With Malice Toward None: A Brief Rejoinder to Leffler and Shapiro

BY KEVIN MCDONALD

When Abraham Lincoln was attacked in print by the eminent Horace Greeley, he began his response this way:

I have just read yours of the 19th. addressed to myself through the New-York Tribune. If there be in it any statements, or assumptions of fact, which I may know to be erroneous, I do not, now and here, controvert them. If there be in it any inferences which I may believe to be falsely drawn, I do not, now and here, argue against them. If there be perceptible in it an impatient and dictatorial tone, I waive it in deference to an old friend, whose heart I have always supposed to be right.

As to the policy I “seem to be pursuing” as you say, I have not meant to leave any one in doubt. I would save the Union.1 Lincoln, I think, understood that responding to the specifics of the attack, pointing out its liberties from the actual record of what he had said and done, was less important to the public than a firm understanding of his position. While I make no pretense to Lincoln’s higher virtues, nor to his matchless prose, I will also spare those of you who have read this far a detailed list of grievances as to how my ideas have been mangled.

What I propose instead is a brief listing of four fundamental principles on which I believe my critics and I disagree—a subject about which the readers of the three pieces addressing my article have a right to be confused.2 This approach, I hope, will give those readers a chance to form their own views—and, ideally, to formulate even better questions than we are asking about the ultimate point: whether the “probability” that a patent may be invalidated during litigation, however small, can be used to justify a legal conclusion that a settlement with payments from the patentee is per se unlawful (according to the Lefflers), or presumptively anticompetitive (according to Professor Shapiro).

If nothing else, this approach may help us to understand why the attack on “reverse” payments continues to flounder in the courts. In addition to the Schering-Plough decision from the FTC’s Administrative Law Judge discussed in my prior article, two federal district courts have recently spoken—one dismissing a complaint based on a Hatch-Waxman settlement altogether;3 the other refusing to find a settlement per se illegal, and noting that “so-called reverse payments are a natural by-product of the Hatch-Waxman process.”4 Although one of these opinions covers 129 pages, neither embraces, or even mentions, the “probabilistic” property theory.5 The principles that follow may explain why.

Antitrust Laws Impose Only Negative Duties. One common mistake is to analyze competitive conduct

as if the function of antitrust law were to compel firms to maximize competition . . . rather than to prevent them from restricting it. [On the contrary,] there is a difference between positive and negative duties, and the antitrust laws . . . have generally been understood to impose only the latter.6

Accordingly, a practice may not be condemned under Section 1 of the Sherman Act unless it reduces competition in the first place. It is not enough to hypothesize an alternative that a plaintiff regards as more competitive (e.g., a license). “It is the choice of an unreasonable alternative, not the failure to choose the least restrictive alternative, that leads to liability.”7

To avoid this fallacy, one cannot define the consumer harm allegedly flowing from patent settlements as the Lefflers do: “It is clear that licensing agreement settlements which allow entry of the alleged infringer are preferable on a static welfare basis to lump sum patent settlements which sustain the existing monopoly supply situation.” Leffler III at 78.8 Thus defined, the harm that they purport to weigh against the conceded benefits of a settlement consists of the difference between the settlement chosen by the parties (payments) and the settlement they might have chosen (a license). Under the law, however, this is not an anticompetitive effect at all. In the words of the Second Circuit: “The [agreement] is not even amenable to scrutiny under Section 1 unless it is a restraint of trade. The fact that it may be in some sense ‘unnecessary’ does not make it a restraint.”9

Professor Shapiro imposes positive duties with assertions like this: “[L]icenses are generally regarded as anticompetitive if http://ssrn.com/abstract=380841, at 36 (“Insofar as antitrust is concerned, among the most problematic settlement agreements are those in which the infringement plaintiff pays the infringement defendant for that latter’s abandonment of the market,” because such an “exclusion payment,” “keeps the rival out of the market and induces it to drop its suit in exchange for a payment.”). id. at 46–47 (“[t]he reason the patentee is willing to make this payment is precisely because the settlement will permit it to exclude competition from the market, whereas if it went to trial there is a [percent-

d] chance that the patent would be held invalid and the market would become competitive . . . [T]hose payments are inherently anticompetitive. On expectation the patentee is payment for an advantage that it could not get if it went to trial”).

