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Implementing *Actavis*: Three Tips for Future Courts Assessing Reverse Patent Settlements Under Rule of Reason Analysis

Alexander Krueger*

INTRODUCTION

In *FTC v. Actavis, Inc.*, 133 S. Ct. 2223 (2013), the Supreme Court took up a hotly contested question: when, if ever, do reverse patent settlements violate the antitrust laws? Ultimately, a five-justice majority held that these patent settlements should be evaluated under a structured version of the rule of reason that focuses on:

- (a) The size of the reverse payment “in relation to the payor’s anticipated future litigation costs;”
- (b) The “independence” of the payment “from other services for which it might represent payment;” and
- (c) The “lack of any other convincing [procompetitive] justification.”¹

This structured rule of reason approach mirrors the proof my co-author, Einer Elhauge, and I presented in our recent article on reverse patent settlements.² Our proof showed that reverse patent settlements *necessarily* harm consumer welfare when:

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1. See *FTC v. Actavis, Inc.*, 133 S. Ct. 2223, 2237 (2013) (noting that these factors tend to indicate the likelihood that a reverse payment would have anticompetitive effects).

2. Einer Elhauge & Alex Krueger, *Solving the Patent Settlement Puzzle*, 91 TEX. L. REV. 283 (2012).

- (a) The reverse payment exceeds the payor's anticipated future litigation costs;³
- (b) The size of this reverse payment exceeds the payor's anticipated future litigation costs even after subtracting the value of any goods or services the payor received in return;⁴
- (c) There are no countervailing procompetitive justifications;⁵ and
- (d) The alleged infringer either would not have entered "at-risk" or was not sufficiently judgment-proof.⁶

In other words, conditions (a)–(c) in the majority's opinion are essentially identical to conditions (a)–(c) in our proof. In particular, the majority specifically focused on the *payor's anticipated future* litigation costs, rather than all of the payor's litigation costs (including sunk costs) or the alleged infringer's costs.⁷ Moreover, the majority specifically admonished district courts *not* to attempt to "relitigate" the patent merits (i.e., to try to directly determine the probability that the patent would have been found valid and infringed),⁸ and our economic proof

3. *Id.* at 304 ("[W]hen a reverse payment exceeds the patent holder's anticipated litigation costs, a court can be confident that the settlement exclusion period will exceed the optimal patent reward, while anticompetitively reducing consumer welfare as compared either to litigation or to an alternative settlement without a reverse payment of that size."); *id.* at 305 ("For the purpose of applying this proof, only the *forward-looking* anticipated litigation costs are relevant; past litigation expenses are sunk costs and thus should not affect the patent holder's willingness to settle.")

4. *Id.* at 305 ("Other times there is also some return consideration, in which case the reverse payment amount is the difference between the expected value of the consideration flowing to and from the entrant, leaving aside the value of setting the entry date and avoiding litigation costs.")

5. *Id.* at 309–10 ("Leaving aside cases of judgment-proof entrants, the proof above shows that when a settlement does nothing else other than set an entry date and provide reverse payments that exceed the patent holder's anticipated litigation costs, then the settlement cannot be justified as necessary to reach a settlement that: (a) shortens the expected exclusion period (which would increase *ex post* consumer welfare); or (b) increases the patent reward to a level still within the optimal patent exclusion period (which would increase *ex ante* consumer welfare). The reason is that our proof precludes those procompetitive justifications. However, in some cases, settlements might have unique features that create *other* procompetitive justifications that can offset any anticompetitive effects.")

6. *Id.* at 307–08.

7. See *FTC v. Actavis, Inc.*, 133 S. Ct. 2223, 2237 (2013).

8. *Id.* at 2236–37 ("[A]n antitrust action is likely to prove more feasible administratively than the Eleventh Circuit believed. The Circuit's holding

provides a guide to courts and economists for exactly how to determine whether a particular reverse payment is anticompetitive *without* trying to relitigate the patent merits.⁹ Our economic proof thus provides an easily administrable way of implementing the majority's structured rule of reason test for reverse patent settlements.¹⁰

In this piece I focus on the questions *Actavis* left open to future courts. In particular, I see at least three tricky questions future courts will have to answer when implementing the majority's structured rule of reason analysis:

- A. Are anticompetitive reverse patent settlements plausible outside of pharmaceutical markets, where Hatch-Waxman does not apply?
- B. What are valid procompetitive efficiencies in reverse patent settlement cases?
- C. What is the most accurate way to estimate the patentholder's anticipated future litigation costs?

