Fall 2003

Evaluating the Risks of Market Swaps

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BY MAURICE E. STUCKE

CONSIDER THIS SCENARIO: Your client has spent the past decade battling its competitor in two geographic markets. Neither side is making headway in these two markets. Both are losing money. But your client is determined to fight it out, hopeful that its competitor soon will exit the market so that its margins can return to healthy levels. On a Saturday morning, your client telephones with news of a breakthrough. Your client has agreed in principle with its competitor to end the competitive war by swapping markets. Each company will sell a limited amount of assets to the other and withdraw from one market, leaving the other, in your client's words, "the only game in town." In drafting the proposed asset purchase agreement, your client's corporate counsel is recommending a ten-year non-compete provision and other restraints to prevent the competitor from re-entering or assisting any other company from entering the protected market. Although the asset swap falls below the thresholds of the Hart-Scott-Rodino provisions, your client is calling to verify that this asset swap does not run afoul of the antitrust laws. How should you respond?

The issue is whether such an asset swap between two competitors is (a) per se illegal under Section 1 of the Sherman Act as a horizontal market allocation agreement, or (b) a potentially legitimate sale of assets, the legality of which is determined under the Sherman Act's rule of reason standard, or the standard relevant to Section 7 of the Clayton Act.[1] The case law and antitrust commentary on this issue vary. Some courts and commentators argue that asset sales (including sales with stringent non-compete provisions) invariably should be subject to the more lenient rule of reason standard; others suggest that a per se approach may be appropriate in certain situations. The implications for your client of these different analytical approaches are significant in terms of the available defenses.[2] How do you determine whether your client is planning a transaction that could be deemed to unreasonably restrain trade, and, at worst, could result in a criminal prosecution?

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Divining the Swap's Purpose

As the Supreme Court has long held, territorial allocation schemes between direct competitors are naked restraints of trade with no purpose except stifling competition.[3] For example, if your client and its competitor simply agree to allocate certain markets or refrain from seeking business from each other's existing accounts, these arrangements likely would be condemned as per se illegal under the Sherman Act and would expose your client and its executives to criminal liability.[4] As the FTC and Antitrust Division have noted in the Competitor Collaboration Guidelines, the "mere coordination of decisions on price, output, customers, territories, and the like is not integration, and cost savings without integration are not a basis for avoiding per se condemnation."[5]

In a recent consent decree involving an asset swap, the Antitrust Division said that it will "examine[ ] the substance, rather than the form, of the parties' agreement in evaluating its potential effect."[6] Simply put, the essential question that counsel must ask a client that is proposing an asset swap with a competitor is: What is the central purpose of the transaction? Where the primary purpose of the transaction is to eliminate competition by allocating territories, then the asset swap likely will be treated as per se illegal. If the asset swap is intended to, and likely will, promote competition and benefit consumers through efficiency-generating integration, then the swap (and any reasonably necessary ancillary non-compete provisions) probably will be analyzed under the rule of reason standard.[7]

There are five factors that will help to shed light on the central purpose of the asset swap agreement, which, in turn, will help determine whether the per se or rule of reason standard is likely to be applied: (1) the parties' business justification, (2) the nature of the assets transferred, (3) the structure of the transition, (4) the likely impact on the market, and (5) the terms of any non-compete provisions.

1. Parties' Business Justification. The first question to ask your client is why is it seeking to swap these assets with its competitor? A valid business justification does not necessarily immunize a market swap from per se condemnation. But the absence of such a justification will certainly expose the swap as a naked restraint of trade. What then are the client's business justifications for withdrawing from this market? Are these reasons consistent with—and supported by—the client's internal documents (especially those created before the asset swap was contemplated)? How does the market swap, on its face, appear to promote productivity and enterprise?

