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# Patents -- Allocation of Territories -- Restrictions on Sublicensees -- Per Se Violations of Section 1 of the Sherman Act -- American Industrial Fastener Corp. v. Flushing Enterprises, Inc.

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from the Sherman Act since a mandatory bargaining subject was not involved.

It thus appears that, as in the situation following the *Duplex* decision, Congress must act to resolve some of the judicially-created ambiguities regarding labor's exemption from the Sherman Act. If the courts persist in finding the Sherman Act to be applicable to union efforts to achieve, maintain or exploit its monopoly in the labor market for union ends, it is suggested that Congress should clearly state whether violations of the labor laws should ever give rise to antitrust liability.

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**Patents—Allocation of Territories—Restrictions on Sublicensees —Per Se Violations of Section 1 of the Sherman Act—*American Industrial Fastener Corp. v. Flushing Enterprises, Inc.*** [1]—A suit for breach of contract was brought by the plaintiffs, American Industrial Fastener Corporation (American) and its secretary-treasurer Arthur Herpolsheimer.[2] The defendants, Flushing Enterprises, Inc. (Flushing) and specified individuals, counterclaimed that the agreement sued upon was void and unenforceable because it contained restrictions constituting per se violations of the Sherman Act,[3] and on these grounds moved for summary judgment.

The contract sued upon established a pyramidal relationship ranging from licensors to subdistributors. At the top of the pyramid, as licensors, were both Herpolsheimer and American. The original patent was obtained by Herpolsheimer, who transferred to American the exclusive rights of sale throughout the world.[4] One level below the licensors was Flushing, who, as licensee, obtained from the plaintiffs the exclusive manufacturing and sales rights of the patented device within a fourteen state territory. Pursuant to the minimum requirements, the licensee (Flushing) was to establish distributors subject to approval by the licensor (American); the distributors in turn were to set up subdistributors. The distributors were permitted to manufacture and sell the patented device, *provided they agreed to be bound by the territorial restrictions* imposed

[1] 362 F. Supp. 32 (N.D. Ohio 1973).

[2] The statement of facts is based on that set out in 362 F. Supp. at 33-35.

[3] 15 U.S.C. §§ 1, 2 (1970).

[4] For a discussion of the assignability of patents generally, see Deller's Walker on Patents §§ 335 et seq. (2d ed. 1965). The major distinction between an assignment and a license is that "an assignment endows the assignee with the right to sue for infringement, while a license merely provides the licensee with immunity from suits for infringement." Id. § 343, at 377. See also R. Ellis, Patent Assignments §§ 49 et seq. (3d ed. 1955); R. Ellis, Patent Assignments and Licenses §§ 54 et seq. (2d ed. 1943).

on the licensee. Any violation of these restrictions was considered tantamount to a material breach actionable within the licensor's discretion.

The United States District Court for the Northern District of Ohio, addressing itself to the territorial restraints issue, HELD: the provision in the agreement that binds the sublicensees to the territorial restraints imposed by the licensor-patentee is per se invalid as a contract in restraint of trade or commerce within the meaning of section 1 of the Sherman Act.[5] The court reached its conclusion on the basis of the rule against restraints on alienation, as adopted in *United States v. Arnold, Schwinn & Co.*,[6] involving a nonpatented product. The reasoning of *Schwinn* was expanded to purchasers of patented products sold by the patentee's licensees, on the basis that a strict reading of section 261 of the Patent Act[7] did not permit territorial restrictions on resales.

This casenote will examine the district court's reasoning and the practical consequences of this decision. Included will be an analysis of the statutory basis of territorially restricted exclusive licenses, as well as the relevant judicial basis. After an evaluation of the per se rule as applied by the district court, the uncertainties of the decision will be discussed.

## Statutory Basis for the Licensing Agreement

As a result of the patentee's public disclosure of a new and useful invention, the Patent Act grants to the patentee, for a period of seventeen years, "the right to exclude others from making, using, or selling the invention throughout the United States . . . ."[8] These exclusive rights can be conveyed, subject to certain limitations, to encompass the whole or any specified part of the United States.[9] The nature of such limitations on a patentee's rights was the key issue confronting the district court in *American Industrial*.

At first glance it would appear that the provisions of the Patent Act are limited by the broad language of the Sherman Act.[10] However, the two statutes can be reconciled to some extent. Both share the same basic goal: "the efficient allocation of scarce resources for

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[5] 362 F. Supp. at 38-39.

[6] 388 U.S. 365 (1967). For a discussion of the rule against restraints on alienation, see text at notes 29-32 infra.

[7] 35 U.S.C. § 261 (1970), which provides:

Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing. The applicant, patentee, or his assigns or legal representatives may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States.

[8] 35 U.S.C. § 154 (1970).

[9] 35 U.S.C. § 261 (1970).

