.

142. *Id.*

143. *Id.* at 564.

144. The court reached this conclusion despite counter-arguments referencing *Youngstown Sheet & Tube v. Sawyer*, 343 U.S. 579 (1952), and the rarity of federal common law. *Eash*, 757 F.2d at 566, 568–69.

A careful review of case law proves that federal courts have never denied the existence of inherent authority: "That the Federal courts *have power*, or may *be empowered*, to make rules of procedure for the conduct of litigation has been settled for a century."[145] The number of assertions of inherent power by federal courts led one scholar to note the following: "The only fair question is not whether inherent power exists at all, but rather, what is the scope of such power?"[146] Nonetheless, neither all assertions of inherent power, nor all the categories listed by the *Eash* court, survives a separation of powers analysis. This Note considers each of these three categories to determine if any have textual or precedential backing.

D. Inherent Power to Ensure the Fair and Accurate Adjudication of Cases

Though the theory of separation of powers stems from three constitutional clauses, including the Judicial Power Clause, neither courts nor scholars have articulated extensively the meaning and scope of the phrase "judicial power." Yet, if under the doctrine of separation of powers, the legislature writes the laws, the executive enforces the laws, and the judiciary applies the laws, then the Judicial Power Clause must include the power to adjudicate cases fairly and constitutionally.[147] If the judiciary cannot fairly and constitutionally apply the law, it cannot fulfill its function.

Because some procedural rules are necessary to adjudicate cases, the first form of inherent power is the power to make rules essential to the application of laws.[148] This power is "implied from strict functional necessity" and is "essential to the administration of justice."[149] This Note contends that the adjudicatory power at the

145. 30 F.R.D. 73, 101 (1962) (emphasis added).

146. Joiner & Miller, *supra* note 126, at 626.

147. *See* Muskrat v. United States, 219 U.S. 346, 356 (1911) ("Judicial power . . . is the power of a court to decide and pronounce a judgment and carry it into effect between persons and parties who bring a case before it for decision."); State v. Clemente, 353 A.2d 723, 727–28 (Conn. 1974) (finding that core of judicial power is rendering judgment); Lawson, *supra* note 99, at 202–03 (noting that Founders did not give "judicial power" much debate, but that such power includes "the power to decide cases in accordance with governing law").

148. This power is analogous to corporation law's agency theory. The principal (Congress) has given its agent (federal courts) a duty (to adjudicate cases under the laws provided). The principal empowered the courts, as agents, to take all necessary steps to accomplish the duty until the principal changes or retracts the duty or specifies how to accomplish said duty. *See* RESTATEMENT (THIRD) AGENCY § 2.02 (2006) (defining agent's authority).

149. *Eash*, 757 F.2d at 562–63; *see also* Mullenix, *supra* note 7, at 1320–21 (noting that inherent powers include those necessary to administer justice); *cf.* United

heart of the Judicial Power Clause grants an inherent power to create rules necessary for the fair and constitutional adjudication of cases.

The Supreme Court's first official act was procedural, not substantive in nature: it created its seal and established requirements for attorneys who could appear before it.[150] Without such power, the Court could not decide cases as no one could argue before it. But the Court still had a long way to go; the absence of other necessary procedural rules prohibited adjudication. Basic court procedure like the submission of briefs and the procedure for oral argument remained unspecified. Thus, in *Hayburn's Case*,[151] the Court concluded by declaring that "[The Court] considers the practice of the courts of King's Bench and Chancery of England, as affording outlines for the practice of this court . . . ."[152] These two examples, setting standards for attorneys arguing before the Court and adopting English procedure, demonstrate the necessity of procedure to adjudication.

Eventually, Congress delegated statutory authority to the Supreme Court, and later to all federal courts, to create their own procedure,[153] but the absence of pre-existing procedural rules continued to plague courts. For example, a court cannot apply the law to the facts if there is no reliable evidence to establish the facts.[154] Therefore, before the advent of codified federal evidentiary rules, if state rules did not apply then federal courts developed federal common law rules of evidence. In *Funk v. United States*,[155] the Court held that it and the other federal courts could articulate current common law rules on spousal testimony in the absence of congressional legislation.[156] Later, in *McNabb v. United States*,[157] the Court held a criminal confession inadmissible because of a court's inherent power over the creation and maintenance of "civilized stan-

States v. Curtiss-Wright Export Corp., 299 U.S. 304, 314 (1936) (discussing inherent executive power).

150. 2 U.S. (2 Dall.) 399 (1790).

151. 2 U.S. (2 Dall.) 408 (1792).

152. *Id.* at 413–14.

153. 28 U.S.C. § 2071(a) (1988).

154. *But see* Charles Anthony Riedl, *To What Extent May Courts Under the Rule-making Power Prescribe Rules of Evidence?*, 26 A.B.A. J. 601, 602 (1940) (arguing that evidence rules are non-essential to constitutional function of legislature and judiciary).

155. 290 U.S. 371 (1933).

156. *Id.* at 381–83. *See* Doe *ex dem.* Patterson v. Winn, 24 U.S. (11 Wheat.) 380, 384–85, 391 (1826) (upholding court-made evidence rule that did not conflict with statute).

157. 318 U.S. 332 (1943).

dards of procedure and evidence."[158] Thus, despite the absence of a constitutional requirement or any controlling federal statute, the Court developed its own federal rules of evidence.[159]

Even after the enactment of codified rules of procedure, the Court continued to fill in voids in the rules. It recognized the inherent power of courts to create procedural rules, writing that "[c]ertain implied powers must necessarily result to our Courts of justice from the nature of their institution."[160] Such powers include the powers to fine for contempt or to imprison to preserve courtroom order, both of which "are powers which cannot be dispensed with in a Court, because they are necessary to the exercise of all others . . . ."[161] Later, the Court re-emphasized that the power to punish for contempt is inherent in all courts because it is "essential to the administration of justice" that courts be able to vindicate their own authority without complete dependence on other branches.[162] Without it, "what the Constitution now fittingly calls 'the judicial power of the United States' would be a mere mockery."[163] Similarly, expanding the concept of "order" in *Link v. Wabash Railway Co.*,[164] the Court held that

> [t]he authority of a court to dismiss *sua sponte* for lack of prosecution has generally been considered an "inherent power," governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases.[165]

158. *Id.* at 340–41.

159. *See* Amy Coney Barrett, *The Supervisory Power of the Supreme Court*, 106 COLUM. L. REV. 324, 370, 374–76, 379, 387 (2006) (noting Supreme Court rulings filling evidentiary gaps by appealing to common law).

160. United States v. Hudson & Goodwin, 11 U.S. (7 Cranch) 32, 34 (1812).

161. *Id.*

162. Young v. United States *ex rel.* Vuitton et Fils S.A., 481 U.S. 787, 795–96 (1987) (quoting Michaelson v. United States *ex rel.* Chicago, St. P., M., & O. Ry. Co., 266 U.S. 42, 65 (1924)).

163. *Id.* at 796 (citing Gompers v. Bucks Stove & Range Co., 221 U.S. 418, 450 (1911)); *see* Willy v. Coastal Corp., 503 U.S. 131, 132 n.12 (1991) (acknowledging inherent power), *aff'd* 488 U.S. 361, 392 (1989); *cf.* Supreme Court of Virginia v. Consumers Union of United States, Inc., 446 U.S. 719, 721–24 (1980) (recognizing state supreme court's inherent and statutory authority to discipline attorneys and prescribe code of ethics).