For example, if your client tells you that it wants to withdraw from this geographic market because it is too far from its core markets and, therefore, too expensive to support, do your client's documents and past actions support this contention? Some questions to ask your client include:

- When and why did your client first enter this "non-core" market?
- Has your client recently undertaken any action that would suggest its commitment to stay or expand in this non-core market, such as a significant investment in promoting its brand?
- Is your client expanding into, or making significant investments in, other "non-core" markets?
- What prompted the idea of the asset swap: had there been an internal review about withdrawing from the "non-core" market or did the idea suddenly arise after a conversation with the other party's executives?
- Do your client's documents consider the possibility of withdrawing from the "non-core" market?
- Has your client reviewed in the ordinary course of its business the profitability of the "non-core" market? Just what is it about the distance of the "non-core" market that makes it too costly to support?
- Are the parties engaging in these swaps with other competitors in other markets (which would make it look more like an orchestrated market allocation plan than ad hoc divestitures)?
- What are your client's plans with respect to prices, post-asset swap, in its protected market?

These questions are not meant to be exhaustive, but to illustrate the underlying theme: counsel must try to ascertain any inconsistencies between the client's current business justification for the asset swap and its past and current behavior (or future plans). If your client simply avers in an affidavit that it unilaterally decided to withdraw from the market before it agreed to the asset swap, this justification, in all likelihood, will be unpersuasive.[8]

2. Nature of the Assets Transferred. A second factor in divining the central purpose of the transaction is determining what real assets, if any, are actually being transferred. If real assets are being transferred, what are the parties' plans for integrating these assets into their businesses; what, if any, efficiencies result from this swap, and how, if at all, will these efficiencies benefit consumers? Absent the transfer and meaningful integration of real assets, the asset swap looks more like an agreement between competitors to withdraw from each other's market.

The Antitrust Division's recent *New Times* case is an example of a swap of insubstantial assets that, in reality, was, as the United States alleged, a disguised market allocation agreement. The defendants were the two national chains of alternative newsweekly publications that competed for several years in two geographic markets: Cleveland and Los Angeles.[9] In October 2002, the defendants agreed to swap assets, with New Times' acquiring certain assets in Cleveland from Village Voice Media, which, in return, acquired certain assets in Los Angeles from New Times. The day after agreeing to transfer these assets, Village Voice Media stopped publishing its alternative newsweekly in Cleveland and New Times stopped publishing its alternative newsweekly in Los Angeles.

The defendants' written contracts, however, did not involve the transfer or integration of any meaningful economic assets associated with those shuttered alternative newsweeklies. New Times sold its former competitor only the *New Times LA*'s accounts receivable, customer lists, and advertising contracts. Village Voice Media, in exchange, sold New Times only the *Cleveland Free Times*'s accounts receivable, customer lists, advertising contracts, and street boxes. Each defendant already knew its competitor's advertisers in both markets (as their ads appear in the newsweekly) and had attempted in the past to sign up the other's advertisers. The assets (primarily the accounts receivable) actually transferred in Los Angeles accounted, according to the defendants' calculations, for only 7 percent of the $11 million sale price in Los Angeles and 24 percent of the $2 million sale price in Cleveland.

The defendants' written contracts specifically excluded from the sale most of the assets associated with the actual operations and goodwill of the two shuttered newsweeklies, notably: (1) the staff, (2) the back issues and archived materials of the closed publications, including editorial articles, photos, and art work, and (3) the logos, trade names, trademarks, and copyrights associated with the closed publications. New Times specifically retained the rights to its *New Times LA* logo or "flag," and Village Voice Media specifically retained the rights to its *Cleveland Free Times* logo or "flag," but both defendants were contractually prevented from using, or letting anyone else use, these logos.

The fact that the defendants in the *New Times* case did not exchange significant assets was one of the factors that led the Division to conclude that the purpose of the asset swap was to eliminate competition in the alternative newsweekly markets in Los Angeles and Cleveland.[10]

3. Structure of the Transaction. A third factor in determining the central purpose of an asset swap is examining the structure and interdependence of the transaction. A "swap" implies that the transaction is contingent on each party selling its assets to the other (and to no one else). The very notion of a "swap" tends to support the inference of an allocation agreement, as it appears that each party is ceding one market to the other.

Any inference that a mutual sale of assets between competitors is a disguised market allocation agreement is reduced when the parties do not condition each sale on the other, and instead shop the assets in one or both of the markets to other potential buyers. For example, your client agrees to sell its New York assets to its competitor, but your client's competitor then auctions off its Los Angeles assets to the highest bidder. Even if your client ends up as the highest bidder for the competitor's Los Angeles assets, you can argue to the antitrust enforcers that the risk that some third party could have purchased these assets is inconsistent with any agreement to allocate markets, and that the acquisitions should be reviewed under the rule of reason (or Section 7) standard. Yet, an auction process should not automatically immunize an otherwise illegal market swap. If the risk is very low that someone else would acquire the auctioned assets, then the auction might be treated as a sham.

