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Ninth Circuit Affirms Legality of Manufacturer's Market Share Discounts, Sole-Source Agreements and Design Innovations

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In *Allied Orthopedic Appliances Inc. v. Tyco Health Care Group LP* (Case No. 08-56314, 9th Cir. January 6, 2010) ("Allied Orthopedic"), a putative class action alleging violations of Sections 1 and 2 of the Sherman Act, the U.S Court of Appeals for the Ninth Circuit affirmed the lower court's grant of summary judgment in favor of the defendant. In so doing, the Ninth Circuit both reaffirmed and announced important guidelines related to analysis of alleged exclusive dealing arrangements and product innovation in the antitrust context.

Overview

Tyco Health Care Group LP ("Tyco") manufactures pulse oximetry sensors and monitors, which measure the amount of oxygen in the blood. Tyco, an early developer of and market leader in pulse oximetry technology, initially protected its products with its "R-Cal" patent. Tyco purportedly knew that when its patent expired in November 2003, competitors would produce generic sensors compatible with Tyco monitors. Allegedly in anticipation of increased competition, Tyco entered into market share discount and sole-source agreements with customers, and created a new patented sensor and monitor system ("OxiMax") that offered improved features and performance, but was incompatible with competing generic sensors. Tyco introduced OxiMax and announced it would be discontinuing R-Cal.

Plaintiffs, a putative class of hospitals and other health care providers that purchased Tyco's pulse oximetry sensors after November 2003, alleged two main theories: (1) that Tyco's market share discounts and sole-source agreements unreasonably restrained trade in violation of Section 1; and (2) that Tyco unlawfully maintained a monopoly by developing the OxiMax system and discontinuing the R-Cal system in violation of Section 2. Opinion at pp. 400-401.

Section 1 Claim: Market Share Discounts and Sole-Source Agreements

Tyco's market share discount agreements offered discounts if customers committed to purchase a minimum percentage of their pulse oximetry requirements from Tyco. The higher the percentage, the greater the discount. Notably, the agreements did not contractually obligate any purchases from Tyco — if customers purchased less than they had agreed upon, then customers would simply lose the negotiated discounts. Opinion at pp. 402-403.

Tyco's sole-source agreements precluded group purchasing organizations ("GPOs") from entering into contracts with other pulse oximetry vendors. In exchange, Tyco offered deep discounts. These agreements, like the market share discounts, did not contractually obligate GPO members to purchase anything from Tyco. Opinion at p. 403.

Plaintiffs alleged these two types of agreements constituted an incentive for exclusivity which led to substantial foreclosure in the relevant market. The Ninth Circuit disagreed. Plaintiffs' claims failed because the agreements did not contractually require Tyco's customers to make any purchases, but merely provided for discounts if purchases were made. Hospitals had the option of ignoring the agreements and purchasing the less expensive generic sensors. This "easy terminability" of the exclusive dealing arrangements substantially undercut the agreements' potential to foreclose competition. Opinion at p. 406. The Court distinguished a prior design in a related case because it found "the sole-source agreements in that case contractually obligated GPO members to purchase a set percentage of their pulse oximetry requirements from Tyco." Opinion at p. 407 n.2.

Moreover, even where a sole-source agreement prevented a GPO's members from belonging to any other GPO, plaintiffs offered no evidence that members were unable to access less expensive generics through alternative channels. When such potential alternative channels of distribution exist, "'it is unclear whether such restrictions foreclose from competition any part of the relevant market.'" Opinion at pp. 406-07. Plaintiffs thus could not show that competition had been foreclosed in a substantial share of the market.

Section 2 Claim: Alleged Unlawful Innovation

Plaintiffs next claimed that Tyco violated Section 2 of the Sherman Act by creating the newly patent-protected OxiMax design to unlawfully maintain monopoly power in the U.S. pulse oximetry sensor market. Plaintiffs claimed that the new sensors were designed to only be compatible with the new OxiMax monitors (or the installed base of R-Cal monitors), while the new monitors purportedly were designed to be incompatible with Tyco's old R-Cal sensors and their generic competitors. Plaintiffs argued that the district court should have balanced the benefits of Tyco's alleged product improvement against the product's alleged anticompetitive effects. Opinion at p. 408.