164. 370 U.S. 626 (1962).

165. *Id.* at 630–31. Similarly, in *United States v. Furey*, 514 F.2d 1098, 1104 (2d Cir. 1975), the Second Circuit upheld the use of inherent power to create a local rule allowing dismissal with prejudice for inexcusable delay by the prosecution. *See* Frank H. Gibbes, III, Note, *The Judiciary and the Rule-Making Powe*r, 23 S.C. L. REV. 377, 386-87 (1971) (citing holdings that establish court power to control order of business as necessary to enforce rights and redress wrongs).

Thus, the Supreme Court has explicitly recognized an inherent power to create rules necessary for the adjudication of cases.

But the above examples are all conditioned on the absence of an already existing governing rule or law. Illustrating this limitation is the case of *Alyeska Pipeline Service Co. v. Wilderness Society*,[166] in which the Court held that without congressional authorization, federal courts cannot create an exception to the general rule barring attorney's fees.[167] In dicta, the Court explicitly referenced the inherent power to assess attorney's fees for some instances of willful disobedience or bad faith.[168] But Congress had issued exceptions to the general prohibition in statutes inapplicable to the case.[169] As a result of these exceptions, the Court concluded that to expand the exceptions would conflict with the congressional policy to carve out only limited exceptions.[170] This ruling limited a federal court's inherent power to issue fees to circumstances in which Congress has not established a policy.[171] In sum, there is an inherent power to create procedural rules if 1) the rule is necessary to adjudication and 2) Congress, or a body delegated authority by Congress, has not provided a governing principle.

E. Inherent Power to Protect the Independence and Integrity of the Judiciary

The Supreme Court has expounded the importance of an independent judiciary: "[O]ur Constitution unambiguously enunciates a fundamental principle—that the 'judicial Power of the United States' must be reposed in an independent Judiciary. It commands that the independence of the Judiciary be jealously guarded, and it provides clear institutional protections for that in-

166. 421 U.S. 240 (1975).

167. *Id.* at 269.

168. *Id.* at 259–60.

169. *Id.* at 259.

170. *Id.* at 269.

171. Similarly, in *Societe Internationale Pour Participants Indusrielles et Commerciales v. Rogers*, 357 U.S. 197 (1958), the Court rejected claims of its inherent power to dismiss for noncompliance with a discovery order because a Federal Rule of Civil Procedure controlled. *Id.* at 207. *See* Shane v. McNeil, 41 N.W. 166, 168 (Iowa 1889) (finding that legislature enabled judicial conference to make laws; but noting that if conference fails to act, each court has common law power to make rules that do not conflict with laws or conference's rules); Mills v. Bank of United States, 24 U.S. (11 Wheat.) 431, 439–40 (1826) (upholding local rule designed to further justice and save costs in part because rule did not interfere with any rules of evidence).

dependence."[172] When procedural rules infringe on the independence of the judiciary, courts can assert an inherent power to protect their independence.[173] There are two constitutional bases for this inherent power. The first is that congressionally-created rules infringing on judicial independence are never "necessary and proper" to the "creation of inferior courts" and thus are always beyond legislative authority.[174] The second is that the fair administration of justice and fair adjudication of cases is at the core of the Judicial Power Clause and guarantees an independent judiciary such that all other constitutional clauses must be read to accord with this proposition.[175] Federal courts have referenced the historical use of their inherent power[176] but have never identified its constitutional source. Although the congressional authority theory is equally plausible, this Note will focus on the judicial independence theory because of its strong support in precedent.

Although rare, federal courts have sometimes asserted inherent authority on the grounds of judicial independence.[177] Congress may establish general laws, but not laws tailored specifically against

172. N. Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50, 58–60 (1982) (citing United States v. Will, 449 U.S. 200, 217–18 (1980)).

173. In the words of the *Eash* court, it "might be termed irreducible inherent authority, [and] encompasses an extremely narrow range of authority involving activity so fundamental to the essence of a court as a constitutional tribunal that to divest the court of absolute command within this sphere is really to render practically meaningless the terms 'court' and 'judicial power.'" Eash v. Riggins Trucking, Inc., 757 F.2d 557, 562 (3d Cir. 1985). *See also* Lawson, *supra* note 99, at 205–07, 210–11 (stressing importance of independence, and arguing that judicial power includes power to reason to outcome of case); Robert J. Pushaw, *The Inherent Powers of Federal Courts and the Structural Constitution*, 86 IOWA L. REV. 735, 824 (2001) ("The Constitution does not prohibit all implied powers, however. Rather, the presumption against their existence can be rebutted by a showing that a certain power must be inferred because otherwise a department would be unable to perform its express constitutional functions."); *cf.* Carter v. Commonwealth, 32 S.E. 780, 785 (Va. 1899) ("That in the courts created by the [Virginia State] Constitution there is an inherent power of self-defense and self-preservation; that this power may be regulated, but cannot be destroyed, or so far diminished as to be rendered ineffectual, by legislative enactment; that it is a power necessarily resident in, and to be exercised by the court itself.").

174. Lawson, *supra* note 99, at 192, 198–200; *see also* Pushaw, *supra* note 173, at 742.

175. *See* Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 848 (1986) (stating that Article III Section 1 protects judiciary from other branches and protects litigant rights); Stump v. Sparkman, 435 U.S. 349, 368 (1978) (Powell, J., dissenting) (stating that judicial independence benefits litigants).

176. For examples of such cases, see the *Eash* court's case citations *infra* Part II.F.

177. *See* United States v. Klein, 80 U.S. 128, 146–47 (1871).

individuals or classes of individuals.[178] For example, the Court held that Congress cannot declare a rule of decision in a specific case because then "Congress has inadvertently passed the limit which separates the legislative from the judicial power."[179] A "rule of decision" renders the judicial process a mere formality. As Dean Pound wrote, "None of the coordinate and co-equal departments of our polity can do its work effectively if the minute details of its procedural operations, as distinct from the substantive law it applies or administers, are dictated by some other department."[180] Courts adjudicate cases, and a rule of decision would prohibit any adjudicatory process, thereby stripping courts of their independence.[181]

The case of *Legal Services Corp. v. Velazquez*[182] exemplifies how a court would determine whether a law infringed on its independence. In *Velazquez*, the Court struck down a federal law providing funds to attorneys of indigent clients on the condition that the attorneys not contest the validity of any statute.[183] Although deciding the case on First Amendment grounds, the decision's reasoning rings of separation of powers logic. The Court wrote that "[t]he restriction distorts the legal system by altering the traditional role of the attorneys,"[184] and in so doing,

> the statute here threatens severe impairment of the judicial function . . . . The courts and the public would come to question the adequacy and fairness of professional representations when the attorney, either consciously to comply with this statute or unconsciously to continue the representation despite the statute, avoided all reference to questions of statutory validity and constitutional authority. A scheme so inconsistent with accepted separation-of-powers principles is an insufficient basis to sustain or uphold the restriction on speech.[185]

Here the separation of powers concern is judicial review. Depriving advocates of valid constitutional arguments strips courts of their check on the legislature. More broadly, any restrictions on

178. Lawson, *supra* note 99, at 201.

179. *Klein*, 80 U.S. at 146–47.

180. Pound, *supra* note 12, at 601 (1926).

181. *See* Dean Alfange, Jr., *The Supreme Court and the Separation of Powers: A Welcome Return to Normalcy?*, 58 GEO. WASH. L. REV. 668, 673–75 (1998) (explaining that mechanical application of laws and procedure is not check on legislature).