The parties cannot escape antitrust scrutiny by structuring the asset swap in such a way as to mask its purpose. For example, in the *New Times* case, the defendants drafted two separate asset purchase agreements: one for the assets in Cleveland and the second for the assets in Los Angeles. But both contracts contained nearly identical terms, and were executed on the same day. The defendants also shut down their alternative newsweeklies within two days after both agreements were executed. These factors strongly suggested that the two contracts were interdependent. Any doubt, however, was eliminated when the parties included in each asset purchase agreement a clause stating that the execution of each asset purchase agreement was contingent on the execution of the other agreement.[11]

Likewise, staggering an asset swap (such as waiting a year before selling the second half) will not immunize the swap from potential per se condemnation. In fact, efforts to disguise a market allocation agreement could actually increase the risk of criminal prosecution.

4. Impact on the Market. A fourth factor in examining the central purpose of an asset swap is its likely impact on competition. Although the per se standard is designed so that the courts need not "ramble through the wilds of economic theory,"[12] blatant anticompetitive conduct by the defendants certainly will increase the court's comfort level that the asset swap is indeed a "naked" restraint on competition.

For example, in applying the per se standard in *Palmer*, the Court noted that the price of the incumbent bar review course increased from $150 to over $400 immediately after the asset sale went into effect.[13] Judge Posner in *General Leaseways, Inc. v. National Truck Leasing Association*[14] also did a quick look to see if the restraint restricted competition and decreased output. Likewise, the Antitrust Division noted in the *New Times* case that the defendants planned to, and in some cases did, implement rate hikes after allocating markets, which confirmed that the defendants' agreement was formed for the purpose, and with the effect, of raising advertising rates.[15]

The fact that the allocation agreement may enable the competitors to better compete against other firms does not necessarily shield the allocation agreement from per se condemnation.[16] But if the two parties have low market shares, the swap will enable them meaningfully to integrate assets in order to produce a better product, and the parties' customers support (or, at least, do not complain about) the swap, it is unlikely that the asset swap's central purpose is to restrain competition.

5. Non-Compete Provisions. The last factor to examine is whether the swap contains any ancillary restraints on competition, such as a non-compete provision. If both parties are free to re-enter their former markets, one could argue that there is no market allocation agreement. But this freedom may be illusory. When entry barriers or other economic factors effectively deter the parties from re-entering their former markets, then the absence of a non-compete provision is not determinative.[17] But if the asset swap agreement contains specific restraints on future competition, additional questions are raised about the asset swap's central purpose.

As a general rule, courts have upheld non-compete provisions in asset purchase agreements when the restraints are reasonably necessary to assure that purchaser can enjoy the fruits of its acquisition, including goodwill.[18] Some courts may uphold an asset swap, coupled with a non-compete provision, even though the competitors were motivated to enter into the transaction to "escape the competition" with one other.[19] One court went so far as to declare that these non-compete covenants are "uniformly" examined under the rule of reason standard, and are "generally not recognized as antitrust violations."[20]

But counsel should not rely exclusively on these sweeping declarations, because other courts have recognized that a covenant not to compete can be used as part of a scheme to unlawfully allocate markets.[21] In *Palmer*, for example, an asset sale coupled with a covenant not to compete amounted to a per se illegal market allocation scheme.[22]

The sometimes confusing and inconsistent treatment of non-compete provisions by the courts[23] may leave the lawyers drafting the asset swap agreement scratching their heads: should they include a non-compete provision or would the provision generate more antitrust scrutiny than it is worth? In considering any non-compete provision in an asset swap transaction, counsel should consider two key questions.