A. ARE ANTICOMPETITIVE REVERSE PATENT SETTLEMENTS PLAUSIBLE OUTSIDE OF PHARMACEUTICAL MARKETS, WHERE HATCH-WAXMAN DOES NOT APPLY?

The majority spent a large portion of its opinion describing how the Hatch-Waxman Act allows a pharmaceutical

does avoid the need to litigate the patent's validity (and also, any question of infringement). But to do so, it throws the baby out with the bath water, and there is no need to take that drastic step. That is because it is normally not necessary to litigate patent validity to answer the antitrust question In a word, the size of the unexplained reverse payment can provide a workable surrogate for a patent's weakness, all without forcing a court to conduct a detailed exploration of the validity of the patent itself.”)

9. Elhaug & Krueger, *supra* note 2, at 304 (“This conclusion does not rely on any particular level of patent strength . . . or any assumption that the parties agreed on that level. Nor does it require knowledge of the parties’ varying estimates of patent strength or even knowing which side’s estimate is greater. It does not even require us to assume that the parties picked the settlement that maximized profits or to make any particular assumption about the extent to which the parties considered the risk of antitrust liability. It simply requires us to assume that neither party to the patent dispute would agree to a settlement that made it worse off.”).

10. Though the majority did not bring up the possibility that a reverse payment in excess of the patent-holder's future litigation costs might not evince anticompetitive harm when the generic would have entered at-risk and was significantly judgment-proof, that likely was simply because there was no allegation in *Actavis* that any of the settling generics were even plausibly judgment-proof.

patentholder and a potentially infringing generic to settle in a way that guts the incentive of other generics to challenge the disputed patent.¹¹ This was the majority's answer to the defense's claim that anticompetitive reverse payment schemes are implausible because "a high reverse payment [would] signal to other potential challengers that the patentee lacks confidence in its patent, thereby provoking additional challenges, perhaps too many for the patentee to 'buy off[.]'"¹² A future court may therefore wonder whether reverse patent settlement payments are plausible when the Hatch-Waxman act does not apply.

Economics shows that the answer is clearly yes. The relevant economic proof does *not* hinge on the Hatch-Waxman Act's unique generic exclusivity provisions.¹³ Although the Hatch-Waxman Act's generic exclusivity period does provide an additional entry barrier in the pharmaceutical industry, anticompetitive reverse payments are plausible in *any* industry where *some* barrier prevents more than a few firms from challenging the patent.¹⁴ The Hatch-Waxman Act provides a convenient *legal* barrier, but an anticompetitive reverse payment scheme would also be plausible in a market where *technological* barriers prevented more than one firm from challenging the patentholder.

For example, Boeing and Airbus are currently each other's only competition in the commercial airliner market.¹⁵ Further, it would require any other firm an inordinate amount of time and resources to enter the commercial airliner market.¹⁶ Thus, if Boeing entered into an anticompetitive reverse payment settlement with Airbus based on a dubious airliner patent, no other competitor would plausibly be able to profit from

11. *Actavis*, 133 S. Ct. at 2227–29, 2235.

12. *Id.* at 2235.

13. Elhauge & Krueger, *supra* note 2, at 304.

14. *Id.*

15. See DATAMONITOR, AIRLINES IN THE UNITED STATES: INDUSTRY PROFILE 13 (2007) ("The airline industry in the US is characterized by strong supplier power; a consequence of the global duopoly of Boeing and Airbus that exists in the manufacture of aircraft globally and the fact that, as yet, no viable substitute for jet fuel has been discovered.").

16. *Id.* at 17 ("Entering the market as a new company requires considerable capital (for example, to acquire a fleet of planes); and, even for an existing company to begin operating in the US, the market may impose significant costs in terms of overheads, wages, and so on.").

challenging Boeing's patent because no other firm would be able to actually enter the commercial airliner market even if it won the patent case. Boeing would thus be able to pay off all potential challengers (here, just Airbus) even though the Hatch-Waxman Act does not apply to airliner patents.

More generally, our proof showed that any payment in excess of the patentholder's anticipated future litigation costs necessarily implies that the patentholder *thought* it would be able to pay off enough of its competitors to anticompetitively increase its profits.¹⁷ There is thus no economic justification for limiting the antitrust scrutiny of reverse patent settlements to cases in the pharmaceutical market.