182. 531 U.S. 533 (2001).

183. *Id.* at 536–37.

184. *Id.* at 544.

185. *Id.* at 546. *See* Chicago Council of Lawyers v. Bauer, 522 F.2d 242, 248, 259 (7th Cir. 1975) (striking local rules regulating attorney extrajudicial comments on First Amendment grounds and noting potential impact on fair trials).

making valid legal arguments undermines the adversarial process, thereby prohibiting courts from deciding cases accurately and completely.

Use of this inherent power prompts a serious concern, justifying an assertion of inherent power with an argument based on independence carries grave consequences. In such cases, courts are not filling voids, but rather are voiding congressional laws and establishing exclusive control over a field. Only a constitutional amendment could overturn such a decision. Compounding this concern are the unclear boundaries of this inherent power. Hence, there is a concern that federal courts could assume too much power, with little chance of legislative recourse. As a result, federal courts have been reluctant to make such assertions.[186]

In contrast, state courts have been active in asserting such inherent authority. Although most state constitutions have explicit separation of powers clauses,[187] and despite potential conflicts with substantive policies, many courts have protected their control of these arenas as necessary to their independence.[188] Among the areas state courts have held to be within the exclusive regulation of the judiciary and beyond legislative control are: aspects of pleadings,[189] control of the docket,[190] the structure of court opinions,[191]

186. For some examples, see *infra* note 261. *See* Silas A. Harris, *The Extent and Use of Rule-Making Authority*, 22 J. AM. JUD. SOC. 27, 29 (1938); Pushaw, *supra* note 173, at 738. For a discussion about concerns with rules made by courts because of the difficulty in changing them see Warach, *supra* note 76, at 386; Allan Ashman, *Measuring the Judicial Rule-Making Power*, 59 JUDICATURE 215, 218 (1975) (noting that Supreme Court rarely uses rulemaking power unless clear statutory or inherent power); W. Glenn Forrester, Note, *Substance and Procedure: The Scope of Judicial Rule Making Authority in Ohio*, 37 OHIO ST. L.J. 364, 384 (1976); Gertner, *supra* note 46, at 44 (noting that courts are reluctant to make rules unless they are certain such rules are within their power).

187. Gertner, *supra* note 46, at 5–6 (detailing state constitutional grants of rulemaking power to high courts).

188. Levin & Amsterdam, *supra* note 51, at 18–23, 30–36.

189. Epstein v. State, 128 N.E. 353, 353 (Ind. 1920) (striking law conflicting with court rule requiring concise statement in pleadings); White v. Fisher, 689 P.2d 102, 103, 107 (Wyo. 1984) (striking law regulating ad damnum clauses as infringing on court constitutional and inherent authority to control pleadings).

190. Atchinson v. Long, 251 P. 486, 489 (Okla. 1926) (recognizing legislature's power to control procedure but striking law prioritizing certain cases because of court's inherent authority to control court business, without which court would become "impotent and useless").

191. Houston v. Williams, 13 Cal. 24, 25–28 (1859) (striking law requiring courts to issue written opinions), *superseded by constitutional amendment*, CAL. CONST. art. VI, § 14 (requiring California Supreme Court and appellate courts to write down reasons and causes).

the space allocation within courthouses,[192] control of courthouse facilities,[193] control over courthouse personnel,[194] the method of impaneling jurors,[195] correcting judgments based on fraud,[196] control of discovery,[197] the fixing of bail and release from custody,[198] dismissing a case when a party failed to appear,[199] control over certiorari petitions,[200] and jury instructions.[201] These state court decisions provide a sense of the potentially large scope of this unchecked inherent power.[202]

The scope and use of this power depends on several factors, including (1) encroachments on the Article I legislative power of Congress; (2) the historical use and meaning of inherent power;[203]

192. Dahnke v. People, 48 N.E. 137, 139–141 (Ill. 1897) (recognizing inherent power to control space inside courtroom when county board ordered janitor to lock judge out of courtroom).

193. Bd. of Comm'rs of Vigo County v. Stout, 35 N.E. 683, 685–86 (Ind. 1893) (asserting constitutional and inherent authority over controlling elevators in courthouse as necessary to dignity, decorum, and convenience).

194. *See In re* Janitor of the Supreme Court, 36 Wis. 410, 410 (1874) (claiming constitutional and inherent authority to appoint janitors because they are necessary to administer justice and judges develop bonds of trust with them).

195. People v. Brown, 212 N.W. 968, 969 (Mich. 1927) (upholding process of choosing jurors by pulling names from box).

196. *See In re* McDonald, 164 N.E. 261, 263 (Ind. 1928) (per curiam) (finding inherent power to vacate judgment based on fraud).

197. State v. Clemente, 353 A.2d 723, 731 (Conn. 1974).

198. State v. Smith, 527 P.2d 674, 677 (Wash. 1974) (striking law conflicting with court rule regulating the setting of bail and finding that court's power is inherent and incidental from power to hold defendant).

199. Agran v. Checker Taxi Co., 105 N.E.2d 713, 715–16 (Ill. 1952) (affirming dismissal for failure to appear despite law requiring party receive notice five days before dismissal).

200. Fischer v. Bedminster, 76 A.2d 673, 676 (N.J. 1950) (noting that state supreme court has exclusive power to decide certiorari petitions because if legislature could regulate them, then it could make some of its acts beyond judicial review).

201. Newell v. State, 308 So. 2d 71, 76 (Miss. 1975) (finding that judge has discretion about manner of presenting jury instructions, and noting that legislature can make rules as long as they coincide with fair and efficient administration of justice).

202. Scholars have speculated on other realms potentially within such inherent power, like administrative matters—such as a court's docket and record keeping—as well as arenas crucial to accurate fact-finding and judgments, like compelling testimony and appointing experts. Whitten, *supra* note 54, at 56; Pushaw, *supra* note 173, at 742.

203. *See, e.g.*, Miner v. Atlass, 363 U.S. 641, 644 (1960) (finding that history did not support use of inherent power to partake in type of discovery at issue); *see* Mistretta v. United States, 488 U.S. 361, 392 (1989) (Supreme Court's function in promulgating procedural rules is central element of historically acknowledged mis-

(3) the practical impact on judicial independence and the ability to adjudicate cases accurately and constitutionally; and (4) a preference to exert inherent power as a last resort because federal courts are not accountable democratically and because of the difficulty for Congress to overturn the decision. The most difficult cases are likely to arise when congressional action to improve the integrity of the judicial branch conflicts with court tradition, such as if Congress passed a law prohibiting judges from dissenting without opinion, or if Congress required appellate courts to count the votes of each judge on an issue-by-issue basis instead of by each judge's view of the outcome of the case.[204]

F. There is No Inherent Power to Create Useful or Beneficial Laws that are Not Necessary to Adjudication or Independence

The *Eash* Court observed a third form of inherent power: the power of a court to equip itself with useful but not necessary tools in the absence of contrary legislation.[205] Examples of this power included the ability to appoint an auditor,[206] certify issues to state courts,[207] grant bail in a situation not covered by statute,[208] dismiss a case under the doctrine of *forum non conveniens*,[209] and a general

sion of Judicial Branch). "The language of the Constitution cannot be interpreted safely except by reference to the common law and to British institutions as they were when the instrument was framed and adopted." *Ex parte* Grossman, 267 U.S. 87, 108–09 (1925); *see also* Pound, *supra* note 12, at 601 (advocating looking to colonial and English history to clarify powers of branches of government).

