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UNITED STATES DISTRICT COURT
DISTRICT OF MONTANA
MISSOULA DIVISION

UNITED STATES OF AMERICA,	)	
	)	
Plaintiff,	)	Civil Action No. CV96-121-M-CCL
	)	
v.	)	
	)	**THE UNITED STATES' SURREPLY TO DEFENDANT'S MOTION TO DISMISS**
GENERAL ELECTRIC COMPANY,	)	
	)	
Defendant.	)	

In its Reply Memorandum in support of its motion to dismiss ("Reply"), General Electric Company ("GE") does not dispute that if the complaint alleges an agreement that is per se illegal, GE's motion to dismiss must be denied because the United States is not required to allege a relevant market. Instead, GE develops three new arguments why its agreements not to compete are not per se illegal. First, GE contends that the agreements are vertical because GE sells the hospitals equipment and licenses the hospitals to use its software. GE simply ignores the fact that the complaint alleges that GE also has a horizontal relationship with the hospitals because it competes with them to service third parties' equipment, and that it is well established

that restraints among horizontal competitors can be per se illegal even if those competitors also have a vertical relationship.

Second, GE contends that its agreements with the hospitals are analogous to ancillary restraints, such as covenants not to compete typically found in employment contracts, that are analyzed under the rule of reason. This argument ignores the fact that the complaint alleges that GE's agreements not to compete are not reasonably necessary to effectuate any legitimate transaction.

Third, GE argues that its agreements not to compete are not agreements to allocate markets because they allocate the market entirely to GE. GE's argument is plainly contrary to the Supreme Court's holding and rationale in Palmer v. BRG of Georgia, Inc., 498 U.S. 46 (1990) (per curiam).[1]

A. GE and the Hospitals Are Horizontal Competitors

The complaint clearly alleges that GE exacted agreements not to compete from hospitals that actually or potentially compete with GE to service the medical equipment of other health care providers.[2] Because the hospitals are actual or potential

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[1] GE's reply also includes arguments about the sufficiency of the complaint's allegations with respect to relevant markets and intent. Because these arguments were first raised in GE's motion and were addressed in our earlier opposition, we do not address those issues here.

[2] See Complaint at ¶ 23 ("As a result, hospitals with in-house service departments are among GE's most significant actual or potential competitors in servicing medical equipment."), ¶ 25 ("In the past, both St. Patrick and Deaconess have sold service to other health care facilities."), ¶ 34 ("On several occasions, after learning that a licensee or its employees had serviced another facility's medical equipment, GE contacted the licensee, notified it that its conduct violated the license agreement's terms, and sought the licensee's commitment not to compete with GE in the future."), and ¶ 39 ("But for the commitments GE exacted from them, St. Patrick and Deaconess would have preferred to service other hospitals' and clinics' medical equipment.").

competitors of GE, GE and the hospitals are in a "horizontal" relationship.[3] And, as GE concedes, "'naked' [or non-ancillary] agreements among horizontal competitors not to compete are subject to the per se rule." Reply at 6.

GE argues that its relationship with the hospitals is "vertical" because it sells them imaging equipment and licenses them software for use with that equipment. Reply at 4. Defendants in Palmer v. BRG of Georgia, Inc., 498 U.S. 46 (1990) (per curiam), made a similar argument, claiming that they did not have a horizontal relationship because they did not compete with each other, but that they had a vertical relationship because one defendant (HBJ) licensed its copyrighted materials to the other (BRG). See Respondents Brief in Opposition to Petition for Writ of Certiorari at 2, 4-6 (attached at A). Although the Eleventh Circuit agreed with defendants, see Palmer, 893 F.2d 293 (as modified), the Supreme Court reversed finding the covenant not to compete contained in the license to be "illegal on its face." 498 U.S. at 50; see also Palmer v. BRG of Georgia, 874 F.2d 1417, 1432-33 (11th Cir. 1989) (Clark J., dissenting) ("As an initial matter, HBJ and BRG argue that the plaintiffs' horizontal per se theories do not apply to them because they are in a vertical supplier/retailer relationship. . . . These arguments, however, are simply disingenuous and meritless. It is firmly established that entities in a seemingly vertical relationship may be capable of horizontal restraints if they are actual or potential competitors. . . . [The defendants'] argument would essentially nullify the per se rule because horizontal competitors could