[10] 15 U.S.C. § 1 (1970) provides: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States . . . is declared to be illegal . . . ."

those products and services consumers value."[11] The antitrust laws seek this objective by promoting "a market-oriented, profit-incentive process unimpeded by artificial roadblocks to efficiency."[12]

Nevertheless, the antitrust law permits a monopoly when a monopoly is more efficient.[13] Thus, the temporary patent monopoly[14] was established for "the creation of a profit incentive for allocating resources to the production of a special kind of knowledge in order to insure the economical provision of those things consumers value most highly."[15] But the permissible reward to the patentee must respect "the rights and welfare of the community."[16] Accordingly, the territorial restraints permitted by section 261 must be subservient to the antitrust challenge, and confined to afford only a reasonable reward to the patentee.[17] However, instead of confronting this issue of territorial restraints squarely by means of antitrust principles,[18] the court in *American Industrial* cautiously hewed a limited path, and went only as far as the venerated rule against restraints on alienation would permit.

The court's first step was to apply the strict construction test toward patent statutes, as set forth in *United States v. Masonite*

[11] W. Bowman, Jr., Patent and Antitrust Law: A Legal and Economic Appraisal 13 (1973).

[12] Id. at 2. "The very aim of all the anti-trust laws is to ban conduct and practices which destroy free and unhampered competition." United States v. Timken Roller Bearing Co., 83 F. Supp. 284, 307 (N.D. Ohio 1949), aff'd, 341 U.S. 593 (1951). See also Addyston Pipe & Steel Co. v. United States, 175 U.S. 211, 237 (1899); United States v. E.C. Knight Co., 156 U.S. 1, 16 (1895).

[13] See, e.g., Board of Trade v. United States, 246 U.S. 231, 238 (1918), and Standard Oil Co. v. United States, 221 U.S. 1, 63-68 (1911), where the Court tempered the seemingly limitless scope of § 1 of the Sherman Act by means of a rule of reason.

[14] The distinction between a patent and a monopoly—see, e.g., United States v. Dubilier Condensor Corp., 289 U.S. 178, 186 (1933)—confuses the issue in suggesting that there really is no conflict between patent and antitrust law. Adelman & Jaress, Patent-Antitrust Law: A New Theory, 17 Wayne L. Rev. 1, 2-3 (1971). "[W]hile the patent system certainly does not restrain competition in inventive activity, but in fact encourages it, it cannot be argued that patents do not affect competition in *existing* inventions." Id. (emphasis in original). In agreement with this view, this note will employ the term "monopoly" in its economic sense, meaning sole seller.

[15] W. Bowman, Jr., supra note 11, at 15.

[16] Kendall v. Winsor, 62 U.S. (21 How.) 322, 329 (1858), cited in United States v. Masonite Corp., 316 U.S. 265, 278 (1942).

[17] See Gibbons, Domestic Territorial Restrictions in Patent Transactions and the Antitrust Laws, 34 Geo. Wash. L. Rev. 893, 896 (1966).

[18] The dichotomy of patent versus antitrust standards is well treated in Adelman & Jaress, supra note 14, at 7-8. In their analysis of bilateral actions in restraint of trade, e.g., price fixing, territorial and market divisions, etc., they concluded: "Thus, as a general rule, bilateral conduct other than the payment and collection of royalties should not be the subject of an implied exemption and hence must be tested solely under antitrust principles." Id. at 13.

Collaterally, the patent-misuse doctrine prohibits a patentee from extending the scope of the patent's subject matter. Zenith Radio Corp. v. Hazeltine Research, Inc., 395 U.S. 100, 135-40 (1969). This doctrine has been applied to achieve equitable results on behalf of the public interest even in the face of a valid patent. See Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 492-93 (1942).

*Corp.*[19] There is, however, more than one way of reading section 261 strictly. Professor Baxter has construed section 261 to authorize merely assignment by the patentee of his title and interest in his invention.[20]

Similarly, in the early case of *Keeler v. Standard Folding Bed Co.*,[21] when the Court was still very conscious of the demarcation line between assignment and license, the Court spoke only of assignments whenever it referred to the predecessor of section 261.[22] A distinction should therefore be made between the patentee's permissible grants to an assignee and those to a licensee. But the court in *American Industrial,* unlike the Court in *Folding Bed,* was not prepared to deny special status to the patentee-licensee relationship between American and Flushing.

Contrary to this strict interpretation, section 261 could authorize territorially restricted exclusive licenses, especially if read in isolated sentences. Choosing this path, the court in *American Industrial* determined that section 261 permitted each of the parties named therein to convey an exclusive right to a specified territory, but not in succession, and that because of a disjunctive reading the statute did not convey territorial exclusiveness with the patented product at each subsequent step.[23] However, section 261 definitely does permit a conveyance in succession—patentee to first exclusive assignee to second exclusive assignee. Moreover, no mutual exclusiveness is required since both the patentee and his assignees may convey in their respective territories under section 261. It is only when the patentee has assigned his "exclusive" rights in one area that he cannot assign them again in the same area, for otherwise "exclusive" would acquire a false meaning. In sum, the district court correctly determined that the Patent Act did not permit the patentee to impose territorial restrictions on the sales of his sublicensees. It is submitted, however, that the court could have reached the same determination by a better approach.