204. To illustrate, consider the following example: a criminal defendant claim seeks a new trial, alleging violations of the Fourth and Fifth Amendments. Four Justices conclude that neither amendment was violated and accordingly deny the request for a new trial. Three Justices conclude that both amendments were violated and would order a new trial. One Justice concludes that there was a Fourth Amendment violation but no Fifth Amendment violation and would thus order a new trial. The final Justice concludes that there was no Fourth Amendment violation, but that there was a Fifth Amendment violation and accordingly would order a new trial. If the Court counted its votes by each Justice's view of the ultimate outcome of the case, then the defendant would receive a new trial, as five Justices reached that conclusion. However, if the court counted its votes by issue, then the prosecution would win because on each issue five Justices concluded there was no violation. Lewis A. Kornhauser & Lawrence G. Sager, *The One and the Many: Adjudication in Collegial Courts*, 81 CAL. L. REV. 1, 11–17 (1993) (illustrating the different impacts that counting votes by issue as opposed to by outcome can have on a litigant).

205. Eash v. Riggins Trucking, Inc., 757 F.2d 557, 563–64 (3d. Cir. 1985).

206. *Id.* at 563 (citing Supreme Court and circuit court decisions).

207. *Id.* at 564.

208. *Id.*

209. *Id.*

power to dismiss cases.[210] Although courts have asserted such inherent power, doing so is a breach of the separation of powers. Such power is limitless so long as there are no contrary federal laws and Congress has not preempted that field of procedure. More importantly, there is no constitutional basis for assertions of such authority. Still, one could argue that rules made under this justification, like *forum non conveniens*, are necessary to the fair adjudication of a case or that there is statutory authority for courts to make these rules, such as the general rulemaking power established by § 2071(a) or via federal rules, like Federal Rule of Civil Procedure 83.[211]

III.
DELEGATION OF POWER

A. Introduction

The non-delegation doctrine restricts Congress's power to delegate authority to other bodies.[212] On the whole the non-delegation doctrine raises three issues regarding federal rulemaking powers. First, the delegated power should be strictly and exclusively legislative in nature.[213] Second, the delegation of power should be accompanied by an intelligible principle to guide the body receiving such authority.[214] Third, the assertion of such authority cannot cause an exertion of nonjudicial powers by the courts that would violate the Judicial Power Clause or the Case or Controversy Clause.[215]

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210. *Id.*

211. When there is no controlling law or procedure, "A judge may regulate practice in any manner consistent with federal law, rules adopted under 28 U.S.C. §§ 2072 and 2075, and the district's local rules." FED. R. CIV. P. 83(b).

212. *See* Patrick M. Garry, *The Unannounced Revolution: How the Court Has Indirectly Effected a Shift in the Separation of Powers*, 57 ALA. L. REV. 689, 701–02 (2006).

213. *See* Mistretta v. United States, 488 U.S. 361, 385 (1989) (noting that delegation of power to Sentencing Commission is unconstitutional only if "Congress has vested in the Commission powers that are more appropriately performed by the other Branches or that undermine the integrity of the Judiciary").

214. *See* FCC v. Fox TV Stations, Inc., 129 S. Ct. 1800, 1823 (2009) (Kennedy, J., concurring) ("Congress must 'lay down by legislative act an intelligible principle,' and the agency must follow it.") (citation omitted).

215. Morrison v. Olson, 487 U.S. 654, 677–78 (1988) ("'[E]xecutive and administrative duties of a nonjudicial nature may not be imposed on judges holding office under Art. III of the Constitution.' The purpose of this limitation is to help ensure the independence of the Judicial Branch and to prevent the Judiciary from encroaching into areas reserved for the other branches.") (quoting Buckley v. Valeo, 424 U.S. 1, 123 (1976)) (citations omitted); Muskrat v. United States, 219 U.S. 346, 352 (1911) ("That neither the legislative nor the executive branches can

Federal courts will likely reject challenges to the rulemaking process made under the non-delegation doctrine.[216] Dicta from *Mistretta* largely forecloses these claims.[217] In *Mistretta*, the Court explained: "[W]e specifically have upheld . . . Congress's power to confer on the Judicial Branch the rulemaking authority contemplated in the various enabling Acts."[218] Indeed, Supreme Court precedent has continually upheld such delegation throughout the nation's history.[219] Although the Court's language supports the conclusion that the REA would survive a non-delegation challenge, the topic deserves a more intricate analysis.

B. Non-Delegation Doctrine Analysis

The first issue introduced by the REA is whether Congress delegated uniquely legislative, as opposed to judicial, power to the courts. If uniquely legislative, then the non-delegation doctrine may have been violated because "[a]ll legislative powers herein granted [by the Constitution] shall be vested in a Congress."[220] The *Mistretta*

constitutionally assign to the judicial any duties but such as are properly judicial, and to be performed in a judicial manner.").

216. *Mistretta*, 488 U.S. at 375 (noting that Court has only struck down two cases under non-delegation doctrine.).

217. Notably, *Mistretta* is persuasive evidence of how the Court would decide a challenge to the rulemaking process on the basis of the non-delegation doctrine. But *Mistretta* concerned the constitutionality of the United States Sentencing commission, thus all references to rulemaking are dicta.

218. *Mistretta*, 488 U.S. at 388 (referencing REA and Court's decision in *Sibbach*); *see also id.* at 386–87 (citing Sibbach v. Wilson & Co., 312 U.S. 1 (1941) and Wayman v. Southard, 23 U.S. (10 Wheat.) 1, 43 (1825)).

219. *See Wayman*, 23 U.S. (10 Wheat.) at 20, 22–23; Bank of the United States v. Halstead, 23 U.S. (10 Wheat.) 51, 61–62 (1825) ("Congress might regulate the whole practice of the Courts, if it was deemed expedient so to do but this power is vested in the Courts; and it never has occurred to any one that it was a delegation of legislative power . . . Partakes no more of legislative power, than that discretionary authority entrusted to every department of the government in a variety of cases."). *But see* WEINSTEIN, *supra* note 12, at 3–4 ("Court rules have much the form and effect of legislative enactment. Until repealed or modified they control all litigation encompassed within their ambit. Like legislative enactments, they are subject to interpretation and to a declaration of invalidity when they are in conflict with legislation or constitutions.").

220. U.S. CONST., art. I, § 1; Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 472 (2001) ("In a delegation challenge, the constitutional question is whether the statute has delegated legislative power to the agency. Article I, § 1, of the Constitution vests 'all legislative Powers herein granted . . . in a Congress of the United States.' This text permits no delegation of those powers . . . ."). *But see* FCC v. Fox TV Stations, Inc., 129 S. Ct. 1800, 1826 n.2 (2009) ("[T]he Framers vested 'All legislative Powers' in the Congress, Art. I, § 1, just as in Article II they vested the 'executive Power' in the President, Art. II, § 1. Those provisions do not purport to

Court described rulemaking as being neither inherently legislative nor judicial; instead, adopting a functionalist perspective stressing cooperation between the branches, the Court described it as being in a "twilight area" because it is either nonjudicial or not a function exclusively committed to another branch.[221] This description suggests it is not a delegation of uniquely legislative power.[222]

The second issue is whether the acts enabling the rulemaking process have an intelligible principle to guide the judiciary.[223] All the authorizing procedural statutes at issue contain directives. For example, the REA's delegation of power to the Supreme Court is to "prescribe general rules of practice and procedure" that "shall not abridge, enlarge or modify any substantive right."[224] Likewise, all of the entities that aid the Court in developing the rules have clear legislative mandates. Congress charged the Judicial Conference with promoting uniformity, expedience, "simplicity in procedure, fairness in administration, the just determination of litigation, and the elimination of unjustifiable expense and delay," as well as ensuring the federal rules are consistent with federal law.[225] Congress directed the Judicial Conference's standing committees to change and develop rules "necessary to maintain consistency and otherwise promote the interest of justice."[226] In reaching its decision, the *Mistretta* Court cited the language of the delegations to the Judicial Conference and its committees.[227] This dicta, combined with the

limit the authority of either recipient of power to delegate authority to others.") (citation omitted).