2 See, e.g., id. at 2, 46–49 (arguing that “exclusion payments that exceed litigation costs should be deemed illegal per se).
they restrict competition in comparison with what would have occurred in the absence of the license.” Shapiro at 76 (emphasis added). The Tamoxifen plaintiffs used such reasoning to argue that a settlement was anticompetitive because it prevented the parties from agreeing to a “competitive license.” The court disagreed.10 Because positive duties are not required, we cannot avoid the question I raised in the prior article: “No matter who paid what to whom, what lawful competition has been reduced by the settlement?” McDonald at 68. If the patent is valid, and (this is crucial, although ignored by my critics) the settlement does not extend the preclusive effect of the patent, then the answer remains “None.”11

“Competition” Under the Antitrust Laws Is Not Defined by Rivalry Alone. The notion that more rivals means more competition is superficially appealing and sometimes true, but has been proven unreliable.12 It nonetheless drives, for example, the Lefflers’ conclusion that a settlement with a license has more “static efficiency” than one with payments. E.g., Leffler III at 78. Over the last three decades, however, as Judge Posner has noted, “the emphasis of antitrust policy [has] shifted from the protection of competition as a process of rivalry to the protection of competition as a means of promoting economic efficiency.”13

A corollary of this rule is that the protection of valid patents and the innovation that results are procompetitive benefits. Especially in a market like pharmaceuticals, new inventions can provide dramatic and genuine improvements in product quality, which for an economist is the same as lowering prices. If that requires less rivalry, and even monopoly, nothing in the antitrust laws is offended. This is why Dennis Carlton notes that “[e]ven the introduction of a product subject to monopoly power can represent a gain to society,”14 and why Richard Posner concludes that “[a]pparitions to the contrary notwithstanding, the antitrust laws are not much concerned with monopoly as such.”15 Both are referring expressly to the procompetitive aspects of intellectual property protection.

This truth cannot be evaded by accusing me of “defending settlements that reduce consumer surplus on the grounds that they promote innovation.” Shapiro at 76. The devil, of course, is in the definitions. Since settlements that “promote innovation” are procompetitive to that extent, they do not necessarily “reduce consumer surplus”; they can (and by definition must, when the settlement does not exceed the scope of a valid patent) increase consumer surplus, properly defined. Thus, I do not trade off innovation for consumer surplus; I challenge any definition of consumer surplus that fails to account for the procompetitive benefits of innovation. Professor Shapiro’s characterization of my argument is an attempt to impose another asymmetrical “presumption” here—that consumer surplus can only “grow” when a patent is defeated. Unless rivalry is deemed an end in itself, however, that presumption will not work.

The Antitrust Laws Do Not Protect Infringing Competition. The proposition that “the public is not entitled to profit by competition among infringers” is older than the Sherman Act itself,16 and it remains unchallenged here. But it is ignored every time my critics assert that the patentee is paying a “competitor” to exit the market.17 Two companies may compete vigorously otherwise, but Professor Hovenkamp has explained that, when one has a patent, they do not “compete” for the patented invention in any sense relevant to antitrust liability (he used GE and Westinghouse as an example).18

It thus remains suspect, in my view, to declare competition proved to be infringing under the patent laws “entirely legitimate” while acknowledging, as Professor Shapiro must, that both the sellers of the infringing product and every consumer who buys or even “uses” the product, are breaking the law. He protests that he never sought clemency for the infringing seller (Shapiro at 74) (which was my point exactly; he should have done so, if the competition is “entirely legitimate”). When he finally addresses the point that consumers are also acting illegally, we are told that the infringer and the consumers will carefully weigh the “strength” of the patent in order to determine the optimal level of infringement. Shapiro at 74. If the competition produced by these “market forces” proves to be illegal, the patentee “will be compensated as allowed under the patent system.” Id. So, all is well.

Except for a few things. First, this is a complete justification for protecting black markets. We will therefore have to rethink the maxim that “[w]e do not want an efficient market in stolen goods.”19 The robbery victim, after all, can be compensated “as allowed for” by the legal system as well. Why not let these same “market forces” determine just how strong the owner’s right to his car really is? Second, I for one will need some empirical evidence before finding it plausible that consumers will be evaluating the validity of the patent, rather than evaluating—as would the car thief—whether they’ll be caught. (“Fred, make sure you buy that new generic drug this time; that branded drug makes me suspicious of double patenting.”) I could go on, but the decisive point is whether the antitrust laws care about competition that is proven to be illegal. As I have shown previously, they do not.

The “Possibility” of Harm to Competition Cannot Support an Inference of Actual Harm. I note the telling absence in the three comments of any challenge to the legal rule that the mere possibility of harm to competition cannot substitute for actual harm. That “[i]n our legal system, . . . a 10 percent chance of rain is not rain.” McDonald at 72. As I noted, this rule has been applied with particular force when a claim of injury is based on the outcome of a contest, whether horseracing or litigation: “[N]o matter how meritorious one’s claim may appear at the outset, the course of litigation is rarely predictable.”20 In light of this law, I suggested that there is a fundamental choice to be made when considering, after the fact, whether a settlement within the scope of a presumptively valid patent harms competition. We may begin by asking (1) whether the patent is invalid, in the same sense and under the same evidence as in actual patent cases, or (2) whether (as the proponents of the “probabilistic” property theory suggest) the specific litigation that was settled would have resulted in a defeat for the patent. Shapiro at 70.