## JUDICIAL BASIS FOR THE LICENSING AGREEMENT

Having concluded that American's practice was not specifically authorized by legislation, the court applied what it considered the relevant judicial proscription to the contractually restrained sale: the ancient rule against restraints on alienation.[24] Basically, this rule

[19] 316 U.S. 265, 280 (1942): "Since patents are privileges restrictive of a free economy, the rights which Congress has attached to them must be strictly construed . . . ."

[20] Baxter, Legal Restrictions on Exploitation of the Patent Monopoly: An Economic Analysis, 76 Yale L.J. 267, 347-52 (1966).

[21] 157 U.S. 659, 661 (1895).

[22] Rev. Stat. 4898 (1875).

[23] 362 F. Supp. at 37.

[24] "Once the licensee sells the patented product, restrictions on its resale would violate the ancient rule against restraints on alienation, and may not be imposed." Id.

has come to mean that the sale of an item transfers all of the vendor's rights in that item to the purchaser. This rule was modified somewhat by the common law doctrine of ancillary restraints, whereby reasonable restraints on alienation were allowed if necessary to accomplish some legitimate purpose.[25] But it is safe to say that today the rule against restraints on alienation has attained utmost reverence. On this rule alone the Supreme Court decided *Schwinn,* and the district court *American Industrial,* both finding a per se violation of section 1 of the Sherman Act.[26] However the *Schwinn* case did not provide an automatic answer for *American Industrial,* because in *Schwinn* the Court refused to consider the rights of a patentee vis-à-vis the "ancient rule."[27]

Patent cases have instead traditionally referred to the exhaustion-by-sale doctrine, rather than the ancient rule against restraints on alienation. The exhaustion-by-sale doctrine, as developed in *Adams v. Burke,*[28] provided that the subsequent use or resale (after sale of a patented article) could not be enjoined as an infringement of the patent. The early patent cases, however, dealt only with infringement suits, and not with the rights of a patentee to restrict a purchaser by way of contracts.[29]

A manufacturing patentee may impose territorial restraints by selling his patent rights subject to section 261, or by setting up a licensing system, whereby the licensees would be subject to agency agreements.[30] American, however, was not a manufacturing patentee. Like a manufacturing patentee, it could have followed a licensing plan without any sales except to the ultimate consumer. Instead, American set up a pyramidal manufacturing-licensing system involving sales between the tiers. The court conceded that this statutory power to sell patent rights superseded the ancient rule, since "[a]fter a *sale* of the patented product to a licensee, *with transfer of dominion and control* over the product, section 261, strictly construed . . . permits a patentee to impose on the licensee territorial restrictions on the distribution of the product."[31] But after recognizing that section 261 superseded the "ancient rule" against restraints

[25] See Comment, Restricted Distribution After "Schwinn," 9 B.C. Ind. & Com. L. Rev. 1032, 1037 & n.29 (1968), which stated that the doctrine of ancillary restraints was applied in a limited class of cases usually involving purchase and sale of goodwill interest. See also United States v. Glaxo Group Ltd., 302 F. Supp. 1, 10 (D.D.C. 1969), rev'd on other grounds, 410 U.S. 52 (1973).

[26] See Comment, supra note 25, at 1042. "*Schwinn,* therefore, establishes a new per se violation of the Sherman Act; one based on an estimation of the antitrust significance of a violation of the ancient rule against restraints on alienation." Id.

[27] 388 U.S. at 379 n.6.

[28] 84 U.S. (17 Wall.) 453, 456 (1873). See also Hobbie v. Jennison, 149 U.S. 355, 361-62 (1893); *Folding Bed,* 157 U.S. at 666.

[29] See, e.g., *Folding Bed,* 157 U.S. at 666. "Whether a patentee may protect himself and his assignees by special contracts brought home to the purchasers is not a question before us, and upon which we express no opinion." Id.

[30] See United States v. General Elec. Co., 272 U.S. 476, 479, 484 (1926).

[31] 362 F. Supp. at 36-37 (emphasis added).

on alienation, the court focused its attention on territorial restrictions on subsequent sales. In this context the court ultimately asserted that the "ancient rule" limited section 261.[32]

This incongruity apparently springs from the relationship between the exhaustion-by-sale doctrine and the "ancient rule." The express rights conferred on a patentee by section 261 carve an exception to the "ancient rule." However, by the "exhaustion doctrine" the sale of a patented article exhausts the section 261 patent rights of the "applicant, patentee, or his assigns or legal representatives"[33] to control the article.[34] Thus, in essence, the "exhaustion doctrine" denies to subsequent owners the statutory patent protection afforded by section 261, thereby exposing them to the "ancient rule."