221. "That judicial rulemaking, at least with respect to some subjects, falls within this twilight area is no longer an issue for dispute. None of our cases indicate that rulemaking *per se* is a function that may not be performed by an entity within the Judicial Branch, either because rulemaking is inherently nonjudicial or because it is a function exclusively committed to the Executive Branch." *Mistretta*, 488 U.S. at 386–87, 407–08.

222. *See id.* This holding may be weaker in the context of rulemaking for bankruptcy cases because Article I, Section 8 grants Congress the authority to make "uniform laws on the subject of bankruptcy." But the courts could likely limit this phrase to substantive powers thereby not restricting the current delegation of rulemaking powers.

223. *See Whitman*, 531 U.S. at 472 (citing J. W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928)). For examples of impermissible delegations of power, see *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935), and *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

224. 28 U.S.C. § 2072(a), (b) (1990).

225. 28 U.S.C. § 331 (2008).

226. 28 U.S.C. § 2073(b) (1994).

227. *Mistretta*, 488 U.S. at 388–89 (citing Chandler v. Judicial Council, 398 U.S. 74, 86, n. 7 (1970) ("Though not the subject of constitutional challenge, by established practice we have recognized Congress' power to create the Judicial

instructions contained in each statute, suggests there is an intelligible principle in each of the enabling acts.

The final contention concerns the Judicial Power and Case or Controversy Clauses.[228] The *Mistretta* Court explained that while, as a general rule, Congress cannot require Article III judges to execute nonjudicial and administrative duties, there are significant exceptions.[229] Elaborating, the Court said, "[C]onsistent with the separation of powers, Congress may delegate to the Judicial Branch nonadjudicatory functions that do not trench upon the prerogatives of another Branch and that are appropriate to the central mission of the Judiciary."[230] Under this test the Court suggested it would uphold the statutes authorizing the Judicial Conference of the United States, the rules advisory committees, and other rulemaking and administrative entities.[231]

The Court conceded that these rulemaking bodies made political decisions with substantive implications and authored standards of general application divorced from individual fact scenarios.[232] Acknowledging that the Judicial Conference does not decide issues that arise within either a case or controversy, the Court observed that it contributes to the fair and efficient adjudication of cases. The Court has never disavowed the delegation of such nonjudicial power.[233] For example, federal courts have accepted the powers to

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Conference of the United States, the Rules Advisory Committees that it oversees . . . .")). Most scholars agree with the Court on this point. *See, e.g.*, Moore, *supra* note 35, at 1047. *But see* Yeazell, *supra* note 12, at 243–44 (suggesting that because judges make and interpret rules proscribed via the REA, it suffers from same concerns present in *Schecter Poultry* and *Panama Refining*).

228. *Mistretta*, 488 U.S. at 361–62 ("According to express provision of Article III, the judicial power of the United States is limited to 'Cases' and 'Controversies.' . . . These doctrines help to ensure the independence of the Judicial Branch by precluding debilitating entanglements between the Judiciary and the two political Branches, and prevent the Judiciary from encroaching into areas reserved for the other Branches by extending judicial power to matters beyond those disputes 'traditionally thought to be capable of resolution through the judicial process.' As a general principle, we stated as recently as last Term that 'executive or administrative duties of a nonjudicial nature may not be imposed on judges holding office under Art. III of the Constitution.'") (citations omitted).

229. *Id.* at 385–86; *see* Mullenix, *supra* note 7, at 1317; Alfange, *supra* note 181, at 674–81.

230. *Mistretta*, 488 U.S. at 388.

231. *Id.* at 388–89 (citing Chandler v. Judicial Council*,* 398 U.S. 74, 86, n.7 (1970)).

232. *Id.* at 392.

233. *Id.* at 389–90 ("'These entities, some of which are comprised of judges, others of judges and nonjudges, still others of nonjudges only, do not exercise judicial power in the constitutional sense of deciding cases and controversies, but

oversee the administrative and personnel matters of courts, study judicial administration, make appointments, supervise grand juries, and review search warrant and wiretap applications.[234] Thus, the judiciary's acceptance of nonjudicial powers lays a strong foundation in defense of the rulemaking delegation despite the text of Article III.

Additional reasoning in *Mistretta*, however, suggests there may not be a clear answer. The Court distinguished the delegation of power to the Sentencing Commission on the grounds that the Commission was not a court and that it was accountable to Congress, which could revoke or amend all of its decisions.[235] Furthermore, the Court treated it as an independent agency, despite having some federal judges as members, because it was controlled in part by the President—who determined membership—and because its rulemaking had a notice and comment procedure per the Administrative Procedure Act.[236]

In contrast, the federal rulemaking process does not share these features. A court, the Supreme Court, creates procedural rules. Congress did not delegate the Judicial Conference power to make rules as it did with the Sentencing Commission to make guidelines. Rather, it delegated to the Conference the power to research and propose rules, but the Supreme Court has the power to "promulgate" the rules. Also, although Congress can amend or withdraw the power of the Court to create rules under the REA, it is unclear whether Congress can override a federal rule of procedure by statute.[237] Furthermore, the Supreme Court is part of the judi-

they share the common purpose of providing for the fair and efficient fulfillment of responsibilities that are properly the province of the Judiciary. Thus, although the judicial power of the United States is limited by express provision of Article III to 'Cases' and 'Controversies,' we have never held, and have clearly disavowed in practice, that the Constitution prohibits Congress from assigning to courts or auxiliary bodies within the Judicial Branch administrative or rulemaking duties that, in the words of Chief Justice Marshall, are "necessary and proper . . . for carrying into execution all the judgments which the judicial department has power to pronounce."' Because of their close relation to the central mission of the Judicial Branch, such extrajudicial activities are consonant with the integrity of the Branch and are not more appropriate for another Branch.") (internal citations omitted).

234. *Id.* at 390–92 & n.16; *see also* WEINSTEIN, *supra* note 12, at 142 (noting that "strict separation of powers has really never existed in its country; it is one of the strengths of our pragmatic system that there is a certain leakage from one branch to the other that seems to lubricate the entire system").

235. *Mistretta*, 488 U.S. at 393–94.

