The Antitrust Analysis of Product Design Modifications:

Product Hopping and Other Product Design Issues

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Introduction: The Interface Between Innovation and Antitrust

- Innovation is a Major Driver of Economic Growth
  - In his classic study of the determinants of economic growth, Nobel Prize winner Robert Solow noted that most economic growth in the U.S. in the 20th Century was attributable to R&D and education
- Consumers benefit from the flow of new goods and services provided by innovation, but also benefit from low prices
  - Antitrust laws have grown up to foster competition and the benefits of low prices and innovation that come from competition
- In Certain Instances, Product Design Modifications (Innovations?) Can Lessen Competition

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The Important Questions:

- Conduct that involves innovation can harm consumers in some circumstances
- But, can antitrust enforcement detect and police such instances?
- Does antitrust enforcement risk chilling incentives for firms to develop innovations that improve consumer welfare?

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Antitrust Policy Conundrum:

Conduct that involves innovation may harm consumers in some circumstances, but antitrust enforcement should not chill incentives for firms to innovate in ways that improve consumer welfare

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The Four Primary Allegations of Anticompetitive Innovation

1. The Product Hop
2. New Products that Defeat Interoperability
3. The Technological Tie
4. Failure to Supply Information that Rivals Desire to Supply Compatible Products

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IBM

Actavis

Kodak

Microsoft

Once-Daily
Namenda XR
(memantine HCl) extended release capsules
7 mg, 14 mg, 21 mg, 28 mg

KEURIG

Windows

Long History of Cases Alleging Anticompetitive Product Design Modifications

Berkey Photo, Inc. v. Eastman Kodak Co.

In the 1970s, Kodak launched its successful Kodacolor II system, which used a new camera format and film that disadvantaged Kodak's competitors in the film and photofinishing markets.

Eastman Kodak Co. v. Image Technical Services, Inc

Kodak refused to supply certain patented photocopier parts to independent repair shops and was charged with illegally tying the sale of its photocopiers with its parts and service.

Long History of Cases Alleging Anticompetitive Product Design Modifications

United States v. Microsoft Corp.

In the late 1990s, Microsoft accused of bundling of its operating system and Internet-browsing software to lessen competition from Netscape

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More Recent Examples of When Anticompetitive Issues Have Arisen Around Product Design and Innovation

State of New York v. Actavis

New York alleges that Actavis redesigned it Alzheimer drug Namenda from an immediate release version to an extended release version and pulled the immediate release version from the market to thwart competion

In Re: Keurig Green Mountain Single Serve Coffee Antitrust Litigation

Plaintiffs allege that design of Keurig 2.0 designed to foreclose competing sellers of single serve portion pack suppliers

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What the Courts Have Found

- 9th Circuit: Virtually per se legal, as long as new product is improved (*Allied Orthopedic Appliances v. Tyco*)
- Federal Circuit: Intent to Harm Competition is determinative (*C.R. Bard v. M3 Systems, Inc*)
- DC Circuit, 2nd Circuit: Stepwise Analysis (*U.S. v Microsoft, NY v. Actavis*)
  1. Does conduct by defendant with market power have effects (plaintiff's burden)
  2. If so, any procompetitive benefits? (defendant's burden)
  3. Weighing of 1. v. 2.

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What the Courts Have Found

- Objective evaluation of whether new product is an improvement has not been determinative
  - "If a monopolist's [new] products gain acceptance, …it is of no importance that a judge or jury may later regard them as inferior, so long as that success was not based on any form of coercion." (*Berkey Photo v. Kodak*)
- Coercion is the Key

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“Soft Switch” v. “Hard Switch” and the Primacy of Consumer Demand

- Antitrust policy and precedent favors letting consumers decide whether a new innovation improves welfare
- Courts have generally recognized that it is the curtailment of alternatives—not the innovation itself—that raises antitrust concerns
- How to encourage adoption of new technologies? Encourage consumers to switch from old technologies to new:
  - “Soft Switch”- encourage adoption of the new technology while maintaining market availability of old technology
  - “Hard Switch” – Encourage adoption of new technology while removing old technology from the market

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Recent Proposals for “Almost Safe” Harbors

1. Soft Switch Should be Virtually Per Se Legal
   – But, what about other ways to harm rivals? (Sampling, Marketing, Removal from Formulary. Etc.)
2. Hard Switch Where Competition Not Meaningfully Foreclosed
3. (Some) Vertical Issues of Compatibility and Complementarity
   – The trickier case

Vertical Issues of Compatibility and Complementarity

- Several cases involve vertical issues (Keurig, M3, Tyco)
- Firm with Market Power at one stage may prefer competitive market for complements
- But, may have economic incentives to limit competition for complements
  - Limitations on pricing at one vertical stage
  - Price discrimination when using variable proportions technology
  - When sales of complements provide a way to enter at different vertical stages (Netscape)