The court made no mention of the "exhaustion doctrine," possibly because it was developed in infringement suits rather than contract suits. However, such a distinction is seemingly illogical. The policies behind the "exhaustion doctrine" essentially are free use and alienability,[35] both of which are "directed against the restraints as such, and are equally applicable to enforcement on a contract basis."[36] Thus, in this respect there is no effective difference between the "ancient rule" and the exhaustion-by-sale doctrine.

Instead, the court relied on strict construction[37] and policy grounds to define the scope of contractual rights under section 261, as affected by the "ancient rule." The underlying policy reason of section 261 is the concept of just compensation to the patentee.[38] This section permits a patentee to sell a territorial monopoly in any area that he may not want to monopolize himself. Without the offer of a territorial monopoly, the patentee's bargaining position for royalties would be considerably weaker.[39] Thus, without section 261 a patentee could maximize his monopoly profits only by manufacturing and selling everything himself, or else by making one total assignment. The anomalous result would be that only the already powerful individuals or corporations would end up with monopolies.[40] But section 261 sought to eliminate this anomaly.

[32] Id. at 37.

[33] 35 U.S.C. § 261 (1970).

[34] See note 29 supra and accompanying text.

[35] Gibbons, supra note 17, at 908-09. Some policy factors in favor of free use and alienability include a concern over possible harassment of innocent purchasers, the difficulty of judicial administration of systems of restrictions, the inconvenience to business, the traditional attitudes of buyers toward the concept of ownership, and antitrust considerations. Id.

[36] Id. at 910.

[37] See text at notes 19-23 supra.

[38] See United States v. General Elec. Co., 272 U.S. 476, 490 (1926).

[39] Baxter, supra note 20, at 347, points out that "[t]he more valuable the invention, the more likely it is that royalty obligations would force an endproduct price approximating a monopoly price in the area . . . ." As a result he would "compel the issuance of identical licenses to all qualified applicants with respect to any geographical area for which an assignment or a license has previously been issued." Id.

[40] See Gibbons, supra note 17, at 895.

Thus, a patentee can exercise his monopoly in one small area himself, while still being able to charge the same royalty rates for the other areas as though he were offering a total territorial assignment. The court considered these royalties as "the prime benefit protected by the statute."[41]

Arguably, in order to guarantee the patentee a monopoly bargaining position in charging royalties, the patentee should be able to restrict the sales of the sublicensees (distributors) to the same area as the respective licensee. For otherwise a sublicensee may sell in the territory of a second exclusive licensee. However, the licensee's own sublicensees probably would prefer to sell in *any* area, since the sublicensees are in competition with each other in their licensee's exclusive territory. Such restrictions could therefore weaken a patentee's bargaining position by diminishing the value of the package sold to the sublicensee. Moreover, a manufacturing patentee's concern over reduced profits is unwarranted if the patentee does not charge an unreasonably high price for his goods, or if he operates in a reasonably efficient manner. In any event the court correctly concluded:

> Extension of territorial restrictions to the second vendee can only serve to decrease competition at that level and artificially maintain higher prices. Its extension does not, *in any meaningful sense;* promote greater security of the patentee's reward for his invention . . . .[42]

## Per Se Rule

The court viewed American's extension of territorial restraints as "not reasonably necessary."[43] However it was not content with this reasonability of reward test, and applied a per se rule of illegality. As such the court gave notice that regardless of any reasonably competitive motives on behalf of a patentee, an extension of territorial restraints to second level vendees would not be permitted. In adopting a per se rule, courts are not oblivious to the adverse party's interests, and a balancing is still performed.[44] Nevertheless, courts are wary of agreements or practices having a pernicious effect on competition and a lack of any redeeming virtue.[45] Needless to say, the elements of perniciousness and virtue provide no clear formula for a per se rule. In this area of uncertainty the district court in

[41] 362 F. Supp. at 37.

[42] Id. (emphasis added).

[43] Id.

[44] See text at note 62 infra.

[45] See Northern Pac. Ry. v. United States, 356 U.S. 1, 5, 6 (1958), where tying agreements were held to be per se violations of § 1 of the Sherman Act. See also International Salt Co. v. United States, 332 U.S. 392, 394-96 (1947), where arrangements tying unpatented products to patented machines constituted per se violations of § 1 of the Sherman Act and § 3 of the Clayton Act.

*American Industrial* was very much influenced by the Supreme Court's application of the per se rule in *Schwinn*. Although *Schwinn* did not involve patents, the district court impliedly equated the patentee's second level vendees with the first level vendees of an unpatented manufacturer.[46] Thus in both situations territorial restraints on the relevant vendee by his respective vendor now result in a per se violation of the Sherman Act, assuming interstate commerce is involved.