236. *Id.*

237. For example, Congress withdrew from the Supreme Court the power to create rules concerning evidentiary privileges. But if Congress passed a law con-

cial branch, has membership composed entirely of federal judges, is appointed by the President with heavily restricted removal power vested in the Senate, and has no notice and comment requirements.[238]

These facts, however, do not raise red flags because, although the Supreme Court promulgates the rules, the federal system entertains a fiction that it is not the Supreme Court, in an Article III sense, making these rules. As elaborated below, the *Mistretta* Court held that the federal judges on the Sentencing Commission acted in a purely administrative non-Article III capacity.[239] Similarly, in the rulemaking process, the Justices act as part of an independent agency within the judicial branch but outside the bounds of the Supreme Court and their status as Justices. This fiction allows parties to contest the validity of the rules, avoids the prohibition on advisory opinions, and allows the Justices and members of the Judicial Conference to later rule on these issues impartially.[240]

A related issue is the Chief Justice's influence over the Judicial Conference in the drafting process. Congress outlined most of the membership requirements for the Conference, but the text is silent on the selection of practitioners and academics for the committees of the Judicial Conference.[241] Traditionally, the Chief Justice, as chair of the Conference, appointed them.[242] This structure caused concern that the Chief Justice could disproportionately influence the policy decisions of the Conference and the future of the federal rules.[243] Further, because the Conference knows the Supreme

flicting with a current federal rule of procedure, the supersession clause could be construed to invalidate the rule. *See infra* Part IV.B (discussing supersession clause).

238. The current federal rulemaking structure closely parallels the notice and comment requirements of the Administrative Procedure Act, although there is no statutory compulsion to do so. Whether this is a requirement under the non-delegation doctrine or the Due Process Clause has never been decided. *See* U.S. Courts website, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/Overview.aspx (describing notice and comment process); *cf.* Bone, *supra* note 21, at 908 (comparing judicial rulemaking to administrative rulemaking and to Sentencing Commission).

239. *Supra* notes 245–47; *see* Garvito, *supra* note 86, at 1078–79 (noting that judicial conference is not a strictly judicial organ and does not sit as a court).

240. *See* Mississippi Pub. Corp. v. Murphree, 326 U.S. 438, 446 (1946).

241. 28 U.S.C. § 331 (2008).

242. *See* U.S. Courts website, http://www.uscourts.gov/FederalCourts/JudicialConference.aspx (last visited January 17, 2011); BROWN, *supra* note 29, at 13–15.

243. Former committee reporter Judge Weinstein remarked that "it was a disquieting moment" when the Chief Justice commanded the committee to defend an old version of a rule despite the committee's support of a proposed Congres-

Court must approve the rules, it may cater its proposals to a majority of the Court.[244] However, viewing the entire process as an independent agency with multiple subcommittees obviates any delegation problems with the head of an agency (the Supreme Court) having some control over the lower echelon. Indeed, the heads of all administrative agencies exert at least some control over the hiring of their employees. Moreover, as an agency designed by Congress, the Conference is free to establish its own hierarchy and procedures. One would expect the head of an agency to direct his employees and serve as the final evaluator of their work.

Mistretta further distinguished the Sentencing Commission from Article III courts in that the Commission's technical placement in the judiciary did not increase the branch's authority.[245] The Court noted that prior to the passage of the act, courts had the power to decide sentences; also, Congress did not unconstitutionally delegate its own authority or diminish its or the executive branch's power.[246] In a footnote, the Court noted that the "constitutional calculus" is different for considering non-judicial activities delegated to courts, in part because of the constitutionally required autonomy of courts.[247]

This same reasoning supports the delegation of rulemaking authority to the judiciary. The federal judiciary's rulemaking power has existed for two hundred years and Congress retains, and has periodically asserted, the power to modify such grants of authority.[248] Further, the undefined "constitutional calculus" does not apply to the Supreme Court under the theory that it acts as part of an independent agency.[249] Moreover, even if a more rigid calculus did

sional amendment. WEINSTEIN, *supra* note 12, at 102; *see* Alan B. Morrison & D. Scott Stenhouse, *The Chief Justice of the United States: More Than Just the Highest Ranking Judge*, 1 CONST. COMM. 57, 65 (1994) (noting that publications of academics allow Chief Justice to choose ones that will advance his/her desired policies).

244. WEINSTEIN, *supra* note 12, at 8–9 (expressing concern that Chief Justice will not select ideologically diverse group).

245. Mistretta v. United States, 488 U.S. 361, 395–97 (1989).

246. Notably, Congress could repeal the act creating the Sentencing Commission and the Executive never had the powers given to the Commission. *Id.*

247. *Id.* at 394 n.20.

248. WEINSTEIN, *supra* note 12, at 57–74; Edgard Bronson Tolman, *Historical Beginnings of Procedural Reform Movement in This Country—Principles to be Observed in Making Rules*, 22 A.B.A. J. 783, 785–86 (1936); Edson R. Sunderland, *Implementing the Rule-Making Power*, 25 N.Y.U. L. REV. 27, 29–32 (1950).

249. *See Mistretta*, 488 U.S. at 394 ("[B]ecause Congress vested the power to promulgate sentencing guidelines in an independent agency, not a court, there can be no serious argument that Congress combined legislative and judicial power within the Judicial Branch.").

apply, Congress's control over the scope and structure of the authority, the courts' history in having such power, and the "twilight zone" status of rulemaking suggests that the judiciary has not gained power, nor has any other branch lost power, by the delegation.

C. The Effect of the Delegation of Rulemaking Power on the Integrity of the Judicial Branch

Although not a per se aspect of the non-delegation doctrine, delegation can sometimes raise the issue of whether an act will undermine the integrity and independence of the judicial branch. Both the delegation of sentencing power in *Mistretta* and the delegation of rulemaking authority present similar concerns on this point. Decades of case law, history, and the Article III protections of federal judges reinforce the importance of an independent federal judiciary.[250] Equally important is the legitimacy of the Judicial Branch, which depends on public confidence and the appearance of impartiality.[251] The *Mistretta* opinion provides compelling support for the position that the current delegation of rulemaking power does not threaten these essential characteristics.

Mistretta provides a solid foundation for upholding the role of federal judges in the rulemaking process. As the Court concluded, "The text of the Constitution contains no prohibition against the service of active federal judges on independent commissions."[252] The Court also cited rejected proposals made at the Constitutional Convention and during the first Congress, and a long history of allowing Article III judges to assume extrajudicial responsibilities in government; examples included federal judges serving as ambassadors, cabinet members, and members of executive and cultural commissions.[253] Crucially, the Court labeled such roles "extrajudicial service," establishing clearly that while in these roles federal judges were not acting pursuant to Article III authority but rather

250. *See* N. Pipeline Constr. Co. v. Marathon Pipeline Co., 480 U.S. 50, 59–60 (1982).

251. *Mistretta*, 488 U.S. at 407–08 (noting that "legitimacy of the Judicial Branch ultimately depends on its reputation for impartiality and nonpartisanship").

252. *Id.* at 397.

253. *Id.* at 398–404. *See* Morrison & Stenhouse, *supra* note 243, at 57–68 (detailing nonjudicial powers of Chief Justice of the United States, including control over federal court procedure, appointment power, and participation in legislative process).

in an administrative capacity.[254] Viewing the actions of the Supreme Court and the judges on the Judicial Conference as administrative in nature, the rulemaking process is consistent with this reasoning.