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[3] Competitors have a horizontal relationship. See Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 471 n.18 (1992); see also United States v. Falstaff Brewing Corp., 410 U.S. 526, 533 (1973) (potential competitors exert "beneficial influence on competitive conditions").

avoid antitrust liability by simply entering into anticompetitive agreements that have vertical aspects.") (footnotes and citations omitted).[4]

Courts have frequently treated agreements between competitors as per se illegal, even though there was also a vertical aspect to the relationship. The existence of a "vertical" relationship between two companies with respect to one product or service simply does not foreclose per se treatment of agreements to eliminate competition between them with respect to other products or services. See, e.g., Kodak, 504 U.S. at 471 n.18 (stating that although Kodak had previously sold parts to independent service organizations ("ISOs") for use in their servicing operations, "[i]n the relevant market, service, Kodak and the ISOs are direct competitors; their relationship is horizontal"); United States v. Koppers Co., 652 F.2d 290 (2d Cir. 1981) (vertical elements of defendants' relationship could not shield horizontal restrictions from per se treatment); Engine Specialties, Inc. v. Bombardier Ltd., 605 F.2d 1, 11 (1st Cir. 1979) (finding an agreement not to compete between manufacturer and distributor, who was also the manufacturer's potential competitor, to be a horizontal agreement that was per se illegal).

GE relies on several "dual distribution" cases to support its argument that the per se rule does not apply to its agreements with the hospitals. Reply at 5. In a typical "dual distribution" case, a manufacturer sells a product to a distributor.

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[4] GE seems to suggest that Palmer does not apply because in that case prices rose after the agreement was reached. Reply at 8. Although a finding that an agreement is per se illegal and "unlawful on its face" means that no proof of anticompetitive intent or effects is necessary, the complaint here also alleges that prices for service are higher because GE has required that the hospitals agree not to compete. See Complaint at ¶ 40.

Subsequently, both the manufacturer and distributor "compete" in the sale of the very same product at the retail level. See Taggart v. Rutledge, 657 F. Supp. 1420, 1442 n.10 (D. Mont. 1987) (dual distributorship refers to a situation where the defendant "'operates at two distinct levels of the distribution chain in the same market by acting as both a supplier and a distributor of [the] product.'") (citation omitted). In such a case, it is the distributor's vertical relationship with the manufacturer that makes the horizontal relationship possible. Without the vertical relationship (i.e., without the supplies of the product), the distributor would be unable to compete with the manufacturer.

Indeed, in a dual distribution case that GE cites, Dimidowich v. Bell & Howell, 803 F.2d 1473 (9th Cir. 1986), the Ninth Circuit explained the limits of "dual distribution" or "hybrid" analysis:

> We note that a "hybrid" arrangement only justifies the application of the rule of reason where the market in which the conspirators are in a vertical relationship is in some way interdependent with the market in which they have a horizontal relationship. The fact that Conglomerate A supplies Conglomerate B with bread to sell in B's retail stores almost certainly has nothing to do with A and B's ability to agree to sell steel at the same price. The latter is still horizontal price-fixing and illegal per se. Only when there is a possibility that the restraint in the market in which there is a horizontal relationship will have significant procompetitive effects in the other market, as is the case when the markets are for the service and the distribution of the same product, is rule of reason analysis appropriate.

Id. at 1481 n.6.