The first inquiry is difficult, sometimes grueling, but undertaken routinely in thousands of cases; the second, I tried to show, is both misguided and infeasible. By rejecting the second inquiry, I avoid a thicket of analytical problems that my critics...
either ignore or assume away (e.g., the parties’ asymmetric views of the “chance” of winning the case). The unavoidable need to consider “false positives” when evaluating the competitive result of a specific lawsuit is one factor that renders the conclusion of per se illegality, or even presumed competitive injury, untenable in my view, as I also tried to show.22

What I plainly did not suggest is a third and different inquiry, which my critics dub “objective validity”: “McDonald (p. 69) nevertheless asserts that there is something akin to ‘the patent’s objective validity’—regardless of what a federal court may say.” Leffler III at 78. The idea is that I believe in some platonic ideal of patent validity that could be used to contradict even a court decision striking the patent down.

Of course, none of this can be found in my paper. I do believe that an inquiry into the merit of the patent itself is more “objective” than an inquiry into the result of a specific lawsuit (which the Lefflers suggest may turn on the judge’s bias or the death of a key witness).23 But that does not mean that a prior ruling against the patent—which I pointed out would have external res judicata effect against the patentee (McDonald at 74 & n.66) — would ever be rejected in a subsequent antitrust analysis. The Lefflers nonetheless build on this false premise until they exclaim, “He suggests (at 69 and 75) that the true validity of the patent, which a federal court adjudicating the patent litigation declares patent validity “irrelevant” does not apply to him. Shapiro at 72–73. To “prove” that reverse payments are nefarious, he offers an example of a settlement in which the patentee, believing it has a “75 percent chance of winning,” agrees to let the challenger enter in the last year of the patent’s remaining four-year life. After a long series of assumptions (that would justify another article), Shapiro states that “both settlement and litigation would thus give [the patentee] monopoly profits [of $100 million per year] 75 percent of the time and duopoly profits [of $60 million per year] 25 percent of the time.” Both scenarios would give the patentee $360 million. If the patentee then adds a reverse payment of $16 million, Shapiro concludes that the patentee is settling for less profit than it would expect from the 75 percent chance of winning (360 – 16 = 344), demonstrating that the real strength of the patent is lower—here 65 percent. Shapiro at 71–72.

But try this example. The patentee believes his chance is 90 percent. Using Shapiro’s own numbers and methodology, the expected value of litigation is $384 million. This settlement, however, allows no entry for the life of the patent (the challenger simply agrees not to infringe) and the same reverse payment of $16 million. This yields profits to the patentee of . . . $384 million.25 In other words, the exact same reverse payment can occur in a case where the patent’s “strength” is (under Shapiro’s view) accurately perceived as 90 percent, and the patentee receives exactly the same profit as Shapiro would “expect” from litigation.

Here is the dilemma. If Professor Shapiro would condemn both settlements (as I suspect he would), then he has developed a model that cannot distinguish between a patent with 65 percent “strength” and a patent with 90 percent “strength.” This result can be characterized in various ways, but I think “to render patent validity irrelevant” is more than fair. McDonald at 69. If, on the other hand, he would not condemn both settlements, then he must concede that the same “reverse” payment (1) can be made for a vastly stronger patent than in his example, and (2) can precisely reflect the expected profits of the patent holder. The “presumption” against reverse payments thus collapses.26 No matter which result he chooses, moreover, my example shows that his statement that “the larger the cash payment, the weaker the patent holder must have regarded its own litigation prospects” (Shapiro at 72) is simply wrong.

Let me close with a word about probability and expected value. Contrary to Professor Shapiro’s suggestion that I am “confused” about probability, his mistake (substituting the expected value of a binary outcome for the actual outcome itself) is commonplace in antitrust litigation. In a class action, a plaintiff may define a class improperly to include members entirely uninjured. No problem, says the plaintiff, I will simply compute an “average” class-wide injury. This is when I have heard economists say, unanswerably in my view: “I can average ‘injury’ and ‘no injury,’ but I can’t make the answer meaningful.”

So, here, we can (in theory) compute the expected value of the result of a specific lawsuit by “averaging” the probability of two mutually exclusive results, but we cannot claim, as does Shapiro, that it represents “the level of competition that would have prevailed, on average, had the two parties litigated the patent dispute to a resolution in the courts.” Shapiro at 70.27 It is simply a prediction of an uncertain outcome, candidly unknowable. If Professor Shapiro wishes to award consumers a “property right” (to use his term) in a portion of that uncertainty, he will need a new statute and, in my view, a justification less dependent on the use of the word “presumption.” It is one thing to label property “probabilistic”; quite another to label possibilities property.