The per se rule was developed to make "the type of restraints which are proscribed by the Sherman Act more certain" and to avoid "the necessity for an incredibly complicated and prolonged economic investigation . . . ."[47]Although the court in *American Industrial* cited ample corroborating cases in which a per se rule was applied,[48] the question still remains whether a per se rule was the best solution for the case at hand. As in *Schwinn*, the critical issue was the element of title-passing, with the resultant application of the rule against restraints on alienation.[49] Also as in *Schwinn*, the district court offered no economic analysis of the anticipated anticompetitive effect such vertically imposed territorial restraints[50] would produce. It simply concluded that "[e]xtension of territorial restrictions to the second vendee can only serve to decrease competition at that level and artificially maintain higher prices."[51] However, courts should seek to limit per se prohibitions, under the *Northern Pacific* test, only to those agreements with a "pernicious effect on competition and lack of any redeeming virtue . . . ."[52]

Some laudable exceptions to *Schwinn*'s per se rule include failing and entering firms. These firms need the additional competitive edge established by the elimination of intrabrand competition just to stay in business, thereby increasing interbrand competition.[53]

[46] Second level vendees are those vendees located two levels below the patentee in the overall pyramidal structure, whereas a second vendee is the purchaser who buys from the original purchaser. In *American Industrial*, the second level vendees are the sublicensees (distributors) who are actually the first vendees; i.e., they are the first to buy the patented product from the manufacturing licensee. As such the second vendee would refer to the subdistributors or other customers of the distributors.

[47] Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958).

[48] E.g., United States v. Topco Associates, Inc., 405 U.S. 596 (1972); United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967); Hensley Equip. Co. v. Esco Corp., 383 F.2d 252, 263-64 (5th Cir. 1967).

[49] 388 U.S. at 380. Moreover the Court's concern was not limited to interbrand competition, but extended also to intrabrand competition. Id. at 369.

[50] Vertical restraints are imposed by the top onto the subordinate tiers, as in a "*vertical* arrangement by one manufacturer restricting the territory of his distributors or dealers." White Motor Co. v. United States, 372 U.S. 253, 261 (1963) (emphasis in original). The Court in *Schwinn* contrasted horizontal restraints as those "in which the actors are distributors with or without the manufacturer's participation." 388 U.S. at 372.

[51] 362 F. Supp. at 37.

[52] Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958).

[53] Comment, supra note 25, at 1046. See also *White Motor*, 372 U.S. at 263. *Schwinn* avoided this issue since Schwinn was neither a newcomer nor a failing company. 388 U.S. at 374.

In *American Industrial,* however, the court made no mention of any exceptions to its per se rule. As far as the court was concerned, the rule against restraints on alienation applied universally. Nevertheless, one cannot escape the conclusion that the decision impliedly contains the same exceptions to its per se rule as did the *Schwinn* case. The court relied on the *Schwinn* decision, and applied the "ancient rule" the same way.[54] Patentees restraining second level vendees are now no different than unpatented manufacturers placing territorial restraints on their vendees. But since *Schwinn* conceded the exception of new or failing manufacturers,[55] then one can reasonably conclude that new or failing patentees should likewise be exceptions to the per se rule.

The exceptions of new and failing firms exist because the justifications for the territorial restrictions, as applied to these firms, sufficiently counterbalance the antitrust policy of competition.[56] As mentioned earlier, the chief reason for allowing territorial restrictions is to assure adequate reward to the patentee.[57] In considering the effect on competition, however, Gibbons suggested that territorial restrictions encourage small businesses (which have limited power to attract development capital) because licensees are induced by the reduced risks to invest capital equipment, specialized production techniques and distribution experience.[58] The relevant factors which courts would weigh under this approach include (1) the novelty of the patented technology; (2) the length of the development period, compared to the length of the restriction period; and (3) the size of patentee and licensee.[59]

The exceptions of failing and entering firms have also been noted by Turner, who seems to favor a rule of presumptive invalidity rather than a per se rule of unreasonability.[60] He goes much farther, however, than *American Industrial,* for his presumptive rule would apply whenever a patentee issues a license with a territorial restriction.[61] Otherwise, however, there may be little effective difference between the per se rule and Turner's presumptive rule. This apparent anomaly can be explained by the fact that

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[54] See text at note 46 supra.

[55] 388 U.S. at 374.

[56] Regarding the balancing between the policies of free competition and monopoly, see note 14 supra and accompanying text.

[57] See text at note 38 supra.

[58] Gibbons, supra note 17, at 894-95.

[59] Id. at 895.

[60] Turner, The Patent System and Competitive Policy, 44 N.Y.U.L. Rev. 450, 469-74 (1969).