The dual-distribution cases are not applicable here because the hospitals' status as competitors of GE in servicing medical equipment does not derive from or depend on their vertical relationship with GE. The hospitals do not need (and, pursuant to other terms in the license, cannot use) the specialized sets of software and manuals

("Advanced Diagnostics") that they license from GE to compete with GE in servicing other hospitals' equipment. Indeed, in many instances, the licensee hospitals competed with GE to sell service before GE licensed its Advanced Diagnostics. Thus, the horizontal relationship--the hospitals' status as actual or potential competitors--is independent of the vertical relationship; and restrictions on the horizontal relationship should be reviewed independently of the vertical relationship. Since the hospitals can compete with GE to service the medical equipment of others without purchasing GE's imaging equipment or licensing GE's Advanced Diagnostics, the horizontal and vertical relationship between GE and the hospitals are not "interdependent."

B. The Agreements Not to Compete That GE Extracts from Hospitals Are Not Ancillary to GE's Software Licenses

GE also contends that its agreements must be analyzed under the rule of reason because they are analogous to covenants not to compete found in employee and other contracts. Reply at 8-9. The cases upon which GE relies, however, are inapposite. While a covenant not to compete, if truly ancillary to an otherwise legitimate transaction, should be analyzed under the rule of reason, Palmer clearly establishes that a covenant not to compete in a copyright license can be per se illegal. Indeed, the restriction in Palmer was specifically identified as a "Covenant Not to Compete" and was included in a "vertical" agreement in which one company licensed copyrighted materials to the other. 498 U.S. at 401.

GE quotes extensively from a hypothetical used by the Seventh Circuit to describe the difference between a naked restraint and a restraint that contributes to an enterprise that expands competition. Polk Brothers, Inc. v. Forest City Enters., Inc., 776

F.2d 185, 189 (7th Cir. 1985); Reply at 6. In the hypothetical, a covenant not to compete meant "that A may trust B with broader responsibilities, the better to compete against third parties." Id. Thus, Polk Brothers applied the rule of reason because the covenant not to compete made the "cooperation [between A and B] possible." Id. at 190. Unlike the agreement in Polk Brothers, GE's covenant not to compete does not make possible or even contribute to an enterprise that increases competition. Cf. General Leaseways, Inc. v. National Truck Leasing Ass'n., 744 F. 2d 588, 595 (7th Cir. 1984) (finding the restraint to be a per se violation because "the organic connection between the restraint and the cooperative needs of the enterprise that would allow us to call the restraint a merely ancillary one is missing").

Under the test the Ninth Circuit articulated in Los Angeles Memorial Coliseum Comm'n. v. National Football League, 726 F.2d 1381 (9th Cir.), cert. denied, 469 U.S. 990 (1984), a restraint is ancillary if it is "subordinate and collateral to another legitimate transaction and necessary to make that transaction effective." Id. at 1395 (emphasis added) (quoting R. Bork, The Rule of Reason and the *Per Se* Concept: Price Fixing and Market Division, 74 Yale L.J. 775, 797-98 (1965)). The restrictive clause in GE's contracts clearly do not meet that test because, as the complaint alleges, they are unrelated to any legitimate interest GE may have in licensing its Advanced Diagnostics. See Complaint at ¶ 8.[5]

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[5] GE misstates the holding of LA Coliseum when it contends the rule of reason was applied to a restraint that was unnecessary to achieve a procompetitive goal. Reply at 9 n.2. In fact, just the opposite is true. The District Court undertook a rule of reason analysis because of "the unique nature of the business of professional football" and that finding was not challenged on appeal. 726 F.2d at 1387. Therefore, in reviewing the jury's verdict, the Ninth Circuit assumed that territorial restraints were