However, not every kind of extrajudicial service necessarily accords with the Constitution; the test remains whether it undermines the integrity of the judicial branch.[255] Accordingly, the *Mistretta* Court evaluated claims that judicial involvement with the Sentencing Commission threatened the integrity, independence, and impartiality of the judicial branch as a whole.[256] The petitioners cited the required service by at least three federal judges, but the Court rejected the argument because each judge presumably consented to appointment by the President.[257] The Court also noted that service on the Commission did not prevent federal judges from fulfilling their Article III duties, nor did it result in substantial numbers of recusals that hindered the judicial branch, because federal courts are free to assess the validity of federal procedural rules.[258]

In contrast, the REA requires chief judges, justices, and unspecified district court judges to sit on the Judicial Conference.[259] Nonetheless, the Court cited these aspects of the rulemaking process approvingly, explaining that it has "given at least tacit approval to this degree of congressionally mandated judicial service on

254. "The judges serve on the Sentencing Commission not pursuant to their status and authority as Article III judges, but solely because of their appointment by the President as the Act directs. Such power as these judges wield as Commissioners is not judicial power; it is administrative power derived from the enabling legislation . . . In other words, the Constitution, at least as a *per se* matter, does not forbid judges to wear two hats; it merely forbids them to wear both hats at the same time." *Mistretta*, 488 U.S. at 404; *accord* Garvito, *supra* note 86, 1078–79 (noting that judicial conference is not a strictly judicial organ and does not sit as a court).

255. "This is not to suggest, of course, that every kind of extrajudicial service under every circumstance necessarily accords with the Constitution. That the Constitution does not absolutely prohibit a federal judge from assuming extrajudicial duties does not mean that every extrajudicial service would be compatible with, or appropriate to, continuing service on the bench; nor does it mean that Congress may require a federal judge to assume extrajudicial duties as long as the judge is assigned those duties in an individual, not judicial, capacity. The ultimate inquiry remains whether a particular extrajudicial assignment undermines the integrity of the Judicial Branch." *Mistretta*, 488 U.S. at 404.

256. "While the problem of individual bias is usually cured through recusal, no such mechanism can overcome the appearance of institutional partiality that may arise from judiciary involvement in the making of policy. The legitimacy of the Judicial Branch ultimately depends on its reputation." *Id.* at 407.

257. *Id.*

258. *See id.* at 406–07.

259. *Id.* (citing REA).

nonadjudicatory bodies."[260] Moreover, there is no indication that service on the Judicial Conference leads to widespread recusals that inhibit the judicial branch. Although the responsibility of reviewing rule proposals could burden an overworked Supreme Court, the few indications we have from the Justices suggest that rule proposals receive a cursory review.[261] Barring a sworn statement by the Justices, contentions that the Court's role in the rulemaking process undermines its integrity are unlikely to receive much support from the Court.

Lastly, the *Mistretta* Court exhibited concern with the potential loss of public faith in the integrity of the branch as a whole given its involvement in the Commission. Ultimately, however, the Court concluded that there was no reputational loss, stressing the judicial nature of the Commission's function, the expertise of the judiciary, the practical value of federal judges sitting on the Commission, and Justice Jackson's *Youngstown* concept of reciprocity.[262] The widespread support for the current rulemaking process mirrors these same traits.[263] The analogous structure and power of the Sentencing Commission and the discussion from *Mistretta* strongly suggest that the federal rulemaking scheme undermines neither the independence nor the integrity of the Judicial Branch.

D. Proper Delegation But Improper Execution

Even if the delegation itself does not undermine judicial independence and integrity, some exercises of this delegated power could do so. Although such an issue has never arisen concerning rules passed under the REA, it has arisen in other contexts. For example, internal circuit court rules prohibiting district court judges from handling cases[264] or permitting the investigation of alleged improper conduct by a judge[265] have raised concerns about their affect on judicial independence. These concerns would apply

260. *Id.* at 406 n.29 (citing Chandler v. Judicial Council, 398 U.S. 74 (1970)).

261. *See, e.g.*, 146 F.R.D. 401, 504–05 (1993); Stephen B. Burbank, *Ignorance and Procedural Law Reform: A Call for a Moratorium*, 59 BROOK. L. REV. 841, 842 (1993); Karen Nelson Moore, *The Supreme Court's Role in Interpreting the Federal Rules of Civil Procedure*, 44 HASTINGS L.J. 1039, 1072 (1992).

262. *Mistretta*, 488 U.S. at 407–08.

263. *See supra* notes 68–75, 77.

264. *See* Chandler v. Judicial Council, 398 U.S. 74, 130–38, 143 (1970) (Black, J., dissenting) (concluding that rule undermined judicial independence by punishing and regulating idiosyncrasies of judges).

265. *See In re* Certain Complaints Under Investigation, 783 F.2d 1488, 1505 (11th Cir. 1986) (upholding statute authorizing judicial council to investigate improper conduct by federal judge).

with equal force to rules passed under the REA that have similar effects. Thus, although the Court has found the process to be permissible, constitutional challenges to the implementation and execution of such power remain viable.

IV. CONSTITUTIONAL CHALLENGES TO THE PROCESS

Having defended the delegation, placement, and use of federal rulemaking power by federal courts, the only challenges that remain are to specific statutory provisions. Two potential challenges to the rulemaking process warrant discussion. The first is the constitutionality of Congress's "legislative veto" over proposed federal rules. The second is the validity of the supersession clause.

A. *Is the "Legislative Veto" Valid?*

One issue engendered by Congress's role in promulgating federal rules is the constitutionality of its ability to invalidate proposals. In *I.N.S. v. Chadha*,[266] the Supreme Court invalidated legislative vetoes.[267] At issue in *Chadha* was a statute authorizing either house of Congress to overturn the Attorney General's decision to suspend the deportation of an illegal alien residing within the country.[268] The practical advantages of the legislative veto could not stand in light of the constitutionally imposed requirements of bicameralism and presentment to pass a law.[269]

The REA is distinguishable from the statute at issue in *Chadha*. Crucially, Congress's role in the federal rulemaking process differs from the legislative veto because if and when it acts, Congress does so before the proposed rules take effect.[270] Thus, Congress intervenes in the process of creating a rule and not in the application of the rule; it is merely preventing a proposed rule from becoming

266. 462 U.S. 919 (1983).

267. *Id.* at 959.

268. *Id.* at 924–25.

269. "Its wisdom is not the concern of the courts; if a challenged action does not violate the Constitution, it must be sustained . . . . By the same token, the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution." *Id.* at 944, 946, 947–48, 950–51.

270. The Supreme Court must submit each rule promulgated under this act's authority to Congress by May 1, and the rules may not take effect until at least December 1 of the year submitted. 28 U.S.C. § 2074 (1988). Absent congressional action during this time period, the rule becomes law. U.S. Courts, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/Overview.aspx.

effective. Moreover, when Congress intervenes it often does so after having satisfied the bicameralism and presentment requirements. For example, when Congress disagreed with portions of the proposed Federal Rules of Evidence, it passed a law, approved by both houses and signed by the President, to prevent the proposal from taking effect.[271] Later, having made modifications to the proposal, Congress passed its version of the rules of evidence as a bill that went through both houses and was signed by the President into law.[272] Similarly, when Congress amends pre-existing federal rules, it does so by passing a law.[273] Furthermore, the REA does not discuss a legislative veto. All it requires is that the Supreme Court transmit the proposed rules to Congress by May 1 and that they take effect no earlier than December 1 of that same year.[274] This provision can be understood as a simple notice requirement. Congress need not act nor be in session for the rules to take effect; the required time interval does nothing more than give Congress time to decide if it wishes to intervene in the rulemaking process of an independent agency. In effect, Congress has decided that the affirmative action of one of its houses is enough to halt the rulemaking process of the agency it created.[275] Congress ordering an independent agency to stop its process does not seem to be a "law" and thus does not require bicameralism and presentment.[276]

B. Is the Supersession Clause Valid?

The second constitutional issue concerning the process of making the federal rules is the REA's supersession clause, which specifies that "[a]ll laws in conflict with such rules shall be of no further force or effect after such rules have taken effect."[277] The clause raises two potential constitutional issues. The first is whether a rule can functionally nullify a law without violating the bicameralism and presentment requirements. The second issue is whether

271. Pub. L. No. 93-12, 87 Stat. 9 (1973).

272. Pub. L. No. 93-595, 88 Stat. 1926 (1976).

273. *See, e.g.*, Federal Rules of Civil Procedure Amendments Act of 1982, Pub. L. No. 97-462, 96 Stat. 2527 (1983) (amending Federal Rule of Civil Procedure 4).