[61] Compare Turner, supra note 60, at 469-74, with Adelman & Jaress, supra note 14, at 17-18. Adelman and Jaress agree with Turner insofar as nonmanufacturing patentees are concerned, but they differ with respect to manufacturing patentees. Absent proof of an actual agreement with his licensees, a manufacturing patentee who does not want to experience further competition should be permitted under § 1 of the Sherman Act to refuse to license additional competitors likely to materially harm the patentee's business. Id. at 18.

historically, a per se rule is not applied as blindly as the name suggests, as was pointed out in *United States v. Jerrold Electronics Corp.*:

> [W]hile the *per se* rule should be followed in almost all cases, the court must always be conscious of the fact that a case might arise in which the facts indicate that an injustice would be done by blindly accepting the *per se* rule.[62]

At this point it should be mentioned that exceptions to an established per se rule are nonetheless very rarely allowed to override the rule. Certainly if courts intend a per se rule not to apply to a certain group, *e.g.*, new or failing firms, then those exceptions should be clearly spelled out when the rule is established. The opinion made no mention of any exceptions to the general per se rule it laid down, and new or failing patentee firms can find but little consolation in *Schwinn* and *Jerrold.*[63]

The validity of a general per se rule is subject to dispute. The Supreme Court in *United States v. Topco Associates, Inc.* warned that "[i]t is only after considerable experience with certain business relationships that courts classify them as *per se* violations of the Sherman Act."[64] The Supreme Court in *Schwinn* and the district court in the *American Industrial* felt confident enough to apply a per se rule, with the ancient rule against restraints on alienation as its support. Only four years before *Schwinn* the Supreme Court in *White Motor Co. v. United States*[65] reached a contrary conclusion. The *White Motor* case involved *sales* by a single manufacturer of his products to distributors, dealers and users, with territorial and customer restrictions, as well as price restrictions, imposed on the distributors and retailers. In discussing the vertical territorial restrictions, no mention was made of any "ancient rule." It simply concluded:

> We do not know enough of the economic and business stuff out of which these arrangements emerge . . . . We need to know more than we do about the actual impact of these arrangements on competition to decide whether they . . . should be classified as *per se* violations of the Sherman Act.[66]

[62] 187 F. Supp. 545, 556 (E.D. Pa. 1960), aff'd, 365 U.S. 567 (1961). A legitimate business purpose was found, permitting the new industry to have required, as part of its sales contract, a service contract. 187 F. Supp. at 556-57. But this combination was permitted under the Sherman Act only for a short time, before the legitimate business purpose was overshadowed by the public policy favoring free competition. Id. at 557-58. See also Appalachian Coals, Inc. v. United States, 288 U.S. 344, 361, 368, 376-77 (1933), where price fixing was allowed in a failing industry.

[63] The Court in *Schwinn* specifically excluded patentees from its decision, 388 U.S. at 379 n.6, and *Jerrold*-type exceptions are rarely allowed.

[64] 405 U.S. 596, 607-08 (1972).

[65] 372 U.S. 253 (1963).

[66] Id. at 263.

However by 1967 the Supreme Court had changed its mind, at least where sales were concerned.

The Court in *Schwinn* was conscious of possible justifications which would override this per se rule. As such, the Court recognized the uniqueness of new or failing firms.[67] Surely the decision in *American Industrial,* which also did not involve a new or failing firm, should not stand for the proposition that such firms are now under the per se rule as applied to patentees. Where an economic analysis by qualified experts concluded that such exceptions are beneficial, it is submitted that the district court could not reasonably have claimed sufficient experience in this area since 1967 to conclude contrariwise. The district court rightfully made no such claim, but simply ignored the issue altogether. Thus, as it stands now, the decision could have a very detrimental effect on new or failing businesses. To avoid this problem the district court should have spelled out the exceptions which are implicit in the decision, and which the court must have recognized in its reliance on *Schwinn.*

A better solution would have been a presumptive rule, whereby vertical territorial restrictions by a patentee on second level vendees are presumptively invalid under section 1 of the Sherman Act. Such a rule would have virtually the same degree of clarity for businessmen as the per se rule. The advantage of the presumptive rule would be that the court could specify what factors would overcome the presumption without necessarily excluding any group completely. Consequently, some new or failing firms could still be held in violation of the Sherman Act if the presumption were not overcome. On the other hand, if new or failing firms are specified as exceptions to the per se rule, their anticompetitive effect would be subjected only to the much lighter reasonability test.

In effect there is a considerable difference in whether new or failing firms are specified as exceptions to a per se rule, or instead listed as relevant factors in overcoming a presumption. In the former situation there seems to be no mandate on new or failing firms whatsoever. With the presumptive rule, however, *all* firms are on notice of the compelling policy against vertical territorial restraints with sales. Although such notice would have a restraining effect on some new or failing firms, it would not affect those firms with meritorious grounds for such restraints.

