

The Supreme Court's 2005 Term: Formalism Under Review

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Antitrust law should be based on empirical analysis of behavior in specific markets, not on rigid formalism or abstract propositions. Three Sherman Act cases now before the Supreme Court provide the Court with the opportunity to reaffirm this basic principle. The three matters are *Independent Ink*, *Dagher*, and *Schering Plough*. The Supreme Court has already granted certiorari on the first two cases, and the Federal Trade Commission seeks the Court's review on the third. Good decisions here will help to push back against what I fear may become a creeping formalism in antitrust law.

In each of these cases, the FTC has taken a strong position on the merits because, in each case, the Commission believes the court of appeals got it wrong. Each case departed from the modern, bipartisan consensus on antitrust methodology. Rather than carry out a concrete empirical economics-based assessment of the impacts of challenged practices on consumer welfare, efficiency, and innovation, the three circuit court decisions simply relied on formal rules that were based on formal legal constructs. After affixing a label to the conduct on the basis of these formalistic categories, the courts gave little consideration to whether these formalistic analyses actually fit with the underlying purposes of the antitrust laws or the specific realities of the marketplaces at issue.

Each of these cases, if allowed to stand, will harm the Commission's ability to enforce a properly balanced antitrust policy—one targeted, as it should be, at protecting the welfare of consumers while leaving entrepreneurs the freedom they must have to innovate, to cut prices, and to compete vigorously with their rivals. This term gives the Court a chance to carry out the judicial equivalent of baseball's triple play. Just as three runners are put out during the same play in a triple play, the Commission is hoping all three of these cases will be called "out" during the Court's October 2005 term.

*Illinois Tool Works, Inc. v. Independent Ink, Inc.*¹

In the *Independent Ink* case, the circuit court made a formalistic presumption that a patent automatically confers market power.

The defendant makes patented printheads. Those devices are later incorporated into the specialty printers that place bar codes on cartons. It is important to design the printheads so that they can efficiently handle the significant amount of ink required. Three solutions to this problem are available in the market, only one of which is the product patented by defendant. Defendant also

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¹ Cert. granted, 125 S. Ct. 2937 (U.S. June 20, 2005) (No. 04-1329).

manufactures ink, and it allows its customers to make, use, or sell its patented printhead only when they also use in it the ink that the defendant supplies.

The plaintiff makes a competing ink that is usable in the defendant's printheads. The plaintiff alleged that the defendant's tie-in arrangement violated both Section 1 of the Sherman Act, as an illegal restraint of trade, and Section 2, as attempted monopolization. On motions for summary judgment, the district court dismissed both these claims.²

On appeal, the Federal Circuit affirmed dismissal of the Section 2 count.³ Attempted monopolization requires that there be a dangerous probability of success—in this case, that defendant would succeed in achieving market power in ink. The court held that summary dismissal was appropriate because the plaintiff had made only conclusory allegations regarding the appropriate market.

There is no reason to condemn a tie-in in the absence of market power. No one thinks that supracompetitive prices can be charged in circumstances where the seller lacks market power in the tying product.

Nevertheless, the Federal Circuit panel reinstated the Section 1 claim. Whether a tie-in constitutes an unreasonable restraint of trade depends, as a threshold matter, on whether the party has market power in the tying product—here, the printhead machines. The circuit court believed it was bound by Supreme Court precedent which it read as holding that, in tie-in cases involving patented or copyrighted products, the requisite economic power is at least rebuttably presumed to exist.⁴ Despite the presence of several other printhead offerings in this market, and despite the circuit court's other conclusion that there was no evidence of potential harm to competition in the ink market, the court concluded that this presumption made summary judgment inappropriate.

The Supreme Court granted certiorari to consider whether market power should be presumed from the simple presence of a patent, or whether, instead, a tie-in case requires the plaintiff to prove such power. The Solicitor General filed an amicus curiae brief signed by officials of the DOJ's Antitrust Division, the FTC, and the Patent and Trademark Office.⁵

The amicus brief argues three main points: (1) there is no reason to condemn tying arrangements in the absence of market power; (2) possession of a patent on the tying product does not establish market power; and (3) a presumption that patents confer market power would conflict with the procompetitive policies of the antitrust laws. I believe that each of these principles is clearly correct.