First, are there sufficient real assets transferred on which to attach the non-compete restraints, so that the restraints are ancillary to (rather than the purpose of) the asset swap? As Judge (later Chief Justice) Taft noted over 100 years ago the theory underlying these ancillary restraints is that they promote the free purchase and sale of businesses, including the businesses' goodwill:

> It was of importance, as an incentive to industry and honest dealing in trade, that, after a man had built up a business with an extensive good will, he should be able to sell his business and good will to the best advantage, and he could not do so unless he could bind himself by an enforceable contract not to engage in the same business in such a way as to prevent injury to that which he was about to sell.[24]

Consequently, the rationale for non-compete restraints is that the temporary and limited loss of competition, if any, is outweighed by the "long-run benefit of enhancing the marketability of the business itself—and thereby providing incentives to develop such an enterprise."[25] It follows that for the restraint to be "ancillary," it cannot be the only or primary asset transferred. As Judge Taft stated, "[t]here is in such contracts no main lawful purpose, to subserve which partial restraint is permitted, and by which its reasonableness is

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measured, but the sole object is to restrain trade in order to avoid the competition which it has always been the policy of the common law to foster."[26] Thus, if the purpose of the parties' agreement is not to transfer any meaningful assets and integrate them into the acquiring party's business, then any non-compete restraints in the asset purchase agreement logically are not "ancillary" to a legitimate sale, but rather "naked" restraints on competition.

As noted above, in the *New Times* case, none of the assets associated with the actual operations and goodwill of either of the defendants' shuttered alternative newsweeklies were actually sold or integrated into the other defendant's newsweekly, and the assets actually transferred were of little value, even by the defendants' own calculations. As a result, there were insufficient real assets to support the defendants' contractual restraints on competition, which included:

- essentially identical non-compete clauses in which each defendant agreed not to publish an alternative newsweekly in the other defendant's market for at least ten years;
- commitments by each defendant not to solicit or attempt to induce any advertiser to advertise in a competing publication over the next decade;
- requirements that each defendant redirect any traffic on its closed weekly's Web site to the other defendant's Web site for a period of one year, and to prominently state on its Web site that its alternative newsweekly was no longer in circulation;
- provisions to deter any new competitive entry into each defendant's protected market. For example, Village Voice Media agreed not to use, and to prevent anyone else from using, over a 10-year period its logo "*Cleveland Free Times*" in connection with any current or future publication in the greater Cleveland area. Similarly, New Times agreed not to use, and to prevent anyone else from using, its logo "*New Times LA*" or any variant containing "*New Times*" in connection with any current or future publication in the greater Los Angeles area; and
- prohibitions on selling or otherwise making available any of the fixed assets associated with each defendant's closed publication to any of its former employees, consultants, or independent contractors in the affected markets.[27]

These restraints were not subordinate and collateral to any procompetitive integration of assets, but were, as the United States alleged, part of the defendants' overall plan to gain a monopoly in its protected market.

The second question to consider is whether the restraint is reasonably tailored in its scope (such as its duration, affected geography, and activities) to protect each party's legitimate interests.[28] For example, does the restraint include product or geographic markets not involved in the asset sale? Fundamentally, the restraint should be limited to what is necessary to place the asset purchaser in the same competitive position as the seller at the time of the sale. Or, as Judge Bork stated, "[i]f it is so broad that part of the restraint suppresses competition without creating efficiency, the restraint is, to that extent, not ancillary."[29]

Conclusion

An asset swap between competitors is a high risk transaction because it resembles a per se illegal market allocation agreement. Accordingly, counsel must determine the central purpose of the transaction: is it a legitimate, efficiency enhancing sale of real assets or is it a naked restraint of trade? The five factors discussed in this article should help counsel in making this critical determination.☐

[1] It is arguable that the standard under § 7 of the Clayton Act differs from the rule of reason standard under § 1 of the Sherman Act, in that the Clayton Act reaches monopolistic tendencies in their incipiency. See Brown Shoe Co. v. U.S., 370 U.S. 294, 318 n.33 (1962) (noting that the Senate committee wished to make it clear that the Clayton Act was "not intended to revert to the Sherman Act test" but also "to cope with monopolistic tendencies in their incipiency and well before they have attained such effects as would justify a Sherman Act proceeding"). But some courts today would dismiss this distinction. *See, e.g.*, U.S. v. Rockford Memorial Corp., 898 F.2d 1278, 1281 (7th Cir. 1990) ("We doubt whether there is a substantive difference today between the standard for judging the lawfulness of a merger challenged under section 1 of the Sherman Act and the standard for judging the same merger challenged under section 7 of the Clayton Act."); 2 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 304c, at 9 (1995).