In sum, the court in *American Industrial* applied a blanket per se rule against the contract. As such, it sounded a general notice to all patentee firms that vertical territorial restrictions imposed by the patentee through the licensee's sales would not be permitted. Nevertheless, *American Industrial* should not stand for the proposition that *Schwinn*'s exceptions of new or failing firms are eliminated when dealing with patentees. First, the principal case did not even deal with new or failing firms, and secondly, the exceptions have

[67] 388 U.S. at 374.

been recommended on justifiable policy grounds. It is submitted that a better approach would have been a presumptive rule. This rule would have given the general notice which the district court intended. At the same time, it would have recognized the uniqueness of new or failing firms while still imposing a presumption of invalidity. In contrast, although a blanket per se rule sounds a general notice, it makes no recognition of new or failing firms, and a per se rule with exceptions has no immediate application to the given exceptions.

## UNCERTAINTIES OF THE DECISION

The decision is actually quite clear regarding the contractual rights of a patentee, as long as sales are involved. But problems develop regarding the scope of the term "sale," as applied to various fact situations. The court in *American Industrial* viewed a sale of a product as the transfer of dominion and control over the product.[68] This view differed slightly from *Schwinn*'s definition, which required transfer of title, dominion or risk with respect to the article.[69] The district court did not, however, purport to expound any authoritative definition of the term "sale," since the issue was not even raised. The contract itself clearly specified, *inter alia,* that American was to receive a ten percent royalty of the licensee's total gross sales to any sublicensee. The contract recognized that the licensee could make sales to his sublicensees. Nevertheless, all sales of the sublicensees (distributors) had to be bound by the territorial restrictions imposed on the licensee. The contract was declared void on its face, without any troublesome inquiry as to whether any sales were in fact made between the licensee and sublicensee.[70]

The district court properly attached much significance to the word "sale" in the contract. Probably the court looked to the contractual rights and expectations of the licensee's purchasers. A purchase from the licensee, whether by a sublicensee or by an individual consumer, was for complete title in the patented product. Part of the price went to the manufacturer-licensee, and the remaining part went to the patentee in the form of royalties.

In contrast, the Court in *Schwinn* looked beyond the naked agreements to the specifics of the challenged practices,[71] and advocated a fact determination to distinguish an agency relationship from a sale.[72] It is submitted that the combined effect of *Schwinn* and

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[68] 362 F. Supp. at 36.
[69] 388 U.S. at 379.
[70] 362 F. Supp. at 38-39.
[71] 388 U.S. at 374.
[72] Id. at 380, where the Court espoused the following test:
Where the manufacturer retains title, dominion, and risk with respect to the product and the position and function of the dealer in question are, *in fact,* indistinguishable from those of an agent or salesman of the manufacturer, it is only if the impact of the

*American Industrial* creates a one-way street from agency agreements to sales agreements. As such, an agreement labelling the relationship an agency could on its facts be deemed a sale, but not vice-versa. This approach does not violate any rights of the manufacturer-vendor. Arguably a manufacturer should be entitled to the specified restraints under an agency relationship if the agreement is labelled as such, and if he assumes higher costs as a principal instead of a vendor. But if a *fact* determination concludes that he really was a vendor (without the right to impose restraints), then he simply has ended up with those rights actually due and no more. Conversely, if a manufacturer-vendor specifically by agreement sells an article, but the conditions of sale are such that he still bears many of the burdens of a principal, then he simply has struck an unfavorable sale and should not be permitted to alter the terms of a completed sale so as to impose territorial restraints.

Uncertainty still reigns over the permissible contractual rights, of either a patentee or a nonpatentee, under an agency relationship rather than under a sale. *American Industrial* sheds no light on this question since the case was decided on the basis of the term "sale" in the contract.[73] As a result of *Schwinn,* any vertical territorial restraints in an agency arrangement are subject to a reasonability test under the Sherman Act.[74] Unfortunately, a gray area exists between an agency relationship and a sale, and the courts will thus have to choose between the reasonability test and the per se rule. At this point it should be mentioned that an agency relationship is no shield from the per se rule. In *United States v. Masonite Corp.,*[75] the Supreme Court found a per se violation of the Sherman Act, even assuming *del credere* agency agreements. Although the case was unusual in its facts,[76] the Court refused to be bound by labels in a contract.[77]

Although patentees have been conferred special status, as in *United States v. General Electric Co.,*[78] the scope of their contractual rights under agency agreements is still undefined. The Supreme Court recognized that the patentee would come within the operation

> confinement is "unreasonably" restrictive of competition that a violation of § 1 results from such confinement, unencumbered by culpable price fixing.

Id. (emphasis added).

[73] But see Security Materials Co. v. Mixermobile Co., 72 F. Supp. 450, 456 (S.D. Cal. 1947), where a territorial restriction on a purchaser was enforced. The court recognized the rule that a purchaser from the patentee or an authorized licensee does not commit infringement by violating territorial restraints on use or resale. Nevertheless it carved an exception to the rule against restraints on alienation where the purchaser himself was a manufacturing licensee for another territory.

[74] 388 U.S. at 380.

[75] 316 U.S. 265, 274 (1942).