First of all, there is no reason to condemn a tie-in in the absence of market power. No one thinks that supracompetitive prices can be charged in circumstances where the seller lacks market power in the tying product. The buyer confronted with such a demand would simply move elsewhere. The Supreme Court has made this point in a number of cases, including *Eastman Kodak*⁶ and *Jefferson Parish*.⁷

² 210 F. Supp. 2d 1155 (C.D. Cal. 2002).

³ 396 F.3d 1342 (Fed. Cir. 2005).

⁴ See *United States v. Loew's, Inc.*, 371 U.S. 38 (1962); *United States v. Int'l Salt Co.*, 332 U.S. 392 (1947).

⁵ Deciding whether to participate in an amicus effort can sometimes be a complex process. Many factors are relevant to the Commission's decision, including whether there has been an invitation from the Court; the importance of the legal issues at stake; the extent to which the agency has particular expertise or particular enforcement priorities in those issues; the competing demands on the Commission's time and resources; and the clarity with which the issue is presented by the fact pattern of the case. These factors often counsel against participating on behalf of private parties at the cert petition stage. Once a case has been accepted by the Court, however, the Commission will often want a chance to participate in the proper development of the law.

⁶ *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 462 (1992).

⁷ *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 12–18 (1984).

Next, there is no reason to presume that the mere possession of a patent establishes this kind of market power. A patent gives a right to practice a particular invention, but the invention itself does not have market power if there are other methods, patented or not, that can accomplish more or less the same thing. In the United States, it is possible to patent a particular configuration of a golf course, but the owner of such a course surely cannot charge monopoly rents to all golfers. A patented mousetrap does not have market power in a world containing many designs of mousetrap. This point has been made by a number of scholarly commentaries.⁸ It has also been formally stated by the antitrust agencies in their Guidelines. The agencies do “not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner,” because, “[a]lthough [a patent] right confers the power to exclude with respect to the *specific* product, process, or work in question, there will often be sufficient actual or potential close substitutes . . . to prevent the exercise of market power.”⁹

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The Federal Circuit understood these arguments, but believed that it was bound by Supreme Court precedent on the presumption. In the amicus brief, it is noted that these precedents were forty years old and have been undercut by subsequent events. One such event was the decision in *Northern Pacific*, which came between the two cases that the circuit court relied upon, and questioned the putative linkage between patents and market power.¹⁰ Another event was legislation in 1988, which specified that a tying arrangement does not constitute patent misuse in the absence of market power.¹¹ For both these reasons, it appears that the old precedents are no longer controlling. But if the Supreme Court believes that they retain some validity, then the Commission suggests that the time has come to overrule them.

Finally, applying a presumption that patents confer market power would conflict with the pro-competitive policies of the antitrust laws, which foster rationality and efficiency. Were the decision below to be upheld, the antitrust legality of important business arrangements would no longer turn rationally on their actual competitive impacts but rather on the formal source of the property rights involved. Tying arrangements involving patented products would be treated, for no good reason, in a way fundamentally different from other tying arrangements. Casting doubt on tie-ins in this way could impede a number of efficient and beneficial uses—convenient combinations that consumers affirmatively value. The presence or absence of patents should not determine whether cars can be sold with radios, whether right shoes and left shoes can be boxed together, and whether a gas station that insists we buy a car wash along with our gasoline would lose not only many customers but also an antitrust suit.

⁸ A patent grant “creates an antitrust ‘monopoly’ only if it succeeds in giving . . . the exclusive right to make something for which there are not adequate market alternatives, and for which consumers would be willing to pay a monopoly price.” 1 HERBERT HOVENKAMP ET AL., IP AND ANTITRUST § 4.2, at 4–9 (2002); J. Dianne Brinson, *Proof of Economic Power in a Sherman Act Tying Case: Should Economic Power Be Presumed When the Tying Product is Patented or Copyrighted?*, 48 LA. L. REV. 29 (1987).

⁹ U.S. Dep’t of Justice & Federal Trade Comm’n, Antitrust Guidelines for the Licensing of Intellectual Property § 2.2 (1995), available at <http://www.usdoj.gov/atr/public/guidelines/0558.htm>.