[2] *See, e.g.*, U.S. v. Realty Multi-List, Inc., 629 F.2d 1351, 1362–63 (5th Cir. 1980) ("The per se rule is the trump card of antitrust law. When an antitrust plaintiff successfully plays it, he need only tally his score.").

[3] Palmer v. BRG of Georgia, Inc., 498 U.S. 46, 49 (1990); U.S. v. Topco Assoc., 405 U.S. 596, 608 (1972); *see also* Addyston Pipe & Steel Co. v. U.S., 175 U.S. 211 (1899), *modifying and aff'g* 85 F. 271 (6th Cir. 1898) (Taft, J.).

[4] See, e.g., U.S. v. Andreas, 216 F.3d 645, 666–67 (7th Cir. 2000); U.S. v. Brown, 936 F.2d 1042, 1045 (9th Cir. 1991); U.S. v. Suntar Roofing, Inc., 897 F.2d 469, 473 (10th Cir. 1990); U.S. v. Cooperative Theatres of Ohio, Inc., 845 F.2d 1367, 1371 (6th Cir. 1988).

[5] U.S. Dep't of Justice & Federal Trade Comm'n, Antitrust Guidelines for Collaborations Among Competitors § 3.2 (2000), *available at* http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf.

[6] U.S. v. Village Voice Media, LLC and NT Media, LLC, Civ. Action No. 1:03CV0164 (N.D. Ohio 2003), Competitive Impact Statement at 11 [*New Times* CIS], *available at* http://www.usdoj.gov/atr/cases/f200700/200715.htm.

[7] *Id.*; *see also Palmer*, 498 U.S. at 48 (combination formed for the purpose and with the effect of fixing prices is illegal per se); Timken Roller Bearing Co. v. U.S., 341 U.S. 593, 597–98 (1951) (where central purpose of agreement is to allocate trade territories, restraints are per se illegal), *overruled on other grounds*, Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984).

[8] *See Palmer*, 874 F.2d 1417, 1418 (11th Cir. 1989), *rev'd*, 498 U.S. 46 (1990) (Supreme Court applied per se standard without regard to defendant's affidavit that it unilaterally decided to withdraw from market before entering agreement); *In re* Cardizem CD Antitrust Litig., 105 F. Supp. 2d 682, 701 n.13 (E.D. Mich. 2000) (court rejected as defense company's testimony that it unilaterally would not have entered market), *aff'd*, 332 F.3d 896 (6th Cir. 2003).

[9] *New Times* CIS, *supra* note 6, at 6–10.

[10] *Id.* at 13.

[11] *New Times* Complaint, *supra* note 6, ¶ 34, *available at* http://www.usdoj.gov/atr/cases/f200600/200673.htm.

[12] *Topco*, 405 U.S. at 609 n.10.

[13] *Palmer*, 498 U.S. at 47.

[14] 744 F.2d 588, 595–96 (7th Cir. 1984).

[15] *New Times* CIS, *supra* note 6, at 13.

[16] *Topco*, 405 U.S. at 605, 610 (rejecting argument that by restricting competition in the sale of Topco brand goods, defendant association actually increased competition against larger regional and national chains); New York ex rel. Spitzer v. Saint Francis Hosp., 94 F. Supp. 2d 399, 417–18 (S.D.N.Y. 2000) (rejecting claim that allocation agreement enabled defendants to offer patients a full panoply of services to effectively compete with larger hospitals in the region).

[17] See Hawaii ex rel. Anzai v. Gannett Pacific Corp., 99 F. Supp. 2d 1241, 1251 (D. Haw.) (as defendant lacked infrastructure to publish newspaper, practical effect of defendants' agreement was to eliminate competition), *aff'd*, 203 F.3d 832 (9th Cir. 1999).

[18] Eichorn v. AT&T Corp., 248 F.3d 131, 144–45 (3d Cir. 2001); Perceptron, Inc. v. Sensor Adaptive Mach., Inc., 221 F.3d 913, 919 (6th Cir. 2000); Polk Bros., Inc. v. Forest City Enters., Inc., 776 F.2d 185, 190 (7th Cir. 1985); *Addyston Pipe & Steel*, 85 F. at 283.