To argue that the restrictive clause is ancillary, GE must claim that the license of its Advanced Diagnostics for one type of equipment--a GE CT scanner, for example--will not be effective unless the hospital that receives the software agrees not to compete with GE in servicing any other equipment owned by any other medical facility, whether that equipment is a Toshiba CT scanner, a Siemens EKG monitor, or even a Phillips stethoscope. See Complaint at ¶ 33. That claim is inappropriate in a motion to dismiss, since it necessarily requires GE to rely on evidence outside of the complaint. Should GE choose to present such evidence it would need to provide a nonpretextual explanation for its requirement that hospitals not compete to service any other equipment. That will be difficult considering that the Advanced Diagnostics for one model of GE imaging equipment cannot be used to service another manufacturer's equipment or even another model of of the same type of GE imaging equipment. Id. at ¶ 30.[6]

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ancillary (or reasonably necessary) to the production of NFL football. Id. at 1395. The court then held that the jury could find that the benefits to competition flowing from the restraint could have been achieved by less restrictive means and thus that the clause was illegal, although ancillary. Id. at 1396.

[6] GE apparently misreads the Department of Justice's Intellectual Property Guidelines. Reply at 10. Those guidelines plainly state that per se treatment is applied unless the "restraint"--not the license--"can be expected to contribute to an efficiency-enhancing integration of economic activity." U.S. Dept. of Justice & Federal Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property § 3.4 at 16 (attached at B). The guidelines reinforce that point with an example of a restraint that would be treated as per se unlawful and a recital of those facts that would need to be changed to cause the restraint to be evaluated under the rule of reason. See id. at 17, Example 7. One of the key differences between per se treatment and rule of reason analysis under the example is that, for the former, the license did not actually facilitate the licensees' production of the product to which the restraint related. That is the case here: the license for Advanced Diagnostics does not help the licensees service other hospitals' medical equipment.

C. The Complaint Alleges an Illegal Agreement to Allocate Customers

The complaint alleges that GE and the hospitals agreed that the hospitals would not "compete with GE in servicing certain medical equipment at any other hospital or clinic." See Complaint at ¶ 5. GE contends that the hospitals' agreement not to service equipment outside their own hospitals is not an agreement to allocate customers because the agreement does not "divide" the service markets but simply reserves the markets entirely to GE. Reply Brief at 6-8. That argument, however, was flatly rejected by the Supreme Court in Palmer. Defendants there had allocated all of Georgia to one defendant and reserved the rest of the country to the other defendant. They claimed that an allocation of markets was not illegal unless a market in which the two had competed was divided between them. The Supreme Court held that "[s]uch agreements are anticompetitive regardless of whether the parties split a market within which both do business or whether they merely reserve one market for one and another for the other." 498 U.S. at 49-50.

The logic behind the Supreme Court's holding in Palmer is plain. Market allocation schemes are per se illegal under the antitrust laws because they restrain trade by reducing the number of competitors in a given market with "no purpose except stifling of competition." Id. at 49. Consequently, an agreement to allocate evenly the customers in a given market and an agreement to allocate all or most of those customers to one competitor have the same harmful effect of eliminating all competition between firms for those customers. See also E. Sullivan & J. Harrison, Understanding Antitrust and Its Economic Implications, § 4.14 at 111 (1988) ("A horizontal market division is created when competitors agree not to compete in a designated market.").

The agreements between GE and the hospitals are an allocation of customers because the agreements reserve for GE customers needing medical equipment service.

GE further attempts to distinguish Palmer by claiming GE may still compete against a hospital for the hospital's own business, even though the hospital has agreed not to compete against GE for third-party service. Reply at 8. This type of argument has been rejected by the courts. See Garot Anderson Agencies, Inc. v. Blue Cross & Blue Shield United of Wisconsin, 1993 -1 Trade Cases ¶ 70,235 at 11-13, 1993 WL 78756 at *11-13 (N.D. Ill. 1993) (rejecting defendants' arguments that Palmer did not apply because while one of the defendants had agreed not to compete, the other had not). It is enough that the hospitals have ceded customers to GE.

CONCLUSION

The United States has alleged facts that support a finding that the covenants not to compete between GE and the hospitals are per se illegal. Thus, the

United States is not required to plead a specific market definition in its complaint and GE's motion to dismiss must be denied.

Respectfully submitted,

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