¹⁰ *N. Pac. Ry. Co. v. United States*, 356 U.S. 1 (1958).

¹¹ The Patent Misuse Reform Act, 35 U.S.C. § 271(d)(5).

*Texaco Inc. v. Dagher*¹²

In the *Dagher* case, the court assumed that simply because two products exist as distinct brands they are required to be in price competition with one another, even if both brands are owned by the same legal joint venture.

Plaintiffs are a class of 23,000 gas station owners. They sued Shell and Texaco for price fixing gasoline. The two suppliers were once, it is true, fierce competitors in all aspects of the oil and gasoline markets. And the firms had, indeed, agreed to unify the pricing of Shell and Texaco gas in certain areas. But in 1998, they had formed joint ventures to refine, market, and sell both Shell and Texaco gasoline, one venture for the eastern United States, the other for the western part of the country. The FTC had reviewed the formation of these joint ventures, obtained a consent order mandating certain specific divestitures necessary for competition, and otherwise let the rest of the ventures go forward.¹³ Following this resolution, Shell and Texaco transferred all the assets related to their downstream marketing functions to the joint ventures, and ceased competing in the downstream markets themselves. Shell and Texaco retail gasolines maintained their unique chemical compositions, their brand names, and their marketing strategies. But the exclusive licenses to sell both brands were held by the joint ventures. The managers of the ventures decided that they would sell each brand at the same price in the same market area.

Petitioners urged that this “price-fixing” agreement was unlawful per se and therefore offered no proof of actual effects. Most importantly, the petitioners did not challenge in any way the legality of the joint venture. They also disavowed any reliance on a rule of reason analysis in which actual anticompetitive effects need be demonstrated. Consequently, the petitioners were left to contend that the arrangement on prices was per se unlawful although the joint venture itself was unobjectionable.

The district court granted summary judgment for defendants,¹⁴ but the Ninth Circuit Court of Appeals, in a divided opinion, reversed.¹⁵ To the court majority, defendants were seeking “an exception to the per se prohibition on price fixing where two entities have established a joint venture that unifies their production and marketing functions *yet continue to sell their formerly competitive products as distinct brands.*”¹⁶ Finding no such exception in the case law, the court reversed the grant of summary judgment. The court sent the case back to the trial court for a determination whether defendants had actually violated the Act by agreeing to unify the gas prices.

It does not require detailed analysis to see that the circuit court in *Dagher* was not only wrong, but plainly wrong. The court simply forgot that one cannot restrain competition where there is no competition to be restrained.

To return to baseball analogies, the *Dagher* decision may be dubbed the Merkle’s Boner of antitrust law. Merkle’s Boner occurred in 1908 when Fred Merkle, a young first-baseman for the NY Giants who went on to have a distinguished career, forgot to touch second base on a ball hit to centerfield with two outs that would have driven in the winning run for his team in a pivotal game.

¹² *Cert. granted*, 125 S. Ct. 2957–58 (U.S. June 27, 2005) (Nos. 04-805, 04-814).

¹³ *See Shell Oil Co.*, 125 F.T.C. 769 (1998).

¹⁴ D.C. No. CV-99-06114-GHK (C.D. Cal.).

¹⁵ 369 F.3d 1108 (9th Cir. 2004).

¹⁶ *Id.* at 1116 (emphasis added).

Because Merkle never touched the base, he was forced out at second. Consequently, the other base runner could not score and, ultimately, the Giants lost the game. Having lost the game, his team had to play in a playoff game, which they also lost. So Merkle's Boner cost his team both a championship and a trip to the World Series.

The *Dagher* court committed a Merkle's Boner here. The majority judges forgot to touch all the bases. Specifically, they forgot to ask what the purpose is of the per se prohibition against price fixing. Had they stopped to ask that question, they would have understood that it is to protect against restraints on competition, and that there is no actual competition within a joint venture.

The Supreme Court granted certiorari.¹⁷ The Solicitor General's amicus brief, signed by both the FTC and the Antitrust Division, makes two simple and inarguably correct points: (1) an agreement between the owners of a legitimate joint venture respecting the pricing of the joint venture's products, where neither of the owners competes with the joint venture, cannot violate the antitrust laws; and (2) the court of appeals' contrary conclusion is inconsistent with the procompetitive purposes of the antitrust laws.