[76] The case involved price regulations on a patented product which were "based on mutual agreement among distributors of competing products, some of whom had competing patents . . . ." Id. at 280.

[77] Id. at 274.

[78] 272 U.S. 476 (1926).

of the antitrust laws when "he steps out of the scope of his patent rights and seeks to control and restrain those to whom he has sold his patented articles . . . ."[79] Nevertheless, in a "genuine agency" case, a patentee-licensor may limit the licensee's "method of sale and the price . . . provided the conditions of sale are normally and reasonably adapted to secure pecuniary reward for the patentee's monopoly."[80] The *General Electric* case is still law today[81] even though a price fixing arrangement by anyone but a patentee is a per se violation of section 1 of the Sherman Act.[82] Yet nothing in the decision purports to grant a patentee special status over sublicensees.

In looking at a contractual arrangement, the Supreme Court in *General Electric* followed a two-step approach: (1) is there a sale or an agency relationship?[83] (2) if an agency relationship exists, are the restrictions in the licensing agreement valid?[84] The case of *Simpson v. Union Oil Co.*[85] added a third step: if there is a valid private contract, does the overall result of the agency setup violate federal antitrust policy? The Court in *Simpson* recognized that "[t]he interests of the Government also frequently override agreements that private parties make," such that "a consignment, no matter how lawful it might be as a matter of private contract law, must give way before the federal antitrust policy."[86] This broad antitrust policy statement in *Simpson* was, however, specifically confined to non-patent fact situations.[87] Thus the limited approach of *General Electric* is still the applicable law in agency relationships involving patents.

As a final point of interest, it should be noted that in the area of sales between the manufacturing patentee and first vendee, *American Industrial* leaves many questions unanswered. For example, should a patentee be permitted to place territorial restrictions on all licensees, even if they are manufacturers of unpatented end products incorporating the patented component?[88] As it stands now, a patentee has considerable control over his first vendee. It remains to be

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[79] Id. at 485.

[80] Id. at 490.

[81] But see United States v. Line Material Co., 333 U.S. 287, 316 (1948), where four of the eight justices concluded in a concurring opinion that *General Electric* should be overruled.

[82] See United States v. Parke, Davis & Co., 362 U.S. 29, 47 (1960); United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940).

[83] 272 U.S. at 479, 484.

[84] Id. at 488, 494.

[85] 377 U.S. 13, 18, 21-22 (1964).

[86] Id. at 18.

[87] Id. at 23. "But whatever may be said of the *General Electric* case on its special facts, involving patents, it is not apposite to the special facts here." Id. Nevertheless, in a strong dissent, Justice Stewart concluded: "It is clear, therefore, that the Court today overrules *General Electric*." Id. at 29 (dissenting opinion).

[88] See Gibbons, Domestic Territorial Restrictions in Patent Transactions and the Antitrust Laws, 34 Geo. Wash. L. Rev. 893, 903-04, 911-12, 926 (1966), where the author concludes in the negative.

seen how far the rule against restraints on alienation erodes this control.

## CONCLUSION

As a result of *American Industrial,* a patentee may not by agreement impose territorial restraints on his sublicensees' sales if the sublicensee purchases the product from the manufacturing licensee. The district court correctly determined that section 261 did not permit these restraints. In the process, however, the court overly strained the meaning of section 261. Instead the court could have construed section 261 as inapplicable to licensees of an exclusive right.

The conjunction of the ancient rule against restraints on alienation and the exhaustion-by-sale doctrine gave rise to a limitation of section 261. From a policy viewpoint, the court's strict construction was favorable because the reward to the patentee was deemed too speculative to permit the anticompetitive agreements.

In applying the per se rule, the district court was very much influenced by *Schwinn.* However, a presumptive rule of invalidity would have been preferable, to accommodate the meritorious exceptions of some new of failing patentee firms while still sounding a general notice.

*American Industrial* still leaves many issues unresolved. As in *Schwinn,* problems arise as to the scope of the term "sale." As a result of these two cases, an agreement labelling the relationship an agency will be judged on the facts to see if a sale is involved. But a contract labelling a transaction as a sale will not be scrutinized to see whether the more lenient reasonability test for an agency should be applied. Furthermore, the court did not challenge the patentee's territorial control over the licensee's sales, nor did the court dwell on the patentee's degree of territorial control over his sublicensees under a "valid" agency relationship.

MARC R.K. BUNGEROTH

**Commercial Law—Confession of Judgment—Hearing Required on Voluntariness of Waiver Before Entry of Judgment—*Virgin Islands National Bank v. Tropical Ventures, Inc.*** [1]—Defendants, Tropical Ventures, Inc. and World Resorts, Ltd., obtained a loan from plaintiff, Virgin Islands National Bank. The loan was evidenced by a demand note and secured by a mortgage on properties in St. Croix.[2] As part of this transaction, defendants signed a power of

[1] 358 F. Supp. 1203 (D.V.I. 1973).

[2] Id. at 1205.