NY v. Actavis-An Application

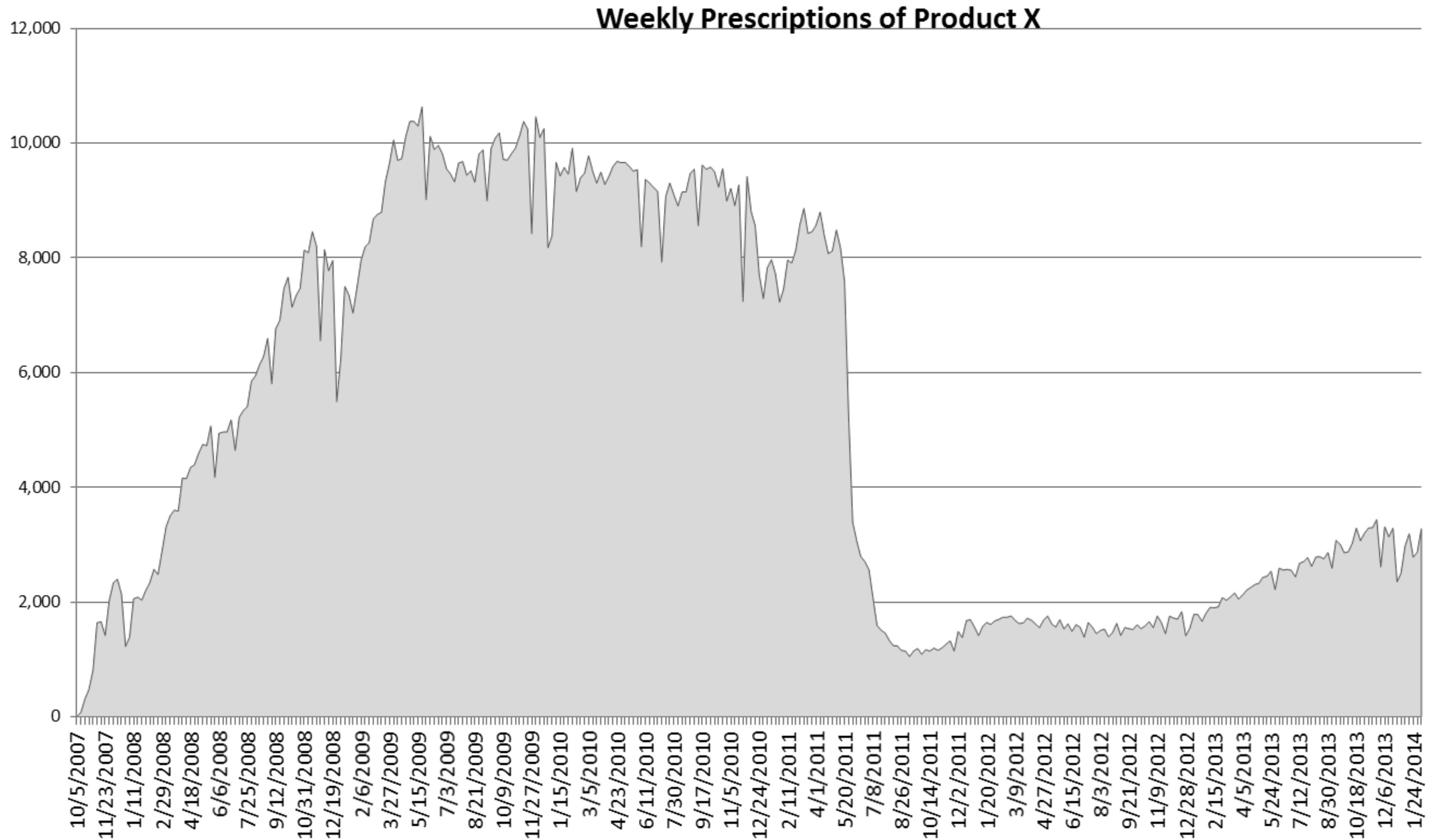
Background:

- Nemenda IR entered in 2004 to treat moderate to sever Alzheimer's – twice a day formulation
- Namenda XR approved in 2010 and first marketed in 2013
  - Once daily formulation (Like every other Alzheimer's drug at the time)
- IR patents scheduled to expire in October 2015, XR in 2029
- Initially, both versions sold, although marketing effort focused on XR to attempt to convert as many patients as possible to XR (Soft Switch)
- Determined only 30% or so of patients would convert to XR before patent expiration
- Announced plan to effectively remove IR from market by August 2014, although production issues delayed date (Hard Switch)

Important Regulatory and Economic Factors

- 1984 Hatch Waxman Act encouraged generic entry
- State substitution laws encouraged (mandated) generic dispensing when available
- Rise of Managed Care for pharmaceuticals encouraged generic dispensing
    - Formulary status is important for sales
    - Copayments encourage generic dispensing
- These factors gave rise to “patent cliff”
- These factors also gave rise to a business model for generic firms that depends heavily on the ability to free-ride on branded efforts to build sales

Typical Patent Cliff



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NY v. Actavis-An Application

- Issue before 2nd Circuit is the Injunction Granted by District Court Requiring Actavis to keep IR on the market
- Reviewed under the Three Part *Microsoft* Test:

1. Market is the molecule
   - Hard Switch constitutes coercion and limits consumer choice
   - Regulatory structure limits generic responses to withdrawal of IR
2. A number of procompetitive justifications offered
   - Preventing free-riding has a legitimate business purpose and encourages innovation
   - XR is superior
   - Third party payers can protect themselves
3. Weighing of 1 and 2
   - Procompetitive justifications “pretextual”

Where do we stand?

- Court used the *Microsoft* test but skeptical of procompetitive justifications
- How important was actual experience during soft switch period?
  - Does evidence support that marketplace did not consider XR an improvement?
  - What if hard switch to XR occurred in 2013?
- Are there procompetitive reasons for hard switches?
  - Stickiness of demand, path dependence can make it difficult to switch consumers even when new product is superior
  - Economies of scale with respect to new product means prices may fall faster if more sales for new product sooner
  - Lessens confusion in the marketplace

Where do we stand?

- Antitrust Policy Issues:
  - Step 1 is easier to quantify than step 2, making “type II errors” likely, perhaps retarding innovation
  - Antitrust litigation is a drawn out process, often with only limited remedies available
    - Further advances could render the predatory innovation obsolete
    - Remedies in *U.S. v. Microsoft* considered a failure by most, but competition from Google, Apple, and others has weakened Microsoft’s dominance
  - Is judicial scrutiny of innovation likely to yield better results?

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