Per se analysis is reserved for conduct that is pernicious, virtually without potential benefits to consumers, and "manifestly anticompetitive."¹⁸ The conduct here cannot be characterized that way. There being no competition whatsoever between Shell and Texaco on the presumed facts of this case, the agreement to unify prices might look like a price-fixing agreement between competing brands, but it was not so in fact. Yes, there were—and still are—two brands here: Shell and Texaco. But with plaintiffs offering no challenge to the formation of the joint venture, making no assertion of demonstrable anticompetitive effects, and failing to claim a "sham" agreement to mask price fixing, those brands did not compete with each other or with any other brand of either defendant.¹⁹ Thus the agreement did not restrain anything with which antitrust law is concerned.²⁰

More fundamentally, the circuit court's pursuit of this matter is unresponsive to the underlying procompetitive purposes of the antitrust laws. It threatens to turn antitrust into an engine of inefficiency at best, and chaos at worst. If allowed to stand, the court's decision would prohibit all manner of routine agreements that have no effect on competition. Imagine telling Pepsi that because Pepsi and Diet Pepsi are distinct brands they cannot be priced together.

It is worth noting that the decisions in *Independent Ink* and in *Dagher*, otherwise quite different cases, operate from a common misperception—that because the law places a formal label on some intellectual property, that label alone will generate answers to antitrust questions. In *Independent Ink*, the defendant possesses a "patent," a label that is taken to mean "monopoly over production of the product," which is then assumed to serve as proof of "market power" for tying purposes. In *Dagher*, defendants own two trademarked "brands," Shell and Texaco—a label that is then taken to mean rival or "competing" goods, and is then applied to deem an agreement between their owners a forbidden "restraint of trade."

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¹⁷ Nos. 04-805 and 04-814.

¹⁸ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49–50 (1977).

¹⁹ *Cf. Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984).

²⁰ As the amicus brief noted, the joint venture partners "could have agreed to market a single brand of [joint venture] gasoline at a fixed price, and their decision to maintain two brands at the same price" is functionally the same. Brief for the United States and the Federal Trade Commission, *Texaco v. Dagher*.

*FTC v. Schering-Plough*²¹

A very similar error underlies the Eleventh Circuit's decision in the *Schering-Plough* case, which the Commission hopes the Court will add to its error-correction docket. In *Schering-Plough*, the court assumed that a patent automatically gives a right to exclude competitors, disregarding the possibility that the competitor might be using noninfringing technology.

Schering-Plough sold a drug, "K-Dur 20," that was the most frequently prescribed potassium supplement. Its active ingredient, potassium chloride, is in common use and is unpatentable. But Schering owns a formulation patent, which will expire in 2006, that relates to the coating on the pills, providing an extended-release mechanism.

To fully understand the competitive dynamics of this case would require a fairly elaborate course in U.S. drug law. Suffice it to say that two companies, ESI and Upsher-Smith, each developed a generic version of Schering's K-Dur 20, and each certified to the FDA that its drug was a non-infringing bioequivalent of K-Dur 20. Schering filed two infringement actions opposing that entry, one against each company. Both infringement cases were settled.

The Commission held both settlements unlawful.²² To understand fully the nature of the disputed settlements would require another seminar in the complexities of the parties' negotiations and their final agreement. It is possible to skip over most of that as well, however, and focus only on the simpler of the two settlements, involving Schering and ESI.

The ESI settlement, reached in 1998, provided that ESI would not market any generic version of Schering's K-Dur 20 until January 2004. Among other terms, the agreement provided that Schering was to pay ESI \$10 million for this delay. Under the agreement, ESI was not entitled to the payment until it received FDA approval of its application to sell the generic. ESI received that approval, forewent entering the market, and Schering then paid ESI the \$10 million.²³

The Commission, after a lengthy administrative trial, held that this arrangement violated the antitrust laws. The evidence showed that Schering had expected to encounter generic competition before its patent expired in 2006. The evidence also showed that, following a well-established pattern of prescription drug pricing after generic entry, ESI's generic would be priced substantially below the branded drug, and that generic competitors (ESI and Upsher) would rapidly garner most of the market. Generic entry would thus save consumers tens of millions of dollars.²⁴

Schering-Plough argued that the challenged arrangement permitted ESI's entry more than two years before the Schering patent was to expire. (ESI settled separately with the Commission.)