274. 28 U.S.C. § 2074.

275. By analogy, there does not appear to be a constitutional barrier to Congress requiring the EPA to give it advanced notice of its proposed laws and allow Congress the opportunity to reject them before they take effect. Congress created these agencies and created their procedure.

276. Of course, any rejection of rules codifying the inherent powers of courts would reject the codification but not the courts' constitutional authority to exert such inherent power.

277. 28 U.S.C. § 2072(b) (1990).

this would constitute a core legislative act that Congress cannot delegate.

Case law on the supersession clause is rare and only partially illuminating. The *Sibbach* Court held that Congress may delegate rulemaking powers to the federal courts "to make rules not inconsistent with the statutes or Constitution of the United States."[278] This phrase suggests that the supersession clause is invalid. But only a few federal cases have ever considered the supersession clause, and no court has held it invalid.[279] In *Jackson v. Stinnett*,[280] the Fifth Circuit attempted to reconcile the clause with *Chadha*.[281] The Court explained that the clause has never been held to invalidate all conflicting federal statutes; rather, it only applies to statutes existing before the rule's passage and therefore does not apply to any subsequent statutes.[282] In other words, the *Jackson* court held that because Congress passed the statute after the rule had been in effect, the statute repealed the rule.[283]

The *Jackson* court's emphasis on the retrospective, rather than prospective, power of rules has some formalist support. Courts technically do not have the power to repeal laws. For example, when a court holds a statute unconstitutional, the statute remains law; the holding is a directive to courts to not enforce that law. Only Congress may act to withdraw the text of the law.[284] For the same reason, when a district court holds a statute unconstitutional and the circuit court reverses this decision, Congress need not re-pass the statute because it never ceased to exist; the district court's holding prevented the application of the statute but never repealed it. This

278. Sibbach v. Wilson & Co., 312 U.S. 1, 3 (1941).

279. In the same year, the Second Circuit handled two such cases. In one it held that a rule of appellate procedure regulating the taxable costs for brief filing superseded a conflicting federal statute; the opinion was brief and decided the issue solely upon the supersession clause without any discussion of the separation of powers. *See* Albatross Tanker Corp. v. SS. Amoco Delaware, 418 F.2d 248, 248 (2d Cir. 1969) (per curiam). The second case, in the same brief manner, held that two rules of appellate procedure regulating the costs of printing briefs and docket fees trumped conflicting federal statutes, again citing the supersession clause dispositively but with no discussion of its validity. *See* Waterman S.S. Corp. v. Cottons, 419 F.2d 372, 374 (2d Cir. 1969).

280. 102 F.3d 132 (5th Cir. 1996).

281. *Id.* at 134 n.3.

282. *Id.* at 135 & n.3.

283. *Id.* at 136.

284. For example, after the Supreme Court declared Section 3 of the National Industrial Recovery Act unconstitutional, the statute remained in the United States Code until Congress repealed it shortly after the decision. *See* Goldwater v. Carter, 617 F.2d 697, 729 (D.C. Cir. 1979).

logic supports the *Jackson* court's reasoning because the supersession clause would only strip prior statutes of their force but would not repeal them. Therefore, if a new rule conflicts with a pre-existing statute, that statute becomes ineffective but continues to exist. If that new rule is then repealed, the statute's power is revived. As the *Jackson* court concluded, this seems to circumvent *Chadha* concerns because although the supersession clause may nullify a statute's effectiveness, it does not repeal it; thus, bicameralism and presentment are not required.[285]

This logic, however, does not quell concerns that rendering a statute functionally invalid, even if only temporarily, is a legislative act that only Congress can perform. Some scholars argue that the supersession clause means Congress made the decision that laws it passes in the procedural realm are only temporary and that Congress has elected not to retain exclusive jurisdiction over that realm of law.[286] This may be so, but in the hierarchy of sources of law, laws should trump rules because of their democratic origins. Further, in *Chadha*, the Court noted that not all actions taken by the legislature are legislative; one must examine the character and effects of the action to determine if it is legislative in nature.[287] Rendering a law functionally void seems legislative in nature.

The only way to circumvent the Article I issue is to view the supersession clause as a congressional instruction to courts on how to handle a conflict between a law and a rule. Per the *Jackson* court, the instruction is that chronology is dispositive. The degree to which Congress can regulate how the judiciary interprets laws is a question fraught with concerns about the separation of powers and judicial independence. The lack of federal court discussion of the supersession clause and the Judicial Conference's reluctance to pass rules conflicting with pre-existing laws suggests there is no clear answer to the constitutional question of the supersession clause's validity.

285. *But see* Moore, *supra* note 35, 1051 (suggesting that clause violates *Chadha*, noting failed amendment to REA attempting to repeal clause, and citing Chief Justice Rehnquist's statement that Judicial Conference will avoid producing rules that conflict with laws); *cf.* Whitten, *supra* note 54, at 63–66 (noting that scope of supersession clause may depend on level of Congressional action in procedural area at issue).

286. *See, e.g.*, Whitten, *supra* note 54, at 61–62.

287. INS v. Chadha, 462 U.S. 919, 952 (1983).

V. CONCLUSION

This Note's separation of powers analysis sheds light on several relevant issues for courts and practitioners, and identifies the constitutional boundaries of federal court rulemaking power.

Although other bodies may do the actual drafting, according to case law and the statutory language, the Supreme Court has the power to create the federal rules. When exerting this rulemaking power, the Court acts within the judicial branch. Despite the Court's reliance on statutory power to create procedural rules, federal courts possess two forms of inherent power to do so. Inherent power exists because Congress cannot stop courts from performing their constitutional function of adjudicating cases nor infringe on their independence. If courts cannot remain independent and fairly adjudicate cases, then their function as a co-equal branch of government is compromised.

Nonetheless, the Court can constitutionally create rules under its statutory authority. The REA does not violate the two requirements of the non-delegation doctrine: Congress did not delegate legislative power, and it did provide an intelligible principle. Moreover, viewing the rulemaking process as occurring within an independent agency within the judicial branch rather than in the federal courts' Article III capacity alleviates constitutional concerns about the powers of the judiciary. Further, the process does not undermine the integrity of the judicial branch to an unconstitutional degree. Finally, this Note both justifies Congress's role in the process, by dispelling the perception that the REA confers a legislative veto, and provides a defense of the supersession clause. The current federal procedural rulemaking process is largely defensible under a formalist separation of powers analysis. The above analysis outlines the proper steps to determine if future rules passed under, or modifications made to, the process comply with the separation of powers.