The Ninth Circuit explained that invention and innovation is "necessarily tolerated by the antitrust laws," and that courts should be very skeptical of claims that a dominant firm's product design changes have harmed competition. Such design changes may appropriately face antitrust scrutiny only where there is no "procompetitive justification" for the changes (citing *United States v. Microsoft Corp*., 253 F.3d 34, 59, 66-67 (D.C. Cir. 2001)).

When a design change improves a product by providing a new benefit to consumers, the Ninth Circuit held that this does not violate Section 2 unless there is other associated anticompetitive conduct. To establish a violation, the plaintiff must prove that some conduct of the monopolist associated with the introduction of the new and improved design "'constitutes an anticompetitive abuse or leverage of monopoly power, or a predatory or exclusionary means of attempting to monopolize the relevant market.'" Opinion at p. 411 (quoting *Foremost Pro Color, Inc. v. Eastman Kodak Co*., 703 F.2d 534, 545-46 (9th Cir. 1983)).

Building off prior case law, the Ninth Circuit arrived at a pro-innovation/anti-judicial interference result:

> To weigh the benefits of an improved product design against the resulting injuries to competitors is not just unwise, it is unadministrable. There are no criteria that courts can use to calculate the 'right' amount of innovation, which would maximize social gains and minimize competitive injury….The balancing test proposed by plaintiffs would therefore require courts to weigh as-yet-unknown benefits against current competitive injuries. Our precedents and the precedents we have relied upon strongly counsel against such a test. Opinion at p. 412.

The Ninth Circuit also rejected plaintiffs' reliance on Tyco documents questioning the added benefit of OxiMax and whether the market would perceive it as simply an attempt to lock out generics. The Court noted that "evidence of an innovator's initial intent may be helpful to the extent that it shows that the innovator knew all along that the new design was no better than the old design, and thus introduced the design solely to eliminate competition." The Court, however, went on to find that "the documents here show that Tyco initially believed that clinicians would value the new feature set" and "that Tyco continued to believe that the flexibility of the new OxiMax platform would appeal to consumers at the point that it introduced OxiMax." Opinion at pp. 414-15.

As for the new monitors' incompatibility with the old R-Cal sensors (and thus the new monitors' incompatibility with the generic sensors), "precedents make clear that a monopolist has no duty to help its competitors survive or expand when introducing an improved product design." Opinion at p. 416.

Finally, the Ninth Circuit held that while a "monopolist's discontinuation of its old technology may violate Section 2 if it effectively forces consumers to adopt its new technology," Tyco's discontinuation of R-Cal was not unlawful because competitors were able to compete both in monitors and in sensors compatible with existing R-Cal monitors. Therefore, consumers were not forced to buy Tyco's OxiMax monitors.

Takeaways For Potential Antitrust Litigants

Allied Orthopedic is a notable opinion for companies engaged in aggressive price discounting programs, and also for market leaders seeking to maintain their strong position via technological innovation. Here are some of the key "takeaway" points:

- Traditional defenses to exclusive dealing claims, such as terminability and alternative means of distribution, can still be powerful tools for antitrust defendants, including in the *de facto* exclusive dealing context.
- Incentives for exclusivity (or near-exclusivity) may be particularly defensible where the contracts at issue do not contractually obligate customers to buy anything from the seller, and/or where customers can forego negotiated discounts and purchase less expensive products elsewhere.
- The Ninth Circuit's refusal to engage in competitive effects balancing suggests a renewed willingness to allow the marketplace to function without unnecessary intervention, particularly in areas of technology and product development.
- Companies (even those with high market share) should not be deterred from defending their market position by aggressive product innovation, even if improved products disadvantage competitors relying on compatibility with prior versions. Technical improvements should be considered carefully (and perhaps documented) during the research and development process, and speculation about effects on competitors should be avoided.
- While a firm has no duty to aid competitors, before discontinuing a high market share product one should consider whether doing so "effectively forces consumers to adopt its new technology."

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