²¹ *Petition for cert. filed*, Aug. 29, 2005. The Court has subsequently invited the Solicitor General to express the views of the United States (Oct. 31, 2005).

²² *FTC v. Schering-Plough Corp.*, FTC Docket No. 9297 (Dec. 18, 2003) (final order), available at <http://www.ftc.gov/os/adjpro/d9297/031218finalorder.pdf>.

²³ A second anticompetitive settlement was made between Schering and Upsher, with Upsher paid \$60 million to delay its entry. The parties created a fig leaf for themselves in that Schering received rights to an unrelated product that it could claim it valued at that sum. The Commission found that the payment was actually for delay, however, and the circuit court's refusal to accept that factual finding is another issue for certiorari.

²⁴ *FTC v. Schering-Plough Corp.*, FTC Docket No. 9297 at 16–23 (Opinion of the Commission), available at <http://www.ftc.gov/os/adjpro/d9297/031218commissionopinion.pdf>. In the recent past, generic competition following successful patent challenges to Prozac, Zantac, Taxol, and Plantinol alone is estimated to have saved consumers more than \$9 billion. *Generic Pharmaceuticals Marketplace Access and Consumer Issues: Hearing Before the Senate Commerce Committee*, 107th Cong. (Apr. 23, 2002) (statement of Kathleen D. Jaeger).

Therefore, Schering claimed, the settlement had the dual benefit of settling patent litigation and bringing more competition faster to the market.²⁵

The Commission held that, although the arrangements to delay entry were not per se unlawful, they caused significant anticompetitive effects. The key point in the Commission's analysis is the recognition, widely agreed to by those who specialize in the economics of patents, that the strength of a patent depends only in part on its expiration date. The probability that litigation will or will not lead the patent to be judged valid or, in this case, infringed, is also relevant. Therefore, a hypothetical settlement, in which the parties compromised on a time of entry without cash payments, would reflect the strength of the patent as viewed by the parties.²⁶

In some cases, the Commission held, the addition of a cash payment might still remain consistent with this efficient assessment of risk. For example, the patent holder might compensate the generic for its expected litigation costs. In the absence of some plausible efficient justification, however, a payment by the brand raises the question what the brand is receiving in exchange. The ESI case involved this more troublesome type of cash payment because there was no explanation for the \$10 million payment other than the agreed-upon entry date. The Commission found that the likely effect of the payment was therefore to delay entry by sharing monopoly profits with a potential challenger. The agreement was therefore anticompetitive because it caused substantial anticompetitive price effects while serving no discernible or conceivable procompetitive purpose—only the purpose of further delaying entry. Thus, the agency need not decide on the exact scope or effect of the patent. The agreement acted to *increase* the exclusionary effect, whatever the specific baseline starting point of that effect may have been, by acting to give the patent holder more exclusion than it expected to achieve from the litigation alone.

On review, a panel of the Eleventh Circuit reversed, finding that the agreement was not only unlawful, it was (virtually) per se lawful.²⁷ Why? Because of formalistic assumptions about the scope of a patent. The court of appeals reasoned that the agreed-upon entry date was prior to the expiration of the patent, and the settlement served the public purpose of bringing litigation to a close. Schering was entitled to the full exclusionary force of its patent, the court found, until an antitrust challenger met the burden of proving that the patent was invalid or not infringed. Absent such a showing, the settlement could not have anticompetitive effects, the court of appeals held, because it was within the exclusionary potential of the patent.

The Commission is seeking Supreme Court review of this decision.²⁸ About 30 years ago, Congress gave the FTC the authority to act on its own to seek certiorari, independently of the Solicitor General, in cases the Commission deems vital. Here, for only the third time, the Commission has exercised that authority.²⁹ The petition concisely explains the problems with the circuit court decision: (1) the decision fails to recognize how some agreements limiting entry during the term of a patent can still be improper; and (2) the decision jeopardizes particularly important consumer interests.