2 The responses in the current issue include: Merrill Hirsh, Are False Positives Really So Negative? A Response to Kevin D. McDonald, Antitrust, Summer 2003, at 83; (Hirsh); Keith Leffler & Cristofer Leffler, The Probabilistic Nature of Patent Rights: In Response to Kevin McDonald, Antitrust, Summer 2003.

In re Tamoxifen Citrate Antitrust Litig., MDL No. 1408 (ILG), Memorandum and Order, slip op. (E.D.N.Y. May 13, 2003) (granting motion to dismiss under Rule 12(b)(6)).

In re Ciprofloxacin Hydrochloride Antitrust Litig., 1:00-MDL-138 (DGT), Memorandum & Order, slip op. at 117 (E.D.N.Y. May 20, 2003) (plaintiffs’ motion for partial summary judgment denied; defendants’ motion to dismiss denied in part and granted in part). I am one of the attorneys for the defendants.

Reating to this Rejoinder, the Lefflers respond that these opinions provide “little or no support for McDonald’s position.” Leffler III at 82 n.21. By a “little” support, they may have in mind the fact that both the ALI in Schering-Plough and the district judge in Ciprofloxacin flatly rejected the argument that “reverse” payments are per se illegal. Their most countering statement is the claim that Ciprofloxacin court “did embrace” a probabilistic analysis (see pp. 188–92).” Leffler III at 82 n.21. If you look at the pages of the opinion they cite, however, you will not find the words “probabilistic” or “property,” together or apart. What you will find is the court citing the same authority I cited in my prior articles to explain that the procedures of Hatch-Waxman have shifted risk to the patentee in such a way that “[t]o compromise, consideration flows from the patent owner . . . to the challenger . . . and not vice versa as in a traditional context.” In re Ciprofloxacin Hydrochloride Antitrust Litig., supra note 4, at 191. This is exactly the same conclusion that the Lefflers, citing my first article on this subject, brand a “non sequitur.” Leffler III at 82–83 n.31. According to the Lefflers, then, a court that has (a) adopted the same view I have set forth repeatedly (a non sequitur, no less) and (b) expressly rejected their view that “reverse” payments are per se illegal, has nonetheless, and by virtue of the same words, “embraced” their probabilistic analysis.

USM Corp. v. SPS Technologies, Inc., 694 F.2d 505, 513 (7th Cir. 1982).

In re IBM Peripheral EDP Devices Antitrust Litig., 481 F. Supp. 2nd 655, 1022 (N.D. Cal. 1979). See, e.g., Herbert Hovenkamp, Antitrust Law ¶ 191.3(c) at 306 (1998) (less restrictive alternative “[i]nquiry [is] relevant only after threshold showing” of competitive harm).

The assumption that a license necessarily bestows greater benefits to consumers is far from established, and was debunked by Judge Posner in his decision. Brunswick Corp. v. Reigel Textile Corp., 752 F.2d 261, 267 (7th Cir. 1984).


See also Professor Shapiro also tries to change the question presented when he says that I have “neglect[ed]” key issues: “A settlement that eliminates non-infringing competition, or competition based on the inventing around a narrow patent, could well be anticompetitive. McDonald ignores these important cases, all of which are built into the notion of patent strength employed in my analysis.” Shapiro at 74. But it is he who ignores the very explicit limitations I placed on the hypothetical chosen “to test the logic of those who argue the irrelevance of patent validity.” McDonald at 75 n.17. Obviously, the validity of the patent alone will not justify an agreement not to “invent around” it, or not to market non-infringing drugs (though other things might). But where, as I put it, “the patent is broad enough to preclude all generic competition and . . . the settlement’s preclusive effect is no broader than the patent itself,” the question that cannot be avoided is: what lawful competition has been excluded? If Professor Shapiro wishes to acknowledge that his presumption of competitive harm for “reverse” payments does not apply in this scenario, I would be delighted.

Under Shapiro’s methodology, expected value of litigation: (90% x $100mm x 4 years) + (10% x $60mm x 4 years), or 360 + 24 = $384 million. Actual value of settlement: ($100mm x 4 years) less ($16 million), or 400 – 16 = $384 million.

Only by insisting that consumers must be given the benefit of any possibility of loss can the settlement in my example be deemed to harm competition. The reverse payments tell us nothing about patent “strength”—only that the consideration from the patentee is flowing in one form (payments) rather than another (a license). By declaring one of those forms of consideration suspect, Shapiro’s rule is an attempt to impose the kind of compulsory licensing that the courts have always rejected. See, e.g., King Instrs. Corp. v. Perego, 65 F.3d 941 (Fed. Cir. 1995).