B. WHAT ARE VALID PROCOMPETITIVE EFFICIENCIES IN REVERSE PATENT SETTLEMENT CASES?

Another vital question the majority left open is exactly what counts as a valid procompetitive efficiency in reverse patent settlement cases. The only "redeeming virtues" the Supreme Court explicitly acknowledged were: (a) saved litigation costs; and (b) compensation for other services (i.e., the payment being for a service from the generic, rather than for delay).¹⁸ Given that the relevant size of the reverse payment for the purposes of comparing it to the patentholder's future anticipated litigation costs is the payment *minus* the value of any other services in return,¹⁹ the majority thus really only listed one potential procompetitive efficiency: saved litigation costs. Consequently, courts may ask under what conditions it is

17. Elhauge & Krueger, *supra* note 2, at 311 ("This same analysis also rebuts the claim that anticompetitive effects could be eliminated because nonsettling entrants can still challenge the patent. Even though that possibility generally exists, our analysis proves that the patent holder would never make a reverse payment of this size if nonsettling entrants could—through entry or patent litigation—create the same constraint on its market power. The patent holder would make a reverse payment that exceeds its anticipated litigation costs only if excluding the settling entrant confers an enhanced market power on the patent holder that it otherwise would not enjoy." (footnote omitted)).

18. *Actavis*, 133 S. Ct. at 2236.

19. Elhauge & Krueger, *supra* note 2, at 305 ("Other times there is also some return consideration, in which case the reverse payment amount is the difference between the expected value of the consideration flowing to and from the entrant, leaving aside the value of setting the entry date and avoiding litigation costs.").

plausible for a given reverse payment to be necessary for settlement.

When defenders of reverse payments attempt to argue that reverse payments are necessary for settlement, they usually rely on the basis that settlement can be difficult when the patentholder and the generic differed greatly in their estimates of the patent's strength.²⁰ In particular, settlement will be more difficult when the patentholder thinks its patent is stronger than the generic does (in contrast, if the patentholder thinks its patent is weaker than the generic does, this difference in estimated patent strength makes settlement easier, not harder).²¹

However, economic analysis shows that reverse payments in excess of the patentholder's anticipated future litigation costs are *never* necessary to induce *procompetitive* settlements.²² A procompetitive patent settlement is one that does not exclude the generic for any longer than the probabilistic expected amount of exclusion that would result from patent litigation.²³ But such a settlement is impossible when the reverse payment exceeds the patentholder's future anticipated litigation costs, because such a settlement would obviously make the patentholder worse off than just continuing to litigate (it would pay *more* than it would have in litigation expenses, but not receive any additional exclusion period).²⁴ Thus, economic analysis shows that it is possible for reverse payments to procompetitively induce settlement *only* when the payment is smaller than the patentholder's anticipated litigation costs. In all other cases, the parties either could have settled without a reverse payment, or the settlement must have anticompetitively excluded the generic for longer than the patent strength merited.²⁵

20. See, e.g., Robert D. Willig & John P. Bigelow, *Antitrust Policy Toward Agreements that Settle Patent Litigation*, 49 ANTITRUST BULL. 655, 660 (2004).

21. Elhauge & Krueger, *supra* note 2, at 302.

22. *Id.* at 303.

23. *Id.* at 296–304.

24. *Id.* at 299–304.

25. *Id.* at 303.

C. WHAT IS THE MOST ACCURATE WAY TO ESTIMATE THE PATENTHOLDER'S ANTICIPATED LITIGATION COSTS?

A third question explicitly left open by the majority is how courts should estimate the patentholder's anticipated future litigation costs. This can be tricky because future litigation costs have, by definition, not actually occurred. Worse yet, defendants have strong incentives to distort their internal predictions of their future litigation costs in order to protect their lucrative (but anticompetitive) reverse patent settlements.²⁶ Reverse payments in future cases will thus exceed the patentholder's own internal estimate of its future anticipated litigation costs only in rare cases where the patentholder is not aware of the near-automatic antitrust liability that would result. Consequently, courts will routinely have to turn to other evidence in order to accurately estimate the patentholder's anticipated future litigation costs.

In prior scholarship, I have suggested two alternative types of evidence that can independently show that the payment exceeded the patentholder's anticipated litigation costs. First, courts could ask whether the reverse payment exceeds the upper bound of litigation costs from similar cases.²⁷ The economic literature indicates that this threshold is \$15 million for pharmaceutical cases, which is still significantly smaller than any of the reverse payments at issue in past cases.²⁸ Second, courts could call patent lawyers as expert witnesses to provide estimates of how expensive it would have been for the patentholder to litigate.²⁹ Although this would likely be somewhat expensive, the difficulty of estimating how much it would cost to litigate a patent case pales in comparison to the difficulty of actually trying to re-litigate the patent.

26. *Id.* at 306.

27. *Id.* at 306.

28. *Id.* at 305–06.

29. *Id.* at 307.