²⁵ *FTC v. Schering-Plough Corp.*, FTC Docket No. 9297 at 36–39 (Opinion of the Commission), available at <http://www.ftc.gov/os/adjpro/d9297/031218commissionopinion.pdf>.

²⁶ *Id.* at 79.

²⁷ 402 F.3d 1056 (11th Cir. 2005).

²⁸ No. 05-273.

²⁹ The other two cases were *FTC v. Superior Court Trial Lawyers' Ass'n*, 493 U.S. 411 (1990), and *FTC v. Indiana Federation of Dentists*, 476 U.S. 447 (1986). The Commission won both those cases, *Indiana Federation of Dentists* unanimously, and *SCTLA* through an opinion that was unanimous as to four of its six sections.

First of all, the circuit court decision is wrong for the same reason that *Independent Ink* and *Dagher* are wrong. Only an excessively formalistic approach would conclude that the effect of a patent is to exclude, until its expiration date, anyone else from making a competing product. For one thing, not all granted patents, when challenged, are found to be valid; in fact, 46 percent of those challenged in litigation are invalidated.³⁰ Indeed, in the pharmaceutical context in which *Schering* arose, an FTC study found that 73 percent of the brands lost their cases to challengers in disputes that reached a final decision.³¹ For another thing, infringement is not to be presumed. It must be proved by the patent holder, not disproved by a challenger.³² Otherwise, the holder of a single patent could harass and inflict damage on hundreds of rivals. For all these reasons, the court was wrong to rule that a payment to a patentee, accompanied by an agreement by the challenger to defer entry, could not support an inference that the challenger had agreed to the later date in return for the payment, especially if there was no other plausible explanation for the payment.

The court's formulaic approach did more than harm sound patent-antitrust doctrine. It also put important consumer interests at risk. This decision would give virtual carte blanche to owners of branded drugs who enjoy market power to buy off their potential rivals by offering them a better deal: share in monopoly rents rather than earn competitive rates of return, while leaving consumers to pay ever higher drug prices. The stakes are high. Of the 20 top-selling prescription pharmaceuticals in the United States, today, 11 drugs, with combined annual sales of nearly \$25 billion, have been involved in brand-generic patent litigation this year. These include such well known products as Lipitor, Neurontin, and Celebrex. In all these cases, the generic manufacturers would be better off—if it were legal—to split monopoly rents with the brand company rather than compete. But the gains for the parties' agreement are the consumers' loss. If left on the books, the *Schering* decision will give pharmaceutical companies unwarranted reason to think that they are now free to buy off those generic competitors.

Courts understandably would like to see patent litigation settled rather than tried, but the antitrust laws provide no exception for anticompetitive settlements, patent suit or not.

Conclusion

We need to be careful with abstract constructions. It is not correct that merely because two products have different brand labels that they are in competition with one another. *Dagher*. It is not correct that a patent, which confers a right to exclude, therefore also confers an economic (or antitrust) monopoly on its holder. *Independent Ink*. And it is equally incorrect to assert that the expiration date of a patent suitably measures its exclusionary potential. *Schering-Plough*.

Antitrust enforcement cannot be premised on such constructs, divorced from the economic realities of the particular marketplace to be examined. This term presents the Court with an opportunity to re-affirm what it has said in cases like *Sylvania*. The antitrust laws are a consumer welfare prescription, and it is the economic effects of commercial practices that bear on that welfare, not the formalistic legal labels under which the parties may operate outside the antitrust arena. ●

³⁰ See John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q.J. 185, 205–06 (1998).

³¹ FEDERAL TRADE COMM'N, *GENERIC DRUG ENTRY PRIOR TO PATENT EXPIRATION: AN FTC STUDY 19–20* (July 2002), available at <http://www.ftc.gov/os/2002/07/genericdrugstudy.pdf>.

³² See *Kegel Co. v. AMF Bowling*, 127 F.3d 1420, 1425 (Fed. Cir. 1997); *Wolverine World Wide v. Nike, Inc.*, 38 F.3d 1192, 1196 (Fed. Cir. 1994).