[19] *Perceptron*, 221 F.3d at 919.

[20] *Eichorn*, 248 F.3d at 144–45.

[21] Schine Chain Theatres, Inc. v. U.S., 334 U.S. 110, 119 (1948) (non-compete agreements used in asset purchase agreements part of defendant's illegal monopolistic practices), *overruled on other grounds*, Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984); U.S. v. Crescent Amusement Co., 323 U.S. 173, 181 (1944) (non-compete provisions exceeded far beyond protection of business sold, and demonstrated clear intention to monopolize theatre operation); U.S. v. American Tobacco Co., 221 U.S. 106, 183 (1911); Andrx Pharm., Inc. v. Biovail Corp. Int'l, 256 F.3d 799, 811 (D.C. Cir. 2001) (agreement's restraints not tailored to preserve the status quo between litigants but can reasonably be viewed as attempt to allocate market share); *Cardizem CD Antitrust Litig.*, 105 F. Supp. 2d at 699 (agreement to allocate U.S. territory to branded drug manufacturer per se illegal); U.S. v. General Dyestuff Corp., 57 F. Supp. 642, 646 (S.D.N.Y. 1944) (non-compete provisions not ancillary to legitimate sale but means of executing market allocation scheme).

[22] *Palmer*, 498 U.S. at 47 n.2. In exchange for HBJ's exclusive license of its "Bar/Bri" name in Georgia, BRG agreed in 1980 not to compete with HBJ outside Georgia. In 1982, a group of Georgia law students challenged this agreement. The defendants settled and also modified their earlier written agreement by deleting the non-compete provision. Defendants were sued again by a second class of law students (those who took the bar review course after June 1984), which was the action that came before the Supreme Court. Although the defendants struck the non-compete provisions from their written agreement, neither defendant was competing in the other's territory. *See* 874 F.2d 1417, 1429–30 (11th Cir. 1989) (Clark, J., dissenting).

[23] Aside from the courts, even two FTC Commissioners were puzzled about the Commission's stance on non-compete provisions in two contemporaneous consent decrees. In the General Mills consent decree, the Commission condemned an 18-month non-compete provision limited to the manufacture and sale of private label Chex cereal products. *See* Statement of Commissioner Mary L. Azcuenaga (Concurring in Part and Dissenting in Part), and Statement of Commissioner Roscoe B. Starek, III (Dissenting), in General Mills, Inc., FTC File No. 961-0101, 62 Fed. Reg. 2,162 (Jan. 15, 1997). But weeks earlier in the Ciba-Geigy consent decree, the Commission imposed an affirmative obligation on the newly merged entity not to compete in the United States and Canada for six years in the sale of methoprene-based flea control products. Commission Statement in Ciba-Geigy, Ltd., FTC File No. 961-0055, 62 Fed. Reg. 409 (Jan. 3, 1997).

[24] *Addyston Pipe & Steel*, 85 F. at 280.

[25] Nat'l Soc'y of Prof'l Eng'rs v. U.S., 435 U.S. 679, 689 (1978).

[26] *Addyston Pipe & Steel*, 85 F. at 283–84.

[27] *New Times* CIS, *supra* note 6, at 9–10.

[28] *Compare* Lektro-Vend Corp. v. Vendo Co., 660 F.2d 255, 267 (7th Cir. 1981) (defendant enforced non-compete covenants to reasonable time, space and product limitations); Snap-On Tools Corp. v. FTC, 321 F.2d 825, 836 (7th Cir. 1963) (no antitrust violation after one-year geographic non-compete restriction was amended from entire state to terminated dealers' former territories) *with Timken*, 341 U.S. at 598–99 (restraints went beyond protection of specific trademark and provided for control of manufacture and sale of antifriction bearings outside the trademark); Blackburn v. Sweeney, 53 F.3d 825, 828 (7th Cir. 1995) (restraint's infinite duration supports application of per se standard); *Cardizem CD Antitrust Litig.*, 105 F. Supp. 2d at 704 (per se illegal territorial restraint barred competitor from marketing other bioequivalent or generic versions of drug which were not at issue in underlying patent litigation).

[29] Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210, 224 (D.C. Cir. 1986).